InvestmentNews DAILY
August 17, 2011

Broker-dealers brace for lower trading volumes

Small and mid-size B-Ds could be on thin ice if transactions slow - and the economy heads south

By Bruce Kelly
August 14, 2011 6:01 am ET

In the wake of last week's fear-inducing market tumult, small and midsize broker-dealers are bracing for reduced trading volumes in the months ahead, which will squeeze already tight margins and could push some of them out of business.

"It will flat-line," said Mark Goldwasser, chief executive of National Holdings Corp., the holding company for two independent broker-dealers.

"It takes about a month or two, and volumes will be reduced. These are the most extraordinary markets I've ever seen, and I've been doing this for 30 years," Mr. Goldwasser said.

"This is not good for brokers," said Timothy Hurley, managing director at Bentley Associates LP, a boutique investment bank. "Clients tend not to do anything when they're transfixed with fear."

Broker-dealers have faced a number of pressures during the past few years, including investor anxiety about the stock market.

Firms have been going out of business steadily. Since 2006, the number of firms registered with the Financial Industry Regulatory Authority Inc. has declined by 10%, standing at 4,525 last month.

“I don't see a wipeout of broker-dealers [from the market drop], but it might accelerate a couple that were going to go out anyway,” said David Alsup, director of business development for The Compliance Department Inc., which tracks broker-dealer openings and closings.

“This is not a 60 to 80 BDW,” he said referring to the “broker-dealer withdrawal” form that firms file with Finra when shutting down.

“Most broker-dealers are prepared for this,” Mr. Alsup said.”Over the past years, they've stripped themselves down to the bone. They're quite lean at this point.

“It's not a free fall of firms going out of business, and maybe we'll stabilize for a while,” Mr. Alsup said. “But if the market caves in, that's a different story.”

OTHER PROBLEMS

A declining market isn't the only problem that broker-dealers face, according to some executives.

They pointed to the crush of proposed regulation from Finra this summer, such as a 400-page advertising rule and a 420-page supervision rule, along with a new suitability rule that will take effect this fall, as more immediately problematic and stressful for firms than the market volatility.

Federal Reserve chairman Ben S. Bernanke's decision Tuesday to keep interest rates exceptionally low through mid-2013 is another blow to potential profits.

Historically, low interest rates have decimated broker-dealers' revenue from interest rate spreads on money market funds and cash balances, formerly a lucrative part of firms' business.

“We are lowering our earnings estimates for brokerage firms that have significant exposure to U.S. interest rates,” Patrick O'Shaughnessy, an analyst with Raymond James & Associates Inc., wrote in a research report. He covers online brokerage firms.

“For firms that were perceived to have significant earnings upside in a rising-rate environment, we believe the Fed's statement will substantially lower consensus earnings estimates for 2012 and 2013,” Mr. O'Shaughnessy wrote.

Executives at clearing firms reported that broker-dealers' clients were, for the most part, able to meet demands of margin calls, and the market downturn so far has resulted in no apparent blow-ups of securities houses.

“With this type of volatility, in the short term, firms will make a bunch of money from trading, but then, the business goes dormant. As long as there's volatility, firms usually do pretty well,” said Christopher Frankel, chief executive of Legent Clearing Corp.

“After 2008, retail investors were not fully engaged, so it was a struggle,” he said. “In fact, I don't think they've come back, and this market movement is not engendering confidence in retail investors.”

If stocks don't bounce back quickly, investors could be on the sidelines at least for a couple of months as the stock market finds a new level, Mr. Hurley said.

“Investors wait for markets to stabilize,” he said. “That's not good for brokers, who want volume.”

The market free fall of the past two weeks also could slow down any wirehouse representatives and advisers who are looking to move to an independent-contractor broker-dealer, Mr. Hurley said.

“Brokers at wirehouses will stay put and get their "draw' on their commissions,” he said.

Reps affiliated with independent-contractor broker-dealers get no such regular draw, Mr. Hurley said.

“They eat what they kill,” he said. “They're not getting a regular paycheck till the market comes back.”

[Highlighted by Peter Kote – must understand the business of financial services!]

bkelly@investmentnews.com

“This is not good for brokers.”

Timothy Hurley

Managing director

Bentley Associates