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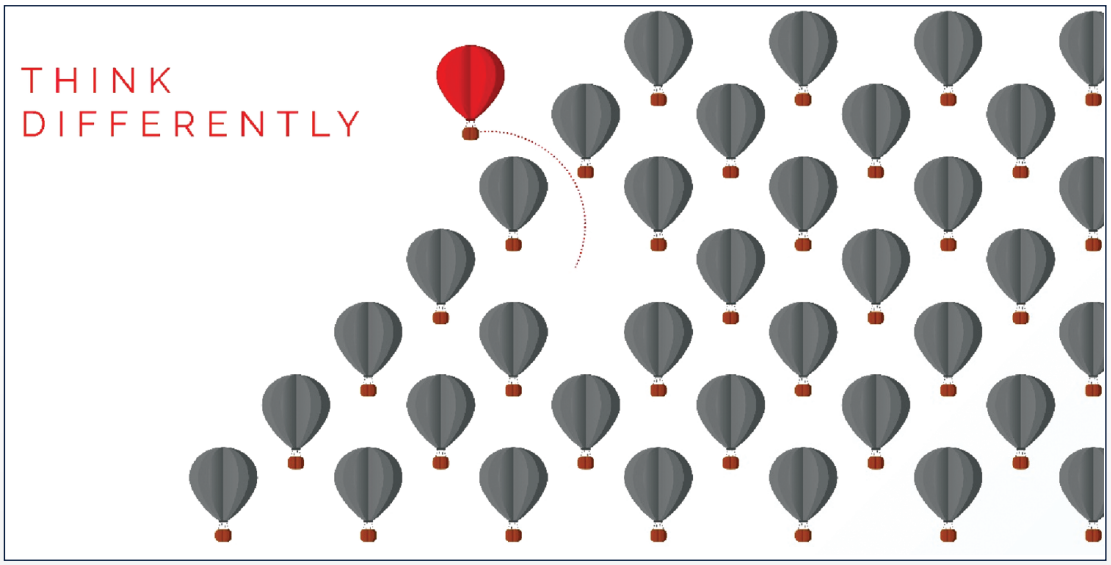
When, Why, and How to Switch from Commission to a Fee-Based Practice

November 26, 2018



By: Michael P. Czajka, Chief Executive Officer

The broker-dealer community's shifting from traditional commission-based environments to alternative fee-based models started around the late 1990's. Over the years, there have been many rule changes, such as the 1999 exemption under Rule 202 and the proposal that was struck later in 2007 for RIA arrangements. These rule changes have contributed greatly to broker-dealer revenue moving from less than 10% to over 50% from fee-based programs today. First, Rule 202 only permitted broker-dealers to operate fee-based accounts without needing to register as investment advisers. It was then revised in 2007 to allow them the capability of fully transitioning from commissions to a hybrid or dual-registration.

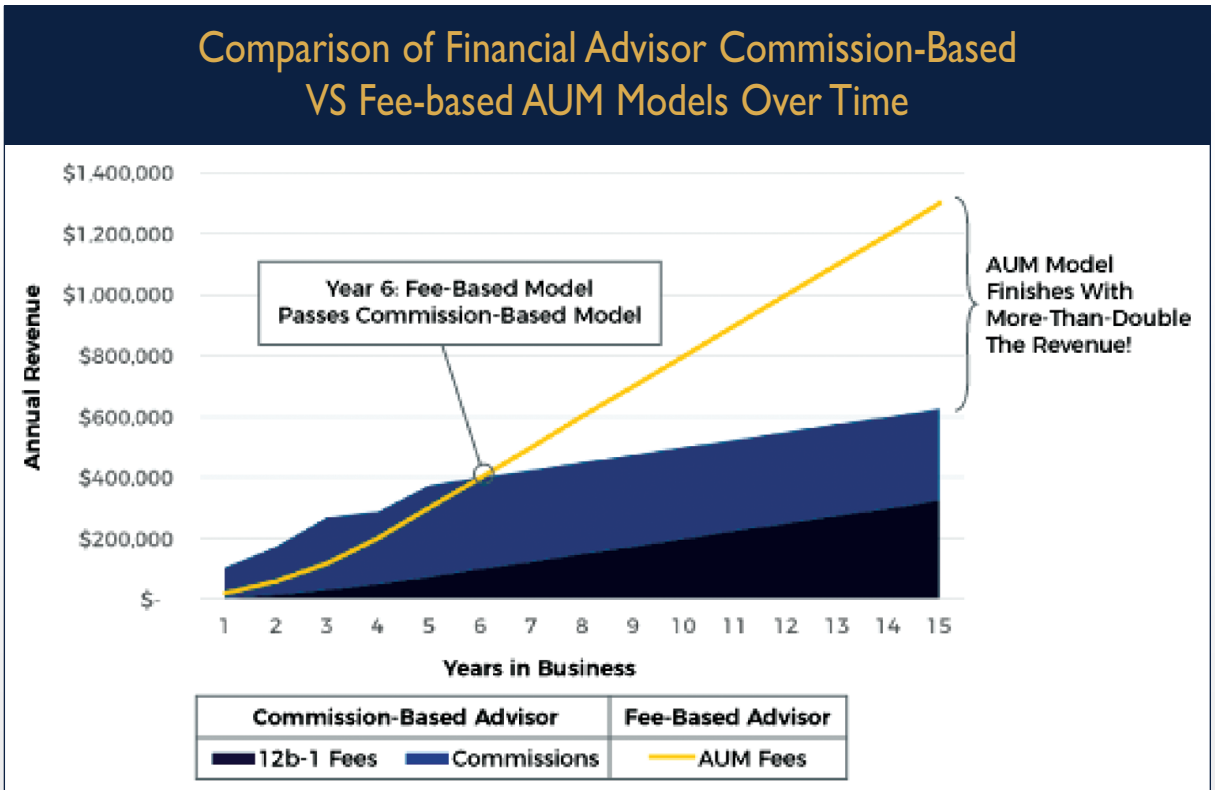
The increasing regulatory scrutiny of today's business environment places downward pressure on commission-based practices. Also, the continuous trend of more and more financial advisors making the switch to fee-based models has many commissioned based advisors thinking they must make the transition to fee-based models or at some point become obsolete.

One very important reason for this shift in preference towards fee-based models is the fact that it facilitates growth and the building of more successful businesses. A business based on commission revenue is transactional and limits the number of clients an advisor can realistically service, and the products or investments he/she can sell personally and frequently. Contrarily, an advisory business with recurring revenue from a fee-based process can be successful without having to continually generate new clients, so far as quality service is still being delivered to already existing clients.

Yes, some of your colleagues who made the transition a few months or years ago are doing great. They are now enjoying a more steady stream of fee income, greater income certainty and other benefits to their businesses and lifestyles; not to mention benefits to their clients.

The prospects of jumping off of a cliff into unchartered waters or better yet, the unknown, makes the transition from a commission-based transaction practice to a fee-based practice a very scary set of circumstances. However, the rewards, just like any entrepreneurial opportunity can be extremely rewarding.

See the graphic below courtesy of Michael Kitces. In short, it will take an average of six years to convert your commission-based business into a fee-based business whereby you receive the same amount of revenue as before the change. However, this can be accelerated immediately by choosing an outsourced service provider to handle your investments, compliance and client billing.



Source: Michael Kitces. www.kitces.com

This may have you wondering now about the perfect time and way to go about a transition. The good news for you is that the trend is set to continue for the foreseeable future because of the numerous advantages in fee-based advisory models. Additionally, there has never been a better time for brokers or registered representatives to make the switch than NOW.

However, switching from commission to mostly fee or a fee-only model requires sufficient planning and proper implementation to ensure success. Getting expert support from a dedicated professional like Malvern Capital Management may actually present the best route to take.

Why Make the Switch: Benefits of Changing to a Fee-based Model

Here are some of the reasons why you need to go ahead with making the switch from a Commission-based to a Fee-based Model:

Better Suited to Today's Investment Climate

It has become clearer over the years that a fee-based approach is much more suited to the investment climate of today. Uncertainty and instability have become norms in many areas of investment since the financial crisis and investors now need financial consultants rather than salespeople (i.e. professionals who can help them achieve their financial goals by providing answers to when, where, and how to invest whenever there is a need). A transactional commission-based approach clearly can't support clients this way.

Autonomy from a Large Corporate Entity or Your Competition

Succeeding at building a fee-based business is essential to being able to be independent of a large corporate entity with your unique services and relationships with clients. Also, differentiating yourself from the competition is much easier as well.

You don't have to rely solely on finding prospects and closing them, but your track record with existing clients gives you recurring income, promotes growth and gives you a unique identity even within a bigger organization or among your competitors. Investors are now looking at both the products they invest in as well as the advisors who can build financial wealth.

Larger Incomes for the Same Book of Business

For the same size of business, a fee-based approach tends to result in larger incomes. Although it usually takes longer to get going or to arrive at the point of a financial break-even, it offers the capacity of taking your business beyond you over time thanks to growing cumulative fees. The flexibility in hiring staff and expanding resources ends up with bigger income returns.

A fee Business Places Clients and Advisor on the Same Page

Upon opening a fee-based account with an advisor, clients sign an investment management agreement which outlines the agreed upon fees, how they are calculated, and when they will be charged. Unlike a transactional or commission fee basis, what this does is align the best interests of the client with those of the advisor. For instance, if a client's assets grow and the client's fees are based on the account's market value, the advisor will increase his/her compensation if he/she succeeds at growing the value of the account. A decline in account value, therefore, dwindles the advisor's compensation.

Most financial reps and brokers get into the business because they enjoy the income growth and not because they are just good salespeople. Periodic payment of fees works for both clients and financial professionals.

Ability to Monetize your Business After Transition

Commission-based models are nearly impossible to predict when it comes to your firm's income and growth rate. The business' high chances at topping out when you can't afford any more time for new clients and difficulty to hire professional support is the complete opposite of what you get with a fee-based approach.

The steady and predictable income from a model based on recurring fees gives you the ability to

monetize your business once you make the switch. It's much easier to spend extra on your business to find valuable outsourcing support that will boost growth while not excessively increasing your overhead. This will help create value when you want to monetize or sell your practice.

How to Successfully Make the Transition to a Fee-Based Model

If you want to adapt to major industry trends, changing the model of your business entails risks, but could offer exponential benefits once you perfect it. Although there is really no specific way to best make the transition, you definitely need a sound plan. You might want to brace yourself for the considerably low initial revenue a hard switch brings; or prefer the option of flexibility by combining a hybrid commission-based / fee-based business especially in the early years to fill the income gap.

Whichever way you choose to go about it, you need a sound plan and the steps below can help you initialize one:

1. **Understand your Motivation and Ideal Approach**

   Establishing your motivation for wanting to change to a fee-based model is a very important step in the transition. Beyond your zeal for the financial benefits, you need to ask certain questions and determine their answers. For instance; What service(s) are you looking to offer clients for a justified ongoing fee? Does it provide something your current model is missing? Do you want independence?

   The transition shouldn't just be about wanting to be able to charge ongoing fees but about having a well-defined value proposition for your fee-based clients. If you find the right reasons, your chances at choosing the right approach are high and the financial benefits will definitely follow.

2. **Forecast your Finances with Practical Considerations**

   Cash flow timing in a commission-based model is very different from the cash flow from a fee-based model. Detailed expense and income projections are essential in the transition to a fee-based model as you can better plan for a complete or gradual drop of commissions. Especially because of the definite income lag from the start.

   If it's going to affect your personal earnings, you better know it from the very beginning. Projections are much more helpful when practical considerations are not overlooked because there are many ways to start. You could decide to start your own solo RIA or join an existing RIA depending on which approach fits you better.

3. **Become a Dual-Registered or Hybrid Advisor**

   For your planned transition to begin, you need to become eligible to carry out your fee-based business. So, you will have to become a "dual registered" advisor with your corporate RIA or the more appealing option of a "hybrid" advisor by forming your own RIA.

   Getting the necessary authorization normally requires that you have the Series 65 license. It kick-starts the transition which then moves to the issue of retaining or disposing of former commission-based clients. Finding an interesting way to transition your existing book of business to

the new fee-based model or retaining its commission format is going to be key to your success. Malvern Capital Management can help you get through this step like an expert.

4. **Stay Focused on the Bigger Picture with Expansive Financial Planning**

Moving your business from commission to fee-based is a big decision and involves more than just a change of your compensation model. Advisors need to understand they are shifting from selling products to the purchasing of services on behalf of their clients. In today's environment, this at least includes ongoing investment management or monitoring as the minimum standard for an advisory fee.

However, providing substantial personal financial planning advice will help boost the value proposition of your advisory firm and justify your advisory fees. Making sure you keep expanding your advice knowledge or hiring expert support keeps your business on track towards long-term success.

There's no doubt that it costs more to secure a new client than it does to keeping an existing client. You don't want to be left behind; there has never been a better time to change your commission business to fee-based.

ABOUT MALVERN CAPITAL MANAGEMENT

Among other services, Malvern Capital Management offers transition, outsourced CIO and breakaway "tuck-in" services to the undersized registered investment advisor or financial advisor at a wire house looking to make a transition to a fee-based practice to create autonomy and increase personal revenue.

Our partners have been working with registered investment advisers and institutional clientele for over six decades, understand their businesses, and can help solve problems.

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