



How to Fix the SEC

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I suspect I'm not the only person who gets nervous whenever I hear talk of a self-funded SEC; that is, a regulatory organization that has the power to assess fines from those it oversees, and then put the money in its own pocket. If we believe that incentives matter in the financial services world – and who doesn't? – then just as we want advisors focusing their full attention on the consumer's best interests, so too do we want the SEC focusing on consumer protection, rather than on allowing heinous misdeeds to happen and then rushing in after the fact to assess a fat fine that will raise staff bonuses across the board in late December.

My own view is that the SEC is adequately funded already, but perhaps is not ideally allocating the resources it already has. After an online conversation with a respected advisor, it is becoming clear to me that fiduciary standards and regulatory reform are only part of the solution to protecting consumers from the predatory behavior of some financial services professionals in our midst. The fix is potentially uncomplicated.

Let's take it in steps.

First, the SEC could reallocate (free up) precious resources by completely rewriting the job descriptions of its field examiners.

The press and those who want to characterize registered investment advisory firms as "unregulated" or "under-regulated" are fond of trotting out the statistic that the average firm is only visited once every ten years or so. But this manpower problem, as every advisory firm knows, is entirely one of focus, not of personnel: much of the SEC examiner's time is spent looking for fussy procedural issues – so much so that even Bernie Madoff, according to his jailhouse interview, became impatient with the process. The examiners triumphantly wrote him up on two minor issues that had nothing to do with the fact that he was routinely stealing money from his clients.

You can see how the SEC got into its current fixation with unimportant foot-faults: The odds of any examiner uncovering a Ponzi schemer or advisor who is funneling away client assets are rather low – for the simple reason that there aren't that many of them. So promotion and performance evaluations have to have more detailed metrics. Every advisory firm provides endless metrics which are almost totally beside the point of consumer protection, but offer ways to measure the thoroughness of one examiner



compared with another. The examiners pay a lot of attention to who has received your ADV this year, how good you are documenting your daily activities, the wording of your privacy forms – spending days in every advisor's office when it would take (at most) hours to determine if there are real and present dangers to the investing public.

After Congress passes the financial services reform legislation, and raises the threshold for SEC registration to \$100 million, some 6,000 advisory firms will remain under SEC jurisdiction. The organization currently has 425 examiners of RIAs – which will soon work out to one examiner for every 14 advisory firms. That means that next year, theoretically, they could each spend three weeks visiting each RIA location every year.

Instead of this enormous waste of resources, they should REDUCE the number of field examiners, so that each is responsible for 50 to 70 firms, which they will visit once or twice annually for (at most) a day each, logging into the custodian and brokerage house data, and comparing what they find with the advisor's client statements and transactions. After that, a quick look at office security (is client privacy being treated carelessly?) and perhaps the firm's marketing materials and web site, to see if any outrageous or illegal promises are being made, and a more detailed look at the process by which client portfolios are created and investments are selected – and the audit is finished. If all of that takes more than a day, then there was at least one nap involved.

A few of the remaining personnel could then be reallocated to more precise and detailed monitoring of firms which engage in high-risk activities: either they self-custody client accounts, create in-house partnership investments or otherwise have an opportunity to touch the client's money (a la Bernie Madoff), or they engage in VERY active investment or market-timing activities. Of the 300 or so examiners we have freed up from the field RIA work, maybe 30 can be put to work staying on top of the higher risk advisory firms. (I would guess that this level of scrutiny, all by itself, would cause many of those firms to rethink their high-risk activities, reducing further the enforcement workload.)

That leaves approximately 270 examiners free to take on other responsibilities, plus another 365 examiners who are currently focused on examining broker-dealer organizations. Some of these professionals would check the custodial arrangements of the Schwabs and TD Ameritrades, and the brokerage firms – anybody actually handling the money.

A larger number would also make expanded inquiries into the fairness of transactions where firms have consciously embraced conflicts of interest – on the plausible theory that if a firm embraces conflicts of interest with its customers, then it can expect those conflicts to be examined in detail on an ongoing basis.

For instance, if these firms are trading for their own accounts, are the "investment opportunities" that the company wants to unload out of its own account being presented fairly to the customers? Are there extra commissions involved, and under what criteria?



Are initial public offerings priced appropriately, and (more generally) are the investment banks engaged in cartel-like behavior if we find (as we will) that all of them happen to charge the same commission percentage to bring shares public?

Are there pay-to-play arrangements with the investments that brokers recommend, and if so, do these inevitably direct the flow of customer investment dollars regardless of the actual merit of these and competing investments?

I'm going to guess (and it's only a guess) that these expanded activities can be handled by 100 of the 270 examiners that were freed up earlier; we might allocate an average of ten independent BD organizations to one examiner, and ten specifically assigned to each major (too big to fail) brokerage firm, in addition to the people who are already working this beat.

That leaves 40 former field examiners – probably more, since almost every estimate I made earlier felt generous. I would put those 40 to work examining all the various commission-based products (and riders, in the case of VA and insurance contracts), to determine what a fair compensation should be. Is a 20-year surrender charge in the best interests of the consumer? If you run a model of potential market returns, are the profit margins on equity-indexed annuities in line with fair dealing and consumer protection standards? Are consumers actually being protected from loss by the income protection riders attached to VA contracts? Are these products being adequately disclosed and described by the prospectuses and marketing materials?

Each of those 40 examiners can examine 30 to 50 products a year – and probably raise the product standards in the marketplace dramatically, which is surely what the SEC should aspire to do for the consuming public.

Add it all up, and throw in a fiduciary standard for anyone who provides even a scintilla of advice, and you have the makings of a real difference in the safety and security of investors in all investment sectors, working with all stripes of advisor.

And it wouldn't cost the taxpayer even one more dime than we're spending now.

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