



Is Your Broker-Dealer in a Death Spiral? 4 Steps to Discovery

In a recent conversation with an advisor at an independent broker-dealer, I brought up a few issues of concern regarding his BD. They included a pattern of disparaging press the firm had experienced over the last few years, the loss of numerous advisors, several large fines that had been imposed and their financials running at a loss in the most recent focus filing.

The advisor went to the president of the broker-dealer, who assured him that everything was fine, that they had not lost numerous reps and all was in excellent order. The advisor then shared his feedback with me with an attitude that appeared to imply that either I was misinformed or had not been telling him the truth.

About a month later, I mailed him a news article showing that one of the BD's advisors was being fined almost \$1 million, as well as a copy of the firm's focus filing, which reflected a loss of more than \$500,000 for the most recent reporting period. From my experience conducting broker-dealer due diligence since 1999, and seeing the number of broker-dealers fall from 5,100 to 3,950 in that time, I can say with confidence that broker-dealer management will rarely share any problems that are going on at the firm until it's too late for advisors to do anything proactive.

As an advisor, you don't want to be blindsided by the prospect of your broker-dealer closing.

For example, let's say that your broker-dealer falls into a net capital violation. The broker-dealer is closed, all accounts are frozen and you are left with the prospect of scrambling to find a new broker-dealer. From the time you start your due diligence for a new broker-dealer to switching your accounts, several months can pass. During that time, you're unable to service your clients until their accounts are switched to another broker-dealer.

Another common scenario is when your broker-dealer decides to sell the advisors and their assets to a larger broker-dealer, often leaving you powerless to voice your opinion on the matter as a new owner is thrust into your life.

The best way to avoid potential problems is to be proactive, so here are several ways you can check on your broker-dealer to determine if issues exist and how problematic those issues might be. The need to do financial and regulatory due diligence is greatest when looking at small to mid-sized broker-dealers, unless the broker-dealer has a deep-pocket parent company as financial backing.

Step 1: Use the FINRA Website/ BrokerCheck

BrokerCheck offers information on all current and many former registered securities brokers and all current and former registered securities firms:

1. Go to <http://brokercheck.finra.org>
2. Click on "Firm" box
3. Type in "Firm Name" and hit "return" or "enter"
4. Click on "Detailed Report"

Just as broker-dealers look at patterns with advisor compliance history when doing due diligence before extending an offer to join their firm, so should you look at broker-dealer compliance patterns. Red flag patterns to keep an eye out for include:

- Net capital violations (last five years)
- Disclosures reflecting a lack of supervision system
- Large fines paid out over the last five years for any of the categories (regulatory, arbitration, bond)

Firms that have been around since the 1970s will likely have more marks than a firm formed in the 2000s.

Merrill Lynch, formed in 1958, currently shows 1,527 disclosures with 1,000 of those being arbitrations. Are we concerned that Merrill will be closing their doors? Of course not, but for small and mid-sized independent broker-dealers, a pattern of several large fines paid over the last couple of years can be enough to spur a death spiral.

Step 2: Check the Timing of FINRA Audits

FINRA prioritizes their broker-dealer audits based on risk. What the self-regulator means by this is that higher-risk firms will be audited more frequently and, often, earlier in the year. Broker-dealers are audited once a year, every other year or once every four years. Broker-dealers that don't do municipal bonds and have a good compliance history may be audited only once every four years, otherwise the frequency will be once a year or every other year. A broker-dealer with a good compliance record may be audited by FINRA every other year with those visits scheduled in the second half of the year.

When a broker-dealer receives annual visits in the first quarter of the year, it can be a strong indicator of a problematic firm that is in the cross hairs of FINRA. There are exceptions to this, such as broker-dealers that are geographically close to a FINRA branch office, in which case it may be visited earlier than normal simply because their location is convenient.

One broker-dealer that closed in 2016 was geographically close to a FINRA branch office. Several years ago, FINRA conducted an audit that lasted nearly 10 months. The firm had numerous problematic advisors, which is why FINRA spent so much time conducting its audit (which normally takes several weeks.) The broker-dealer was so flustered by how long FINRA spent auditing them that they moved the home office to New York City with the hope that they would be lost in the sea of broker-dealers based there. The strategy didn't work as they fell into a compliance death spiral and closed.

Step 3: Review a Firm's Financials

To review a firm's financials, follow these steps:

1. Go to **www.SEC.gov**
1. Click on "Filings" then "Company Filings Search"
1. The result may go straight to your broker-dealer or give you several different broker-dealer names, so click on your broker-dealer name and state of domicile.
1. Click on most recent—Document (Paper) Focus Report
1. Click on Scanned.pdf (highlighted in red)

Two primary areas that you want to focus on with the Focus Filing are:

- Net Gain/Loss
- Net Capital and Minimum Capital Requirements



Obviously, you want your broker-dealer to be profitable. If it's showing a loss for the reporting period, investigate if prior Focus Reports also reflect losses.

Firms sometime have situations (usually FINRA fine-related) that can cause an isolated loss. So as with compliance, look for patterns. We've noticed that some firms will do Focus Filings that don't reflect whether they had a loss or profit, which we view as a potential red flag (possibly hiding that they are operating at a loss). Also of note are major bear markets, which can temporarily cause most broker-dealers to show losses, such as in the 2008-2009 market correction.

Net Capital—A broker-dealer's net capital is their backup money for worst-case scenarios. Some firms don't like to keep large amounts in net capital because they feel it may make them vulnerable to frivolous litigation or simply because it's looked at as dead money. If a BD has other sources of capital to tap into, then holding below-average amounts is fine. Otherwise, you want to see healthy levels of net capital on hand to weather regulatory storms.

The amount regulators require a firm to keep on hand is the minimum net capital. You can have a large broker-dealer

with a \$250,000 minimum net capital requirement but they keep a total of \$33 million of net capital on hand while a smaller broker-dealer with the same \$250,000 requirement may have only \$500,000 of net capital. When a broker-dealer has a legal situation arise that isn't covered by its E&O carrier, the net capital is what they dip into to cover legal liabilities, so the more the better.

The risk level of the business the broker-dealer conducts is another factor to consider, so if you have small or mid-sized firms doing concentrations of transactional stock and bond business, REITs, BDCs or alternative investments, you want to make sure they have a least \$500,000 of net capital on hand.

Net Capital Ratio—Another indicator of financial health is the firm's "Net Capital Ratio." This ratio is a measure of a firm's aggregate indebtedness to net capital. SEC Rule 15c3-1 imposes a cap of no more than a 15-1 ratio. However, we tend to favor firms that keep the ratio under 5:1, with a firm under 1:1 being a very healthy indicator of very little debt load.

Step 4: Watch for the Death Spiral 'Tells'

Most poker players have a 'tell,' and so do broker-dealers. Here is a sampling of potential tells to watch for that may indicate your broker-dealer is struggling and may very well be in a death spiral:

- High frequency of disparaging articles over the last five years in the press with large fines paid out (Google the broker-dealer name and many of them will show up)
- Focus reports that don't show "Net Gain/Loss" or show high net capital ratio above 5:1
- Multiple more recent Focus Reports showing Net Loss
- Number of advisors at the broker-dealer has been consistently decreasing
- No improvements in technology or services over last couple of years (firm appears to be coasting)
- Numerous increases in advisor expenses
- Heavy handed compliance audits or calls from compliance with inappropriate behavior directed toward you for the circumstance
- Lack of communication from management

The DOL fiduciary rule is going to make life significantly more difficult for broker-dealers, both on a profitability and litigation level, so more than ever, it's important to be proactive and make sure you are operating your business with a broker-dealer that is viable. Don't be caught with your head in the sand because it can very well leave you and your clients in a very difficult situation—one that could have been avoided with a little due diligence.