



# Buying vs. Building a Broker-Dealer: A Clear Perspective on What's Right for You... and When

By Gregory Levine

## 1 Introduction

In this article I am going to set your mind at ease and remove the clutter that often crowds out the essential elements making up any course of action. When you've finished reading you'll have a clear picture of the buy vs. build decision making process, and you'll be able to make the right decision, and take the steps that naturally follow, with confidence.

You're here because you've come to the conclusion that it makes sense to *own* a broker-dealer. You've likely given substantial thought to the idea, but not to the process of getting there - until now. You're at a crossroads in your decision making process and you're asking yourself whether *buying* a broker-dealer or *building* a broker-dealer would be the smartest path to *owning* a broker-dealer.

I've presented the essential elements of the buying vs. building decision process chronologically and from the potential buyer's/builder's perspective. However, this explanation should be equally helpful to a seller, in that it provides insight as to the buyer's proper mindset, or, more precisely, what I think that mindset should be.

Finally, both buyer and seller should find this explanation helpful in determining whether the broker-dealer is a suitable target and where the leverage lies, and with whom. Both parties will gain insight as to how best negotiate the terms of a potential sale.

## 2 A Brief Digression: Info About FINRA Applications

Spoiler Alert: So before we go any further, let me tell you how the story ends. If you're seeking to own a broker-dealer, no matter which direction you turn on the buy vs. build decision making path you're going to end up in pretty much the same place: A FINRA application.

While there are two distinct applications, one when building and one when buying, they are substantively the same with respect to information and materials requested. Additionally, the length of each type of application depends on a host



of variables, not the least of which is the complexity of the business being created or purchased, respectively.

A FINRA Continuing Membership Application or “CMA” is filed when seeking approval to sell a broker-dealer. I emphasize sell in that the application is filed by the target broker-dealer, whose owner is looking to sell. However, the substance of the application will center on the qualifications and intentions of the buyer.

The CMA is often (and often mistakenly) considered an easier application, presumably because “the broker-dealer firm is up and running and all we have to do is pretty much jump right in with our people and get to work.” That is an exact quote of a client who came to me seeking help with a purchase.

It is worth stating again: The CMA is essentially no different in substance than a New Member Application or “NMA.” Let no one tell you differently. FINRA rules and website provide a substantial explanation of what is involved and what will be requested, and how long it all shall take. However, FINRA examiner subjectivity, variables like the buyer’s background, experience, and plans for the broker-dealer, all infuse the application with enough uncertainty that “been there, done that” experience is hard to beat. Yes, that was self-serving. I apologize, sort of.

### 3 Why Buy?

Buying a broker-dealer firm, rather than building one, makes sense for the buyer in a limited number of scenarios. While there are many variants, there are two primary reasons a buyer would wish to purchase a broker-dealer firm:

**The most popular reason for buying** is that the buyer has a strong need or desire to conduct business during the FINRA application process (the buyer registers its affiliated persons with the target broker-dealer during the application period). Let’s drill down a bit here:

- This need may take the form of responding to a great opportunity to become involved in a transaction or group of transactions that but for broker-dealer affiliation would be impossible for the buyer. In that sense, the potential buyer simply can’t afford to wait, and waiting is what happens when you build.
- Alternatively, the need may be a strategic play whereby the potential buyer believes it would generate enough fee or commission revenue during the application period to offset all or a substantial portion of the purchase price. Not a bad idea.



- Less frequent is the need to simply gain reputational traction and be able to let interested third parties know that you're affiliated and working with the target BD while simultaneously in the process of seeking FINRA approval to purchase the company. I have met many potential buyers who valued greatly the ability to make this claim. Many simply had told colleagues they were going to do this and needed to make good on the claim, or risk losing credibility.

Conducting business during the application period necessarily requires a much more thoughtful negotiated agreement with the current owner (the seller) of the broker-dealer, and I'll discuss what you should consider within that negotiation further below.

**The less popular reason for buying** is usually that the target broker-dealer has certain assets, such as, for example, client accounts, an excellent reputation, or a staff willing to remain with the broker-dealer post sale. These assets justify paying for a broker-dealer rather than saving the purchase price and heading directly into the building process. When current staff is willing to stay on with the broker-dealer after the sale transaction closes is something that I refer to as "Management Continuity."

The most popular of these less popular reasons for purchasing arises when a buyer has the opportunity to purchase a fully viable and profitable broker-dealer that comes complete with management, sales force and considerable client accounts and wishes simply to take ownership. Most broker-dealers for sale do not fall within this category. Most being sold are in a (and I shudder to use this word) "dormant" state, where the next move is either sell or shut down. What follows does not address this specific scenario, as the decision to buy rather than build in this specific scenario is obvious.

## 4 You've Decided to Buy, Now What?

Once you've decided to buy, the first box to check is locating a broker-dealer that is for sale. There are "broker brokers" out there who maintain a roster of broker-dealers for sale and to me that seems the most efficacious way to proceed, unless you know someone who knows someone who knows someone selling. Broker brokers are a busy bunch these days.

**Here's what to look for:** If you're not buying a broker-dealer for any of the alternative and less popular reasons mentioned above, that means that you *are* buying because you wish to conduct business during the application process. Then what you should be looking for is a broker-dealer for sale that already is permitted by FINRA to conduct the type or types of business that you are going to want to conduct right away.



At this stage should the target broker-dealer not have FINRA permission to conduct the type or types of business you need to conduct during the application period then you need to stop, not pass go, and look elsewhere. If, for some reason, you decide to continue down this road, you'll become involved in a FINRA application filed not only seeking approval to purchase, but one seeking approval to conduct the "missing" business lines as well. Please don't do this.

Remember, you're buying a broker-dealer because you want to conduct business during the application process. So the target broker-dealer must already have the permission to conduct such business. That being said, you're not prohibited during the sale application from requesting FINRA approval to conduct *additional* business types.

**Here's' what else to look for.** Here's where Management Continuity comes into play. You'll recall what I said above, that Management Continuity may seem like a great plus when purchasing a broker-dealer, but that in reality, for those of you who are wishing to conduct business during the application period Management Continuity is for the most part a requirement.

Most buyers are completely unaware of the fact that for those wishing to conduct business during the application Management Continuity should be a key decision, potentially even more so than price. Why? Because Management Continuity will be the primary reason FINRA *allows* such business to be conducted. That in turn makes Management Continuity the primary requirement for a seller that wishes to attract a buyer who expects to conduct business during the application period.

Look at it this way:

From FINRA's point of view, if the broker-dealer's management does not plan on remaining during the application period (this presumes that the buyer will attempt to insert its own management during the application period and therefore there is no Management Continuity), and sales personnel are new (obviously), and ownership (is about to be) new, then FINRA will view the application as a new member application because, well, *everything* is new. Especially where there is no disruption of client services to be concerned with FINRA will treat the application no differently than a new member application, and that means no business can be conducted until the application is approved. FINRA, while not admitting to it, will in fact view the contemplated sale as a circumvention of the new membership application.

**How much are you buying? or "The 24/76 Scenario."** You may have heard that a purchase of less than 25% of a broker-dealer does not require an application, and that is the case. Most buyers and sellers arrive at this intermediate step in the 100%



sale process because it allows them to put the ball in motion without immediately having to deal with a full blown FINRA application.

I refer to this process as the “24/76 scenario” where the buyer purchases 24% now, registers certain of its personnel with the broker-dealer and assuming Management Continuity (a must in my opinion as FINRA will be alerted in any event even if a change in management occurs outside of an application process) begins conducting business. This would seem like a better way of avoiding the possibility of having FINRA impose an interim restriction on such business activity.

However, what both parties should consider is that beginning with the complete (100%) purchase process is more streamlined because (a) it requires one closing and not two (the balance of 76%), (b) both clearly require Management Continuity in order to effectively allow the buyer’s personnel to register and conduct business, and (c) should FINRA ultimately not approve the 76% purchase application the buyer and seller are stuck in a 24/76% ownership split.

While joint ownership may be ok with both parties it should be addressed clearly in some form of binding obligation as to how each will get along with the other henceforth. That brings me to my final observation on this point.

Be mindful that no effective change of control can be made pursuant to a 24% change in ownership, meaning the buyer of 24% cannot have any greater than a 24% say in the daily operations of the broker-dealer. If you file an application with FINRA seeking approval of the 76% balance, a premature transfer of authority and control will most likely be blindingly apparent.

**When do you close?** If you pride yourself on having a decent amount of common sense, then it’s not when you think. FINRA rules are clear that before closing you must provide thirty days’ written notice (which takes the form of a full application submitted for review and not just a letter: “Hey FINRA, we’re selling our broker-dealer.”) So you may be thinking *thirty days to close, no problem*.

Unfortunately, FINRA rarely allows the closing to take place thirty days following the acceptance of the application for submission, whether or not Management Continuity and a lack of any new types of business being conducted during the application period are present.

A buyer should make sure that the purchase agreement is drafted in a flexible manner that contemplates this contingency, or simply avoids it by stating expressly that the closing will not take place until such time that FINRA approves the application.



Addressing this contingency is extremely important because of the breathtaking and mind-blowing counterintuitive nature of the rule governing sales: While you may close after providing the thirty days' notice (if FINRA does not tell you otherwise prior to the expiration of those thirty days) FINRA still has 180 days within which to approve or deny the application! Now that deserves an exclamation point. All sorts of interesting things happen at that time, but because FINRA more often than not imposes the interim restriction I've been discussing in response to the lack of Management Continuity, rarely does an application reach the stage where FINRA denies the sale application after the actual closing takes place.

## 5 Why Build?

You build when buying doesn't make sense. That is, you build when none of the reasons for buying described above exist.

What should not be overlooked is that as a builder you may simply not wish to (a) align yourself with a third party, i.e. a seller; for however short a period, and deal with another "personality," (b) work through a target broker-dealer search and a purchase agreement negotiation, and finally (c) navigate the FINRA application, in order to own a broker-dealer at the end of the day. It's hard to put a price tag on working within a less imposing structure, if time is not an issue.

Of course there are more "concrete" reasons to create a broker-dealer from scratch. They include:

- The builder otherwise has no need to conduct business during the FINRA "Continuing Membership Application" period.
- The builder (formerly a potential buyer) has tried but cannot locate a broker-dealer entity that already has the required FINRA permission to conduct the business the buyer needed to conduct in order to make purchasing a broker-dealer doable.
- The builder of a broker-dealer ends up with a "clean" broker-dealer having no hidden liabilities vis a vis FINRA or customers.
- Notwithstanding the potential for doing business during the purchase application (CMA) mentioned above, creating a broker-dealer is almost always less expensive - again, if conducting business during the application period is not a concern.

## 6 You've Decided to Build, Now What?

An individual or entity seeking to build a broker-dealer will submit to FINRA a New Member Application or "NMA" as mentioned above. Here is where we come full circle and you'll recall that I mentioned earlier that the NMA is substantively no different than the application seeking FINRA approval of a purchase ("CMA").

Much is needed to ensure both a successful FINRA New Membership Application when building, and Continuing Membership Application when buying. An explanation of both applications can be found on my website. However, should you care to know what I believe are the 5 main considerations or "must-haves" before filing a New Member Application, please read my 5 Must-Haves Before Building A Broker-Dealer. These "must-haves" apply to a Continuing Membership Application as well.

## 7 Some Take-Aways

**Take Away #1:** With respect to buying a broker-dealer I focused primarily on the most popular scenario, where a buyer wishes to purchase because of the desire to conduct business during the application period. Therefore...

**Take Away #2:** In order for a target broker-dealer to be valuable to a buyer whose primary reason for purchasing is the ability to conduct business during the application period, the current management team needs to remain for the life of the application, which could run between 120-180 days, with 180 days being the formal allotted time within which FINRA has to make their decision. Exceptions are rare. When I refer to team above I mean those supervisors that currently supervise at least those business lines the buyer wishes to conduct during the application period, to the extent that the target broker-dealer has additional business line not relevant to the buyer's current needs.

**Take Away #3:** Not surprising, but helpful to a buyer is that the seller's decision under the circumstances will be based on economics for the most part. What does the seller get for providing management during the application period? The opportunity to sell the broker-dealer for an amount greater than zero? In other words what value does the broker-dealer have if management does not stay on? I would argue that unless one or more of the less popular (alternative) reasons for purchasing also exist, the broker-dealer has little to no value.

**Take Away #4:** Additionally, and assuming that there is Management Continuity (otherwise you don't reach this step in the process), the buyer should expect to



negotiate with a savvy seller for a share of revenue generated by buyer's affiliated personal during the application period, or simply an increased purchase price. If seller and management (usually one and the same in most cases) are going to incur potential liability by "allowing" business to be conducted during the application period seller will argue they need to be paid for it. Conversely, a buyer could reasonably be of the opinion that without these "concessions" by seller the broker-dealer has no value, so nothing of value has really been added because nothing of value existed beforehand.

**Take Away #5:** A reasonable buyer would consider that regardless of the "chicken or the egg" value argument above, the seller will prior to and during the application period incur both legal and regulatory fees. Conversely, there is always the possibility that the economics of the business conducted by the buyer's reps during the application process would outweigh the seller's potential liability, which probably could have gone without saying - but I say it anyway as it could become an important negotiating point and now you have time to think about it.

**Take Away #6:** Don't be an ill-informed buyer who signs a purchase agreement with a seller that does not provide for a release in the event FINRA imposes an interim restriction on your ability to register your own personnel with the broker-dealer in order to conduct business during the application period. Even with Management Continuity there is always the possibility of this type of restriction, so no assumptions please. By the way I've seen this happen. It's not pretty.

**Take away #7:** FINRA rarely allows the closing to take place thirty days following the acceptance of the application for submission, whether or not Management Continuity and a lack of any new types of business being conducted during the application period are present. A buyer should make sure that the purchase agreement is drafted in a flexible manner that contemplates this contingency, or simply avoids it by stating expressly that the closing will not take place until such time that FINRA approves the application.

**Take away #8:** You do not need to purchase 100% up front, but a buyers should be wary of what they may get stuck holding should purchasing the balance of the ownership never materialize.

At the very top I stated that I would remove the clutter and preconceptions keeping you from a better understanding of the buy vs. build decision making process. I hope I have been in large part successful. You may very well have concluded that there is more to it than you first thought. That would not surprise me.





If you don't already feel confident that you have the sufficient clarity required to move forward, I would suggest that you wash, rinse and repeat. I guarantee everything will fall into place with another read!

Otherwise, and in any event, I would welcome the opportunity to discuss your plans with you and answer any questions you may still have in order to fulfill my promise above.

If you'd like to discuss your specific plans, please schedule a courtesy one-hour call with me. I look forward to hearing from you.

Greg

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