HOW BROKER/DEALERS ARE SHIFTING TO STAY COMPETITIVE

INSIDE: Compete more effectively in the marketplace by keeping up with today's regulatory pressures.

LPL Financial

Given the challenging regulatory environment, broker/dealers are spending more time and money on compliance issues, rather than focusing on desired business enhancements or growth. Instead of working to improve and attract more advisors, some firms are simply working to maintain their business. It's difficult out there, but there are solutions that can help.

Small to medium-sized broker/dealers can decide to align with another firm that's able to provide them with a great deal of scale and other benefits, such as increased infrastructure, new technology, and more diverse products for their advisors and clients. That can be achieved through a change in organizational structure like closing down a broker/dealer in favor of a larger, scaled third party. It can also occur by shifting from a full-service to a limited-purpose broker/dealer where significant responsibilities of the broker/dealer become the responsibility of a third party. There are five questions to ask and factors to consider when determining if aligning with a larger firm may be a good option for you.

1. Is Reducing Regulatory Pressures Important to You?

It's no secret that compliance can be an ongoing challenge for broker/dealers. Between the SEC, FINRA, and the Department of Labor (DOL), new rules emerge each year that require broker/dealers to implement updated guidelines, processes, and technology. Since each regulator has different rules, firms must apply broad interpretations and strict enforcement policies—policies that require money and manpower to enforce. Tracking and reporting are especially important, as a lack of precision in policy implementation and enforcement can result in regulatory scrutiny. But to do it right, firms may benefit from having advanced programs, diligent employees, and scale, which often requires deep pockets.

Regulatory requirements have been an ever-increasing burden for broker/dealers in recent years due to many factors, including Dodd-Frank. Dodd-Frank was passed in response to the Great Recession and brought some of the most significant changes to financial regulation in the United States since the regulatory reform that followed the Great Depression. In addition to Dodd-Frank, other regulations have appeared in response to Wall Street scandals and the Great Recession. Greater documentation review and record-keeping requirements mean new employees, efficient technology, and, in many cases, both.

Department of Labor Fiduciary Rule

The DOL fiduciary rule in particular is causing a number of challenges. Implementing the rule will require new products, policies, pricing structures, and likely new technology to deal with the updated supervision mandates, which all come at a cost. But really, the true cost of implementing the DOL fiduciary rule won't be known for years to come.

The DOL rule also has a wider financial impact beyond just the cost of implementation. For example, there are new, labor-intensive disclosure requirements that will require more employees to process.

Anti-Money Laundering

The fiduciary issue isn't the only regulatory rule contributing to the compliance challenges faced by broker/dealers, however. Regulators are paying close attention to broker/dealers' anti-money laundering

In addition to an SEC fiduciary rule that's expected to come, other regulations coming down the pipe include:[3]

- Personalized investment advice standard of conduct
- Third-party compliance assessments
- Transition/succession plans
- Amendments to Regulation D, Form D, and Rule 156
- Amendments to Form ADV and Investment Advisers Act
- Electronic filing of broker/dealer reports

Source: PwC Financial Services Technology 2020 and Beyond

(AML) programs and levying heavy fines for violations—even to smaller firms that might not have the resources to stay on top of the rules. Larger firms have been cited with AML fines in the neighborhood of $17 million, and small and medium-sized firms haven't been left out.[1]

Data and Privacy Protection

Keeping clients' financial information secure is another compliance concern. Today's technology requires complicated encryption, serious firewalls, and often costly levels of protection to keep investors' information safe. But even with the most advanced tools in place, firms are in danger of data breaches, which can result in not only the loss of advisor and client confidence, but also serious regulatory fines.

For example, a large wirehouse was fined $1 million for data-protection failures, but it's simply one in a long string of such occurrences.[2] To survive in today's data-heavy world, broker/dealers must have not only every possible protection available, but also a contingency plan in case a breach does occur. Larger firms can typically afford expensive technology to protect their clients, but smaller broker/dealers might not have the necessary resources.

Upcoming Regulations

Compliance concerns and related costs aren't likely to lessen any time soon. With every new regulation, there is an associated cost. Firms might have to build new technology to meet the requirements, bring in more staff to enforce policies, or perform involved due diligence to make sure products and services are up to par. As a result, overhead cost goes up, adding to the fees and other costs already required.

New regulations also require a great deal of time—time to interpret and understand the rules, as well as how to implement them. Staff members often must be pulled from regular duties to focus on updated regulation. All of this potentially causes upheaval in a business and can be a challenge for firms.

What to Consider: Whether you have the process, procedures, and infrastructure in place to keep up with today's regulatory requirements.

> "Today, there isn't a thriving broker/dealer left that hasn't accepted technology's ability to help drive automation, productivity, and cost-efficiency."[4]
>
> *Chip Kispert*

2. Can You Keep Up with Ever-Changing Technology Requirements?

In today's technology-centric world, broker/dealers use cutting-edge platforms and digital offerings to help differentiate themselves from the competition. Although the financial services sector has been slower to jump on the digital bandwagon than other industries, it's starting to catch up. As a result, if broker/dealers wish to continue to compete in the space, they may benefit by moving to all-electronic solutions. Chip Kispert, founder and managing partner at Beacon Strategies, a consulting firm specializing in technology infrastructure planning for broker/dealers, explained in a recent article, "Today, there isn't a thriving broker/dealer left that hasn't accepted technology's ability to help drive automation, productivity, and cost-efficiency."[4]

To attract other advisors, especially those from a wirehouse, broker/dealers need to develop product, service, and technology platforms that keep pace with current technology. In many cases, platforms need to match or improve the experience advisors enjoy at their current broker/dealers. Advisors are now looking for technology like single sign-on; e-signature; mobile-friendly websites and apps; client portals with complete account aggregation; and sophisticated advisory platforms.

But it's not just about attracting other advisors. Existing advisors increasingly need sophisticated technology to stay in business, due to mounting compliance requirements, product complexity, and client demands. If firms want to retain advisors in today's digitally driven marketplace, they should continually launch updated technology and new platforms.

In addition, to keep up with the regulatory demands noted in the previous section, firms must create or purchase technology platforms that can monitor advisors, scrutinize sales practices, and review client suitability for specific products, among other compliance activities. Data organization is also a big issue, and without technology, it's becoming difficult to keep track of the many and varied product lines and platforms, advisor information, and client details.

To compete with larger firms, small firms in particular need a great deal of automation to make processes more efficient. But that requires technology—and technology requires funds. Building or integrating new technology often takes months of development and several million dollars.[5] New technology also means more IT staff who can help train employees and advisors, service the technology, and handle issues that arise. Bottom line: Firms must invest in technology to make operations happen effectively.

What to Consider: Whether you're willing to invest the time and money needed to bring in the technology required to help support your firm in today's digital world.

3. Is Your Firm Prepared for the Ongoing Product Mix Shift?

The industry has been shifting from commissions to fees for quite some time, but due to regulatory pressure, including the recently released DOL fiduciary rule, that shift has started to pick up speed. According to the PriceMetrix Annual Report on the State of Retail Wealth Management, the percentage of fee-based assets in the average advisor's book of business recently increased from 31% to 35%, and fee revenue rose from 47% to 53%.[6]

Although the switch to fees, where appropriate for the client, may be a good thing in the long run, it also means a decline in commission revenue, which is having tremendous impact on broker/dealers' bottom lines. In fact, 33 of the top 50 firms reported some decline in commission revenue last year.[7] Non-traded REITs in particular posted sales of $10 billion in 2015, a year-over-year decline of close to one-third, according to figures from investment bank Robert A. Stanger & Co. Inc.[7] Variable annuities dropped by 6% from 2014 and almost 17% from the recent high in 2011, according to Morningstar's data.[7]

The introduction of robo advisors into the equation means there's also pressure to reduce fees As a result, while many advisors are shifting to fee-based business—where appropriate for their clients—in reaction to regulatory requirements, volatile markets, and industry trends, the dawn of digital advice is also forcing them to offer their services for a lower cost.[6] In turn, broker/dealers are forced to look to other sources to sustain revenue. With robo advisors picking up steam, this trend is likely to continue.

What to Consider: How you plan to adapt to the product mix shift.

4. Do You Have the Financial Strength to Weather Market Volatility?

Market volatility, which can't be anticipated or planned for, just adds another layer of uncertainty to the current environment. Drops in the equity market can result in parallel dips to firms' income, while a continuous low-yield environment from the bond market would mean fixed income may not be a reliable source of revenue.

Volatility, which scares clients and often causes them to pull back from investing, also makes it more difficult to predict fee revenue. This, along with the rise in the number of fee-based accounts, means revenue is uncertain and planning for the future is a lot harder than it used to be.

What to Consider: Where needed revenue will come from if low yields and volatility continue.

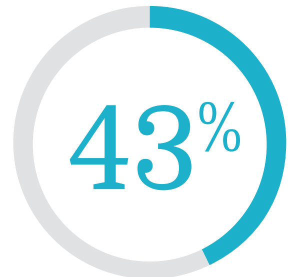
5. Are You Prepared for Changing Advisor Demographics?

The aging and declining advisor population means there are advisors leaving the business every day and fewer advisors to recruit. According to Cerulli Associates, the average age of financial advisers is 50.9, and 43% are older than 55.[5] Nearly one-third plan to retire or leave the industry within the next decade, yet new, younger advisors aren't taking their place. Consulting firm Accenture noted that only about 5% of advisors are under the age of 30.[5] "Broker/dealers continue to struggle to recruit young advisers to offset those who are nearing retirement," Cerulli said.[5]

As a result, the advisor ranks are diminishing and exiting advisors are often taking their profits with them.

Retention is also a struggle for many firms today, especially if they're financially unable to bring in the technology and support that today's advisors want.

What to Consider: If you've sufficiently planned for the aging advisor population.



Advisors older than 55 years of age[5]

How to Move Forward

The combination of compliance requirements and pressures, technology requirements, migration to fees and fee compression, market downturns, and aging advisors can add up to higher costs for broker/dealers and less profits. It's a challenging environment, but there are still ways to thrive, specifically by aligning with a larger firm or getting more focused. "Firms need to get specialized or, if not, get scale," said Sanjiv Mirchandani, president of Fidelity Clearing and Custody, in a recent article.[8]

To get scale, you can align with a broker/dealer that offers a deep pool of resources. There are several ways you can choose to align with another firm, including alignment with a third party following a shutdown of your broker/dealer or limiting the purpose of your existing broker/dealer. These structural options would allow your company's culture to continue as it is today, but by shifting service and compliance to a larger broker/dealer, it may allow you to mitigate risk, improve profits, and compete more effectively in the marketplace through an enhanced value proposition. ■

[1] *InvestmentNews,* "Regulators cracking down on broker-dealers for anti-money laundering violations," June 3, 2016.
[2] *InvestmentNews,* "SEC fines Morgan Stanley $1 million for data-protection failures," June 8, 2016.
[3] *InvestmentNews,* "7 pressing adviser issues on the SEC's 2016 agenda," May 20, 2016.
[4] *MarketsMedia,* "Broker-Dealer Technology Priorities Emerge," January 4, 2013.
[5] *Chicago Tribune,* "Signs of aging may soon affect financial advisers — and brokerages," January 8, 2015.
[6] *The State of Retail Wealth Management,* 5th Edition, PriceMetrix, 2015.
[7] *InvestmentNews,* "Broker-dealers face rising compliance costs from DOL rule, pricing competition from robo-advisers," June 8, 2016.
[8] *InvestmentNews,* "Independent broker-dealer business model is an endangered species," May 29, 2016.

LPL Financial Can Help

LPL can provide the scale and resources to help your business continue to thrive. As the nation's leading independent broker/dealer,* we offer an integrated platform of technology solutions, brokerage, and investment advisory services to more than 14,000 financial advisors and approximately 700 financial institutions. We also support more than 3,700 other financial advisors with customized clearing solutions, advisory platforms, and technology**. Wherever you sit in the broker/dealer space, there's a place for your business here.

To learn about your options and the solutions to help you maintain your vision of success, call us at (888) 250-2420 to speak in confidence with one of our experienced consultants.

* As reported by Financial Planning magazine, June 1996-2017, based on total revenue.

** LPL Financial stats through May 31, 2017.

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