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100% Advisory Payouts and 7 Other 'Heresies'

Advisors take note: Many sacred cow profit centers being disrupted by broker-dealers promoting "loss leaders" to prospects

There is a mad scramble going on as new DOL rules erode once reliable sources of independent broker-dealer revenue. Shifting or creating new profit centers is becoming an obsession for broker-dealers.

For some, it's a matter of survival. For others, such as private-equity owned broker-dealers, getting profits up to a level that will make the broker-dealer attractive for an aggressive sale price is the prime motivation.

New DOL rules are also causing broker-dealers to implement more conservative compliance policies that many advisors find too restrictive. For firms that buck the trend, they are quickly shot down with an almost religious fervor.

An example of this is the 100% advisory payout, which about a dozen broker-dealers offer if an advisor has their own RIA.

If you bring up this model to a broker-dealer executive or staff member that has a standard payout grid to advisory business, heated opinions will likely start to roll off his or her tongue: "That model is not profitable," or "That firm has been looking for a buyer for years but no one wants them because they aren't profitable," or "How can they offer 100% on advisory if they are liable for the risk?"

Today, the greatest competition for value-added independent broker-dealers comes in two forms: advisors moving to the fee-only model, or those going to a broker-dealer model that nets them more.

Over the years, we've witnessed many large producers that have built their practice to the $100 million to $300 million asset range and then move into book maintenance mode, with any growth stemming from referrals only.

Broker-dealer bells and whistles such as pratice management/marketing are less important to them, and they want to net more. If they are at a value-added broker-dealer, they may have numerous expenses that are built into the broker-dealer model that they find little reason to pay if they are not utilizing those services.

One father/son team shared a conversation they had with their broker-dealer as they sought to net more on advisory, wanting a lower administration fee. The broker-dealer responded by explaining, "We have staff to pay, bills to pay, fixed overhead that requires these charges."

The advisor commented to me that he didn't care about their expenses, he cared about his own expenses and wanted to net more—so the team will change broker-dealers in order to do so.

The 100% advisory payout is just one of numerous sacred cow profit centers being disrupted as some broker-dealers promote "loss leaders" to attract advisors.

"Loss leader" is a common marketing tactic in the retail environment in stores such as Wal-Mart or Target. These retailers promote an item such as a television or other popular consumer item at a loss or perhaps

breakeven in order to attract people into the store. As customers come for the sale item, they buy other items that are profitable for the store.

A similar scenario can be seen to the broker-dealer marketplace. Here's a listing of loss leaders or contrary compliance stances offered by broker-dealers that directly or indirectly attract advisors to their firm:

Flat Advisory Administration Fees

For advisors that manage the clients' assets themselves, it is common practice for advisors to pay 10–25 basis points on client assets for billing, statements and performance reporting.

A growing number of broker-dealers are opting to do these functions themselves rather than through their clearing firm, charging $12.50–$40.00 per account annually rather than basis points on assets.

This is a huge savings over basis points charged on assets, and is a primary way advisors can net more for themselves or their clients. Another bonus on this structure is the use of Orion for the administration, which is known for its high accuracy in reporting.

No BD Involvement in Fixed Index Annuities

It was a legal battle between Investors Capital and the state of Massachusetts over Fixed Index Annuities (FIA) their advisors sold and the state holding them liable for those sales that was the tipping point for broker-dealers getting involved with FIA products.

Investors Capital spent about $1 million on legal fees to fight the case, but they lost and paid an additional $1 million in fines. This case sent a shiver down the spines of broker-dealers, so it was at this juncture that broker-dealers started to supervise and track FIA product sales.

Broker-dealers have several potential revenue sources on FIA, which include:

- Applying payout grid
- Charging networked insurance marketing organizations (IMOs) 30–50 basis points
- Pocketing the difference between street-level commissions and national level commissions

Frequently, advisors are not aware that a mark-up is being charged to them, and it is a charge that broker-dealers rarely want to discuss.

There are still broker-dealers that take the stance: "Until they declare FIA a security, we are not going to require it to run through us." For an advisor doing sizable amounts of FIA business, this can equate to netting thousands more.

No Markup on Outside Money Managers

More common at larger broker-dealers, you find that your broker-dealer is marking up the management fee on a third-party money manager by 10–25 basis points.

Frequently, advisors are not aware that a markup is being charged to them, and it is a charge that broker-dealers rarely want to discuss. If you are not sure if you are paying this markup, call TD Ameritrade or Schwab and ask them what the management fee is for your particular money manager.

Small and mid-sized broker-dealers rarely tack on this profit center, so if you are at a larger broker-dealer, there's a good chance you are paying more. (They have to pay for sign-on bonuses somewhow.)

Friendly to Mutual Funds, VAs Held Direct

It is becoming increasingly common for broker-dealers to want mutual fund and variable-annuity (MF and VA) assets to be held in brokerage accounts.

Numerous profit centers within brokerage accounts bring more revenue opportunities to broker-dealers vs. holding the assets direct at the MF/VA companies, providing the broker-dealer with only payout grid as a revenue source.

Some broker-dealers have tried to make holding assets in a brokerage account less expensive by not charging fees for systematic withdrawals/deposits, dollar cost averaging or ticket charges on most mutual funds.

Inactive account fee and IRA custodial fees are still common costs that can be incurred in brokerage accounts. If you want to keep your clients' costs low, seek out a broker-dealer that isn't twisting advisors' arms to put all their assets in brokerage accounts.

Higher Investment Limits on REITs/Alts

Over the last two years, numerous broker-dealers have lowered the amount an advisor can invest client assets into illiquid investments such as REITs, BDCs and alternatives investments. This phenomenon is driven by both FINRA and the broker-dealer.

A 20%–25% limit of a client's investible assets has become commonplace for these products, and for clients over age 70, 10%–15% has been standardized.

For broker-dealers with a strong focus on this product niche, you can still get limits as high as 40% of investible assets, which can also be influenced by a client being an accredited investor vs. a qualified one.

For some of these specialized broker-dealers, higher limits can be considered on a case-by-case basis; they try not to operate compliance policy using a cookie cutter standard.

Ability to Buy E&O Insurance

Most broker-dealers require advisors to purchase their errors and omissions insurance through the broker-dealer's group plan.

It is very common for broker-dealers to mark up the E&O-insurance cost as a profit center, with annual costs of $3,000 now quite common.

Deductibles have also gone up dramatically, with $10,000–$25,000 now the norm, where in the past it was a $5,000 deductible.

If you are at a broker-dealer that does sizable sales of REITs, BDC and alternative investments, you may have even higher E&O rates or higher deductibles for these products.

If your broker-dealer has paid out sizable amounts on litigation, your E&O rates can be higher or they may offset the cost with higher deductibles or less coverage.

A handful of broker-dealers will let their advisors obtain their own E&O insurance, which can bring substantial savings.

With good compliance histories, advisors that do only mutual fund and variable annuity business with a Series 6 license may find coverage for as low as $400 annually, while an advisor also doing fee business may pay around $800–$1,200 annually.

Profitability vs. Profiteering

Don't get me wrong, I'm pro-profit and when I'm doing due diligence on a broker-dealer, I want to see that they are indeed profitable.

Advisors can have the best of both worlds with a profitable broker-dealer and also value pricing in needed areas.

A segment of what we do as a recruiting firm is broker-dealer arbitrage, searching out pricing inefficiencies in the independent broker-dealer marketplace that will benefit our clients in their objective to net more with an alternative broker-dealer.

For an advisor wanting to net more, who may no longer be utilizing the services their firm offers, a change of broker-dealer can most certainly make sense, if the alternative maintains quality service and needed technology.

Broker-dealer profitability is one thing. Excessive or unnecessary expenses to line one's pockets is quite another.

When you see a publically traded broker-dealer that has the need to get a 15% return or more embedded into its cost structure to satisfy shareholders, numerous services that advisors may or may not use, the cost of having its name on a stadium, the cost of sponsoring PGA golf tournaments, or the cost of flying and hosting clients to view a home-office art collection, it begs the question: "Whose financial success are you working to advance, your broker-dealer's or your clients'?"

Find a Broker Dealer

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