Under pressure: Is the RIA industry morphing into the brokerage biz?

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The RIA industry is maturing, but is it in danger of turning into the very thing it stands against: the brokerage business?

When asked, financial advisors who have fled the ranks of the wirehouses typically cite a handful of reasons for why they left the brokerage industry.

Some argue that they wanted to own their clients and equity in their business. For others, becoming an RIA stemmed from a desire to free themselves from their employer's investment proposition and create their own portfolios.

But the world they've entered may start to resemble the one they left.

The most recent sign of that trend came in August, when RIA roll-up Mercer Advisors, which just crossed the $16.5 billion AUM threshold, lashed out at former advisor Skyler Kraemer. In a lawsuit filed in a New York state court, the RIA claimed that Kraemer stole client information when he left the firm to join Mission Wealth, a Santa Barbara, California-based RIA with around $1.9 billion in assets.

If those claims sound familiar, it's likely because you've seen them before. Brokerage firms such as Morgan Stanley and Charles Schwab have also issued similar complaints against their former employees.

As RIAs consolidate and professionalize – Mercer is backed by private equity firm Genstar Capital – expect more of the same, explained Steve Greco, the chief executive of Spotlight Asset Group, a $350 million RIA headquartered in Chicago.

'That was the first time I had ever seen an RIA file a temporary restraining order (TRO), but I do not think it will be the last,' Greco said. 'I think it's one of the biggest issues within the industry. Companies are just blindly filing TROs or going after people on very low evidence. You see that a lot in the Financial Industry Regulatory Authority (Finra) arbitration system.'

The Finra arbitration system has occasionally proved friendly to advisors who have been targeted by some of the larger institutions in the space. In March, a panel of Finra arbitrators ordered Edelman Financial Services (now part of Edelman Financial Engines, the nation's largest RIA) to pay $160,000 to R.J. Reibel, its former manager of retirement plans. Edelman sought more than $3 million from Reibel after he left the firm for Cary Street Partners, claiming he violated a non-solicitation clause in his contract.

Tightening the grip

Advisors' employment agreements with large institutional-sized RIAs are arguably more restrictive than the contracts they may sign with brokerage firms, said Louis Diamond, an executive vice president at advisor recruiting and consulting firm Diamond Consultants.

'It will have very strict non-solicits and non-competes, even more restrictive than the wirehouses,' Diamond said of the typical RIA employment agreement. 'They're probably more likely to come after the advisors who leave than a wirehouse would be. In large part, it's because the individual advisors really don't own their own book of business.'

It's not just the stick that RIAs have aped from wirehouses. The carrot has come into play, as well.

In June, breakaway RIA platform Dynasty Financial Partners unveiled the 'Dynasty Freedom Note.' The forgivable loan is structured so that advisors can receive 100% of their trailing 12-month revenue from Dynasty as they break away from their brokerage firm and set up their independent RIA. Once an advisor is independent, they give Dynasty a 35% share of their revenue over the loan's eight-year term.

Advisors who break away with Dynasty's help retain 100% of the equity in their business, but the note may remind some advisors of the forgivable loans that brokerage firms offer to lure advisors from one business to another.

Dynasty launched the note for a simple reason, explained John Furey, the managing partner of RIA consultancy Advisor Growth Strategies: it makes sense for a certain flavor of advisor who wants liquidity.

'Ten years ago, the only option you had was to go independent. You were uncertain. That was a conversation I was having with the Merrill Lynch teams of the world a decade ago. I go independent, but then how do I get liquidity if I actually want to leave the business? And the answer was: question mark, question mark, Focus Financial Partners,' Furey said. 'Now, there's just way more options.'

Under pressure

The factors that are pushing RIAs towards institutionalization show no signs of disappearing any time soon. Private equity money continues to flow into the RIA space, most recently when $11.8 b illion roll-up Wealth Enhancement Group sold itself to TA Associates. Mercer also recently secured its third private equity backer, with Oak Hill Capital buying a stake in the firm from Genstar Capital and Lovell Minnick Partners.

'There's enough money to keep [RIA consolidation] floating around out there, plus you have an impending market dislocation. There will be a recession in the next couple of years,' said Peter Raimondi, managing partner of $1 billion RIA Dakota Wealth Management. 'As a result, the smaller firms who are targets for the larger, national firms, will feel more compelled to sell, take the money and go.'

Private equity backing comes with its own set of pressures. For the career-minded advisor, that includes pressure to retain advisory assets on the balance sheet. 'They want to protect their investment,' Greco said.

Increased private equity interest may be a sign that the RIA industry is maturing. Whether it becomes a carbon copy of the brokerage business may depend on if it is able to remember where it came from.

'The wirehouses haven't gotten everything wrong,' said Amit Dogra, the chief experience officer at breakaway RIA platform Sanctuary Wealth. 'What they got wrong was their culture. What happened was, they forgot that the client was at the center of everything. They put the shareholder or the business at the center and forgot that the client drives everything.'