H.R. 4624: THE PITFALLS OF A SELF-REGULATORY ORGANIZATION FOR INVESTMENT ADVISERS AND WHY USER FEES WOULD BETTER ACCOMPLISH THE GOAL OF INVESTMENT ADVISER ACCOUNTABILITY

DAVID G. TITTSWORTH[†]

INTRODUCTION

On April 25, 2012, Representative Spencer Bachus III (R-Al.) introduced House Bill 4624, the Investment Adviser Oversight Act of 2012 ("H.R. 4624"), which mandated membership in a self-regulatory organization ("SRO") for many Securities and Exchange Commission ("SEC") and state-registered investment advisers. The bill, while ultimately not enacted, would have subjected thousands of advisory firms to an additional layer of regulation by a private regulator with broad rulemaking, inspection, and enforcement authority—and, in all likelihood, that private regulator would have been the Financial Industry Regulatory Authority ("FINRA").

The Investment Adviser Association ("IAA") strongly opposed H.R. 4624. The substantial drawbacks to an SRO significantly outweigh any potential benefits. These drawbacks include minimal transparency and accountability, insufficient oversight by the SEC and Congress, conflicts of interest, excessive costs, and the lack of meaningful due process protections and cost-benefit analysis restraints.

H.R. 4624 unfairly targeted small businesses. Because of exemptions in the bill, smaller advisers were singled out for additional regulation and costs. The substantial costs and

[†] Executive Director and Executive Vice President, Investment Adviser Association. This Article is adapted from the author's statement from *The Investment Adviser Oversight Act of 2012: Hearing on H.R. 4624 Before the H. Comm. on Fin. Servs.*, 112th Cong. (2012).

bureaucracy of an additional, unnecessary layer of SRO regulation and oversight of advisory firms would have had a significant adverse impact on small businesses and job creation. Further, the bill would have resulted in inconsistent regulation and regulatory arbitrage.

Supporters indicated that the bill responded to an SEC report mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") studying various options to enhance SEC examinations of investment advisers. If enhancing investment adviser examinations was the objective, however, H.R. 4624 represented both the least effective and the most costly option. H.R. 4624 ventured far beyond the focus on investment adviser examinations to extend an additional layer of unnecessary regulation on advisers. Supporters also claimed that the bill would have "level[ed] [the] playing field" for brokers and advisers.[1] They did not, however, commend the benefits of FINRA regulation. Rather, this was an attempt to impose on investment advisers the same regulatory framework that currently exists for brokers. Far from leveling the playing field, this bill would have created a dramatically tilted playing field by burdening those investment advisers captured by this bill with additional, unnecessary regulation.

The IAA particularly opposed, and still opposes, extending FINRA's jurisdiction to investment advisers due to its lack of transparency and accountability, questionable track record, experience and bias favoring the broker-dealer regulatory model, and the costs involved. Alternatively, the IAA has expressed support for appropriate measures to enhance the SEC's examination program for investment advisers. The SEC, a governmental regulator that is accountable to Congress and the public, has more than seven decades of experience and expertise regulating and inspecting investment advisers. The SEC is best positioned to provide effective oversight for all SEC-registered investment advisers, irrespective of asset size and type of clients served. To ensure that the SEC has sufficient resources for adviser oversight, and as an alternative to an SRO, the IAA supports the assessment of an appropriate "user fee" on SEC-

[1] *The Investment Adviser Oversight Act of 2012: Hearing on H.R. 4624 Before the H. Comm. on Fin. Servs.*, 112th Cong. 42 (2012) (statement of Chet Helck, Chief Executive Officer, Global Private Client Group, Raymond James Financial Inc. and Chairman-Elect, Securities Industry and Financial Markets Association).

registered investment advisers to be used solely to fund additional examinations by the SEC. Legislation to authorize user fees should include provisions that: (1) specifically preclude any investment adviser SRO if such fees are imposed; (2) clarify that such user fees will be dedicated to an increased level of investment adviser examinations—instead of simply being used as substitute funding for the existing level of examinations; and (3) set forth specific SEC reporting requirements and review of any such user fees by Congress and the public.

The user fee approach provides many benefits. User fees would provide stable yet scalable resources to support and strengthen the SEC's examination of investment advisers. The fees collected would be used solely to fund enhancements to the investment adviser examination program and increase the frequency of adviser examinations. Importantly, the reporting and accountability embedded in the user fee approach would provide substantial transparency and opportunity for congressional oversight and public input.

As demonstrated by a Boston Consulting Group ("BCG") report, the costs of user fees would be significantly less than the costs of SRO oversight.[2] Further, if an investment adviser SRO were mandated, the resulting new oversight responsibilities would require the SEC to expend significant additional resources. In summary, the IAA strongly believes that there are better answers than the option presented by H.R. 4624. Now that the bill has been defeated, the IAA strongly urges Congress to consider other—and better—options.

I. BACKGROUND

Investment advisers manage assets for a wide array of individual and institutional investors. As of April 2013, approximately 10,500 investment advisers were registered with the SEC, collectively managing assets totaling about $54.8 trillion for millions of individual and institutional clients.[3]

---

[2] BOS. CONSULTING GRP., INVESTMENT ADVISOR OVERSIGHT: ECONOMIC ANALYSIS OF OPTIONS (2011), *available at* http://advisors4advisors.com/files/BCG_IAOversightStudy.pdf.

[3] *See* INV. ADVISER ASS'N & NAT'L REGULATORY SERVS., 2012 EVOLUTION REVOLUTION: A PROFILE OF THE INVESTMENT ADVISER PROFESSION 2 (2013), *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA-NRS_Evolution_Revolution_Reports/evolution_revolution_2013.pdf.

Investment advisers engage in a wide range of advisory activities and implement investment strategies on behalf of their clients, including constructing securities portfolios pursuant to client directives, recommending asset allocation, providing portfolio analysis and evaluation, assisting in selecting and monitoring other advisers, and providing wealth management and financial planning services. In addition, investment advisers manage assets for individuals, families, trusts, mutual funds, hedge funds, private equity funds, pension plans, state and municipal entities, banks, insurance companies, charitable endowments, foundations, and corporations, and serve as sub-advisers to funds or accounts managed by other advisers. These activities play a critical role in helping investors, both individually and through pooled investment vehicles, achieve their financial goals.

While investment advisory firms range from small, local or regional firms to large global financial institutions with varying business models, the overwhelming majority of investment advisory firms are small businesses. Indeed, more than half of all federally-registered advisers employ fewer than ten employees and more than eighty-five percent employ fewer than fifty non-clerical employees.[4] In addition, most of the 17,300 state-registered investment advisers are small businesses.[5] A self-regulatory organization, such as that mandated by H.R. 4624, would have disproportionately affected these small businesses, subjecting them to expansive rulemaking, inspection, and enforcement authority by a private regulator.

H.R. 4624 would have mandated SRO membership for SEC-registered and state-registered investment advisers, subject to broad exemptions.[6] Specifically, the legislation would have exempted an advisory firm if it had a single mutual fund as a client—no matter the fund's size and regardless of other firm characteristics.[7] The legislation would have also exempted an advisory firm if ninety percent or more of the firm's assets under management ("AUM") were attributable to "qualified purchasers"—that is, individuals with $5 million in investments

---

[4] *Id.*

[5] *See* N. AM. SEC. ADM'RS ASS'N, THE IA SWITCH: A SUCCESSFUL COLLABORATION TO ENHANCE INVESTOR PROTECTION 2 (2013), *available at* http://www.nasaa.org/wp-content/uploads/2011/08/IA-Switch-Report.pdf.

[6] H.R. 4624, 112th Cong. § 2 (2012).

[7] *Id.*

or institutions with $25 million in investments—hedge funds, private equity funds, venture capital funds, non-U.S. clients, other investment advisers and broker-dealers, and other entities, including certain non-profit clients, real estate funds, issuers of asset-backed securities, and tax-qualified retirement funds.[8] In addition, investment advisers that were affiliated with these exempt advisory firms would have been largely excluded from the SRO membership requirement.[9] The SEC, however, would have been tasked with determining on a case-by-case basis whether an affiliate is sufficiently independent from the exempt adviser such that SRO membership should be required.[10]

The bill would have required that SRO rules be designed to prevent fraudulent and manipulative acts, to promote "business conduct standards" for its members consistent with advisers' obligations to investors, to be consistent with the fiduciary standards applicable to advisers under the Investment Advisers Act of 1940 ("Advisers Act") or state law, and to not unnecessarily duplicate, overlap, or conflict with such laws.[11] The SRO would have had authority to enforce the Advisers Act and any SRO rules and to establish disciplinary procedures to do so.[12] The bill would have required SRO rules to establish appropriate procedures to "register persons associated with members" and to require "supervisory systems" for members and their associated persons.[13]

Under the bill, the SRO would have been required to provide for "periodic" examinations of its members and their associated persons to determine compliance with the Advisers Act and SRO rules.[14] However, the SRO would not have conducted periodic exams of a state-regulated adviser in a state that had adopted a plan to conduct an on-site examination of all state-regulated advisers, on average, once every four years.[15] In addition, the SRO would have been permitted to conduct "for cause" exams of all members of the SRO, including state-registered advisers.[16]

---

[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*

The bill would have required the SEC to conduct annual inspections of the SRO to ensure it complied with the Advisers Act and its rules and regulations.[17] Further, the bill would have required the SRO to issue a publicly available annual report to the SEC on its operations, performance, and financial condition.[18] Although the legislation would have allowed for more than one "national investment adviser association" to apply to become an adviser SRO, the bill was structured to most readily enable FINRA to act in that capacity.[19]

II. WHY THE IAA STRONGLY OPPOSED H.R. 4624 AND AN SRO FOR INVESTMENT ADVISERS GENERALLY

The IAA strongly opposes mandating an SRO for investment advisers. The SEC's regulation and oversight of investment advisers should not be outsourced to a private regulator unaccountable to Congress or the public. The IAA believes that the SEC is the most efficient and effective regulator of SEC-registered investment advisers. There is simply no compelling reason to outsource oversight of investment advisers to either a new SRO or any existing entity that has no expertise with the investment adviser industry or its regulatory framework.

The SRO regime that would have been established by H.R. 4624 is flawed. It would have resulted in inconsistent regulation of the same or similar activities and encouraged regulatory arbitrage. In addition, the SRO model set forth in H.R. 4624 was not cost effective. It would have specifically targeted small businesses for unnecessary costs and burdens, exacerbated the SEC's challenges in allocating its resources, and resulted in unnecessary expansion of burdensome regulations and bureaucracy. The legislation was clearly designed to favor FINRA's organizational model. We particularly oppose extending FINRA's jurisdiction to investment advisers, due to FINRA's lack of investment adviser expertise, lack of accountability, lack of transparency, excessive costs, and questionable track record.

---

[17] *Id.*
[18] *Id.*
[19] *Id.*

A. The SRO Model Is Flawed.

The SRO model of regulation suffers from significant flaws. SROs are not accountable to Congress or the public and are not subject to requirements related to the Administrative Procedure Act ("APA"), the public records laws, due process, the Freedom of Information Act, cost-benefit analysis, and other critical protections. Moreover, the effectiveness of SROs has not been demonstrated. These deficiencies in the SRO model have been identified in meaningful reports and studies, including those from the SEC staff, the Government Accountability Office ("GAO"), the U.S. Chamber of Commerce, and the Boston Consulting Group.

Congress, in Dodd-Frank Act section 914, directed the SEC to conduct a study to review and analyze the need for enhanced examination and enforcement resources of investment advisers. The SEC issued a staff report ("Section 914 Report") expressing concern that it did not have sufficient capacity to conduct effective examinations of investment advisers with adequate frequency and set forth three options for addressing this concern: (1) assess user fees on SEC-registered investment advisers to fund their examinations by the SEC; (2) authorize one or more SROs to examine all SEC-registered investment advisers; and (3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.[20] The Section 914 Report identified significant drawbacks to the SRO model, notably including conflicts of interest inherent in self-regulation and the costs and funding involved.

A 2011 GAO report studying a potential SRO for private fund advisers similarly found serious drawbacks to the SRO model, including its potential to

> (1) increase the overall cost of regulation by adding another layer of oversight; (2) create conflicts of interest, in part because of the possibility for self-regulation to favor the interests of the industry over the interests of investors and the public; and

[20] SEC. & EXCH. COMM'N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 4 (2011), *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf [hereinafter SECTION 914 REPORT].

> (3) limit transparency and accountability, as the SRO would be accountable primarily to its members rather than to Congress or the public.[21]

In addition, the report noted that the SRO model "expose[s] firms to duplicative examinations and costs."[22]

Consistent with these studies, the U.S. Chamber of Commerce focused, in a 2011 report, on the lack of accountability by certain nongovernmental policymakers with significant and growing influence, including FINRA:

> Despite their tremendous influence over the workings of the capital markets, these organizations are generally subject to few or none of the traditional checks and balances that constrain government agencies. This means they are devoid of or substantially lack critical elements of governance and operational transparency, substantive and procedural standards for decision making, and meaningful due process mechanisms that allow market participants to object to their determinations.[23]

The Chamber of Commerce report further observed that SROs are not bound by the congressional appropriations process or other comparable checks on their power.[24]

Moreover, in a study required by section 967 of the Dodd-Frank Act of the SEC's structure, organization, and need for reforms ("BCG Section 967 Report"), BCG found numerous problems in the SEC's relationship with SROs, including inadequate oversight and lack of standards to measure SRO effectiveness. BCG found that

---

[21] U.S. GOV'T ACCOUNTABILITY OFFICE, PRIVATE FUND ADVISERS: ALTHOUGH A SELF-REGULATORY ORGANIZATION COULD SUPPLEMENT SEC OVERSIGHT, IT WOULD PRESENT CHALLENGES AND TRADE-OFFS 20 (2011), *available at* http://www.gao.gov/new.items/d11623.pdf. Section 416 of the Dodd-Frank Act required the GAO to study the feasibility of forming an SRO to provide primary oversight of private fund advisers.

[22] *Id.*

[23] U.S. CHAMBER'S CTR. FOR CAPITAL MKTS. COMPETITIVENESS, U.S. CAPITAL MARKETS COMPETITIVENESS: THE UNFINISHED AGENDA 5 (2011) [hereinafter CAPITAL MARKETS REPORT], *available at* https://www.uschamber.com/sites/default/files/legacy/reports/1107_UnfinishedAgenda_WEB.pdf.

[24] *Id.* at 14; *see also* BOS. CONSULTING GRP., INC., U.S. SECURITIES AND EXCHANGE COMMISSION: ORGANIZATIONAL STUDY AND REFORM 25 (2011) [hereinafter BCG SECTION 967 REPORT], *available at* http://www.sec.gov/news/studies/2011/967study.pdf.

> [g]iven the role of SROs in the regulatory framework, it is vital that the SEC develop both a clear set of standards for how SROs are to regulate and a means for assessing whether SROs are complying with those standards. . . . To strengthen its oversight of SROs, however, there are additional actions that can be taken . . . .[25]

These actions include "[e]nhanc[ing] SRO disclosures regarding their regulatory operations"; "institut[ing] metrics to monitor SROs and minimum standards for their regulatory activities"; and "enhanc[ing] FINRA oversight."[26]

The BCG Section 967 Report observed that SROs are not accountable to the SEC and that the agency and SROs are not coordinating effectively.[27] The report noted that if the SEC were to be funded adequately, rather than expanding the role of SROs, "there are strong arguments and global precedents to consolidate more regulatory activities from SROs into the national regulator. This will reduce real and/or perceived conflicts of interest that SROs may have, ensure greater control and visibility into market information for the SEC, and clarify the governance of securities regulation."[28]

Further, the BCG Section 967 Report found that the SEC has not been able to fully leverage and oversee SROs due to certain legal issues. For example, FINRA has been reluctant to share examination and other information with the SEC, asserting that under the "state actor" doctrine, such sharing could cause FINRA to be deemed a government actor for various purposes, including the constitutional rights of defendants in enforcement actions.[29]

H.R. 4624 did not adequately address any of these deficiencies in the SRO model. For example, although it would have required the SRO to explain and respond to comments received regarding the costs and benefits of a proposed rule, the

---

[25] BCG SECTION 967 REPORT, *supra* note 24, at 134. The SEC selected BCG, a well-established consulting firm, to conduct the mandated study.

[26] *Id.*

[27] *Id.* at 25.

[28] *Id.* at 150.

[29] *Id.* at 65. Section (g)(2) of H.R. 4624 provides that the sharing of information by an adviser SRO with state or federal agencies will not be "construed to be the action of such an agency." H.R. 4624, 112th Cong. § 2(g)(2) (2012). It is not clear whether this provision adequately addresses the constitutional analysis of state action. Further, while it permits the sharing of information, it does not compel an SRO to actually do so. *Id.* § 2.

bill did not require the SRO to affirmatively conduct its own cost-benefit analysis. Further, it would have provided no direct remedies for an SRO's failure to adequately do so; interested parties would not have been able to bring suit against the SRO to ensure it conducted an appropriate cost-benefit analysis. Presumably, the SEC would have been required to determine that the SRO met its obligations to conduct a cost-benefit analysis with respect to each of its proposals, but, historically, the SEC has not scrutinized SRO proposals in this way. Such analysis by the SEC would have required substantial additional effort and resources.

Similarly, the bill did not address the transparency typically lacking in the SRO model. An SRO designated pursuant to this legislation would not have been required to hold open meetings, to respond to Freedom of Information Act requests, or otherwise comply with the APA. Although the bill required an SRO to submit an annual report, it did not require congressional or SEC oversight of the SRO's budget or governance.[30] Nor did it address concerns regarding due process protections during disciplinary hearings.[31] The bill referenced notice-and-comment rulemaking under the APA but did not clearly apply the APA to an SRO's consideration of its rules and rule changes, nor did it provide direct recourse if APA procedures were not followed. In addition, the SEC's oversight of SRO rulemaking may have been largely deferential: The SEC would only need to find that the "proposed rule is consistent with the Exchange Act"; thus, the SEC was not required to pass judgment on the wisdom or merits of the SRO rules.[32]

[30] *See* SECTION 914 REPORT, *supra* note 20, at 37 n.82 (comparing the PCAOB and FINRA governance models and noting that the PCAOB model requires SEC review of the annual budget and SEC appointment of board members); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-625, SECURITIES REGULATION: OPPORTUNITIES EXIST TO IMPROVE SEC'S OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY 16 (2012) [hereinafter 2012 GAO REPORT], *available at* http://gao.gov/assets/600/591222.pdf (noting that the SEC historically has not overseen FINRA's budget, executive compensation, or governance issues).

[31] *Fixing the Watchdog: Legislative Proposals To Improve and Enhance the Securities and Exchange Commission: Hearing Before the H. Comm. on Fin. Servs.*, 112 Cong. 77 (2011) (statement of Paul S. Atkins, Visiting Scholar, Am. Enter. Inst.) [hereinafter *Atkins Testimony*] (raising due process concerns regarding FINRA disciplinary hearings and noting that FINRA's claim that it is not a "state actor" may deny defendants the right to invoke the Fifth Amendment).

[32] *See* BCG SECTION 967 REPORT, *supra* note 24, at 65 (noting limited nature of SEC's review of SRO rules).

B. H.R. 4624 Would Have Resulted in Inconsistent Regulation and Regulatory Arbitrage

The SRO regime mandated by H.R. 4624 would have been particularly inappropriate for investment advisers. Indeed, the Section 914 Report catalogues numerous problems inherent in designating an SRO for the diverse investment advisory profession, including questions regarding governance, scope of authority, membership, conflicts of interest, and funding. For example, the report observes that an adviser SRO presents unique governance issues given the diversity of the industry, because it will be challenging to ensure that no business model dominates or is given a competitive advantage by the SRO.[33] The report also notes the concern that an SRO might have access to unique data and could seek to sell related services to the members it regulates.

The Section 914 Report particularly notes the challenges presented in considering the scope of a potential SRO, stating that "[c]rafting exclusions for certain types of investment advisers could be difficult in practice because . . . many investment advisers have diverse client bases and business lines. Moreover, exclusions could provide opportunities for regulatory arbitrage."[34] These challenges were amply demonstrated by H.R. 4624.

H.R. 4624 evidently attempted to distinguish between "retail" investment advisory firms and "institutional" advisory firms; the former would have been subject to SRO requirements, while the latter would have remained solely under SEC regulation and oversight.[35] The bill, however, did not appropriately draw these lines.[36] Instead, the legislation's exemptions from SRO requirements would have resulted in inconsistent treatment of investment advisers engaged in similar

---

[33] SECTION 914 REPORT, *supra* note 20, at 35.

[34] *Id.*

[35] *See* H.R. 4624, 112th Cong. § 2 (2012).

[36] There is no settled notion of a "retail" investment advisory firm. For example, an advisory firm may specialize in advising highly wealthy individuals—for example, with $2 million to $4 million in investable assets—and small or mid-sized businesses, pension plans, or endowments—for example, with $10 million to $20 million in assets. Even though most would not consider such a firm to be "retail" oriented, it would not qualify for the SRO exemption under H.R. 4624 because its clients do not meet the "qualified purchaser" threshold—$5 million in investable assets for individuals and $25 million for entities. *Id.*

activities—including different registration and licensing requirements, different substantive regulations, and substantially different costs. In addition to the SRO membership requirements, similar or identical advisers would have likely been subject to different disclosure, advertising, or supervision rules. One set of advisers would have been subject only to SEC or state rules. Another similar or identical set of advisers would have been subject to both SEC or state rules and a new set of technical, detailed "business conduct" rules. These disparities were not justified by reasoned analysis.

For example, the bill exempted from SRO membership any investment adviser if one or more of its clients was a mutual fund.[37] This means that two nearly identical firms—same types of clients, assets under management, number of employees, investment style, revenues, profitability, and so forth—would have been treated differently if one firm had a single mutual fund client and the other did not. An adviser that manages assets for high-net-worth individuals[38] and one mutual fund would have been subject to a different set of rules than an adviser that manages assets only for high-net-worth clients.

The ninety percent test in H.R. 4624 produced similarly anomalous results.[39] An advisory firm that manages $150 billion in assets would have been exempt from the SRO requirements of H.R. 4624, even though a very large amount of assets—up to $15 billion—could have been attributable to thousands of "retail" clients. At the same time, an advisory firm that manages $150 million in assets would have been subject to SRO requirements if only $16 million of its assets were attributable to relatively few "retail" clients. Similarly, an adviser that manages assets, eleven percent of which were attributable to "retail" clients, would have been subject to different rules than an identical adviser that manages assets, nine percent of which were attributable to such clients. Further, an adviser with one client base and investment strategy could have been subject to a

[37] *Id.*

[38] Most SEC-registered advisers—more than sixty percent—manage assets for high-net-worth individuals, according to data filed on Form ADV, Part 1, which defines "high net worth" individuals generally as those with $2 million or more in net worth excluding primary residence. Note that H.R. 4624 only includes *ultra*-high-net-worth individuals—$5 million or more in investments—in its list of exempted clients. *See id.*

[39] *Id.*

different set of rules than an adviser with an identical client base and investment strategy simply because it was affiliated with an exempt adviser.

The legislation likely would have encouraged regulatory arbitrage as firms restructured their businesses and/or dismissed individual and small business clients to avoid the costs and additional regulatory burdens of an SRO. The bill would have driven business models and created structural incentives. For example, many investment advisers that would have otherwise been subject to SRO regulation may have decided to establish or sub-advise a small mutual fund. Similarly, advisers may have chosen to affiliate with other investment advisers that either advise a mutual fund or manage sufficient "institutional" assets to absorb the adviser within its aggregated ninety percent AUM threshold for exemption from SRO membership. Advisers may have also avoided having the AUM of smaller clients attributed to them by structuring arrangements to sub-advise or provide model portfolio management to other advisers with those clients.

These structural changes would have led to even more advisers remaining under SEC oversight than the bill contemplated and that have the same core business and clients as the advisers subject to SRO jurisdiction, further exacerbating the inconsistent regulation of similar businesses. The Section 914 Report identified similar concerns, noting that if an SRO is limited in its membership by clientele type or other characteristics, many advisers would still be left under the SEC's oversight.[40] The report observed that if the SEC and an SRO—or multiple SROs—shared regulatory authority over advisers, the regime would be vulnerable to regulatory arbitrage.[41]

C. *H.R. 4624 Was Not Cost Effective*

Establishing and maintaining a new SRO would impose substantial costs and burdens on investment advisers, with a disproportionate impact on smaller advisers. It would exacerbate, rather than ameliorate, the SEC's resource constraints. Further, it would create an unnecessary additional layer of regulation on advisers. At a time when small businesses, including advisers, are becoming overwhelmed with new

[40] BCG SECTION 967 REPORT, *supra* note 24, at 34–35.
[41] *Id.* at 33.

regulatory burdens, Congress should search for the least costly and most effective alternative to directly address the specific problem identified.

1. The Bill Inappropriately Targeted Small Businesses with Additional Costs and Regulations

H.R. 4624 would have disproportionately burdened thousands of small businesses that serve small and mid-sized investors with the costs of a duplicative and unnecessary layer of regulation and bureaucracy.

The bill's exemptions for advisers to mutual funds, private funds, "qualified purchasers," and certain other clients meant that the vast majority of larger advisory firms would not be subject to SRO membership requirements. Instead, thousands of smaller advisory firms would be required to shoulder the costs of establishing and maintaining an SRO. As one commentator recently noted, H.R. 4624 "would impose a tax on small advisory businesses and, indirectly, the mainstream investors they advise, from which large advisors and their high net worth clients would be exempt."[42] Further, there is no evidence that imposing an SRO on these small firms, which represent a small fraction of the assets managed by advisers, would address the SEC's resource constraints or uncover problems of substantial magnitude.[43]

As discussed below, the costs on small business to establish and maintain an SRO would be substantial. In addition, the impact of an additional layer of regulation and bureaucracy on these small firms would result in a significant and unnecessary burden. Compliance with SEC regulations, as well as other applicable regulations—including Department of Labor regulations—currently requires significant dedication of resources by investment advisory firms. If the substantial costs of this additional layer of regulation on these small businesses were passed on to investors, it would negatively affect retirement

---

[42] Mercer Bullard, *The New Self-Regulator for Advisors: A Taxing Affair for Small Businesses and Small Investors*, MORNINGSTAR (May 10, 2012), http://ibd.morningstar.com/article/article.asp?id=553408&CN=brf295,http://ibd.morningstar.com/archive/archive.asp?inputs=days=14;frmtId=12,%20brf295.

[43] Indeed, the stated poster-child for this legislation, Bernard Madoff's brokerage firm, which had been subject to SEC and FINRA inspections for decades before it registered as an investment adviser in September 2006, would likely have been exempt from the SRO membership requirements in H.R. 4624. *See id.*

savings and investment.[44] If pricing resistance is such that all of the costs cannot be passed on, the costs would have a significant impact on job retention and creation in these small businesses—in which human resources account for the vast portion of the cost structure.

2. The Bill Would Have Exacerbated, Not Ameliorated, the SEC's Resource Issues

H.R. 4624 would not have eased the SEC's resource constraints but would have instead placed additional burdens on the agency. Appropriate government oversight is required in any SRO structure and thus requires dedication of significant government resources. The Section 914 Report observed that an SRO would not free all of the resources the SEC currently devotes to investment adviser examinations:

> Commission resources would still be required to oversee the operations of any SRO by . . . conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee and rule changes. Substantial resources of both [the inspection staff and the policy staff] are currently employed to oversee the activities of FINRA.[45]

For example, the SEC employs more than 300 staff to examine, and oversee FINRA's examination program of, broker-dealers—in addition to close to fifty inspection staff who currently focus on FINRA and other SRO oversight.[46] Additional, substantial SEC expenditures will be required in the future just to effectively oversee the current SROs under its jurisdiction.[47]

These current challenges would be magnified not only by the extension of SRO jurisdiction to SEC-registered advisers but also to thousands of state-registered advisers. The SEC would be obligated to exercise appropriate supervision over the SRO's activities regarding thousands of state-registered advisers with respect to which the SEC currently has no regulatory

---

[44] *See, e.g.*, BCG SECTION 967 REPORT, *supra* note 24, at 151 (noting potential for SRO costs to be passed on "to investors in a way that makes investing unaffordable for many").

[45] SECTION 914 REPORT, *supra* note 20, at 30; *see also* Bullard, *supra* note 42.

[46] BCG SECTION 967 REPORT, *supra* note 24, at 64; SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS A-15 (2011) [hereinafter SECTION 913 REPORT], *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[47] BCG SECTION 967 REPORT, *supra* note 24, at 39–41.

responsibility. As a result, H.R. 4624 likely would have exacerbated the SEC's resource constraints. Indeed, the legislation may have resulted in a double layer of expenditures—investment advisers would have been required to pay substantial fees to an SRO for regulation and the SEC would have had to re-allocate substantial funds to fulfill extensive additional oversight responsibilities for the SRO.

In addition, this bill would have required the SEC to conduct a firm-by-firm analysis of which companies under common control should have been subject to SRO jurisdiction and which should have remained solely under SEC jurisdiction due to their affiliations with other entities solely under SEC jurisdiction. There are almost 4,000 SEC-registered advisers with affiliated investment advisers.[48] The analysis of these firms would have consumed substantial SEC resources, not only initially, but on an ongoing basis as firms affiliated or changed their affiliations over time.

Former SEC Chairman Mary Schapiro has testified regarding the strain that review of SRO rulemaking places on the agency. She stated that the

> Dodd-Frank Act's imposition of new procedural requirements with respect to the SEC's processing of proposed SRO rule changes has placed further demands on an already complex and resource-intensive process. The volume of annual requests has increased by over 80 percent in the last five years, with the Commission receiving over 2,000 requests for approval or guidance in 2011.[49]

The addition of oversight duties for an adviser SRO with rulemaking authority would only compound these concerns and further strain SEC resources.

---

[48] *See* Norm Champ, Deputy Dir., Office of Compliance Inspections & Examinations, Sec. & Exch. Comm'n., Speech at the New York City Bar: What SEC Registration Means for Hedge Fund Advisors (May 11, 2012), *available at* http://www.sec.gov/news/speech/2012/spch051112nc.htm.

[49] *Oversight of the U.S. Securities and Exchange Commission: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 63 (2012) (statement of Mary L. Schapiro, Chairman, Securities and Exchange Commission) [hereinafter *SEC 2012 Testimony*].

3. An SRO Would Result in Unnecessary and Costly Regulation

The current regulatory framework for investment advisers is robust and protects investors. There is no evidence that a second layer of regulation imposed by an SRO is needed. Investment advisers are comprehensively regulated through the rules and requirements promulgated by the SEC and are subject to inspections and oversight by the agency. Investment advisers are subject to an overarching fiduciary duty requiring them to act in their clients' best interest and disclose all material facts and conflicts of interest.

Pursuant to the Advisers Act, as a fiduciary, "an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions."[50] In practical terms, fiduciary duty means that, in the course of providing advice to clients, advisers must disclose all material information and conflicts of interest to their clients, including the fees that they charge, how they plan to recommend securities to clients, and any material disciplinary information involving the firms or their investment personnel. Moreover, as fiduciaries, advisers must treat their clients fairly and not favor one client over another, especially if they would somehow benefit from favoring one particular client or type of client. Most important, whenever the interests of investment advisers differ from those of their clients, advisers must explain the conflict to the clients and act to mitigate or eliminate it, ensuring they act in the interests of the client and not for their own benefit.

This well-established standard has been consistently interpreted and applied by the SEC and the courts to require investment advisers to serve their clients with the highest duty of loyalty and duty of care.[51] Among the specific obligations that flow from an adviser's fiduciary duty are the following: (1) the duty to have an adequate, reasonable basis for its investment advice; (2) the duty to seek best execution for clients' securities transactions where the adviser directs such transactions; (3) the duty to render advice that is suitable to clients' needs, objectives, and financial circumstances; (4) the duty not to subrogate clients'

[50] Thomas P. Lemke & Gerald T. Lins, *Regulation of Investment Advisers* § 2:33 (2013); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963).

[51] *Capital Gains*, 375 U.S. at 194.

interests to its own; (5) the duty not to use client assets for itself; (6) the duty to maintain client confidentiality; and (7) the duty to make full and fair disclosure to clients of all material facts, particularly regarding conflicts of interest.[52]

In addition, all SEC-registered investment advisers are required to submit detailed registration information on Form ADV, Part 1, which is publicly available, and update it at least annually and promptly for material changes.[53] Advisers are also required to provide clients with a plain English brochure and brochure supplement, Form ADV, Part 2.[54] The brochures are filed with the SEC and are publicly available. The brochure and brochure supplement provide extensive information regarding each investment adviser and key advisory personnel. Advisers are required to disclose detailed information about their firms, including: the educational and business background of each person who determines or provides advice to clients; the adviser's basic fee schedule, including how fees are charged and whether such fees are negotiable; types of investments and methods of securities analysis used; how the adviser reviews client accounts; the adviser's other business activities; material financial arrangements with a wide variety of entities; certain referral arrangements; and numerous other disclosures that describe activities that may pose potential conflicts of interest with the adviser's clients, including specific disclosures relating to trading and brokerage practices. In addition, advisers to private funds must soon submit extensive information to the SEC about their holdings, counterparty exposures, performance, and leverage on the new Form PF.

---

[52] *See* Amendments to Form ADV, Investment Advisers Act Release No. 3060, 2010 WL 2957506, at *1 (Aug. 12, 2010) (to be codified at 17 C.F.R. pt. 275, 279); Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406, 59 FR 13,464 n.3 (proposed Mar. 16, 1994) (noting duty of full disclosure of conflicts of interest, duty of loyalty, duty of best execution, and duty of care); Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092, 1987 WL 112702, at *7–8 (Oct. 8, 1987) (discussing fiduciary duties); *see also Capital Gains*, 375 U.S. at 191, 194.

[53] *See* SEC. & EXCH. COMM'N, FORM ADV: GENERAL INSTRUCTIONS 1, *available at* http://www.sec.gov/about/forms/formadv-instructions.pdf.

[54] *See id.* at 3.

Investment advisers also are subject to a variety of requirements relating to proxy voting, books and records, insider trading, custody, privacy, best execution, advertising, and referral arrangements. Importantly, the assets managed by investment advisers must be held at registered broker-dealers or banks.[55] Investment advisers must adopt written codes of ethics, which must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel. Advisers also must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review the policies and procedures at least annually to determine the adequacy and effectiveness of their implementation, and designate a chief compliance officer responsible for administering the policies and procedures. Under these rules, advisers have the flexibility to tailor their policies and procedures to the nature of their business and clientele.

This regulatory framework is appropriate to the nature, scope, and risks of the investment advisory business. No additional layer of regulation is warranted. Further, SRO-style business conduct rules are typically very detailed command-and-control requirements that seek to impose a one-size-fits-all solution for various legal and regulatory issues. In contrast to the principles-based SEC framework, these SRO "check-the-box" regulations do not lend themselves to the widely divergent community of advisers.

In addition, the SEC staff's Section 914 Report raised concerns that subjecting advisers to an SRO could lead to inconsistent interpretations and applications of the Advisers Act. The report noted that the possibility of multiple SROs—which, though unlikely, H.R. 4624 would have permitted—could result in SROs over time developing "different approaches to applying the Advisers Act and their own rules to similar activities," prevention of which would require "vigorous oversight" by the

---

[55] In response to the Madoff case, the SEC strengthened the "custody" rule to enhance protection of client assets. *See Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges: Hearing Before the Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters.*, 111th Cong. 59 (2010) (statement of Mary L. Schapiro, Chairman, Securities and Exchange Commission) ("The rule leverages our own resources by relying on independent, third-party accountants to confirm client assets and review custody controls in situations where the possibility for misappropriation of client assets is most acute because of the adviser's possession of, or control over, client assets.").

SEC.[56] The report also highlighted the difficulties involved in requiring the SEC to oversee an SRO that has enforcement authority with respect to a broad range of state regulatory requirements, which would be the case if H.R. 4624 was enacted.

D. The IAA Opposes Designation of FINRA as an SRO for Advisers

The H.R. 4624 legislation appears to have been designed to favor FINRA as the presumptively designated SRO for advisers. The bill was modeled on, and largely replicated, the Maloney Act, which established the SRO structure pursuant to which FINRA now operates. FINRA—a self-described "non-governmental regulator" with 3,000 employees and more than $1.1 billion in total revenues—was designed and developed to oversee broker-dealer activity.[57] FINRA has clearly indicated its desire to extend its jurisdiction to include oversight and regulation of investment advisers.[58] The IAA strongly opposes extending FINRA's jurisdiction to investment advisers due to its lack of adviser expertise, lack of accountability, lack of transparency, excessive costs,[59] and questionable track record.[60]

---

[56] SECTION 914 REPORT, *supra* note 20, at 33.

[57] *See* FIN. INDUS. REGULATORY AUTH., FINRA 2010 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 48, 78 (2011) [hereinafter FINRA 2010 YEAR IN REVIEW], *available at* http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p123836.pdf.

[58] *See, e.g.*, *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 176 (2009) (statement of Richard Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority).

[59] *See* FIN. INDUS. REGULATORY AUTH., REPORT OF THE AMERIVET DEMAND COMMITTEE OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY, INC. 86 (2010), *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p122217.pdf (FINRA benchmarks its senior management compensation based on levels in the financial services industry and states that "non-profit organizations and governmental agencies were inadequate comparables for compensation purposes."). As disclosed in FINRA's 2010 Annual Report, salaries and bonuses for FINRA's top executives average $1,057,787. *See* FINRA 2010 YEAR IN REVIEW, *supra* note 57, at 18.

[60] *See, e.g.*, Letter from Project on Gov't Oversight to Representative Spencer Bachus, Chairman, and Representative Barney Frank, Ranking Member, House Comm. on Fin. Servs. 1 (May 29, 2012), *available at* http://pogoarchives.org/m/fo/sro-letter-20120529.pdf; Letter from Project on Gov't Oversight to Chairman and Ranking Member, Congress (Feb. 23, 2010), *available at* http://www.pogo.org/our-work/letters/2010/er-fra-20100223-2.html; *see also The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before*

Designation of FINRA as the adviser SRO would result in conflicts of interest, with potential adverse competitive implications for advisers.[61] Broker-dealers are the "sell side" of the securities industry, while advisers are the "buy side." The potential for conflict is demonstrated by FINRA's explicit advocacy of extending the broker-dealer regulatory framework to advisers.[62] Conflicts may arise in that broker-dealers engage in arms-length transactions with investment advisers in various capacities, including as service providers, counterparties, market makers, and syndicators and underwriters. An association representing private fund advisers has observed that these competing relationships "would present challenges to an SRO responsible for overseeing these types of firms fairly and equitably."[63]

---

the S. Comm. on Banking, Hous., and Urban Affairs, 111th Cong. 60 (2009) (statement of John C. Coffee, Jr., Professor, Columbia University Law School) (noting that Madoff's advisory activity was within the NASD's and FINRA's jurisdiction); FIN. INDUS. REGULATORY AUTH., REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 5 (2009), *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf ("FINRA examiners did come across several facts worthy of inquiry associated with the Madoff scheme that, with the benefit of hindsight, should have been pursued."); Letter from Mari-Anne Pisarri, Pickard & Djinis LLP, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 5 (Jan. 12, 2011) [hereinafter Pickard and Djinis Letter] ("There is no question that the NASD/FINRA had both the authority and responsibility to investigate Madoff's fraudulent conduct."); Stewart D. Aaron et al., Arnold & Porter LLP, *SRO Regulation in the Dodd-Frank Era,* LAW360 (Apr. 11, 2011, 3:09 PM), http://www.law360.com/articles/236796/sro-regulation-in-the-dodd-frank-era ("Public perceptions about the effectiveness of self-regulation were not helped by events such as FINRA's failure to detect Lehman Brothers' controversial Repo 105 accounting, or FINRA's declaration of Bear Stearns' capital adequacy on the very day Bear Stearns collapsed.").

[61] *Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs,* 111th Cong. (2009) (statement of Onnig H. Dombalagian, Professor, Tulane University) ("The conflicts of interest between the brokerage industry and the investment advisory industry . . . are too great for FINRA to exercise a meaningful role in the oversight of investment advisers.").

[62] *See* Letter from Marc Menchel, Exec. Vice President & Gen. Counsel, Fin. Indus. Regulatory Auth., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 1 (Aug. 25, 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121983.pdf; *see also* Letter from Nat'l Ass'n of Sec. Dealers to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n 4 (Feb. 11, 2005); Letter from Nat'l Ass'n of Sec. Dealers to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n 1 (Apr. 4, 2005).

[63] Letter from Richard H. Baker, President and Chief Exec. Officer, Managed Funds Ass'n, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 10 (Dec. 16, 2010)

FINRA's lack of accountability makes it particularly ill-suited to extend its reach to investment advisers. The BCG Section 967 Report repeatedly stated that SROs are not accountable to the SEC and that the agency and SROs were not coordinating effectively.[64] In this regard, it stated that FINRA "merits particular attention given its size and scope."[65] For example, the report observes that "FINRA conducts extensive risk assessment activities in support of its examinations," but does not share its analysis with the SEC.[66]

Further, in a report released in May 2012, the GAO found that neither the SEC nor FINRA had conducted any formal retroactive review of FINRA rules to assess their actual impact after implementation.[67] The report also found that the SEC historically has not conducted oversight of FINRA's governance, conflicts of interest, funding, executive compensation, or cooperation with state regulators. Further, FINRA recently opposed an attempt by its members to subject FINRA's rulemakings and amendments to economic and cost-benefit analysis.[68]

According to the Chamber of Commerce Report discussed above, FINRA's members no longer have a meaningful role in establishing its policies and priorities, and the organization is not moving toward greater transparency and accountability.[69] The

---

[hereinafter MFA Section 914 Letter], *available at* http://www.sec.gov/comments/df-title-ix/enhancing-ia-examinations/enhancingiaexaminations-28.pdf.

[64] BCG SECTION 967 REPORT, *supra* note 24, at 65–67, 237–38.

[65] *Id.* at 66.

[66] *Id.* at 67.

[67] 2012 GAO REPORT, *supra* note 30, at 12–15.

[68] *See, e.g.*, Letter from Stephanie M. Dumont, Senior Vice President & Dir. of Capital Mkts. Policy, Fin. Indus. Regulatory Auth., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 7 n.27 (Dec. 23, 2011) ("After all, no SRO is required to undertake an economic analysis of its rule proposals . . . . [T]here is no statutory or Exchange Act Rule requirement to undertake an economic analysis because a commenter makes such demand and we are unaware of any requirement on the part of the Commission to oblige such commenters.").

[69] CAPITAL MARKETS REPORT, *supra* note 23, at 23; *see also* Brief for the Cato Institute and Competitive Enterprise Institute as Amici Curiae Supporting Petitioner at 6–7, Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, 132 S.Ct. 1093 (2012) (No. 11-381), 2011 WL 5128121, at *6–7 [hereinafter Cato Brief] ("Constitutional accountability typically stems from either of two sources: political accountability or legal accountability. Here, political accountability is *de minimis* due to the layers of authority separating FINRA from executive branch officers. Unfortunately, legal accountability—judicial review—has also eroded, leaving

report states that "[t]ransparency into FINRA's governance, compensation, and budgeting practices is extremely limited and superficial. Furthermore, FINRA is not subject to the Freedom of Information Act or the APA, nor is it required to conduct a cost-benefit analysis when it engages in rulemaking or exercises its policy-making functions."[70] Unlike the SEC, FINRA is not subject to the Government in the Sunshine Act and its board of directors does not hold open meetings. On the other hand, FINRA claims that it is a governmental or quasi-governmental regulator when it suits its interests, such as claiming sovereign immunity when sued. Similarly, FINRA is not accountable to any entity with respect to its budget—neither to Congress nor to the SEC.[71]

Because of these numerous shortcomings, the Cato Institute recently concluded that "FINRA's extra-constitutional operation has fostered significant policy failures including agency capture, lax regulation, and biased arbitration. . . . The proliferation of substantial financial industry scandals over the past decade is evidence that FINRA is, at best, a hands-off regulator and, at worst, a corrupt and self-serving company."[72] These concerns are underscored by FINRA's recent settlement of civil charges by the SEC for repeatedly misleading the SEC by altering documents sought by the agency during routine inspections.[73]

III. USER FEES PAID BY SEC-REGISTERED ADVISERS ARE PREFERABLE TO AN SRO

Congress should consider appropriate legislation authorizing the SEC to require that federally registered investment advisers pay user fees, rather than subjecting them to an SRO. Such user fees should be dedicated for the sole purpose of enhancing the SEC's investment adviser inspection program over and above current inspection levels. Legislation authorizing investment

FINRA and similarly situated SROs almost entirely unaccountable." (citations omitted)).

[70] CAPITAL MARKETS REPORT, *supra* note 23, at 23.

[71] *See Atkins Testimony*, *supra* note 31, at 10–11; 2012 GAO REPORT, *supra* note 30, at 21.

[72] Cato Brief, *supra* note 69, at 9, 11.

[73] David S. Hilzenrath, *SEC Accuses Brokers Group of Deception,* WASH. POST, Oct. 28, 2011, at A12; Press Release, Sec. & Exch. Comm'n, SEC Orders FINRA To Improve Internal Compliance Policies and Procedures (Oct. 27, 2011), *available at* http://sec.gov/news/press/2011/2011-227.htm.

adviser user fees should include provisions that will provide for appropriate reporting and audit requirements to enable Congress, the public, and the investment advisory community to ensure that the funds are being used for their intended purposes and to provide accountability and transparency. User fees would be a more effective and efficient means than an SRO to enhance the oversight of investment advisers and would be less costly. Investment advisers strongly support oversight by the SEC, which continues to improve its examination program.

A. *User Fees Are More Effective and Efficient Than an SRO*

User fees would be far more effective and efficient in enhancing examinations of advisers than establishing an unnecessary additional layer of bureaucracy and cost. The SEC has more than seven decades of experience regulating and overseeing the investment advisory profession. Moreover, the SEC is directly accountable to Congress and the public with regard to its budget and performance. As SEC Commissioner Luis Aguilar stated in 2009:

> I do not believe that the answer is to create another SRO – particularly when it would be one without any experience in dealing with the investment advisory industry and the Advisers Act regulatory tradition. Moreover, this current crisis has illustrated the dangers of regulatory fragmentation where the primary regulator is not able to quickly obtain, assess, and analyze information. Now is not the time to fragment even more, but to consolidate and employ smart regulation.
>
> The SEC is the only public agency charged with regulating our capital markets and maintaining a keen sense of the entire market on behalf of investors. To create another regulator at this time without the experience in regulating a principle-based system of regulation would be too costly for the industry and the public in terms of both dollars and investor protection.[74]

---

[74] *See* Luis A. Aguilar, Commissioner, Sec. & Exch. Comm'n, SEC's Oversight of the Adviser Industry Bolsters Investor Protection (May 7, 2009) (also noting that the SEC is "the only entity with experience overseeing investment advisers, an industry governed by the Advisers Act, which is based on a principles-based regime. By contrast, broker-dealer SROs primarily regulate through the use of very detailed, specific sets of rules and are not well versed in the oversight of principles-based regulation").

The Section 914 Report provides many reasons why user fees would be a preferable approach to an SRO or other options. The Section 914 Report notes that investment adviser user fees would provide a stable source of funding that would be scalable to increases or decreases in the adviser population and could be set at a level designed to achieve the SEC's desired examination frequency and scope.[75]

User fees are already an important source of funding for inspections and examinations of other financial institutions and regulated entities by many federal agencies, including the Comptroller of the Currency.[76] In addition, the SEC previously supported user fees in testimony related to legislation under consideration in 1990. Further, investment advisers already pay user fees to support the Investment Adviser Registration Depository ("IARD"), the electronic system through which investment advisers make filings with state and federal regulators.[77] The IARD system therefore provides an existing infrastructure to collect user fees at a small marginal cost.

The Section 914 Report found that the user fee option would permit the SEC's Office of Compliance Inspections and Examinations ("OCIE") to improve the effectiveness of its examinations through long-term strategic planning that would better use modern technology and its workforce. A stable source of funding would permit use of technology-based solutions that can take years to develop and implement.[78] Stable resources would also provide the examination program with increased flexibility to react to emerging risks and better target staffing and strategic resources as appropriate. The staff observed that knowledge gained from the investment adviser examination program would continue to greatly assist in gathering the

---

[75] SECTION 914 REPORT, *supra* note 20, at 25.

[76] The Section 914 Report notes that:

> user fees fund inspections of banks conducted by the Office of Comptroller of the Currency, examinations of credit unions by the National Credit Union Administration, inspections of nuclear facilities by the Nuclear Regulatory Commission, inspections of national marine fisheries by the National Oceanic and Atmospheric Administration, and quality examinations of agricultural commodities and processing plants by the Department of Agriculture.

Id. at 25–26.

[77] *Id.* at 26.

[78] *Id.* at 26–28.

intelligence and expertise critical to the regulatory process.[79] Further, ongoing improvements to the examination program could be further leveraged with the funding provided by user fees. The SRO model would not provide such benefits to the SEC.

Indeed, in its analysis of the various options to increase examinations, the Section 914 Report found that user fees present the greatest number of advantages and the least number of disadvantages.[80] The report observes that "imposing user fees would avoid the difficult scope of authority, membership, governance, and funding issues raised by an SRO . . . . It would avoid the need for the Commission to use resources to staff an expanded SRO examination program."[81] The Section 914 Report also noted that funding from adviser user fees would give the SEC greater flexibility and may be a less costly option than establishing an SRO.

Indeed, the report notes that in many ways, user fees may be a smarter, more efficient use of funds.[82] Allowing OCIE to charge user fees would empower it to build on the expertise and infrastructure it has already established in examining advisers.[83] Within the SEC, OCIE examination staff benefit from close working relationships with other SEC legal and policy staff.[84] In contrast, an SRO would be an isolated cost center that would require extra resources and personnel to build even a preliminary infrastructure.

Further, as noted above, an SRO would still require an increase in the SEC's management and coordination costs in order to oversee the SRO.[85] In fact, the SEC staff expressed concern that if SRO oversight were mandated, it may one day be

---

[79] *Id.* at 27 n.47.

[80] *See, e.g.*, ELISSE B. WALTER, STATEMENT ON STUDY ENHANCING INVESTMENT ADVISER EXAMINATIONS 7 (2011) (noting with disappointment that the "study attributes virtually no disadvantages to the user fee option, but many disadvantages to the SRO and FINRA dual registrant options").

[81] SECTION 914 REPORT, *supra* note 20, at 29.

[82] *See id.* at 27; *see also Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the Comm. on Fin. Servs.*, 112th Cong. 200 (2011) (statement of Paul Schott Stevens, President and Chief Executive Officer, Investment Company Institute); MFA Section 914 Letter, *supra* note 63; Letter from David G. Tittsworth, Exec. Dir., Investor Adviser Ass'n, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 2 (Oct. 19, 2010) [hereinafter IAA Section 914 Letter].

[83] *See* SECTION 914 REPORT, *supra* note 20, at 28, 30.

[84] *See id.* at 28.

[85] *See id.* at 27.

underfunded because there is no certainty that the level of resources available to the Commission over time would provide for effective oversight.[86] In addition, with the user fee option, "the chance that inconsistencies would emerge in interpretation or application of the Advisers Act and its rules between a third-party examining body (such as an SRO) and the statute's and rules' primary administrator (the Commission) would be eliminated."[87]

B. User Fees Would Be Less Costly Than an SRO

In considering legislation to enhance investment adviser examinations, Congress should consider the costs and benefits of the various alternatives. The IAA is not aware of any analysis or empirical data demonstrating that the benefits associated with H.R. 4624 would have outweighed the costs. To the contrary, there is compelling evidence that the costs of outsourcing regulation and oversight of thousands of investment advisers to an SRO—likely FINRA—would be far greater than the comparable costs of enhancing the SEC's inspection program.

In this regard, a study commissioned by the IAA, the Certified Financial Planner Board of Standards, Inc., the Financial Planning Association, the National Association of Personal Financial Advisors, and TD Ameritrade Institutional, is highly relevant.[88] These groups commissioned BCG to produce a report determining the costs of the options outlined in the Section 914 Report on enhancing investment adviser examinations.

The December 2011 BCG economic analysis analyzed the costs of the following: (1) increasing the level of SEC examinations; (2) set-up and operation of an investment adviser SRO by FINRA; and (3) set-up and operation of an entirely new SRO for advisers. BCG's economic analysis was based on the assumption that advisers would be examined by the SEC or an SRO on an average of once every four years.

The economic analysis found that the costs to investment advisers of adequately funding the SEC to conduct additional examinations would be far less than paying FINRA or another

---

[86] *See id.* at 28.

[87] *Id.*

[88] The December 2011 BCG economic analysis is appended to this testimony for the record. *See generally* BOS. CONSULTING GRP., *supra* note 2.

SRO to do so.[89] It underscores the conclusion that the best and most efficient way to enhance investment adviser oversight is to ensure that the SEC has sufficient resources.

Key findings of the BCG economic analysis include the following. First, creating an SRO for advisers would likely cost at least twice as much as funding an enhanced SEC examination program.[90] The incremental cost of the SEC hiring the additional adviser examiners needed to increase the inspection rate for advisers to, on average, once every four years—including supporting expenses—would be $100 million to $110 million per year.[91] The total cost of an enhanced SEC examination program—including both the costs of the existing program and the incremental costs related to hiring the additional examiners—is projected to be $240 million to $270 million per year.[92] In contrast, a FINRA SRO—examination, enforcement, and SEC oversight—is projected to cost $550 million to $610 million per year; and a new SRO is projected to cost $610 million to $670 million per year.[93]

Second, the cost savings to the SEC of creating an SRO is likely to be minimal because the SEC would need to spend significant resources—$90 million to $105 million per year—overseeing an SRO.[94] Third, the startup costs of an SRO alone—$200 million to $310 million—could fund an enhanced SEC examination program for an entire year—$240 million to $270 million.[95] Fourth, shifting primary oversight of dually registered broker-dealers and investment advisers—those regulated by both the SEC and FINRA—to FINRA alone is not expected to result in significant costs savings to the SEC.[96]

Further, as discussed above, H.R. 4624 was structured such that the substantial costs of establishing an SRO for advisers would be imposed on small businesses rather than being shared across the industry, as assumed in the BCG economic analysis. In other words, if the bill had been enacted, the fixed costs of establishing an SRO with rulemaking, examination, and

[89] *See id.* at 12.
[90] *See id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *See id.* at 13.
[95] *See id.* at 12.
[96] *See id.* at 7.

enforcement authority would have been assessed on a smaller group of advisers with limited resources. Accordingly, the actual costs incurred by these small businesses would have been even higher than under an industry-wide or user fee approach.

BCG released an addendum to this analysis on May 10, 2012 to discuss FINRA's estimate—a one-and-a-half page document titled "Investment Estimate for FINRA IA SRO"—that was released concurrent with the introduction of H.R. 4624 on April 25.[97] According to BCG's analysis, FINRA's estimate of the cost to set up, operate, and oversee a SRO for investment advisers greatly underestimated the overhead costs and overestimated investment adviser examiner productivity.[98]

C. Investment Advisers and Other Commenters Strongly Support Continued SEC Oversight of Advisers

In addition to the IAA, a number of other organizations and commenters have voiced numerous concerns about establishing an SRO for investment advisers and have expressed support for ensuring adequate resources for the SEC.[99] For example, the

---

[97] *See* Press Release, Inv. Adviser Ass'n, FINRA's Cost Estimates Challenged: Leading Financial Services Organizations Respond to FINRA's Estimates (May 10, 2012), *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/PressReleases/PressCur/120510prs.pdf.

[98] Specifically, BCG found that: (1) FINRA's estimate omits the cost of SEC oversight of the IAN SRO ($90 to $100 million) and the cost of enforcement ($60 to $70 million), both of which are required by H.R. 4624; (2) FINRA's estimate of $12 to $15 million in setup costs does not include staff costs incurred during the twelve-month setup period, specifically the cost of examiners and support staff. Rather, FINRA only includes these expenses as part of its ongoing investment once the SRO is up and running. This omission accounts for $180 to $230 million of the difference between the BCG and FINRA estimates; (3) FINRA's estimate of the ongoing annual cost of examining 14,500 IA firms once every four years assumes that FINRA's IA examiners would be able to nearly double the productivity rate of SEC IA examiners by performing five or more examinations per examiner per year. This compares to SEC IA examiner productivity of 3.0, and FINRA broker-dealer examiner productivity of 2.8. This productivity assumption accounts for $150 to $170 million of the difference between the BCG and FINRA estimates; and (4) FINRA's estimate does not include overhead costs in its estimate of $150 to $155 million of ongoing annual investment. Overhead costs account for $135 to $140 million of the difference between the BCG and FINRA estimates. *Id.*

[99] *See, e.g.*, Pickard and Djinis Letter, *supra* note 60, at 4 ("While the costs of designating one or more SROs for investment advisers are clear the benefits are less so. In analyzing the question of benefits, we submit that the number of adviser examinations that an SRO could conduct is less important than the quality of those examinations. SROs' lack of familiarity with the extensive regulatory regime imposed on advisers raises serious concerns about such organizations' ability to

Managed Funds Association ("MFA") has expressed multiple concerns about an SRO for investment advisers[100] and its support for ensuring that the Commission has adequate resources, including appropriate user fees.[101] Similarly, the American Institute of Certified Public Accountants ("AICPA") has expressed its strong opposition to an SRO, and FINRA in particular,[102] and instead indicated its support for providing appropriate resources to the SEC, including user fees.[103] The Alternative Investment Management Association ("AIMA") has opposed an SRO and instead supports "full and proper regulation and oversight of investment advisers by the Commission and believes the Commission should be given adequate resources to fulfil its objectives of protecting investors, maintaining fair, orderly, and efficient markets and facilitating capital formation."[104] The North American Securities Administrators Association ("NASAA") has expressed its strong opposition to outsourcing important governmental regulatory functions to a

---

oversee the implementation of that regime effectively. Moreover, as the Madoff and Stanford scandals show, SRO examinations can be ineffective even where the activities being examined are squarely within the purview of the organization's jurisdiction and expertise.").

[100] *See* MFA Section 914 Letter, *supra* note 63, at 2 ("[A]n SRO would lack experience in regulating private fund managers, create inconsistent regulation for investment advisers, face difficult conflicts of interest, increase regulatory costs, and ultimately diminish the quality of regulatory oversight of the industry.").

[101] *See* Letter from Richard H. Baker, President and Chief Exec. Officer, Managed Funds Ass'n, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 5 (Sept. 22, 2010) ("[W]e would support appropriate fees on investment advisers to help ensure that OCIE has the resources they need to conduct examinations of the investment adviser industry.").

[102] *See* Letter from Barry C. Melancon, President & Chief Exec. Officer, Am. Inst. of CPAs, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 2 (Nov. 24, 2010) ("We strongly oppose the creation of a self-regulatory organization (SRO) for investment advisers. An SRO is inherently conflicted and is not the right answer for regulation of investment advisers. We believe that FINRA would bring a broker-dealer perspective, and bias, to investment adviser examinations and that its rules-based, check-the-box approach is not conducive to adequate regulation of the investment advisory profession nor is it in the public's best interest.").

[103] *Id.* ("AICPA strongly believes that the principles-based regulatory approach of the Investment Advisers Act and its related rules should continue to govern investment advisers and further, that regulatory oversight remain exclusively with the SEC and/or states. Providing the SEC with resources to properly enforce their rules, even if it means assessing additional fees on investment advisers, is the best solution for investment advisers and the public.").

[104] *See* Letter from Mary Richardson, Dir. of Regulatory & Tax Dep't, Alt. Inv. Mgmt. Ass'n, to the Sec. & Exch. Comm'n and Gov't Accountability Office 3 (Jan. 12, 2011).

third party.[105] Further, the Financial Planning Coalition has noted the many drawbacks to an SRO for investment advisers, and to FINRA in particular,[106] and stated its support for continuation of the SEC's regulation and oversight of the advisory profession.[107]

D. The SEC Improved Its Investment Adviser Examination Program and Should Continue Its Oversight of All SEC-Registered Advisers

The IAA has consistently supported the SEC's efforts to strengthen its examination program for investment advisers. The IAA testified in 2011 before the Committee on Financial Services in support of efforts to strengthen the SEC's investment adviser examination program conducted by OCIE.[108] Adequate

---

[105] *See* Letter from David L. Massey, President, N. Am. Sec. Adm'rs Ass'n, Inc., and Deputy Sec. Adm'r, State of N.C., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 2–3 (Nov. 22, 2010) ("[I]nvestment adviser regulation is a governmental function that should not be outsourced to a private, third-party organization that does not have expertise or experience with investment adviser regulation. Securities regulation in general and investment adviser regulation in particular is best left with governmental regulators that are transparent and directly accountable to the investing public. One can readily conclude that the designation of an SRO for the oversight of investment advisers, with its attendant direct and indirect costs, its opaque structure and attendant lack of accountability and transparency, would outweigh any perceived benefits to the investing public.").

[106] *See* Letter from Kevin R. Keller, Chief Exec. Officer, CFP Board, et al., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 5 (Dec. 16, 2010) ("Creating a new layer of bureaucracy and cost in order to improve the frequency of investment adviser examinations is not a wise use of limited regulatory resources. Aside from the additional infrastructure costs involved with creating an SRO oversight structure for investment advisers, outsourcing oversight could result in inconsistent or redundant regulation and enforcement (as both the SRO and the Commission interpret and enforce the relevant rules).").

[107] *Id.* at 3 ("We believe it would be much quicker and more efficient to leverage the Commission's existing investment adviser examination staff, which is already fully conversant with all of the legal and regulatory issues that pertain to investment advisers, than to create an entirely new SRO from scratch to oversee investment advisers.").

[108] *See* Letter from David G. Tittsworth, Exec. Dir., Inv. Adviser Ass'n, to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n (July 29, 2009), *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/CS09/comment090729A.pdf. *See generally Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals To Improve Investment Adviser Oversight: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. (Sept. 13, 2011) (statement of David G. Tittsworth, Exec. Dir., Inv. Adviser Ass'n) [hereinafter *IAA 2011 Testimony*].

resources for, and a commitment to, an effective SEC examination program for investment advisers should be a high priority for policy makers and for the SEC.

During the past few years, the SEC has focused on revitalizing and restructuring its enforcement and examination functions.[109] The mission of the examination program is to "improve compliance, prevent fraud, inform policy and monitor industry-wide and firm-specific risks."[110] The SEC has implemented a more risk-focused examination program to provide information for SEC enforcement investigations and to inform the financial industry about risky practices. The program continually collects and analyzes a wide variety of data about investment advisers using quantitative techniques.[111]

OCIE has continued to refine its examination tools and techniques to better allocate and leverage limited resources to their highest and best use.[112] In 2011, OCIE created a centralized risk assessment and surveillance office to evaluate risks across all markets and registrant categories. OCIE's risk office has enhanced the ability of the SEC to perform data analytics to identify firms that present the "greatest risks" to investors, markets, and capital formation, and to determine which firms to examine.[113] OCIE now provides a risk-rating to *all* new and existing investment adviser registrants based on data collected from the newly expanded Form ADV and other public data. In addition, OCIE has increased its outreach to senior management and mutual fund boards along with the examination process regarding risk and regulatory issues.[114] OCIE has also developed a large firm monitoring program whereby OCIE collaborates with SEC divisions and offices in monitoring risks at certain large firms.[115] Under this new

---

[109] *See generally SEC 2012 Testimony*, *supra* note 49.

[110] Carlo V. Di Florio, Dir., Office of Compliance Inspections & Examinations, Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum (May 2, 2012) [hereinafter 2012 Di Florio Speech], *available at* http://www.sec.gov/news/speech/2012/spch050212cvd.htm.

[111] *See SEC 2012 Testimony*, *supra* note 49.

[112] *See* 2012 Di Florio Speech, *supra* note 110.

[113] *See id.*; *see also* SEC. & EXCH. COMM'N, EXAMINATIONS BY THE SEC. & EXCH. COMM'N'S OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS 8 (2012) [hereinafter OCIE EXAMINATIONS], *available at* http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[114] *See* 2012 Di Florio Speech, *supra* note 110.

[115] *See id.*

process, OCIE's examinations are tailored to a firm's risk rating and risk areas such as business model and revenue streams, affiliations and conflicts of interest, and compliance controls. OCIE also uses tips, complaints, referrals, and surprise custody audits to help determine which advisers to examine and the scope of the exams.[116]

The SEC has also continued to take important steps to increase the examination staff's expertise in the securities markets including recruiting experts with knowledge of hedge funds, private equity, derivatives, complex structured products, and valuation, as well as strengthening current examiner skill sets and developing an examiner certification program.[117] In addition, OCIE is developing information management systems to help better organize and evaluate the extensive new information that the SEC collects on Form ADV and Form PF.[118] These systems will provide the SEC with substantial additional detailed information about advisers' business practices to assist in risk-targeted examinations, enforcement, and oversight of advisers.[119]

In fiscal year 2011, OCIE examined approximately eight percent of advisers out of the 11,000 or so SEC-registered investment advisers, representing thirty percent of the total AUM by all SEC-registered investment advisers.[120] While the number of advisers examined can and should be increased, the SEC's breadth in covering thirty percent of investors' assets

---

[116] *See id.*

[117] *See id.*; *see also The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.,* 112th Cong. 62 (2011) (statement of Robert Khuzami, Director, Division of Enforcement, Securities and Exchange Commission and Carlo Di Florio, Director, Office of Compliance Inspections and Examinations, Securities and Exchange Commission); *Oversight of the U.S. Securities and Exchange Commission's Operations, Activities, Challenges, and FY 2012 Budget Request: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 70–71 (2011) (statement of Carlo Di Florio, Director, Office of Compliance Inspections and Examinations, Securities and Exchange Commission); SECTION 914 REPORT, *supra* note 20, at 28.

[118] 2012 Di Florio Speech, *supra* note 110.

[119] *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3145, 2011 WL 242758, at *4 (proposed Jan. 26, 2011).

[120] *See SEC 2012 Testimony*, *supra* note 49.

managed by advisers is substantial.[121] Further, as noted above, OCIE reviews data and information about *all* investment advisers. Both at a national and regional level, the examination staff then can identify from the adviser universe the set of advisers with the most "risky" profiles and subject those advisers to in-depth examinations. The SEC plans to add examination staff in fiscal year 2014 to improve the rate of examination of advisers, including those advisers that have not been examined.[122] Even now, however, OCIE conducts outreach to new advisers and those that have never been examined. The SEC requests information from such advisers and, based on that information and other data, prioritizes such advisers for review. Contrary to the perceptions created by some statistics, *all* investment advisers are on OCIE's radar screen.

The IAA continues to encourage the SEC to consider ways in which it can increase the frequency of investment adviser examinations under its current allocation of resources and any future allocated resources. However, we are prepared to support user fees to the SEC to increase the SEC's frequency of examinations of investment advisers. User fees would be a far more effective approach than outsourcing the SEC's responsibilities to a non-governmental organization.

CONCLUSION

The IAA supports appropriate measures to ensure that the SEC conducts a strong and effective examination program of investment advisers. We strongly oppose establishment of an SRO for investment advisers such as that which would have been mandated by H.R. 4624 and urge Congress to instead consider appropriate user fee legislation.

---

[121] We note, however, that the frequency of examination per adviser is only one factor in an effective examination and oversight program. *See* SECTION 914 REPORT, *supra* note 20, at 26 n.46; *see also* 156 CONG. REC. S5929 (2010) (statement of Sen. Christopher Dodd) (stating the following with respect to Section 913: "In this review, the paramount issue is effectiveness. If regulatory examinations are frequent or lengthy but fail to identify significant misconduct—for example, examinations of Bernard L. Madoff Investment Securities, LLC—they waste resources and create an illusion of effective regulatory oversight that misleads the public.").

[122] *Financial Services and General Government Appropriations for 2014: Hearings Before a Subcomm. of the H. Comm. on Appropriations*, 113th Cong. 56 (2013) (statement of Mary Jo White, Chairman, Securities and Exchange Commission).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات

www.manaraa.com