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It's All Hands on Deck as BDs Enter Rougher Waters

The next few years will be all about regulation as broker-dealers figure out the proper balance of Regulation Best Interest's disclosure, tracking and recordkeeping. Advisors at some broker-dealers tell us the new disclosures required to satisfy regulators have become suffocatingly unacceptable, though not much has changed at other firms.

The future balancing act for most broker-dealers, though, will be implementing enough disclosures and recordkeeping to avoid fines but not so much that their advisors find the paperwork and related requirements oppressively long and complex.

Geneos Wealth Management President and Chief Compliance Officer Jodee Brubaker-Rager feels that by having its own technology firm, the BD has been able to make the required changes to supervise and electronically maintain records in order to comply with the new rules. Still, creating multiple disclosure forms and supervisory systems has been a bigger project than it first anticipated.

But Geneos is the exception and not the rule. Many firms are likely to discover how deficient their recordkeeping is when fines are imposed on them over the next year or so. Plus, disclosures and supervision aren't the only aspect of Reg BI that will be problematic going forward.

'Bad' Commissions

Reg BI has demonized regulators' perception of commission-based products to the point that they look at, for example, variable annuities as "bad" and also earning commissions (rather than fees) as "bad." If an advisor or compliance officer is being questioned over a variable annuity sale, they find it to be: You are guilty until you can prove your innocence.

Many firms have become downright paranoid about commission-based sales and the potential blowback from regulators, making advisors' ability to have commission-based business increasingly difficult.

This likely will be a primary driver in reduced commission sales in the coming years, and that will especially affect BDs that rely more on sales tied to commission-based mutual funds, variable annuities, alternative investments and fixed indexed annuities.

Fee Revenue Under Threat

Strong sales of exchange-traded funds already have cut into mutual fund sales. This is a revenue disruptor for broker-dealers, since mutual funds have substantially higher revenue-sharing arrangements than ETFs.

The trend toward more ETFs and fewer mutual funds appears unabated, so BDs' mutual fund revenue is poised to keep diminishing. Also, fee-based accounts have their own issues in terms of expected revenue disruption going forward.

Reg BI brings the practice of charging a fee on an alternative investments into question. These investments are illiquid, and an advisor can't make any sort of changes to the investment. But they charge a fee to manage the asset anyway, which makes about as much sense as fees for "managing" fixed annuities.

Broker-dealers have their sacred profit centers, with advisory administrative fees being one of the largest and most reliable sources of this income. As advisors experience fee compression, they're discovering that one way to lower such pressure is to bring down the amount clients pay in advisory administration fees and ticket charges.

For example, advisors paying a BD 30 basis points on client assets—to cover administration fees and ticket charges for an all-inclusive fee account—may find out that they can custody these assets at Schwab or Fidelity and have no ticket charges on ETFs and stocks. In addition, a growing number of broker-dealers will do the administration (billing, performance reporting and rebalancing) with Orion, say, for roughly $100 per account each year.

The savings is shocking, as advisors can cut costs by up to 95%—saving the client large sums. Ever since Charles Schwab, TD Ameritrade and Fidelity went to no ticket charges, we've been heavily focused on helping advisors who want to lower advisory administration fees and face no ticket charges.

Because they impose ticket charges and higher administration fees, clearing firms likely will become less attractive places to custody advisory assets in the future.

The administration fees have a net cost to the broker-dealer of around 3 basis points of assets, which are often marked up by the BD to 10 basis points or more. With fewer advisory assets in brokerage accounts, another once reliable profit center for broker-dealers is set to diminish.

FINRA Headaches

"The risks that come with being a financial professional and an advisor are endless," according to Brubaker-Rager. "The biggest risks that keep me up at night include cyber, product and market-event risks that result from the increasing population of claimant attorneys, who actively solicit investors to sue advisors and financial institutions with promises of recovering market losses. The most significant, however... is the risk of being a regulated FINRA member."

While the time and financial resources necessary to interpret FINRA rules are immense, it's "never enough to avoid the endless regulatory requests that can span the course of two years," she explains. Because FINRA has devoted a great deal of time and resources to a situation, it's unlikely "they would be willing to walk away with no action or simply a letter of caution," she says.

For these reasons, many of the brightest, most seasoned compliance and supervisory professionals, as well as FINRA-affiliated financial professionals, "will continue to migrate to purely investment advisory roles over the next few years," Brubaker-Rager concludes.

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