The Empire Strikes Back

By Bob Veres
December 23, 2008

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I'm sure most of you noticed that the CEO of the Financial Industry Regulatory Authority, Mary Schapiro, has been nominated to be the new SEC Commissioner. This reunites her with Elisse Walter, who had been Schapiro's top staffer; Walter was appointed to the SEC Board of Governors over the Summer. Schapiro will give up a reported $2.1 million annual salary at FINRA to accept a position that pays $158,500.

For the fiduciary planning community, there is good reason to think that this may be the worst possible selection.

Why?

An alert reader might be able to see Ms. Schapiro's thinking about the planning/RIA profession's fiduciary, consumer-first culture in a letter she co-penned by Walter--then an NASD Executive Vice President--during the height of the Merrill Lynch Rule debate back in April of 2005. The letter expressed "continuing concern with the gap that exists between the regulation of broker-dealers under the Securities Exchange Act of 1934 and NASD [FINRA's predecessor] rules and the system of investment regulation under the Investment Advisers Act of 1940." Most of us familiar with the thousands of complaints of broker abuse, the scandals, the sales of shoddy products et al might think she would be referring to the fact that RIA (fiduciary) regulation had been effective through the scandals, and be concerned that the NASD's regulation was not up to par.

We would be wrong. The letter could have been written by the marketing department of any large brokerage firm. It expresses concern about "an uneven regulatory playing field with disparate standards." This "matter of investor protection" is particularly troubling because the fiduciary duties that investment advisors owe their customers is "imprecise and indeterminate."

On page two of the letter, Ms. Walter comes right to the point: "A careful analysis of the relative regulatory standards shows that the substantive protections afforded broker-dealer customers are equivalent to, and in many cases exceed, those afforded to adviser customers."

Reading between the lines, one can infer that the top executives at the then-NASD were unhappy that fiduciary advisors are gaining market share. Page 5 of the letter complains that adviser advertising "is subject to far fewer specific standards and requirements than broker-dealer advertising. Investment advisers are subject to few specific content requirements, unlike broker-dealers who must comply with a battery of SEC and NASD standards in this area. Investment advisers do not have to obtain principal pre-approval of all sales material and they do not have to file any sales material." (Maybe because fiduciaries are not selling?)

One is tempted to read these words in light of today's market meltdown, which even veteran brokers will concede was entirely precipitated by the most prominent FINRA member firms. I think the letter offers evidence that the brokerage regulatory organization was rather complacent about the power of its compliance standards to protect the public. On page 7, Ms. Walter seems to take it as a given that the organizations she and Ms. Schapiro were in charge of regulating were well aware of their responsibilities and knew to stay well within the boundaries of ethical behavior. "NASD Rule 2110," she writes, "requires all broker-dealers to observe high standards of commercial honor and just and equitable principles of trade. Those in the brokerage industry have long regarded Rule 2110 as imposing ethical standards on broker-dealers."

Three years later, we can only wish.

Perhaps the most interesting part of Ms. Schapiro's appointment is that it highlights, yet again, how little regard our Presidents and Congress seem to have for the office. This incoming administration is not the first to ignore the qualifications specific to the Investment Advisers Act of 1940 and the fiduciary/advisory culture that the law prescribes. See if you can find the recent SEC chairperson who is NOT deeply entrenched in the brokerage world: Arthur Levitt, former chairperson of the American Stock Exchange. Harvey Pitt, go-to attorney for major brokerage firms. Bill Donaldson, co-founder of Donaldson, Lufkin & Jenrette, a major securities firm.

Ha! You found him. Chris Cox was a politician who sponsored legislation to limit shareholders' rights in lawsuits.

None of these prior Commissioners has had even rudimentary experience with advice under the 1940 Act, although only Schapiro and Pitt took office with a clear history of being hostile and defensive about brokerage regulation. I have a compendium of Schapiro's speeches (they're available on the FINRA web site);

not once has she mentioned fiduciary standards as a powerful or important regulatory instrument. And this is a woman who was once acting head of the SEC, who served as one of the five SEC board members herself!

So now we have somebody running the SEC who has strongly supported the Merrill Lynch Rule (which was struck down by the courts) as best for customers, without any concession that a fiduciary duty is a higher standard. She seems oblivious to the fact that large brokerage firms are clearly frightened by the prospect of being held, by the courts, to a fiduciary standard; incurious as to why. (Mary, if you're reading this, it's because their current business models embrace conflicts of interest against the consumer. Do you really believe it's good public policy to allow brokers to pose as trusted advisors when they recommend the funds their firms manufacture, they sell to customers whatever dog stocks their employers no longer want in their own investment account, they take fees for IPOs and also recommend them to the public, and when they sell newly-minted creative products with hefty built in and undisclosed margins?)

There are only two possible pieces of good news that I can find out of this. First, Schapiro will lead a wounded SEC, and her resume at FINRA (the global market meltdown occurred on her watch) would appear to be a bit tarnished. People in Washington tell me that in a normal year, the SEC would go to Congress and ask for its agenda, and Congress would listen carefully. But now, legislators can plausibly ask whether the SEC or FINRA or any other securities watchdog has a clue about what kind of fix is really needed.

Indeed, in the confirmation hearings, it is possible that some Congressperson or other might wonder if FINRA's multi-million dollar salaries might resemble the culture on Wall Street and its multi-million dollar bonuses. As a side issue, probably with more entertainment value than substance, five years ago, while the Bernard Madoff Ponzi scheme was building like an invisible volcano, Schapiro nominated Madoff's son Mark (then a senior employee at the family firm) to serve on the board of the National Adjudicatory Council — the division that reviews disciplinary decisions made by FINRA. If there is a FINRA enforcement action brought against Madoff, Sr., then thanks to Schapiro, Madoff's son will have an opportunity to review whether the case has merit. (Let's hope he'd recuse himself.)

The downside of this appointment is discouragingly enormous--not just for investors, but also for advisors. Schapiro has a lot of experience overseeing a regulatory process that requires everybody to be closely supervised before they dare give out advice to their customers. WE know how well that system works, but Schapiro seems to think it's a terrific model, and there is precedent under the Cox-run SEC for the chairperson to decide what kinds of things the SEC examiners should be looking for, even if there is no law on the books to support those requirements. In addition, we could see a blizzard of new requirements posted for public comment, making it very difficult for anything but a large securities firm to keep up with all the fussy paperwork requirements.

Whether or not this is Schapiro's goal, it IS the fantasy of the larger securities firms whose executives made up FINRA's board, who are losing market share to honest fiduciary advisors, and could lose more as their credibility undergoes further erosion. The harder and more unprofitable it is to run a small, independent, fee-compensated advisory shop, the less market share they are likely to lose. And who can argue with a million new fussy regulations? Aren't we here to protect the consumer?

If the new SEC Commissioner had spent any time working as an RIA, he/she would recognize that the SEC has been borrowing from the FINRA playbook for years, and the effect has been to focus a lot more attention on paperwork and a lot less on actual checking whether the advisor is dealing fairly with clients. All the paperwork does is make it harder for the advisor to provide advice when he or she already has zero incentive to make that advice harmful.

This, in fact, is what I would look for first in our new SEC Commissioner. Schapiro might be tempted to issue a lot of paperwork, proclaiming that she wants to make sure you are not the next Madoff. If it takes a month for a supervisor to review the investment performance statements or financial planning calculations you want to send to clients, well, who wanted you competing with the Member Firms in the first place?

This is probably our fault; way too many advisors have been simply working for the benefit of their clients, expecting that sooner or later somebody in Washington would notice that you, me and the fiduciary advisor down the street--many thousands of us--were doing the right thing and helping people plan and fund their retirement in the right way. Shame on us! There is no evidence that Congress or the outgoing or incoming president is aware that most advisors don't work for a big brokerage firm, that most advisors are not asking for a bailout, that advisors in the RIA world have not been at the heart of any of these scandals.

Madoff? According to his ADV, he was compensated entirely by commissions, and all of his employees were registered representatives of a broker-dealer--FINRA territory, though you wouldn't know it to read the Cox mea culpa. More importantly, unlike you, Madoff did not work through an independent custodian. Unlike RIA advisors, he could actually touch and move and take client money--which means his offices should have been very closely inspected at least once a year.

I think the planning profession needs to start its own education campaign with everybody you can talk to in Congress and in the press, and we need to point out as clearly as possible that the SEC has been, even before the Schapiro appointment, increasing its attention on things that have little relevance to providing honest advice to the consumer. The more it has moved its resources toward the failed FINRA model of regulation (which led the world to the brink of financial collapse), the less effective the SEC has been at monitoring problems and advisors have been at doing their work with clients.

This appointment will serve as our wake-up call, that we cannot any more assume that somebody will notice the good work and clean reputation of the fiduciary community, that today nobody in Washington even knows that the honest advisor has been slapped in the face.

The message we need to send to Congress is very simple. Advisors who have embraced the fiduciary standard, who are committed to putting the interests of their clients first, are not and never have been the problem with the securities marketplace--and, to be more clear, if EVERYBODY were required to live up to that standard, there is every reason to believe that most if not all of the significant problems with the securities world--scandal after scandal, disaster after disaster--could finally, cleanly, quickly be resolved.

Fiduciary liability is something that the brokerage world clearly fears; for that reason alone, our policymakers should seriously consider it.

I'm going to walk my talk on this one and send a summary and invitation to read this column to whoever reads these messages on the http://www.change.org web site. You can vote for my idea of making everybody a fiduciary by going to the site yourself.

Folks in the Obama Administration: I believe that you want nothing but the best for the American financial consumer. But for some reason, you're ignoring tens of thousands of fee-compensated advisors and fiduciaries, who have been working in the trenches trying to protect their clients from everything Wall Street has thrown at them, all the while gritting our teeth while you bail out the very organizations which caused the damage in the first place, who are our implacable business competitors--who claim to do what we do, but do not.

You've just nominated one of them to regulate us, and there is every reason to believe she has no love for the honest fiduciary advisor. She managed the organization that never managed to corral the greed and damage emanating from the securities world, and we believe that she will put these same theories to work to bury our smaller firms with a blizzard of paperwork, and allow the brokerage firms to disguise themselves in the clothing of honest advisors in order to peddle products and expensive services that do not benefit the consuming public.

We are asking for nothing more than the just consequences for not having contributed to the repeated scandals, for not having been part of the problem. Take a hard look at regulation, take a hard look at the (failed) regulatory track record of those who want to consolidate brokers and registered investment advisors under one regulatory roof, and figure out a way to let the honest fiduciary advisor do his or her job the best way we know how. We will not let you down.

I guarantee that if you, in the Obama Administration, in Congress, take this approach, you'll be rewarded in the end. If you want to go further, require all of the brokers to accept fiduciary obligations, and see if all those spectacular, intractable problems don't suddenly clean themselves up overnight, as the largest firms in the country suddenly have to answer, in court, for their actions, and put their capital on the line if they don't live up to those standards.

Everybody, including those who read this in Washington, have a great holiday season. Here's to a better year in 2009 than what we just went through.

If you would like to vote for the idea, here's the link on change.org.

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