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By Jon Henschen

Three Hidden Broker-Dealer Profit Centers Exposed

As our industry pushes for greater transparency, one area that remains largely opaque is broker-dealer profit centers

There's nothing wrong with broker-dealers being profitable, but how those profits are obtained could use a good dose of disclosure. Representatives deserve to know that what they are paying is a true cost and what they are receiving is the best possible commission from a vendor.

First, let's look at the profit centers that are relatively obvious to reps. In addition to the spreads broker-dealers receive from payout grids, there are two other primary sources of broker-dealer profit: revenue sharing and markup.

Revenue Sharing Between BDs and Vendors

Revenue sharing happens between the broker-dealer and the product vendors, so it's of little concern to reps. For example, on mutual funds and variable annuities, broker-dealers will negotiate with vendors to earn basis points (bps) on assets or sales of products their reps sell.

Broker-dealers will typically make 1 to 10 bps on either assets or sales of products, with small firms making only 1 or 2 bps and larger firms making 8 or more. Larger firms also have the ability to make these basis points on both assets and sales as they leverage their scale to obtain more.

On REITs and alternative investments, BDs earn between 1% and 1.5% extra in commissions on those product sales, which is called "marketing reallowance." You may have noticed the increasingly large REIT and alts presence at BD conferences over the last five years—it's simply because these vendors are currently willing to spend more to get in front of reps.

Markup Charges on Clearing Firm Costs

Markups, such as ticket charges, are something that representatives recognize as a profit center when they look at their various costs and see that firms differ on what they charge for them. It may not be apparent how much the markups are, or how extensively the costs incorporate overall costs, but reps recognize that there is a spread between clearing firms' costs and what broker-dealers charge the representative.

For example, a clearing firm commonly charges $1 for postage and handling fees, and the broker-dealer charges between $4 and $7. A stock ticket charge from the clearing firm may be $9, but they charge the rep $19. BD scale is a primary factor in how low a firm is able to negotiate with the clearing firm: Small broker-dealers may be able to negotiate perhaps $12 from the clearing firm on stock ticket charges, while a large broker-dealer can negotiate down to $5.

When broker-dealers have dual clearing, they dilute their ability to negotiate lower costs because their assets are split between multiple clearing platforms. As they grow, they are often able to renegotiate to obtain lower costs from the clearing firm. They may then choose to offer reps a lower ticket charge. However, most of the time, these savings are added to the broker-dealer's profits.

Three Hidden Profit Centers That Need to Be Uncovered

Once you account for revenue sharing and markups, there are several profit center areas that remain well-hidden, with reps unaware that they are paying additional costs or missing out on additional commissions. There are three areas that I regularly research as part of my due diligence on broker-dealers to ensure that the representatives who I consult with get everything they deserve—both for themselves and their clients.

1. Third-party money manager markups.

Frequently, reps are unaware that they may be paying management fees that are 10 to 15 bps higher than what the fund manager actually charges. Even broker-dealers' own recruiters often are clueless that their firm marks up the manager's fee.

In 2013, a representative called me, irate at his broker-dealer after calling Fidelity Institutional and inquiring what the management fees were on the managers he used. To his surprise, his broker-dealer was marking up the management fee 10 bps. Also in 2013, I did a due diligence trip to a large, publicly traded broker-dealer. My discussion with the head of advisory services was both refreshing and disturbing when I asked, "Do you mark up money manager management fees?"

As one representative pointed out, "My management fees are higher and I have fewer managers at my disposal. What's the value added in that?"

The response was refreshing in his frankness, compared with previous heads who would respond as if I had caught them in their underwear, giving me caught-off-guard, uncomfortable responses. The disturbing part was how much they would mark up: "We mark up 10 to 25 bps. If the representative is a large producer, we may only mark up the manager's fee 10 bps. But if it is a smaller producer, we would go with 25 bps."

Prior to this visit, I had been witnessing markups in the 5 to 15 bps range. Further evidence that this markup is kept largely in the dark was a conversation with a money manager wholesaler. The wholesaler shared that some broker-dealers contact them with instructions that if one of their reps asks about the management fee they charge, they should instruct them to contact their broker-dealer because the amount the manager charges is different from what the broker-dealer charges.

A growing trend is for BDs to bring advisory platforms such as Envestnet in as an internal platform. As one representative pointed out, "My management fees are higher and I have fewer managers at my disposal. What's the value added in that?"

While broker-dealers can charge what they like, I take issue with how these markups are frequently imposed without representatives being aware of the added costs to their clients. Wouldn't it be more appropriate that these markups were visible so reps could make an informed decision regarding the added cost? My research shows that about one-third to one-half of independent broker-dealers are imposing markups on third-party managers. Small and midsized broker-dealers tend to do little if any markup, while larger broker-dealers will charge as high as 25 bps.

It's important to note that a few large broker-dealers choose not to impose any management fee markup. If you are curious whether you are being charged this markup, call one of the outside advisory vendors such as Schwab or Fidelity to verify the management fee of managers you work with through their platform.

2. Variable universal life insurance (VUL). Since 2009, we've seen a large shift away from VUL to universal life, but we still encounter representatives who do substantial amounts of VUL. For these reps, it's all about receiving not only target premiums, but additional backdoor allowances that can raise their commission on premium from a target of 80% to 90% or more. Reps doing large amounts of VUL may have their own contracts in place for getting above target premium, or they may work through an insurance aggregator who leverages insurance companies for greater backdoor allowances.

BDs may have negotiated backdoor allowances with product vendors, but they pocket the added premium and only pay the base target premium to the representative. If the representative is a substantial producer in VUL, the broker-dealer may allow them to have their own contract with the insurance company, but frequently they will not.

At smaller firms, there's a good chance that the product person never attempted to negotiate above target premium because they didn't know they could, or because they sold such a small amount of VUL it was never a concern. If you do substantial VUL, see if your broker-dealer passes through the backdoor allowances to the reps. If not, are they open to you negotiating your own contract with the insurance providers?

3. Fixed index annuities (FIA). Since the legal battle between Investors Capital and the state of Massachusetts (which held the broker-dealer liable for the FIA product their reps sold over a multiple-year period with a $1 million fine imposed in 2006), shivers ran up the spine of broker-dealers. They quickly started to require their reps to run their FIA product through one of the insurance marketing organizations (IMO) that they networked with in order to supervise FIA business and avoid a similar legal quagmire.

Broker-dealers charge the IMOs 25 to 50 bps on business that goes through it, with some broker-dealers also applying payout grid on FIA business. What is rarely discussed is that there is a street-level commission on FIA and a higher national-level commission. Broker-dealers will frequently contract with the IMO to receive national-level commissions, but only pass through street-level to the representative and pocket the spread.

These firms will explain that they pay 100% of the commission earned. In reality, reps would make much more running the commissions through payout grid and getting the national-level commission. If you are a large FIA producer ($100,000 or more), negotiate with your broker-dealer for national-level commissions.

We've seen a trend toward broker-dealers also requiring index universal life to be run through the broker-dealer because the product has the word "index" in it. If your broker-dealer has such a policy, consider verifying whether you are getting additional backdoor allowances.

If a broker-dealer has a strong value-added proposition, reps don't mind sacrificing a portion of commissions or paying markups on third-party managers. Still, we need increased transparency so they are aware of these added costs or pocketed commissions. It's only fair that reps be able to evaluate these costs in order to make an informed, educated evaluation of what is best for them and their clients. The shell game needs to end with a new era of broker-dealer transparency.

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Looking for a Consistent Pipeline of New Clients?

We'll Lead You to the Best New Client Generation Platforms

Finding new clients can be a struggle. It's a time consuming process that many reps simply do not enjoy. We've researched the independent broker dealer channel and narrowed the field to the best new client platforms in the marketplace.

Our research criteria for the **"best of the best:"**

- The marketing group is tied to a quality broker dealer
- The marketing group maintains proper staffing to administer the program
- The program demonstrates a proven history of results

We're not talking about a program where someone throws you into a seminar and then the work falls on you. These are plug-and-play programs where the marketing group does the heavy lifting to bring you clients and you close the business.

The programs on our **"best of the best"** list require a change of broker dealer. We start the process by interviewing you to gather information on your practice and determine if you fit the criteria set by these programs.

Here are a few examples of new-client platforms available:

Retirement Transition Specialist

This program will bring you a steady pipeline of new clients who are looking to retire. These clients will come to you for pre-retirement preparation as well as retirement implementation. You will help clients through the three phases of retirement (Active Retirement/Slowing Down Retirement/ Inactive Retirement).

Using social media, this group runs geographical and industry campaign ads on various social media outlets. You will be fully trained and licensed on the program, with the goal of being the only source the new clients want to turn to for their retirement plans. Employers love this tool and will frequently have you as the exclusive source for their retiring employees because they feel assured that a single source will meet their employees' needs.

For this program you pay a weekly fee and can withdraw at any time. You also pay a small cost for each of the ad campaigns.

2 Prong Marketing (401K, High Net Worth)

401K Platform: This group researches your area to determine certain sectors, industries and companies that are the most likely opportunities for lead generation. Through various media, they continually prospect these markets to build a lead base for their proprietary, structured seminar program. The workshop presentation is designed to fill seats, then generate interest in face-to-face meetings where you convert these prospects into clients.

High Net Worth Platform: Wealth Max Approach (six workshops). This group provides training, sales literature, leads and splits the cost with you for workshop meals. The program requires estate planning skills along with more experience and good closing skills. It delivers high net worth leads that require significant experience in the field of estate and wealth transfer, and provides support for advanced planning that will deliver large case expertise to help you land wealthy clientele.

This is their premiere program with a proven pedigree. They have advisors that are generating $800,000 to $1,000,000 in GDC by running three to four campaigns per year. They offer extensive training through video instruction designed to deliver results. Reps receive payout on their own business of approximately 90%. Business they bring you is split 50/50 on payout and campaign expenses with a two-year vesting period.

In addition to plug-and-play programs, we also have reps needed for bank branches and credit unions throughout the country.

Call today to schedule time for a consultation.

Find a Broker Dealer

HENSCHEN & ASSOCIATES, LLC.
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