As featured on the March 11 issue of ThinkAdvisor
and the March 11 Financial Services Institute (FSI) Newsbrief. ThinkAdvisor

IBD Regulation: Broken Windows, Broken System

By Jonathan Henschen, CFS

At the Financial Services Institute OneVoice conference in late January, FSI President and CEO Dale Brown set the stage for things to come by commenting on the intentions of SEC Chairwoman Mary Jo White. White is the first to assume the SEC chair with a background as a federal prosecutor and securities lawyer, and her priorities reflect this litigation bent. She intends to usher in a period of rigorous enforcement, with a key component to that enforcement being the application of the "Broken Window Theory."

The thinking behind "broken windows" is that no crime is too small to garner the attention of the cop on the beat, including acts such as vandals throwing rocks through windows. As the theory goes, when a window is broken and later fixed, it signals that disorder will not be tolerated. When a broken window is not fixed, it sends a signal that breaking windows will bear no consequences and will lead to more serious crimes. White is upfront that one of her primary goals will be enforcement.

Independents Pay the Price

Given White's broken window approach to regulation, I am hopeful that we will get some relief thanks to the efforts of Dale Brown and FSI, who advocate on behalf of independent broker-dealers and their financial advisors and strives to create a healthier, more balanced regulatory environment. Still, given current circumstances, I have to make mention of former FSI Chairman Joe Russo when he says, "Regulators have a "Put" written on our industry." (Joe happens to be an options principal.)

Dale Brown's response to the SEC was spot on when he said, "The current regulatory environment is still far too costly and complex." Brown also remarks "Not a single independent financial advisor contributed to the financial crisis, and yet they're paying for it today. What we need is not an enforcement mindset on minor issues but more of a consultative approach."

There's the rub. When it comes to financial matters, customer complaints are rarely black-and-white issues like broken windows. Rather there are nuances, shades of grey that need discussion and disclosure from both sides. A good example of this is investment suitability. To police such matters in an enforcement context you'd have to say, "If the client made money on the investment it was suitable. However, if they lost money, it was unsuitable." Back in the days of the NASD, regulators did operate in more of a consultative role. They gave feedback, guidance and advice on how to better supervise and run a firm. White is moving 180 degrees from this approach, opting for a heavy-handed enforcement policy. Moreover, this is happening at the same time that we face further increases in the number of regulations thanks to Dodd Frank implementation.

Unfortunately the question "What is enough regulation and enforcement?" has the same answer as, "What is the fair share of taxes for the wealthy to pay?" with the answer being "always more!"

Ever-Shrinking Islands of Liberty

Jeff Rose, a constitutional lawyer who fights for small business owners struggling with government regulation, argues that, "government grows in one direction and doesn't shrink. Bureaucrats love rules and live to enforce them. America was conceived as a sea of liberty with islands of government power. Now we are a sea of government power with ever shrinking islands of liberty."

Right in line with this thinking, I received an e-mail from a broker-dealer president who was commenting on an article I had published, suggesting, "For your next project, maybe you could look into why FINRA is growing when most of the bad firms are gone, and the number of broker-dealers is down substantially from five years ago." Like any other government bureaucracy, this is all these little emperors know: grow in size, expense and power.

As a recruiting firm, we have already seen the impact of the broken window enforcement approach, with minor offenses being treated as major offenses and larger offenses treated as potential career enders. A 2013 case we worked on involved a representative with an outside business that encountered a liquidity squeeze when the bank called the business loan during the 2010 bank credit pullback. This rep had a clean compliance record and only this one credit issue. The credit issue resulted in state regulators requiring five years of heightened supervision, which is an extremely long requirement, given the situation.

The Risk of Appearing Friendly to "High Risk" Reps

Heightened supervision requirements, once rare events, are becoming quite commonplace as not only FINRA but many state regulators flex their disciplinary muscles. Obviously, broker-dealers don't want the burden of additional oversight and reporting required by heightened supervision, so some firms are discharging reps to avoid the extra supervision required of them. Broker-dealers also face additional pressures from errors and omissions insurance carriers. When these carriers ask about the number of reps under heightened supervision, they can exclude those reps from coverage or limit the coverage extended to the firm as a whole.

Having numerous reps under heightened supervision can also jeopardize a firm's "Rep Expansion Request (1017)" resulting in fewer representatives allowed to join the firm in a given year (I've always found it disturbing and dictatorial when regulators decide how many reps a broker-dealer can add on a year-to-year basis. Imagine regulators telling you how many clients you can add to your book in a given year!).

Broker-dealers have the additional risk of having numerous representatives under heightened supervision becoming a red flag to FINRA as a firm that willfully affiliates with "high-risk" reps. If a firm gets this "friendly to high-risk reps" reputation with regulators, the frequency and length of examinations may increase significantly. For a representative subjected to five years of heightened supervision, there are two options: find a firm willing to take on the burden, or switch to fixed insurance or go fee only.

As the 'broken windows' method of enforcement unfolds, more advisors will be forced out of the industry by minor incidences, or need to find shelter at the ever shrinking number of firms willing to do heightened supervision, which will increasingly be available only to those representatives with ample production numbers.

The Argument for Simplification

The answer to our dilemma lies in what Dale Brown said: "The current regulatory environment is far too costly and complex." The key word here is "complex."

Just as we can simplify our tax code with a flat tax, we could streamline regulation with clear boundaries to work within. Tax preparers justify their existence by the increasing complexity of our tax code just as the SEC and FINRA justify their existence by making regulations extremely complex, so they will fight tooth and nail for the status quo. Economist Thomas Sowell goes to the core of the problem when he said, "The fatal attraction of government is that it allows busybodies to impose decisions on others without paying any price themselves. That enables them to act as if there were no price, even when there are ruinous prices—paid by others."

A recent article by Stuart Isacoff, entitled "The Genius of Miles," has clear parallels to our industry and the liberation that comes with simplification. His article is about the working relationship between jazz piano pioneer Herbie Hancock and his time playing with trumpeter and jazz giant Miles Davis. Isacoff writes of the time when Mr. Hancock felt musically stuck. "Everything I played sounded the same," he confessed. Davis saw his frustration and offered some enigmatic advice. "Don't play the butter notes," he said.

"Butter notes?" thought Mr. Hancock. "What is that? Does butter mean fat? Or does it mean obvious? I had to think about it, and finally realized that if I left out the notes that most clearly define the chords it would allow the harmonies to open up to various views. It affected my playing for the rest of my life. And the audience responded—they felt my openness."

We have a growing sameness in our business as the SEC and FINRA try to regulate risk out of the industry by limiting the availability of a wide variety of products such as alternative investments, REITs and leveraged ETFs, while heaping rules on us with Dodd Frank (14,000 pages of regulations). This is on top of the thousands of pages of regulation prior to Dodd Frank. If we could get the "butter" out of our industry we could open up to greater innovation, initiating an explosion of new firms with resources once directed to regulatory "butter" now applied to better serve clients and offer more product choices.

It's inspiring to think of the possibilities, but then the realities of the current reactionary administration creep back in and I must defer my hope. Government does have the ability to simplify rules and regulations greatly. The Federal Reserve Act was 31 pages long, while the Glass-Steagall Banking Act of 1933 was only 37. A more recent example of this was at the height of the financial services crisis in 2008. At that time, the application to apply for TARP (Troubled Asset Relief Program) was only two pages long, with four clear concise bullet points. In a time of crisis, when the governing powers are in a time crunch, they can make things simple. But given a choice, they much prefer complexity.

Selling Advice to Those They Previously Regulated

Peter Schweizer, author of the book Extortion: How Politicians Extract Your Money, Buy Votes, and Line Their Own Pockets, explains, "Complexity is a useful and lucrative method of legal extortion for politicians" because, as University of London economist Anthony G. Heyes puts it, "it is precisely the complex, opacity and user-un-friendliness which underpin the value of the expertise." And that translates into "selling advice to those they previously regulated."

Many of those who drafted Dodd-Frank now work for consulting firms such as Promontory Financial Group, that advise financial services companies and banks on how to traverse and interpret Dodd-Frank in order to avoid legal vulnerability. This advice doesn't come cheap, with their fees going as high as $1,500 an hour. The former head of the SEC, Harvey Pitt, calls Dodd-Frank, "The Lawyers and Lobbyists Full Employment Act."

Professor Alan Dershowitz estimates that today the average professional commits three felonies a day without realizing it, thanks to the complex layers of regulation and legal requirements that have been built up over time. Given that the financial services industry is the most regulated of any industry, we can assume brokers and broker-dealers average about five felonies a day without realizing it. As Dodd Frank is further implemented, the number of arbitrations will increase while the 'broken windows' approach to enforcement will cause fines to flow like Niagara Falls.

Securities attorneys are salivating at the thought.

HENSCHEN & ASSOCIATES, LLC.
PO Box 56, Marine on St. Croix, MN 55047
PHONE 888.820.8107 | 651.433.3501
FAX 651.433.3570
jon@henschenassoc.com
www.FindABrokerDealer.com
©2011 Henschen & Associates, LLC
HA