The Insurance Solution for Financial Advice Failures

Issue: Implementing mandatory insurance coverage for financial advisors is essential to protect customers from being made penniless when substandard advice causes harm. Instituting insurance coverage requirements would provide protection for investors and allow market forces to discipline conduct. Insurance would greatly reduce the millions of dollars in unpaid arbitration awards.

Substandard advice by financial advisors can lead to significant financial harm. For decades, bottom-tier financial services firms have profited by selling high-commission products only to fold once claims for abusive sales practices arrive. In 2000, the Government Accountability Office found that 49% of arbitration awards against stockbrokers and brokerage firms went unpaid. FINRA's data still shows that, from 2019 through 2023, $77 million of awards went unpaid and that still, twenty years later, nearly 1 in 4 arbitration awards go unpaid. These victims are investors who have lost their life savings, often retirement funds, have followed the rules, filed an arbitration claim, had an arbitration panel determine they were wronged or defrauded, and yet were unable to collect or recover their funds. In response to this long term and pervasive scourge, in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 964, Congress identified ten specific oversight priorities for the SEC's oversight of FINRA, one of which was "arbitration services." The GAO was to periodically report on the SEC's performance of its oversight. According to a 2021 GAO report, the SEC neglected to perform necessary oversight of FINRA and its arbitration process. In the 2024 Senate Appropriations Bill, the SEC was instructed by Congress to "engage with FINRA to identify ways to reduce and eliminate the occurrence of unpaid award." SR-206-118 at 103.

Wall Street's firms come in different varieties which are each regulated by different entities. Some operate as FINRA-supervised brokerage firms, generally selling securities in exchange for transaction-based compensation. Others operate as SEC or state registered investment advisory firms, receiving compensation directly for investment advice about securities. Often financial advisors operate under both regimes simultaneously, with their duties to the customer shifting depending on what hat they are wearing at the time. In recent years, business models have shifted, with more brokers and brokerage firms shifting to operate as investment advisors. Private equity firms have accelerated this move by acquiring investment advisory firms for their predictable cash flows and growth.

Proposed Solution: One of the ways to effectively "reduce and eliminate the occurrence of unpaid awards" is to requiring financial advisers to carry insurance coverage. Here's how:

1. **Investor Protection**: Insurance coverage ensures that investors can recover their losses even if the adviser is unable to pay. This provides a safety net for investors and enhances their confidence in the financial advisory industry.

2. **Market Discipline**: Insurance companies will assess the risk associated with insuring financial advisers. Advisers with a history of misconduct or poor performance will face higher premiums or may be denied coverage altogether. This creates a market-driven mechanism to discipline advisers and incentivize good practices.

3. **Regulatory Alignment**: Implementing insurance requirements would provide a uniform standard of protection across different jurisdictions and regulatory bodies, simplifying compliance for advisers and enhancing investor protection. It would harmonize the fragmented regulatory landscape.

Conclusion: Mandating insurance coverage for financial advisers is a practical and effective solution to protect investors and improve the quality of financial advice. It leverages market forces to discipline advisers, addresses the issue of unpaid arbitration awards, and aligns regulatory standards. Policymakers should consider this approach to enhance the integrity and reliability of the financial advisory industry.