Investment ADVISOR
THE VOICE OF INDEPENDENTS
As published in the December issue of *Investment Advisor* magazine

Are Privately Owned Broker Dealers a Dying Breed?

By Jon Henschen

With the recent sales of broker-dealers, have you noticed how many BDs in the top 50 are privately owned? This was the question posed to me by David Fischer, CMO of Independent Financial Group, a broker-dealer based in San Diego.

Frankly, I hadn't thought about it. So I did some research. In 2008, there were 20 broker-dealers in the top 50 that were privately owned. Fast forward to 2014 and that number drops to 10, a 50% decrease.

During our conversation, Fischer said that his group is loving the fact that his firm is part of a decreasing pool of privately owned broker-dealers because their recruiting has been on fire—they recently brought on a $1.5 million producer within weeks of obtaining another large producer group.

One Master Is Better Than Two

Privately owned broker-dealers have always been attractive, primarily due to the fact that they can focus solely on serving the representative rather than two masters—the rep and corporate interests. This is reflected in another conversation of mine with a recruiter who had just left a large insurance-owned broker dealer. He shared a story about the president of his former broker-dealer who seemed fixated on pleasing upper management of the insurance parent company. Satisfying them meant cutting costs. One of his "brainstorms" was to buy cheaper booze for an upcoming conference—a move far more likely to irritate reps than impact any real cost efficiencies.

It boils down to this: With loyalties divided, insurance-owned broker-dealer management must cater to insurance company interests. Publicly traded broker-dealers need to satisfy share-holders. Privately owned firms have a singularity of focus that is reflected in a high-touch culture that is centered on representative concerns.

Balancing Representative & Corporate Interests

If you look at service surveys in our industry publications, that attention to the reps' needs is reflected in a broker-dealer's high scores and rankings. With the recent purchases of numerous midsized, privately owned broker-dealers (VSR, Girard Securities, KMS, WRP, SSN), the question will undoubtedly arise. Can these firms maintain the singular focus they had or will they have their attention splintered to parent company interests or satisfying shareholders? What makes this question even more tantalizing is the wildcard in our industry: the Schorsch empire. How will the broker-dealers in that empire achieve the balance between corporate and representative interests?

Rewards for Buyers and sellers

The timing of these broker-dealer sales is ripe for both parties. Sellers are being rewarded with prices we've never seen before in our industry. Where 30% to 40% of trailing revenue was the common range in the past, now prices as high as 100% are being offered.

For buyers, their reward is obtaining broker-dealers at the bottom of the interest-rate cycle, which will translate into ever-increasing profits when money market rates begin to trend up (prior to 2008, money market rates accounted for up to half of a broker-dealer's profits; money markets also contribute mightily to RIA custodians' bottom line, by the way).

Privately owned firms have a singularity of focus that is reflected in a high-touch culture that is centered on representative concerns.

For Nicholas Schorsch, purchasing firms with substantial American Realty CAP REIT sales at what appears to be an expensive price for their broker-dealers is actually quite reasonable when you consider the savings in revenue sharing they will pocket.

The challenges for these BD purchases will be retention of reps, especially the higher producers that every BD wants, and keeping representatives engaged with management.

Two Other BD Issues Still Loom

The independent broker-dealer community has consistently and loudly derided the Department of Labor's on-again, off-again plan to redefine fiduciary under the Employee Retirement Income Security Act. In late October, Labor Secretary Thomas Perez said the department continues to "reach out to stakeholders" regarding the redraft of its rule so that DOL can "understand with granularity" what the "nature of the problem is and what the nature of various stakeholders' concerns are" regarding the rulemaking.

When asked if DOL still plans to release in January the redraft of its rule to amend the definition of fiduciary under ERISA, Perez declined to answer specifically, referring only to the January redraft release date as cited in DOL's regulatory agenda.

A second, related DOL move will probably affect broker-dealers as well: Labor is likely to hold broker-dealers who chase IRA rollovers to the same fiduciary standards that retirement advisors must meet. ERISA attorney Fred Reish said in late October that with an estimated $2 trillion in the 401(k) accounts of baby boomers at stake, regulators are "taking it all very seriously."

Speaking at the Center for Due Diligence conference in San Antonio, Reish said broker-dealers should brace for tighter rules from the DOL, most likely as part of its wider effort to impose the fiduciary standard on more of the financial services world.

January or Later?

DOL had announced in late May that it would further delay release of the fiduciary redraft from August to January. The redraft, Perez told reporters in October, is "on our regulatory agenda and we continue to reach out and listen to various stakeholders [...] and we continue to learn a lot from them."

"We're proceeding under the assumption that there will be a proposal," Dale Brown, president and CEO of the Financial Services Institute, said during FSI's second Annual Advisor Summit in Washington.

Phyllis Borzi, assistant secretary of Labor for the Employee Benefits Security Administration and the main architect of the DOL's fiduciary rule, "is intent" on getting a fiduciary reproposal out, Brown told ThinkAdvisor.com at the late September FSI summit.

Robert Lewis, FSI's vice president of legislative affairs, noted at the summit that DOL's redraft could come even later than January, adding that FSI is still "actively educating Congress" regarding FSI's opposition to DOL's fiduciary rulemaking and urged advisors to help. — **Melanie Waddell**

Fewer of the top independent broker-dealers are privately owned: top IBDs by annual revenue

The Shrinking Ranks of Privately Owned IBDs

	2013 Gross Revenues $ Millions	Ownership Status	Fee-Based Revenues $ Millions	Avg. Gross Dealer Concession/Rep $ Thousand
LPL Financial LLC	$4,050.0	Public	$1,180.0	$234.2
Raymond James Financial Services, Inc.	$1,352.0	Subsidiary of Public Company	$540.0	$458.0
Commonwealth Financial Network	$822.1	Privately Owned	$440.4	$464.1
Northwestern Mutual	$654.5	Insurer-Owned	$308.6	$86.5
Cambridge Investment Research, Inc.	$574.4	Privately Owned	$277.7	$221.3
Securities America, Inc.	$475.0	Subsidiary of Public Company	$191.9	$271.4
Royal Alliance Associates, Inc.	$444.4	Insurer-Owned	$170.8	$239.6
Cetera Advisor Networks LLC	$436.0	Subsidiary of Public Company	$162.5	$189.6
Waddell & Reed Financial Advisors	$426.0	Public	$159.7	$199.7
National Planning Corporation	$382.7	Insurer-Owned	$94.1	$237.4
NFP Advisor Services	$381.0	Subsidiary of Public Company	$121.6	$298.8
MML Investors Services	$360.8	Insurer-Owned	$72.0	$60.1
Securian Financial Services	$355.4	Insurer-Owned	$75.1	$334.5
FSC Securities Corporation	$280.3	Insurer-Owned	$93.9	$241.0
Princor Financial Services Corp.	$279.9	Insurer-Owned	$38.1	$114.0
SagePoint Financial, Inc.	$278.6	Insurer-Owned	$76.1	$162.2
INVEST Financial Corporation	$278.1	Insurer-Owned	$53.5	$216.2
HD Vest Financial Services	$273.2	Private Equity-Owned	$100.1	$103.6
First Allied Securities, Inc.	$272.3	Subsidiary of Public Company	$74.4	$336.1
Transamerica Financial Advisors, Inc.	$267.3	Insurer-Owned	$57.0	NA
Cetera Advisors	$261.5	Subsidiary of Public Company	$89.1	NA
Signator Investors, Inc.	$261.2	Insurer-Owned	$39.7	$168.8
Woodbury Financial Services, Inc.	$250.8	Insurer-Owned	$32.2	$204.2
Cetera Financial Institutions LLC	$248.7	Subsidiary of Public Company	$14.8	$140.8
SII Investments, Inc.	$189.6	Insurer-Owned	$45.7	$274.2

Source: Investment Advisor annual survey of independent broker-dealers, June 2014

What's Driving BD Sales?

Beyond the high prices being offered for broker-dealers, the motives for recent sales include competitive and regulatory issues. Midsized broker-dealers in the range of $25 million to $75 million of revenue find themselves with a bit of scale, obtaining more revenue sharing from product vendors. They are also finding it necessary to offer more perks to both existing representatives and those joining the firm.

With small broker-dealers, expectations are simple: supervise representatives, process business and pay representatives in a timely manner. As firms grow, representatives' expectations increase for greater services such as practice management, marketing programs, internal product specialists and better technology.

The advent of outsourcing has helped greatly in providing services without increasing costs. However, internal product specialists and technology are unavoidable expenses that add to overhead. This is on top of the additional regulatory staffing all firms have needed to add to cover Dodd-Frank Act requirements.

Representatives considering joining firms frequently have expectations that up-front forgivable notes are

a bottom-line requirement. To compete, midsized broker-dealers grudgingly offer forgivable notes in the 5% to 15% range. Many of these firms prefer to cover transition expenses in making the change to their firm with no strings attached and offer a forgivable note as a last resort.

When midsized broker-dealers get into the $75 million to $100 million of revenue range we see less concern with regard to offering transition notes. This range is a key threshold for midsized broker-dealer growth to have the financial scale to meet demands for existing and incoming representatives.

Dodd-Frank Rears Its Ugly Head

An even greater driver to selling a firm is the Dodd-Frank regulatory environment. In years when we have major down markets, we typically see a spike of litigation for a few years after a correction, and then lawsuits and arbitrations diminish. We are now in a sustained up-market with the alternative investment malaise behind us.

Yet for just the first half of this year, FINRA fines are running at $42.4 million, compared to total fines of $57 million for all of 2013. According to the law firm Sutherland Asbill & Brennan, if fines continue at their current rate to an estimated $85 million, we will see a 49% increase over 2013 fines (see "FINRA Fines" sidebar, right). Most of these fines are related to books and records and trade reporting violations with the size of fines increasingly supersized.

With the ever increasing opaque complexity of Dodd-Frank and the long leash it gives securities law firms, both FINRA and securities attorneys can now generate substantial fines in both good and bad times, which is leaving broker-dealer owners fearful for the future. Privately owned broker-dealers with less than $100 million of revenue may feel compelled to be tied to deeper sources of capital, so selling to these larger broker-dealer conglomerates fills a need. These marriages bring access to capital not only to cover potential future litigation and FINRA fines, but also capital for additional services, technology and forgivable notes that were a struggle to provide prior to their sale.

It's becoming a dog-eat-dog world for broker-dealers under $75 million of revenue, and to paraphrase Norm from the sitcom "Cheers," some in broker-dealer management feel like they're wearing "Milk-Bone underwear." Those that have attained the $100 million mark will enjoy future prospects for high demand of their rep-centered culture.

An even greater driver to selling a firm is the Dodd-Frank regulatory environment.

FINRA Fines

Fines imposed by the Financial Industry Regulatory Authority in 2014 are poised to far outpace those reported by the regulator in 2013, according to an analysis released Aug.1 by the law firm Sutherland Asbill & Brennan.

FINRA assessed $42.4 million in fines in the first half of 2014, compared with $23 million during the first half of 2013.

Sutherland gleaned the fine data from FINRA's monthly "Disciplinary and Other FINRA Actions" publications. FINRA reported fining broker-dealers and associated persons $57 million in 2013.

If FINRA continues to assess fines in 2014 at the current rate, Sutherland said that 2014's fines will represent a 49% increase from the total fines reported by FINRA in 2013 to an estimated $85 million in 2014. "That figure would represent the highest amount of fines reported by FINRA since the financial crisis," according to Sutherland's analysis, and the most fines reported by FINRA since 2006 ($111 million).—**Melanie Waddell**

PO Box 56, Marine on St. Croix MN 55047
TEL 888.820.8107 651.433.3501
FAX 651.433.3570

jon@henschenassoc.com
www.FindABrokerDealer.com

©2014 Henschen & Associates, LLC