As seen in the January, 2014
Investment ADVISOR
THE VOICE OF INDEPENDENTS

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Is the Grass Really Greener?

When reps are considering changing broker-dealers, they want answers to these nine common questions

Recruiters like myself often get questions from broker-dealer reps considering a move that begin, "Is it normal that my broker-dealer…?" Broker-dealers can be notorious for giving advisors answers that smack of corporate clichés such as, "We're making these changes to be in line with our competitors" or "Regulators are requiring us to make these changes." We thought it would be useful to bring to light nine common questions we, as recruiters, get from reps as they try to solve the puzzles of costs, company policies and supervision.

1: Our BD passes through 12b-1 trails on mutual funds in advisory accounts with non-qualified assets, but not qualified assets. Is it true that legally they are not allowed to pass through qualified 12b-1 trails?

It's partially true. Broker-dealers are not allowed to pass through 12b-1 trails on ERISA assets such as 401(k) mutual fund 12b-1 trails. However, on IRA, 403(b) and 457 accounts they can pass 12b-1 trails through to the advisor. There are a few firms that don't pass through any qualified 12b-1 trails and funnel those trails back to the client. For many firms though, those trails become part of the broker-dealer's profit center.

Our survey of large, medium-sized and small broker-dealers found that most of the large independent BDs did not pass through qualified 12b-1 trails, while numerous small and mid-sized broker-dealers paid out both qualified (non-ERISA) and non-qualified mutual fund 12b-1 trails.

2: Do other firms require their reps to take the "AI Insite" alternative investment test?

Over the last six months, we've seen a spike in the number of BDs requiring the AI test for reps wanting to do alternative investments. With so many arbitrations centered on the issue of reps not being knowledgeable about what they are selling and how they are selling it, any options for educating reps is an appropriate part of a BD's risk management.

We found many larger firms require the AI test if reps want to do alternative investments. Small and mid-sized firms may or may not require the test, or it's left up to the advisor to decide whether to take it.

3: Are other firms charging $3,000 for errors and omission insurance?

Unfortunately, $3,000 is the new "normal" fee from BDs for E&O coverage, especially if it sells sizable amounts of alternative investments or has had numerous recent arbitrations. Deductibles are climbing to rates we've never seen before, with some firms imposing deductibles on alternative investment-related complaints as high as $300,000, with $50,000 increasingly common. With the flow of arbitrations expected to decrease in 2014, perhaps we'll see more reasonable rates return in 2015.

4: Is it common for new client account forms and variable annuity forms to be in the 10- to 15-page range?

We've actually seen reps leave firms over excessive length of forms. A financial planner explained to me that unusually long forms can breed mistrust in the client as they wonder, "What kind of shoddy investment is this if it needs so much disclosure?" The majority of the small and mid-sized broker-dealers we've surveyed had new client account forms in the three- to five-page range, while variable annuity app/switch forms ran in the range of two to five pages. The worst offenders were larger broker-dealers.

5: My BD limits reps in how much of a client's investable assets can be invested in alternatives to 20% and 10% for clients over age 70. How does that compare to other broker-dealers?

The most common percentage restriction we found in our survey was 25% and 15% for clients 70 and older. For firms with a strong focus on alternative investments, it's common to have the percentage restrictions defined as soft limits, with reps able to invest higher percentages on a case-by-case basis.

6: On rep-directed advisory accounts, our administrative fee starts at 25 basis points. On all-inclusive wrap accounts, our cost is 40 bps. Are these charges high compared to other firms?

Unbundled advisory platforms (separate ticket charges) have seen a decline in administrative charges, with 10-15 basis points being a common starting point. For all-inclusive wrap fee accounts, we see costs averaging out at 25 bps with a cap on trades in the 80-120 basis-point range annually.

A trend we've seen over the last two years is firms offering lower administration fees. However, these firms then pocket 50% of the 12b-1 fees on non-qualified mutual fund advisory assets. Or they may charge a per-account fee, which makes advisory accounts under $150,000 in assets rather expensive.

The best pricing value we are seeing on unbundled advisory administrative fees are firms that charge as low as zero, with five bps increasingly common. Pricing value for all-inclusive wrap fee accounts at mid-sized BDs is as low as 10 bps with no cap on trades. The best we saw at large broker-dealers was 19 bps with no cap on the number of trades.

7: Do all broker-dealers check their reps' credit history every six months?

We've heard complaints from advisors at one particular broker-dealer that was doing hard credit checks every six months. Several advisors complained that the hard checks resulted in their credit score dropping between 25 and 50 points. After a storm of complaints from their advisors, this firm changed policy to doing soft credit checks (for more on credit checks, please see sidebar above).

8: When my BD performs an audit, they want to look at my tax return and checkbook, as well as my spouse's. Are other BDs being this intrusive?

It is commonplace during rep audits to look at a rep's checkbook. However, we've only seen one broker-dealer that required looking at a spouse's checkbook, and that was done in response to litigation they had to pay over lack of supervision. Tax return audits are a more recent trend, with the objective being to uncover undisclosed outside business activities.

Another reason broker-dealers are auditing tax returns is to preclude the possibility that during an arbitration, regulators will assume the broker-dealer has audited tax returns, arguing that if they have not done so, they have failed to adequately supervise. With a minority of broker-dealers auditing all their reps' tax returns, most limit audits to only the situations where they feel it's warranted.

9: My firm requires me to have my personal brokerage accounts held with the broker-dealer's clearing firm. Is it true when they tell me it's required of them in order to track and supervise what we are doing?

Over the last three years, an increasing number of firms have required their reps to run their personal brokerage accounts through the broker-dealer's clearing firm. The reasons for this requirement are varied, with one firm requiring reps who are also investment advisors to run accounts through the broker-dealer for personal trading supervision. Their reasoning is that if an advisor trades in their personal account in a stock that's also purchased in one of their clients' accounts at a better price (intentionally or unintentionally), they need the ability to enter trade corrections to adjust the share price so the client receives the most favorable price. If the accounts are held away, they can't process trade adjustments and corrections.

Even though many broker-dealers still allow representatives to custody their personal brokerage accounts away, for many the window is being shut by compliance tracking and the requirements of the fiduciary standard requiring that clients get the same or better pricing on stock trades.

Jonathan Henschen, CFS, is President of Henschen & Associates. Jon's firm helps advisors find broker dealer relationships that best fit their business profiles, while helping them uncover unique, progressive and previously unknown opportunities. Henschen & Associates contracts with more than 70 independent broker dealers and 15 producer groups. Mr. Henschen is also a regular contributor to *Investment News, On Wall Street, Investment Advisor, Broker/Dealer, Broker World, Producers Web, Bloomberg News, Registered Rep* and *Advisorbiz.com*.

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