

On July 18, the House Committee on Oversight and Government Reform held a hearing regarding “Regulatory Burdens: The Impact of Dodd Frank on Community Banks.”

In her testimony, Wake Forest University Professor Tanya Marsh discussed how “Dodd-Frank builds on decades of ‘one-size-fits-all’ regulation of financial institutions, an ill-conceived regulatory framework that puts community banks at a competitive disadvantage to their larger, more complex competitors.”

In her testimony, Marsh argued that “The imposition of regulatory burdens on community banks without attendant benefits ultimately harms both consumers and the economy by: 1) forcing community banks to consolidate or go out of business, furthering the concentration of assets in a small number of mega-financial institutions, and 2) encouraging standardization of financial products, leaving millions of vulnerable borrowers without meaningful access to credit.”

She could have been speaking about small broker-dealers.

Sound Familiar?

As a broker-dealer recruiter, I find Professor Marsh’s description eerily similar to the struggles facing the small broker-dealer. Throughout much of her testimony, you could have replaced the term “community bank” with “small broker-dealer” and the story would still hold true.

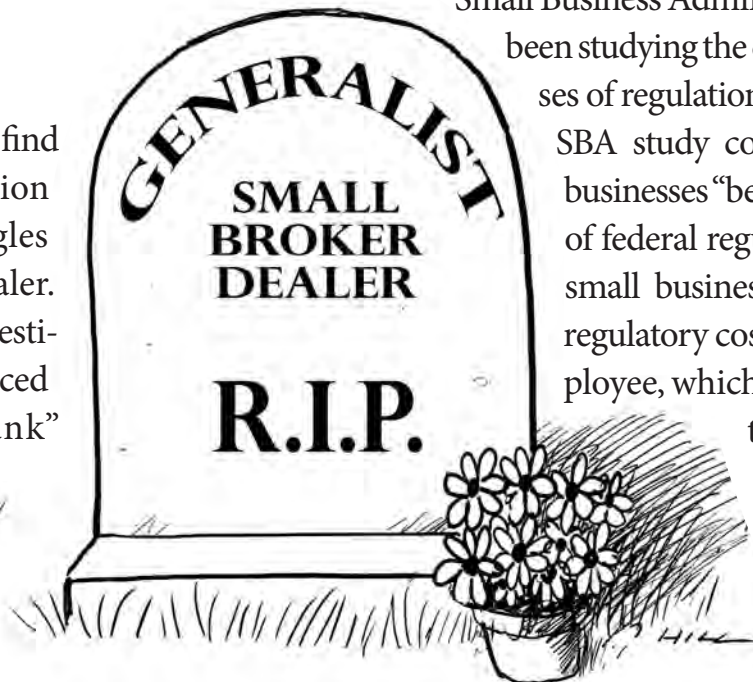
The Small, Generalist Broker-Dealer: R.I.P.?

In her testimony, Professor Marsh continued that “with respect to compliance, community banks are at a disadvantage because they do not have their larger competitors’ sophisticated legal and compliance staffs to interpret the new rules and regulations and look for effective ways to comply with those regulations without compromising their ability to serve customers and earn profits.”

A study released in 2012 by the Federal Deposit Insurance Corp. reinforces the detrimental effect of increased regulation on small community banks. According to that study, “The facts of bank consolidation are striking. From 1984 to 2011, the number of small banks—those with assets of less than \$25 million—declined 96%.” Meanwhile, the number of banks insured by the FDIC has shrunk, while large banks have significantly grown their share of total bank assets.

We know from long experience that smaller businesses are disproportionately impacted by regulatory costs. The Office of Advocacy of the U.S.

Small Business Administration (SBA) has been studying the cost to small businesses of regulation since 1995. A 2010 SBA study concluded that small businesses “bear the largest burden of federal regulations. As of 2008, small businesses face an annual regulatory cost of \$10,585 per employee, which is 36% higher than the regulatory cost facing large firms.” That was before Dodd-Frank.



The Decline of Small Broker-Dealers

While I'm not saying that Dodd Frank is placing our industry in the same dire straits as what we are seeing with community banks, we're not in much better fiscal shape. The Financial Industry Regulatory Authority classifies small broker-dealers as those with less than 150 reps. As a recruiting firm we agree with this segmentation, provided that average production per rep runs around \$100,000 or less, which would make \$15 million of revenue or less a better litmus for categorizing a firm as small.

Like community banks, the number of broker-dealers continues to decline, with the lion's share being small broker-dealers that closed or merged. It's also important to note that the broker dealer decline is not rep-driven; the number of reps since 2005 has dropped by only 3.11%, according to Fishbowl Strategies, a marketing firm that provides trending information about the broker-dealer and RIA arena.

Broker-Dealers in the Marketplace

Year	Number of Broker-Dealers
2006	5,029
2010	4,578
2012	4,289
February 2014	4,181

Offsetting some of these broker-dealer closures or mergers are new broker-dealer formations. However, as Fishbowl Strategies points out, these are also in decline.

New Broker-Dealer Formations

Year	New Broker-Dealers
2010	177
2011	173
2012	127
2013	106

The Federal Reserve Bank of Minneapolis quantified the cost of financial regulation and found a disproportionate effect of regulation on small banks by showing how the costs of hiring just two additional compliance personnel could reverse the profitability of one-third of the smallest banks. Small and some midsize broker-dealers face the same dilemma. One firm shared with us their desire to hire a product person to help reps with education and product selection. Instead, this firm was forced to hire an additional compliance officer to cover additional supervision and tracking dictated by Dodd Frank.

Which Small BDs Will Survive?

While there appears to be a future of doom and gloom for the smaller BDs, those that specialize are best positioned to overcome the obstacles presented by ever increasing regulation. The smaller firms that we see growing at a healthy clip with consistent profitability include those that have a niche in which they excel, which gives them the upper hand. Those broker-dealer specializations we see flourishing include:

- **Alternative Investment Focus** It's all about due diligence, proper education and allocation on alts to keep this model from blowing up
- **IMO Broker-Dealers** Firms that have their own insurance marketing organization are less reliant on securities production for profits, and thus tend to offer a low-cost structure that is especially attractive to reps who produce less than \$100,000.
- **Institutional Business** This focus helps to lower risk and make earnings less cyclical

- **Transaction Orientation** This model can work if the BD weeds out reps who are churners and have multiple disclosure events
- **CPAs/Enrolled Agents**, 403(b) and 457 Plans
- **Overseas Clients** This will become a growing niche as we become more global
- **The Faith-Based** Christian broker-dealers will be able to attract like-minded representatives
- **100% RIA Model** In this model, the BD only makes money on the commission side, so cost controls are important (no frills)
- **Advisory Reporting** using Orion or Black Diamond software, with low administration fees on rep-directed platforms (5 bps or less or a flat fee)

Which Small BDs Will Falter?

We've seen some other specializations fall flat over the years, resulting in broker-dealer closures. Examples include those who focus on internal financial planning and on fee-based advisors without having anything unique to offer. Without something to set them apart, the generalist broker-dealer is going to find that competing with larger firms is increasingly difficult.

Lacking up-front money, a broad array of services, leading technologies or deep pockets to offer financing help with succession planning or marketing expansion, the generalist broker-dealer has little more to offer than personal service and, for larger producers, the management attention that comes with being a big fish in a small pond. Besides recruiting competition from the large broker-dealers, we also see additional regulatory burdens impacting the small broker-dealer's ability to recruit.

Risk Assessment Reports Affect Recruiting

Since 2008, the Financial Industry Regulatory Authority has supplied broker-dealers with quarterly risk assessment reports. These reports let BDs know how their firm compares with industry averages on topics such as:

- Reps registered with three or more firms in the last two years
- Number of terminated reps
- Reps with one or more disclosures
- Reps with customer complaint disclosures
- Reps previously employed by a severely disciplined firm

For example, in a given quarter the industry average of reps with one or more disclosures may be 11.5%, and the broker-dealer's average may be at 23%. The broker-dealer may wonder, "Is that a problem?" FINRA is usually quite vague on such matters.

If you are among the lucky ones, FINRA may hint that they'd like to see you stay under two times the industry average. Otherwise, you might simply need to guess. It stands to reason that FINRA would refer to these risk assessment reports when they are tailoring their inspections of firms. It is during and after such inspections that broker-dealers must quickly make a host of policy changes.

We've received feedback from small broker-dealers that they can no longer bring on reps with credit issues or compliance marks because their percentage on the risk assessment report is too high already. Some firms keep a list of severely disciplined firms handy in order to weed out

candidates from those firms so their own average isn't raised above a certain threshold.

In order to grow, smaller broker-dealers are usually forced to take on greater risk in the form of reps with higher frequency of disclosure events as well as lower producers in order to build scale. As these firms grow toward midsize level, they can then let go of higher-risk reps and low producers because they now have the scale to afford to do so. The risk assessment reports adds an additional dynamic that prevents small broker-dealers from being able to recruit because now "beggars have to be choosy."

FINRA Tightens Thumb Screws on Small Firms

We are also witnessing small and midsize broker-dealers being singled out by regulators on representative credit issues. When broker-dealers are auditing reps, some firms are looking at their tax returns and bank statements. In our survey of larger (noninsurance) broker dealers, we came across none that look at their reps' tax returns. However, with numerous small and mid-sized firms, the frequency went full spectrum: from checking the tax returns of only those reps where it was warranted, to as frequent as annual inspections of tax returns of all reps.

A recent prospect shared with us that a small broker-dealer he considered joining required review of his tax returns in order to join, with further inspections each year thereafter. For the rep, it communicated, "We don't trust you." The heavy-handed approach was a deal breaker for this rep.

Changed Perceptions, Entitled Attitudes

How small broker-dealers are perceived has changed dramatically since 2009, which is evident when we interview representatives looking to switch BDs. "I want a larger firm so I don't have to worry about a couple of arbitrations putting them out of business," is now commonplace thinking. Smaller firms also have to contend with the fact that bigger producers increasingly feel entitled to a substantial transition note when making a move. If a firm can't offer 10% to 20% or more of trailing 12-month production to defer their transition expenses, as well as cover production loss from transition downtime, that firm is out of contention.

The Canary in the Coal Mine

Small broker-dealers can least afford compliance costs or compliance mistakes, making the future of the generalist small broker-dealer look grim indeed. Large firms may be gloating over their advantages now, but that exhilaration may be short lived. With the closure of many small BD firms, and a decline in the number of new broker-dealer formations, this segment of our industry is like the canary in the coal mine.

With ever-increasing regulation, what is ailing small-broker dealers today will affect midsize firms tomorrow and eventually work its way up to the larger firms.

Excessive regulation has a trickle-up poverty effect that hurts everyone.