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Which Broker-Dealers Will Survive? Malcolm Gladwell Offers Some Answers

Determining the ideal elementary school class size has been a hotly debated topic for a number of years. The prevailing wisdom is that smaller is better. But is that always true? In his book *"David and Goliath,"* author Malcolm Gladwell uses the "Inverted U Curve Principle" to demonstrate the ideal class size.

I'd argue that the U Curve provides interesting insights into the ideal size for a broker-dealer, and suggests which BDs will survive in the current market and regulatory atmosphere.

But first, let's explore Gladwell's research.

Gladwell explains that there are three parts to the inverted U curve, and each part follows a different logic. On the left side of the curve, doing more or having more makes things better. On the flat middle, doing more does not make much of a difference. On the right, doing more or having more makes things worse.

According to Gladwell, it turns out that 18 students is the perfect class size. This is because there are enough bodies in the room so that no one feels vulnerable, but everyone can feel important. A class size of 18 also divides nicely into groups of two, three or six. At this size, the teacher can attend to each student when needed. When you get to 24 students, the class verges on having the energetic mass of an audience instead of a team. If you add 6 more students, for a total of 30, the energetic connections weaken to the point that even the most charismatic teacher cannot maintain the magic.

Out of a decade teaching, my wife recalled her first year having 38 students in a fourth grade class. She referred to that first year as her baptism of fire. Four students in the class had behavioral issue problems, with one of the students threatening to take a crowbar to her head and addressing her with numerous expletives. She spent the majority of her time managing these four students, while the rest of the class suffered with virtually no support from the principal.

Gladwell points out how many wealthy parents send their children to private schools thinking that small class size will be to their child's benefit. However, when you go small, say down to 12, you have the Last Supper. A group of 12 is small enough to fit around the holiday dinner table but too intimate for many students, who may wish to protect their autonomy and are too easily dominated by the bombastic or bullying personalities in the group.

When you get down to six students, there is no place to hide, and not enough diversity in thought and experience to add the richness that can come from numbers. The small class is as difficult for a teacher to manage as the very large class. As one teacher put it, when classes get too small, the students start acting "like siblings in the backseat of a car. There is simply no way for the cantankerous kids to get away from one another."

Gladwell uses the inverted U curve to make a compelling argument regarding optimal classroom size. I find that the principle also applies to broker-dealer size.

The U Curve and Broker-Dealers

We see a similar inverted U curve when looking at the size of independent broker-dealers, with midsized broker-dealers reflecting the sweet spot for overall satisfaction. Note that when I refer to independent broker-dealers, I am not including BDs that have both retail and independent channels because that model yields an apples-to-oranges comparison.

If you look at broker-dealer surveys, you see a clear pattern of rankings for overall satisfaction that is concentrated in the midrange, with the low-end of midrange being broker-dealers having approximately $50 million of revenue. On the top end of midsized BDs, we see satisfaction start to decline when they reach the size of 2,500-3,000 reps. All the firms with very high satisfaction levels also have average production per advisor numbers on the higher end for our industry, which is about $200,000 or higher.

When you have numerous smaller producers within a firm, the phone lines tend to get tied up because these advisors are on a learning curve. When larger producers call in, they can't get through in a timely manner. Firms with numerous small producers also tend to have compliance policies that cater to the lowest common denominator. At a firm we know well that has a high satisfaction ranking, average production per rep is in the $400,000 range. This firm's comment on compliance is, "We don't have compliance that caters to the lowest denominator because we don't have lower denominators. We don't bring on advisors unless they have over $200,000 of gross dealer concession."

How Revenue Affects a Firm's Response to Regulation

The low end of midrange broker-dealers with approximately $50 million of revenue is probably the minimum level of revenue for managing the increasing burden of regulation and achieving good satisfaction results. At $50 million to $75 million of revenue, firms are less concerned with their ability to handle staffing costs and are able to maintain robust net capital levels.

At the $100 million level, concerns regarding regulation are minimal to nonexistent as the company scale enables them to easily manage proper staffing levels. For the smaller firms, the obvious strength is service and their ability to have deep relationships with the advisors. Where these smaller firms come up short is access to capital, ability to supply services that will help advisors grow to the next level and the ability to compete for recruits in the marketplace when they are not able to offer competitive amounts of transition money.

Smaller firms can also end up being repositories for advisors that other firms won't take due to a range of issues, including compliance problems, skewed product mixes, credit issues and low production. The irony is that small broker-dealers can least afford the regulatory heat these issues potentially bring to broker-dealers. To counter this, small firms have the ability to know and supervise their advisors on a more personal level than large broker-dealers are capable of doing.

As one smaller broker-dealer president put it, "Larger firms are going to need more net capital because they are going to spend it on a greater frequency of litigation. We know and are able to track our advisors much better than advisors at firms where they get lost in the forest of trees."

While there is some truth to this, smaller firms also have less room for error. The advisors at these smaller firms are insecure due to the fact that their broker-dealer is potentially only one arbitration away from a net capital violation.

The Rule of 150

For larger broker-dealers, I am going to refer to Malcolm Gladwell again, this time referencing his book, "*The Tipping Point*." Gladwell talks about the "Rule of 150," where the size of any grouping of people is a subtle contextual factor that can make a big difference to that group's behavior.

Gladwell illustrated the Rule of 150 using the company Gore Associates, a privately held, multimillion-dollar high tech firm that is best known as the manufacturer of Gore-Tex fabric. At Gore, there are no titles and all employees wear nametags. Under their names on those tags is the title "Associate," regardless of how much money they make or the level of responsibility they have. The atmosphere is one of "us" rather than "management and us."

Gore is a large, established company attempting to behave like a small entrepreneurial startup. It has a rate of employee turnover that is about one-third the industry average, and has been profitable for 35 consecutive years with an innovative, high-profit product line that is the envy of the industry.

Gore discovered on its own that the way to achieve this is to adhere to the Rule of 150, though the company stumbled onto the principle through trial and error.

Gore's late founder, Bill Gore, once told a reporter, "We found again and again that things get clumsy at 150, so 150 employees per plant became the company goal." When asked about long-term planning, the company's response is simple. "That's easy, we put 150 parking spaces in the lot, and when people start parking on the grass, we know it's time to build a new plant." Today, Gore has 15 plants within a 12-mile radius in Delaware and Maryland. Each plant only has to be distinct enough to allow for an individual culture in each.

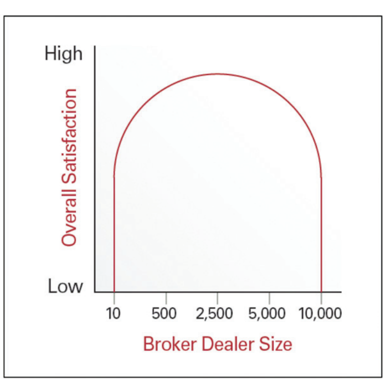
Small and midsized broker-dealers frequently have a "We're all in this together culture," with no overt ivory towers in management.

BD Back Offices and the Rule of 150

While broker-dealers are different than manufacturers, the Rule of 150 applies to the back office contact points where advisors regularly interact with their BD. These include but are not limited to business processing, answering the phones, trading, cashiering, service desks, new accounts and direct business. (Back office departments such as accounting, legal and compliance do not need to be included in the Rule of 150 since they are not contacted by advisors on a regular basis, if at all.)

One broker-dealer with 1,400 advisors that consistently ranks in the Top 10 on satisfaction surveys had 80 staffers in the departments above, well under the Rule of 150. Another firm we surveyed has consistently ranked in the Top 10 as well, but its growth is nearing the 3,000 advisor mark, with over 190 people in operations. Over the last year, we've been hearing rumblings from this broker-dealer's advisors about the decline of overall service.

We may well see future surveys reflecting growing dissatisfaction and lower survey scores. With the operations area over the 150 threshold, the ability to maintain top-notch service will become increasingly difficult.



Broker-dealers on the large end of the midsized category—with 1,000 to 2,500 reps—enjoy a sweet spot of both service and services provided. Firms in this range that have high-quality service levels also have the added benefits of scale. This affords them the ability to provide comprehensive services that can help advisors get to the next level, which can include practice management, greater breadth of technology and integration, marketing programs and services specialties in 401(k), 403(b), insurance or endowment models.

The melding combination of quality services with quality service makes for a compelling combination that high-end producers find very attractive.

Us Versus Them (Management)

If you recall the Gore Associates story, there was little distinction between staff and management but rather an atmosphere of "us." This is in direct opposition to the "us vs. management" style, which is an interoffice battle larger broker-dealers frequently encounter, with the byproduct being a negative effect on employee retention.

A former employee at a large broker-dealer shared with me his resentment with a back office that was "upper management vs. employees" or "the haves" vs. "the have nots." In this case, the division was between those who received company stock versus those who did not. He also recalled a member of upper management's multi-million dollar home being featured on the cover of "Home and Garden" magazine the month the firm went public, which rubbed salt in an already open wound.

Small and midsized broker-dealers frequently have a "We're all in this together culture," with no overt ivory towers in management. As broker-dealers become increasingly large, senior people become isolated from the front lines (operations), which results in increased turnover of front line people and declining service.

"Us vs. Management" back offices have a very low loyalty level, so the first opportunity that comes from the outside is often taken. High turnover in operations results in advisors talking to staffers who are frequently on steep learning curves, translating to incompetence in the minds of the advisors.

Producer Groups Attempting to Fill Service Void

A needs-driven development trend at large broker-dealers is the formation of producer groups, which set up their own administrative back office service for the advisors in their group. The narrative goes something like this,"We have our own premier service desk, so you can bring your issues to us and we'll do the legwork with the broker-dealer to get you prompt resolution." What is really being communicated through these producer groups is the message, "Our broker-dealer's service is so horrible, we had to establish or own administrative services so you won't have to call the home office and deal with incompetent, inept people that will quickly try your patience."

Should advisors really be expected to establish their own administration office in order to get acceptable service? Is it too much to ask for quality service directly from the broker-dealer?

Back Office Consolidation

Multi-broker-dealer owners are attracted to back office consolidation for cost savings. Ladenburg Thalmann (which now runs five independent broker-dealers) has taken an approach similar to that of Gore Associates, where it buys midsized broker-dealers but keeps the management and staff largely intact, with back office consolidation kept to a minimum. This has benefited Ladenburg's stable of broker-dealers with largely high overall satisfaction levels. For other owners of multiple broker-dealers, we are seeing a trend toward consolidating most of the back office functions to one or two locations.

Yes, this offers great cost savings, but long-term advisor satisfaction is likely to drop as these firms battle against the Rule of 150 or get above a 10:1 advisor-to-staff ratio.

Many large firms are quite content with back office service being only adequate. They will ride the line of having just enough service to keep reps from leaving, but are not motivated to make the changes that would get advisors to love their broker-dealer experience.

For them, having mediocre satisfaction rankings is of little concern. The large broker-dealer's enticement, or cheese, is scale, services and a big upfront check to lure advisors into their mousetrap. Perhaps for them the Rule of 150 makes high-quality back office service nearly impossible to accomplish, so they focus on other strengths.

Large Firms Want to Appear Smaller, Small Firms Want to Appear Larger

A recent e-mail conversation on this subject with a friend, who currently wholesales but was previously president of a small broker-dealer, made an interesting point. He noted, "Big firms want to appear smaller and more personal while small firms want to appear larger and thus more solvent." Demonstrating this tendency, my friend recalled recruiting an advisor who had just visited a very large broker-dealer. "The advisor laughed when we first met," he said, "because he observed that we sent a hired sedan with a driver to the airport and the large firm sent an employee."

For midsized broker-dealers that rank high on overall satisfaction surveys, neither insecurity is of concern. They've found the sweet spot.

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HENSCHEN & ASSOCIATES, LLC.
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PO Box 56, Marine on St. Croix
MN 55047
TEL 888.820.8107 651.433.3501

jon@henschenassoc.com

www.FindABrokerDealer.com