FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

STATEMENT FOR THE RECORD

On

The U.S. House Committee on Financial Services,
Subcommittee on Capital Markets and Government Sponsored Enterprises

"Securities Investor Protection Corporation: Past, Present, and Future"

March 7, 2012

FINANCIAL SERVICES INSTITUTE — VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

Statement of the Financial Services Institute
To the Subcommittee on Capital Markets and Government Sponsored Enterprises
For Oversight Hearing on the Securities Investor Protection Corporation

The Financial Services Institute (FSI) represents independent financial services firms and the independent financial advisors affiliated with them. We are pleased that the Subcommittee is holding this hearing to explore the issues facing the Securities Investor Protection Corporation (SIPC). We wish to register our concerns regarding proposed changes to the structure of SIPC assessments, particularly our strong opposition to the disproportionate financial impact that independent broker-dealer (IBD) firms will be forced to bear under revised SIPC assessments and the SIPC Modernization Task Force's recommendations.

Independent Broker-Dealer Firms were not part of the problem and are Disproportionately Impacted by Increased Assessments

It is clear that IBD firms were not part of the problems that created the most recent financial crisis. Yet, these same firms are disproportionately bearing the burden of the failures that resulted in the crisis through the imposition of significant and unanticipated increases in SIPC assessments. The failure of Lehman Brothers and the Ponzi scheme of Bernie Madoff, as well as others, have placed an enormous burden on IBD firms. Prior to 2009, SIPC assessments were at the very minimum, $150 per year. In fact, this had been the practice for so long that our members had developed a reasonable expectation that the cost would remain at that level for the foreseeable future.

Instead, since 2009 SIPC assessments have increased exponentially and without warning. The result has been a significant blow to IBD firms, making already difficult economic circumstances even more challenging. To wit, the following is a brief list that demonstrates the impact:

- A small FSI member firm located in the Southeastern United States, with approximately $20 million in revenues in 2011, had the following SIPC assessments from 2008 to 2011:
    - 2008 - $150.00
    - 2009 – Approximately $10,000 – a 6566.67% increase from the prior year
    - 2010 - $22,417 – a 124.17% increase from the prior year
    - 2011 - $34,891 – a 55.65% increase from the prior year
- A mid-size FSI member firm in located in the Southwestern United States, with approximate revenues of $65 million in 2011, had the following SIPC assessments from 2008 to 2011:
    - 2008 - $150.00
    - 2009 - $32,107 – an increase of 21,304.67% from the prior year
    - 2010 - $84,660 – an increase of 163.68% from the prior year
    - 2011 - $71,595
- A large FSI member firm in the Northeastern United States with approximately $170 million in revenue in 2011, had the following SIPC assessments from 2008 to 2011:
    - 2008 - $150.00
    - 2009 - $486,714 – an increase of 324,376% from the prior year

- 2010 - $795,174 – an increase of 63.38% from the prior year
- 2011 - $835,763 – an increase of 5.1% from the prior year
- 2012 - projects near $1,000,000

Profit margins for IBD firms are generally very small. From 2004 to 2010, the average annual profit margin for IBD firms was 1.7%. SIPC assessments are likely to remain high for the foreseeable future, especially with recent developments involving a court battle between the SEC and SIPC to determine coverage for victims of the R. Allen Stanford Ponzi scheme and the failure of MF Global currently progressing through SIPC liquidation.

These assessments are having a disparate impact on small IBD firms which don't have the resources to absorb the large and unexpected increase in fees. Furthermore, many IBD firms operate as dual registrants conducting both investment advisory and securities brokerage operations under a single corporate entity. Small firms are organized in this manner to reduce costs and simplify their business operations. This structure results in additional complications due to the fact that when investment advisory services are segregated into a separate corporate entity they are excluded from SIPC assessments, but are included when they occur under the same corporate entity as the brokerage services. IBD firms should not be penalized simply for choosing a more efficient business structure that helps lower their costs.

Another reason IBD firms are shouldering a disproportionate share of the burden is that IBD firms present a significantly lower risk of causing SIPC payouts due to the fact that they operate as introducing brokers. As such, they are prohibited from obtaining custody of investor funds and securities, and therefore receive no cash or securities from investors other than for transmittal purposes. Instead checks are made payable directly to the product sponsor and accounts are held, and securities transactions are processed, through clearing firms. The risk to investors is significantly less in this model and, thus, the risk of an adverse event requiring SIPC liquidation is also lower.

In addition, the vast majority of IBD firms do not sell proprietary securities or insurance products. Those IBD firms who do engage in proprietary product sales are usually subsidiaries of large, heavily regulated insurance companies and typically do not offer their financial advisors preferential compensation for the sale of those products. Proprietary products are often the vehicle through which those who perpetrate financial fraud, like R. Allen Stanford, gain access to investor funds. Once again, the structure of the typical IBD firm lowers the risk of SIPC payouts.

Effects of Increased SIPC Assessments to IBD Firms

The results of excessively high SIPC assessments will continue to be predictable: failure of small IBD firms. In 2008 there were more than 5,000 broker-dealer firms. By 2012 that number has fallen to just over 4,500, with approximately 175 broker-dealer firms failing in 2009 alone, the first year of the increased assessments.

The failure of small IBD firms will have a significant impact on the securities industry. Smaller IBD firms are a significant source of industry innovation. With profit margins generally very slim, small IBD firms have incentives to consistently develop new methods of efficiently and effectively meeting their regulatory obligations, while at the same time providing the financial advice and services that Main Street Americans need and demand. These innovations often are adopted by others in the industry and become industry best practices. The excessively high SIPC assessments will lead to not only failures of small IBD firms, but also to reduced investment in new resources and innovation – including the hiring and training of new employees, acquisition of new equipment and development of software – among remaining IBD firms.

Beyond industry innovation, there is a more significant impact that the loss of IBD firms will have: decreased access to financial advice, services and products for Main Street Americans seeking to save for retirement and their children's education. Small IBD firms and the independent financial advisers associated with them typically provide financial services and products to middle-class investors that are not served by larger firms. These investors need access to quality financial advice, products and service every bit as much as wealthier investors. However, many of these investors are unable to access these products and services through large wire house firms, which often find servicing smaller accounts unprofitable. Without the small IBD firms and their associated independent financial advisors providing local access to financial advice, less affluent investors will be left to their own devices to achieve their financial goals.

Implementation of the SIPC Modernization Task Force Recommendations will perpetuate these problems

Should the recommendations of the SIPC Modernization Task Force be adopted, the problems outlined above will only be perpetuated. The Task Force has recommended, among other things, the following:

- Increase the minimum assessments,
- Increase the caps on coverage to $1.3 million indexed for inflation, and
- Eliminate the distinctions between cash and securities to allow larger recoveries.

Unfortunately, the Task Force failed to make major reforms that would more equitably distribute the costs. We believe that this is a result of failing to include small firm representation on the Task Force.

A Better Approach

FSI believes that true SIPC modernization requires a system that provides recovery to defrauded securities investors in a smooth and orderly process. In order to be equitable, such a system should impose the greatest cost for maintaining the system on those that present the greatest risk. This system must also provide broker-dealers with greater predictability so that they can budget appropriately for the costs. Finally, the system must avoid imposing a disproportionate impact on IBD or other firms.

We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues. Please contact David T. Bellaire, Esq., FSI's General Counsel & Director of Government Affairs at 770 980-8488 or david.bellaire@financialservices.org if you would like more information on the Financial Services Institute and our position on this important issue.

Background on FSI and the Independent Broker-Dealer Community

The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees of their affiliated broker-dealer firm.[1] These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market for advisors affiliated with IBDs is clients who have tens and hundreds of thousands, as opposed to millions, of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[2] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. Our mission is to insure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. We also provide our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

---

[1] Cerulli Associates at http://www.cerulli.com/.
[2] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.