Examining the Diminishing Broker-Dealer Landscape

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BEDFORD AND MAIN
FINANCIAL CONSULTING

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This summer FINRA released a statistical report with detailed insights on registered reps, registered broker-dealers and select market activity: *2018 FINRA Industry Snapshot*. It was the first report of this nature, providing interesting raw data on multiple topics. This was a welcomed publication, as such data has been scarce. Supporting the report, FINRA offered even more supplemental details on their web site.

Basic information explaining the makeup of the broker-dealer industry has proven difficult to obtain. When it is available, the complexities of the industry create so many exceptions that the statistics become somewhat fuzzy. Self reporting by the correspondent clearing firms in past years has given strong, if not always precise, indications of where the industry stood. But this covered only a segment of the broker-dealers. Neither FINRA, nor any other leading industry participant, paints the entire picture to provide a broad understanding of today's brokerage industry.

As a consulting firm that focuses on broker-dealers (B-Ds), we often have discussions with clients, particularly new start-up firms, who are looking to understand the big picture of what makes up the industry. This paper will attempt to expand on some of the particular points noted by FINRA and to provide more color on industry trends related to the makeup, business models, and structure of the current broker-dealer environment. Some of this "color" is admittedly subjective, so be forewarned that insights and commentaries from our personal experience will no doubt influence the interpretation of some of the trends indicated by the data. Additionally, please note that to emphasize points we use some ballpark numbers and illustrations that are not to scale.

How Severe Is the Industry Turnover of Brokerage Firms?

To begin, allow us to highlight one of the more noteworthy points to extract from FINRA's report: the loss of broker-dealer firms, and indeed, the turnover within the entire industry, has been nothing short of dramatic. 2002 closed with 5,374 registered broker-dealers. By the end of 2017, 2,909 new firms had joined FINRA, but a walloping 4,557 firms had closed. This left a net decrease of 1,648 broker-dealers in existence, or a 31% loss in 15 years. Despite the addition of new participants each year, 2017 closed with only 3,726 registered firms.

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Examining the Diminishing Broker–Dealer Landscape

While we don't want to sensationalize these statistics, it is tempting to say thank goodness for the new firms that were added. Without them, the industry would now be looking at a mere 817 brokerage firms supporting the US markets. But without any sensationalism, the reality of adding 2,909 firms, while losing 4,557 on a base of 5,374, equates to an industry turnover of almost 139%. And no, the 2007-08 crisis, surprisingly, was not a significant contributor to so many firms folding. The percentage of firms folding has been strangely consistent throughout the 15 year period, typically in the 6-7% range. However, the number of *new* firms did markedly decline after 2008, from the 5-6% range, to new firms averaging only 3.2% of the annual totals.

FINRA provided a current registration update that reported as of July 2018, there were only 3,690 member firms. As this is clearly a fluid statistic, we will move forward using 3,700 as our working number of current FINRA-regulated broker-dealers.

Examining the Diminishing Broker–Dealer Landscape

WHY THE CARNAGE?

Technology

Compliance

Survival of the Fittest

For the last few decades industry analysts, far more qualified than this author, have published their rationale for so many firms failing over the years. A couple of the most accepted reasons, which we also embrace, have been well-documented as major trends.

Technology

The ever changing demands, coupled with a mind numbing pace of change, made technology issues the moving target every firm had to hit. Some firms simply bet wrong. They committed to the wrong vendors, for the wrong solutions, or simply made what proved to be bad choices early on. A few major providers emerged who consolidated related services and grew to dominate segments of the industry. Third party cottage providers also emerged with fairly sophisticated targeted solutions that became cost effective. Senior management had to be knowledgeable, astute, and at times perhaps lucky, when committing to long term system expenses on so many levels. Unfortunately, the technology sword also cut in another less anticipated manner. Technology allowed the industry to commoditize previous revenue lines and to push spreads to bare minimums. Our markets prided themselves on how much they could lower the cost of delivering services and still increase efficiency. The culture of financial services firms evolved to embrace these changes.

Examining the Diminishing Broker–Dealer Landscape

Today we boast our abilities to execute and settle retail trades in two days for the price of a coffee. Some firms just could not adjust their business models quickly enough. Technology created exceptional competitive advantages. Nonetheless, in the end, most would argue that despite the rapid change and failure of so many of firms, this has been a positive trend for the ultimate consumers of our services and for the free markets.

Compliance

Certainly a topic not so warmly embraced in the industry, compliance evolved from a required function, to an often overwhelming force to be administered. The "cool" factor is missing here, while the increasing demands have surely added tension within the industry. We would join the ranks who argue that the burden for smaller firms is exponentially more difficult. It would not be a hard task to list all of the new regulations that have been added these past years. Yet, this author more applicably recalls a conversation with a small Michigan firm of 15 or so advisors, who was closing the B-D to become an OSJ of a larger firm. The founder summed it up by saying that now his job was predominantly compliance and "the joy was gone" in running his own firm.

Here too, there were multiple effects that compliance initiatives had on reducing the number of players in the industry. On the other side of the coin, to be frank, more than a few firms that folded deserved to do so. Some firms were simply not managed properly, either from a lack of innate talent, or a lack of the proper ethics and integrity demanded by this industry. As compliance issues came to the forefront, be it through regulators or litigation, there was a distinct toll taken on broker-dealers who did not manage their shops in the controlled and ethical manner most of us completely support. No tears here.

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Examining the Diminishing Broker–Dealer Landscape

Survival of the Fittest

Despite all that we may legitimately complain about the regulatory environment, allow me to offer a personal insight as a third factor of why so many brokerage firms folded**: Because they shouldn't have been allowed to start in the first place.** The argument here is simple: The industry can do more to control its own turnover with tougher, perhaps more realistic, capital requirements.

We live in an industry where quite often important indicators are reevaluated for how relevant and practical they remain under the current environment. How then do we rationalize forming broker-dealers with $5,000 in capital? Ironically, we even still refer to them as nickel B-Ds. We have often conversed with owners who claim they can't afford the basic requirements demanded by the industry. One can easily see where they are tempted to cut regulatory corners. Related to this, introducing brokers have folded when their clearing firm itself folded, and no other firm would pick them up. Owners claim that if they had to pay more than a few thousand dollars a month for clearing, they would fold. Some did. It is questionable if the industry ever should have approved brokerage firms that cannot afford to have a stable clearing firm support their client's activity.

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Examining the Diminishing Broker–Dealer Landscape

THE PYRAMID—WHAT MAKES UP THE 3700?

Analyzing the existing group of active brokerage firms can be done on various levels. None of these have absolutely precise numbers available. Each grouping has so many exceptions, that by completely dissecting every bit and piece, you risk losing the message. Allow us to use general numbers. The picture will be clear enough for the points to be understood.

At the top of the pyramid are the self-clearing brokers. Obviously the largest of the B-D firms, this group will include all of the correspondent clearing brokers and those who simply clear for their own proprietary business. Not all firms "self-clear" in all products and in all depositories. Some may clear just OCC options, while others clear just equities via DTCC. *

The major depositories make public lists of their members, but these are heavily inflated by multiple participants for affiliated companies and various business lines. For our purposes, we will consider a broker-dealer firm to be "self-clearing" if it is a direct member of any of the DTCC clearing services (equities, fixed income, mutual funds) or the Options Clearing Corp services (equity or index).

Using this definition, it would be very generous to say the total number of US-registered brokerage firms, who are self-clearing members, is around 190. Within this elite group of 190 self-clearing firms, the participants who provide correspondent clearing services for introducing firms to access the markets have also diminished over the years. Again, some may clear limited security types, while others offer more comprehensive market access. Nonetheless, the total universe of firms that offer correspondent clearing services is no more than 30, if we include those with a minimum of at least 10 clients. Even these numbers include some fairly small players, not well known in the industry.

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*We are not considering participants who only clear repo or stock loan activity

Examining the Diminishing Broker–Dealer Landscape

Many of the statistics referenced are based on data provided by La Roche Research Partners LLC. LaRoche publishes an annual report of *US Broker-Dealers Retail Clearing Relationship Changes*. Their June 2018 report tracks eleven major retail-based correspondent clearing firms, the largest, of course, being Pershing and Fidelity. While the report actually reflects 1,866 total retail and institutional relationships, they note that because many introducing firms have secured multiple clearing relationships, the actual number of relationships reported by the correspondent clearing providers is much higher than the true number of IBs. **LaRoche confirmed that in total there are approximately 1700 introducing brokerage firms under FINRA.**

The definition of what constitutes an "institutional" firm can vary. One meaning frequently applies to firms that process trades on a DVP/RVP basis. For our purposes, to distinguish the institutional clearing firms from the retail-based clearing firms, we also looked at those clearing firms who support prime brokerage and market maker activity, in contrast to traditional investment vehicles. We noted there is a significantly smaller market of institutional introducing brokers. BofAML Financing and Clearing, and Goldman Sachs Securities Clearing Services have dominated this segment of this clearing industry for quite some time.

REMAINING SEGMENTS OF THE BROKER-DEALER MARKET

Aside from the self-clearing firms and the traditional introducing brokers they serve, there are lesser publicized firms with more focused models. Interestingly enough, if you combined their numbers, these 1800 B-Ds represent about half of the industry.

They breakdown as follows:

Examining the Diminishing Broker–Dealer Landscape

- **Specialty B-Ds:** This term was coined by LaRoche to encompass the remaining cluster of firms that offer very specialized and focused products. Examples include select private placements, tax shelters, insurance-linked securities, and life settlements. For our purposes, we will also consider the Capital Acquisition Brokers as specialty B/Ds. In their 2018 industry snapshot, FINRA noted they added two new categories for firms: Capital Acquisition Brokers (CABs) and Funding Portals (FPs), (Although the FPs are not technically broker-dealers, they are regulated by FINRA.) We ballpark the specialty B-Ds at 180 firms.

- **Wholesale Distributors:** These firms must be registered as broker-dealers with FINRA and typically have significant capital. They are approved as a variable annuity and mutual fund underwriter or sponsor, and some are authorized for private placements. There are 200+ firms listed as distributors.

- **Referral Brokers:** These firms primarily refer customers to another entity's products or services. This group includes third-party marketers for hedge funds. There are currently 200+ FINRA regulated firms.

- **Direct Mutual Fund and Annuity B-Ds:** Typically these are smaller firms only authorized to sell traditional "check and app" products for private placements, variable annuities, and direct mutual fund products. Almost 230 are under FINRA today.

- **Private Banking and M&A Activity:** Representing nearly 1000 registered broker-dealers, these firms run the gamut in size and can represent broker-dealers that are significant players in the mergers and acquisitions arena.

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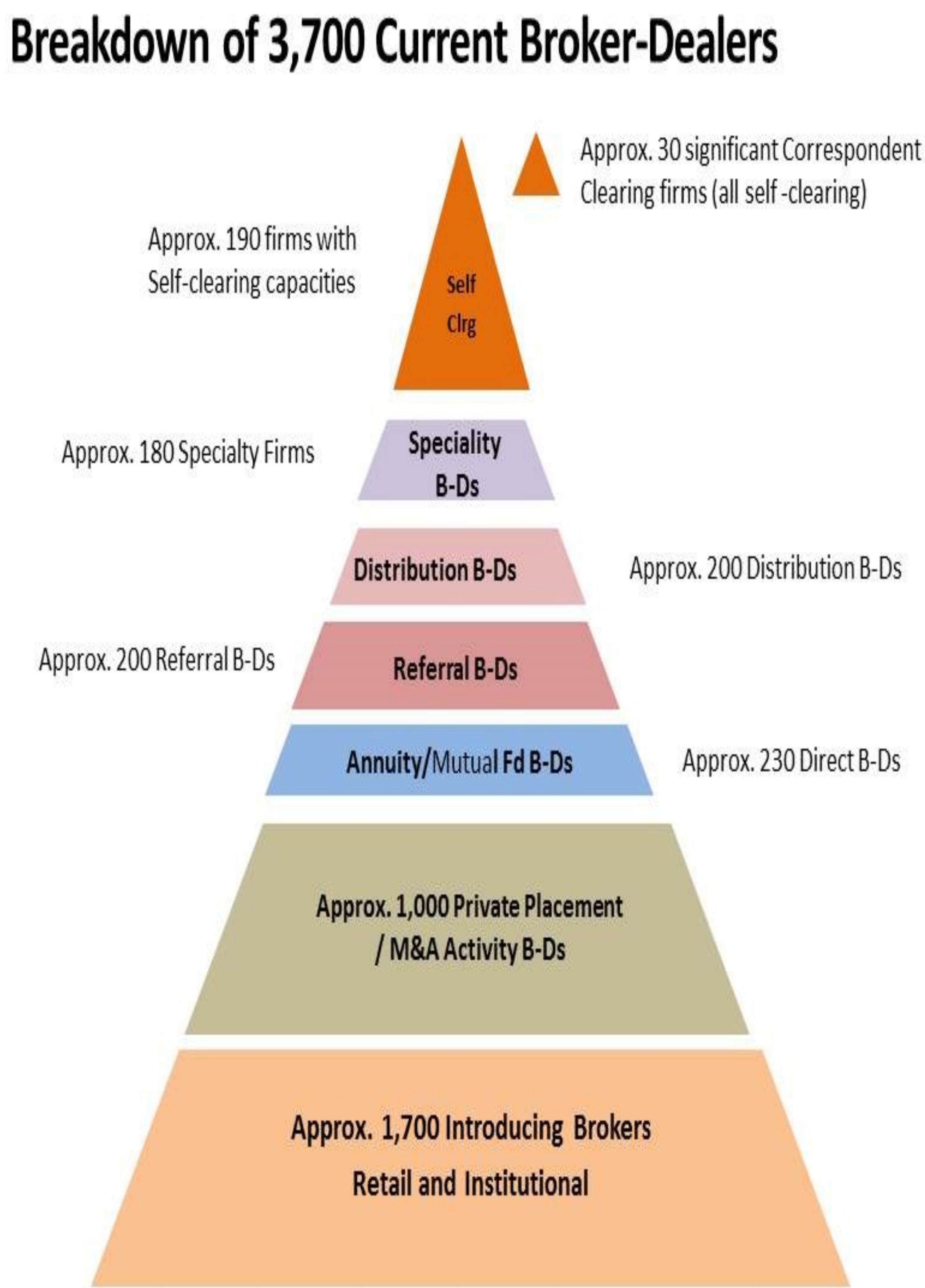

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Clarifications and Definitions

Size Doesn't Matter: It is important to clarify that the size of the broker-dealer does not necessarily dictate whether it will be a self-clearing firm. Indeed there are a significant number of introducing brokers who have enough capital and financial strength to easily become direct members of the clearing corporations and depositories, but elect not to do so. In days gone by, there was a perceived progression in the industry where brokerage firms viewed achieving a self-clearing status as an ultimate goal as the firm grew and prospered.

The primary factors that drove the evolutionary step to go self-clearing were the desire to control expenses, to customize and differentiate the firm via technology, and to have tighter control of customer service.

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This is still the case to a limited degree. However, the factors we noted previously related to dealing with the challenges of technology and compliance issues, also played a heavy part in self-clearing activity plateauing out. Added to this was a noted reduction in basic industry talent. As technology, automation, and the goals of "straight through processing" led the industry for decades, less personnel gained the nuts-and-bolts knowledge of how things actually worked. Couple this with a marked total headcount reduction in the industry in recent years. *

But Location Does: In fact, over the past decade a new trend was seen, wherein some self-clearing firms reverted all or part of their services back to an introducing broker status. Geography now plays a more significant role in the ease of drawing necessary talent to operate a self-clearing broker-dealer. Following the New York/New Jersey region, Chicago is arguably second, with perhaps Dallas or Miami third in the race. Outside of these areas, a firm will face more recruiting challenges. A good margin clerk is hard to find.

*Source: U.S. Census Bureau, 2012 and 2007 Economic Censuses

Examining the Diminishing Broker–Dealer Landscape

Size Doesn't Matter, Take 2: As a point of clarification, FINRA breaks down firm "size" based on the number of registered employees: small firms are up to 150, mid-size firms are from 151 to 499 and large firms have 500 or more registered employees. In 2017 FINRA regulated 3,353 small firms, 195 mid-size and 178 large firms using this definition. While there are some natural correlations between the number of registered employees and a firm achieving a self-clearing status (typically more staff are needed to run a larger operation), there is actually no direct connection that can be made between the FINRA size designation and any clearing status, or any operating model.

W2 Versus 1099 Staff: Another issue to clarify is that the FINRA report does not differentiate between firms depending on their payout structures. The business models between firms hiring financial advisors only as 1099 independent contractors, or as full staff (W2 employees), are often even mixed within a given brokerage house. While this is considered a critical differentiating point in the industry, it was not relevant to FINRA's findings.

Proprietary Trading Firms: We mentioned institutional firms, but should clarify a bit the definition of a Proprietary (Prop) firm. Prop firms are usually trading their own books of business (principle transactions) and often have one predominate business model and a few related models, such as an algorithmic trading group, which also does various types of arbitrage trading. No revenues are generated from commissions for agency placed trades. Financing from a parent entity, or clearing firm, is often a key component and there is usually some stock lending, prime brokerage or repo processing involved, depending on the model. Often designated market maker firms use that activity as source inventory for their other core business lines. These firms may, or may not, self-clear or use a clearing firm.

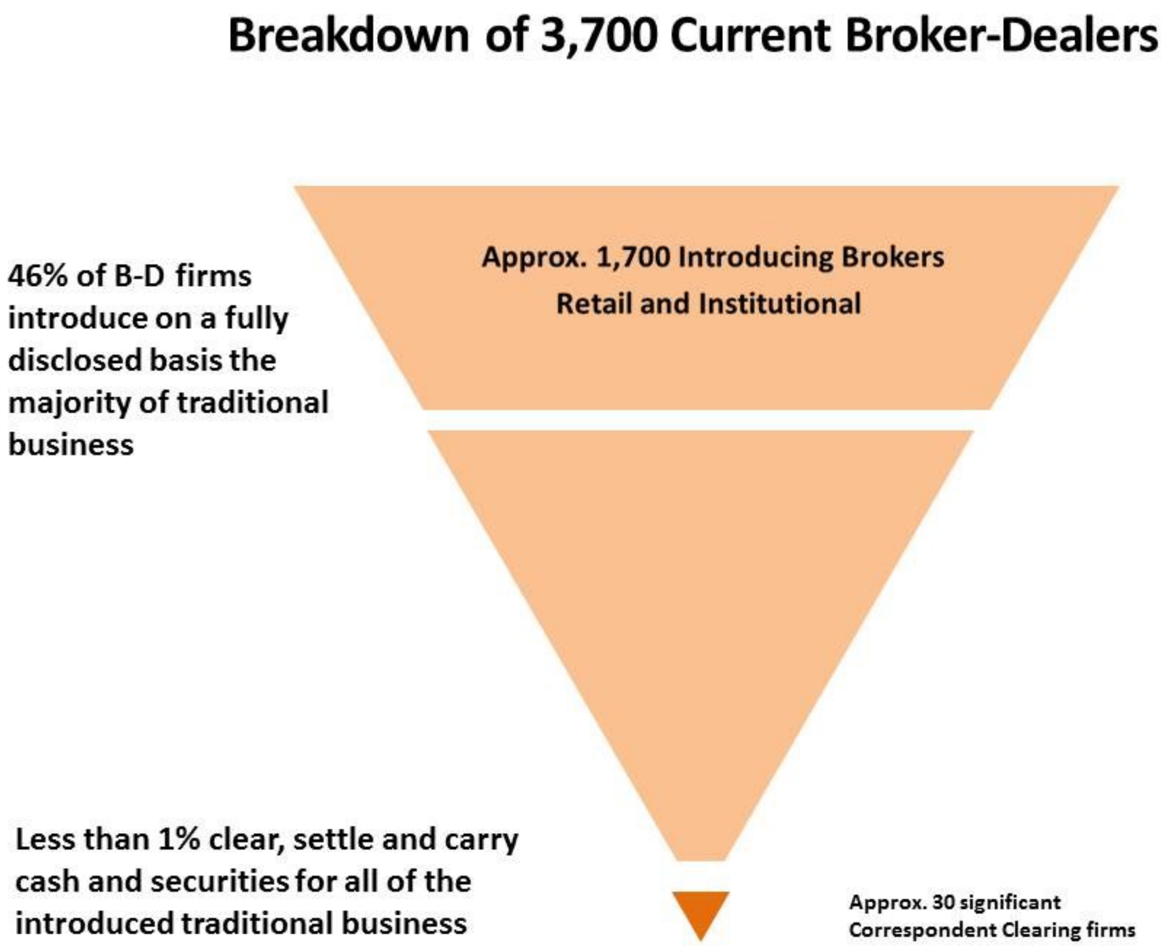
Life Outside FINRA: FINRA notes that it is responsible for every brokerage firm doing business with the US public. There are other brokerage firms that are also registered with the SEC and regulated by the various exchanges in which they are members. They do not deal with the public. These are also reported on BrokerCheck, and each indicates their respective regulating bodies (such as the CBOE Exchange). The types of businesses they are approved for are typically as "trading securities for own accounts" and "put-and-call broker, dealer, or option writer". Effectively they are 100% proprietary trading entities with no clients. FINRA did not include these on its report, nor did this paper consider them, but separately FINRA's website lists 84 such firms.

Examining the Diminishing Broker–Dealer Landscape

Parting Thoughts

Ten years after the financial crisis, we see significant shrinkage in the market. In many cases we believe there is good reason for this. In fact, we would champion the idea that regulators increase minimum requirements to ensure new players are adequately capitalized.

On the other hand, we believe that not enough attention is paid to the shrinking world of correspondent clearing providers. In an industry that is keenly aware of concentration risks, and living in a culture which abhors the idea of "too big to fail," there is surprisingly little said about this critical niche of the industry. The pyramid below illustrates the point:



Examining the Diminishing Broker–Dealer Landscape

About Bedford and Main:

Bedford and Main provides consulting services primarily to the broker-dealer and RIA communities. We offer a unique blend of experience in front office senior management, coupled with an in-depth, nuts-and-bolts knowledge of back-office operations. Our CEO and key consultant has passed the Series 3, 7, 24, 27 and 63. He is certified as a FINRA Dispute Resolution Arbitrator and as a Certified Anti-Money Laundering Specialist (CAMS).

Our principal area of expertise include:

- Introducing Brokers / Correspondent Clearing / Platform Selections
- Conversion Specialist - Clearing Broker Conversions / Securities Processing System Changes / B-D Mergers
- Compliance Support: Annual Independent AML Testing / FINRA Exams / AWCs
- Support Strategic Management Projects
- Supporting Start–Up B/Ds
- Firm Restructuring / Efficiency Evaluations and Implementations
- Contract Negotiations

We provide **Securities Expert Witness and Litigation Support** to both sides of the table.

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