How to Respond to the Bachus-McCarthy Bill

By Bob Veres
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By now, I'm sure you've heard that the chairperson of the House Financial Services Committee and a member of the Committee – Spencer Bachus and Carolyn McCarthy, respectively – have introduced new legislation to authorize "one or more self-regulatory organizations" for investment advisors, which would be funded by membership fees. You can find a copy of the bill here. It is a bipartisan bill, sponsored and supported by both parties, which makes it that much scarier for the profession.

It has long been clear that Rep. Bachus speaks as a proxy for FINRA on the subject of "enhanced" regulation, and I don't think anybody close to the profession can see this as anything but a way to let FINRA take over regulation of the fiduciary RIA profession. The press release accompanying the legislative proposal goes so far as to praise the diligent regulation of broker-dealers and the lax regulation of RIAs. I think this one line offers particular insight into where this legislation is coming from:

“Customers may not understand the different titles that investment professionals use but they do believe that ‘someone’ is looking out for them and their investments. For broker-dealers that is true, but for investment advisers, it is all too often not true and that must change,” concluded Chairman Bachus.

In other words, the RIAs are the bad guys in the marketplace, who must be watched much more vigilantly, while the brokerage firms are the good guys who protect consumers.

This, of course, is taken straight from the mouths of FINRA and SIFMA, and it is not hard to find out why this particular legislator has been so persistent on this subject. When you look up where the lobbying money has gone, you find that Rep. Bachus's top ten contributors include commercial banks (a total of $213,650 in 2011-12), insurance companies ($191,010), securities and investment firms ($184,277), finance/credit companies ($90,438) and "miscellaneous finance" ($89,250). In the 2011-2012 election cycle, he was the number one fundraiser from commercial banks, from finance/credit companies and also from mortgage bankers and brokers. (All of that can be found here.)

I honestly don't want to overhype this or scare people unnecessarily, but I'm not the only person who believes that FINRA regulation of RIAs would sound a death knell for fiduciary RIA advice. It is easy to envision regulation upon regulation pounded down your throats, and enforcement of every inadvertent foot-fault which tarnishes your reputation compared with the "good guys" in that brokerage office down the street.

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I would recommend that everybody reading this contact your elected representatives and tell them that this legislation (these are the key words) would be detrimental to the small businesses in their district or state. Below is a sample letter for you to send to your elected representatives, and a press release for you to send to your local paper and press contacts. Please feel free to edit or amend this, and in the press release you should add your own quotes and contact information. Some of the press release materials can be used in anything you want to send to your clients; I tried to lay out everything that a writer/reporter would need to craft a very strong article on this subject, including some fascinating information at the end about the "public" members of FINRA's board of governors, about the Madoff connection with FINRA, staff salaries, transparency, Rep. Bachus's campaign coffers and everything else.

Beyond that, if you think passage of this bill is inevitable, backed as it is by the power of FINRA lobbying muscle, plus the brokerage industry's lobbying dollars, plus the Financial Services Institute's strong and vocal support, then there really is only one alternative. The profession has to put together a strong proposal of its own for how best to protect consumers – one that is hostile only to the malefactors and bad folks who (we all know) will enter the profession from time to time.

Fortunately, we're already moving down this path. In one of my previous e-columns, I asked advisors to give me their thoughts and ideas about what better regulation would look like.

Here, in broad outline, are the recommendations I received back. Please read and offer feedback and comments, so we can hone this down to something that is workable and also reflects a consensus in the profession (the more detail, the better):

1. The regulatory agency should also function as a compliance resource for the RIAs that it regulates. Some of its resources would be devoted to creating compliance best practices, consulting with advisory firms on the best way to make their books and records compliant, and the fiduciary processes that could be implemented in advance to make an on-site inspection less painful and more time-efficient for the inspection team.

   In addition to being proactive in helping its "members" (the Bachus bill would have the regulated RIAs be members of the SRO) stay compliant, the regulator would help develop an effective compliance software platform with third-party vendors. Which leads us to the second suggestion:

2. Develop a way to monitor RIAs remotely, by having members (or their software) automatically and electronically submit client account information that would be matched up with the custodian's records. The goal here is to address the biggest danger to consumers: that the client's money is where the advisor says it is, down

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to the penny. The regulatory agency could conduct these audits as frequently as necessary, and much of the work would be automatic – requiring little staff time.

Interestingly, there were several detailed recommendations about this process. One of the more interesting ones: have a consolidated figure at the advisor's office (the total dollars under management) match up with the consolidated figure at the custodian's. Is any money missing anywhere?

The goal is to address the biggest consumer protection need: confirm that the investor's money is safely in the hands of the custodian, in the amount that the advisor is reporting.

3. A better regulatory scheme would strongly consider outsourcing some or all of the on-site inspections and audits to third parties under contract.

   Several commentators said that we should prevent any new SRO from becoming yet another bloated bureaucracy that has no incentive to streamline or seek out efficiency improvements or better staff productivity. The recent Boston Consulting Group report commissioned by the FP Coalition made it abundantly clear that neither the SEC nor FINRA have any interest in efficiency at all, and why should they? The SEC can just ask Congress for more money. And more. And more... Or FINRA can just ask its "members" for more and more and more.

   If the auditing work were outsourced, then a lean staff at headquarters could put the work up for bid to respected private contractors (Accounting firms? Compliance law firms?) and give those firms an incentive to be innovative, stay efficient, keep costs low, maintain cordial relations with honest advisors and, most importantly, be consistently effective at identifying problem firms. Otherwise, they can be replaced by more efficient, more effective competitors.

4. Make use of secret shoppers and a wealth of information that is widely known in the profession.

   Some of the greatest threats to consumer safety come from interpersonal communications between the advisor and client, which cannot easily be monitored. Regulators (or outsourced service providers) posing as financial planning consumers would give greater insight into the real world advice that advisors are offering.

   Meanwhile, the on-site examiners would do something very simple: ask the advisor, at the end of the examination, if he/she knows of anybody in the market who has a bad reputation or seems to engage in questionable activities. Most advisors work with clients who have been given advice from other advisors, and all of you have seen the occasional mess that that other advisors have caused. If the mess seems to cross the line, shouldn't the regulator be given a heads-up?

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In addition, the regulator would have process for collecting whistleblower information from advisors who spontaneously see a client work that poses a danger to consumers in their corner of the market. Perhaps one of the first responses to this information would be to send a secret shopper to the offices of the advisor whose work has been brought to the regulator's attention.

This would obviously have to be handled carefully. The regulatory organization could establish a committee, membered only by independent directors (non-advisors), which would be granted authority to handle the procedures, management and investigation of the peer-whistleblower function. By excluding advisors from the board, whistleblowers do not have to be concerned with their peers finding out about the reporting. The committee would determine when a report seems to be valid, and when action should be taken against false reporters who seem to be acting out of malice or for competitive reasons.

5. Advisors would be held to Department of Labor fiduciary standards.

6. If a separate regulatory body were created, an alternative to FINRA, then that body would only be responsible for regulating advisors who opted in, and were willing to sign a fiduciary oath. This alone would create a clear distinction in the minds of consumers about who is, and is not, obligated to look out for their best interests. Is a given advisor regulated by FINRA under the compliance/rules-based standard set up by the brokerage industry, or have they voluntarily submitted to regulation by a separate SRO organization that imposes more stringent consumer-protection standards?

7. Adapt regulation to fit the business model of the firm being regulated. For instance, some advisors don't manage assets, but provide advice for a fee. Others manage assets and take only fees as compensation. Others take commissions. Others aggregate client assets into LLC vehicles that make more complex investments. A few firms custody assets or have control over client money through bill-paying services. There should be a checklist that identifies the level of regulatory risk in an advisor's business model.

8. There should be competence standards for those who monitor RIA activity in the regulatory home office, and those (outsourced or in-house) who are doing the examinations in the field. Over and over again, advisors commented that they had to educate, and re-educate SEC examiners about the fiduciary business model and help them understand that they weren't hiding commissions anywhere. Beyond that, advisors pointed to the Harry Markopolos proposals that the regulator hire forensic examiners and experts in the industry to examine the more complex issues that come up from time to time.

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9. Other miscellaneous proposals include having RIAs undergo psychological testing, increased scrutiny for any advisors who have changed their BD relationships often, or who get a high percentage of their revenue from high-commission products.

I hope you'll take the time to comment on these ideas, even if all you have to say is that you like this list of proposals.

There are two reasons why I hope to hear back. I would like to know which advisors are engaged on this important topic, so that in the future we can form a committee of supporters for an alternative to FINRA's proposed regulatory structure. And I would like to be able to put forth the best possible recommendations for better, more meaningful, more effective RIA regulation – something that would be hard for any future SRO to argue with as it tries to make the case for a lot of rules and quasi-fiduciary obligations.

Naturally, I would hope this exercise will ultimately have an impact. If FINRA manages to have its way in Congress, the profession might be able to shift the debate to the SEC, and ask for sounder processes than the rules-based regulation that the organization favors.

If that fails, then please notice that the Bachus legislation calls for one or more SROs to be created. I think there would be a real opportunity, if FINRA bids to become an SRO to regulate RIAs, for the profession to offer up a second SRO that would only regulate true fiduciary advisors under DOL standards. Most of you have seen my article on the Self-Regulatory Organization for Independent Investment Advisers, which I believe would be a viable candidate as that second SRO option.

I don't often experience a chill of fear as a writer/commentator for the planning/RIA profession. Today, I feel it, not for myself, but for the profession I know and love. This is a very VERY serious matter, and I hope you'll give it your full consideration. I am not being facetious when I say that my goal here is to keep you and your firm safe from serious harm.

Sample letter to your elected representative:

Dear XXX:

I want to express my strong opposition to the recently proposed Bachus-McCarthy bill, also known as the Investment Oversight Act of 2012.

This piece of legislation has the potential to do significant harm to your small business constituents by subjecting them to yet another layer of bureaucratic regulation. Worse, it would hand off regulation to an entity – FINRA – that has proven to be extremely ineffective at protecting consumers. FINRA is the organization that regulates Wall Street, which failed to prevent the 2008 scandals, including the sale of toxic investment products. Bernie Madoff was under FINRA regulatory jurisdiction for his entire career.

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Please, if and when you have an opportunity to vote on this measure, vigorously oppose this effort to build yet another bloated regulatory bureaucracy in Washington. There are far better alternatives to enhancing consumer protection than allowing Wall Street's regulator to expand its authority over the many small businesses that provide fair and transparent advice to consumers.

Model press release, to be sent out to the local papers, and any press contacts you may have.

Add your own quotes to this press release, in the form of "quote" says (your name, position, company). "further quote" You can put this anywhere in the release you want, or several places if you want.

Press Release

Contact: (your name and contact information)

Congress's Answer to Consumer Protection: Make Everybody a Wall Street Broker

On April 25, 2012, Rep. Spencer Bachus of AL and Rep. Carolyn McCarthy of NY introduced a bill which, according to the accompanying press release, would enhance consumer protection in light of the 2008 market meltdown that took the U.S. economy to the brink of collapse, and the Bernie Madoff scandal.

The solution: expand the regulatory authority of the organization that currently regulates Wall Street brokers. Make all who give investment advice answer to the organization that allowed Wall Street to sell trillions of dollars of toxic mortgage pools and derivatives, and which once had Bernie Madoff sit on its board of governors.

In other words, create a world where all advisors become brokers, and eliminate consumer access to independent, objective advice.

The Bachus-McCarthy bill, also known as the Investment Oversight Act of 2012, talks about enhancing the protection of financial consumers by allowing the Securities and Exchange Commission to delegate its oversight of many thousands of independent registered investment advisors to a self-regulatory organization. As many press reports have pointed out (see links below), the self-regulatory organization would be the Financial Industry Regulatory Authority (FINRA), the regulator that oversees Wall Street, and which has Wall Street executives sitting on its board of directors.

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FINRA is the same organization that was in charge of policing Wall Street when the 2008 scandals broke. Bernie Madoff was under FINRA jurisdiction for his entire career (including its predecessor organization, the National Association of Securities Dealers or NASD), served as a member of the board of governors of the NASD in 1984, and on numerous committees. His brother and business partner, Peter Madoff, was elected vice chairman of the NASD in November 1992.

We do not support handing over expanded regulatory authority to an organization that failed to prevent the flood of toxic mortgage pools, the sale of derivatives and sat by unconcerned while the Madoff Ponzi scheme continued for decades.

The real agenda of the bill is very clear: to give Wall Street (through its regulatory arm) control over its most persistent competition: independent advisors who, in contrast to the Wall Street sales culture, put the interests of their clients first when giving financial advice. At a time when Wall Street's credibility is at its lowest ebb, when consumers are walking away from the opportunity to send their retirement dollars into the bloated brokerage industry bonus pools, the preferred solution is not more transparency, not changing the culture to put the consumer's interests first, but to create a new regulatory overlay on the competition and bury it in paperwork.

In fact, when the Boston Consulting Group evaluated the expected cost of FINRA regulation on registered investment advisors, it concluded that the cost would be $51,700 a year in additional expenses for the average independent advisor. This is more than twice as much as it would cost to develop enhanced oversight by the Securities and Exchange Commission. (See the link below for more detail on the numbers.)

There are other ways to estimate the cost differential. FINRA (as mentioned earlier) is not exactly transparent about its salary structure, but public records show that current SEC chairperson Mary Schapiro's base salary as FINRA CEO came to $3.2 million a year – plus a $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 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 as a regulatory body. In 2008, eight FINRA executives received more

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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.

In addition, consumers and members of the press 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.

There may be significant conflicts of interest in the way this legislation was crafted and produced. It has long been clear that Rep. Bachus speaks as a proxy for FINRA on the subject of "enhanced" regulation, and I don't think anybody close to the profession can see this as anything but a way to let FINRA take over regulation of the fiduciary RIA profession. The press release accompanying the legislative proposal goes so far as to praise the diligent regulation of broker-dealers and the lax regulation of RIAs. I think this one line offers particular insight into where this legislation is coming from:

“Customers may not understand the different titles that investment professionals use but they do believe that ‘someone’ is looking out for them and their investments. For broker-dealers that is true, but for investment advisers, it is all too often not true and that must change,” concluded Chairman Bachus.

In other words, the RIAs, who are required by law to live up to a fiduciary standard (and put their clients' interests first in all advice-giving) are the bad guys in the marketplace, who must be watched much more vigilantly, while the brokerage firms (which have resisted registering their brokers as RIAs and thus evading this tougher standard behavior) are the good guys who protect consumers.

This, of course, is taken straight from the mouths of FINRA and SIFMA (the brokerage industry's lobbying group), and it is not hard to find out why this particular legislator has been so persistent on this subject. When you look up where the lobbying money has gone, you find that Rep. Bachus's top ten contributors include commercial banks (a total of $213,650 in 2011-12), insurance companies ($191,010), securities and investment firms ($184,277), finance/credit companies ($90,438) and "miscellaneous finance" ($89,250). In

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the 2011-2012 election cycle, he was the *number one* fundraiser from commercial banks, from finance/credit companies and from mortgage bankers and brokers. (All of that can be found here.)

Beyond that, Rep. Bachus has been accused of a peculiarly Wall Street crime: insider trading (see link below).

When you connect the dots on this piece of legislation, it becomes frighteningly clear that the actual agenda is something very different from consumer protection. Yet unless the public learns about this power grab by Wall Street just a few years after it brought the economy to its knees, consumers may find themselves living in a world where everybody who gives investment advice is a broker, and regulated like one.

The SRO would be FINRA: http://www.financial-planning.com/blogs/veres-sro-sec-finra-2678577-1.html

http://www.investmentnews.com/article/20120425/FREE/120429948#

The excessive cost of FINRA regulation: http://www.fa-mag.com/fa-news/9412-rias-back-sec-as-regulatory-body.html

http://www.financial-planning.com/news/finra-sro-napfa-2678574-1.html

FINRA's regulatory effectiveness (or lack thereof):
http://registeredrep.com/advisorland/opinion_finra_is_an_ineffective_regulator_1006/

FINRA's lack of transparency at the board level:
http://www.dailymarkets.com/stock/2010/06/22/finra-owes-america-answers-on-these-proposals/

http://newsandinsight.thomsonreuters.com/Legal/news/2011/02_-_february/court_refuses_to_dismiss_lawsuit_demanding_finra_transparency/

Rep. Bachus insider trading scandal: http://www.washingtonpost.com/politics/rep-bachus-faces-insider-trading-investigation/2012/02/09/gIQA21Ui2Q_story.html

Do brokerage industry representatives actually sit on FINRA's board of governors? Here's a list of the current board of governors:
http://www.finra.org/AboutFINRA/Leadership/P009756 Among others, you find representatives of Morgan Stanley Smith Barney, LPL Financial, Deutsche Bank and Edward Jones.

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But look more closely at some of the "public" members of the board of governors. John Schmidlin, who is listed as a member of the consuming public, is the former chief technology officer and managing director at JP Morgan Chase (http://www.harlemacademy.org/about/board-trustees). Richard S. Pechter, another member of the consuming public, is actually former CEO of Donaldson, Lufkin & Jenrette, and chairman of the board of Credit Suisse USA. (http://investing.businessweek.com/research/stocks/private/person.asp?personId=12665753&privcapId=165284&previousCapId=23021&previousTitle=SONY%20CORP-SPONSORED%20ADR) Kurt Stocker was chief Corporate Relations Officer of Continental Bank Corp. (http://investing.businessweek.com/research/stocks/people/person.asp?personId=11713969&ticker=NYX:US&previousCapId=3777896&previousTitle=Rensselaer%20Polytechnic%20Institute) "Public" governor William Heyman is the former Chairman of Citigroup Investments, and Executive Vice President of the Travelers Companies.

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