Financial Services Industry
Regulatory Reform and Arguments of Standards

Vincent Micciche CRCP, GFS®

The system of regulation of Financial Services in the U.S. is seen as one of the most complex and comprehensive to be found in the world. Indeed the rules and regulations promulgated by FINRA and the SEC are emulated by many countries in Europe and Asia that have advanced financial markets. Ours is arguably the most advanced regulatory structure and the benchmark to which others would be compared.

In spite of this fact, in 2008 we experienced a series of cataclysmic events in the financial markets which precipitated one of deepest recessions in history. The near simultaneous burst of the real estate bubble, the failure of Bear Stearns and Lehman Brothers, frozen credit markets and the meltdown in equities caused many an informed observer to believe that we were facing the possibility of a global collapse in financial markets.

Not surprisingly, these events fueled further political polarization between conservatives and liberals, a growing sense of distance between Wall Street and Main Street and feelings of fear, insecurity, and loss of confidence among investors. Furthermore, the fallout from 2008 raised fundamental questions of fairness in the financial marketplace, the integrity of corporate governance and, the effectiveness of regulation.

My interest in regulatory reform started back in the 80's and ramped up in 2000. As the most recognized Self Regulatory Authority (SRO) in the world, the NASD in cooperation with the Wharton School of the University of Pennsylvania launched the Certified Regulatory and Compliance Professional (CRCP) program. This program was designed to study public policy, law and regulation regarding financial services at a graduate level with a diverse population of regulators and industry professionals. Notably, it would engage high impact players in the industry in a dialogue concerning best practices and effective regulation.

At that time, I was a Chief Compliance Officer (CCO) of a rapidly growing broker/dealer. With 27 branches and over 500 reps, we were a significant player in the independent financial services market. Our representatives were classic independent practitioners that sold insurance and securities and provided broad based financial services to businesses and individuals. I already had 17 years of experience as a CCO and was committed to advancing the highest standards and best practices in the industry.

<u>Dodd-Frank Act</u>

Not surprisingly, the financial meltdown that began in 2008 led to widespread calls for regulatory reform. In June 2009, President Obama introduced a proposal which in his words called for a "sweeping overhaul of the United States financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression."

To summarize briefly, as the finalized bill emerged, the major components of Obama's original proposal included:

1. The consolidation of regulatory agencies, elimination of the national thrift charter, and new oversight council to evaluate systemic risk;
2. Comprehensive regulation of financial markets, including increased transparency of derivatives by bringing them onto exchanges;
3. Consumer protection reforms including a new consumer protection agency and uniform standards for "plain vanilla" products as well as strengthened investor protection;
4. Tools for financial crises, including a "resolution regime" complementing the existing FDIC with authority to allow for orderly winding down of bankrupt firms, and including a proposal that the Federal Reserve (the "Fed") receive authorization from the Treasury for extensions of credit in "unusual or exigent circumstances";
5. A variety of measures aimed at increasing international standards and cooperation including proposals related to improved accounting and tightened regulation of credit rating agencies.

At the President's request, Congress later added the Volker Rule to this proposal in January 2010. The massive act ultimately included 16 Titles aimed at improving transparency of financial markets, strengthening oversight of all financial institutions and increasing consumer protection. While it would be interesting to explore Dodd-Frank in depth, I have focused on those aspects of the Act that I believe impact the industry debate over standards, more specifically, a uniform standard.

Today

As of now, 280 rulemaking requirement deadlines have passed which is approximately 70% of the 389 total rulemaking requirements of the act. Of the 280 deadlines that have passed, 128 (45.7%) have been missed and 152 (54.3%) have been met with finalized rules.

Section 913 of the Act is of particular interest to today's financial consultant (FC) and bears on a primary debate within the industry. It charged the Securities Exchange Commission (SEC) with determining whether a uniform fiduciary standard of care would best serve the public interest. As of now, that determination has not been made.

Since its introduction, two distinct camps have emerged regarding Dodd-Frank and any additional rulemaking for that matter. There are those that believe stronger surveillance, accountability and enforcement will restore public trust and confidence. Then there are those that believe the industry already has plenty of rules and that adding more would only impair the ability of the industry to conduct business. It would add expense, decrease efficiency and do little, if anything, to improve customer service or protection.

I think we are more likely to find agreement while exploring the merits and pitfalls of a uniform standard for the industry whether fiduciary or otherwise.

Is there a correlation between rules and behavior?

To anyone that has raised children this may seem like a rhetorical question. I think we understand intuitively that rules do little to motivate good behavior but can be effective at deterring bad behavior provided there are substantial penalties and consistent enforcement awaiting violations.

In my experience as an expert witness and Chief Compliance Officer I find that the correlation between rules and behavior is inversely related to the size of the institution. In small and midsize firms, the cost of non-compliance in the form of regulatory fines and censures can be enough to put them out of business and, therefore, compliance is an important variable in the business model of the firm. On the other hand, very large firms may be willing to challenge the compliance envelope systematically if the fines levied by regulators are a small portion of the profits earned by the marginal activity. In other words it may make perfect economic sense to violate certain rules.

Absent a clearly defined ethos that is deeply embedded in the culture of any institution, governance of behavior will more likely be affected by anticipated and actual economic outcome.

An unintended consequence of a complex rules based system is that it may provide opportunity for an unethical practitioner. Don Trone, a renowned fiduciary expert, explains "Voluminous regulations only make it easier for dishonest organizations to hide within the system; and complicated financial disclosures make it more difficult for the public to make informed decisions" (Trone)

The Retail Financial Consultant and Marketplace Have Evolved

Until about 1980, the primary disciplines within the retail financial services industry were very separate and discreet.

- **Insurance Agents** were highly trained, specialized and confined to selling life insurance and related products. They were licensed and regulated by the insurance department of the state in which they were domiciled. The more advanced practitioners worked in estate planning, retirement planning and business succession planning.

- **Stock Brokers** were similarly specialized and confined to selling stocks, bonds and other traditional securities. They were licensed and regulated by the National Association of Securities Dealers (NASD).

- **Portfolio Managers** only managed assets – they didn't sell anything. They were Registered Investment Advisors (RIA) with and regulated by the SEC.

Today's FC commonly performs several or all of the above mentioned services. Almost without exception, the registered representatives that I have worked with and trained for over thirty years hold a Life and Health Insurance license, a securities license (series 6 or 7) and many have a series 65 which allows them to provide services of a Registered Investment Advisor (RIA).

The number of designations available to today’s financial consultant has grown exponentially. Many practitioners have business cards and letterheads that look like alphabet soup. They commonly present themselves as broad based financial advisors that are capable of meeting most retail customer’s financial needs including Insurance, Securities, Managed Accounts and Financial Planning.

The appearance of “Holding Out” as an element in arbitration claims is growing along with concerns of regulators. In recent years FINRA has significantly increased targeted examination of firms and individuals that hold out as senior specialists and included the topic in the 2011 Annual Regulatory and Examination Priorities Letter.

In January 2011, FINRA conducted a firm survey of retail broker-dealer firms that varied in terms of size, location, product mix and business model to obtain information regarding the use and oversight of senior designations[1]. This survey is part of FINRA's ongoing efforts to focus on firms' fair dealings with senior investors. FINRA reiterated that the protection of vulnerable customers, including senior investors, continues to be a high regulatory priority. Regulatory Notice 11-52 includes further information regarding the 2011 survey.

[1] We received survey responses from 157 firms. The survey results show that for those firms responding, 68 percent of firms allow the use of senior designations by registered persons. Of the firms that permit the use of senior designations:

- 89 percent currently have registered persons who use senior designations; and
- 11 percent do not have any registered persons using senior designations at this time.

Firms that allow the use of senior designations were also asked if they required registered persons to obtain senior or other professional designations prior to marketing certain products to senior investors. Only two firms responded affirmatively to this question.

Ambiguity is a Serious Problem for Everyone

The Customer

The typical consumer, when speaking to their financial consultant, is unaware of the fact that different rules, regulations and standards apply to that FC depending on which hat he is wearing at the moment. More than likely, in the course of their discussion, the FC will touch on all of the aforementioned products and services. The customer tends to assume that the FC is without conflict and acting in their best interest. At the risk of sounding cynical, we all know that is rarely the case. The ability to discern what rules and standards apply is beyond the customer's capacity and raises fundamental questions of fair dealing.

The Financial Consultant

As illustrated above, today's FC is a broad based practitioner who holds multiple licenses in multiple jurisdictions and is answering to many masters. Standards of care and duties are jurisdictionally sensitive, especially in the area of insurance products and services. His continuing education requirements are literally all over the map and are often redundant and non-reciprocal. From his perspective, the policies and procedures of the broker/dealer he is registered with are controlling and sufficient to meet his regulatory obligations. This is often not the case as the broker/dealer is concerned only with his securities activities. Even more problematic is the fact that professional organizations to which he belongs may impose still different rules and standards.

Regulators and Litigation Counsel

I group these two for a couple reasons – litigation is an effective para regulatory tool and the dilemmas they face are similar. A common scenario that could be highly problematic for both regulators and litigators is as follows:

A registered representative has sold investments and fixed insurance products to a customer pursuant to a financial plan that he prepared. Subsequently the indexed universal life (one of the fixed products) fails to perform as expected and becomes the subject of a complaint to FINRA and arbitration against the broker/dealer and registered representative.

FINRA will have a lot of difficulty sanctioning the firm and rep because, among other things, the product in question is not a security.

Claimants Counsel will have their hands full dealing with the defense expert that eloquently and convincingly explains that the recommendation to purchase the life insurance was reasonable and suitable, the disclosures were ample and adequate, and the customer had the opportunity to decline the policy under a "free look" and did not.

The Insurance Company, if named as a defendant, will probably get dismissed from the arbitration arguing that they are not a FINRA member and thus not subject to arbitration. If you sue them in court, they will argue that this dispute belongs in arbitration as it concerns the sales practices of a registered representative which they cannot control like the broker/dealer does. They will argue that the standard of care owed by the insurance company is minimal and was met by causing the broker/dealer to certify annually that they have adequate policies and procedures in place to ensure suitable sales.

From FINRA 2310 to 2111 - A New Look at Suitability

New FINRA Rule 2111 generally is modeled after former NASD Rule 2310 (Suitability) and requires that a firm or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.

The new rule continues to use a broker's "recommendation" as the triggering event for application of the rule and continues to apply a flexible "facts and circumstances" approach to determining what communications constitute such a recommendation. Notably it recognizes "investment strategies" as recommendations.

In the past, the "Know Your Customer Rule" (NYSE Rule 405) was referred to tangentially and not specifically a FINRA rule. FINRA Rule 2090, which was introduced with 2111, fully incorporated 405. FINRA Rule 2090 (Know Your Customer) is modeled after former NYSE Rule 405 and requires firms to use "reasonable diligence," in regard to the opening and maintenance of every account and to know the "essential facts"[2] concerning every customer. Furthermore, it recognizes the fact that the know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation.

Many compliance professionals, like me, believe that viewing 2111 in conjunction with 2090 and the overarching rule 2010 is an indication that FINRA is moving toward a principles based regulatory platform.

The Solution: A Uniform Standard for the Financial Services Industry

Nearly four years later, it appears doubtful that the SEC will impose a uniform fiduciary standard pursuant to section 913 of Dodd-Frank. It is also unlikely that the imposition of more rules on the industry will motivate positive behavior of practitioners or improve the quality of service they provide to the public.

In order to restore public trust, the industry needs to demonstrate affirmative action in addressing issues of ethics, morality and stewardship. A prerequisite to the debate of standard of care is the acceptance of the fact that such a duty is owed not just legally but morally.

[2] From FINRA 2090 "essential facts" are "those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."

While acknowledging the fact that principles are a bit amorphous when compared to rules, there is a middle ground that I believe can significantly improve the quality and integrity of retail financial services. If the industry is willing to, it can adopt and enforce a standard based on stewardship principles.

A Blue Print

The logical place to begin would be FINRA. They have the largest infrastructure of any regulator, they are already moving in the principles based direction, they have a mandate and the authority to regulate sales practices and most importantly, they already have a rule in place that can evolve into a Stewardship Standard in the form of rule **2010 - Standards of Commercial Honor and Principles of Trade** which states:

A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.

Intuitively, it would be designed around industry best practices and fiduciary principles that apply to fiduciaries which essentially require that one must demonstrate:

1. The detail of their decision making process;
2. That the process was prudent and;
3. That the decision was in the clients best interest

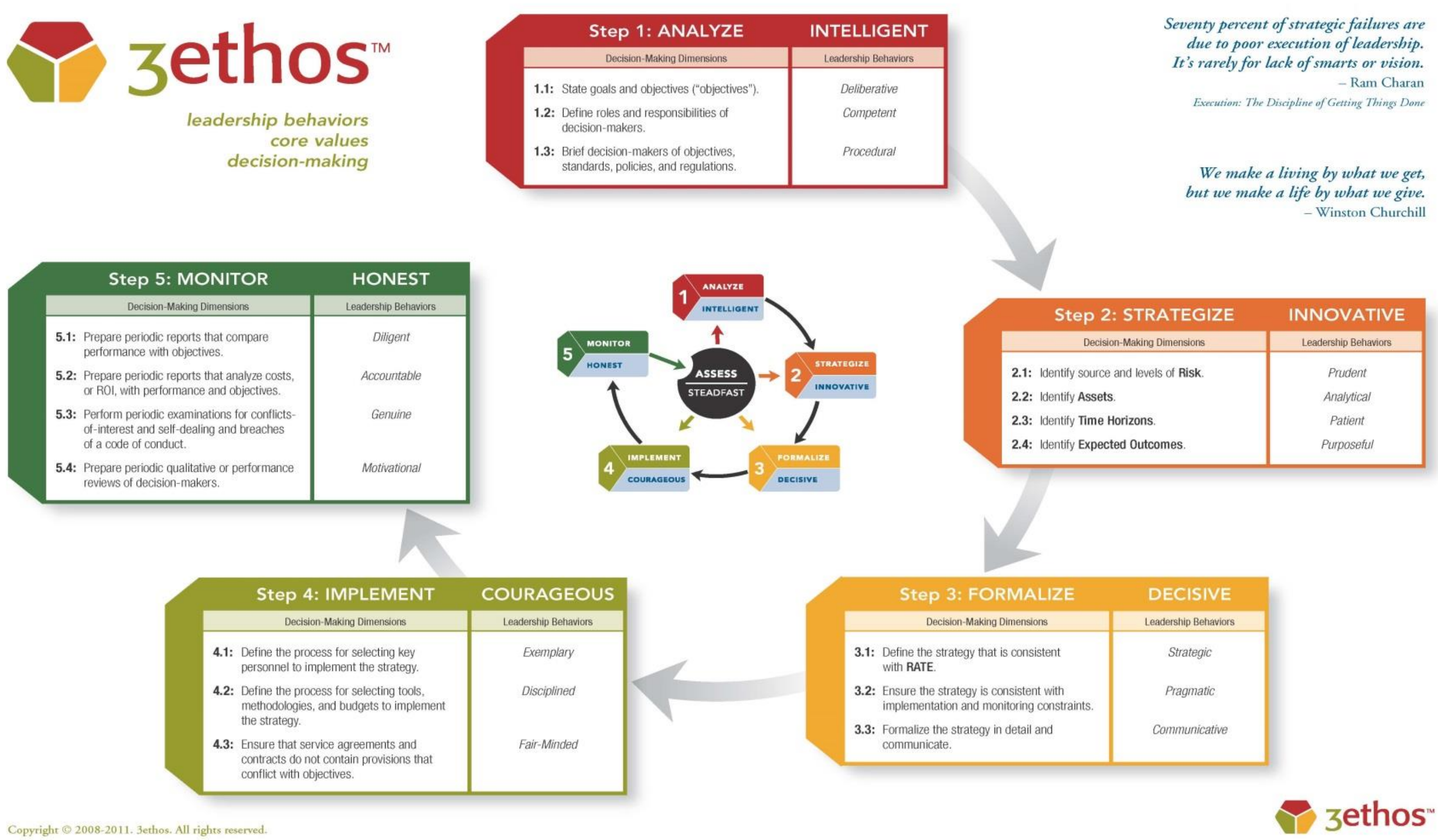
In order to be effective and practical it must be easily adopted within a sales environment, easily taught and implemented, and be portable as it would need to work with the primary disciplines of the industry.

For over three decades, I have strived to build and deploy a sales practice model that meets these conceptual criteria. Along the way I have come to know many firms and advisors that are committed to serving the best interests of their clients. One of the most influential professionals I have ever met was Don Trone[3] who I referenced earlier. We met at an industry summit meeting a few years ago where I was introduced to the model that Don designed. I immediately realized that he beat me to it. I felt like I found the Rosetta Stone!

The image below is a schematic of a procedurally prudent process that is taught in leadership training programs that were designed by Don. With Don's permission I adopted the curriculum underlying this diagram as firm element training for my firm, LifeMark Securities Corp. We were the first to conduct firm wide training and last year we graduated 25 candidates and conferred to them the Global Financial Steward (GFS®) designation. This year, the Leadership Center for Investment Stewards of which Don is co-founder and President will conduct many leadership training boots camps at West Point, New York.

Most of the boot camps are being commissioned by large firms for the benefit of their top producers. While not firm wide, it's a great start! The movement has begun.

[3] Don Trone is a co-founder and President of the Leadership Center for Investment Stewards, a Swiss-based professional society with its U.S. office in Mystic, CT. The mission of the Leadership Center is to inspire and train decision-makers to serve more effectively as stewards in critical leadership roles. Don also is the founder and CEO of 3ethos; the first Director of the Institute for Leadership at the U.S. Coast Guard Academy; founder and former President of the Foundation for Fiduciary Studies; and, principal founder and former CEO of fi360.



In Summary, as the financial services industry continues to evolve, we can reasonably expect the financial instruments offered to the public to become more complex. Accordingly it will become more difficult for a strictly rules based system to achieve the primary goals of maintaining fair markets and public trust. Such a system naturally demands more rules, more surveillance and more penalties and more effective enforcement.

The fundamental problem is this, the well-intended community of compliance professionals and regulators charged with the duty of protecting the public cannot reasonably possess the total knowledge necessary to do so. The creators of complex products like swaps, CDO's, indexed insurance instruments, hybrid derivatives, high frequency trading platforms, virtual exchanges and the like will always have the upper hand.

We are more likely to achieve positive change by embracing policies that are directed toward developing a more ethical corporate culture. Corporate governance and leadership should be as concerned with the duty of care they owe the public as they are with the profit they owe their shareholders.

I am not suggesting that we can somehow legislate good behavior. Instead, I believe that efforts to improve training in stewardship principles and to incent responsible corporate leadership will improve the manner in which we serve the public. Furthermore the adoption and enforcement of uniform standards will frustrate the ability of the predatory element of the industry to operate under the cover of ambiguity and confusion.

About the Author:

Mr. Micciche is a nationally renowned insurance and securities expert. Mr. Micciche has been the Chief Compliance Officer of LifeMark Securities Corp., an independently owned national broker/dealer which he co-founded, since 1983. He has held senior management positions in the securities industry for 30 years. In 2003 he was awarded the distinguished designation of Certified Compliance and Regulatory Professional CRCP from the Wharton-NASD Institute of Professional Development. He holds a Certificate in Fiduciary Governance from the Walker Center for Global Entrepreneurship and the professional designation of GFS™ (Global Financial Steward).

He has taught, consulted, and provided expert testimony on the suitability of insurance products and securities, sales practices, duties of brokers and firms, and adequacy of supervisory systems and due diligence for over fifteen years. He has been retained in over 450 matters involving securities and insurance products including several large class actions. He frequently lectures on the subject of industry standards and norms, and regulation in both the insurance and securities industries.

He provides consulting and expert services to claimants, respondents, financial institutions, state and federal regulators. He has been quoted in Investment News, Life Insurance Selling, National Underwriter, Dow Jones Newswire, and various other industry publications.

Vince is presently a member of the Life Insurance Task Force whose purpose is to compile and publish a set of best practices for the industry and propose they be adopted as a uniform standard as called for in the Dodd-Frank Act.

