FINRA Supports Regulation to Quell Competition
by David John Marotta and Megan Russell

The financial services world is split between investment advisers and broker-dealers.

Investment advisers are legally required to act as fiduciaries. They must subordinate their interests to those of their clients. Should a conflict of interest arise, they must either eliminate it completely or fully disclose it to their clients.

Broker-dealers, in contrast, are regulated by a loosely defined “suitability standard.” They are agents of a brokerage firm first and obliged to act primarily for its benefit. Massive legal disclosures handle their many conflicts of interest.

Process governs the broker-dealer. A signed disclosure is sufficient to meet regulation.

The investment adviser is governed by principles. Every action must be in the best interest of the client.

Broker-dealers generally become members of the Financial Industry Regulatory Authority (FINRA), a private self-regulatory organization. Both investment advisers and broker-dealers must register with the Securities and Exchange Commission (SEC).

The SEC is a federal agency that oversees the entire securities sector including investment advisors, broker-dealers and FINRA.

What makes the financial sector even more confusing is that some registered representatives of broker-dealers also register as investment advisor representatives (IARs). This strange breed of financial professional must submit both to the fiduciary standard of care mandated by the SEC and to the obligations and interests placed on them by their brokerage firms. Many fail at this bizarre balancing act.

According to SEC commissioner Daniel M. Gallagher, these broker-dealers have poor compliance records with 20% having to disclose one to five items “such as customer complaints, regulatory violations, terminations, bankruptcy, judgments and liens.” At the firm level, 17% of broker-dealer firms have more than 6 of these negative marks; 5% of broker-dealer firms have over 20.

On top of a high frequency of SEC citations, 842 individual broker-dealers and 30 firms on average are suspended, expelled or barred every year by FINRA because of their bad conduct.

While only 5% of the firms registered with the SEC as investment advisors are also registered as broker-dealers, FINRA firms employ 88% of the investment adviser representatives. These are the wolves of Wall Street pretending to be the helpful sheep of investment advisors.

The other 12% of IARs, however, are investment advisors who are independent of any broker-dealer. And fewer still belong to the National Association of Personal Financial Advisors (NAPFA), a private organization that imposes an even stronger fiduciary standard than the SEC. Their high standards are incompatible with the broker-dealer way of operating. Less than 1% of investment advisers are members of NAPFA.
Our firm and many NAPFA investment firms like ours purposefully avoid the high-risk practices typical of broker-dealers. We do not have custody of client investments. We only invest in publicly priced and traded investments. We buy investments that do not depend on market timing. We ensure our clients understand their investment strategy. We have no “secret sauce.” We have no financial hooks. We do not sugarcoat the reality of the markets. We receive zero commissions or brokerage fees.

We are principled advisers who are monetarily, legally and willfully incentivized to put our clients’ interests first. The only fee we receive is from our clients. We are subject to both the SEC and NAPFA’s fiduciary standard of care.

We believe these practices help safeguard our client’s financial investments.

Every Ponzi scheme has to violate several of these safeguards. Although we don’t believe these principles should be mandated by law, we do believe that firms who engage in riskier practices deserve greater regulatory scrutiny.

For years, the SEC agreed. It wisely focused its reviews on the 5% of broker-dealer firms, and those with the most risky financial practices.

However, FINRA and Commissioner Gallagher have called for a change. They have proposed three so-called solutions, but each punishes well-behaving fee-only fiduciaries and benefits FINRA member firms.

The first suggestion is to ask Congress to impose fees on non-FINRA firms so the SEC can inspect them more frequently.

SEC registration already carries a bill, but this proposal adds an additional fee at the time of the SEC’s visit. Imagine if the police made you pay a fine every time they interacted with you regardless of your guilt.

Large broker dealers have an entire department of lawyers to handle their compliance paperwork. For them, compliance issues only make up a small percentage of their operating overhead.

But the typical NAPFA firm often consists of one or two advisors and a secretary. When the SEC comes to visit smaller firms, the interruption of servicing clients is a major ordeal. Subjecting them to more frequent visits and requiring them to foot the bill punishes smaller independent firms. There is already so much regulatory compliance work that it further depletes time and resources that could be better spent elsewhere.

A second proposal asks FINRA to oversee the other 12% of financial advisors it is not already overseeing. Liken this to asking the restaurant chain with a terrible record of health code violations to oversee their competition. As a rule, FINRA does not like fee-only financial advisors because we are stealing their business. As more people understand the difference between fee-only and fee plus commission, the trend is moving toward fee-only advisors.

Even if FINRA were to evenhandedly oversee fee-only fiduciaries, their rules-based transaction mindset of written disclosures is simply not the right one for fiduciaries who put client interests first.

We should be suspicious of firms that invite government regulation into their own industry. When government regulation is requested, it is often an attempt of one industry model to quell its competition.

If FINRA was in charge of setting regulatory policy, it could destroy its fee-only competition by making their practices illegal regardless of their benefits.
We believe the ability of some firms to distinguish themselves in the free market is an important freedom to preserve. The trend among investors has been to continue the migration away from commission-based agents and broker-dealers toward fee-only fiduciaries. Keeping nonbrokerage advisors independent from FINRA is critical to this distinction.

The third proposal would require everyone in the financial services industry to be subject to a fiduciary standard including those currently only subject to a suitability standard.

This idea is somewhat naive. We put everyone in the United States under the law, but that doesn’t make everyone a law-abiding citizen. Putting criminals under the law doesn’t solve the problem of crime. We already have regulations that they are not abiding by; adding more doesn’t change that fact.

A fiduciary standard of care is more than rules and procedures. Any attempt to turn it into compliance is doomed to dilute it until the wolves have some procedures-based sham of a fiduciary standard of care, making them even harder to distinguish.

Perhaps the current situation places too much responsibility on consumers to decide for themselves. But we would rather be free to compete than pushed by government regulation to become more like the very commission-based broker-dealers with whom we compete.

Beware of government regulation, especially when a portion of the industry thinks it'll be good for business.