

10 Red Flags to Watch When Switching BDs

Market conditions aside, there are many situations that make pursuing a broker-dealer change inappropriate.

My next-door neighbor is a full-time artist. In our eroding economy, I'm concerned that his business flow will diminish, because an art purchase is a "want," not a "need."

When economies go into decline, we see the shift from want to need, as the stock markets increasingly focus on companies with products that fill needs rather than wants. Examples include companies such as General Mills for food, Target for staples, and in the case of my wife (and others), Hershey for much-needed chocolate.

When an advisor is recruited to a new broker-dealer, it can be a want or a need. For instance, our firm recently placed an advisor changing BDs based on need, parting ways at the broker-dealer's request.

But many recruiting situations are more want than need, and recruiting can take a backseat to more pressing matters. A recent email I received illustrates this point.

Clients Come First

In it, an advisor wrote, "While I appreciate you touching base with me and providing information/reasons/opportunities for changing broker-dealer, that is the last thing on my mind right now. My time and energy are being spent servicing and communicating with our clients. That client focus appears to be for the foreseeable future, given the state of the world economy."

I completely agree that clients come first and that advisors should keep their focus on their clients' needs during this market upheaval. To pressure advisors to make a change during this turbulent time is simply self-serving and inappropriate.

Market conditions aside, our firm has seen a number of situations where pursuing a BD change is inappropriate. Probably the best guide to determine this is the Financial Industry Regulatory Authority's **Registered Representative Composition Report**.

The report includes 10 categories that BDs should track. If an advisor meets any of these criteria, there's the potential that a change of broker-dealer could be problematic.

List of Red Flags

1. Representative new to the industry: A newer advisor will be under more scrutiny due to lack of experience; for example, their trades will be looked over in more detail. Otherwise, there's no issue changing broker-dealers.

2. Transferred from another firm: As long as leaving the other firm was voluntary and there is no open-ended compliance issue, this is not problematic.

3. Registered with three or more firms in the last two years: This has been increasingly problematic, as some advisors have a history of repeatedly switching firms every year or two.

Fewer firms are willing to bring on advisors with job-hopping histories, except for perhaps lower-quality BDs.

More difficult, still, is when an advisor expects to receive transition note money from a new firm when in reality, they may be lucky to simply have a firm make them an offer.

4. Termination: Many larger firms have blanket policies to not hire an advisor with an Employment Separation after Allegations within the last 10 years, while others will look at the context of the separation. Forging client signatures or unfilled forms that are signed by the client can make you a toxic consideration.

5. Multiple disclosures: One or two customer complaints isn't much of an issue. When you get up to three marks within the last five years you become problematic to a broker-dealer because you are problematic to FINRA.

The hiring broker-dealer may be required to perform heightened supervision on you, which is more liability and work for the compliance department.

We've seen advisors wanting to change BDs when they have as many as 17 disclosures on their record. In these cases, we've informed them that they should appreciate that they have a broker-dealer to call home.

Even for advisors with high production, or fees and commissions, over \$1 million in a year, being able to place an advisor with numerous disclosures on their Form U-4 is burdensome.

In cases such as this, if you are able to join a new firm, it may be one that is already a melting pot for troublesome representatives. In terms of "multiple" disclosures, those where there is no action taken, dismissed or denied are not included.

Also, if the disclosures are due to tax liens and other credit issues, finding a new broker-dealer may be workable, depending on the extent and reason for credit problems.

6. Customer complaint disclosures: This can work against you if the customer complaint is topically egregious, such as borrowing money from a client, stealing money from a client account or making unauthorized trades.

Claims such as market loss during a bear market may result in a fine, but will not hamper an advisor's ability to change BDs unless there is a repeating pattern.

7. Criminal disclosures: Sometimes these disclosures occur in an advisor's life before becoming an advisor, such as in college when wild oats are sown. These transgressions are usually not a problem.

On the flip side, we've seen advisors terminated over drunk driving convictions in recent history or having their homes raided by FBI agents who find child porn on a computer, which ended their career and resulted in prison time.

8. Financial disclosures: This was a large problem in 2008-2011, when some advisors had upside-down mortgages that they walked away from or had financial hardship due to loss of production with the market drop.

With the current market upheaval and future stagflation, we anticipate a resurgence in financial disclosures as well as customer complaints over market loss.

Over the last five years, broker-dealers have become much less tolerant of financial problems unless they were the result of divorce or health issues. If you have a recent tax lien, make sure you have a payment plan in place with the IRS or state before looking for a broker-dealer.

9. Previously with a severely disciplined firm: This was more of an issue back in the '80s and '90s when there were lots of penny stock firms in business, but that's not on BDs' radar often today.

10. Arbitration/civil litigation disclosures: Showing a pattern of arbitrations being paid is the litmus test for broker-dealers as is the amount of fines being paid.

One or two disclosures are typically not a problem. Three or more disclosures over the last five years can make finding a new firm difficult.

When fines are \$25,000 or less, it is perceived as a payoff by the broker-dealer to make the case go away and avoid

costly arbitration. If this is the case with your disclosures, it will hold less weight.

Also, BDs that focus on established advisors will frequently have arbitration levels above industry averages because established advisors have more disclosures than newer advisors.

The same is true for firms that specialize in illiquid investments (sought out by securities attorneys), such as alternative investments and REITs.

Civil litigation is rare and frequently is tied to legal conflicts with outside business activities, like real estate. We've never seen civil litigation become an obstacle to being considered by a broker-dealer.

More Considerations

During an audit of a broker-dealer, FINRA staff uses the Representative Composition Report as a guide to see if the firm is above the industry average in any of these 10 categories.

BDs have told us that FINRA expressed concerns about their having averages higher than that of the overall industry, and if they brought on any more advisors that increased that average, more FINRA visits and scrutiny could take place.

For example, if a BD ranks above the industry average in terms of customer complaint disclosures, and you have three customer complaint disclosures on your record, you could be rejected from consideration.

An advisor's production volume also comes into play on a risk vs. reward basis. A BD may reject an advisor with \$100,000 of yearly fees and commissions and with three disclosures, but accept an advisor producing \$500,000 and the same number of disclosures.

We see many situations in which an advisor wants to change broker-dealer but it's in their best interest to stay where they are due to the fact that they fall into one or more of the 10 categories in the Representative Composition Report.

If your motive to move is a need and you fall into one of the 10 categories, realize that it's getting increasingly difficult to maneuver through the marketplace with successful results as FINRA and BDs continuously tighten standards.

Numerous compliance issues that were not a big deal five years ago are now heinous.