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BRIDGING THE CHASM TO INDEPENDENCE

Advisors going independent should be aware of the money and skills it takes to do so. An independent broker-dealer may be the bridge some need to becoming an RIA.

By Edward K. Riley

A major change is taking place in the financial industry as brokers increasingly depart large wirehouses and banks to go independent, either as RIAs or as advisory representatives of independent broker-dealers.

According to a study by Cerulli Associates, some $800 billion in client assets will relocate because of brokers and advisors changing firms during 2009. Wirehouses are expected to lose $188 billion in assets, with RIAs, independent broker-dealers and dually registered advisors claiming roughly 85% of those assets.

For brokers, the move to independence typically involves one of two alternatives: establishing an independent RIA or affiliating with an independent broker-dealer as an independent advisory representative. Each offers distinct advantages. But there are obstacles aplenty, some of which can be overlooked amid the urgency and excitement of taking control of a new business.

Big Is No Longer Better

In decades past, innovative brokers and advisors felt obligated to belong to a wirehouse or large national network in order to get access to their proprietary products and presumed high level of service. However, these advantages came at a cost.

Most large brokerage firms are publicly traded, which means they have an extended hierarchy vested in the firm's financial performance. The group includes shareholders, board directors, senior executives, managers, advisors, and finally, investors, the pecking order's bottom dwellers. The interests of those residing on the top rungs of the hierarchy are often focused on driving up the price of the firm's stock, principally as short-term earnings, and their interests take precedence over those of the investors.

For many regional brokerages, the repeal of Glass-Steagall in the mid-1990s offered an opportunity to sell their firms to banks at substantial premiums; a few people made a bucket of money in these transactions. Brokers at smaller and mid-size firms often hung on, hoping to cash in when a bank or other large player acquired their firm. But for rank and file brokers, if a payoff came, it was usually too small to compensate for the new rules and cultural shift associated with the merger. Today, banks are questioning whether they should be in the brokerage business at all. The prospect of a big-money payoff has all but disappeared.

At the same time, the big brokerage monopoly on product innovation has come to an end. The vast majority of investment products and services that were once exclusive to large brokerage houses are now ubiquitous. The playing field has leveled; company size is no longer a measure of product access or advisor support.

Just as advisors have come to realize that bigger is not necessarily better for their careers, the investing public is coming to the same conclusion. Investors now question what benefit, if any, big brokerage affiliations have brought them. As victims of inferior, commission-soaked proprietary products that left them holding the bag, investors are justifiably angry. The image of the brokerage industry has been tarnished by dubious fees, investment scams, tainted research and advisors being told not only how to conduct their business but with whom.

Wirehouse firms have done their best to erode the client-advisor relationship by touting the size, strength, and capabilities of the firm to the exclusion of the advisor. Smart clients have never bought that argument. The most important and enduring relationships have always existed between investors and advisors. Try as they might, the firms supplying advisors with product could never break that bond. Investors know and relate to their advisors personally, which is why they are willing to follow their advice and trust them with their money.

The events of 2008 placed these elements in sharper contrast than at any time in the last 50 years. Advisors and clients alike are questioning the overall structure of the industry and how that structure benefits them. As a result, in recent months the number of inquiries from brokers seeking guidance on going independent has mushroomed. Many are frustrated with company mandates to push preferred products and feel they can't serve their client's best interests unless they gain the independence to chart their own course.

The question on their minds: "If not here, where?"

First Things First

The first decision is whether to establish an RIA or affiliate with an independent broker-dealer. Departing a brokerage to start an RIA may seem like the simplest and most logical solution, but there are complications, not all of which are immediately apparent.

For example, becoming a completely independent RIA means giving up the ability to be a one-stop shop for clients. The exiting broker must tell clients with integrated accounts that their brokerage needs will be assigned to someone else at the firm, thus binding the commission clients to the old firm and letting the devil in the back door.

For the advisors' remaining fee-based clients, a time consuming and potentially overwhelming obstacle surfaces: The process of papering the client accounts to transfer them from the current firm to the new one. Advisors forming new RIAs may face undertaking this laborious project alone. Depending on the number of accounts involved, it could take weeks or even months to complete.

Affiliation with some broker-dealers can facilitate the transfer of client accounts utilizing an automated process and a dedicated transition team. The process begins with the advisor transmitting "allowable" client data to the new firm. This can be done immediately following resignation from the current firm. Within hours, pre-filled forms for several hundred clients can be in the mail.

Speed becomes a critical factor if the firm the advisor just left decides to block the transfer of departing accounts by obtaining a temporary restraining order. The sooner the accounts are transferred and opened at the new firm, the sooner the advisor is back in business.

RIA Startup Costs

Brokers may be frustrated and want a flight to freedom, but many have a fear of flying. Even more fear the cost of the ticket, and they have a right to be afraid.

A major consideration of opening an independent RIA is startup cost. In its marketing piece "A Case for Starting or Joining a Registered Investment Advisory Firm," Charles Schwab & Co Inc. estimates the average first-year costs for someone establishing an independent RIA:

Health and other insurance benefits: $10,963
Marketing and business development: $14,000
Office rent and maintenance: $5,133
Information technology and utilities: $48,255
Furniture purchases: $27,146
Office expenses (supplies, copies, etc.); $2,623
Compliance/legal professional services: $11,500

Business insurance: $6,940
Total: $126,560

While these numbers can and will vary depending on a number of factors, my recent experience in speaking to numerous brokers is that few have anywhere near an accurate handle on the aggregate costs associated with starting an RIA business.

The Five-Tool Business Owner

Successful advisors are typically five-tool players. They are terrific at prospecting, planning, asset allocation, risk management and client service. As business owners, however, advisors must acquire an additional set of tools. They must become proficient at operations, compliance, accounting, marketing and office management. Those are two completely separate and unique skill sets.

Advisors who grew accustomed to staff support may discover they are operating without a net as an RIA. Every minor distraction becomes a tax on an advisor's time. It's difficult to manage client portfolios effectively while simultaneously putting out fires and solving problems that don't generate revenue.

When our firm started in business, it took a month to find office space and negotiate a satisfactory lease, another six weeks to settle on the office layout and choose furniture. Pressure mounts to make the many choices before the enterprise can operate smoothly. What kind of phone system and data service do you need? Should you buy your own server? What should you run on it?

By the way, you need to do some prospecting and it's time to decide your quarterly balancing strategy.

How do you backup data? Do you walk it over to the bank or backup to the cloud? Do you need encryption? Can you get the website address you want? How about an "800" number that's easy to remember? Where do you go to buy a good telephone system and how much does it cost?

By the way, the copier is jammed and your Web site just crashed.

There's a year's worth of work just getting things set up. Do you have sufficient assets to meet the SEC registration threshold? If not, you have 90 days to get to that level or you have to register with the state instead, and that means more issues. Who's going to handle the registration? Do you hire a consultant or an in-house compliance person?

By the way, your quarterly statements went out with errors because of an entry oversight.

Leaving a large wirehouse or bank also means losing their formidable business development support. Many advisors who are phenomenal investment managers and tacticians lack integrated marketing skills. That's understandable, since many have been long-time beneficiaries of media campaigns that provided a solid foundation of support for even the most talented prospector. But how will they generate new business on their own? How much time will they be able to dedicate to the effort? It's easy to get sidetracked by the thousand and one decisions nascent business owners have to make.

It invariably takes much longer to develop that second five-tool set of skills than new RIAs anticipate. Hiring an assistant is an option, but finding a qualified person at an affordable salary can be difficult. A common misconception among advisors is assuming they will be able to hire a $50,000-a-year assistant who will handle all the pesky administrative issues and other problems that arise when starting a new business. Don't believe it. Advisors often opt to handle everything themselves, particularly those with limited budgets. And while their business skills are being refined, precious time is slipping away, time needed to manage and maintain client relationships and prospect for new ones.

Learning Curve

Before I opened our firm, I previously started and managed an independent branch that grew to 10 employees over several years, so my business skills were not unsubstantial. Even then, I had to make a quantum leap in proficiency. Overall, it took our organization about five years to reach a high level of competence in all critical areas. I don't think there's any way to do it much faster. It takes time to create the proper infrastructure and acquire the necessary technology. There's a huge difference between the promise of technology and its delivery.

Then there is the issue of compliance.

If no one has warned you, beware of the registration filing requirements, whether SEC or state, specifically Form ADV Part II. Satisfactorily completing this form is the equivalent of surviving an IRS field audit, and you better have competent, experienced professional assistance.

The form requires RIAs to fully describe their business, accounts, services, fees, any existing conflicts or potential conflicts of interest, how they are to be dealt with, agreements and other issues. Supervisory procedures must also be spelled out in written format. The uninitiated may think this is a process than can be completed over a weekend by simply filling in the ADV blanks but that's not the case. The SEC scrutinizes these forms with persistent vigor, comparing your ADV to your ongoing business practice from every perspective to assure that your procedures match your disclosures. It's not enough to only do the right thing for your client—you need to support doing the right thing by saying how you do it and have the documentation to prove it.

One option is to hire an attorney to handle this paperwork behemoth, but the task can easily take one hundred hours or more. I learned that lesson painfully. At $350 an hour for a specialist attorney, that's an initial outlay of $35,000. I say "initial" because this is a living document that requires ongoing maintenance, so the cost is not one-time but perpetual. The beast keeps eating.

An alternative is to hire a compliance consultant, but that can delay filing as the consultant must spend considerable time with the RIA to fully understand the business before sitting down to complete the various schedules. Tricky issues such as procedures for handling cross transactions and partial allocations can trip up even an experienced consultant. There are relatively inexpensive templates available but they only provide a format. The research and responsibility for information accuracy still lies with the individual RIA.

However the new RIA plans to handle compliance, it will take more time and cost more than is expected. It's an intense process and must be maintained to keep up with new regulations.

Small Jump Or Big Leap?

Without sufficient assets to forgo one's brokerage income and convert to a purely consultative practice, making the leap from brokerage to RIA may not be financially feasible. However, those without the critical mass but who want to go independent don't necessarily have to assume the costs, paperwork and operational issues of an RIA, nor do they have to relinquish or reassign their brokerage accounts.

An alternative that provides independence and can, if the advisor wishes, serve as an intermediate stage to eventually becoming an RIA, is affiliation with an independent broker-dealer.

The arrangement allows advisors to retain and transfer the maximum portion of their established brokerage business, open a branch, gain the invaluable experience of running and growing a business, and, eventually making the final leap to RIA. The interim steps can soften the impact of change and help protect a fledgling advisory business. Meanwhile, the advisor has the luxury of time to grow the necessary asset base and develop the business skills needed for full entrepreneurship.

Brokers who want independence badly enough and whose book of business is primarily advisory accounts may be tempted to simply walk away from their brokerage accounts. Those brokerage accounts, likely too small to qualify for or justify the fees to convert into advisory accounts, may nevertheless represent the assets of friends or family members, and be difficult to give up. Since wealth is grown, not dropped in our lap fully mature, those small accounts, taken as a whole, may well represent a significant amount of wealth at a future date if given sufficient time to grow.

Consider UTMA custodial accounts, which typically start small but may lead to opportunities to manage other client assets. As an advisor with an integrated business at an independent broker-dealer, a relationship already exists to help retain and nourish those seedlings until they are large enough to become advisory accounts or provide access to client business.

Another advantage to taking a segmented approach towards independence is increased negotiating leverage. Individual RIAs don't have much clout when it comes to negotiating the many subcontract services supplementary to a new business.

An interim broker-dealer relationship allows brokers to be up and running with a full complement of support services quickly. The relationship also alleviates the necessity to tackle the arduous ADV and accompanying schedules and procedures. Given the avalanche of decisions that accompany any business transition, it can be liberating to have compliance, operations, marketing, technology and a menu of products and services ready and waiting from day one.

When brokers ask me what's involved in the move to an independent RIA and I tell them about the purchase decisions, SEC regulations, operational issues and other new demands on their time, they are riveted. The implications of those requirements on their book of business can be intimidating. If they are forced to leave their brokerage business behind when they make the move, the impact on their income can be debilitating.

Ultimately, an independent RIA may be the best choice for some entrepreneurial-minded brokers, but for others, making the move in a single bound can be overwhelming. The alternative, an association with an independent broker-dealer as an independent advisor, can provide a bridge to ultimately becoming an RIA. Taking this path can provide advisors business protection, an easier transition now and greater career flexibility in the future.

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