Regulatory Armageddon

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Suppose you were somehow able to convince 40 advisors, who are all well-known thought leaders in the profession, to gather in the same room for a 6-hour brainstorming session. There would be an agenda, but the goal is more basic: to identify the single most important thing that the financial planning profession should be thinking about now, and to offer their best ideas, through a back-and-forth-and-back-again dialogue, about what we can or should do about it.

What do you think they'd come up with? Fasten your seat belts, because this may be the most important report you'll read all year.

You're going to hear an interesting buzz about the Business & Wealth Management Conference in Chicago, the attendee roster that reads like a Who's Who of the planning profession, what may be the first-ever invitation-only exhibit hall – and most importantly the sessions. After the attendee evaluations came back, it looked like we had either six or seven true home run presentations, depending on whether you count Tom Giachetti's breakout speech on The New Regulatory Normal. (Is it possible for even an extraordinary compliance-related session to be given a home run grade? It is, after all, compliance...)

You've already seen the Don Phillips speech, and the Michael Kitces MPT 2.0 presentation offered attendees a fundamentally different way of applying their familiar portfolio design formulations. The post-2008 asset management panel discussion, featuring Harold Evensky, Bill Bengen and Jerry Miccolis, received rave reviews. During the conference, there was constant buzz about the opening keynote, with Mark Tibergien and Matt Lynch unplugged and unscripted talking about the deeper aspects of succession planning. And Stephanie Bogan's closing presentation, which looked at the practice metrics of the audience members and then showed how small changes can add up to practice-transforming results, showed up on evaluation after evaluation as one of the best practice management sessions of the year.

Finally, as you'll see in the next issue of Inside Information, the portfolio managers panel with Michael Aronstein of the Marketfield Funds, John Rogers of the Ariel Funds and David Marcus of Evermore Global Advisors offered insight into, well, all sorts of things, including what, exactly, ails Europe (hint: the debt crisis is just a symptom), why the equity markets have suddenly gotten more volatile (hint: don't expect it to end any time soon), to the best

way to capture the return premium of value stocks (hint: don't get impatient or you're doomed).

Other sessions that the evaluations gave high marks to: how to use iPads in your practice, a keynote primer on working with Generation X and Y as clients and employees (or successors), and Joel Bruckenstein and Dave Drucker on the future of advisor technology. (That might have been a home run too. I didn't get to attend it because I was moderating a panel at the same time.)

All of this took place immediately following something called The Leadership Forum – that preconference group brainstorming session that I alluded to earlier. It actually happened, and I think when the dust finally settled and everybody retired to the cocktail reception, the profession as a whole had a surprisingly clearer view of where we stand and what needs to be done on one very VERY important topic.

How important? We are talking about nothing less than the survival of the fiduciary RIA/financial planning profession.

Wait a minute; the profession in some kind of mortal danger that you haven't heard about? Actually, by the end of the discussion, we realized that we had all been peripherally aware of the danger, but none of us had really grasped the full extent of it. As the talk progressed, as we began putting pieces together, the situation grew more and more alarming – until finally we found ourselves staring at what might be called regulatory armageddon.

How to kill a profession

This journey from complacency to alarm started when several of the attendees pointed out what you already know: that the brokerage industry – one of the largest and most powerful industrial groups in the world, currently the subject of an uncomfortable Occupy Wall Street protest movement – has been losing money and clients and brokers to the financial planning profession – for decades.

Fast forward into the fiduciary debate, through the very public reputational loss of face amid the bailouts and Congressional hearings of 2008, and the Wall Street executives are looking at a growing leakage of brokers into the RIA space. They see RIA competitors boldly soliciting their customers, whose loyalty was never shakier. They are intelligent people, not slow to grasp the nature of the challenge they face.

The long, slow erosion of Wall Street's market share seems to be accelerating.

"They will not," one advisor told the group, "sit by idly watching themselves die a slow death."

What can they do about it? As it happens, they're already well into the process. The Republican leadership in Congress has proposed that the SEC authorize one or more self-regulatory organizations to take over regulation of RIAs, and you know that this has been coordinated with massive Wall Street lobbying and with FINRA's very public assertions that it really, really wants the job. You know that the Wall Street brokerage firms control FINRA through their seats on its board of directors. Some might see a pattern here.

In fact, there is evidence that this exact scenario was planned at least as long ago as 2007, when the NASD merged with the New York Stock Exchange and suddenly decided to change its name from the National Association of Securities Dealers (which certainly sounds like an organization of investment salespeople) to the more general-sounding Financial Industry Regulatory Authority.

When the new name was proposed, everybody in the fiduciary world smelled a rat. There were objections to the rebranding. It was misleading in a variety of different ways. It seemed to be transparently aimed at clearing away the branding obstacles so that the brokerage industry's self-managed trade organization could expand its regulatory reach consistent with the new name. People might immediately object to the securities dealers taking over regulation of independent fiduciary advisors. But The Financial Industry Regulatory Authority sounds like a natural fit to regulate "the financial industry." Right?

When FPA and NAPFA leaders pointed out these issues, NASD spokesperson Howard Schloss responded (this is an exact quote): "I would need a degree in psychology to comment on the level of paranoia in this press release." In a different interview, he said: "While the level of paranoia displayed by these financial advisor associations is mildly amusing, at least they admit that their customers will not have FINRA protection."

In other words: How could you even THINK that we would ever want to expand our regulatory authority over the competitors of our most influential and powerful members? You're being amazingly paranoid to read that into a simple name change. Just a couple of years later, FINRA was vigorously lobbying to do exactly what it was being accused of. Today, everybody seems to have forgotten that the organization was branding people as paranoid for worrying about exactly what FINRA seems to have been planning to do all along.

This is the level of disclosure and truth-telling that advisors may have to deal with in their eager new regulator.

As you read this, another shining example of openness and transparency at FINRA has just come to light. According to Investment News, a FINRA office director in Kansas City was asked by SEC officials in Chicago to produce three sets of NASD staff meeting minutes. Before turning them over, he edited the minutes, removed entire passages, and then changed the author's signature – basically falsifying the documents and hiding something. We are not told anything about the redacted information that he was hiding,

and the SEC simply allowed the organization to neither admit nor deny guilt, but simply agree to hire an independent consultant and pledge to step up its internal compliance procedures.

This counts as barely a tap on the wrist for actions which, had a broker or firm been caught doing them, would have been suspended or barred from the business under FINRA's own rules.

The NASD CEO at the time of the violation is the same person who is ultimately responsible for the gentleness of the light tap on the wrist: SEC Chairperson Mary Schapiro.

Visioning armageddon- Part I

The Leadership Forum attendees spent more than an hour putting together the pieces of what FINRA regulation of RIAs would actually look like in the real world – something I haven't seen done anywhere else. As the pieces fell into place, the picture became more and more disturbing. A securities attorney who deals with FINRA examinations pointed out that the organization's current team of examiners has no experience with the fiduciary business model, and there is reason to believe they will be hostile to it. They are accustomed to imposing a lot of procedural hurdles and burdens on how you run your business, and the whole independent "I do things my way" or "it's good if it benefits my clients" mindset of many RIAs would no longer be tolerated. Principles would be replaced by rules, many of them.

Several people in the room have owned broker-dealers at various times in their careers, and at least one is an executive with an independent BD firm today. Distilling a long conversation down to a sentence or two, imagine what your life would be like if a bureaucrat has to review your advertising and messages to clients. He may decide to take up to six weeks to tell you whether you can send it out or not. He may also decide to pre-review every piece of correspondence you send out. You might have to have somebody initial every order ticket. And you may be subject to a $100,000 (or more, depending on AUM) net capital requirement.

And, of course, you'll pay for the privilege of being regulated. How much? Those who have direct experience with FINRA regulation and oversight were asked to estimate the user fees FINRA would assess to do on-site inspections. The answer (I hope you're sitting down): at least $15,000 a year for smaller firms, more for larger ones.

It gets worse. We were told that FINRA examiners are much MUCH quicker to bring enforcement action and hold on-the-record hearings when they find something they don't like or don't understand – unlike the SEC, which usually handles non-criminal activities with a deficiency letter. When enforcement is involved, so too are legal expenses.

Does this sound like more paranoia? In the discussion, we were told that many smaller independent broker-dealers already face what they regard as a hostile environment inside the FINRA regulatory structure. One executive with a mid-sized firm said that non-wirehouse broker-dealers are regarded as a "nuisance" by the brokerage firm executives who set FINRA policy on the board of directors. "If you talk to small BDs," he told the group, "they believe that FINRA's objective is to make sure there are no small BDs in the country." These smaller independent BDs have been battling for decades to get representation on the NASD/FINRA board.

Others said that independent advisors might be astonished at how little transparency FINRA operates under.

To take a recent example, just last year, Amerivet Securities president Elton Johnson (a former Green Beret) managed to get seven proxy votes onto the agenda at FINRA's 2010 annual meeting. These initiatives would, among other things, have required FINRA to do things that any guardian of the public interest would normally do as a matter of course: tell us the compensation paid to its ten most highly-paid employees, disclose FINRA's investment transactions to members and the public, and open up its board meetings or at least provide transcripts of the discussions among Wall Street executives and others who currently (this, to me, is amazing) make the organization's decisions in secret.

All seven of these initiatives passed overwhelmingly, garnering more than two-thirds of the membership vote, some more than 80%. The FINRA board of directors debated these measures in a closed meeting, and decided to reject them.

Visioning armageddon - Part II

As the pieces all fell in place, this is the picture that emerged. Imagine that FINRA is successful in its regulatory ambitions, and its inspectors arrive at your office door for an audit. You've paid your $15,000 (or more), set aside $100,000 to meet the net capital requirement, and stopped communicating with your clients unless absolutely necessary. You now devote half or more of your time to various paperwork issues.

What you don't know is that the FINRA board, whose discussions take place under a shroud of secrecy, has decided that firms like yours are a pest. The board members have brainstormed a number of creative ways to find fault during the inspection processes, which ties you up in expensive litigation. There are accounts of your "regulatory problems" in the local newspaper.

Meanwhile, the organization is sending out press releases saying that all this rigorous enforcement is "cleaning up the mess left by the SEC," and that the organization is being "hyper-vigilant about protecting the public in this post-Madoff world," "bringing a breath of fresh air to the regulatory environment."

How long do you think you'll be in business after, say, your second annual inspection? How long do you think the profession that has become Wall Street's primary competitor will survive under these (entire plausible) conditions?

This is regulatory armageddon.

"Being a small RIA," one person in the room told the group, "I have a real concern that if things continue to go down the road they're going down, small firms like mine will have an extremely difficult time surviving in the FINRA regulatory regime. Let's face it; they are an association of broker-dealers. They are still the NASD. I don't care what they call themselves; they haven't changed their spots."

The 21st century regulator

That summarizes the first major part of our Leadership Forum discussion. The next three or so hours focused on what we – the profession – might be able to do about this mortal threat to the profession. The conversation went back and forth and back again, but at the end I was amazed at how the group settled on a consensus solution.

Which is? Until now, the profession has been lobbying mostly against FINRA, without providing a realistic alternative, without saying what it's FOR. At the same time, the profession has been slow to acknowledge a self-evident truth: that the current examination system is broken, and has been for some years. If Bernie Madoff can survive examination after examination, and impatiently throw SEC auditors out of his offices, if he can enjoy a cozy relationship with the NASD board to the extent that whistleblower Harry Markopolos could actually FEAR FOR HIS LIFE if he took his case to the broker-dealer trade organization (as he testified in a Congressional hearing), then the system is visibly broken and everybody knows it.

You know it at a deeper level. The audits you've undergone do very little to actually protect the public – which is the most basic function of our regulators.

Once we put those two pieces in place, the solution was not hard to identify. The independent RIA/fiduciary/financial planning profession needs to stop lobbying against, and lobby for something.

Specifically, it needs to propose a better regulatory scheme than the ones that the SEC and FINRA administer today. It needs to propose a new SRO independent of FINRA or a new, better regulatory process administered by the SEC.

Perhaps most importantly, you and all your colleagues need to be willing to pay for this better regulatory scheme. "It's either pay me now or pay me later," said one participant to the group. "If FINRA succeeds in getting regulatory authority, it will cost a lot more than whatever this group proposes."

Gradually, piece by piece, the outlines of a better regulatory structure became surprisingly clear. We would call it a 21st Century Examination Process, one that takes full advantage of the technology available to the profession and the new SRO.

To start with, each RIA firm would undergo a risk assessment, and the amount of attention they receive would be graded proportionately. The regulatory fee would start with a flat amount (which we did not estimate during the brainstorming session), and go up based on how risky the RIA's activities are to the public, and how many conflicts of interest the RIA's business model embraces.

First and most basic: do you have custody of client assets, or are those assets held at a major name-brand custodian? If the assets are held at a custodian, then the most basic regulatory check can be conducted without ever visiting your offices. An examiner in the new SRO's home office could see if the money you report in your performance statements matches up against online account balances at the custodial level.

Does the RIA engage in soft dollar practices? Higher regulatory fees and more inspections. Same if the firm recommends hedge funds.

Instead of being checked every 10-14 years, audits like these, looking for the most common dangers to the consuming public, could be conducted QUARTERLY – a huge improvement in oversight right there. As an attorney in the room put it: "No more would we wait once every ten years to find out if somebody is stealing money. We will have the mechanism to electronically find out where the money is."

If, on the other hand, the firm has custody of client assets, if the RIA firm can actually touch client money, then the SRO's examiners would pay regular visits – and the RIA would pay proportionately more for the privilege of being regulated. One recommendation was that the new SRO hire retired CPAs who have done work in forensic accounting – who would instantly become the best-qualified examiners in our entire regulatory structure. (If the SRO takes over the examination chores from the SEC, then it might also hire the best SEC examiners, who would be looking for work.)

More risk assessment: Does the RIA firm only recommend investments that are priced daily with complete transparency (like stocks, bonds, mutual funds, ETFs)? The firms that create private funds or LLCs would pay higher regulatory fees to the SRO and be examined more frequently by those aforementioned forensic accountants.

This defines the first regulatory layer: process that does nothing more than systematically, in real time, confirm that your clients' money is not being stolen.

The second layer would check books and records, advertisements and how you are holding yourself out and whether you use testimonials or guarantee returns or advertise

your investment performance, whether you have a disaster recovery plan in place and a plausible policies and procedures manual that is a working document.

Just like the SEC? Not exactly. The new SRO would conduct more frequent on-site inspections of these things than the SEC does now – perhaps (we didn't get into this level of detail) every three years or so. But most importantly, there would be a systematic review of what advisors are required to do, what records they must keep etc., with an eye toward making the inspection process much clearer and more efficient than it is today. No less rigorous, you understand, but far more focused on consumer protection, rather than the current emphasis on micro-interpretations of procedure.

And, once again, many of the examiners would be experienced forensic accountants, whose job description would prominently include discovering whether you're hiding something, stealing money, or behaving sloppily with client assets.

Those in the room who have regulatory experience thought that this on-site examination could be conducted, thoroughly, in two to three days for the advisory firms at the low end of the risk scale.

FINRA vs. SEC vs. New SRO

There were more details, but the bottom line is that a plausible, thorough, workable regulatory proposal can and should be drafted, sooner rather than later, and those drafting it should not be afraid to think outside the box and use the technology resources available throughout the profession.

Of course, this proposal could be put into effect by the SEC or an independent SRO. Either way, it would involve user fees – and you should be prepared to pay them. In fact, the profession as a whole may need to contribute the first year's estimated user fees to get an independent SRO financed and off the ground.

The current political climate in Washington suggests that user fees would be easier granted to an SRO than to a government body. "The legislators are saying that user fees paid to the SEC is a tax, and we can't have any new taxes," one participant who has spent time in lobbying meetings told the group. "But it's all right to pay user fees, much higher ones, to an SRO like FINRA, because that is not a tax."

To call a spade a spade, this is actually a disguised argument for FINRA, paid for with Wall Street lobbying money. But the argument could be turned against the bought-and-paid-for Congressional representatives if, suddenly, a competing SRO proposal emerged.

The new SRO would have to be convincingly committed to protecting the public, rather than a means to protect the profession from regulatory hassles. If it was visibly smarter, more efficient and totally focused on consumer protection, a new SRO initiative might have an advantage over an organization that has, in the past, taken care of its brokerage

members. (How many FINRA enforcement actions did we see in the wake of the disastrous securitized debt sales or reckless derivative speculation leading up to 2008?)

The cost issue might also favor a new SRO or the SEC itself. To educate myself on the subject, I looked up the difference in salaries between FINRA executives and comparable people at the SEC, just to get a ballpark guesstimate of how much more FINRA might charge in user fees than the SEC would. While (as mentioned earlier) FINRA is not exactly transparent about its salary structure, I was able to find that Mary Schapiro's base salary as FINRA CEO came to $3.2 million a year – plus the $9 million bonus payment she received when she left to join the SEC. (We only know this because a number of news outlets filed Freedom of Information Act requests that were apparently vigorously resisted before the data was finally handed over.)

Schapiro's current salary at the SEC: $163,000 a year. If we simply compare that with her base salary at FINRA, without including the bonus, it would appear that FINRA regulation would be a remarkable *19 times more expensive* than the SEC as a regulator of RIA activities.

There is reason to think this is a low estimate. In 2009, FINRA collected over $700 million in regulatory fees, user fees, dispute resolution fees, transparency services fees, and contract services fees. In the same year, FINRA's leadership used the dues collected from its members to pay its top ten executives $11.6 million, to spend over $1 million lobbying Congress and the SEC (do *regulatory organizations* engage in lobbying activities?), and to spend undisclosed amounts on advertisements in The Washington Post and on CNN touting its record. In 2008, eight FINRA executives received more than $1 million in compensation and benefits, and the top 12 most-compensated employees received more than $24.8 million. One might fairly question the organization's rigorous stewardship of dollars allocated to regulatory efforts.

Before we get off the issue of a new SRO, let me tell you about one other interesting thought that circulated around the Leadership Forum discussion toward the end. A new SRO could, possibly, create a daughter SRO that would provide the same RIA oversight as the parent, but would also regulate the financial planning activities of those who hold themselves out as financial planners.

In other words, a new regulatory body could, down the road, sanction financial planning as a regulated profession. I have seen no other credible proposal that would accomplish this in the current regulatory environment.

Mixed messages

By far the messiest part of our Leadership Forum discussion involved messaging: that is, how the profession can better communicate with regulators, Congress and the public. At the most basic level, we concluded that the current messages have not been very

effective. In particular, the lobbying against rather than for has backfired in a big way against the fiduciary lobbyists. At one point, Kurtz told the group that the SEC's miserable performance getting its examiners out to advisor offices has handed FINRA a powerful message of its own. "It's killing us," he said. "FINRA's representatives will look across the table at us and say, "why don't you want to be regulated?"

Many in the room believed, one way or another, that the fiduciary RIA community has gotten off track; instead of talking about the benefits of a professional relationship, they bash the brokerage business model in routine conversations with the various stakeholders and the press. This message resonates powerfully internally; many advisors have direct experience in the brokerage world, and feel the same stridency that, say, a person who has quit smoking feels about the habit. They understand the conflicts on a much deeper level than the public ever will.

"Whenever we bash brokers, what we are doing is going up to complete strangers and saying, you know that person that you've trusted with your life savings? He's out to scam you and I'm the real thing," said one participant. "That's a terrible message, I think, to deliver. It doesn't resonate with people. You are telling them the people they trust are wrong and you're right, which is a horrible way to build trust with anyone. We breed this tremendous distrust into our message. We send the distrust message, and then we can't figure out why nobody trusts our view on this."

Another participant told the group: "When I am looking to shop for something, and the person behind the counter starts telling me how bad the other guy is, I stop and leave right away. Professionals don't do that."

What SHOULD we say? On the subject of FINRA regulation, a participant offered an absolutely marvelous line that puts the whole situation into instant perspective. "I feel like I'm a doctor who is getting ready to be regulated by the drug industry," she said.

Turning the negative message into a positive one proved more difficult. There was some discussion about Apple and the iPad, the fact that Apple's marketing materials don't talk about the Android operating system, but instead talk about how the iPad can change your life in positive ways. We didn't come up with a specific message nearly as powerful as the drug company thing, but this seemed to be the right direction to explore.

Another message: fiduciaries are in the consumer's corner. As Don Phillips pointed out in the speech I sent out earlier in the week, the fiduciary advisory profession has successfully demanded lower-cost institutional share investments. The same pressure led Schwab Advisor Services to – reluctantly – create an institutional channel where advisors can access those institutionally-priced funds. One advisor said that the money market fund alone saves his clients $300,000 a year.

Perhaps the most important message is to the profession itself. Few advisors realize that FINRA regulation may be a bullet aimed at the heart of their firms, and many seem to have given in before the battle is fairly joined. Early in the discussion, one advisor in the room questioned why we were having this conversation at all. "I believe the fix is in, and this will just be another cost of doing business" he said.

If this attitude becomes prevalent, then the battle is already lost.

I have to say, given the quality of the people in the room, I expected the Leadership Forum discussion to produce something worthy of your attention. I had no idea that we would focus so intensely on a single topic, and the results of the discussion far exceeded any reasonable expectations. In the actual 6 hours that we talked, the progress was not linear, there were many detours, many opinions. It was messy, and at times frustrating to all of us.

But in the end, these veteran professional leaders produced remarkable insight not only into a not-fully-recognized danger that we face as a profession, but also a way to address it. All in a single day.

There are two important bottom lines here that advisors everywhere should think hard about. First, FINRA regulation may be far more dangerous to the profession than we have so far realized. It may well be fatal, a bullet aimed by Wall Street at the heart of the fiduciary RIA community.

Second, one way or another, you are going to start paying user fees to whatever organization gets approval to regulate you. If the attendees at the Leadership Forum create a business plan for a new 21st Century SRO, they will ask you to pay for it, and it will be a huge bargain compared with the FINRA alternative. Please, please be publicly willing to pay less now to any organization they might propose, so that you can forestall paying much more later.

Please share this report with your friends. Regulatory armageddon is upon us. The question now is: how will the profession as a whole respond to it?

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