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The Trouble With Being a Big Advisor at a Small BD

Advisors with large books of business sometimes consider joining a smaller broker-dealer to ensure that they rank in the top 10 or 20 in production (or yearly fees and commissions).

Getting the extra attention, service level and admiration from BD staff, management and peers certainly has its attractions. But the ground is shifting under these advisors—with many unaware of the dynamics affecting smaller broker-dealers as well as some midsized firms.

Recently, I was at our cabin property, where we have a small pond stocked with several fish species. After a very dry winter, the pond level dropped so low that it's doubtful any of the fish have survived due to oxygen deprivation.

For small broker-dealers, a similar situation is unfolding—with multiple factors drying up smaller firms' ability to compete in the marketplace. One of these factors, recruiting, disproportionately favors larger BDs. Here are some of the factors at play.

A Struggle to Attract Advisors

Lacking the ability to offer forgivable note money, which advisors increasingly assume is part of the transition equation when they switch firms, smaller broker-dealers are frequently left out of consideration—because they don't have the discretionary capital to offer transition notes.

Besides their struggles to bring advisors into the firm, these BDs find their advisors retiring at an increasing rate or going fee-only. This means small broker-dealers are becoming ever smaller. Besides a drought in recruiting, their profit centers are being affected by regulatory and industry trends.

Declining Profit Centers

A broker-dealer executive who recently sold his firm told me that with the Securities and Exchange Commission's Regulation Best Interest (or Reg BI) in place, variable annuity revenue—which had accounted for a substantial portion of his firm's revenue—would drop dramatically going forward. He felt fortunate to sell when he did.

Smaller broker-dealers may only make one or two basis points on the sales of mutual funds and variable annuities, as well as on handling the assets themselves. Large broker-dealers will earn five to 10 basis points on both the assets and the sales of these products, leveraging their size to gain bargaining power.

Another profit center drying up is mutual fund sales, as advisors increasingly shift to ETFs, which have much smaller revenue-sharing agreements from product vendors. Many smaller broker-dealers have higher concentrations of mutual funds and variable annuities than larger firms, which have greater concentrations of advisory assets.

Besides the fact that these profit centers are on the decline, smaller broker-dealers lack the ability to be rainmakers on services that drive growth.

A Lack of Quality Services

In a recent ThinkAdvisor **interview**, Michael Rose, associate director of wealth management research at Cerulli, summed up the state of large firms versus small firms: "BDs need to invest significant amounts of capital to operate and maintain brokerage and advisory platforms and increasingly sophisticated advisor-facing technology tools, in addition to other areas of their business, while facing increasingly competitive threats."

In addition, Rose explained, "Greater scale enables firms to increase these relatively fixed investments, and returns on those investments can increase significantly when they support a larger number of advisors and assets under management. Investments made in these areas can significantly increase the appeal of a broker-dealer to prospective advisors, better positioning firms to increase market share."

So, larger scale makes these firms more appealing and more likely to grow. Advisors are starting to appreciate this—and it's influencing their perception of small broker-dealers.

Perception Is Everything

Right or wrong, the current advisor perception of small broker-dealers as firms without a deep-pocket parent firm or other capital backing is this: Small BDs will struggle to keep up with regulatory requirements and be profitable, requiring them to sell or merge.

This perception eventually becomes a self-fulfilling prophecy, as getting advisors to think otherwise is the equivalent of swimming against the current.

Small broker-dealers also have a regulatory disadvantage, because the Financial Industry Regulatory Authority restricts their growth in terms of how many advisors they can add from one year to the next. Large firms have no such restrictions.

Also, FINRA fines for infractions are disproportionately detrimental to small broker-dealers. A $500,000 fine is of little consequence to a large broker-dealer.

But for a small firm, it is potentially a net capital violation. They might have to close their doors, while advisors' client accounts are frozen—sometimes for months, as we saw when IFS Securities had a net capital violation caused by a rogue bond trader.

Further diminishing the appeal of smaller broker-dealers is the fact that many of these firms are a refuge for advisors with multiple compliance disclosures—which, like carp in a pond, muddy up the waters of risk exposure.

As an example, many larger firms have blanket policies for not bringing on advisors with employment separations for cause. Many smaller firms seem to have no issue in bringing on someone with a recent employment separation unless FINRA intervenes and threatens them due to a ranking that puts them above the industry average in any of the 10 categories included in Registered Representative Composition Reports.

What Constitutes a Small BD?

By FINRA standards, a small broker-dealer is one with under 150 advisors.

From a recruiting perspective, we use broker-dealer revenue to measure size. A firm with less than $25 million in revenue is a good example of a small firm.

Firms that are more immune to small broker-dealer vulnerabilities tend to specialize, such as in alternative investments. Some less-vulnerable small firms have access to outside capital backing—such as a BD that also owns an insurance marketing organization (IMO).

At what size does a firm have the ability to easily handle compliance requirements, offer quality service and thrive? We tend to view standalone BDs with $100 million in annual revenue and up.

If you're a large producer at a small broker-dealer, reality dictates that the grass is greener at midsized and large broker-dealers—where you can have the tools necessary to thrive and the comfort of knowing that the foundation you are building on is sound. Still, getting a lot of attention from your broker-dealer won't matter if their profitability pond dries up.

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