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H.R. 4624, THE INVESTMENT ADVISER OVERSIGHT ACT OF 2012

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

JUNE 6, 2012

Printed for the use of the Committee on Financial Services

Serial No. 112–132

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H.R. 4624, THE INVESTMENT ADVISER OVERSIGHT ACT OF 2012

Wednesday, June 6, 2012

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Manzullo, Biggert, Capito, Garrett, Neugebauer, McHenry, Campbell, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Schweikert, Canseco, Stivers, Fincher; Frank, Waters, Maloney, Watt, Meeks, Capuano, Hinojosa, McCarthy of New York, Lynch, Scott, Green, Ellison, Perlmutter, and Carney.

Chairman BACHUS. The committee will come to order. We are going to have opening statements for a total of 20 minutes, 10 minutes on each side. I will begin with my opening statement.

This morning, the committee will examine bipartisan legislation, the Investment Adviser Oversight Act that Congresswoman McCarthy and I have introduced to protect investors. In September, the Subcommittee on Capital Markets held a hearing on the draft version of this bill, and I thank both proponents and opponents of the legislation who offered constructive suggestions.

While the average American investor may not understand the different titles that investment professionals use, they do believe there is a reasonable level of oversight designed to protect their investments from fraud. For broker-dealers, that reasonable level of oversight exists. Broker-dealers face routine examinations on a regular and consistent basis. But the average investment adviser is examined only once a decade. Even worse, the Securities and Exchange Commission reports that an astonishing 38 percent of investment advisers have never been examined, not once.

The investing public deserves more timely oversight of these professionals to whom they have entrusted their hard-earned money, certainly more oversight than the public received in the Madoff case, as well as the very recent case of financial adviser Matthew D. Hutcheson, who is known as America's retirement coach, and the indictment of Mark Spangler, former chairman of the National Association of Personal Financial Advisors. This bipartisan bill helps close what everyone agrees is a glaring regulatory gap, a gap that puts average American investors at risk and undermines in-

vestor confidence. The Dodd-Frank Act recognized that inadequate investment adviser oversight is a weakness of our system.

The SEC study mandated by Section 914 of Dodd-Frank presented Congress with three options. One of those options, which authorizes one or more self-regulatory organizations, or SROs, to examine investment advisers is, in my opinion, the most practical, comprehensive, and streamlined approach to address this weakness.

But that is not the only possible solution. Obviously, two other options were offered by the SEC. But as SEC Chairman Mary Schapiro herself stated before this committee on April 15th, "The ability to leverage an SRO organization is really critical. Look at our numbers. We examine about 8 percent to 9 percent of investment advisers every year."

The Consumer Federation of America also stated in testimony that an SRO would be "a significant improvement over the status quo." Others have said that more funding for the SEC is the answer. But the SEC itself has admitted that even if the agency receives the full amount of funding it and the Administration requested for 2013, it would be able to examine only 1 in 10 investment advisers annually. I understand why many investment advisers are not enthusiastic about increased oversight. No one is excited when the SEC or any regulator for that matter schedules an exam, but when fraud occurs and investors are harmed, outrage, bewilderment, and astonishment follow, and Members of Congress and the public then properly and predictably ask, "Where are the regulators?"

In fact, they go beyond that, and at least three Members of Congress have filed legislation in these cases asking the taxpayers to pick up the tab, or the industry. As I have said repeatedly since discussion of this bill began, I stand ready to work with anyone who has an idea on how to improve it or another idea. For example, some have expressed concerns about the exemptions in this bill. I am more than willing to work with any Member or interested stakeholder to address these concerns and thereby achieve our objective of protecting retail investors who use the services of investment advisers.

The only goal of this bipartisan legislation is to deter bad actors and help protect the American investors. I see no way to do that without timely examinations. The debate over who conducts these examinations and how is open to debate, a debate that we will continue today with this hearing. I hope my colleagues will support this bipartisan bill that Mrs. McCarthy and I propose. But if they do not, I hope they will at least offer constructive suggestions on how to either improve this legislation or craft their own solution and present it for debate. Until something changes, American investors are at risk of another Madoff scandal. And that ought to be a sobering thought, not only for this Congress, but for investment advisers as well.

At this time, I recognize the ranking member, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman. I will take 4 minutes. And I appreciate the fact that we have recognition that we have to do a better job of supervision here. And let's be very clear, this is a recognition of the important interaction between the private

market and a public element of regulation. Now, particular legislation would have the public sector by statute delegate regulatory powers to an organization not part of the government. And that is a valid option. But it is part of the scheme of regulation, and there have been too many people who have talked as if there was this problem if you tried to regulate the private sector. So I am glad to be here discussing how to regulate, how to use the statutory authority that the Federal Government has to increase regulation over an important part of the financial community. And as I said, an SRO is this, it would have power only if it is, in fact, delegated to us by the Congress.

Second, one of the things I wanted to do—and I was very pleased that the Majority agreed to our insistence that the North American Securities Administrators be here. I, from time to time, had the privilege of listening to the Secretary of the Commonwealth of Massachusetts, Bill Galvin, who is an outstanding regulator, very active. We have today Mr. Morgan from Texas. Too often, there is an irony here, frankly, including some of my conservative friends who generally want to talk about Federalism and the limits of State power, and we act as if the States are not a factor here.

State regulation is very important. And I have had a chance to read, and I won't be able to stay, but a very thoughtful testimony from our Texas commissioner, and I hope that the members will be taking seriously the points that he makes. We should not be—we have a Federal statutory authority here that we have given to the SEC, and when we talk about how to share that, we should not share the States' role and subject the States to this role without their full participation.

This is not just an SEC/CRO division, it is a three-way. It is the SEC and it is the States. And there are some very useful statutes. I see the State—and this is the North American Securities Administrators, which in this case are the Canadians as well, which is relevant because we don't have a sharp border here when it comes to security. The criticisms in a constructive way that the Commissioner makes should be taken into account.

Finally, I want to get to the role of the SEC. And yes it is true if the SEC was given only what the President asked for, they wouldn't be able to do as much as they should. The President didn't ask for enough. We are talking about relatively small amounts of money here. We are talking about an SEC appropriation of $1 billion and some hundreds of millions. I like to have units of measurement. One unit of measurement it seems to me that would be useful when we talk about funding our regulatory agencies is a JPMorgan Chase derivative loss. A unit should stand for how much JPMorgan Chase lost in one set of derivative transactions. It is about $3 billion now—in that one set of transactions, JPMorgan Chase lost more than the total budgets of the SEC and the CFTC combined.

The argument that we can't afford I think is feckless. What we need to do in the first place, and I think we can impose more on the industry, but my final point is, I would first like to fully fund the SEC. We had a very good hearing, Mr. Chairman, and I am glad you held it, on the constraints the SEC faces with regard to resources, which may lead them sometimes as they acknowledge to

settle on less terms than they should, less rigorous terms for people who have done things wrong.

So at the very least, the very fact that we are considering an SRO argues strongly against the inadequate funding that this Congress has give the SEC. I don't think the President asked for enough. We voted for even less. In the next couple of months, we will be considering the CFTC and the SEC, and one of the arguments that this bill should make clear is we need to and can very well afford the relatively small amounts of money for increasing their funding.

Chairman BACHUS. Mr. Garrett for 2 minutes.

Mr. GARRETT. Thank you. Thank you, Mr. Chairman, for recognizing me and for holding this hearing today, and for your legislation as well, to create an SRO for retail investment advisers. I certainly commend the chairman for his leadership on this issue, which is a very complicated and challenging issue.

Ensuring adequate protection exists for all retail investors is a top priority, not only for the chairman, but for this committee as well. The multi-billion dollar Bernie Madoff fraud has made a detrimental impact on literally thousands of families and people across this country. And it was a colossal and historical failure by the entity that is supposed to be the lead watchdog for these investors, the SEC.

Now, the SEC in recent history has been examining investment advisers approximately once every 10 years, once every decade. And the frequency of examinations of course is not the only consideration. FINRA, for example, examined Madoff's broker-dealer unit and they did it much more frequently, but it still missed the fraud. So with too much on its plate, some of the basics aren't getting done apparently. For instance, the SEC now must focus more on its core mission of protecting investors and ensuring broader markets and promoting capital formation, and maybe a little bit less on politically-motivated agenda items like global warming and political donation disclosures as well. Nevertheless, I look forward to a robust discussion of the chairman's bill today.

And I am interested to hear from our panel regarding their thoughts about how to improve accountability and transparency of the SRO model, and also on ideas to ensure a robust cost-benefit analysis is conducted for any current and also possible new SROs. Finally, I look forward to learning more about other revisions that Chairman Bachus has made to his legislation since we held a hearing on this topic, I guess it was back in the fall.

In the end, we must work to carefully balance the need to sufficiently protect retail investors from doing wrong with the need to ensure our Nation's small businesses are not burdened with new and costly regulations.

Finally, I realize there is no easy answer to this challenging issue, and I do give the chairman a lot of credit, and also his staff as well, for thoroughly examining this important topic. And I thank the chairman again and I thank the members of the panel as well. I yield back.

Chairman BACHUS. Thank you, Mr. Garrett. Mr. Lynch for 3 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. And I thank the ranking member as well. I would also like to thank our panel here for coming forward and trying to help this committee with its work. Over the past 5 years, we have had a series of high-profile Ponzi schemes and scandals that have done serious damage to the reputation of the investment adviser community, FINRA, the SEC, and Congress, all of which bear some measure of blame for the gaps in financial adviser oversight. But the one positive we can take away from these events is that we have now called attention to the lack of meaningful oversight of the investment adviser community and we provided some momentum for calls for meaningful reform.

One casualty in the wake of the 2008 financial crisis and these aforementioned scandals is the integrity of the financial services industry. All of us here today want the same thing basically, and that is for the American people to have the confidence that when they entrust their savings to investment advisers, those funds are invested appropriately and prudently.

I do applaud the sponsors of H.R. 4624 for putting forward a thoughtful approach to improving investment adviser examinations. I believe this bill is a good start. I do have some lingering concerns, however, about the bill, particularly the effect that a newly-created SRO will have on some of our smaller mom-and-pop investment advisers typically examined by the State securities administrators. And also, I believe the bill could do a better job of protecting the authority of State regulators. In Massachusetts, as the ranking member mentioned, we have a fairly robust examination process headed by our Secretary of State, Bill Galvin. He does a good job at this. I would not want to see him shunted to a secondary role or perhaps banned from doing his good work.

I also think that by making the SRO the sole game, so to speak, you are also increasing the burden on some of these State-registered advisers. So hopefully, we can together examine ways to accomplish some of the refinements that I think are necessary with the witnesses that we have today. We have a great group, and I look forward to a productive discussion. And I want to thank you again, Mr. Chairman, and the ranking member for the work you have done on this important issue. I yield back the balance of my time.

Chairman BACHUS. Thank you. Are there any other Members who wish to be heard? Mr. Scott for 3 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. First of all, I think that this hearing is very important. It is very timely. The consumer and investment confidence is waning. We need to take some constructive steps to make sure consumer confidence is high. I think that the general thrust of this is that there is, and I think we all can agree, a critical gap in investor protection. And I think that this is supported by some information that in 2011 the Securities and Exchange Commission reviewed only 8 percent, only 8 percent of over 12,000 registered investment advisers. And this is compared to FINRA's examination of 58 percent of its registers in the same year.

I would say to you, if that was put before the investment community, they would go for examining at the 58 percent level to make

sure this doesn't happen. So I think that we really, really need to look at this bill. I think it is a good foundation, as any legislation is. I think that investment advisers and broker-dealers are, in fact, inherently different. So if that is the case, why subject investment advisers to the same type of SRO that broker-dealers are currently subjected to?

And so, we have some really serious questions on the preemption level. If this bill preempts the States from regulating registered investment advisers, then the question becomes, aren't the States preempted from regulating brokers? So I think we have a lot of issues here on the table. I think this bill is a good start. I commend both Mrs. Maloney and Chairman Bachus for putting forward the bill and I look forward to working with it and moving this whole approach forward and making sure that paramount in our minds is making sure that investor confidence regains the high plateau that it once was before the Bernie Madoff scandal and so many others. Mr. Chairman, with that I yield back the balance of my time.

Chairman BACHUS. We have approximately 2 minutes left on our side, and none on the other side. What we are going to do is increase to three on our side, and one on your side—we are going to cede you all 1 minute, which will give Mrs. McCarthy 2 minutes, Mr. Hinojosa wants a minute, and then I will take the one remaining minute.

Mr. FRANK. Mr. Chairman, thank you. That is very gracious.

Chairman BACHUS. Thank you. Mrs. McCarthy?

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. And I thank the ranking member. I usually don't do opening statements. I always want to come to these hearings to hear the witnesses. I think there has been a lot of misinformation on the bill. And obviously, we have a hearing to clear up the misinformation that is out there. But also, this is the first step. We go forward, we work, there will be amendments before a markup. I happen to think that this is a great start. We keep talking about Madoff, but let me tell you, in New York and Long Island, we have had many, many cases of fraud, unfortunately, and that hurts my investors. And I think it is something that we need to do. I think that also, you will see when the bill is exactly explained that the States are still going to have the oversight. We are going to be working with the States. This is going to be a partnership.

Would I prefer if we went through the SEC? Absolutely. Are we going to get the money to do it? No, we are not. I would love to, but it is just not going to happen. So to me, this is a great start. This is where certainly we can protect our constituents. And I think that is the bottom line for all of us to do. So with that, Mr. Chairman, I yield back the rest of my time.

Chairman BACHUS. Thank you.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairman Bachus, and thank you, Ranking Member Frank, for holding this hearing today. And thank you to our esteemed panelists for your testimony, which I look forward to hearing. I wish to speak about two issues in particular that concern me about creating a new self-regulatory organization or adding more jurisdiction to FINRA's oversight. I have heard from small independent advisers by calling them and asking for

their opinion, and they are advisers with less wealthy clients in my congressional district who will be subject to a new added expense for regulatory oversight if this policy takes place. They are concerned about the effect of member fees on their ability to serve as independent advisers. With that, I yield back, Mr. Chairman.

Chairman BACHUS. Thank you. We have a little over a minute remaining on our side. Let me point out three things. First, Madoff has been mentioned, that FINRA missed Madoff. FINRA regulated the broker-dealer side of Madoff. It was on the investment adviser side where the fraud went on, so they could not regulate that. That was up to the States and the SEC where that fraud took place.

Second, I can say that State regulators have done an exceptionally good job. I think they have done a better job than Federal regulators. And they now, under this bill, will regulate not only the small investment advisers, but also the mid-sized investment advisers. In fact, after the Dodd-Frank transfer occurs, the SEC will oversee approximately 10,000 investment advisers and the States will take on approximately 4,200 additional investment advisers with up to $100 million in assets under management, according to my staff's estimate. And we want to be very sensitive to the State regulators and make sure that this bill does not preempt your ability.

I know there has been some expression, and I know Mr. Ketchum has said several times he wants to have better cooperation, and I think that is key. And if there is something else we need to do. I know the State actor doctrine, I have heard cases where the State regulators contacted FINRA, and FINRA said, "We can't go into that because it is a State action." And I am not sure that is a good situation. That needs to be refined. But we very much want to do what is right.

And the third point is, and Mr. Morgan said that some of the investment advisers, regulatory fatigue. We don't want to unnecessarily burden investment advisers. But at the same time we do want to, they need to be examined, and I think they agree with that. And I think we are all open to saying that it is not duplicitous or that it is not overbearing. And this is not a markup, this is a hearing, and there is a big difference. People out in the public may not know the difference, but you gentlemen know the difference. I am very sensitive to State regulation. I think States have done an outstanding job. I know independent advisers in Alabama usually behave because of Joe Bohr.

Mr. FRANK. Mr. Chairman, I have an unanimous consent request—

Chairman BACHUS. Without objection, it is so ordered.

Mr. FRANK. —to enter into the record four statements from an individual in some organizations in opposition to the bill, in some cases, in principle, in some cases, as drafted. One is from the Project on Government Oversight. Another is from Professor Ernest Young at Duke Law School. One is from the Financial Planning Coalition. And one is from the Consumer Federation of America. And I ask unanimous consent that they be introduced. And my colleague from North Carolina, I believe had a similar unanimous consent request.

Mr. WATT. Mr. Chairman, I was going to offer for the record the letter to you and Mr. Frank from Professor Ernest Young. But I assume that is the same letter that is being entered into the record.

Mr. FRANK. I apologize for preempting North Carolina's representation on one of its premier institutions. It is the same guy.

Mr. WATT. I have to look out for my little brother institution.

Chairman BACHUS. Without objection, those letters are introduced. And the coalition is actually a coalition of three different financial planning groups.

Mrs. MALONEY. May I have unanimous consent to put my opening statement into the record?

Chairman BACHUS. Okay. Without objection, all Members' opening statements will be made a part of the record.

Ms. Waters?

Ms. WATERS. I ask unanimous consent to have my opening statement entered into the record.

Chairman BACHUS. So ordered. With that, we will hear from our esteemed panel: Mr. Dale Brown, president and chief executive officer of the Financial Services Institute; Mr. Thomas Currey, past president, National Association of Insurance and Financial Advisors; Mr. Chet Helck, chief operating officer, Raymond James Financial, Inc., on behalf of SIFMA; Mr. Richard Ketchum, chairman and chief executive officer, the Financial Industry Regulatory Authority; Mr. John Morgan, Securities Commissioner of Texas, on behalf of the North American Securities Administrators Association; and Mr. David Tittsworth, executive director and executive vice president, the Investment Adviser Association.

We welcome all you gentlemen. And Mr. Brown, you can proceed with your opening statement.

STATEMENT OF DALE E. BROWN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCIAL SERVICES INSTITUTE (FSI)

Mr. BROWN. Thank you, Mr. Chairman. I am Dale Brown, president and CEO of the Financial Services Institute, and I am pleased to express our support for the Investment Adviser Oversight Act. We urge the committee at the right time to approve this bill because it will protect Americans who need investment advice. An effective regulatory structure for all financial advisers is a critical component to building and maintaining the trust of American savers and investors. FSI's more than 100 member firms and 35,000 financial adviser members, most of whom are small businesses, work with middle-class investors across America. Our members are regulated under both broker-dealer and investment adviser rules. They rely on their personal reputations to earn and maintain trusted client relationships. They have a powerful incentive to put their client's interest first and to embrace the highest ethical standards and most effective oversight that will bolster their client's trust.

These clients are saving and investing for retirement, for their children's educations, and to care for their aging parents. Today, a middle-class family who wants professional help with investing their kid's college fund has no real way of knowing if someone is checking up on their investment adviser. FINRA might have audited their adviser in the last 2 to 3 years, or that adviser might not have seen an SEC examiner since 1999, if at all.

American investors should not have to be regulatory experts to know whether they are being protected. There are many reasons for this unacceptable regulatory gap, but the question today is, how do we close it? We believe H.R. 4624 is the best solution for this urgent investor protection problem. The bill would shift the responsibility for investment adviser examinations from the SEC to an independent regulator paid for by the industry, not taxpayers. This would free the SEC to regulate the regulator as it has done for decades for the brokerage and municipal securities industries, among others.

The Dodd-Frank Act identified this serious regulatory gap. Under the status quo, broker-dealers face routine examinations every 2 to 3 years. In contrast, the typical investment adviser is examined on average once every 13 years. The SEC told this committee that it had examined only 8 percent of registered investment advisers in 2011. They also revealed that nearly 40 percent have never been examined, not even once. This is not acceptable. In its Section 914 study, the SEC called it very unlikely that they will ever have the resources to conduct RIA examinations with adequate frequency. Their recommendations laid the groundwork for this bill—18 months ago, FSI endorsed FINRA as the best choice for an independent industry regulator for retail investment advisers.

FINRA already has a solid working relationship with the SEC and an infrastructure in place that it can adapt quickly to supervise and examine RIAs. I am avoiding the term self-regulatory organization and SRO because frankly they have become misnomers, implying that the industry regulates itself. This is simply not true under FINRA. FINRA's governing board is a majority of non-industry public members and their staff are professional experienced regulators. We have no illusions that FINRA is a perfect regulator. Some of the criticism it is receiving is valid. Many credible observers, such as the GAO, have documented areas in which FINRA can improve its transparency and accountability. FINRA should embrace these reforms as it continues to improve as the broker-dealer regulator and become the investment adviser regulator.

The issue of cost associated with H.R. 4624 is important and shouldn't be downplayed. The hard truth is that any remedy for this unacceptable regulatory gap will cost money. We have an opportunity to solve the problem in a way that does not burden the taxpayer and closes this gap quickly and cost-effectively. The Bachus/McCarthy proposal does just that. I have many friends in the industry, including some FSI members, who are adamantly opposed to this bill. I respect their views, but the status quo is not acceptable. So let us work together toward a practical solution that will benefit American savers and investors. It is the right thing to do.

Thank you, Chairman Bachus and Congresswoman McCarthy, for taking this critical bipartisan step forward. We urge the committee to pass this bill as quickly as possible. Thank you very much.

[The prepared statement of Mr. Brown can be found on page 44 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Currey?

STATEMENT OF THOMAS D. CURREY, PAST PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS (NAIFA)

Mr. CURREY. Good morning, Chairman Bachus, Ranking Member Frank, and members of the committee. My name is Tom Currey, and I am here on behalf of the of the National Association of Insurance and Financial Advisors, or NAIFA. For more than 30 years, I have been licensed as a registered representative of my broker-dealer, and for more than 10 years, I have been licensed as an investment adviser representative for my corporate RIA. This is in addition to my insurance licenses in Texas and California.

I appreciate the opportunity to share with you why NAIFA supports the Investment Adviser Oversight Act of 2012. NAIFA has always supported smart, balanced regulation that provides consumer protections without creating compliance burdens that would impede our members' ability to serve the middle market. H.R. 4624 satisfies those criteria.

NAIFA members are largely small business owners serving the middle class. Most of our clients have household incomes of less than $100,000, with less than $50,000 invested in financial markets. And that is true for my practice as well. My clients—who span several generations; I am now working with children of some of my early clients and even, in some cases, grandchildren—average between $50,000 and $250,000 investable assets, and almost all of them had less than $50,000 to invest before we started working together on their financial plans.

In short, we are Main Street, not Wall Street. We help Main Street investors achieve their financial goals by offering them financial advice and services they can afford. Two-thirds of us are broker-dealer registered reps and like me, about 40 percent of the registered reps are also investment adviser representatives. Today, we spend an average of nearly 530 hours every year on compliance and examination costing us more than $8,800 annually, a substantial amount of time and money, since many members may only have one additional person on staff.

Today, the SEC only examines 8 percent of investment advisers every year, and one-third of investment advisers have never been subject to an SEC compliance exam. FINRA, on the other hand, examined 57 percent of its broker-dealer members in 2008 and 54 percent in 2009. NAIFA members are generally audited by their broker-dealers annually, but there is no consistent examination practice for investment adviser representatives. There is a consensus that the gap between these two regimes should be filled.

From NAIFA's perspective, allowing FINRA to serve as the SRO for investment advisers is the logical way to fill the gap. The Investment Adviser Oversight Act would get us there. And virtually all of our members who are investment adviser representatives are also broker-dealer registered, thus, they and the broker-dealers with which they are affiliated already are subject to FINRA oversight. Requiring broker-dealers and investment advisers to be subject to two distinct regulatory regimes and corresponding examination processes is burdensome and unnecessary.

This is in no one's interest. Coordination of the rules and examinations for both sides of the business, however, would best serve

all constituents' interest. Simultaneous broker-dealer and registered investment adviser exams would not only lead to a more effective examination process; it would be less burdensome and intrusive for financial professionals than having to submit to different exams at different times in order to comply with the rules and schedules of different regulators, or SROs.

It would clearly be more efficient and cost-effective for NAIFA members if FINRA were allowed to expand its current substantial examination capabilities to cover registered investment advisers than it would be to subject NAIFA members to a new SRO or to the SEC to perform this function.

Our hope is that the final result of this process will be an efficient regulatory scheme that protects middle market investors and the professionals who serve them. NAIFA is eager to continue working with the committee to ensure that investors are protected and have access to competent financial advice and services. Thank you very much for the opportunity to present NAIFA's views to you today, and I would be pleased to answer your questions when appropriate.

[The prepared statement of Mr. Currey can be found on page 73 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Helck?

STATEMENT OF CHET HELCK, CHIEF EXECUTIVE OFFICER, GLOBAL PRIVATE CLIENT GROUP, RAYMOND JAMES FINANCIAL INC.; AND CHAIRMAN-ELECT, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. HELCK. Chairman Bachus, Ranking Member Frank, and committee members, my name is Chet Helck. I am chairman-elect of the Securities Industry and Financial Markets Association, known as SIFMA. I also am the CEO of the global private client group for Raymond James Financial, which has over 6,000 financial advisers operating in 2,500 locations in all 50 States, and who serve over 2 million client accounts.

SIFMA supports H.R. 4624 as introduced by Chairman Bachus and co-sponsored by Representative McCarthy. We believe this bill will result in enhanced oversight of retail investment advisers, and thereby better serve and protect individual clients. Over the years, the retail advisory services of investment advisers and broker-dealers have converged. Today, broker-dealers provide some of the same services as investment advisers. We believe that the same services should be held to the same standard. That is why SIFMA supports the establishment of a uniform fiduciary standard for brokers and advisers when they provide personalized investment advice about securities to retail clients.

We also believe that when brokers and advisers provide the same service, they should be subject to the same level of examination and oversight. Currently, broker-dealers are subject to FINRA, SEC, and State regulation and are generally inspected by FINRA biannually, and in larger firms such as ours, much more frequently. Investment advisers, however, are not subject to oversight by a so-called SRO and are inspected by the SEC only about once every 11 years. This gap in oversight is unacceptable and must be

addressed given the billions of dollars of client assets that are entrusted to retail investment advisers. Individual clients would be better protected by consistent standards for and consistent examination and oversight of investment advisers and broker-dealers that provide retail advisory services.

We support H.R. 4624 because we believe it will directly benefit and protect the investing public. We note that last year, the SEC was only able to examine 8 percent of registered investment advisers. Since 2004, the number of SEC examinations has decreased by nearly 30 percent and the frequency by 50 percent. To increase the frequency of examination to acceptable levels, SEC Commissioner Walter stated that the SEC would need to add more than 2,000 examiners to its advisory program. Of course, individual investor protection requires more than just proper examination or audit levels. The oversight afforded by an SRO would better ensure that retail investor advisers develop and maintain policies, procedures, and systems necessary to meet the ongoing obligations in their individual clients at the highest levels.

A retail adviser SRO with oversight over the thousands of IRAs that are not regularly examined by the SEC today would effectively supplement the SEC's resources in the same way that FINRA supplements the SEC in the oversight of broker-dealers. In our view, the so-called adviser SRO option most directly answers the question posed by Congress under Dodd-Frank, Section 914, because it would, in fact, increase the frequency and number of examinations for retail investment advisers. But let us be clear about the term "self-regulatory organization," or SRO.

We need to understand that the term is a misnomer. Here we are not asking an industry to self-regulate or police itself. On the contrary, today, regulatory organizations like FINRA are independent and self-funded and their priority is to protect investors. As recently as 2010, Congress recognized this shift when it expanded the Municipal Securities Rulemaking Board's (MSRB's) regulatory authority and remodeled the MSRB's board of directors after FINRA's as a majority public board.

Today, the term "independent self-funded regulatory organization," or IRO, is the more accurate way to describe and convey the integrity and quality of the modern financial services regulatory organization. This is the type of regulatory organization that H.R. 4624 would authorize and that we would support. At the same time, we should recognize that this bill represents a key opportunity to improve upon the existing SRO regime, to improve upon FINRA, and to take what is working well at FINRA and other SROs and build upon it to create an optimal regulatory organization for retail investment advisers.

Specifically, we support the bill's approach to the rulemaking process for adviser SROs and the requirement for the SRO to consider costs and benefits. We do believe, however, that the cost-benefit requirements should be enhanced to improve the transparency and accountability of the SRO. We also believe that both rulemaking procedures and cost-benefit requirements should be equally extended and applied to broker-dealer organizations like FINRA.

In closing, we support H.R. 4624 because it creates a retail adviser SRO that will increase the amount and frequency of oversight

to an appropriate level and also help ensure a uniform level of oversight consistent with uniform standard of care for brokers and advisers. Accordingly, we fully expect the bill will better protect and serve individual clients. Thank you.

[The prepared statement of Mr. Helck can be found on page 81 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Ketchum?

STATEMENT OF RICHARD G. KETCHUM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE FINANCIAL INDUSTRY REGULATORY AUTHORITY (FINRA)

Mr. KETCHUM. Thank you. Chairman Bachus, Ranking Member Frank, and members of the committee, I am Richard Ketchum, chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today. No one involved in regulating securities and protecting investors can be satisfied with a system where only 8 percent of investment adviser firms are examined each year by the SEC. Yes, that is the system we have today. It is an unacceptably low level of oversight and represents a major gap in investor protection. The many Americans who choose to invest through advisers deserve better. Further, because broker-dealers and investment advisers operate under vastly different levels of oversight, firms offering similar services can arbitrage regulation. They may simply choose the form of registration that offers the least oversight and minimizes the risk of enforcement against misconduct.

H.R. 4624 represents a direct bipartisan response to this problem and would help fill the gap in the protection of investment adviser clients. Specifically, the legislation addresses the current lack of government resources and allows self-regulatory organizations to assist in providing closer and more regular oversight of investment advisers who serve predominantly retail customers.

The SEC oversees more than 12,000 investment advisers, but in 2010 conducted only 1,083 exams of those firms due to lack of resources. This means that the average registered adviser could expect to be examined less than once every 11 years. Further, approximately 38 percent of advisers registered with the SEC have never been examined. By contrast, the SEC and FINRA examine more than 50 percent of broker-dealers annually.

The SEC study on investment adviser exams released last year concludes that the Agency will not have sufficient capacity in the near or long-term to conduct effective examinations of registered investment advisers with adequate frequency. This gap in investment adviser oversight is a significant threat to the protection of advisory clients and should be addressed as quickly as possible. The bipartisan legislation introduced by Chairman Bachus and Congresswoman McCarthy would establish SEC authority for designating adviser SROs and set a framework of requirements for any entity designated as such.

These requirements would ensure that the oversight by any adviser SRO reflect the nature and diversity of the investment advisory industry and ensure that investment advisers are examined

regularly. H.R. 4624 would guarantee that adviser SROs perform regular examinations on investment advisers while not imposing unnecessary burdens. The legislation would also provide assurance that a registered representative who wears two hats could not escape inspection as an investment advisory representative even while being subject to SEC oversight as a broker-dealer—SRO oversight as a broker-dealer representative.

In addition, the legislation would also ensure that the Investment Advisers Act is enforced and that those advisers who commit serious offenses will be disciplined, and if necessary, removed from the industry.

It is important to note the important consideration the bill gives to SRO structure and oversight. The legislation sets out criteria for governance that would require any adviser SRO to have a majority public board. It also includes members of the investment adviser industry. Also, the legislation establishes a high standard for SEC approval of SRO rules in the adviser area and a requirement for consultation with the SEC in developing an examination program for investment advisers.

We support that approach. The concept of an SRO for investment advisers is not a new one. The SEC recommended establishing an investment adviser SRO in the special studies securities markets conducted in 1963. In 1989, the Commission submitted legislation to Congress that would authorize an SRO for investment advisers. In the nearly 5 decades that have passed since the adviser SRO concept was first introduced, protections afforded to investors have only waned. It is clear that none of the approaches taken during that time have allowed oversight to keep up with the growth in the adviser industry.

This situation must be addressed in a way that delivers real and timely results for investors. Just as FINRA, the SEC, and the States work together in overseeing broker-dealers, we believe government regulators and SROs could have the same valuable collaboration relative to investment advisers. Providing the SEC authority to designate one or more SROs to assist in overseeing investment advisers is the most practical and efficient way to address this critical resource and investor protection issue.

Finally, Mr. Chairman, let me end by addressing the very legitimate concerns raised by a number of members of the committee with respect to the impact on small investment advisers. Let me be clear, the bill provides that with respect to any State program that has an active exam program, the SRO would not engage in oversight examinations. I want to assure you that with respect to any members of FINRA of an investment adviser—SRO, that we would expect that fees for those entities with respect to States that have an active program to be extremely low. As an example of that, out of our less than 5,000 firms, 1,700 of those firms paid less than $1,000 in 2011 as a matter of fees. I can assure you that we would look as well for those compliant investment advisers who are subject to active State oversight to pay extremely low fees. Thank you very much. I look forward to answering any questions you may have.

[The prepared statement of Mr. Ketchum can be found on page 94 of the appendix.]

Chairman BACHUS. Thank you.
Commissioner Morgan?

STATEMENT OF JOHN MORGAN, SECURITIES COMMISSIONER OF TEXAS, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC. (NASAA)

Mr. MORGAN. Good morning, Chairman Bachus, Ranking Member Frank, and members of the committee. I am John Morgan, the Securities Commissioner of Texas and a member of the North American Securities Administrators Association, NASAA, the association of State and provincial securities regulators, and I am honored to be here today on behalf of NASAA to discuss H.R. 4624. I would like to emphasize just a few points and I would like to do so by using my State as an example. Texas is different in some ways from other States, but the same in many others. It is known for having a tough securities law enforcement program. And the number of indictments and convictions for securities fraud and related offenses every year is a reflection of that. But it is also a State that works to strike a regulatory balance that is not overly burdensome and fosters economic development while maintaining important investor protections.

It is home to about 1,100 investment advisers registered and regulated solely by Texas. And just like other States, the firms registered in Texas are located in communities throughout the State. These are not just in the big cities. They are in places like Flint, Jacksonville, Beeville, Alice, and Farwell, where small firms are working in their communities to help residents meet financial goals and save for college educations and retirements.

And these are small businesses where cost really matters. Many have investor assets under management of $5 million to $10 million, and for them, charging the usual 1 percent to 1.25 percent management fee realizes an income of $50,000 to $125,000, and that is before rent, salaries, taxes, insurance, utilities, and other costs of compliance. Costs of compliance in Texas include a $275 registration fee each year, and keeping up with the extensive State regulations requiring maintenance of records, regulatory reporting, supervision, disclosure to clients, advertising, and custody of client funds.

They must also find ways to keep up with changes to those regulations when they occur. And just as is the case with other States, these firms are subject to inspections. In Texas, these are on-site, unannounced inspections, and generally occur on a 5-year cycle. But additional funding approved during the last session of the Texas legislature should enable the agency to improve the cycle to about 4 years going forward. That is good, but it is not as good as some other States with 1- to 3-year inspection cycles. A recent survey of NASAA jurisdiction shows that 89 percent of States conduct on-site inspections on a formal cycle of 6 years or less.

There are a very small number of States that take a different approach. These States may benefit from the ability going forward to augment their examination capabilities, but that should be studied, tailored to the needs of that jurisdiction, and addressed at the direction of that jurisdiction. H.R. 4624, as drafted, would require firms already well-regulated by the States to become members of

a self-regulatory organization. That is not necessary. There is no regulatory gap there. But worse is the requirement of membership costs and ongoing costs of compliance with the new self-regulatory organization.

Much has been said in recent weeks regarding the potential cost burden on investment advisers generally, although it is unclear the size of the burden on State-registered investment advisers. One thing is known, the economics for many State-registered investment advisers plainly indicates that it is perilous for these firms to be forced to bear the weight of another layer of regulation and cost, particularly when it is unnecessary to do so. I have heard from a group of these firms in Texas who are very worried about this, and I have also spoken to individuals who help State-registered firms remain in compliance.

The chorus is the same. There is regulatory fatigue. These small firms have already undergone significant regulatory changes and they just want to be able to focus on the markets and on their clients. They have said that small advisers will see the advent of a new regulatory body as the final straw, and will simply close their doors, and those are their exact words. A survey of investment advisers registered in Massachusetts released last week by Secretary of the Commonwealth William Galvin showed that about 40 percent responding to the survey provided comments suggesting that the bill as presently drafted would force them out of business.

Mr. Chairman, Texas and Massachusetts are very different places, but the message I am hearing from investment advisers is the same, as heard by Secretary Galvin. The unintended consequence of H.R. 4624 as presently written may be that of a job killer. There is a belief strongly held where I come from that regulatory oversight should be effective and not unduly burdensome. And the States that do this work as I have described are performing that work in that exact way with respect to investment adviser regulation, and they absolutely need to be excluded from whatever solution is created to address the regulatory gap that has been identified at the Federal level. Thank you for the opportunity to speak with you today.

[The prepared statement of Commissioner Morgan can be found on page 103 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Tittsworth?

STATEMENT OF DAVID G. TITTSWORTH, EXECUTIVE DIRECTOR AND EXECUTIVE VICE PRESIDENT, THE INVESTMENT ADVISER ASSOCIATION (IAA)

Mr. TITTSWORTH. Chairman Bachus, I greatly appreciate the opportunity to provide our views today. Our organization represents SEC-registered investment advisory firms. Our members serve a wide range of clients, from individuals, trusts, and families, to endowments, charities, foundations, State and local governments, pension funds, mutual funds, and private funds. Our diverse membership provides a broad spectrum of advisory services on behalf of their clients. They perform a critical role in helping investors achieve their financial goals. When provisions of Dodd-Frank are implemented this summer, there will be about 10,500 SEC-reg-

istered investment advisers. It is critical to remember that most of these firms are small businesses. More than half employ fewer than 10 employees, and more than 85 percent employ fewer than 50 employees.

It is also important to understand that investment advisers are already comprehensively regulated. Our written statement outlines the rigorous and extensive regulations and laws that all investment advisers must adhere to no matter their size or resources. Additional regulations are not needed to address the issue at hand. Indeed, the issue at hand is clear: to find the best way to strengthen investment adviser oversight. We strongly support efforts to enhance SEC inspections. Our members know that effective and robust oversight is essential to investor protection and confidence.

While the SEC has taken steps to improve its program, we believe more can and should be done. Section 914 of Dodd-Frank directed the SEC to study how to enhance adviser examinations. The report issued last year is very instructive. It sets out three options: investment adviser user fees; an SRO for advisers; or extending FINRA's jurisdiction to dually registered firms. Of these options, the report suggests that user fees have the greatest advantages, and we agree.

We have reviewed H.R. 4624 as recently introduced by Chairman Bachus and others. The bill mandates membership in a nongovernmental SRO for many SEC-registered, as well as all State-registered investment advisers. The bill would subject thousands of advisory firms to broad rulemaking, inspection, and enforcement authority by an SRO, in all likelihood, FINRA.

We strongly oppose H.R. 4624. Outsourcing the SEC's responsibilities to an SRO is not the most efficient or effective way to enhance adviser oversight. The substantial drawbacks to an SRO outweigh any potential benefits. These drawbacks include insufficient transparency and accountability as well as greater costs.

Other organizations agree with our position. Indeed, many diverse groups, including the U.S. Chamber of Commerce, GAO, the Cato Institute, and the Project on Government Oversight have catalogued the drawbacks, costs, and inefficiencies of the SRO model, and FINRA in particular. H.R. 4624 unfairly targets small businesses. Because of exemptions in the bill, smaller advisers are singled out for additional regulation and costs, while larger advisers are unaffected. The substantial costs and bureaucracy of an additional, unnecessary layer of SRO regulation and oversight would have a significant adverse impact on small businesses and job creation. The bill would also result in inconsistent regulation and encourage regulatory arbitrage.

As documented in a recent Boston Consulting Group report, the cost of FINRA oversight will be significantly greater than an incremental increase in SEC resources. And at any rate, the SEC will incur additional costs to exercise appropriate oversight of FINRA. The much better alternative is to build on the SEC's examination program. The SEC, a governmental regulator accountable to Congress and the public, has more than 7 decades of experience and expertise regulating and inspecting investment advisers. To achieve more robust oversight, we would support legislation impos-

ing appropriate user fees on SEC-registered investment advisers in lieu of an SRO.

This legislation should specify that user fees will be solely dedicated to an increased level of advisory examinations, and it should also include reporting and review requirements to ensure full accountability and transparency.

Thank you again for the opportunity to testify. I would be happy to answer any questions.

[The prepared statement of Mr. Tittsworth can be found on page 115 of the appendix.]

Chairman BACHUS. Thank you.

Before I ask questions, I do want to clarify two things. Mr. Tittsworth, I think you and I disagree on whether the U.S. Chamber of Commerce opposes this legislation. I think I heard you say that.

Mr. TITTSWORTH. Mr. Bachus, I don't think that they have taken a particular view on this legislation. The Chamber of Commerce issued a report last summer—

Chairman BACHUS. On SROs?

Mr. TITTSWORTH. —and it was very critical of SROs and FINRA.

Chairman BACHUS. On their cost?

Mr. TITTSWORTH. Yes, sir.

Chairman BACHUS. I agree, but they have not taken a position against this bill.

Mr. TITTSWORTH. To my knowledge, that is correct.

Chairman BACHUS. And I think you said the SEC in their report indicated that they favored user fees, but I have never read that either.

Mr. TITTSWORTH. I understand that. I guess different people will come to different conclusions. What I said in my statement is that the report suggests there are the greatest number of advantages to user fees.

Chairman BACHUS. It actually suggests that is the better path?

Mr. TITTSWORTH. That is correct.

Chairman BACHUS. Does it say that, or is that your interpretation of it?

Mr. TITTSWORTH. That is my interpretation. I would be happy to stand by that.

Chairman BACHUS. Yes, I have read it, and I don't see that. But, reasonable people can disagree.

You talk about a user fee, that you are advocating a user fee being paid by investment advisers. That would be an increased cost, would it not?

Mr. TITTSWORTH. Absolutely.

Chairman BACHUS. How much do you envision that a small investment adviser would pay?

Mr. TITTSWORTH. That is a great question, Mr. Chairman. I guess the answer is: what is the additional total cost divided by the number of firms that would have to pay the fee? And then I think it would have to be adjusted based on other factors: the size of the firm; complexity; risk factors; and those types of things.

Chairman BACHUS. But if under the SRO—and I know Mr. Stivers has a suggestion, an amendment to make a de minimis fee for

small investment advisers to the SRO. Would you be opposed to a de minimis fee?

Mr. TITTSWORTH. I think that it is always hard to support any fees. The bottom line is, whatever approach you are going to take here, there are going to be additional costs. Somebody is going to have to bear those costs. So I think that while we particularly appreciate the problems of small businesses with less resources, I think that spreading the pain, if you will, is something that is going to have to happen.

So again, I think you have to look at the total cost and divide that by the total number of companies that would have to pay either to the SEC or to Mr. Ketchum and FINRA.

Chairman BACHUS. Mr. Ketchum, the Boston Consulting Group, Mr. Tittsworth and, I think, two other organizations, you all funded a study that they made, and they were critical of the costs of what you all were charged. Did they ever approach you and ask you for information on the potential costs?

Mr. KETCHUM. No, they did not. They never talked to us once to understand our exam program or to have any understanding of how we would conduct a program with respect to investment advisers if we were authorized as a self-regulatory organization.

Chairman BACHUS. How did they create their estimate without talking to the SRO?

Mr. KETCHUM. I honestly can't imagine. They used a variety of assumptions, one of which was that, notwithstanding the fact that FINRA had standing an examination program for broker-dealers with offices around the country, with the technology to support it, and notwithstanding the fact that approximately 87 percent of the registered individuals who were registered as investment advisers are affiliated with a broker-dealer, that there would essentially be virtually no synergies, they were wrong with that.

They also made the assumption—because there is much to what Mr. Tittsworth says about the different environment and different business model of an investment adviser and how they interact with customers, they made the assumption that the cost would essentially be the same to look at investment adviser compliance as it would be for broker-dealer compliance.

Our evaluation from the way we approach risk-based exams and the like again was very different from theirs. So our conclusions were start-up costs that were trivial compared to what they suggested and annual costs that were less than one-third of what they suggested.

Chairman BACHUS. All right. Commissioner Morgan, I understand Texas does have a robust examination process, but Georgia, Minnesota, West Virginia, and Michigan have no examinations whatsoever, no on-site examinations. And I am being told that New York doesn't even have an exam program. But I do understand, I acknowledge you all are doing a good job, and I think that there ought to be—particularly if it was a de minimis fee, and I am not saying an amount—but something that the States could be satisfied with, or maybe some credit for States which have a vigorous program.

But I would like to work with you further and explore with maybe you and Mr. Ketchum and these other men, the stake-

holders, including Mr. Tittsworth, that you all continue to pursue this, because obviously if there can be some agreement among yourselves, it would be, I think, obviously more desirable and beneficial than the Congress simply dictating something.

I know that Joe Borg, the director of the Alabama Securities Commission, has some concerns about coordination. I think all the Members, both Republican and Democrat, are sensitive to the cost to investment advisers, because all else being said, I think it is like with any other thing: 95 percent of the people, 98 percent of the people are doing nothing wrong except serving their members, and there are always a few bad actors, unfortunately. That is why you have to have enforcement of some kind.

Mr. MORGAN. NASAA would be happy to work with the committee on the issue relating to the very small number of States.

Chairman BACHUS. And I don't know if you know, but I was one of the ones who advocated expanding State jurisdiction and going up on that, giving you more jurisdiction. And although you all—Texas has a lot of money, like North Dakota, but there are States that are not funding anywhere near the level that Texas is.

But my time has expired.

Ms. Waters?

Ms. WATERS. Thank you very much, Mr. Chairman.

I would like to direct a question to Mr. David Tittsworth, executive director and executive vice president, Investment Adviser Association. There has been a lot of discussion of the cost of a user fee approach to investment adviser regulation versus establishing this self-regulatory organization. I know that the organization commissioned one study by the Boston Consulting Group, and FINRA has its own competing study.

So let us just put aside the cost here for a moment. Independent of cost, why does your organization support a user fee model rather than an SRO model? I think that in the testimony, you described some of this, and I want to make sure that I understand why there would be any consideration—this particular legislation—in establishing the SROs that would have some oversight, I suppose, with the States, and that businesses, particularly concerned about small businesses, would be paying maybe a registration fee to the State and then to the SRO. Dodd-Frank, I think, basically did—allowed us to raise the threshold for these small businesses from $25 million to, I think, about $100 million, and it seems as if the States would be able to handle that adequately without an SRO. So explain to me, why does your organization basically support a user fee model rather than this SRO model?

Mr. TITTSWORTH. Thank you, Ms. Waters.

We do support appropriate user fee legislation because it would be the most direct, the most efficient, and the most effective way to enhance investment adviser oversight.

And I might add, an appropriate user fee provision, in our view, would have several elements. It should be in lieu of an SRO. Investment advisers should not have to pay both the SEC user fees and an SRO. It should be absolutely dedicated to an enhanced level of oversight, so it would be something in addition to the SEC's current, baseline level. And you would have to have a review mecha-

nism so that all of you, and us, and the public can measure whether or not the SEC is using this money for the intended purposes.

Ms. WATERS. I am not sure whether you are actually aware that I am drafting legislation that would allow the SEC to collect user fees to enable the examination of investment advisers. I don't know if you have had an opportunity to look at the draft that we are putting together and whether or not you have any suggestions for making sure that we are accomplishing exactly what Dodd-Frank basically recommended. Have you taken a look at that?

Mr. TITTSWORTH. Yes, ma'am. I appreciate your efforts and we would be happy to continue our discussions and would love to support an appropriate user fee provision.

Ms. WATERS. Thank you, Mr. Chairman. I have no additional questions. I yield back the balance of my time.

Chairman BACHUS. Thank you.

Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman. I yield 30 seconds to the chairman.

Chairman BACHUS. Thank you.

Ranking Member Frank mentioned JPMorgan and the $2 billion loss, but let me put that in perspective. No public member investor or taxpayer lost a dime. Madoff was $46 billion, and yet we choose to talk about JPMorgan. Sanford was $8 billion, 4 times as much loss, but, again, it was investors' money, it was people's pension funds.

This JPMorgan loss of their own money, which represented about $1 out of every $1,000 that they have as assets, I think is motivated principally by people wanting more regulations on all the regulations we have. That is why we keep hearing about JPMorgan. I think there is an agenda there.

But no taxpayer money, no member of the public loss money. We ought to be more concerned about Solyndra and that $500 million of total loss that was taxpayer money. I am concerned about taxpayers and investors. I am not concerned about an individual or companies losing their own money as long as it doesn't jeopardize the system, and it is quite a stretch to continue to talk about that as any threat to our bank—

Ms. WATERS. Would the gentleman yield?

Chairman BACHUS. Mrs. Biggert?

Mrs. BIGGERT. Reclaiming my time, because I do have questions.

I have heard from a number of small advisory firms in my district that they fear that if they are regulated by an SRO, they will be subject to costly new regulations and fees that could put them out of business, and then there are fewer jobs, and no job creation.

The objective of H.R. 4624 is to increase investor protection by increasing the frequency of exams of investment advisers. It is an important objective, but it is equally as important that we strike the right balance so that small advisory firms are not disproportionately affected.

This question is for Mr. Tittsworth. You seem to be in the hot seat today. It is my understanding that SROs like FINRA are not required to go through a formal rulemaking process, unlike Federal regulators, and also don't conduct any meaningful economic analysis of rules. And like the Consumer Financial Protection Bureau,

SROs are not regulators subject to appropriations or directly and regularly accountable to Congress. Would it make sense to require SROs to conduct a more robust cost-benefit analysis on rulemaking?

Mr. TITTSWORTH. Absolutely, Ms. Biggert. And I believe in H.R. 4624, there is a very meager swipe at that issue. But from our reading of it, it does not require FINRA or an SRO to conduct a cost-benefit analysis. And most importantly, our reading is that there is no remedy in case the SRO does not conduct an appropriate cost-benefit analysis. So you can sue the SEC, and they have been sued in court, for lack of a cost-benefit analysis, but I don't think under the legislation, at least as we read it, that you would have that option with FINRA or an SRO.

Mrs. BIGGERT. Okay. Would it be possible to achieve the goals of H.R. 4624 by allowing an SRO like FINRA to have a targeted set of authorities to examine investment advisers and enforce SEC-promulgated rules?

Mr. TITTSWORTH. I think deleting the rulemaking authority for an SRO from the bill would be an improvement because that would certainly mitigate the opportunity to have a different set of regulations than the SEC. But I think there are still drawbacks, and part of that is an examination program should inform regulatory policies. So I don't think it would be good to separate those two functions and put them in two different entities.

And at any rate, the SEC is going to bear significant costs in overseeing FINRA, and I think that is a point that may be lost in this whole debate. But the SEC is being criticized for not doing enough to oversee FINRA, and this bill would require even greater expenditure to achieve that.

Mrs. BIGGERT. Having the SEC-promulgated rules, would this provide firms, especially the small advisory firms, some certainty and transparency and cost-benefit analysis in their rulemaking while increasing oversight of the investment advisers?

Mr. TITTSWORTH. Yes. Having one set of rules is always most desirable in terms of having regulatory certainty.

Mrs. BIGGERT. I think maybe you answered this: How do we address small advisory firms' concerns about costly fees that could result from the bill?

Mr. TITTSWORTH. We would propose that a user fee approach would be much less costly, whether it is for small businesses or other investment advisers.

Mrs. BIGGERT. All right, then, Mr. Morgan, is H.R. 4624 clear about which entity, the SEC or an SRO, would conduct audits of State regulators' exams of investment advisers?

Mr. MORGAN. It appears that it contemplates that an SRO would do it, but it is NASAA's position that we should be excluded from this altogether for the reasons that I stated.

Mrs. BIGGERT. Doesn't the bill require State security regulators to report annually to a private-sector entity such as SROs?

Mr. MORGAN. Yes, it does require that.

Mrs. BIGGERT. And I have heard that the bill would then delegate to an SRO the authority to oversee States, and there are State sovereignty and constitutional concerns.

Mr. MORGAN. There has been an argument made about the constitutionality of that, and from NASAA's perspective it seems completely inappropriate. The State is reporting to a private entity. It is being required to disclose its exam methodology. The SRO is allowed to comment on that plan, and this would not be a disinterested party that would be commenting on the plan.

Mrs. BIGGERT. Given these concerns, should the bill make clear that the SEC, a Federal agency, should be tasked with the function of oversight of State security regulators' regulation of investment advisers?

Mr. MORGAN. The States would have that authority. It shouldn't be the other way around where the States are reporting to the SRO.

Mrs. BIGGERT. All right. Thank you. I yield back.

Chairman BACHUS. Mrs. Maloney?

Mrs. MALONEY. Thank you very much. I would first like to thank all the panelists for their testimony.

And I would like to ask Mr. Ketchum and Mr. Brown to respond to Mr. Tittsworth's statement that the bill inappropriately targets small businesses with additional costs and regulations. It would seem to me that we would want to share the burden. But if the bill apparently exempts large investment advisers, it also exempts certain advisers based on the size of institutional assets, and it appears to allow them to choose one regulator over another, which I don't feel is a good policy, because I think you should have one regulator.

But I am concerned about inappropriately putting the burden of the cost on the small businesses, and my question is directed in that area, but also why are these other areas—there are three or four areas that are exempted, and what is the policy reason for exempting large institutions over smaller institutions? It just seems unfair.

But Mr. Ketchum first, then Mr. Brown, and, Mr. Tittsworth, if you would like to respond, as well?

Mr. KETCHUM. Sure, Congresswoman. Let me respond to both of your questions.

First, from the standpoint of small advisers, as I indicated in my opening statement, with respect to small advisers and the particular concern that Mr. Morgan articulates very well, with respect to any State program that meets the requirements to have an active examination program, we would entirely support an amendment that any SRO fee be de minimis, certainly with respect to any entity that does not have serious compliance problems, entirely supportive.

I would note, as I said before, that over 1,700 members of our less than 5,000 members pay less than $1,000 in fees to FINRA. We would support a de minimis standard.

Secondly was your concern about—

Mrs. MALONEY. Do you support the exemptions, that larger firms should be exempt?

Mr. KETCHUM. I did want to address that as well. First a clarification. I don't—certainly my reading of the bill does not exempt large investment advisers. It provides exemptions for those advisers that provide advice to mutual funds or unregistered funds, and

it provides exemptions with respect to entities that are predominantly providing advice to institutional investors.

My experience from—

Mrs. MALONEY. So they are exempted, correct? They are exempted.

Mr. KETCHUM. —working at a large firm is that indeed the customer retail-facing side of the business that provides investment advice for retail investors, still very large, is combined with the broker-dealer in an entirely separate corporation. I do agree there is a potential that the exemptions are too broad now. I appreciate the point you made and that Chairman Bachus made. We would be pleased to work with the committee to ensure that the exemptions don't result in customer-facing large investment advisers being outside.

Mrs. MALONEY. Also the ability to choose your regulator.

Mr. KETCHUM. That would be one possible way to address this.

With respect to the holding company exemptions that are built into here, there is a specific inability for the SEC to determine that it inappropriately exempts an entity or a related entity in a company.

Mrs. MALONEY. It seems like we might legislate that. Why do we have to rely on the SEC?

Mr. Brown, do you have any comments on that?

Mr. BROWN. Thank you for the opportunity.

Two quick thoughts on the issue of choosing another regulator. We have seen a trend in the industry for years of that already happening because of the disparity between the frequency of exec exams of RIAs both at the State and Federal level and the frequency of examination on the broker-dealer side. We certainly wouldn't want to support new legislation that would accelerate that, so we would expect to work with the committee to address that legitimate concern.

I agree with Mr. Ketchum we need to take a look at the exemptions, the support, the intent to make sure that this increases examinations for retail investment advisers. They are the ones that don't have frequent enough examinations. The SEC, in my understanding, is already rigorously examining institutional advisers, mutual funds, etc., and we support working with the committee to identify the right balance on the exemptions so we close the regulatory—

Mrs. MALONEY. It seems to me that if we are going to have the right balance, everybody should bear the burden somewhat. Why should someone not have to pay the fee if there is going to be a fee to support this to FINRA or the SEC?

I would like to ask a question about transparency, since really the heart of the whole Dodd-Frank bill was to bring sunlight into transactions. There have been some transparency concerns that were raised by people because FINRA rules are not subject to the Administrative Procedures Act (APA), which requires the standard notice-and-comment period, which is very important in—really in the House of Representatives, and regulated members have little insight as to how FINRA makes regulatory decisions. So I am concerned about the transparency, and I would like to see if Mr.

Tittsworth would like to talk about the transparency challenge, and really anyone else.

Chairman BACHUS. We are over the time, but if you have a 10- or 20-second response, Mr. Tittsworth, you may give it.

Mr. TITTSWORTH. Ms. Maloney, I think that the Project on Government Oversight letter that was produced last week, and that I believe was introduced into the record earlier today, would provide a very sound response to your question about transparency. It is an important question.

Mr. KETCHUM. Congresswoman Maloney, let me just clarify that, in fact, all FINRA rules get published—or all substantive ones get published twice for comment. We publish once generally before we file with the SEC, and then it is published again by the SEC, and the SEC must approve it. So while not subject to the Administrative Procedures Act, it is subject to provisions that require public comment, require specific findings of the SEC, including findings that can relate to costs and benefits, and this bill even provides greater clarity with respect to the SEC's responsibilities.

Chairman BACHUS. Thank you.

Mr. Garrett?

Mr. GARRETT. I thank the chairman and the panel.

Just a couple of questions actually, and the first question goes to the whole panel, but I think I will start with Mr. Ketchum.

It is my understanding that as current law states, there is no—and Mr. Tittsworth touched on this—requirement under law for a cost-benefit analysis to be done by FINRA, although obviously the regulations that you just set out of the procedure to go through may very well have a significant impact upon the economy, and also the member companies as well. And as you know, I have a piece of legislation that would do this for the SEC.

So I would ask you, is this an appropriate time, then, in any legislation—whether it is this bill, modify this bill or some other bill—to include that in the statute?

Mr. KETCHUM. I think it is certainly an appropriate time to clarify the self-regulatory organizations' responsibility to both focus on costs, measure that versus benefits, evaluate alternatives, and for the SEC to evaluate that clearly with respect to their review. I think the SEC has been pretty clear lately that is how they approach even our rules with respect to our existing self-regulatory organizations. I think this bill is even clearer, and I view it entirely as our responsibility to look at those and to carefully evaluate alternatives that may have lesser costs.

Mr. GARRETT. Would any other member of the panel like to chime in there on the necessity in statute form for this?

Mr. TITTSWORTH. If I may, Mr. Garrett?

Mr. GARRETT. Sure.

Mr. TITTSWORTH. I apologize for dominating the discussion here, but, again, our reading of H.R. 4624 is that it does not require FINRA to conduct a cost-benefit analysis. And there is certainly no remedy other than maybe the SEC taking FINRA to task if they don't do the analysis.

Mr. GARRETT. Okay. Thank you.

Aside from that one issue that I sort of harp on all the time, this is for the rest of the panel as well, the bill does go into some pre-

scriptive—I will use the words "prescriptive language" as to what the SEC can do—look at as far as whatever the SRO would be going forward. Is that list exhaustive enough or too exhaustive? Is there something else? Should the legislation be more prescriptive or less prescriptive with regard to a potential new SRO?

Mr. HELCK. We pointed out in our comments that we felt like the rules should be extended to amend the 1934 Act and apply to FINRA so that there would be a requirement for transparency and cost-benefit analysis that would be consistent among all providers, and therefore broker-dealers should be affected by that as well as investment advisers.

Mr. GARRETT. Okay. Mr. Brown?

Mr. BROWN. Two quick comments. First, we would agree with extending the provisions to the broker-dealer side of FINRA. And second, we have supported your legislation that you have put forth to require regulatory reform in a cost-benefit analysis. That is appropriate.

Mr. GARRETT. Thank you.

I will end with Mr. Tittsworth on just two points. First of all, what is the percentage of investment advisers who are stand-alone or investment advisers who are tied with a broker-dealer?

Mr. TITTSWORTH. I believe out of the 12,000 currently registered advisers, which as you know will soon drop to around 2,600, that 2,700 are affiliated. That would include 580 dually registered firms. I believe that is in the ballpark.

Mr. GARRETT. And is there—so for the percentage of them that are already under FINRA that—at least the broker-dealer section of them are, right? How would that work, in your mind, if just for that segment of the marketplace that they would be subject to a version of this bill, that they would be required to have an SRO, whether it be FINRA or otherwise, required for dealing with them, since they are already having the audits, as someone else testified here about?

Mr. TITTSWORTH. I think there is a difference between dually registered firms, and I know some of the members of this panel have opposed the dually registered firms going to FINRA as well. FINRA would support that. But there is a difference between just being affiliated. You can have an investment adviser that is an advisory shop, a mutual fund company, for example, that has a limited-purpose broker-dealer for distribution purposes only, and I would submit to you, Mr. Garrett, that is much different than a firm that is consolidated and markets both functions actively.

Mr. GARRETT. Does anybody else want to chime in on that general topic?

And for that smaller category of—and I see my time is up—for the smaller category that actually—not just has an affinity to it—how would that work for them?

Mr. TITTSWORTH. For the dually registered firms?

Mr. GARRETT. Yes.

Mr. TITTSWORTH. There could be legislation that would subject dually registered firms to SRO oversight or FINRA oversight.

Mr. GARRETT. And your thoughts on that?

Mr. TITTSWORTH. I think that would be a better approach than H.R. 4624. I still think user fees would be a better approach.

Mr. GARRETT. Did you support user fees when the whole Dodd-Frank legislation was coming through the process?

Mr. TITTSWORTH. We didn't support that specific provision. The fact that it was an open-ended authority would be my main objection to the way that particular provision was in the House version. There was also a self-funding mechanism in appropriations.

Mr. GARRETT. Okay. Thank you. I yield back.

Chairman BACHUS. Let me direct all the Members to page 19 of the legislation that we have drafted. On this cost-benefit analysis, it says that the Commission, meaning the SEC, before they make a decision on how the national investor adviser association, whether it be FINRA or someone else, that they will include from the industry and consumer groups concerning the potential cost or benefits of the proposed rule or the proposed rule change and provide a response to those comments in its public filing with the Commission. In other words, if it is FINRA, the cost-benefit from all groups will be included. FINRA will be required to make a response to those.

And it goes on to say that response, whether it is from FINRA or someone else, will include why they are adopting those suggestions or why they are not adopting those suggestions on cost-benefit analysis. So whomever is designated will be required to say why they are adopting those cost-benefit recommendations or rejecting them; and further, the reasons—if they reject them, the reasons they reject those specific cost-benefit suggestions or—so Mr. Tittsworth's group could say, we want to you do this. If it is FINRA, they could say, we don't want to do this, and here are the reasons. And then, the Commission would make a decision on whether or not they would have to adopt them.

Now, if that is not tight enough, I think we would all be willing to work for some other language, but I think that is—certainly that is asking for a cost-benefit analysis of all parties, not just FINRA or the SEC, but for the industry groups and consumer groups to offer their cost-benefit analysis, and for the Commission to either adopt them or reject them, and for the SRO to either say they would be willing to do that or would not be willing to do that. So we can continue to work on this.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman.

I felt compelled to come down. I was listening to the hearing, and I heard Ranking Member Barney Frank's comment about JPMorgan's loss and Chairman Bachus' spot about protecting taxpayers from that loss. And I have to completely agree with Congressman Frank's comment. I think he was absolutely on target.

When you think about it, we are spending more than $1 billion a week, $1 billion a week, to control marketplaces in Kabul, and no one has a problem, particularly my colleagues across the aisle, with that. You have no problem with that. But when it comes to protecting our investors and patrolling our securities markets, it seems as though all of a sudden, my colleagues on the other side become Scrooges.

The bill, as I have read it, seems to employ a convoluted and circular reasoning that I don't really understand. If you starve the SEC from funding, I don't know how they can be successful. And

the bill lacks—the SEC lacks adequate resources, and thus the agency is unable to conduct comprehensive oversight of the investment adviser community on an annual basis. And then you starve the beast, and then so you say, let us outsource it. It just doesn't make sense to me.

And I have, Mr. Chairman, a report that was made by the U.S. Chamber of Commerce's Center for Capital Markets and Competitiveness, which has taken a look at nongovernmental organizations. I ask unanimous consent to submit that report for the record.

Chairman BACHUS. Sure. Is that the report that came out about 13 months ago?

Mr. MEEKS. That is correct.

Chairman BACHUS. Without objection, it is so ordered.

Mr. MEEKS. And I ask Mr. Tittsworth whether or not you had an opportunity to see this report?

Mr. TITTSWORTH. Yes, Congressman.

Chairman BACHUS. He actually testified about it in his opening statement.

Mr. MEEKS. And what would you say or what does the report say about the accountability of such organizations?

Mr. TITTSWORTH. Congressman Meeks, the U.S. Chamber of Commerce report indicates that the accountability of nongovernmental regulators, and FINRA in particular, is lacking.

Mr. MEEKS. And I also would ask whether or not you are familiar with a brief summary from the Cato Institute that was given?

Mr. TITTSWORTH. Yes, sir. There was a brief that the Cato Institute filed in December of last year with the U.S. Supreme Court in a case against FINRA.

Mr. MEEKS. Mr. Chairman, I also ask unanimous consent to include the Cato briefing as part of the hearing record.

Chairman BACHUS. Yes. We are actually operating on a rule that any Member can offer any evidence or documents they wish in support of their comments.

Mr. MEEKS. Thank you.

Mr. Tittsworth, I was wondering whether you can give us a brief summary of Cato's arguments?

Mr. TITTSWORTH. Yes, Mr. Meeks. And I would suggest to members of the committee that if you haven't read this amicus brief the Cato Institute filed in December, it would be very instructive to the issues that the committee is considering today.

The Cato Institute basically talks about the lack of accountability and transparency with FINRA, and that no one has ever overseen their budget, executive compensation, biased arbitration system, and many other issues.

Mr. MEEKS. And finally, Mr. Tittsworth, and I have just been looking, but a Republican, Mr. Paul Atkins, who previously served as an SEC Commissioner, testified before this committee last fall. He included in his opinions the subject of FINRA serving as an SRO for advisers, and he said, "Perhaps most concerning is the lack of transparency. While FINRA and other SROs can enact rulemakings that carry the force of law, they are not subject to the Administrative Procedures Act, Freedom of Information Act requests, and are not required to conduct any cost-benefit analyses. The disciplinary process raises due process concerns. Its board

meetings are private and not subject to the Sunshine Act, of course. This lack of transparency and accountability to either the SEC, its members, or the public is a real concern underlying the present discussion over delegating authority to oversee investment advisers. I must raise serious concerns regarding expanding FINRA's empire without a fundamental reevaluation of its statutory functions and organization."

What do you think about that position; do you agree or disagree?

Mr. TITTSWORTH. I certainly agree.

Chairman BACHUS. You have time for a 10-second response.

Mr. TITTSWORTH. I agree with it, Congressman.

Chairman BACHUS. That is even better.

Mr. Neugebauer?

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

When I was listening to the testimony of the panel today, basically I think there is a common theme here, and I will just kind of go down the row here. But I think, Mr. Brown, you said that currently, you don't think the SEC is doing an adequate job in overseeing investment advisers? Is that a yes or a no?

Mr. BROWN. Yes.

Mr. NEUGEBAUER. I am sorry?

Mr. BROWN. Yes, sir, that is correct.

Mr. NEUGEBAUER. And, Mr Currey, would you say they are not doing an adequate job?

Mr. CURREY. It appears so.

Mr. HELCK. I agree.

Mr. TITTSWORTH. I also agree.

Mr. NEUGEBAUER. So I am listening, and one of those kind of a common theme in Washington, and that is when we have a regulator that is not doing their job, we go create another regulator. And I respect what the chairman is trying to do. Everybody agrees that the SEC is not doing their job, so he is trying to introduce or has introduced an idea.

I think the thing that troubles me is that when we—people brought up Mr. Madoff and Stanford. Again, that was the result of a regulator not doing their job. On several occasions, we have had hearings on both of those issues, and we brought to people's attention within those agencies that there was a problem, and the regulator, unfortunately, ignored that.

And so what I am trying to get my arms around is, when are we going to just start holding the regulators accountable and making sure they are doing their job rather than creating new regulations and new regulators? Because what we—in many cases, that is how we ended up with Dodd-Frank is rather than go back and identify where there was regulatory failure, we just threw a big whole new blanket of regulations and new regulators over the entire financial market. And so, I am trying to get my arms around how creating another regulator fixes the problem if we are not holding regulators accountable that currently have that responsibility?

Mr. Brown, do you want to take a shot at that?

Mr. BROWN. That is a great question. Thank you very much.

I think this bill creates an opportunity to do just that, to start holding FINRA more accountable. I am not sure I agree with the framing that it is creating a new regulator. It is leveraging the

benefits of an existing regulatory body to expand and to address an important investor protection concern, and that is inadequate frequency of IA exams.

Mr. NEUGEBAUER. Mr. Currey?

Mr. CURREY. Thank you.

From our standpoint—I am a practitioner. I am a guy who sees people on a day-to-day basis and does this kind of business on the street. And so from my members' perspective and my perspective, we don't get up every day looking for a new cupful of regulations from our neighbors. We feel like we have a gracious plenty of regulation now and then some in most cases.

The thing we want to avoid, though, for our members, is being subject to two regulators. And so, we would like to see this combined into one regulatory body with maybe two sets of rules that they can coordinate so that we can consolidate those examination processes and keep the costs to our members and their clients down to a bare minimum. So I think that speaks to FINRA as the choice for us.

Mr. NEUGEBAUER. Thank you.

Mr. HELCK. Yes, sir, I would agree with that. We are not looking for more regulators either; we are looking for consistency among all providers of the same services. And if one of the choices is to create a new regulator, then that would be problematic. If we have one regulator that can consistently apply the same high standards, I think we have accomplished what we came here to do.

Mr. NEUGEBAUER. Mr. Ketchum?

Mr. KETCHUM. I am just reiterating what has been said. FINRA provides oversight with respect to broker-dealer members that are either part of the same corporation or affiliated with 87 percent of the human beings who are registered as investment advisers. We can provide that service effectively at their cost, and I agree with you, we should do that in a way that does not inappropriately expand regulation.

Mr. NEUGEBAUER. Mr. Morgan?

Mr. MORGAN. Congressman, that is exactly the point NASAA is making. You are creating a new regulator for the States that are doing the job, and we need to be excluded from this.

Mr. NEUGEBAUER. Mr. Tittsworth?

Mr. TITTSWORTH. I agree that creating a new regulator is unnecessary. I don't have an answer, Congressman, for how you hold regulators accountable, and I understand your frustration with that.

Mr. NEUGEBAUER. I thank the chairman, and I would note that I finished on time, too.

Chairman BACHUS. We have an Oversight Subcommittee that is holding them accountable, I think, every day, and doing a good job.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairman Bachus.

As I said in my opening remarks, I am concerned about the effects of this legislation on the smallest advisers. These are small businesses that serve the middle class with investments of, let us say, $500,000 or less, and we need to ensure that additional fees do not put them out of business.

My first question is to Mr. Tittsworth. Will State-registered investment advisers be subject to the same membership fees even if they are already registered and examined by their States?

Mr. TITTSWORTH. Yes, sir. As we read H.R. 4624, all State-registered advisers would have to belong to an SRO.

Mr. HINOJOSA. My next question would be to John Morgan, the securities commissioner of Texas. What sort of pros and cons does this legislation hold for the advisers who are working with large investors of $750,000 or more?

Mr. MORGAN. The jurisdiction has been divided $100 million or less assets under management or subject to State regulation, and are regulated in Texas by the State Securities Board.

Mr. HINOJOSA. So if it is $1 million or more that they are advising, could they do a better job by passing this legislation?

Mr. MORGAN. No, not with respect to the regulation by Texas and the vast majority of other States that are already doing the job. What is being proposed is a duplicate layer of regulation, and the fees, the membership fees, are just part of the cost. The ongoing compliance costs would be substantial as well.

Mr. HINOJOSA. I have to agree with you, and I think that this legislation is not necessary, and I believe that we ought to take a look at the SEC and maybe strengthen their position to oversee them.

So with that, I yield back, Mr. Chairman.

Mr. MCHENRY [presiding]. We will now go to Mr. Posey for 5 minutes.

Mr. POSEY. Thank you very much, Mr. Chairman. And I compliment Chairman Bachus and Ms. McCarthy on their good intentions to protect investors. I assume that the advisers mostly fear overregulation by the Consumer Financial Protection Bureau, and this is maybe a step that might insulate you a little bit from that. I don't think it will do that. I think you will just have two people overregulating you rather than one.

But I don't believe shifting an unfunded mandate, a burden onto the States, is a correct answer. More laws, rules, regulations, more employees and more costs is not going to solve the problem, as we have seen evidenced by Madoff's caper, for example. Madoff's caper was not caused by any lack of laws, rules or Federal employees; it was caused by a lack of employees who were willing to do their jobs. We had 20-something examiners and 30-something investigators, or vice versa, whatever the numbers are, who just failed to do their jobs. I don't know what they are doing now, but they are the ones who empowered Madoff, not a lack of laws.

It appears that the SEC, who is empowered to oversee interstate regulation of securities and things, does not want to do their work and sees this as a great opportunity to shift burden onto the States, an unfunded burden, I might add, which is not the responsibility of the States, ostensibly because the SEC has too much work to do and can't afford to do anything else.

But we know they have 1,200 lawyers at the SEC, who file an average of one case a year. I know a lot of lawyers who would like to have a heavy caseload like that. We know they squandered millions and millions of dollars on unused office space. And so, the question that begs for an answer is not how much money they

waste or how much money they spend, but what do they actually do?

We know how much money they spend. Certainly, that is not a measure of quality or performance. What do they actually do to protect the public, which is their number one job, and not employees who don't do their job?

Mr. Chairman, to put this in the proper perspective, and if there are no objections, I would like to ask the SEC to tell us what they do. I would like the SEC to give us a one-page summary, and at the top of the page, I would like the SEC to state all the money that came through the SEC—reversions, credits, budget items, fees collected, penalties—and then I would like them to list on one page what they actually do, and how many times they do it, and then the cost of doing each function each time, and those lists of things should add up to the total amount of money that runs through the agency.

And then, Mr. Chairman, when I see what the SEC actually does and what it actually costs to do what they say they actually do, I think we will be put in a whole lot better position to determine how we are going to move forward with allocating resources for enforcement. But I don't think at this time we should waste a whole lot of time, and a whole lot of energy, or a whole lot of taxpayers' money trying to invent a wheel, particularly a wheel that is already broken.

I yield back, Mr. Chairman.

Mr. MCHENRY. I thank you, and I will now recognize Ms. McCarthy for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. I just want to ask you a quick question. Does your organization have in place a compliance database accessibility and searchable by an investor that includes the State-by-State information on registered investment advisers, the examination process, and the disciplinary action that has been taken on the individuals in the firms?

Mr. MORGAN. We have access to the CRB database that has information and the IARD database that has information.

Mrs. MCCARTHY OF NEW YORK. So that is for all the States?

Mr. MORGAN. Correct.

Mrs. MCCARTHY OF NEW YORK. Has that been updated recently?

Mr. MORGAN. Yes.

Mrs. MCCARTHY OF NEW YORK. Because I know about 2 years ago or 3 years ago, we had asked for that information, and you didn't have it.

Okay. Mr. Tittsworth, what is the examination frequency of your members who are subject to SEC regulation and oversight? And has there been an increase or decrease in examinations since the financial crisis?

Mr. TITTSWORTH. I do not know, Congresswoman, other than the statistics that have been thrown around here today, 8 percent of all SEC-registered advisers in 2011, representing 30 percent of the total assets under management.

Mrs. MCCARTHY OF NEW YORK. Could you send that to me in written form, then, when have you that information?

Mr. TITTSWORTH. Sure.

Mrs. MCCARTHY OF NEW YORK. Thank you.

And one more. Mr. Ketchum, there have been criticisms of the SROs' role in coordination with State authority for those States that satisfies the examination requirements under the bill. Can you explain again what you would anticipate the role of the SRO to be, and how the coordination will be achieved with individual State authorities when necessary?

Mr. KETCHUM. Thank you, Congresswoman.

First, let me say that since I became CEO of FINRA some 3 years ago, I have made it a major priority to include the coordination and common working efforts with respect to NASAA. As an example, this year there have been 103 access requests made to us on our existing self-regulatory side from the States. We have provided information back on all 103 access requests.

We have tried to take as aggressive as possible an interpretation and reading with respect to concerns we previously had with respect to what is referred to as the State actor position. I will note that this legislation specifically addresses and provides far greater comfort on the appropriateness of interaction between the SRO and the provision of data and consultation than exists on the Exchange Act side, and I am delighted to see that.

I would finally note that with respect to the annual meetings that occur that are built into the legislation, we view this just as we have always viewed the SEC's annual 19(d) meetings on the broker-dealer side as purely collegial and an opportunity to share information. To the extent there are any concerns the States have with respect to our role, we would certainly be glad to work with them with respect to clarifying that in the legislation.

Mrs. MCCARTHY OF NEW YORK. Thank you.

Mr. Helck, one criticism we have heard a number of times today, and also before today, is the potential for regulatory arbitrage of the examination process as a result of the enhanced oversight and examinations by an SRO. You had mentioned a few things, but what are your thoughts on that, and what suggestions do you have that would further enhance the cooperation between the SEC and the SRO beyond what is currently in the bill?

Mr. HELCK. I thought your first question was very insightful, and it goes right to that very point. The CRD, which FINRA administers, is a record of all registered persons in the securities world, and it contains their licensing, their disciplinary history, and all the relative data. It is publicly available. And therefore, it gives the public the ability to monitor and have transparency into the records of their adviser.

There is no similar kind of infrastructure in place for the people involved in the registered investment advisory world, so therefore, it goes to the differences and therefore inconsistencies of being able to establish and track at the same level. I think it would be useful for us to have consistent records on participants providing services across the industry and all the various regulatory regimes that they are operating.

Mrs. MCCARTHY OF NEW YORK. I agree. With that, I yield back the balance of my time.

Mr. MCHENRY. I thank the gentlelady for yielding back. Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I thank the gentlemen for being here this morning. I have some questions here that keep coming to my mind as I listen to Mr. Neugebauer, and Mr. Posey, in particular. Can you give me an explanation on what you feel over the last 4 years has been the problem with your industry? We have had some scandals and some scams. Was it due to the lack of proper rules to protect the consumer? Was it due to the lack of enforcement of existing rules? Or was it just the inadequacy and the failings of the regulatory officials to catch those things and do due diligence? Mr. Brown, can we go down the line here, I just would like to know what your thoughts are on it?

Mr. BROWN. I think my members would say the biggest single challenge they faced in the last 4 years as a result of the financial crisis, as a result of Mr. Madoff's crimes, and Mr. Sanford's crimes, is the undermining of trust. The crimes of a few have painted all legitimate industry participants with the same broad brush and it undermined trust between client and the adviser.

Mr. LUETKEMEYER. Okay. The crimes have been committed. However, what is the problem there? Was it they just had some folks who just are going to go out and do some mischievous things here and got away with it and the reason they did was because we didn't have the rules in place to protect the people or the enforcement of existing rules wasn't there just or the regulators just dropped the ball?

Mr. BROWN. I think it is more the latter.

Mr. LUETKEMEYER. The regulators dropped the ball. Mr. Currey?

Mr. CURREY. I have to caution you that I am a big-picture guy, so if you get too detailed here, we are going to be in trouble. I would say it is a combination of both. Probably, there were some regulations that needed to be different, if not additional regulation. But greater than that, enforcement is always a problem. It is the most expensive end of the thing and probably that is where a good deal of the blame lies.

Mr. LUETKEMEYER. So you believe the enforcement end was the problem here?

Mr. CURREY. Yes.

Mr. LUETKEMEYER. Mr. Helck?

Mr. HELCK. I would agree with that. We have good rules and laws on all sides of the industry. There are inconsistencies. So when we have failings of human beings to either be effective in doing their roles or we just have circumstances beyond anyone's control, what we look to are what is the structural framework that would have and could have and maybe in the future could be improved to make sure that it doesn't happen again, so we should learn from those mistakes. Consistency, I think we all have stated here today, is one of those strategies that would help us achieve that. And that is why we think that if we had a consistent policy, and therefore oversight and enforcement process, we would be less subject to things falling through the cracks as they don't interface well.

Mr. LUETKEMEYER. Mr. Ketchum?

Mr. KETCHUM. Congressman, no regulator can be happy with what has happened in the last 4 years. Any regulator that hasn't reviewed the way we approach examinations, enforcement, or in-

vestigations is deficient in not doing so. We have. We think we have made changes that are important. I also agree with you, speaking on the investment adviser side, that the basic rule and statutory environment is excellent. I don't believe that the need here is, in any way, primarily related to rule making. But as a last piece, if you don't examine and if you examine only 8 percent of persons, then have you to depend on nothing but enforcement. And that probably explains why the SEC has as recently as today talked about such a banner year in investment adviser enforcement actions.

Mr. LUETKEMEYER. Thank you. Mr. Morgan?

Mr. MORGAN. It is important to keep in perspective that this is a Federal problem, and all of the examples are Federal issues. And not doing the inspections on the cycle that makes sense or that is adequate, or following up on information that is provided, that you would expect it would follow up on an enforcement investigation. These aren't State problems; the States are doing their job.

Mr. LUETKEMEYER. Very good. Thank you. Mr. Tittsworth?

Mr. TITTSWORTH. There is not a lack of regulations. There are plenty of laws prohibiting fraud. I don't know the answer to why people continue to commit fraud, Congressman.

Mr. LUETKEMEYER. My question is by not catching them, is it a problem with the rules, a problem with enforcement of the rules or is the problem that the regulators aren't catching anything and just being inadequate in their job?

Mr. TITTSWORTH. I think the regulations are adequate; it is more a question of inspections and enforcement.

Mr. LUETKEMEYER. Okay. So there seems to be a consensus that the regulation is the problem. Does this bill solve the problem, yes or no?

Mr. BROWN. It is a tremendous step in the right direction.

Mr. LUETKEMEYER. Okay.

Mr. CURREY. As long as it increases and equalizes the examination process across both lines of the business, yes, it does.

Mr. LUETKEMEYER. Okay. Mr. Helck?

Mr. HELCK. A good step in the right direction, not far enough.

Mr. LUETKEMEYER. Okay. Mr. Ketchum?

Mr. KETCHUM. An environment of increased examinations directly addresses the problem.

Mr. LUETKEMEYER. Mr. Morgan?

Mr. MORGAN. Absolutely not. The States are not part of the problem.

Mr. LUETKEMEYER. Okay. Mr. Tittsworth?

Mr. TITTSWORTH. I believe I have been clear. We oppose this bill and think there is a much better approach.

Mr. LUETKEMEYER. Thank you. I know this is a comment. I know I come from Missouri and we have, our own State does an excellent job of this. And I am not sure we need another layer there, but as a former regulator myself, I understand what you are talking about. And if we have a regulatory problem, we need to solve it somehow, some way and get together and make it all work. I thank you, Mr. Chairman, for the extra time.

Mr. MCHENRY. Mr. Scott for 5 minutes.

Mr. SCOTT. Thank you, sir. It is always good to know to keep score, and I just tried to keep score just now. I want to make sure I am right about this. Is the score on this among the 6 of you, 4 to 2 in favor of the legislation, is that correct? All right. That is very good.

Let me start with you, Mr. Currey. You represent a very fine organization, the National Association of Insurance and Financial Advisors. I think it is very important for us, particularly as you represent financial advisors, to really get your take on this. Tell us what you feel are the strong points about this bill, tell us where we might be able to improve it, and the concerns that were raised by those two who are opposed to that, how might that be addressed?

Mr. CURREY. I am sorry, the last part again, sir?

Mr. SCOTT. This is a hearing. They have raised some concerns. I think you have heard the two who are opposed to this concern. Are they areas in which those can be addressed? But generally, what I want to know from you, because you represent the financial advisors, is what generally is your take on this? Are we going in the right direction, are we doing what needs to be done here to enhance what I feel is the most important thing: investor confidence? Is this solving the problem?

Mr. CURREY. We believe this would certainly go a few steps in that direction. We support the bill, of course. I guess we have just a couple of things. As I said earlier in response to Mr. Neugebauer, we didn't come looking for new regulation; we have plenty of that to go around. But there appears to be consensus or common agreement that there is a gap in regulation, particularly as it applies to the investment adviser world. And most of our folks, most of our members, are investment adviser representatives, that is, they work under a corporate RIA, which is subject already to SEC oversight and regulation.

And so for us, to consolidate our regulator that we deal with into one entity is a very good thing, and we see the chance in this bill to do that. We think the appropriate choice in that matter is FINRA because they have already have a great regulatory chassis established, and we think they would get up to speed on the IAR side and the RIA side as well. Sure, there would be two different sets of rules, but you would have one regulator coordinating those rules and making sure that they got applied equitably across both lines of business.

And the most important thing for our members is we would only have one regulator in our face at a time, and that really is important. Examinations could be consolidated. We believe there is a way to do that. These are two different lines of business, but they are not utterly dissimilar; they are alike in many ways. And we think those rules could be consolidated into a single examination.

The other thing I would say, it is in the bill, of course, that asked for field representation. In other words, adviser representation on the governing board of any new SRO or governing board that is created. And I would suggest that maybe it would be a good idea for you guys to think of, too, Mr. Ketchum. We think that field experience, current field experience, knowing how it really goes when

you are in somebody's living room or they are in your office, we think that is an important part of this.

Mr. SCOTT. Okay. Thank you very much. Now, I think Mr. Morgan and Mr. Tittsworth, you guys were two of the two who oppose the bill, is that correct? Let me ask you, because one of the concerns that was raised by those who had some concerns about it was the impact on some of the smaller operators here. So let me ask you, because if this bill is enacted, it clearly states that those investment adviser firms with under $100 million in assets would not be affected if they are not already covered by State regulations. So doesn't this sort of refute the argument that the expense is prohibitive and would be damaging to the operation of smaller investment adviser firms, as was pointed out, I think by one of you, and also by Mr. Hinojosa, who is opposed to it.

Mr. MORGAN. If I might go first, they absolutely would be affected. They would be required to join the SRO, pay the membership fee, and they would be subject to the ongoing compliance costs, whatever those are. And for the small firms that I have referred to, for example, there are many of these firms with $5 million to $10 million in assets under management, if you do the math on what they are bringing in, $50,000 to $125,000, it is a small amount of money and they have all of the costs that they have to run a business. And if you have adequate regulation in place, which we have in Texas and in the other States, it is absolutely an unnecessary layer of costs, not just initial costs, but the ongoing costs that they would have to comply with. It makes no sense.

Mr. MCHENRY. The gentleman's time has expired. Mr. Canseco is recognized for 5 minutes.

Mr. CANSECO. Thank you, Mr. Chairman. Mr. Brown, the chart in your testimony shows that a lot of the growth in industry reps over the next several years will be dual registered reps, and that is registered both as broker and also as adviser. So how would this legislation make the examination regulation of dual registered reps more effective and efficient for everybody involved?

Mr. BROWN. Thank you for the question. Similar to what Mr. Helck has said, it would create a lot more consistency. Two things: One, it would create a lot more consistency to have one regulator looking at both sides of the business. It would also, as we have said over and over here, close the regulatory gap so that those nondual registered RIAs, those independent RIAs who are subject to virtually no oversight, they would finally have someone coming in and verifying that they are complying with the rules.

Mr. CANSECO. And ultimately, how would this benefit the client of a dual-registered rep?

Mr. BROWN. Clients want to know that they can trust the person they are getting advice from. And a key component of that trust, not the only component, but a key component of that trust, is knowing that adviser is subject to some ongoing oversight. So I think it would do that.

Mr. CANSECO. It would be good. Do you expect the growth in dual-registered reps to continue to grow over the next decade?

Mr. BROWN. Yes, sir.

Mr. CANSECO. And if so, would retail investors ultimately benefit from a streamlined regulatory regime that has less gaps than it does currently?

Mr. BROWN. Absolutely.

Mr. CANSECO. So Mr. Brown, we are potentially moving towards a scenario where the rules regarding broker-dealers and investment advisers could be harmonized. So what would be the outcome of the industry and investors if the regulatory oversight bodies are not harmonized as well?

Mr. BROWN. We have an opportunity to harmonize the rules because the business is now harmonized. The typical investment financial adviser who is affiliated both with a broker-dealer and is also registered as an RIA is delivering comprehensive advice, products, and services to the average middle-class investor. This is an opportunity to help the regulation and oversight catch up with that development in the marketplace.

Mr. CANSECO. So given that the broker-dealers are already examined much more often than investment advisers, does that constitute a serious inequity between these two professionals?

Mr. BROWN. Absolutely.

Mr. CANSECO. If Congress authorized the SEC funding at the level they recently requested, which would amount to a budget increase of about $250 million, a report showed they would still only be able to examine 11 percent of investment advisers, given that we are on the verge of a budget crisis that is increased. Isn't it possible—so what is the best way to examine advisers that currently are not being examined?

Mr. BROWN. In light of the fact that it is not likely for the SEC's budget to increase, this legislation allows the resources of the industry through FINRA to be leveraged in a most cost-effective manner to close the regulatory gap.

Mr. CANSECO. Thank you, Mr. Brown. So Mr. Ketchum, if FINRA were eventually approved by the SEC as the SRO for investment advisers, would you expect the fees for firms already examined by States to be minimal?

Mr. KETCHUM. Yes, we would.

Mr. CANSECO. Did the Boston Consulting Group talk to you or any FINRA staff before creating a cost estimate for what an SRO for investment advisers would cost?

Mr. KETCHUM. No, they did not, and their cost estimates are widely inflated.

Mr. CANSECO. All right. Mr. Morgan, do you disagree that the potential costs for State-registered advisers would be minimal?

Mr. MORGAN. Yes. I don't know what the costs are. I have heard various descriptions of what they might be. But you have, even if the membership costs, again, are low, the ongoing compliance costs could be significant. And again, with respect to the advisers in Texas, and I am sure this is true in a number of other States, small advisers, any cost, any added layer that you put on is going to be harmful and unnecessary.

Mr. CANSECO. Is there a way this bill could be improved to address the concerns you have as a State regulator?

Mr. MORGAN. By excluding the States from coverage that have a program in place to cover investment advisers.

Mr. CANSECO. And would you include in that, those that have a certain quality or level of mandates or matrix?

Mr. MORGAN. I think there would have to be a study done to determine whether or not that was even appropriate. I think the starting point should be that they should be excluded.

Mr. CANSECO. Thank you very much, Mr. Morgan. I yield back.

Chairman BACHUS. Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman, for holding this hearing. I do believe that it is exceedingly important, and I thank all the witnesses for appearing. I especially thank the Texan for appearing today. We are honored to have you, sir. Thank you very much. All of the Texans. Let me just check. We may have some Texans who don't acknowledge it on paper. Do we have any other Texans? How many Texans? Raise your hand if you are a Texan. All the Texans in the house. Thank you. I really opened the door to something, Mr. Chairman.

Permit me to do this, because I think that sometimes what appears to be a disagreement is an agreement that we just can't quite agree on. It is a rather nebulous way of speaking, I know. But I think that we have three possible solutions that have been recommended to us, if I may just capsulize them: one, to use the SEC; two, to work with SROs, one or more; and three, to do more with FINRA. We have these three possibilities. But I am curious, do we all agree that as I speak right now, some person is, in a dastardly way, trying to defraud someone, and that that person ought to be caught? My suspicion is that as I am speaking, someone is trying to perpetrate a dastardly deed.

Now, if you differ with me, kindly raise your hand. Okay. The absence of hands up, Madam Reporter, would seem to indicate that people agree with me. It is nice to have so many people agree with me. It is a rare thing. But now if we know that we have these persons who are trying to perpetrate these dastardly deeds, I assume that we all agree that we should be able to prosecute, we should be able to capture and prosecute them. And if you don't agree, or if you think there is another way to do this without catching them, and maybe there is a way to prevent them from doing things, and I would like to see this done, but I think we all agree that somebody is going to slip through the nets probably notwithstanding regulation.

We do all that we can to prevent things, but we still have cops on the beat so that we can capture those that will, not withstanding the best of intentions, slip through the nets. So does everybody agree that somebody is going to slip through the nets?

Okay. Now, but we do agree, I think also, that there ought to be some way by which we can prevent, but also capture, prevent and capture people who do these things. So if this is the case, then the question really becomes, what is the best methodology for doing what we know has to be done?

So, I have given you three possibilities. What I would like to do is start with Mr. Brown. And Mr. Brown, rather than go through a long dissertation, if you don't mind, just tell me, do you think that we should use the SEC methodology, the FINRA, or should we go with an SRO? Where are you on it, or some combination?

Mr. BROWN. We think that an SRO should be designated to take on this responsibility, and we think FINRA is in the best position to take on that role.

Mr. GREEN. So you are SRO and FINRA?

Mr. BROWN. Yes, sir.

Mr. GREEN. Okay. That is good to know. All right. Let's go to the next gentleman, please.

Mr. CURREY. Thank you, Mr. Green. Even if the examination frequency could be stepped up with the SEC, I would say that our members would experience that as two regulators, and that is what we don't want. We want to deal with one regulator. So we support an SRO and FINRA as an SRO.

Mr. GREEN. So the two of you are in the same place?

Mr. CURREY. Yes.

Mr. GREEN. Okay. SRO and FINRA. Thank you very much. The next person, please?

Mr. HELCK. Yes. SIFMA believes that we should have consistent oversight and supervision, that an SRO is best prepared to do that, and this bill goes only part of the distance in determining exactly who that should be, I think that should be part of the ongoing process, to evaluate and discuss with FINRA and other alternatives there capabilities and make that decision when we are prepared to do that, but not the SEC, an SRO.

Mr. GREEN. So you are SRO?

Mr. HELCK. Yes.

Mr. GREEN. Okay. Yes, sir?

Mr. KETCHUM. H.R. 4624 has it right. There should be provision for one or more SROs, whether or not that SRO is FINRA.

Mr. GREEN. SRO. Yes, sir?

Mr. MORGAN. First, it is a Federal question; the States are doing their job. And with respect to the Federal question, we think that user fees are appropriate and that the SEC is the appropriate agency to handle that.

Mr. GREEN. SEC?

Mr. MORGAN. Yes.

Mr. GREEN. Okay.

Mr. TITTSWORTH. The SEC would be the most effective and most efficient way to deal with this issue.

Mr. GREEN. All right. As you can see, my time has expired. I do appreciate, Mr. Chairman, your giving me the opportunity to ask these questions. And the 4 seconds I have gone over, I will give to you at another time. Thank you.

Chairman BACHUS. Thank you. You actually were more diligent with your time than anyone else on the committee.

Mr. GREEN. Thank you, Mr. Chairman.

Chairman BACHUS. Mr. McHenry? And thank you for chairing the hearing.

Mr. MCHENRY. Thank you, Mr. Chairman. Mr. Tittsworth, you say in your testimony, because of the exemptions within this bill for large advisers, small advisers are singled out for additional regulations and costs, okay. So I want to understand this. Small advisers, do they have—are their clients of more modest income than large advisers?

Mr. TITTSWORTH. Sometimes, yes, sir.

Mr. MCHENRY. Is that often or sometimes?

Mr. TITTSWORTH. Sometimes. Advisers come in all shapes and sizes, Congressman.

Mr. MCHENRY. But we are talking about the large advisers versus the small advisers.

Mr. TITTSWORTH. Understood. And actually, characterizations of the differences between larger and smaller advisers is a generality as well. As you may know, in H.R. 4624, the exemptions are structured so you would be exempt from the SRO requirements if you have any mutual fund clients or if you meet the 90 percent test, which gets more complicated.

As a general matter, the larger investment advisers would tend to be exempt from the SRO requirements, and as a general matter, smaller firms would be covered.

Mr. MCHENRY. Right. I recognize that in my asking you the question. So you just confirmed to me what I knew going in. I will just move on, because the point I am trying to make is that if you have folks of more modest income, would this legislation inhibit or restrict their ability to get the services that they currently have?

Mr. TITTSWORTH. I understand the question, I believe. I think that, as I testified, this bill could create opportunities for regulatory arbitrage. And one possibility is that an investment adviser, a larger investment adviser, might shed smaller, less profitable clients in order to meet the 90 percent test for SRO exemption in the bill.

Mr. MCHENRY. So in your view, those folks of modest incomes with modest investments could be adversely affected, or in your view, would be adversely affected?

Mr. TITTSWORTH. It is possible, yes, sir.

Mr. MCHENRY. It is possible. Okay. And to that point, Mr. Helck, there is the distinction between broker-dealers and investment advisers. They have two different regulatory structures currently. Do most investors even know the distinction between a broker-dealer and investment adviser?

Mr. HELCK. The SEC's RAND study done a couple of years ago confirmed the fact that the public really doesn't understand this, and I would offer, can't be expected nor should they have to understand this to receive the same and consistent protections.

Mr. MCHENRY. Okay. So as a follow-up to that, because the public doesn't really know the difference between a broker-dealer and an investment adviser, do they understand the distinction between their regulatory structures?

Mr. HELCK. Not at all.

Mr. MCHENRY. Not at all. So to Mr. Tittsworth's point about regulatory arbitrage, is that real, is that serious?

Mr. HELCK. I would argue that we have regulatory arbitrage today. That is part of the problem we are trying to address here. To have consistent policy and oversight across all providers of individual services would clarify for the public and remove the need to understand the differences between various structures and provide consistent protection.

Mr. MCHENRY. Okay. So in your view, broker-dealers have greater oversight today than investment advisers?

Mr. HELCK. In today's world, firms like ours and Mr. Currey's and most other providers are governed by all of the above. We are a registered investment adviser, we are a broker-dealer, we have all 50 States, and we have the SEC and FINRA, and so therefore, we are dealing with all of the above. It is those who are escaping portions of that where the inconsistencies lie, and that is where we need to make the level playing field.

Mr. MCHENRY. Mr. Ketchum, Mr. Tittsworth, in his testimony, contends that if an investment adviser SRO were mandated, the resulting new oversight responsibilities would require the SEC to expend significant additional resources. Do you agree with that?

Mr. KETCHUM. I don't agree with "significant." Yes, the SEC would have additional oversight responsibilities. They already have them over us as an organization, our exam program. They would have to add to it. I think that would be a small fraction of the cost of them doing the program themselves.

Mr. MCHENRY. All right. Mr. Tittsworth, do you want to respond?

Mr. TITTSWORTH. I think that people don't appreciate right now how much the SEC spends on broker-dealer oversight in addition to FINRA. I believe the Section 914 report—and I would be happy to check on it—states that the SEC has 380 examiners on the broker-dealer side plus an additional 40 or 50 to oversee FINRA and other SROs. And the Boston Consulting Group and others, including the GAO last week, have said that the SEC doesn't do an adequate job of overseeing FINRA now.

Mr. MCHENRY. Thank you, Mr. Chairman. And thank you for holding this hearing on this important piece of legislation.

Chairman BACHUS. I appreciate that, Mr. McHenry. I want to commend you on your oversight work on this committee and also on government oversight. You have done some important, meaningful work. With that, we have a unanimous consent request to introduce the statement of the Investment Company Institute in support of this legislation.

I appreciate the Members. I think this was an interesting discussion and will serve us in good stead as we move forward in trying to come up with a solution that is beneficial to the American investing public, and also those who serve them as investment advisers and broker-dealers. So, thank you.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

This hearing is now adjourned.

[Whereupon, at 12:26 p.m., the hearing was adjourned.]

A P P E N D I X

June 6, 2012

Testimony of
Dale E. Brown, President & CEO
Financial Services Institute

Before the Committee on Financial Services

United States House of Representatives

On

H.R. 4624, the Investment Adviser Oversight Act of 2012

June 6, 2012

Introduction

Good morning, Mr. Chairman, Ranking Member Frank, and members of the Committee. I am Dale Brown, President & CEO of the Financial Services Institute (FSI), and I am pleased to be here today to express our support for H.R. 4624, the Investment Adviser Oversight Act of 2012.

As you know, H.R. 4624 would authorize the Securities and Exchange Commission (SEC) to approve one or more National Investment Adviser Associations (NIAAs) to register member firms and associated persons, to set regulatory standards for their activities and operations, and to monitor compliance with these standards through routine and for cause examinations. The creation of this new regulatory structure is designed to close an unacceptable regulatory gap that leaves investors exposed to potential fraud and abuse at the hands of unscrupulous investment advisers.

FSI applauds this legislation as an essential step in creating and enhancing the trust essential for financial stability, and in making sure that all American investors receive equal protections, regardless of whether they do business with a broker-dealer or an investment adviser. FSI has supported the creation of such an organization for some time, and we applaud you, Chairman Bachus, and Representative McCarthy for your work in drafting this bipartisan approach to this important investor protection issue.

Improving the regulatory oversight of investment advisers is very important to the members of FSI. The independent broker-dealer (IBD) community we represent 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, most importantly for today's discussion, 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.[1]

[1] The term "financial advisor" is used throughout this testimony to refer to individuals who provide financial advice, products and services as either a registered representative of a broker-dealer, or as an investment adviser representative of an investment adviser firm, or both.

In the U.S., more than 201,000 independent financial advisors – or approximately 64% percent of all practicing registered representatives – operate in the IBD channel.[2] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. 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 of financial advisors affiliated with IBDs is comprised of 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.[3] 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

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

incentive to put the interests of their clients first and 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 financial advisors play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to ensure 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. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Confidence in Our Financial Markets is Essential to Our Nation

Nearly all financial advisors realize that their livelihoods depend on earning the trust of their clients and sustaining their reputations in their community. As a result, they obtain information on each client's investment objectives, risk tolerance, financial situation, and other needs. They educate their clients on the various product and service options available to them through in-person meetings, disclosure documents, and other communications. Once the client is familiar with the options available, the

financial advisor makes suitable recommendations based upon the information provided by the client and facilitates the implementation of the client's informed decision-making.

After the initial investment, the financial advisor insures that their client understands the account statements and other information related to their investments. The financial advisor also keeps abreast of market developments, reviews the client's portfolio periodically, and recommends changes as appropriate. The financial advisor, along with the broker-dealer or investment adviser with which he is affiliated, designs a system of supervision to insure compliance with state and federal statutory and regulatory requirements. In other words, these financial advisors dedicate themselves to act in the best interests of their clients. It is simply how they operate as financial advisors.

Unfortunately, a small number of financial advisors take advantage of their clients' trust by directing clients to high-priced options intended to generate more compensation for the financial advisor or, worse still, simply converting client funds to their own use. When one unscrupulous financial advisor abuses an investor's confidence in this fashion, the reputation of all financial advisors is sullied. When one investor is harmed, the trust and confidence in our markets and financial advisors is shaken in all investors. Thus, recent market events, including the emergence of several high profile

Ponzi schemes, indicate that a careful reexamination of our current financial services regulatory framework is needed.

We know that both policymakers and our members share a common goal: to secure the American public's financial future. We believe this can best be accomplished by improving the public's confidence in our financial markets and the financial professionals who work in those markets. Investor confidence will improve our nation's savings rate, fuel economic growth and provide stability and independence to American families and individuals.

Trust is the foundation of the business relationship between investors and financial professionals, and success for all parties depends on investors' ability to rely on those professionals' competence and integrity. Studies have shown that investors save significantly more when they seek professional advice.[4] In addition, those who receive professional advice avoid many common investor pitfalls (e.g., buying high and selling low based upon emotional reactions to the market). Therefore, it is in the best interest of both individual investors and the economy as a whole if our system of regulatory supervision protects and encourages those who seek out this professional advice. We support H.R. 4624 because it will create a structure that enhances trust and confidence in the supervisory system.

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[4] For example, an analysis by Aon Hewitt and Financial Engines of eight large defined contribution plans between 2006 and 2010 demonstrated that workers who received some form of professional advice experienced higher returns averaging 2.92 percentage points, net of fees, than those who managed their retirement assets on their own.

The Need for an Effective Supervisory System

In your letter of invitation, Mr. Chairman, you asked specifically whether the current oversight and inspection of registered advisers is sufficient. FSI believes that it is most emphatically not. On January 21, 2011, the SEC published a Study on Enhancing Investment Adviser Examinations (Study). The Study was required under Title IX, Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which President Obama signed into law on July 21, 2010. Section 914 of Dodd-Frank required the SEC to review and analyze the need for enhanced examinations and enforcement resources for investment advisers. Congress mandated the Study because it recognized that investment advisers and broker-dealers are subject to very different levels of regulatory supervision. The Study confirmed Congress' concerns by concluding "the [SEC] likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency."[5]

Since the release of the Study, the situation has deteriorated further. Broker-dealers continue to face routine examinations on a regular and consistent basis; in 2011, FINRA examined 58% of the broker-dealer firms it

[5] See STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS, U.S. SECURITIES AND EXCHANGE COMMISSION (January 19, 2011) at pages 38-39.

is responsible for regulating. Unfortunately, investment adviser firms are not subject to routine examination. The SEC recently testified before Congress that it had examined only eight percent of registered investment advisers in 2011 – an average exam cycle of once every 13 years. Even more troubling, the SEC told Congress that nearly 40 percent of advisers registered with the SEC have never been examined – not once.[6]

The risks inherent in the current regulatory system have become only too clear in recent years. Bernard Madoff was able to operate his Ponzi scheme through an unsupervised investment adviser. In addition, many "mini-Madoffs" have been flushed out by the recent recession.[7] Frauds such as Madoff's do immeasurable damage to confidence in our capital markets, with a ripple effect that goes far beyond the individual investors impacted. A retail investor may look at the Madoff case and believe him or herself better off without professional advice or decide that the financial markets are rigged for the benefit of a few. These individuals will not only expose themselves to greater risk of failing to achieve their financial goals, but will also hurt our national economy by keeping their assets on the sidelines.

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[6] See testimony of Caro di Florio, SEC Director of the Office of Compliance Inspections and Examinations, before the U.S. Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance, and Investment (November 16, 2011) at http://sec.gov/news/testimony/2011/ts111611rk.htm.

[7] See the following recent examples: SEC CHARGES PHOENIX-BASED INVESTMENT ADVISER FIRM WITH FRAUD, SEC RELEASE 2012-105 (May 30, 2012), at http://www.sec.gov/news/press/2012/2012-105.htm and EX-NAPFA HEAD HIT WITH FRAUD RAP, INVESTMENTNEWS.COM, May 20, 2012, available at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20120520/REG/305209973.

It is almost impossible to weigh the costs of trust betrayed or destroyed by a few rogue investment advisers. FSI's members cannot set a dollar value on the loss of business and opportunity caused by the Madoff fraud, but we have spent untold resources on efforts to rebuild that trust and restore confidence in investment advisers. We are our customers' allies and partners in the most serious decisions and goals of their lives: how and when to buy a home, where to send their children to college, whether they'll be able to retire. Effective supervision gives us the backing we need to justify our clients' confidence in us.

The investing public deserves better protection than our current regulatory system provides. They deserve more robust oversight and supervision of the professionals to whom they have entrusted their hard-earned money. The creation of an independent regulator under SEC oversight will help close this unacceptable regulatory gap, by assuring regular examinations for a sector of the industry that currently has almost no meaningful oversight.

We will explore the benefits provided by H.R. 4624 to investors and the industry in the sections that follow below.

Benefits to Investors from The Investment Adviser Oversight Act

The passage of H.R. 4624 and the authorization of a NIAA under the

auspices of the SEC will provide several immediate benefits to the investing public. First, it will greatly enhance investor protection by replacing the current patchwork of regulation with a set of uniform examination and enforcement standards, so that all financial advisors, regardless of registration status, will be subject to routine regulatory examinations. Our nation's overlapping and sometimes conflicting financial regulatory infrastructure allows unscrupulous individuals to look for opportunities to avoid supervision, or to exploit gaps in regulation. Regulatory gaps and inconsistencies create temptations for honest people to make bad decisions. They provide safe havens in which unscrupulous individuals can do great harm to the unsuspecting. Regulatory reforms are needed to close these safe havens for those who would commit fraud. H.R. 4624 will do so by insuring regular and routine examinations of all financial advisors.

Second, H.R. 4624 will enhance investor confidence in our financial markets. The average investor should not need to be an expert in the arcane details of securities industry registration in order to have confidence that their financial advisor is subject to effective regulatory oversight. Customers have the right to expect a uniform standard of oversight; indeed, they do expect regular and routine regulatory oversight. Unfortunately, the current structure is unable to deliver these expected protections. H.R. 4624 will solve this problem. This is why we believe the Consumer Federation of

America has endorsed the concept of an independent self-regulatory organization for retail investment advisers.[8]

Third, the layered regulatory framework resulting from the adoption of H.R. 4624 will allow the SEC to review the quality of the supervisory work performed by the NIAA, resulting in a more effective system of supervision than otherwise available. Under the supervision of the SEC, the NIAA would focus on the routine examination and supervision of retail investment advisers. The SEC would thus be free to focus on capital markets concerns, the development of appropriate regulations for all regulated entities, the supervision of the new NIAA, and the fulfillment of other appropriate regulatory goals. By working together, the NIAA and SEC can consistently improve the quality of investment adviser supervision and investor protection.

Finally, passage of H.R. 4624 and the authorization of an NIAA will impose the cost associated with the new regulator on the regulated, not the taxpayer. The bill does so by specifying that the NIAA must be funded

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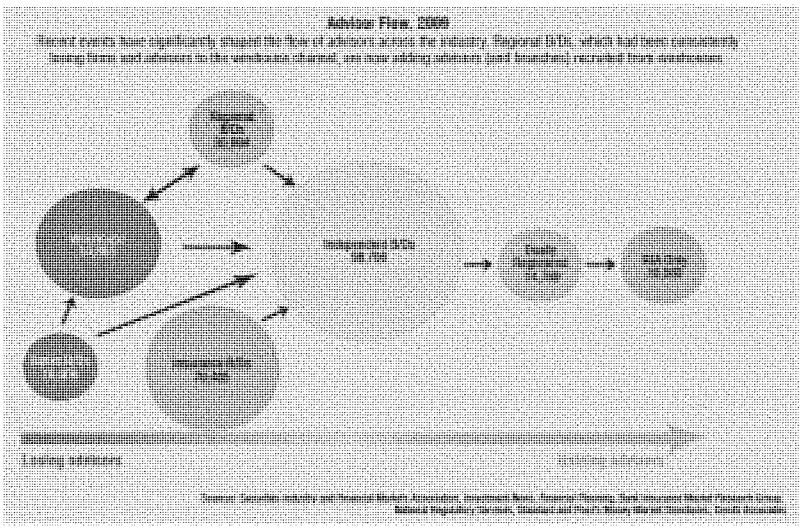
[8] See testimony of Barbara Roper, Director of Investor Protection at the Consumer Federation of America, before the Capital Markets and Government Sponsored Entities Subcommittee of the U.S. House Financial Services Committee (September 13, 2011) at http://financialservices.house.gov/UploadedFiles/091311roper.pdf. "In the past, CFA has categorically opposed delegating investment adviser oversight to an SRO, particularly one dominated by broker-dealer interests and particularly if that SRO were given rule-making authority. However, having spent the better part of two decades arguing for various approaches to increase SEC resources for investment adviser oversight with nothing to show for our efforts, we have been forced to reassess our opposition to the SRO approach. Specifically, we have concluded that a properly structured SRO proposal would be a significant improvement over the status quo."

through an equitable allocation of fees and charges among its members and users. This system mirrors that used by FINRA to fund its supervision of broker-dealer firms. The result is that RIAs will pay for their own supervision through a well-established and equitable system rather than placing the financial burden on the American taxpayer.

Benefits to the Industry from the Investment Adviser Oversight Act of 2012

The passage of H.R. 4624 and the authorization of a NIAA under the auspices of the SEC will also provide several immediate benefits to the financial services industry. First, the bill will provide a balanced playing field for all financial advisors. In recent years, financial advisors have been fleeing broker-dealer and FINRA supervision to become registered investment advisers. The chart below graphically depicts this growing phenomenon:[9]

[9] See at http://retirementincomejournal.com/upload/567/advisor-flow-2009.jpg.



While there are many reasons for the movement of financial advisors from wirehouse, regional, insurance, bank, and independent broker-dealers to investment advisers, avoidance of regulatory oversight is clearly one significant factor.[10] Under the current regulatory system, financial advisors who wish to operate their business free from vigorous regulatory scrutiny have a viable option – investment adviser registration.

The flight of financial advisors from the heavily regulated broker-dealer channel to the under-regulated investment adviser channel is projected to

[10] For example, Mike Byrnes and Brooke Southall ADVISOR SPOTLIGHT: HOW A BIG-TIME IBD REP ENDED UP AS A SCHWAB RIA, RIABIZ.COM, October 25, 2010, *available at* http://www.riabiz.com/a/2885078.

continue in the near future. The chart below represents projections provided to FSI by Cerulli Associates:

Projected Advisor Headcount Market Share by Channel, 2009-2014

Channel	2009	2010	2011	2012	2013	2014	2009-2014 Market Share Change
Bank	4.8%	4.6%	4.5%	4.3%	4.2%	4.0%	-0.7%
Wirehouse	15.0%	15.2%	15.0%	14.8%	14.4%	14.1%	-1.0%
Regional	11.5%	11.2%	10.9%	10.7%	10.4%	10.1%	-1.4%
Insurance broker/dealer	29.0%	28.1%	27.2%	26.3%	25.4%	24.5%	-4.5%
IBD	29.6%	29.6%	29.6%	29.6%	29.6%	29.5%	-0.1%
Dually registered	4.2%	4.8%	5.4%	6.1%	6.9%	7.7%	3.5%
RIA	5.9%	6.6%	7.3%	8.2%	9.1%	10.1%	4.2%

The flow of financial advisors from to the investment adviser channel has significant consequences for investors. Chief among these is the lack of routine regulatory examinations of the entities responsible for managing the investors' portfolios. In addition, it limits investor access to investment advice by reducing the availability of low cost commission compensation options. It also has an impact on the small businesses operated by FSI members who bear the cost of close regulatory supervision while their competitors are free to operate free from that burden. This is inherently unfair since retail financial advisors operating in the broker-dealer and investment adviser business channels offer very similar services to investors.

Secondly, H.R. 4624 will benefit the industry by streamlining the examination process for dual registrant firms – those operating as both broker-dealers and investment advisers. Dual registration is prevalent in the industry. There are approximately 2,500 firms that are dually registered as broker-dealers and investment advisers or are broker-dealers with one or more affiliated investment advisers. In addition, the vast majority of investment adviser representatives also offer brokerage services. In fact, approximately 88 percent of all investment advisory representatives are also registered representatives of a broker-dealer.

Currently these firms and individuals are subject to frequent broker-dealer examinations by the SEC, FINRA and state securities divisions and occasional investment adviser exams by the SEC and the states. If FINRA were to serve in the role of NIAA, as FSI believes is appropriate, the result would be a consolidated exam program for dual registrant firms. Such a system would limit business disruptions caused by regulatory exams thereby reducing the related costs that are passed onto investors, allowing for the hiring of additional staff and the development of innovative methods of delivering financial products, services and advice. Investor protection would also be greatly enhanced by subjecting firms to more frequent and meaningful regulatory examinations that are not constrained by jurisdictional boundaries that have outlasted their usefulness.

Finally, H.R. 4624 will benefit the industry by removing a significant source of uncertainty. The adoption of the legislation would provide firms with clarity as to how this universally recognized investor protection problem will be resolved. Firms cannot control costs if they do not know what will be expected of them in the future. Passage of H.R. 4624 provides the certainty and clarity desired by the industry.

Answering the Critics

Despite these tremendous benefits to investors and the financial services industry, some have criticized H.R. 4624. We respond to the most common arguments against the adoption of H.R. 4624 below:

- Funding SEC Oversight is the Better Option – The SEC's Section 914 Study suggested that one option for solving the regulatory gap would be to assess an appropriate "user fee" on investment advisers to be used solely to fund additional exams of investment advisers. Others have suggested increasing the SEC's budget to allow for the hiring of additional examination staff. We disagree with each of these approaches.

  In its own study under the requirements of Dodd-Frank, the SEC concluded that it lacks the necessary resources to oversee the nation's 12,600 federally registered investment advisers. SEC Commissioner

Elisse B. Walter has indicated that the Commission would need to hire more than 2,000 examiners to its advisory program to increase RIA exam frequency to the level achieved by FINRA in its oversight of broker-dealer firms.[11] Staffing up to take on this responsibility would require that Congress either authorize additional funds for this purpose or impose taxes in the form of user fees on investment adviser firms, an effort that, frankly, seems impossible in the current legislative and fiscal environment. Even if these funds were authorized by Congress or obtained via user fees, it would be almost impossible to ensure that they were spent solely on the supervision of retail investment advisers. The SEC has a broader mandate, and allocates resources toward its most urgent priorities. Supervision of retail investment advisers has not proven to be an urgent priority for the SEC to date, nor is it likely to remain a priority once Congress turns its attention to other issues. As a result, we believe funding the SEC is not a viable option for improving investor protection.

- Establishing FINRA as the Regulator of Dual Registrants is a Better Option - The SEC's Section 914 Study suggested that another viable option for solving the regulatory gap would be to authorize FINRA to

[11] See SEC Commissioner Elisse B. Walter's STATEMENT ON STUDY ENHANCING INVESTMENT ADVISER EXAMINATIONS (REQUIRED BY SECTION 914 OF TITLE IX OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT) (January 21, 2011) at http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.

examine dual registrants for compliance with the Investment Advisers Act. We also disagree with this recommendation.

Authorizing FINRA to supervise only the investment adviser activities of dual registrant firms will drive up the regulatory burden and costs on these firms and financial advisors while providing further incentive to firms and financial advisors who are seeking less regulatory supervision to escape to the under-supervised investment adviser world. H.R. 4624 avoids this problem by requiring all financial advisors to be subject to regular and routine regulatory examinations from an independent regulatory organization.

- Expense of an NIAA Unnecessarily Burdens Small Business Owners – Some critics argue that the NIAA model imposes a costly additional layer of regulation and bureaucracy on RIAs without providing a commensurate benefit to investor protection. We disagree.

  FSI has endorsed FINRA as the best organization to establish and administer a NIAA for retail investment advisers. As the nation's largest independent regulator of securities firms, FINRA already has a long and productive working relationship with the SEC and an infrastructure in place that can be rapidly adapted to the supervision and examination of retail investment advisers.

Figures recently released by FINRA show that it would incur one-time startup costs of $12 million to $15 million to create a self-regulatory structure for retail investment advisers, with ongoing annual examination costs of between $150 million and $155 million.

These figures are considerably below those estimated in a study conducted by the Boston Consulting Group (BCG), which predicted startup costs of as much as $255 million, with annual costs of up to $510 million. FINRA has extensive experience and firsthand knowledge of the costs of running an independent regulatory organization. BCG does not and failed to leverage FINRA's knowledge in compiling their own cost projections. As a result, we consider FINRA's estimates far more reliable than those of BCG.

Finally, the question of cost, while important, is by no means the only or even the most important criterion for choosing the appropriate regulatory organization for the retail investment industry. The most important priority must be effectiveness in providing supervision and consumer protection, and FINRA has a proven track record as an effective supervisor of financial service firms. FSI believes that FINRA is the strongest and most cost efficient organization available to serve as a unified supervisor for both segments of the financial services industry (i.e., broker-dealers and registered investment advisers). We

conclude that the anticipated costs are reasonable and that the benefits to investors, and the industry, will prove substantial.

- FINRA is an Inappropriate Choice for NIAA – Critics of H.R. 4624 argue that FINRA, the most likely NIAA option, would prove to be an inappropriate choice due to its alleged conflicts of interest, lack of accountability, lack of transparency and enforcement track record. We disagree.

As stated above, FSI has gone beyond merely supporting H.R. 4624 option to specifically endorse FINRA to serve in the role of NIAA. While H.R. 4624 would not immediately designate FINRA as an NIAA, FSI believes FINRA is particularly well suited for the role of retail investment adviser regulator because it has:

- An existing comprehensive examination program with dedicated resources of more than 1,000 employees.
- Experience operating an independent regulator whose structure is designed to ensure its governing body, committees, and staff act independently in the public interest.
- Experience with a private funding model capable of equitability allocating the cost of the examination, enforcement, surveillance, and technology resources needed to do the job among regulated entities at no cost to the taxpayer.

- Knowledge of the overlapping nature of the financial products and services offered by broker-dealers and investment advisers.
- Experience in performing regulatory examinations of a wide variety of financial service providers, including thousands of dual registered entities.
- Demonstrated the ability to handle a complex expansion of their regulatory responsibilities through the recent NASD/NYSE merger.
- Successfully developed and operated the Investment Adviser Registration Depository (IARD), a key resource for any investment adviser regulator.

In addition, H.R. 4624 specifically addresses the critics concerns about FINRA by insuring effective SEC oversight of the NIAA. The bill permits the SEC to suspend or revoke the NIAA's registration, or censure or impose limits on the NIAA's activities and operations, if the SEC finds that the NIAA has violated the Investment Advisers Act, SEC rules or its own rules. The SEC would also be able to suspend or revoke an NIAA's registration if the association has failed to enforce compliance with any provision by an NIAA member firm or associated person.

The bill also requires the SEC to determine whether the NIAA has the capacity to carry out the purposes of the Investment Advisers

Act and to enforce compliance by its members and their employees with the Investment Advisers Act, the SEC's rules, and the NIAA's rules before the association can register as an NIAA.

In addition, the bill ensures effective oversight by requiring the SEC to determine that the NIAA's rules:

- are designed to prevent fraud and protect investors;
- are consistent with the Advisers Act and fiduciary duties under the Act and state law;
- do not impose any burden on advisers that is not in the public interest or for investor protection;
- provide for periodic examinations of members and their related persons, and for coordination of those examinations with the SEC and state securities authorities;
- assure a fair representation of the public interest and the investment adviser industry in its selection of directors and administration of its affairs, and provide that a majority of its directors do not come from the securities industry; and
- provide for equitable allocation of dues and fees and establish appropriate disciplinary procedures for members and their associated persons that violate the Advisers Act, SEC rules or NIAA rules.

As a result, we conclude that the Investment Adviser Oversight Act has sufficient protections to address the concerns critics have raised with FINRA.

- States Have the Resources to Examine Smaller Investment Advisers – Some critics argue that state registered investment advisers should not be obligated to register with the NIAA because state securities regulators have sufficient resources to examine these advisers on an acceptable schedule. We disagree.

H.R. 4624 recognizes the authority given to the states over small investment advisers in Title IV of the Dodd-Frank Act by preserving the states' sole authority over investment advisers with fewer than $100 million in assets under management, so long as the state conducts periodic on-site examinations on at least a 4 year cycle.

This is important because the inspection, examination, and enforcement capabilities of state securities regulators vary significantly from state-to-state. Approximately 8 state securities regulators do not currently conduct routine examinations of the brokers-dealers or investment advisers under their jurisdiction.[12] The remaining 42 states that do conduct routine examinations have significant resource

[12] Elizabeth MacBride, *It's looking official: Advisors switching to state oversight to face many more audits*, RIABIZ.COM, September 28, 2010, *available at* http://www.riabiz.com/a/2323150.

constraints that prevent them from completing robust and comprehensive examinations.

Some examples of the challenges at the state level may prove helpful. The State of New York does not routinely examine broker-dealers or investment advisers registered in the State. The Investor Protection Bureau of the State of New York is charged with enforcing the Martin Act, which is the New York State blue-sky law. Article 23-A,[13] sections 352 and 353 of the Martin Act give the Attorney General broad law-enforcement powers to conduct public and private investigations of suspected fraud in the offer, sale, or purchase of securities. Where appropriate, the Attorney General may commence civil and/or criminal prosecutions under the Martin Act to protect investors. The Bureau also protects the public from fraud by requiring broker-dealers and investment advisers to register with the Attorney General's Office. However, the Bureau does not have the authority to conduct routine examinations of the broker-dealers or investment advisers registered in the State.

The lack of a routine examination program in New York has had consequences for investors. Bernard Madoff operated his massive Ponzi scheme from his firm's office on Third Avenue in New York

[13] N.Y. Gen. Bus. § 23-A (McKinney 2009), *available at* http://law.justia.com/newyork/codes/general-business/idx_gbs0a23-a.html.

City.[14] In addition, Cohmad Securities Corporation brought investors into the Ponzi scheme from offices located within the Madoff firm.[15] There is no indication that the New York Investor Protection Bureau ever conducted an examination of the offices or activities of Bernard L Madoff Investment Securities or Cohmad Securities Corp. As a result, valuable opportunities to uncover the ongoing frauds were lost.[16]

In contrast to the State of New York, the Texas State Securities Board does conduct examinations of broker-dealers and investment advisers. According to the Texas State Securities Board Strategic Plan for Fiscal Years 2009 – 2013,[17] Texas has 19 full time employees who conduct examinations for the Agency.[18] As of August 31, 2009, Texas

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[14] *See* BrokerCheck report of Bernard L. Madoff Investment Securities LLC at http://brokercheck.finra.org/.

[15] *See* page 5 of the REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES (September 2009) at http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf.

[16] The SEC and FINRA also failed to uncover the Madoff Ponzi scheme and Cohmad's involvement in it despite examining each firm's activities. However, each of these regulators engaged in a thorough public review of the failures of their exam programs and has made specific commitments to improve them based upon the lessons learned. The New York Investor Protection Bureau has not.

[17] TEXAS SECURITIES BOARD, AGENCY STRATEGIC PLAN FOR THE FISCAL YEARS 2009 – 2013 PERIOD, (2008), *available at* http://www.ssb.state.tx.us/About_Us/StratPlan2008.pdf.

[18] *Id.* It should be noted that in 2007, the Texas State Securities Board experienced an employee turnover rate of approximately 20%. The Texas Securities Commissioner has indicated that they plan to add 10 additional staff positions in the near future to accommodate the investment advisers that will now fall under state jurisdiction because of the Dodd-Frank Act. In addition, it should be noted that the headquarters of Stanford Financial Group was located in Houston, TX. On February 17, 2009, the SEC put the company under management of a receiver alleging it operated a massive Ponzi scheme. There has been no public indication that Stanford Financial Group was ever the subject to a Texas State Securities Board examination. The SEC and FINRA also failed to uncover Stanford's Ponzi scheme despite examining the firm's activities. However, each of these

had approximately 2,700 registered broker-dealers (both FINRA and non-FINRA member firms), 1,200 state registered investment advisers, and 3,500 SEC-registered Notice filers subject to their jurisdiction.[19] As previously mentioned, the number of RIAs regulated by the states, including Texas, has risen given as investment advisers who manage $100 million or less are now subject to state regulation.[20] Texas appears to be a well-funded state,[21] however, they cannot match the frequency of broker-dealer examinations conducted by FINRA. In fact, Texas states that their current examination program amounts to trying "to get to every adviser once every five years."[22] It remains to be seen what impact the jurisdictional change will have on Texas' examination program.

Based on the lack of routine examination programs in every state and the budget problems being experienced by most state

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regulators engaged in a thorough public review of the failures of their exam programs. The Texas State Securities Board has not.

[19] *Id.*

[20] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

[21] Texas State Securities Board was appropriated funding of $5,712,676 for Fiscal Year 2008 and again for Fiscal Year 2009. *See* TEXAS SECURITIES BOARD, *supra* note 124, at 7.

[22] Kara Scannell, *States will be Hedge-Fund Police*, Wall St. J., August 19, 2010, *available at* http://online.wsj.com/article/SB10001424052748704557704575437663904234590.html?KEYWORDS=denise+crawford+TX. It is important to note that Section 410 of the Dodd-Frank Act will further stress state securities regulators by shifting oversight responsibility for some 4,000 registered investment advisers to the states.

governments,[23] we believe that the states are not universally prepared to take on the inspection, examination, and enforcement role assigned to them under the Dodd-Frank Act.[24] Ultimately, investor protection will be diminished if state regulators are unable to increase substantially the quality and frequency of RIA examinations.

Fortunately, H.R. 4624 offers a solution by giving the NIAA authority to conduct periodic examinations of investment advisers except in states in which the investment adviser is regulated and maintains its principal office and place of business and the state has adopted a plan to conduct on-site examinations of all such investment advisers on average at least once every 4 years. In this way, H.R. 4624 insures a reasonable exam cycle by providing resources to those states that are unable to achieve the goal on their own. Because we believe routine examinations will enhance investor confidence in our capital markets, we believe H.R. 4624 adopts an appropriate balance between respect for the states' jurisdiction over smaller investment advisers and the very real investor protection needs.

Conclusion

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[23] *See* NATL. CONF. ST. LEGISLATORS, *supra* note 119; *see also* SUNSHINE REVIEW, *supra* note 119.
[24] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

Nearly 4 years since Bernie Madoff's investment adviser fraud was exposed, the safe harbor in which he operated remains open to others to exploit. Passage of the Investment Adviser Oversight Act of 2012 would bring this unconscionable situation to an end. Congress has shown, in adopting the Dodd-Frank Act and introducing H.R. 4624 that it understands the importance of maintaining and enhancing individual investors' confidence in our financial system and in the investment advice they receive. The coordinated system of enhanced supervisory oversight provided by the regulatory system proposed by the bill will offer investors an additional measure of confidence, and will ensure that all Americans have access to competent, affordable financial advice, products and services with the highest level of consumer protection.

Main Street investors deserve an efficient, effective and unified system of oversight, whether they are working with investment advisers or broker-dealers – a smarter system that ensures true consumer protection. H.R. 4624 will help to create such a system. We commend you, Chairman Bachus, and you, Representative McCarthy, for taking this important bipartisan step toward better regulation and supervision, and we urge you to pass this bill as quickly as possible.

I would be happy to answer any questions the Committee may have.

Statement of Thomas D. Currey, CLU, ChFC

on behalf of

NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

prepared for the House Financial Services Committee hearing entitled

"H.R. 4624, the Investment Adviser Oversight Act of 2012"

June 6, 2012

Good Morning Chairman Bachus, Ranking Member Frank, and members of the Committee. My name is Tom Currey, and I am here on behalf of the National Association of Insurance and Financial Advisors (NAIFA). I am from Grand Prairie, TX and in 2009 and 2010 I served as the elected President for NAIFA. For more than 30 years I have been licensed as a registered representative for my broker-dealer; and for more than 10 years I have been licensed as an investment adviser representative for my corporate RIA. This is in addition to my insurance licenses in Texas and California. Thank you for the opportunity to speak to you today regarding the regulation and examination of investment advisers. On behalf of the members of NAIFA, we appreciate your work on this important issue and your interest in our views.

Founded in 1890 as The National Association of Life Underwriters (NALU), NAIFA is one of the nation's oldest and largest associations representing the interests of insurance professionals from every Congressional district in the United States. NAIFA members assist consumers by focusing their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. NAIFA's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its

members.

My testimony this morning will focus on why NAIFA supports the Investment Adviser Oversight Act of 2012. We believe it is an important step in the right direction for protecting consumers and enhancing public faith in all financial professionals. NAIFA members support smart, balanced regulation – regulation that provides appropriate consumer protections and effective and efficient oversight without creating compliance burdens that would impede the delivery of consumer financial services. H.R. 4624 satisfies those criteria. The legislation addresses an important gap in regulatory oversight – the regular examination of investment advisers – with a common sense regulatory fix – empowering a self-regulatory organization with authority to oversee investment advisers.

As it stands today, the Securities and Exchange Commission (SEC) is tasked with examining registered investment advisers, but by its own admission the SEC only examines approximately 8% percent of investment advisers each year. Further, because of its risk-based approach to examinations, a full one-third of investment advisers have never been subject to an SEC compliance examination. NAIFA agrees with the concerns raised by other stakeholders and policymakers that this constitutes a critical regulatory gap that could lead to undetected problems that may cause financial harm to consumers or, at the very least, could lead to trust and credibility problems for the entire industry. Any breach of that trust will not only harm industry participants such as NAIFA members but, more importantly, the middle market investors we serve. That is why NAIFA supported Section 914 of the Dodd-Frank Act requiring the SEC to review and analyze the need for enhanced examination and enforcement resources, and that is why we support H.R. 4624.

After much consideration, we believe the Financial Industry Regulatory Authority (FINRA) is best equipped to serve as the Self-Regulatory Organization (SRO) for investment advisers. Granting FINRA this authority would be the least disruptive and most cost-efficient way to eliminate this trust gap by instilling confidence in consumers that their investment advisers, like broker-dealers, are subject to regular supervision and compliance examinations.

NAIFA Members and their Regulatory Environment

This issue is important to us because, although all NAIFA members are licensed insurance producers, a majority of our members also provide broader financial services to their clients. Nearly two-thirds of NAIFA members are licensed as registered representatives of broker-dealers (Registered Representatives) to sell securities to their clients; 41% of these NAIFA members are also licensed as investment adviser representatives (IAR) for a corporate Registered Investment Adviser (RIA). In other words, more than one-quarter of NAIFA members are "dually registered" as both Registered Representatives and IARs. In addition, a small number of NAIFA members are IARs, but are not Registered Representatives.

NAIFA members who sell securities are subject to significant compliance and regulatory requirements that provide an abundance of ongoing investor protections through vigorous enforcement of various rules imposed by the SEC and FINRA and, in turn, implemented by broker-dealers. On top of this, because our members are also licensed insurance professionals, they must adhere to comprehensive regulations imposed by the various state insurance departments.

As a result of these regulatory layers, NAIFA members are among the most comprehensively regulated individuals in the financial services industry. We spend an average of 514 hours a year on compliance and 12 hours per year on examinations. Direct compliance costs to NAIFA members currently average $8,877 a year: $264 in exam expenses, $569 in broker-dealer and/or registered investment adviser fees, and $8,044 in staff expenses related to compliance. This is a substantial amount of time and money, particularly because many of our members are small business owners who may only have one additional person on staff.

These regulatory requirements are significant, which is why NAIFA advocates for smart and efficient regulation that balances the need to protect consumers with the need to ensure that financial professionals are not subject to unnecessary or duplicative regulations that make it difficult to serve the clients who depend on us. Most NAIFA members are community-based small business owners providing affordable financial services to middle-market investors. The

clear majority of NAIFA members' clients have household incomes of less than $100,000, and a sizeable percentage of our members' clients have less than $50,000 invested in the financial markets. An overwhelming majority of NAIFA members serve Main Street, not Wall Street.

This if true for my practice as well. My clients on average have between $50,000 and $250,000 in investable assets. Almost all of them had less than $50,000 to invest before I worked with them to develop their financial plan.

Section 914 of Dodd-Frank and the SEC's Report to Congress

Section 914 of the Dodd-Frank Act required the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers and revise its regulations as necessary, as well as to report to Congress on regulatory or legislative steps necessary to address concerns raised in the SEC study.

Pursuant to this mandate, in January 2011, the SEC reported the results of its review to Congress. In its study the SEC conceded that resource limitations, coupled with a rise in registrants, have made and will continue to make it difficult for the SEC to provide effective oversight of SEC-registered investment advisers. Although the number of SEC-registered investment advisers has increased in the past six years, the report notes that the amount of SEC resources dedicated to adviser examinations has decreased. To close the examination gap the SEC staff suggested to Congress the following three options to address the problem:

1) Authorize the SEC to impose user fees on SEC-registered investment advisers to fund their examinations by the SEC Office of Compliance Inspections and Examinations (OCIE);

2) Authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or

3) Authorize FINRA to examine dual registrants for compliance with the Advisers Act.

NAIFA's Position

NAIFA members believe consumers are best served when they are confident that all financial professionals are subject to reasonable oversight to ensure compliance with rules and regulations. The regulatory structure in place today does not breed this confidence because investment advisers are examined infrequently or not at all. Statistics have made it very clear that investment adviser examinations are not occurring with sufficient frequency—on average, SEC-registered investment advisers are examined approximately once per decade. This is a serious gap in regulatory oversight.

NAIFA supports reasonably-structured and-timed investment adviser examinations to ensure that all financial professionals are complying with the law and that consumers are adequately protected. FINRA's broker-dealer model results in examinations approximately every two years. For NAIFA members who are Registered Representatives, broker-dealers review our members for compliance at a rate of 100% per year. Although we have some recommendations for improving broker-dealer regulation generally, we believe FINRA's examination schedule ensures that the SRO is familiar with the broker-dealers that it oversees and is in a position to see problems or deviations from the norm, including potentially regulatory violations.

In 2008 FINRA examined 57 percent of its broker-dealer members, and it examined 54 percent of its members in 2009.[1] The SEC's OCIE, by contrast, examined just 9 percent of its investment advisers, a 29.8% rate of decrease since 2004.[2] In 2011 the SEC planned on examining just 11 percent of investment advisers, but could not even reach that minimal level, and ultimately examined just 8% of advisers last year. This year the Commission estimates it will examine just 9% of investment advisers.[3]

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[1] SEC Staff Study, *Study on Investment Advisers and Broker Dealers* (Jan. 2011), *available at* http://www.sec/gov/news/studies/2011/913studyfinal.pdf, at pg. 30.
[2] *Id.* at pg. 14.
[3] SEC, Budget Justification for the Budget of the SEC, Fiscal Year 2013 (Feb. 2012), available at www.sec.gov/about/secfy13congbudgjust.pdf at pg. 24.

Thus, changes must be made in order to ensure investment advisers are subject to regular compliance reviews. While we recognize that there is general agreement about the investor protection gap that exists, there is disagreement over how to solve the problem. From NAIFA's perspective, the Investment Adviser Oversight Act is the most sound and practical approach. Allowing FINRA to serve as the SRO for investment advisers is simple common sense. Virtually all NAIFA members who are investment adviser representatives are also broker-dealer registered representatives. Thus, they are *already* subject to comprehensive FINRA oversight. NAIFA believes that authorizing FINRA to examine investment advisers is simply the most efficient option for dual-registered NAIFA members.

Simultaneous broker-dealer and registered investment adviser exams would not only lead to a more effective examination process, it would be less burdensome and intrusive for financial professionals than having to submit to different exams at different times in order to comply with the rules and schedules of different regulators or SROs. It would clearly be more efficient and cost effective for FINRA to expand its current, substantial examination capabilities to cover registered investment advisers than it would be to establish new SROs to perform this function.

Some stakeholders have stated that they support an approach that would increase the rate of SEC examinations of investment advisers by imposing a user fee on registered investment advisers. Although this might have the potential to increase the number of examinations, NAIFA has questions about the ability of the SEC to actually do the work given the Commission's resource challenges. Moreover, it would greatly increase the likelihood that NAIFA members, and other financial professionals like them, would be subject to more inefficient, duplicative, burdensome regulatory processes, as opposed to the more streamlined process that we believe FINRA could provide under H.R. 4624.

Another reason NAIFA supports the approach taken by the Investment Adviser Oversight Act is that it provides certainty that ***all*** investment advisers, regardless of state or federal oversight, will be subject to a routine examination. The Dodd-Frank Act increased the asset threshold for state-registered advisers to advisers with up to $100 million in assets under management (AUM). As a result, approximately 4,000 additional investment advisers have

shifted from SEC to state oversight. However the degree to which advisers are examined varies by state, and some states, such as New York and Wyoming, have no examination program. Thus H.R.4624 appropriately establishes a benchmark that all states much examine state registered investment advisers at least once every four years. All states that meet the criteria will retain full authority over state registered advisers. For states that cannot meet that standard, the authority would shift to an SRO. We believe this is the best approach to instill confidence that all investment advisers, like broker-dealers, will be subject to regular reviews.

We recognize that reasonable regulations are necessary to have an efficient and fair marketplace. That is why we support giving FINRA enhanced regulatory oversight over investment advisers, including NAIFA members, even though it *increases* the likelihood that they will be subject to examination.

Having said that, we believe it is critical that all stakeholders have a say in the regulatory process. If FINRA (or any other SRO) is given examination authority over investment adviser representatives, we strongly believe that an *independent* investment adviser representative should have a place on that entity's governing board. Independent adviser representatives have a unique perspective on their business model—one that is not shared by investment advisers or their affiliated representatives. The regulating body should hear that perspective. Past experience with FINRA's regulation of broker-dealers has shown that if all perspectives do not get through to regulators, compliance obligations – and costs – tend to get pushed down to registered representatives. This ultimately gets passed along to the consumer in the form of increased fees and/or diminished engagement with their financial professional (who may be busy dealing with unnecessary regulatory burdens). It is important to avoid this scenario with an investment adviser SRO, and we think Board representation will go a long way to providing a voice for the independent IAR.

In addition, it is important that any adviser representative subject to examination be given adequate due process rights before they are disciplined. This should include, at a minimum, the right to a hearing at which there is adequate opportunity to present evidence supporting their position before they have their license (and livelihood) taken away from them.

Conclusion

NAIFA members realize that there are many complexities associated with examining investment advisers and their representatives. After much consideration, we believe supporting H.R.4624 -- and more specifically giving FINRA the authority to conduct such examinations -- is the most reasonable, efficient path to achieving our mutually compatible goals. We appreciate the opportunity to share our views with you today on this critical issue. We look forward to working with the Committee to ensure that investors are both protected and have access to competent financial advice and services.

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TESTIMONY OF CHET HELCK

CHAIRMAN-ELECT, SECURITIES INDUSTRY
AND FINANCIAL MARKETS ASSOCIATION
AND
CEO, GLOBAL PRIVATE CLIENT GROUP
RAYMOND JAMES FINANCIAL, INC.

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON: H.R. 4624, THE INVESTMENT ADVISER
OVERSIGHT ACT OF 2012

JUNE 6, 2012

Introduction

Chairman Bachus, Ranking Member Frank, and members of the Committee: My name is Chet Helck. I am the Chairman-Elect of the Securities Industry and Financial Markets Association ("**SIFMA**").[1] I am also the CEO of the Global Private Client Group of Raymond James Financial, Inc., which has over 6000 financial advisers operating in 2500 locations in all 50 states who serve over 2,000,000 client accounts. Thank you for the opportunity to testify at this important hearing.

Today I will present SIFMA's views generally, in support of the creation of an

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

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independent, self-funded regulatory organization for retail investment advisers and specifically, in support of H.R. 4624, the Investment Adviser Oversight Act, as introduced by Chairman Bachus and co-sponsored by Representative McCarthy.

Over the years, the retail advisory services of investment advisers and broker-dealers have converged and in some cases, those services are indistinguishable, particularly for individual clients. Where the services have become essentially identical, we believe that individual clients would benefit from, and be better protected by, consistent standards, consistent examination, and consistent oversight for investment advisers and broker-dealers.

We support this bill because we believe it will result in enhanced oversight of retail investment advisers and thereby better serve and protect individual clients. We further support the bill because its purpose is not to foist *new* regulatory oversight on retail investment advisers, but to restore the oversight that is already supposed to be happening – but is not, while relieving pressure on the limited examination resources of the Securities and Exchange Commission ("**SEC**").

A. The same conduct should be subject to the same standard.

SIFMA's support for a so-called self-regulatory organization ("**SRO**") for retail advisers is premised on the recognition that broker-dealers provide some of the *same* services as investment advisers – including providing personalized investment advice to individual clients. We believe that when broker-dealers and investment advisers

provide the *same* service, they should be held to the *same* standard. That is why SIFMA supports the establishment of a uniform fiduciary standard for broker-dealers and investment advisers when they provide personalized investment advice about securities to retail customers.[2]

Our support is predicated upon appropriate cost-benefit analysis, and the standard being implemented in a manner that preserves investor choice, is cost-effective and business model neutral, and avoids regulatory duplication or conflict. We believe that a uniform fiduciary standard is consistent with current best practices in our industry and will result in a heightened focus on serving the best interests of individual clients.

B. The same conduct should be subject to the same level of examination and oversight.

We believe that an investment adviser and broker-dealer who provide the same service to individual clients should be subject to the same level of examination and oversight. Currently, investment advisers are not subject to SRO oversight and are inspected by the SEC only about once every eleven years.[3] Broker-dealers, on the

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[2] SIFMA's position is limited to individual retail customers or clients, *i.e.*, natural persons who use investment advice for personal, family or household purposes. *See Hearing Before the H.Comm. on Financial Servs., Subcomm. on Cap. Markets and Gov't Sponsored Ent.*, 112th Cong. (Sept. 13, 2011) (statement of John Taft, Chairman, SIFMA), available at http://financialservices.house.gov/UploadedFiles/091311taft.pdf.

[3] SEC, Division of Investment Management, Study on Enhancing Investment Adviser Examinations, as required by Dodd-Frank Section 914 (Jan. 2011) at p.14, available at http://sec.gov/news/studies/2011/914studyfinal.pdf ("**Dodd-Frank Section 914 Study**").

other hand, are subject to FINRA and SEC regulation, and are generally inspected biannually.

This gap in regulatory oversight simply must be addressed. Clients deserve the same level of regulatory protection regardless of the status of their intermediary. But that is simply not the case today: adviser examinations are not happening with the frequency and regularity as those of broker-dealers. This lack of oversight is unacceptable, given that billions of dollars of retail assets are entrusted to registered investment advisers. We cannot allow this situation to persist.

In short, retail customers of investment advisers should be able to expect and benefit from the same level of oversight and examination that is currently applied to broker-dealers. As we move toward a uniform fiduciary standard for brokers and advisers, the case for taking action now is even more compelling.

Thus, where broker-dealers and investment advisers provide the identical service to individual clients, and as we develop a uniform standard to govern that conduct, we ought to also ensure uniform examination and oversight of brokers and advisers. Retail customers deserve the same level of protection and congruity in their securities regulations. Thus, we support H.R. 4624 because we believe it will help ensure uniform examination and oversight of investment advisers and broker-dealers that provide retail advisory services, and thereby directly benefit and protect our clients.

C. The SEC's Dodd-Frank Section 914 Study reveals the IRO option as the most practical and prudent.

In a January 2011 *Study on Enhancing Investment Adviser Examinations*, as required by Dodd-Frank Section 914, the SEC's Division of Investment Management ("**IM**") recommended that Congress consider three alternative approaches:

1) authorize the SEC to impose user fees on investment advisers to fund their examination by the SEC;
2) authorize FINRA to examine dual-registrants for compliance with the Advisers Act; or
3) authorize a regulatory organization to examine investment advisers.[4]

1) SEC Examination. With respect to the SEC examination alternative, we note that last year, the SEC was able to examine only 8% of registered investment advisers, primarily due to lack of funding. Since 2004, the number of examinations has decreased by nearly 30% and the frequency by 50%.[5] Thus, the SEC is not now fulfilling its examination mandate with respect to investment advisers.[6] We believe, as many do, that SEC budgetary and resource constraints will continue into the foreseeable future, resulting in a continuing decline in the number and frequency of

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[4] *Id.*

[5] See Commissioner Elisse B. Walter Statement on Study Enhancing Investment Adviser Examinations at p.2 (January 2011), available at http://sec.gov/news/speech/2011/spch011911ebw.pdf.

[6] *Id.*

investment adviser examinations by the SEC.[7]

Consequently, we do not believe that the SEC is a viable or practical candidate to fill the "examination enhancer" role contemplated by Dodd-Frank Section 914.

2) FINRA Examination of Dual-Registrants. The FINRA examination of dual-registrants alternative would not provide any enhanced oversight or examination for the thousands of retail, stand-alone, registered investment advisers ("**RIAs**") that are not affiliated with a broker-dealer. This option is not only grossly under-inclusive, but also inconsistent with taking a uniform approach to the examination and oversight of advisers who provide the identical services to retail customers.

This approach also represents a risk to clients, as it would encourage even more brokers to flee from the highly-regulated broker-dealer environment – which is subject to rigorous FINRA and SEC oversight – to a once-a-decade examination regime operated by an overworked and underfunded SEC. Considering that the number of investment advisers has increased nearly 39% in recent years, while the amount of assets under management has increased even more – by nearly 59%,[8] we believe that this second alternative does not address concerns about inadequate adviser oversight.

3) Regulatory Organization for Retail Investment Advisers. We believe that the retail adviser regulatory organization alternative – which is embodied in the

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[7] *Id.*

[8] *Id.*

Investment Adviser Oversight Act – is the most practical and prudent approach. As we explained in our comment letter to the SEC on Section 914,[9] for many decades now, oversight of broker-dealers has been bolstered by the examination and oversight activities of regulatory organizations like FINRA, particularly with respect to conduct directed toward retail customers.

A regulatory organization with examination authority over the thousands of RIAs that are not regularly examined by the SEC today would be an effective supplement to the SEC's resources. In light of the limited SEC resources available for examining and monitoring independent RIAs, examination and oversight of independent RIAs would be enhanced by a retail adviser regulatory organization.

A regulatory organization with jurisdiction over RIAs would be able to devote sufficient examination resources to ensure investor protection standards are upheld. In addition, such an organization would be able to focus on the specific activities and challenges that are unique to RIAs, thus making the regulatory organization's efforts more effective.

Today, FINRA oversees nearly 630,000 individual registered representatives (over 250,000 of whom are dually registered as investment adviser representatives), and has approximately 3,400 full-time employees, approximately 1,100 of which are focused on examining member firms. Under this bill, we are talking about

[9] SIFMA comment letter to SEC re: Section 914 (Jan. 12, 2011), available at http://www.sifma.org/issues/item.aspx?id=22972.

examination and oversight for an additional, approximately 14,500 retail advisory firms (which excludes institutional and state-regulated advisers).[10] The SEC currently has about 500 full-time employees dedicated to its advisory program. To increase the frequency of examination to FINRA's average, however, the SEC would need to add more than 2,000 examiners to its advisory program – representing a 50% increase in total SEC full-time employees.[11] FINRA, on the other hand, estimates it would require only an additional 900 full-time employees to perform the entire function of examining and overseeing retail advisers.

In our view, and based on the foregoing, the regulatory organization option most directly answers the question posed by Congress under Dodd-Frank Section 914 because it would in fact increase the frequency and number of examinations for retail investment advisers. The regulatory organization model has worked well for broker-dealers to ensure frequent and regular examinations, and thereby stem abuses, enhance compliance, and protect investors, and we expect the same benefits would extend to retail investment advisers – and more importantly to their clients – under a retail adviser SRO model.

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[10] See FINRA Investment Estimate for FINRA IA SRO, available at http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p126542.pdf.

[11] See Commissioner Elisse B. Walter Statement on Study Enhancing Investment Adviser Examinations at p.2 (January 2011), available at http://sec.gov/news/speech/2011/spch011911ebw.pdf.

D. SRO does not mean self-regulation or self-policing; Here, we seek to create an independent, self-funded, regulatory organization ("IRO").

Nowadays, when you hear the term self-regulatory organization, or SRO, in the context of the securities industry, we all need to understand that the term is truly a misnomer. Here, we are not talking about "self" regulation. We are not asking an industry to police itself. After many decades of legislation, oversight, and regulation, regulatory organizations like FINRA are not controlled, or unduly influenced, by the industry they regulate.

On the contrary, today, regulatory organizations like FINRA are widely viewed and respected as independent, self-funded, organizations whose priority is to protect investors. As recently as 2010, Congress recognized this shift when it designated the Municipal Securities Rulemaking Board ("**MSRB**") as the regulatory authority to carry out expanded oversight of the municipal marketplace, and remodeled the MSRB's Board of Directors after FINRA's as a majority public board, in order to better protect market participants and the public.[12]

Thus, today, the term independent, self-funded, regulatory organization – or IRO – is the more accurate way to describe and convey the integrity and quality of the modern financial services regulatory organization. This is the type of regulatory organization that H.R. 4624 would authorize, and that we would support.

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[12] See Dodd-Frank Act Section 975.

E. The regulatory organization option does not necessarily mean FINRA.

Notably, the bill does not require that there be a single IRO for retail advisers, nor does it require that the retail adviser IRO be FINRA. Certainly, the bill allows for both possibilities, but does not compel either. We support this level of flexibility and optionality.

In the event there is more than one IRO for retail advisers, however, we believe that an adviser IRO should be required to coordinate its examinations and other activities with respect to a member that is also overseen by another IRO, in order to avoid overlapping or duplicative oversight by two IROs. In addition, we believe that an investment adviser dually registered as a broker-dealer should be permitted to register with a single IRO, if the IRO is registered as both an adviser IRO and a broker-dealer regulatory organization.

F. The regulatory organization option provides a unique opportunity to improve upon the existing SRO regime.

As I mentioned, the current regulatory organization model is the product of decades of evolution into its present independent, self-funded, investor-protection focused, state. But it's not perfect. FINRA, for example, gets its fair share of complaints and frankly, there's room for improvement.

That is why we need to recognize that this bill represents an important opportunity to improve upon the existing SRO regime – to improve upon FINRA – to take what is widely agreed to be working well at FINRA and other SROs, and to build

upon it to create an optimal regulatory organization for retail investment advisers.

In this regard, we believe that H.R. 4624 generally strikes an appropriate balance among the interests of ensuring robust oversight of retail investment advisers, avoiding an unreasonably burdensome and costly regulatory regime for those advisers, and providing for appropriate transparency and accountability of the retail adviser IRO.

Thus, we strongly believe that certain regulatory enhancements in the bill should be equally extended to broker-dealers under FINRA, and other SROs that oversee broker-dealers. Specifically, we support the bill's approach to the rulemaking process for adviser IROs, and we generally support the requirement for the IRO to consider costs and benefits. We do believe, however, that the cost-benefit requirements should be enhanced to improve the transparency and accountability of the IRO and the quality and efficiency of its regulations.

Moreover, we believe that both the rulemaking procedures and cost-benefit requirements applicable to the retail adviser IRO should be equally extended and applied to regulatory organizations registered under the Securities Exchange Act of 1934, thereby harmonizing the investment adviser and broker-dealer regulatory regimes.

Finally, we believe the bill recognizes the need to strike the appropriate balance between subjecting advisers that predominantly serve retail customers to IRO oversight, while exempting advisers to institutional clients. Thus, we would be

supportive of the Committee's efforts to ensure that retail advisers are subject to IRO oversight and institutional advisers remain under the jurisdiction of the SEC.

Given these suggested improvements, we believe that H.R. 4624, the Investment Adviser Oversight Act, represents an opportunity for Congress to accomplish the goal of comparable examination and oversight of brokers and advisers who provide personalized investment advice to individual clients.

Conclusion

Thank you, Chairman Bachus, Ranking Member Frank, and members of the Committee, for allowing me to present SIFMA's views. SIFMA and its members remain committed to being constructive participants in the process of establishing a uniform fiduciary standard for broker-dealers and investment advisers, and ensuring uniform examination and oversight of the standard through the creation of an IRO for retail advisers.

We support H.R. 4624 because:

(i) the bill fills a gaping void in current investment adviser oversight, by creating a retail adviser IRO that will increase the amount and frequency of investment adviser examinations and oversight, while relieving long-standing pressure on the limited examination resources of the SEC;

(ii) the bill strikes an appropriate balance among the interests of ensuring robust retail adviser oversight, avoiding an unreasonably burdensome and costly regulatory regime, and providing for appropriate transparency and accountability of the organization; and thus,

(iii) the bill provides an opportunity to improve upon the existing regulatory organization regime that now applies to broker-dealers.

Based on the foregoing, we fully expect the bill will better protect and serve individual clients, and thereby build trust and confidence in the financial markets, and ultimately, promote our economic growth, while helping to maintain our competitiveness in the global financial services marketplace.

We stand ready to provide any further assistance requested by this Committee on this important topic.

Testimony of

Richard G. Ketchum
Chairman and CEO
Financial Industry Regulatory Authority

Before the Committee on Financial Services

U.S. House of Representatives

June 6, 2012

Chairman Bachus, Ranking Member Frank and Members of the Committee:

I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today on H.R. 4624, the Investment Adviser Oversight Act of 2012.

There are approximately 4,800 broker-dealer firms registered with the Securities and Exchange Commission (SEC), and between the SEC and FINRA approximately 55 percent of those firms are examined annually. By contrast, according to the SEC, only 8 percent of registered investment advisers were examined in 2011 and approximately 38 percent of advisers registered with the SEC have never been examined. The average SEC-registered investment adviser is looked at by regulators only once every 10 to 13 years, and the frequency of SEC examinations of investment advisers has decreased 50 percent since 2004. No one involved in regulating securities and protecting investors can be satisfied with a system where only 8 percent of regulated firms are examined each year. It is completely unacceptable and represents a major gap in investor protection.

Given this dramatic lack of oversight and coverage, Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to review and analyze its need for enhanced examination and enforcement resources for investment advisers. The study, released in January 2011, clearly states that the SEC "will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency" and made several recommendations for Congress to consider, including allowing the SEC to authorize one or more self-regulatory organizations for the investment adviser industry.

H.R. 4624 represents a direct, bipartisan response to the SEC's study and recommendations, and is an important and thoughtful effort to help fill the gap in the protection of investment advisory clients. Specifically, the legislation addresses the current lack of Commission resources and allows self-regulatory organizations registered with and subject to strict SEC oversight to assist government regulators in providing closer and more regular oversight of

investment advisers who serve predominantly retail investors. The legislation also would free up resources for the SEC to examine investment advisers who primarily serve institutional clients.

FINRA

FINRA is the largest independent regulator for all securities firms doing business in the United States. FINRA provides the first line of oversight for broker-dealers and, through its comprehensive regulatory oversight programs, regulates both the firms and professionals that sell securities in the United States and the U.S. securities markets. FINRA oversees approximately 4,400 brokerage firms, 163,000 branch offices and 629,000 registered securities representatives. FINRA touches virtually every aspect of the securities business—from registering industry participants to examining securities firms; writing rules and enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms.

In 2011, FINRA brought 1,488 disciplinary actions, levied fines totaling $63 million and ordered the payment of $19 million in restitution to harmed investors. FINRA expelled 21 firms from the securities industry, barred 329 individuals and suspended 475 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,400 cycle examinations and 6,800 cause examinations.

FINRA has a Board of Governors composed of a majority of public governors, along with industry representation. FINRA's operations are designed to ensure that its Board, key committees and staff act independently and in the public interest. While the views of the industry are taken into account, FINRA-regulated firms have no authority to approve or disapprove FINRA rule proposals, interpretations or enforcement proceedings. FINRA's activities are overseen by the SEC, which approves all FINRA rules and has oversight authority over FINRA operations.

Evolution of Broker-Dealers and Investment Advisers

In recent years, increasing numbers of retail investors have sought the advice of financial professionals to plan for their retirement, help them through the financial crisis, prepare for their children's college education and meet their other financial goals. These investors have sought the advice of brokers and investment advisers. At one time, the investment adviser and broker-dealer businesses were distinct and separate. Today, while the services offered in each channel may differ, the businesses have converged in many ways. While broker-dealers and investment advisers are regulated differently, the reality is—as the Rand Corporation said in a study completed for the SEC in 2008—that "trends in the financial service market since the early 1990s have blurred the boundaries between them." Many customers now hold investment adviser and brokerage accounts with the same firm and rely on the same financial professional who is registered as both a broker-dealer and an investment adviser representative.

In fact, there are approximately 2,300 firms that are dually registered as broker-dealers and investment advisers or are broker-dealers with one or more affiliated investment advisers.

Beyond that, a vast majority of registered investment adviser representatives also offer brokerage services. Approximately 87 percent of all registered advisory representatives are also registered representatives of a broker-dealer.

This means that firms offer customers a combination of brokerage and advisory services in a product menu, and that, in many cases, financial professionals offer commercially indistinguishable brokerage and investment advisory services to the same customer. This makes it highly unlikely that the customer can distinguish between those services and the differing obligations and protections that are present in advisory and brokerage channels.

Despite this convergence in services, the regulation of investment advisers and broker-dealers remains quite different. The two industries are subject to different standards of conduct and different levels of oversight and enforcement. In light of the rising investor interest in seeking the advice of professionals, one would expect the convergence of the investment advisory and brokerage businesses to continue and even accelerate. This overlap in services has important implications for policy makers and regulators.

Because broker-dealers and investment advisers operate under vastly different levels of oversight due to resource constraints of government regulators, firms offering similar services can arbitrage regulation by choosing a form of registration that offers the least regulatory oversight and minimizes the risk of enforcement if the firm engages in misconduct.

In Dodd-Frank, Congress authorized two studies related to the regulation of broker-dealers and investment advisers that were completed by the SEC in January 2011. The first study examined the differences in the standards of care and other regulations for investment advisers and broker-dealers, and the second reviewed the SEC's frequency of investment adviser examinations and outlook for coverage going forward.

FINRA has been clear in its view that the standard of care in both channels should be a fiduciary standard for the provision of personalized investment advice to retail customers. However, just as critical as harmonizing standard of care is the need for a consistent oversight regime to ensure investors are being properly protected. As the SEC's study notes, "to fully protect the interests of retail investors, the Commission should couple the fiduciary duty with effective oversight."

Despite what some in the advisory industry often imply, the existence of a fiduciary standard alone is not a guarantee against misconduct. The risks to investors can be seen in the types of enforcement actions that have been taken against advisers. As we have seen all too often in headlines, registered investment advisers have been implicated in a number of Ponzi schemes. Other SEC actions involve a range of abusive behavior—such as trade recommendations that benefited the adviser over clients, misleading advertising, failure to disclose conflicts of interest, misappropriation of client funds, and inappropriate compensation and client referral arrangements. While there are certainly a great number of investment advisers committed to complying with the rules, it is clear that compliance with the fiduciary standard must be regularly and vigorously examined and enforced to ensure the protection of investors.

SEC Study on Enhancing Investment Adviser Examinations

The SEC's study on investment adviser exams concludes that the agency "will not have sufficient capacity in the near or long term to conduct effective examinations of registered

investment advisers with adequate frequency." The study further acknowledges that new examination responsibilities provided to the agency under Dodd-Frank means that an increase in agency examination staff "is unlikely to keep pace with the growth of registered investment advisers."

In order to address the lack of oversight resources for investment advisers, the SEC's study recommends that Congress consider three possible approaches: 1) authorize the Commission to impose user fees on SEC-registered investment advisers to fund their examinations; 2) authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or 3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.

The SEC oversees more than 12,000 investment advisers, but in 2010 conducted only 1,083 exams of those firms due to lack of resources. As such, the study notes, "the average registered adviser could expect to be examined less than once every 11 years." In contrast, more than 50 percent of broker-dealers are examined annually by the SEC and FINRA. As the SEC's study states, "the Commission's and the Commodity Futures Trading Commission's experiences with SROs support the view that an SRO can augment government oversight programs through more frequent examinations."

The frequency of SEC investment adviser examinations has declined 50 percent since 2004. The study notes that while there may be a short-term percentage increase due to the number of advisers being shifted to state oversight, any potential increase "may be offset by the need to divert examination resources to fulfill new examination obligations that the Commission was given by the Dodd-Frank Act." The SEC study estimates that it would need to double the numbers of examiners to increase the frequency of examinations to even 20 percent.

In a statement issued at the time of the study's release, SEC Commissioner Elisse Walter noted that based on that calculation, the SEC would need to add more than 2,000 examiners to its advisory program to increase the SEC's examination frequency to FINRA's current average for broker-dealers. Commissioner Walter noted that in addition to the 50 percent decrease in the frequency of examinations since 2004, the number of examinations also decreased 30 percent over that time. The Commissioner attributed the decreases in part to the growth in the number of investment advisers (38.5 percent) and in assets under management (58.9 percent) during the same timeframe. Walter explained that while there may be a near-term decrease in the number of advisers subject to Commission oversight due to Dodd-Frank's shifting of some of that population to state regulation, there will be an immediate increase in assets under management "as larger and more complex entities enter the Commission's oversight." She noted that these advisers are "more likely to be assessed as higher-risk advisers, requiring more resources," and highlights the staff estimate that "due to the Dodd-Frank Act, the number of large and complex entities registered with the Commission will increase from 38 percent of all advisers to 58 percent."

The gap in investment adviser oversight is a significant threat to the protection of advisory clients and should be addressed as quickly as possible. Providing the SEC authority to designate one or more SROs for investment advisers, subject to SEC oversight, is the most practical and efficient way to address this critical resource and investor protection issue. The bipartisan legislation introduced by Chairman Bachus and Congresswoman McCarthy would establish that authority and set a framework of requirements for any entity that would be designated as an adviser SRO. These requirements would ensure that the oversight by any such SRO reflect the nature and diversity of the investment adviser industry. We believe the

legislation is a thoughtful approach to addressing the critical need for increased adviser regulation.

Benefits of the SRO Model

Self-regulatory organizations have always been a cornerstone of the federal securities laws. Even before the securities laws were enacted, the securities exchanges regulated their members. In 1934, Congress codified and strengthened the governance requirements that applied to the exchanges even as it created the SEC. In 1938, Congress passed the Maloney Act, which extended the SRO model to broker-dealers who trade in the over-the-counter market. Congress preferred the SRO model because it recognized that reliance only upon direct regulation by the SEC "would involve a pronounced expansion of [the SEC's] organization . . . a large increase in the expenditure of public funds . . . and a minute, detailed, and rigid regulation of business conduct by law."[1] FINRA's predecessor, NASD, became a registered SRO as a result of the Maloney Act. In 1975, Congress again concluded that the SRO model "should be preserved and strengthened" as it amended the federal securities laws concerning the SEC's oversight responsibilities.[2]

FINRA serves as the front line of regulation, ensuring that broker-dealers and their representatives are regularly inspected for compliance with the law, and that those laws are enforced. FINRA conducts regular examinations and investigations of firms to ensure that they are complying with applicable laws and rules. We undertake enforcement and disciplinary proceedings when violations have been uncovered, and penalties include barring firms and individuals from the industry. FINRA also administers registration and disciplinary databases to provide critical information to regulators and the public, and implements continuing education and training programs.

Self-regulatory organizations like FINRA provide these benefits without significant additional cost to taxpayers, since they are typically funded by fees assessed on regulated entities. Self-regulatory organizations also have more flexibility than their government counterparts to devote and direct resources to large, multi-year technology development efforts that can support a variety of regulatory programs, including those focused on examinations, enforcement, market transparency and licensing qualifications.

Under federal law, the SEC must oversee all aspects of FINRA's programs. For example, the SEC:

- approves all FINRA rulemaking and seeks public comment on FINRA proposals through notice in the *Federal Register*;
- can add, delete or amend FINRA rules as it deems necessary or appropriate;
- hears appeals of FINRA disciplinary actions, which also may be appealed to the federal courts;
- requires FINRA to keep records and file reports with the Commission, and records are subject at any time to Commission inspection;
- inspects FINRA regulatory programs to ensure that it is fulfilling its regulatory responsibilities and to mandate corrective action as needed;

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[1] S. Rep. No. 1455, 75th Cong., 3d Sess. I.B.4. (1938).; H.R. Rep. No. 2307, 75th Cong., 3d Sess. I.B.4. (1938) (duplicate text quoted in both reports).
[2] S. Rep. No. 94-75, 94th Cong., 1st Sess. 7, II (1975).

- may conduct special inspections at any time for any reason;
- can impose limitations on FINRA's operations if it finds deficiencies justifying such action;
- may compel FINRA to act if it determines that FINRA is failing to provide adequate protection to investors; and,
- may suspend or revoke FINRA's registration under the Exchange Act and remove from office or censure any FINRA officer or director.

The United States has a long and successful experience with the SRO model, and H.R. 4624 would represent a tailored extension of the SRO model to the investment adviser industry.

The concept of an SRO for investment advisers is not a new one. The SEC first recommended establishing an SRO for investment advisers in its 1963 Special Study of the Securities Markets. And in 1989, the Commission submitted legislation to Congress that would have authorized an SRO for investment advisers. Over the nearly five decades since that time, the gap in oversight has continued to increase and governmental regulatory resources have continued to fall short of supporting needed oversight for advisers and the customers they serve.

The legislation would help ensure that investment advisers are examined regularly by an SRO, while requiring that the SRO conduct its examinations in a manner consistent with the investment adviser business and the principles of the Investment Advisers Act. H.R. 4624 would ensure that a registered representative who "wears two hats" could not escape inspection as an investment adviser representative, even while being subject to SRO oversight as a broker-dealer representative. The legislation would ensure that the Investment Advisers Act is enforced, and that those advisers who commit serious offenses will be disciplined and, if necessary, removed from the industry.

Cost Estimate for FINRA IA SRO

Much has been said by opponents of increased oversight for investment advisers about the potential costs of an IA SRO. The cost projections in the Boston Consulting Group (BCG) study—which was funded by trade groups for investment advisers and the advisory industry—of FINRA becoming the SRO for investment advisers are inaccurate and based on flawed methodology. By its own admission, BCG never consulted with FINRA or the SEC to discuss projected costs of IA oversight. As such, it is evident that their analysis was meant to be a political document rather than a serious attempt to explore costs.

We at FINRA thought it was important to take an accurate and realistic look at what the numbers would actually look like for our organization. To calculate an estimated investment level for the establishment and ongoing work of an investment adviser SRO, FINRA assumed a universe of approximately 14,500 firms out of the total population of over 26,000 current IA firms. This assumption is an attempt to reflect an approximate number of firms that could be subject to SRO examinations, given that the pending legislation provides exemptions for IAs with institutional customer bases as well as for state-regulated IAs for which examinations are conducted by state regulators an average of once every four years. We assumed a risk-based examination program across all firms, and assumed that all firms would be examined at least once every four years. The examination program would assess risk based on factors such as custody arrangements, business lines, personnel, customer complaints and assets under management.

Based on that analysis, we determined that FINRA's one-time start up cost would be approximately $12 - $15 million. This reflects an investment in technology solutions to support an investment adviser examination program, as well as initial organization, training and governance costs. Ongoing technology maintenance is reflected in the ongoing investment numbers, as are staffing costs.

This investment builds upon FINRA's established, nationwide program for examinations currently in place, district offices across the country and ability to leverage existing infrastructure, technology and staff.

Again, based on the assumed universe of approximately 14,500 firms, we determined that ongoing costs would total approximately $150 – $155 million annually. We anticipate a staff increase of approximately 900 employees, the vast majority of whom would be examinations staff. Because staffing is unlikely to be complete in the first year, the staffing estimate is reflected in the annual ongoing cost.

This estimate also includes overhead and support costs for examinations and enforcement. It does not include costs for testing, advertising review or dispute resolution. If either Congress or the Commission determines that those functions should be included, then the annual ongoing investment would increase by approximately $10 million.

Our numbers reflect a realistic estimate for extending FINRA's examination program to covered investment advisers. By contrast, in determining its estimated costs for a FINRA IA SRO, BCG used as its base the costs for establishing the Public Company Accounting Oversight Board and the Consumer Financial Protection Bureau from scratch. BCG used these figures—set up costs for organizations that did not have one desk or employee—and provided for only a 20 percent discount off the from-scratch start-up costs to allow for efficiencies in FINRA's existing infrastructure. While FINRA would need to hire additional staff to serve as an SRO for investment advisers, we believe BCG vastly underestimated our ability to leverage existing staff, district offices and the technology underlying our existing nationwide examination program.

In addition, BCG misconstrued data concerning FINRA regulatory and user fees. BCG relied on this data to estimate examination program costs, even though the fees support a wide variety of programs beyond just examinations, including testing, advertising review and dispute resolution. BCG also relied upon SEC data to estimate the number of annual examinations per examiner, but the SEC ratio of annual examinations per examiner is less than FINRA's ratios.

The study demonstrates a bias in several respects. For example, it added on the costs to the SEC of overseeing an investment adviser SRO program, but didn't include a reduction in the SEC's costs if FINRA were to conduct examinations of investment advisers. It also assumes that it costs the SEC about half as much to examine an investment adviser as the costs that FINRA would incur—even for dually registered investment advisers who are already examined by FINRA.

The BCG study is flawed in a number of ways, but even more important, it is tangential to the principal reason why enactment of IA SRO legislation is necessary. The primary purpose of the pending legislation is to ensure that the investment adviser industry is, at last, subject to regular inspections, oversight and enforcement of the Investment Advisers Act. Our experience with the SRO model demonstrates that extension of the model to the investment adviser industry would ensure that these objectives are achieved in the most efficient manner available.

Structuring an SRO Approach to Enhancing Investment Adviser Oversight

H.R. 4624 is crafted to ensure that the SRO's governance structure provides the independence and objectivity necessary for the SRO to perform its responsibilities, that its jurisdiction is appropriately focused, and that the SRO's regulatory programs reflect the nature of the investment adviser business and the principles of the Investment Advisers Act.

Governance

H.R. 4624 would require that the SEC approve applications of any organization that seeks to become an SRO, subject to standards set out in the legislation. The SEC would be required to determine that an applicant will provide fair representation of the public interest and the adviser industry in the selection of its governing body; adopt rules designed to prevent fraud and protect investors, consistent with existing law, and not impose burdens on advisers that are not necessary or appropriate; conduct periodic examinations of members and their associated persons; and allocate reasonable fees in an equitable manner. The legislation's approach is based upon the application process for national securities associations in the Exchange Act, modified to reflect the investment adviser industry. FINRA supports the proposed requirement in H.R. 4624 that public representatives should form a majority of any governing body. We also support the proposed requirement that participants in the investment advisory industry should be allocated a number of the remaining seats, to ensure that the industry is adequately represented.

Focus on Retail Investors

The focus of any adviser SRO should be on retail-facing business. FINRA supports the approach taken by the legislation that would exempt certain advisers from SRO regulation, such as advisers that primarily serve mutual funds and other qualified institutional buyers. By focusing on SRO oversight of retail advisers, the legislation would free-up SEC resources to examine institutional advisers.

The SEC study similarly recognized that some exclusions from membership may be appropriate. As the study states: "For example, advisers to registered investment companies that are subject to examination under the 1940 Act could be excluded. Or specific exclusions could be provided for investment advisers to private funds (such as hedge funds) or advisers that do not have retail clients."

Reflecting the Nature of the Advisory Business and the Investment Advisers Act

FINRA supports the various provisions of H.R. 4624 that would ensure that the regulatory programs of an SRO reflect the nature of the investment adviser industry. The investment adviser industry provides a diverse array of services to the investing public. We strongly believe that any SRO must conduct its regulatory programs in a manner that reflects the nature of those services and the principles of the Investment Advisers Act.

H.R. 4624 would, for example, require that the rules of the SRO are consistent with the purposes of the Investment Advisers Act and the fiduciary standards applicable to investment advisers under the Act and state law. The legislation would require that those rules are necessary or appropriate "in light of the business of registered investment advisers." These

provisions would help to ensure that the SRO administers its programs in a manner that is appropriate to the investment adviser business.

Before concluding, I want to be very clear—if FINRA becomes an SRO for investment advisers, we would implement regulatory oversight that is tailored to the particular characteristics of the investment adviser business. FINRA would establish a separate entity with separate board and committee governance to oversee any adviser work, and would plan to hire additional staff with expertise and leadership in the adviser area. That said, given our experience operating a nationwide program for examinations and our ability to leverage existing technology and staff resources to support a similar program for investment advisers, we believe we are uniquely positioned to serve as at least part of the solution to this pressing problem. In addition, FINRA's current programs would be enhanced and investors would be better protected if we had the authority to examine the full operations of dually registered firms, where currently we can only see the broker-dealer side of what is typically a fully integrated business.

Conclusion

The SEC and state securities regulators play vital roles in overseeing both broker-dealers and investment advisers, and they should continue to do so. Investor protection demands, however, that more resources be dedicated to regular and vigorous examination and day-to-day oversight of investment advisers. While the regulatory status quo may be appealing to some in the investment advisory industry, the current level of adviser exams is unacceptable, and authorizing the SEC to designate one or more SROs to assist it with overseeing investment advisers is the most efficient solution to addressing this critical investor protection issue.

FINRA is committed to working closely with other regulators and this Committee as you work to address the lack of examination resources for investment advisers.

Written Testimony of John Morgan

Securities Commissioner of Texas

On behalf of

The North American Securities Administrators Association, Inc.

Before the

House Committee on Financial Services

"*H.R. 4624, the Investment Adviser Oversight Act of 2012*"

June 6, 2012

Washington, DC

Good morning Chairman Bachus, Ranking Member Frank, and members of the Committee, I'm John Morgan, Securities Commissioner of Texas and a member of the North American Securities Administrators Association, Inc. ("NASAA"), the association of state and provincial securities regulators. I am honored to be here today on behalf of NASAA to discuss H.R. 4624, the Investment Adviser Oversight Act of 2012.

State securities regulators have protected Main Street investors from fraud for the past 100 years, longer than any other securities regulator. I have been a regulator in Texas for 28 years and, along with my state colleagues, am understandably proud of our commitment to investor protection. State securities regulators have continued, more than any other regulator, to focus on protecting retail investors. Our primary goal is to act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

Securities regulation is a complementary regime of both state and federal securities laws, and the states work closely together to uncover and prosecute securities law violators.

The securities administrators in your states are responsible for enforcing state securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents. Ten of my colleagues are appointed by state Secretaries of State, five fall under the jurisdiction of their states' Attorneys General, some are appointed by their Governors and Cabinet officials, and others, like me, work for independent commissions or boards.

States are the undisputed leaders in criminal prosecutions of securities violators. In 2010 alone, state securities regulators conducted more than 7,000 investigations, leading to nearly 3,500 enforcement actions, including more than 1,100 criminal actions. Moreover, in 2010, more than 3,200 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action.

Oversight of Investment Advisers

On September 13, 2011, my colleague Steve Irwin, a securities commissioner for the State of Pennsylvania, testified before the Subcommittee on Capital Markets and Government Sponsored Enterprises on what was then a draft bill on investment adviser oversight. At the outset of his testimony he noted NASAA's vigorous opposition to the creation of a self regulatory organization ("SRO") for state regulated investment advisers and their associated persons. NASAA's position then, and now, is that the regulation of investment advisers should continue to be the responsibility of state and federal governments and that these regulators must be given sufficient resources to carry out this mission.

Federal vs. State Responsibilities in Investment Adviser Oversight

Since the passage of the National Securities Markets Improvement Act in 1996 and the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (the "Dodd-Frank Act"), the division of federal and state regulatory responsibility over investment advisers has been delineated according to the amount of investors' assets under management. Certainly, from the perspective of Texas, and to the best of my knowledge, for most states, this division has worked very well.

However, according to the U.S. Securities and Exchange Commission ("SEC"), in 2011 it examined only 8 percent of the investment advisers under its jurisdiction and it has never examined approximately 40 percent of federally registered investment advisers.[1]

The problems that exist with the SEC's oversight of federally registered investment advisers have been characterized as a "regulatory gap." NASAA recognizes these problems place investors at risk, and agrees that Congress should act to address them.

Crucially, however, no similar gap exists with respect to investment adviser regulation in Texas, nor in the overwhelming majority of states.[2] To the contrary: the Dodd-Frank Act placed great confidence in state investment adviser examination programs by increasing state oversight to those advisers with $100 million in assets under management, up from $25 million. This means that a significant number of investment advisers are switching from federal to state regulation.

This switch, targeted for completion on June 28th of this year, is one of the largest regulatory events involving a coordinated effort by the states and the SEC. When the dust settles, approximately 2,500 investment advisers will have transferred their registrations from the SEC to one or more states. This means that the states will be responsible for the oversight of approximately 17,000 investment adviser firms and the SEC will regulate roughly 10,000 investment adviser firms.

States have been preparing for this switch for two years and look forward to accepting the increased regulatory oversight of mid-sized investment advisers. This is our main focus. NASAA believes that Congress should focus its attention on improving deficiencies in the oversight of federally registered investment advisers, while allowing

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[1] Testimony on "SEC Oversight" by Chairman Mary L. Shapiro: Hearing before the Capital Markets and Government Sponsored Enterprises Subcommittee and Financial Institution and Consumer Credit Subcommittee of the House of Committee on Financial Services (Apr. 25, 2012), available at http://www.sec.gov/news/testimony/2012/ts042512mls.htm; *see also* Study on Enhancing Investment Adviser Examinations, As Required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011), available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

[2] NASAA Report to SEC, State Securities Regulators Report on Regulatory Effectiveness and Resources with Respect to Broker-Dealers and Investment Advisers (Sept. 24, 2010), available at http://sec.gov/comments/4-606/4606-2789.pdf.

the states to continue to focus on our distinct responsibility for the oversight of state registered investment advisers.

H.R. 4624 and State-Registered Investment Advisers

Mr. Chairman, NASAA genuinely appreciates your efforts to improve the oversight of investment advisers. We share the same mission of investor protection. As we outline our concerns, please consider them in the context that we have shared goals in this effort, but different approaches to solving the regulatory gaps.

Unfortunately, H.R. 4624 embraces a "one size fits all" approach to regulation. It will require some federally registered investment advisers and most state registered investment advisers to become members of an SRO, pay membership fees to the SRO, comply with its rules, and be subject to inspection by the SRO—regardless of whether the firm has clients in more than one state or conducts business in a way that has any demonstrable effect on national markets.

From a state regulatory perspective, H.R. 4624 is unnecessary in Texas as Texas-registered investment adviser firms are currently subject to strong state oversight and inspection. The same holds true for the overwhelming majority of states.

The regulatory process at the state level typically begins before an entity ever becomes a registrant. State securities regulators review information submitted by applicants to determine whether the applicant satisfies the standards necessary to achieve registration as an investment adviser or investment adviser representative. States monitor ongoing compliance of investment advisers and their representatives in a variety of ways including, but not limited to, post-registration reviews, annual questionnaires, and both on-and off-site examinations. Thousands of on-site examinations employing sophisticated examination modules are performed on a routine and for-cause basis every year in virtually every state. In fact, according to NASAA's most recent nationwide survey which was conducted in 2010, the vast majority (89%) of states that conduct routine examinations complete these examinations on a formal cyclical basis of six years or less. Moreover, a majority of those states examine investment advisers at a rate that is on average at least once every four years.[3] In sum, states use a variety of regulatory tools in carrying out the oversight of investment advisers.

Leaving the structural issues of the legislation aside for the moment, we are extremely concerned about the very real impact this legislation will have on state registered investment advisers and the clients they serve. In short, the most urgent problem with this legislation is that it has the very real potential to be a job killer.

Most state registered investment advisers are small businesses employing only a few people. The majority of their clients are not wealthy individuals or institutions but hard working Americans trying to plan for retirement or their child's education. As

[3] NASAA expects to update information on state oversight of investment advisers when the investment adviser "switch" mandated by the Dodd-Frank Act has been completed.

introduced, H.R. 4624 would threaten the financial viability of these small businesses in Texas and across the country by creating an unnecessary, expensive, and duplicative layer of regulation.

Much has been said in recent weeks regarding the potential cost burden on investment advisers generally, although a clear picture of the size of the burden on state registered investment advisers has yet to emerge. One thing is known: the economics for many state registered investment advisers indicate that it is perilous for these firms to bear the weight of another layer of costs, particularly when it is unnecessary to impose such costs.

I have heard from an association that represents investment adviser firms in Texas that are worried about these costs and I have also spoken to individuals who help state registered investment advisers maintain compliance. The chorus is the same. Texas investment advisers suffer from regulatory fatigue, having already undergone significant regulatory changes, and they want to focus on the markets they serve and their clients. In fact, they have told me, based on the comments from their clients and others, that small investment advisers will see the advent of a new regulatory body as a final straw and will simply close their doors.

Texas' investment advisers are not alone in their concern about the devastating consequences H.R. 4624 may bring to small and mid-sized investment adviser businesses if enacted. A survey of investment advisers registered in the State of Massachusetts, released last week by Secretary of the Commonwealth William Galvin, indicated that investment advisers in that state are "adamantly opposed" to a bill such as H.R. 4624 that would require them be members of an SRO.[4] According to Secretary Galvin, over half of the 649 investment advisers registered in Massachusetts responded to the survey, and of those who did, 41 percent volunteered comments suggesting that they would be forced out of business if the bill passes in its current form.[5]

Let me reiterate: *41 percent of investment advisers surveyed in the State of Massachusetts feel that H.R. 4624 – if enacted – may force them out of business.*

Mr. Chairman, the message I am hearing from investment advisers in Texas is the same message Secretary Galvin is hearing in Massachusetts: H.R. 4624, in its present form, has the very real potential of being a job killing bill for these small and mid-sized firms. The legislation would create redundant and unnecessary layers of new regulation and cost, and this cost may force many small investment adviser firms to close their doors.

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[4] News Release, Investment Advisers in Massachusetts Strongly Oppose Pending Federal Oversight Bill, (May 31, 2012), by William Francis Galvin, Secretary of the Commonwealth of Massachusetts.
[5] Id. at 1.

NASAA Urges the Committee to Address the Following Critical Flaws with H.R. 4624

1. State registered investment advisers should not be required to become members of an SRO.

As discussed above, requiring state registered investment advisers to become members of an SRO in states where these firms are already adequately regulated is unnecessary and will harm small businesses. This mandate will have the effect of placing a costly new burden on thousands of small and mid-sized investment advisers (the majority of whom are one and two person shops). Under the bill, most of these firms will receive no benefit from their membership in the SRO as they will continue to be primarily regulated and examined by the states.

Imposing an additional layer of bureaucracy runs contrary to the many recent attempts by Congress and by the Financial Services Committee to support small business and reduce regulatory hurdles. Simply stated, many small businesses are likely to be harmed or even put out of business by the costs associated with joining an SRO. To make matters worse, as the bill's expressed aim is to "preserve state authority over investment advisers with fewer than $100 million in assets under management,"[6] it is difficult to conceive of a valid reason for requiring state registered investment advisers to join and pay membership fees to an SRO. Essentially, these small businesses would be forced to subsidize costs of the SRO's examination program related to larger firms.

States' track record in examining small and mid-sized investment advisers with less than $25 million in assets under management is exemplary and that performance was recognized and validated by Congress when the Dodd-Frank Act expanded the states' oversight role. State securities regulators are prepared to take on this additional oversight, and have already put into place new resources to meet this responsibility in anticipation of the SEC's June 28th deadline.[7] These resources include additional personnel, training programs, and a protocol for the sharing of resources among state regulators. It is premature to assume that states are not able to uphold this increased regulatory authority.

Finally, even as NASAA ardently opposes the bill's requirement that all state registered investment advisers be members of an SRO, and although we consider it essential that state registered investment advisers be expressly exempted from such a membership requirement, NASAA does recognize that a very small number of states may want the option to augment their current examination programby enlisting the resources

[6] Press Release, House Financial Services Committee (Majority), Chairman Bachus and Rep. McCarthy Propose Bipartisan Bill for More Effective Oversight of Investment Advisers (April 25, 2012), available at http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=292499.

[7] Testimony on "Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight" by Steve Irwin, Pennsylvania Commissioner of Securities: Hearing before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House of Committee on Financial Services (Sept. 13, 2011), available at http://financialservices.house.gov/UploadedFiles/091311irwin.pdf.

of an SRO. In the event Congress chooses to establish an SRO for federally registered investment advisers only, NASAA would be prepared to work with the Committee to explore options that would allow individual states , acting on their own accord, to enlist the assistance of an SRO for purposes of examining investment advisers under their direct jurisdiction for compliance with state laws and regulations.

2. States should be able to adopt examination practices that are best suited to their pool of investment advisers.

The four year on-site examination requirement ignores the reality that investment advisers vary significantly in the size and types of businesses they conduct. Some manage and maintain custody of sizable client assets while others don't actively manage any assets, but instead develop sophisticated financial plans for their clients. These differences play a key role in determining the amount of risk posed by an investment adviser's business. States have extensive experience designing examination programs to account for these variables and differences in risk profiles. To this end, states utilize examination methods and review cycles that maximize investor protection through a focused use of resources. Of course, the period between examinations should not be ignored, and does serve as an important factor in determining the need to conduct an examination. However, requiring regulators to visit every investment adviser on a four year cycle may actually undermine investor protection by forcing regulators to overemphasize one component of risk instead of effectively accounting for all components of an investment adviser's business.

The regulatory flexibility of the states to do what is in the best interest of investor protection within their own borders should not be supplanted by afederally-mandated "one size fits all" standard.

3. State securities regulators should not be required to report to an SRO.

H.R. 4624 would require state securities regulators to report to an industry-funded SRO overseen by the SEC. States are sovereign, independent entities, and should not be subordinated to a private, industry-funded corporation. Such a regulatory structure would compromise the independence and flexibility that are essential to effective state regulation. It would also ignore fundamental democratic principles from which regulation derives legitimacy.

Further, even though the majority of the SRO's membership would likely be state registered investment advisers prohibited from registering with the SEC under section 203A of the Investment Advisers Act of 1940, H.R. 4624 gives the SEC exclusive oversight of the SRO for purposes of approving its rules and hearing appeals involving the discipline of its members. State regulators are given no role in overseeing the SRO. Moreover, because decisions of the SRO would be appealable to the SEC rather than a state securities regulator, the SEC becomes the final arbiter of actions against persons (state regulated investment advisers) that it does not regulate.

Perhaps most troubling is the bill's burdensome and highly unwarranted requirement that the SRO hold an "Annual Conference" with NASAA for the purpose of determining which states are meeting the examination standards prescribed in the bill, and then submit a report to Congress identifying: "[s]tates that have adopted a State examination plan" in conformity with the bill, and "providing any information available to the [SRO] concerning the States' proposed methodology of their examinations and the extent to which those States have been able to meet their previously-submitted examination plans."

Taken collectively, these requirements diminish state independence by effectively compelling sovereign states to report to an industry-run SRO, which may then critique the states in its annual report to Congress. This creates a reporting structure that is antithetical to securities regulation and state sovereignty.

We believe that such a delegation of authority to a private agency is constitutionally problematic as was pointed out by Professor Ernest A. Young of Duke University School of Law in a recent letter to the Chairman and Ranking Member of this Committee. Further, the regulatory scheme proposed in this bill whereby the principal regulator—in this case state regulators—is subordinated to a private organization is an attack on the principles of federalism and state sovereignty established in the Constitution. States, like the federal government, are statutory regulators and accordingly should not be subordinated to an industry self-regulator.

4. The exemptions in H.R. 4624 undermine the legislation's goal and purpose.

H.R. 4624 is a misapplication of the 914 Study. H.R. 4624 in many ways fails to address or remedy the problems that were the study's core focus. If the rationale for the legislation is to "augment and supplement the SEC's oversight to dramatically increase" its examination rate for investment advisers with retail customers, the numerous exemptions set forth in Section 203(B)(b) need substantial narrowing. This subsection exempts major categories of SEC registered advisers from SRO membership including advisory firms with at least one mutual fund client, regardless of the amount of assets the adviser has under management, and advisory firms with at least 90% of its assets attributable to institutional and high net worth clients or private funds.

Congress Should Consider All Options Available to Enhance Federal Oversight of Investment Advisers

As part of the 914 Study, the SEC examined various alternatives designed to increase the frequency of examinations of federally registered investment advisers. The alternative preferred by the SEC staff was the imposition of user fees that would be charged to investment advisers. H.R. 4624 makes no mention of this option and disregards the findings of the SEC—the individuals most familiar with the challenges that come with examining federal registered investment advisers.

The best way to improve IA oversight at the federal level is through SEC user fees.

Regulation of the financial services industry is the responsibility of the government agencies answerable to the investing public and not private organizations that report to a board of directors. These agencies should be adequately funded to carry out the responsibilities entrusted to them by the government. Therefore, as a matter of policy, the most appropriate way to improve the oversight of federally registered investment advisers is to provide the SEC with the resources needed to do the job, either through increased appropriations or by authorizing the SEC's Office of Compliance Inspections and Examinations to collect user fees from the investment advisers it examines.

As a matter of efficiency and cost, authorizing the SEC to fund enhanced oversight of federally registered investment advisers through the imposition of user fees also makes more sense than establishing a new SRO for investment advisers. Further, imposing user fees would be a less expensive option because the SEC would not have to spend significant resources in overseeing an SRO. The 914 Study acknowledged the high costs of coordination between the SEC staff and an SRO "which might include, for example, not only direct costs like additional management costs required to oversee the SRO's effectiveness, but also other costs that are even more difficult to quantify." In the 914 Study, the SEC staff went on to state as follows:

> There is no certainty that the level of resources available to the Commission over time would be adequate to enable staff to effectively oversee the activities of the SRO. Therefore, a user fee approach, which would contribute directly to the Commission's investment adviser examination program, would avoid the risk of underfunded oversight of an SRO.[8]

According to the BCG analysis, the start-up costs alone of an SRO could fund an enhanced SEC examination program for an entire year.

Before Creating a New SRO Congress Should Fix Flaws in the Current SRO Model

NASAA's primary position regarding investment adviser regulation is that it should continue to be the responsibility of state and federal governments that bring experience unmatched by any entity in existence. NASAA therefore urges Congress not to enact an SRO model for investment advisers.

[8] Study on Enhancing Investment Adviser Examinations, As Required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011), available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

However, in the event that Congress determines to establish an SRO for federally registered investment advisers, NASAA believes it is essential that this bill be improved to address the following concerns that are inherent in an SRO model.

1. Accountability of SROs.

Time and experience have demonstrated that SROs simply cannot match the accountability of government regulators, nor the proximity to and familiarity of state regulators with investment advisers when considering investor protection and regulatory thoroughness. The challenge of ensuring accountability of an SRO is linked to the question of whether an SRO is a "state actor." If an SRO's rules are viewed as equivalent to federal securities regulations by not being subject to oversight from state securities regulators, they will displace state laws and rules.

States are understandably sensitive to the prospect of federal preemption occurring at the behest of a private corporation such as FINRA, acting pursuant to its authority as a federally designated SRO. This is, for obvious reasons, contrary to the public interest and to the basic tenets of democratic society.

In a separate report prepared by the Boston Consulting Group examining the SEC's management structure including the oversight the SEC currently conducts of SROs, the BCG was forceful and direct in its call for improving SRO accountability, stating that, in view of "the important role SROs play in the governance of securities markets today, it is critical that the SEC maintain a robust level of oversight over their regulatory operations."[9] Their analysis went on to state that "the SEC should develop careful guidelines to SROs for overseeing investment advisers and ensure that those guidelines are followed meticulously."[10]

Notably, the BCG analysis placed particular emphasis on the need for more accountability in the relationship between the government and the largest SRO – FINRA. Citing FINRA's ongoing efforts "to further expand the scope of its regulatory activities," the BCG analysis stated that "the current level of oversight over FINRA should be enhanced."[11] A similar conclusion was reached very recently by the Government Accountability Office. (insert FN citing recent GAO report). Before efforts to expand the authority of SROs are undertaken these issues regarding oversight should first be addressed.

NASAA appreciates that H.R. 4624 includes a provision apparently intended to ensure that the legislation will not preempt the authority of the states to regulate investment advisers under their jurisdictions. Should the Committee consider H.R. 4624 this session, NASAA hopes to work with the Chairman and the Committee to refine and strengthen this provision.

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[9] The Boston Consulting Group, U.S. Securities and Exchange Commission, Organizational Study and Reform, pg. 237 (March 10, 2010), available at http://www/sec/gov/news/studies/2011/967study.pdf.
[10] Id. at151.
[11] Id. at 135.

2. Conflicts of interest and susceptibility to industry capture.

The existing securities industry SRO model, as typified by FINRA, is replete with conflicts of interest. Members of the industry serve on the SRO's board and occupy other positions of prominence such as serving on various advisory committees. Even where there is an independent Board of Directors, SROs remain organizations built on the premise of self-rule and are, as a matter of first principle, accountable to their members and not the investing public. NASAA appreciates that H.R. 4624 takes some steps to limit conflicts of interests in an investment adviser SRO. Notably, the bill provides that a majority of the new SRO's board of directors shall not be associated with any member of the SRO, and shall not be investment advisers or broker dealers. Nevertheless, by its very nature, there is some conflict of interest inherent to the SRO model. Further, any SRO that depends on its members as its primary funding source faces a heightened susceptibility to industry capture.

3. Barriers to collaboration between SROs and government regulators.

The sharing of information among state and federal regulators is essential to ensuring that investors are protected. Collaboration and cooperation are required for an effective regulatory system. The SRO model brings with it a barrier to collaboration and cooperation in the form of the "State-Actor Doctrine."

NASAA appreciates that H.R. 4624 attempts to mitigate obstacles to information sharing between SROs and government agencies. Specifically, the bill includes a provision that provides, in pertinent part, that "Nothing in this Act shall be construed to limit the authority of any national investment adviser association, whether or not it is also a self-regulatory organization registered under the Securities Exchange Act of 1934, to share any information in its possession with a Federal, State, or local governmental agency, nor shall the sharing of information be construed to be the action of such an agency."

NASAA is gratified to see that the legislation takes into account barriers to information sharing between regulators and SROs. Nevertheless, based on experience in working with various SROs over decades, state securities regulators remain concerned that the "State-Actor Doctrine" could persist as an obstacle to collaboration. As this doctrine arises from the Constitution, its breadth will be established not by Congress but by the courts, and, at present, the case law in this area is unsettled and contradictory.

4. Transparency of SROs.

Collaboration issues aside, the regulatory work performed by SROs lacks transparency. SROs are not subject to the Freedom of Information Act (FOIA) or other similar public records requirements, as are state securities regulators and the SEC. Even where there is public disclosure by SROs regarding members, as in the case of *BrokerCheck*, the SRO has placed limitations and filters on regulatory records that exceed FOIA provisions, resulting in less public disclosure of information than state

securities regulators routinely make publicly available. The end result is that important information is withheld by the SRO from the investing public.

Conclusion

In summary, state securities regulators share the Committee's concern regarding the oversight and examination of federally registered investment advisers. Further, we appreciate the improvements that the Chairman and Congresswoman McCarthy (NY) have made to the bill since a discussion draft was made public last fall—notably, in the independence of the SRO's governance structure, the sharing of information between the SROs and government regulators and the non-preemption language. Nevertheless, NASAA remains strongly opposed to H.R. 4624 in its present form, without significant changes.

As a matter of policy, investment adviser regulation is a governmental function that should not be delegated to an SRO. If Congress adopts an SRO model its scope and authority must be limited to specific regulatory need, and state securities regulators and the SEC must be maintained as the primary regulators of investment advisers. Moreover, any such SRO must be answerable to the appropriate government regulators, not the other way around, as both a legal matter and as a matter of fact.

Above and beyond NASAA's concerns with the SRO model and its application to investment adviser regulation, however, state securities regulators are adamantly opposed to H.R. 4624 because we believe it would subordinate state regulators to an SRO, impose redundant regulation and new costs on small and mid-size investment advisers that are impossible to justify, and very likely put many of the small firms that we regulate out of business.

We look forward to working with Congress to arrive at a legislative solution that maintains appropriate oversight of investment advisers.

Thank you, Mr. Chairman, for the opportunity to testify at today's hearing. I will be pleased to answer any questions that you or other members of the Committee may have.

Statement of

David G. Tittsworth
Executive Director and Executive Vice President
Investment Adviser Association

Before the
Committee on Financial Services
United States House of Representatives

Hearing on the Investment Adviser Oversight Act of 2012

June 6, 2012

Executive Summary

H.R. 4624, the "Investment Adviser Oversight Act of 2012," mandates membership in a self-regulatory organization (SRO) for SEC- and state-registered investment advisers. The bill would subject 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 be FINRA.

The IAA strongly opposes 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 targets small businesses. Because of exemptions in the bill, smaller advisers are singled out for additional regulation and costs. The substantial costs and bureaucracy of an additional, unnecessary layer of SRO regulation and oversight of advisory firms would have a significant adverse impact on small businesses and job creation. Further, the bill would result in inconsistent regulation and regulatory arbitrage.

Supporters indicate that the bill responds to an SEC report mandated by the Dodd-Frank Act studying various options to enhance SEC examinations of investment advisers. If enhancing investment adviser examinations is the objective, however, H.R. 4624 represents both the least effective and the most costly option. H.R. 4624 ventures far beyond the focus on investment adviser examinations to extend an additional layer of unnecessary regulation on advisers. Supporters also claim that the bill would "level the playing field" for brokers and advisers. They do not, however, commend the benefits of FINRA regulation. Rather this is 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 create a dramatically tilted playing field by burdening those investment advisers captured by this bill with additional, unnecessary regulation.

We particularly oppose extending FINRA's jurisdiction to investment advisers due to its lack of transparency and accountability, questionable track record, the costs involved, and its experience and bias favoring the broker-dealer regulatory model.

We support effective and 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-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 recent Boston Consulting Group report, the costs of user fees would be significantly less than the costs of SRO oversight. Further, if an investment adviser SRO were mandated, the resulting new oversight responsibilities would require the SEC to expend significant additional resources.

We look forward to participating fully in the discussion of how best to protect the interests of investors by ensuring effective and efficient oversight of investment advisers. We strongly believe there are better answers than the option presented by H.R. 4624 and look forward to working with the Committee to implement the best solution.

Introduction

The Investment Adviser Association (IAA)[1] greatly appreciates the opportunity to appear before the Committee today to discuss H.R. 4624, the Investment Adviser Oversight Act of 2012.

Investment advisers manage assets for a wide array of individual and institutional investors. Currently, approximately 12,500 investment advisers are registered with the SEC, collectively managing assets totaling about $49 trillion for millions of individual and institutional

[1] The IAA is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937 as the Investment Counsel Association of America, the IAA's membership consists of more than 500 firms that collectively manage in excess of $10 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit our web site: www.investmentadviser.org.

clients.[2] 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 85 percent employ fewer than 50 non-clerical employees. In addition, most of the 15,500 state-registered investment advisers are small businesses.[3] H.R. 4624 would disproportionately affect these small businesses, subjecting them to expansive rulemaking, inspection and enforcement authority by a private regulator.

H.R. 4624 would mandate SRO membership for SEC-registered and state-registered investment advisers, subject to broad exemptions. Specifically, the legislation would exempt an advisory firm if it has a single mutual fund as a client – no matter the fund's size and regardless of other firm characteristics. The legislation would also exempt an advisory firm if 90 percent or more of the firm's assets under management ("AUM") is attributable to "qualified purchasers" (*i.e.*, individuals with $5 million in investments or institutions with $25 million in investments),

[2] These statistics are taken from information investment advisers filed with the SEC as of June 1, 2012. They include data from advisers that indicated they are switching from SEC to state registration pursuant to provisions of the Dodd-Frank Act, as well as data from firms that failed to make their required filing. When those advisers complete their switch to state registration, there will be approximately 10,500 advisers registered with the SEC.

[3] This data is taken from information investment advisers filed with the states as of June 1, 2012. As noted above, it is anticipated that 2,000 additional investment advisers will be registered with the states once smaller advisers complete their switch from SEC to state registration.

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. In addition, investment advisers that are affiliated with these exempt advisory firms would be largely excluded from the SRO membership requirement. The SEC, however, would be 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.

The bill would require 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. The SRO would have authority to enforce the Advisers Act and any SRO rules and to establish disciplinary procedures to do so. The bill would require SRO rules to establish appropriate procedures to "register persons associated with members" and to require "supervisory systems" for members and their associated persons.

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

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

I. The IAA Strongly Opposes H.R. 4624.

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. We believe 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 be established by H.R. 4624 is flawed. It would result in inconsistent regulation of the same or similar activities and encourage regulatory arbitrage. In addition, the SRO model is not cost effective. It would specifically target small businesses for unnecessary costs and burdens, exacerbate the SEC's challenges in allocating its resources, and result in unnecessary expansion of burdensome regulations and bureaucracy. The legislation is 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.

A. The SRO Model Is Flawed.

The self-regulatory organization 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 ("BCG").

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 expressing concern that it will not have sufficient capacity to conduct effective examinations of investment advisers with adequate frequency, and setting 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.[4] The Section 914 Report identifies significant drawbacks to the SRO model, notably including conflicts of interest inherent in self-regulation and the costs and funding involved.

A recent 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 (3) limit transparency and accountability, as the SRO would be accountable primarily to its members rather than to Congress or the public."[5] In addition, the report noted that the SRO model "expose(s) firms to duplicative examinations and costs."[6]

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

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[4] Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011) ("Section 914 Report").

[5] *Private Fund Advisers: Although a Self-Regulatory Organization Could Supplement SEC Oversight, It Would Present Challenges and Trade-Offs*, U.S. Gov't Accountability Office, at 20 (July 2011) ("2011 GAO Report"). 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.

[6] *Id.*

> "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."[7]

The Chamber of Commerce report further observes that SROs are not bound by the congressional appropriations process or other comparable checks on their power.[8]

Moreover, in a study required by Section 967 of the Dodd-Frank Act of the SEC's structure, organization, and need for reforms, 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 "[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," including: "[e]nhance SRO disclosures regarding their regulatory operations; institute metrics to monitor SROs and minimum standards for their regulatory activities; and enhance FINRA oversight."[9]

The BCG Section 967 Report observed that SROs are not accountable to the SEC and that the agency and SROs are not coordinating effectively. The report noted that if the SEC were to be funded adequately, rather than expanding the role of SROs, "there are strong arguments

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[7] *U.S. Capital Markets Competitiveness: The Unfinished Agenda*, U.S. Chamber of Commerce (Jul. 19, 2011) ("Chamber of Commerce Report"), *available at* http://www.uschamber.com/sites/default/files/reports/1107_UnfinishedAgenda_WEB.pdf.

[8] *Id. See also* The Boston Consulting Group, Inc., *U.S. Securities and Exchange Commission Organizational Study and Reform*, at 25 (Mar. 10, 2011) ("BCG Section 967 Report"), *available at* http://www.sec.gov/news/studies/2011/967study.pdf (identifying common critiques of SROs, including lack of accountability).

[9] BCG Section 967 Report, *supra* note 8, at 134. The SEC selected BCG, a well-established consulting firm, to conduct the mandated study.

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."

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.[10]

H.R. 4624 does not adequately address any of these deficiencies in the SRO model. For example, although it would require the SRO to explain and respond to comments received regarding the costs and benefits of a proposed rule, the bill does not require the SRO to affirmatively conduct its own cost-benefit analysis. Further, it would provide no direct remedies for an SRO's failure to adequately do so; interested parties would not be able to bring suit against the SRO to ensure it conducts an appropriate cost-benefit analysis. Presumably, the SEC would be required to determine that the SRO met its obligations to conduct 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 require substantial additional effort and resources.

Similarly, the bill does not address the transparency typically lacking in the SRO model. An SRO designated pursuant to this legislation would not be required to hold open meetings, to respond to Freedom of Information Act requests, or otherwise comply with the APA. Although the bill requires an SRO to submit an annual report, it does not require congressional or SEC oversight of the SRO's budget or governance.[11] Nor does it address concerns regarding due

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[10] *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 agency." 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.

[11] *See also* Section 914 Report, *supra* note 4, at 37 (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);

process protections during disciplinary hearings.[12] The bill references notice-and-comment rulemaking under the APA, but does not clearly apply the APA to an SRO's consideration of its rules and rule changes, nor does it provide direct recourse if APA procedures are not followed. In addition, the SEC's oversight of SRO rulemaking may be largely deferential: the SEC only need find that the rule "is consistent with the requirements of this title, the rules thereunder, and the rules and regulations applicable" to the SRO. Thus, the SEC is not required to pass judgment on the wisdom or merits of the SRO rules.[13]

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

The SRO regime mandated by H.R. 4624 would be 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. 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 "crafting exclusions for certain types of investment advisers could be difficult in practice because, as discussed above, many investment advisers

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see also Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority, U.S. Gov't Accountability Office, at 16 (May 2012) ("2012 GAO Report") (noting that the SEC historically has not overseen FINRA's budget, executive compensation, or governance issues).

[12] Testimony of Paul S. Atkins, Visiting Scholar, American Enterprise Institute and former SEC Commissioner, before the House Committee on Financial Services, at 10 (Sept. 15, 2011) ("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).

[13] *See also* BCG Section 967 Report, *supra* note 8, at 65 (noting limited nature of SEC's review of SRO rules).

have diverse client bases and business lines. Moreover, exclusions could provide opportunities for regulatory arbitrage."[14] These challenges are amply demonstrated by H.R. 4624.

H.R. 4624 evidently attempts to distinguish between "retail" investment advisory firms and "institutional" advisory firms; the former would be subject to SRO requirements, while the latter would remain solely under SEC regulation and oversight. The bill, however, does not appropriately draw these lines.[15] Instead, the legislation's exemptions from SRO requirements will result in inconsistent treatment of investment advisers that are engaged in similar 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 likely be subject to different disclosure, advertising, or supervision rules. One set of advisers would be subject only to SEC or state rules. Another similar or identical set of advisers would be subject to both SEC or state rules and a new set of technical, detailed "business conduct" rules. These disparities are not justified by reasoned analysis.

For example, the bill exempts from SRO membership any investment adviser if one or more of its clients is a mutual fund. This means that two nearly identical firms (types of clients, assets under management, number of employees, investment style, revenues, profitability, *etc.*) will be treated differently if one firm has a single mutual fund client and the other does not. An adviser that manages assets for high net worth individuals[16] and one mutual fund would be subject to a different set of rules than an adviser that manages assets for high net worth clients and one hedge fund or one pension plan.

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[14] Section 914 Report, *supra* note 4, at 35.

[15] There is no settled notion of a "retail" investment advisory firm. For example, an advisory firm may specialize in advising highly wealthy individuals (*e.g.*, with $2-4 million in investable assets) and small or mid-sized businesses, pension plans, or endowments (*e.g.*, with $10-20 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).

[16] Most SEC-registered advisers (more than 60 percent) manage assets for high net worth individuals, according to data filed on Form ADV, Part 1, which defines "high net worth" individual 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.

The 90 percent test in H.R. 4624 produces similarly anomalous results. An advisory firm that manages $150 billion in assets would be exempt from the SRO requirements of H.R. 4624, even though a very large amount of assets (up to $15 billion) could be attributable to thousands of "retail" clients. At the same time, an advisory firm that manages $150 million in assets would be subject to SRO requirements if only $16 million of its assets are attributable to relatively few "retail" clients. Similarly, an adviser that manages assets, 11 percent of which are attributable to "retail" clients will be subject to different rules than an identical adviser that manages assets 9 percent of which are attributable to such clients. Further, an adviser with one client base and investment strategy could be subject to a different set of rules than an adviser with an identical client base and investment strategy simply because it is affiliated with an exempt adviser.

The legislation likely will encourage regulatory arbitrage as firms restructure their businesses and/or dismiss individual and small business clients to avoid the costs and additional regulatory burdens of an SRO. The bill would drive business models and create structural incentives. For example, many investment advisers that would otherwise be subject to SRO regulation may decide to establish or sub-advise a small mutual fund. Similarly, advisers may choose to affiliate with other investment advisers that either advise a mutual fund or manage sufficient "institutional" assets to absorb the adviser within its aggregated 90 percent AUM threshold for exemption from SRO membership. Advisers may also avoid 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 lead to even more advisers remaining under SEC oversight than the bill currently contemplates 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 will still be left under the SEC's oversight. The report observed that if the SEC and an SRO (or multiple SROs) share regulatory authority over advisers, the regime will be vulnerable to regulatory arbitrage.

C. H.R. 4624 Is Not Cost Effective.

Establishing and maintaining a new SRO will impose substantial costs and burdens on investment advisers, with a disproportionate impact on smaller advisers. It will exacerbate rather than ameliorate the SEC's resource constraints. Further, it will create an unnecessary additional layer of regulation on advisers. At a time when small businesses, including advisers, are becoming overwhelmed with new regulatory burdens, this Committee should search for the least costly and most effective alternative to directly address the specific problem identified.

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

H.R. 4624 will disproportionately burden 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 mean that the vast majority of larger advisory firms will not be subject to SRO membership requirements. Instead, thousands of smaller advisory firms will 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."[17] Further, there is no evidence that imposing an SRO on these small firms, which represent a small fraction of the assets managed by advisers, will address the SEC's resource constraints or uncover problems of substantial magnitude.[18]

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[17] Bullard, Mercer. *The New Self-Regulator for Advisors: A Taxing Affair for Small Businesses and Small Investors*, available at www.news.morningstar.com (May 10, 2012) ("Bullard article").

[18] 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* Bullard article, *supra* note 17.

As discussed below, the costs on small business to establish and maintain an SRO will be substantial. In addition, the impact of an additional layer of regulation and bureaucracy on these small firms will 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 are passed on to investors, it will negatively affect retirement savings and investment.[19] If pricing resistance is such that all of the costs cannot be passed on, the costs will 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 Exacerbate, Not Ameliorate, the SEC's Resource Issues.*

H.R. 4624 will not ease the SEC's resource constraints but will instead place 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 observes that an SRO would not free all of the resources the SEC currently devotes to investment adviser examinations: "SEC 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."[20] 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 50 inspection staff who currently focus on

[19] *See, e.g.*, BCG Section 967 Report, *supra* note 8, at 151 (noting potential for SRO costs to be passed on "to investors in a way that makes investing unaffordable for many").

[20] Section 914 Report, *supra* note 4, at 30; *See also* Bullard article, *supra*, note 17.

FINRA and other SRO oversight).[21] Additional substantial SEC expenditures will be required in the future just to oversee effectively the current SROs under its jurisdiction.[22]

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

In addition, this bill would require the SEC to conduct a firm-by-firm analysis of which companies under common control should be subject to SRO jurisdiction and which should remain 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. The analysis of these firms will consume substantial SEC resources, not only initially, but on an ongoing basis as firms affiliate or change their affiliations over time.

SEC Chairman Mary Schapiro recently 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."[23] The addition of oversight

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[21] BCG Section 967 Report, *supra* note 8, at 64; Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011) ("913 Report") at A-15.

[22] BCG Section 967 Report, *supra* note 8, at 39-41.

[23] *Oversight of the U.S. SEC; Hearing before the H. Sub. on Capital Markets and Government Sponsored Enterprises,* 112th Cong. (Apr. 25, 2012) (testimony of Chairman Mary L. Schapiro) ("SEC 2012 Testimony").

duties for an adviser SRO with rulemaking authority will only compound these concerns and further strain SEC resources.

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 Investment 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."[24] 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

[24] Thomas P. Lemke and Gerald T. Lins, *Regulation of Investment Advisers*, at 2:33 (2012); *see also* SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) ("Capital Gains").

and duty of care.[25] Among the specific obligations that flow from an adviser's fiduciary duty are: (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' 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.[26]

In addition, all SEC-registered investment advisers are required to submit detailed registration information (Form ADV, Part 1), which is publicly available, and update it at least annually and promptly for material changes. Advisers are also required to provide clients with a plain English brochure and brochure supplement (Form ADV, Part 2). 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 new Form PF.

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[25] Capital Gains, *supra* note 24.

[26] *See* Amendments to Form ADV, Investment Advisers Act Rel. No. IA-3060, (July 28, 2010); Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Rel. No. IA-1406, n.3 (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 Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Rel. No. IA-1092 (Oct. 16, 1987) (discussing fiduciary duties); *see also* Capital Gains, *supra* note 24.

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.[27] 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 permit – 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

[27] 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 H. Sub. on Capital Markets, Insurance and Government Sponsored Enterprises*, 111th Cong. (Jul. 20, 2010) (testimony of SEC Chairman Mary L. Schapiro) ("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").

"vigorous oversight" by the SEC. 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 were enacted.

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

The legislation appears to have been designed to favor FINRA as the presumptive designated SRO for advisers. The bill is modeled on, and largely replicates, 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.[28] FINRA has clearly indicated its desire to extend its jurisdiction to include oversight and regulation of investment advisers.[29] The IAA strongly opposes extending FINRA's jurisdiction to investment advisers due its lack of adviser expertise, lack of accountability, lack of transparency, excessive costs,[30] and questionable track record.[31]

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[28] *See* FINRA, 2010 Year in Review and Annual Financial Report (June 2011) *available at* http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p123836.pdf ("FINRA 2010 Report").

[29] *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. (Oct. 6, 2009) (oral testimony of Richard Ketchum, Chairman and CEO, FINRA).

[30] *See* FINRA, Report of the Amerivet Demand Committee of the Financial Industry Regulatory Authority, Inc. (Sept. 13, 2010), *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p122217.pdf, at 86 (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 Report, *supra* note 28.

[31] *See, e.g.*, Letter from Project on Government Oversight (POGO) to House Committee on Financial Services Chairman Bachus and Ranking Member Frank opposing Self-Regulation of Investment Advisers (May 29, 2012) *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20120529-finra-investment-advisers.html; Letter from Project on Government Oversight (POGO) to Congress calling for increased oversight of financial self-regulators (Feb. 23, 2010), *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html;*see also* FINRA Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes (Sept. 2009) at 5, *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."); *The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. (Jan. 27, 2009) (testimony of John C. Coffee, Jr., professor at Colum. Univ. Law School) (noting that Madoff's advisory activity

Designation of FINRA as the adviser SRO would raise conflicts of interest with potential adverse competitive implications for advisers.[32] 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.[33] 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."[34]

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.[35] In this regard, it stated that FINRA "merits particular attention given its size and scope." For

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was within the NASD's and FINRA's jurisdiction); *SRO Regulation in the Dodd-Frank Era,* by Stewart D. Aaron, Elissa J. Preheim, and William Miller, Arnold & Porter LLP, published in Law360 (April 11, 2011) ("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 declaration of Bear Stearns' capital adequacy on the very day Bear Stearns collapsed"); Letter from Pickard & Djinis, LLP to Elizabeth M. Murphy, Secretary, SEC (Jan. 2011) ("Pickard & Djinis Section 914 Letter") ("there is no question that the NASD/FINRA had both the authority and the responsibility to investigate Madoff's fraudulent conduct").

[32] *Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform, Hearing Before the S. Comm. on Banking, Housing and Urban Affairs,* 111th Cong. (August 17, 2009) (statement of Prof. Onnig H. Dombalagian, Tulane University) ("[t]he 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").

[33] *See* Letter from Marc Menchel, General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, SEC re: File Number 4-606 Study Regarding Obligations of Brokers, Dealers and Investment Advisers (Aug. 25, 2010). *See also* Letters from NASD to Jonathan G. Katz, Secretary, SEC re: *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Rel. No. 34-50980; File No. S7-25-99 (Feb. 11, 2005 and Apr. 4, 2005).

[34] Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC (Dec. 16, 2010) ("MFA Section 914 Letter") at 10.

[35] BCG Report, *supra* note 8, at 65-67, 237-38.

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.[36]

Further, in a report released last week, the GAO found that neither the SEC nor FINRA has conducted any formal retroactive review of FINRA rules to assess their actual impact after implementation.[37] 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.[38]

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.[39] The 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."[40] 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

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[36] *Id.* at 67.

[37] 2012 GAO Report, *supra* note 11, at 12-15.

[38] *See, e.g.*, Letter from Stephanie M. Dumont, Senior Vice President and Dir. of Capital Markets Policy, FINRA, to Elizabeth M. Murphy, Secretary, SEC re: SR-FINRA-2011-058-Response to Comments, at 7-8 n.27 (Dec. 23, 2011) ("After all, no SRO is required to undertake an economic analysis of its rule proposals . . . . there 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.").

[39] Chamber of Commerce Report, *supra* note 7. *See also* Brief for the CATO Institute as Amicus Curiae, p. 6-7, 9, 11, Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, 637 F.3d 112 (2d Cir. 2011) ("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 FINRA and similarly situated SROs almost entirely unaccountable.").

[40] Chamber of Commerce Report, *supra* note 7, at 23.

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.[41]

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."[42] 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.[43]

II. User Fees Paid by SEC-Registered Advisers Are Preferable to an SRO.

The Committee 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 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.

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[41] *See* Atkins Testimony, *supra* note 12, at 10-11; 2012 GAO Report, *supra* note 11.

[42] CATO Brief, *supra* note 39, at 6-7, 9, 11.

[43] *SEC Accuses Brokers Group of Deception,* The Washington Post (Oct. 28, 2011); SEC Press Rel. 2011-227: *SEC Orders FINRA to Improve Internal Compliance Policies and Procedures* (Oct. 27, 2011), *available at* http://sec.gov/news/press/2011/2011-227.htm.

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."[44]

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.[45]

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

[44] *See SEC's Oversight of the Adviser Industry Bolsters Investor Protection,* Speech by SEC Commissioner Luis A. Aguilar (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").

[45] Section 914 Report, *supra* note 4, at 25.

Comptroller of the Currency.[46] 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.[47] 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.[48] 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 intelligence and expertise critical to the regulatory process.[49] 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.[50] The report observes that "imposing user fees would avoid the difficult scope of

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[46] 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.

[47] *Id.* at 26.

[48] *Id.* at 26-28.

[49] *Id.*

[50] *See, e.g., Statement on Study Enhancing Investment Adviser Examinations,* by Commissioner Elisse B. Walter (Jan. 2011) at 7 (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").

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."[51] 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.[52] Allowing OCIE to charge user fees would empower it to build on the expertise and infrastructure it has already established in examining advisers.[53] Within the SEC, OCIE examination staff benefit from close working relationships with other SEC legal and policy staff.[54] 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.[55] In fact, the SEC staff expressed concern that the SRO oversight may one day be underfunded because there is no certainty that the level of resources available to the Commission over time will provide for effective oversight.[56] 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."[57]

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[51] Section 914 Report, *supra* note 4, at 27.

[52] *See* Section 914 Report, *supra* note 4, at 27; *see also* Letter from David G. Tittsworth, Exec. Dir., IAA, to Elizabeth Murphy, Secretary, SEC, re: SEC Study on Enhancing Investment Adviser Examinations under Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Oct. 19, 2010) ("IAA Section 914 Letter"); MFA Section 914 Letter, *supra* note 34, at 10; *Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence, Before the H. Sub. on Capital Markets and Government Sponsored Enterprises,* 112th Cong. (June 24, 2011) (statement of Paul Schott Stevens, President and CEO, Investment Company Institute).

[53] Section 914 Report, *supra* note 4, at 28, 30.

[54] *Id.* at 28.

[55] *Id.* at 27.

[56] *Id.* at 28.

[57] *Id.*

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. We are not aware of any analysis or empirical data demonstrating that the costs associated with H.R. 4624 would be outweighed by the benefits. 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.[58] 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: (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 average 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 SRO to do so. 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:

[58] The December 2011 BCG economic analysis is appended to this testimony for the record.

1. Creating an SRO for advisers would likely cost at least twice as much as funding an enhanced SEC examination program.

    - 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 $100-110 million per year.

    - 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 $240–270 million per year.

    - In contrast, a FINRA SRO (examination, enforcement, and SEC oversight) is projected to cost $550–610 million per year; and a new SRO is projected to cost $610–670 million per year.

2. The cost savings to the SEC of creating an SRO is likely to be minimal because the SEC would need to spend significant resources ($90–105 million per year) overseeing an SRO.
3. The startup costs of an SRO alone ($200–310 million) could fund an enhanced SEC examination program for an entire year ($240–270 million).
4. 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.

Further, as discussed above, H.R. 4624 is structured such that the substantial costs of establishing an SRO for advisers will be imposed on small businesses rather than being shared across the industry, as assumed in the BCG economic analysis. In other words, the fixed costs of establishing an SRO with rulemaking, examination, and enforcement authority will be assessed on a smaller group of advisers with limited resources. Accordingly, the actual costs that would be incurred by these small businesses will be 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.[59] According to BCG's analysis, FINRA's estimate of the cost to set up, operate, and oversee a self-regulatory organization for investment advisers greatly underestimates the overhead costs and overestimates investment adviser examiner productivity.[60]

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 instead have expressed support for ensuring adequate resources for the SEC.[61] For example, the Managed Funds Association ("MFA") has expressed multiple concerns about an SRO for investment

[59] *See FINRA's Cost Estimates Challenged; Leading Financial Services Organizations Respond to FINRA's Estimates,* IAA press release (May 10, 2012), *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/PressReleases/PressCur/120510prs.pdf.

[60] Specifically, BCG found that: (1) FINRA's estimate omits the cost of SEC oversight of the IA SRO ($90-$100 million) and the cost of enforcement ($60-70 million), both of which are required by H.R. 4624; (2) FINRA's estimate of $12-$15 million in setup costs does not include staff costs incurred during the 12-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-$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 5 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-$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-$155 million of ongoing annual investment. Overhead costs account for $135-$140 million of the difference between the BCG and FINRA estimates. *Id.*

[61] *See, e.g.,* Pickard & Djinis Section 914 Letter (from a law firm with extensive experience representing both advisers and brokers), *supra* note 31, 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 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.").

advisers[62] and its support for ensuring that the Commission has adequate resources, including appropriate user fees.[63] Similarly, the American Institute of Certified Public Accountants ("AICPA") has expressed its strong opposition to an SRO, and FINRA in particular,[64] and instead indicated its support for providing appropriate resources to the SEC, including user fees.[65] 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 fulfill its objectives of protecting investors, maintaining fair, orderly, and efficient markets and facilitating capital formation."[66] The North American Securities Administrators Association ("NASAA") has expressed its strong opposition to outsourcing important government regulatory functions to a third party.[67] Further, the Financial Planning Coalition has noted the many drawbacks to an

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[62] *See* MFA Section 914 Letter, *supra* note 34 ("[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.").

[63] *See* Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC (Sept. 22, 2010), at 5 ("{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.").

[64] *See* Letter from Barry C. Melancon, CPA, President & CEO, AICPA, to Elizabeth M. Murphy, Secretary, SEC (Nov. 24, 2010), at 2 ("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.").

[65] *Id.* at 1-2 ("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 remaiu 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.").

[66] *See* Letter from Mary Richardson, Director of Regulatory & Tax Department, Alternative Investment Management Association to Securities and Exchange Commission (Jan. 12, 2011), at 3.

[67] *See* Letter from David L. Massey, NASAA President and North Carolina Deputy Securities Administrator to Elizabeth M. Murphy, Secretary, SEC (Nov. 22, 2010), at 2-3 ("[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.").

SRO for investment advisers, and to FINRA in particular,[68] and stated its support for continuation of the SEC's regulation and oversight of the advisory profession.[69]

D. The SEC Has 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. We testified last year before this Committee in support of efforts to strengthen the SEC's investment adviser examination program conducted by OCIE.[70] Adequate 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.

Over the last three years, the SEC has focused on revitalizing and restructuring its enforcement and examination functions.[71] The mission of the examination program is to improve compliance, prevent fraud, inform policy, and monitor industry-wide and firm-specific risks.[72] 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

[68] *See* Letter from Kevin R. Keller, Chief Executive Officer, CFP Board, Marvin W. Tuttle, Jr., Executive Director/CEO, FPA, and Ellen Turf, Chief Executive Officer, NAPFA to Elizabeth M. Murphy, Secretary, SEC (Dec. 16, 2010), at 5 ("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)."

[69] *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.").

[70] *Regulation and Oversight of Broker-Dealers and Investment Advisers; Hearing before the H. Sub. on Capital Markets, Insurance and Government Sponsored Enterprises*, 112th Cong. (Sept. 13, 2011) (testimony of David G. Tittsworth, Executive Director, Investment Adviser Association) ("IAA 2011 Testimony"). *See also, e.g.*, Letter from David G. Tittsworth, Exec. Dir., IAA, to The Hon. Mary L. Schapiro, Chairman, SEC re: SEC Exams of Investment Advisers (July 29, 2009), available on our web site under "Comments and Statements."

[71] SEC 2012 Testimony, *supra* note 23.

[72] *Address at the Private Equity International Private Fund Compliance Forum,* Speech by Carlo V. Di Florio, Director of OCIE, SEC (May 2, 2012) ("2012 Di Florio Speech").

practices. The program continually collects and analyzes a wide variety of data about investment advisers using quantitative techniques.[73]

OCIE has continued to refine its examination tools and techniques to better allocate and leverage limited resources to their highest and best use.[74] 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 determining which firms to examine.[75] 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.[76] OCIE has also developed a large firm monitoring program whereby OCIE collaborates with SEC divisions and offices in monitoring risks at certain large firms.[77] Under this new 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 and referrals and surprise custody audits to help determine which advisers to examine and the scope of the exams.[78]

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

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[73] SEC 2012 Testimony, *supra* note 23.

[74] 2012 Di Florio Speech, *supra* note 72.

[75] *Id.; See also Examinations by the Securities and Exchange Commission, Office of Compliance Inspections and Examinations*, (Feb. 2012) ("OCIE Examinations"), *available at* http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[76] 2012 Di Florio Speech, *supra* note 72.

[77] *Id.*

[78] *Id.*

current examiner skill sets and developing an examiner certification program.[79] 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.[80] 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.[81]

In fiscal year 2011, OCIE examined approximately 8 percent of advisers out of the 11,000 or so SEC-registered investment advisers, representing 30 percent of the total assets under management by all SEC-registered investment advisers.[82] While the number of advisers examined can and should be increased, the SEC's breadth in covering 30 percent of investors' assets managed by advisers is substantial.[83] Further, as noted above, OCIE reviews data and information about *all* investment advisers. Both at a national and regional level, the examination staff then cull from the adviser universe the set of advisers with the most "risky" profiles and subject those advisers to in-depth examinations. The SEC will be adding examination staff in fiscal year 2012 to improve the rate of examination of advisers, including those advisers that have not been examined.[84] Even now, however, OCIE conducts outreach to new advisers and

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[79] *Id. See also* Section 914 Report, *supra* note 4, at 15, 28; *The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud, Before the H. Sub. on Oversight and Investigations,*, 111th Cong. (May 13, 2011) (testimony of Robert Khuzami, Dir. of SEC Div. of Enforcement, and Carlo di Florio, Dir. of SEC Office of Compliance Inspections and Examinations); *Budget and Management of the U.S. Securities and Exchange Commission; Hearing before the H. Sub. on Capital Markets, Insurance and Government Sponsored Enterprises*, 112th Cong. (Mar. 10, 2011) (testimony of Carlo di Florio).

[80] 2012 Di Florio Speech, *supra* note 72.

[81] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Rel. No. IA-3145 (Jan. 26, 2011).

[82] SEC 2012 Testimony, *supra* note 23.

[83] 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 4, at 26 n.46. *See also* 156 Cong. Rec. S5920 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd stating 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").

[84] SEC 2012 Testimony, *supra* note 23.

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.

We continue 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 its 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 and urge the Committee to instead consider appropriate user fee legislation.

We appreciate the opportunity to share our views with the Committee. We look forward to working with Congress and the SEC on these important issues.

BCG

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APPENDIX

Investment Adviser Oversight

Economic Analysis of Options

December 2011

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The Boston Consulting Group ("BCG"), a global management consulting firm, was engaged by a group of organizations with Investment Adviser ("IA") stakeholders to conduct an economic analysis of IA oversight scenarios. These scenarios are based on recommended options contained in the Securities and Exchange Commission's ("SEC") study released in January 2011, which was conducted per Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The objective of this report is to establish an economic fact base, informed by publicly available information.

The economic analysis relied upon publicly available research, studies, and reports, as well as more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts. The BCG team involved in this effort was not involved in any prior BCG work for related organizations. Further, the BCG team conducted this analysis independently of any prior related work performed by the firm. The SEC and the Financial Industry Regulatory Authority ("FINRA") were not interviewed or consulted as part of this effort. They did not provide any input, feedback or guidance on the materials or on the analysis contained in this report.

This report does not consider, evaluate, or comment on the benefits of any specific IA oversight scenario, in terms of effectiveness, ease of implementation, or other relevant criteria. This report, any statement made therein, or any statements made by BCG or by any other organization regarding this report, does not constitute a BCG endorsement or recommendation of any of the specific IA oversight scenarios referenced in this report or of any specific approach to IA oversight more generally, and should not be interpreted as such.

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I. Executive summary

As required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Securities and Exchange Commission ("SEC") released a study in January 2011 ("SEC Section 914 Study") that identified three recommended options to Congress regarding examination of SEC-registered Investment Advisers ("IAs"), all of which would require federal legislation before they could be implemented[1]. To inform the discussion on this issue, a group of organizations with IA stakeholders ("Clients") commissioned The Boston Consulting Group ("BCG") to perform an independent and objective economic analysis including an estimate of the level of funding required for each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[2]

BCG profiled and modeled three core scenarios, informed by the first two recommended options in the SEC Section 914 Study. The three core scenarios are:

1. Enhance SEC examination capabilities ("Enhanced SEC"): Achieve an acceptable frequency of IA examinations by hiring additional Office of Compliance Inspections and Examinations ("OCIE") staff, funded by user fees;[3]

2. Authorize a FINRA SRO for IAs ("FINRA-IA SRO"): Authorize the Financial Industry Regulatory Authority ("FINRA"), the self-regulatory organization ("SRO") for Broker-Dealers ("B-Ds"), to develop an IA SRO capability with an IA examination and enforcement mandate,[4] funded by membership fees, and overseen by the SEC; and

3. Authorize a new SRO for IAs ("New-IA SRO"): Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The estimated cost of each of the three core scenarios is summarized in Table 1 below.[5,6,7] The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years:

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[1] The implementation timelines cited in this report are independent of any timelines related to legislative action.
[2] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 and is examined as an additional scenario in Section III.3.3.
[3] Only the cost of examination is funded via user fees, and the SEC would continue to rely on pre-existing sources of funds to support other aspects of its administration of the Investment Advisers Act of 1940 (SEC Section 914 Study, p. 25). However, the estimated costs of enforcement are included in Section III.1.2 for comparative purposes.
[4] SROs typically have rulemaking, examination, and enforcement authority. An enforcement mandate is included along with examination in this analysis, as it is reasonable to assume that an SRO would have authority to discipline its members. Rulemaking is considered separately in section III.3.1 due to possible exclusion from an SRO's mandate.
[5] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[6] Enhanced SEC scenario costs are shown both as incremental OCIE IA costs (i.e., additional IA examiners needed to achieve the target frequency of examinations) and full OCIE costs (i.e., both existing and incremental OCIE IA costs).
[7] Estimates reflect the direct costs of regulatory operations and not the total cost of compliance to IA firms.

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Table 1: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Setup costs	$6–8M (7)	$6–8M (7)	$200–255M (230)	$255–310M (280)
Estimated setup time	6–12 months		12–18 months	18–24 months
Ongoing mandate costs	$100–110M (105)	$240-270M (255)	$460–510M (485)	$515–565M (540)
SEC oversight of an SRO costs	Not required		$90–100M (95)	$95–105M (100)
Total annual costs	**$100–110M (105)**	**$240–270M (255)**	**$550–610M (580)**	**$610–670M (640)**

The estimated costs are described below, and further elaborated on in Section III of the report:

Setup costs[8]

- Setup of the Enhanced SEC scenario involves the hiring of additional IA examination staff, and may be achieved in 6-12 months at an estimated cost of $6-8M.
- Setup of a FINRA-IA SRO may be achieved in 12-18 months at an estimated cost of $200-255M. A FINRA-IA SRO could leverage some existing infrastructure that supports B-D oversight activity (e.g., corporate functions, senior management, and potentially some regional offices).
- Setup of a New-IA SRO may be achieved in 18-24 months at an estimated cost of $255-310M. A New-IA SRO is assumed to have no existing infrastructure to leverage.

Ongoing mandate costs[9]

- Per the SEC Section 914 Study, the ongoing costs of the Enhanced SEC scenario are limited to examination costs and do not include enforcement costs. Estimated ongoing examination costs are $240-270M in total or $100-110M more than the current cost of OCIE's IA examination program.
- Ongoing costs of a FINRA-IA SRO or a New-IA SRO include both examination and enforcement costs and are estimated at $460-510M and $515-565M, respectively. Estimated overhead costs per examiner are higher in these two scenarios than in the Enhanced SEC scenario based on current FINRA overhead costs. The estimated ongoing mandate cost of a FINRA-IA SRO reflects scale benefits not available to a New-IA SRO.

Costs of SEC oversight of an SRO

- Cost of SEC oversight of an SRO (either FINRA-IA SRO or a New-IA SRO) are estimated at $90-105M, and includes oversight of SRO examination and enforcement activities. This activity is not required under the Enhanced SEC scenario.

[8] Estimated setup times are the point at which roughly half of examination staff will be hired and the SRO will begin examination of IAs, based on the reference points cited in Appendix Section IV.4.
[9] Ongoing mandate costs are adjusted to allocate the benefits of scale provided by additional IA personnel to all non-administrative staff across the entire organization to reflect standard accounting practice.

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User fees paid to the SEC and/or membership fees paid to an SRO are assumed to provide the funding source for setup and ongoing mandate costs; no assumption is made regarding the source of funding for the costs of SEC oversight of an SRO. Fees are identified in the SEC Section 914 Study as a potential source of funding. Fees collected during the setup period might be relied upon to fund the setup costs.

The estimated level of funding and associated average fee per IA firm is indicated in Table 2 below.[10] This report does not evaluate the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to setting fees.

Table 2: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated funding required for ongoing mandate costs	$100–110M (105)	$240–270M (255)	$460–510M (485)	$515–565M (540)
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[11]

Beyond the three core scenarios, BCG also examined three additional scenarios:

- Rulemaking mandate for an SRO: If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of an SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC costs for SRO oversight by an estimated ~$10M.[12] Given rulemaking is within the current SEC mandate, this variation is not relevant to the Enhanced SEC scenario.
- Investment Adviser Oversight Act of 2011 draft ("IAO Draft"): If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond estimates in Table 2 under the two SRO scenarios, as ~1,810 currently-registered IA firms (16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (38% of total ADV-reported assets), would be removed from the funding base.[13]

[10] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[11] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[12] An SRO rulemaking organization is assumed to be similar in size to that of the SEC for IA rulemaking today.
[13] This total does not include ~780 additional private investment fund advisers that will be added in 2012, as per the Dodd-Frank Act. This scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Only IA firms with more than $100M AuM are

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- Dual-registered IA / B-Ds (third recommended option of the SEC Section 914 Study): If the IA examination mandate for dual-registered IAs / B-Ds, of which there are ~580, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC, the estimated costs of IA examination are $30M for FINRA and $240M for the SEC. In this scenario, the average annual fee per IA firm is estimated to be $53,900 for firms under the jurisdiction of FINRA, and $27,300 for firms under the jurisdiction of an Enhanced SEC (full OCIE costs). As dually-registered firms are estimated to represent 6% of the IA population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. In this scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

considered in this calculation, as per the Dodd-Frank Act. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison across the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the 4% increase in the core SRO scenarios. See Section III.3.1 for more details.

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II. Context and methodology

II.1 Context

As required by Section 914 of the Dodd-Frank Act, the SEC released a study in January 2011 (the SEC Section 914 Study) that made recommendations to Congress regarding examination of SEC-registered IAs. The SEC Section 914 Study examined the growth in the investment adviser industry over the last six years and the SEC's challenges in maintaining an acceptable level of examination frequency of SEC-registered IAs. The Study determined that the anticipated growth of IAs would outstrip the SEC's resources absent additional funding. The Study recommended consideration of three options to ensure more stable and scalable funding for IA examinations, all of which would require federal legislation before being implemented:

- Impose user fees on IAs (to fund the SEC), set at a level appropriate for achieving an acceptable frequency of IA examinations (by the SEC);
- Authorize one or more SROs to examine all SEC-registered IAs, subject to SEC oversight; or
- Permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 ("Advisers Act").[14]

A group of organizations with IA stakeholders commissioned BCG to perform an independent and objective economic analysis of the recommended options in the SEC Section 914 Study, with a focus on the first two.

II.2 Objectives

The objective of this report is to perform an independent and objective economic analysis including an estimate of the level of funding required under each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[15]

The economics of each scenario reflect:

- Direct Costs incurred to:
  - Setup IA examination infrastructure to achieve an acceptable frequency of examinations under each scenario and includes the costs of moving from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
  - Ongoing IA examination for all scenarios, at an acceptable frequency, and ongoing enforcement in the FINRA-IA SRO and New-IA SRO scenarios and includes the costs of salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
  - SEC oversight of SRO examination and enforcement activities in the FINRA-IA SRO and New-IA SRO scenarios and includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities

[14] See footnote 2.
[15] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 is examined as an additional scenario in Section II.3.3.

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as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).

- Level of funding and potential fees:
  - Level of funding for each scenario is composed of ongoing mandate costs. This report assumes that the funding will be covered by user fees paid by IA firms to the SEC or membership fees paid by IA firms to one or more SROs.
  - Fees paid by IA firms during the setup period might be used to fund setup costs.
  - No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).[16]

II.3 Methodology

BCG conducted an objective and fact-based analysis, drawing on relevant benchmarks and publicly available cost data (current and historical), research, and other studies and reports to estimate the setup costs, ongoing mandate costs, and the costs of SEC oversight of SRO examination and enforcement activity.

BCG validated the analysis with a bottom-up review of the primary cost components. BCG also conducted more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts to identify, corroborate, and better inform relevant assumptions and key sensitivities.

The three core scenarios modeled in this report are characterized along four key dimensions:

- Regulator options: Which regulatory body should oversee IAs?
  - Options: the SEC, a FINRA-IA SRO, or a New-IA SRO
  - In the SRO scenarios, the SEC oversees the SRO.
- Mandate: What mandate should the regulator possess?
  - Options: Examination or examination and enforcement
  - In all scenarios, the study assumes the regulator is authorized to examine and the SEC retains rulemaking authority. In the SRO scenarios, limited rulemaking authority incidental to the execution of examination or enforcement would likely be granted.[17]
  - A scenario whereby the SRO is given a full rulemaking mandate is explored in Section III.3.1.
- Jurisdiction: Which IAs will be required to register with the SEC or an SRO?
  - Default: IA registration requirement as per the Dodd-Frank Act[18]
  - A variation based on the IAO Draft, which exempts a sub-set of IAs from the jurisdiction of an SRO based on the type of assets and investors, is examined in Section III.3.2.

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[16] Fees are just one potential funding source; we focus on fees in this report as the SEC Section 914 Study did so.

[17] The cost of limited rulemaking incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations) is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

[18] Includes IA firms with AuM above $100M plus those below $100M that are registered with the SEC (e.g., IA firms with principal offices in New York or Wyoming; those permitted to register with the SEC because they would otherwise be required to register with 15 or more states). Also includes private investment fund advisers with AuM of $150M or more.

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- Funding: How much funding and what level of fees per IA firm may be required to cover the cost of ongoing examination and enforcement activities?
  - Funding level options: Cover all setup and/or all ongoing mandate costs
  - Fee level: Many approaches to apportioning fees to IA firms are available and will need to be considered. This report estimates the average fee per IA firm for illustrative purposes.

Based on these dimensions, and informed by the first two recommended options described in the SEC Section 914 Study, three core scenarios were defined and modeled in this report. The three core scenarios are:

1. Enhanced SEC: Achieve an acceptable frequency of IA examinations by hiring additional OCIE staff, funded by user fees;[19]

2. FINRA-IA SRO: Authorize FINRA, the SRO for B-Ds, to develop an IA SRO with an IA examination and enforcement mandate,[20] funded by membership fees, and overseen by the SEC; and

3. New-IA SRO: Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years. The analysis focuses on 2012, and does not estimate how the number of IAs and the associated ongoing mandate costs to the SEC or to IAs via user fees or membership fees might change over time.

[19] See footnote 3.
[20] See footnote 4.

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III. Economic analysis

III.1 Cost analysis

This section details the direct setup costs, ongoing mandate costs, and the costs of SEC oversight of an SRO examination and enforcement activity, under each of the three core scenarios.[21] The indirect costs of compliance incurred by IA firms and how indirect costs might vary across the three core scenarios were not estimated or examined.

III.1.1 Assumptions and inputs

The economic analysis reflects the following inputs and assumptions, which are further elaborated upon in Appendix Section IV.2-IV.6:

- Size of the IA population to be examined: 9,440 IAs in 2012
  - Based on the number of IAs in 2011 adjusted for the estimated impact of the Dodd-Frank Act and projected growth from 2011 to 2012.
- Number of examiners required to achieve the target exam frequency: 787 examiners
  - Target exam frequency is once every four years per IA firm on average.
  - Rate of exams per examiner per year is assumed to be 3.0, which is the current average number of IA exams conducted by an SEC examiner per year.
- Setup costs are estimated based on benchmarks identified in recent SEC budget requests and the setup costs of other relevant, similarly located organizations.
- Ongoing mandate costs are estimated based on fully loaded costs per examination and enforcement employee derived from publicly available SEC and FINRA budget data for 2010, adjusted to account for scale and appropriate allocation of any scale benefits.
- Costs of SEC oversight of a SRO examination and enforcement activity are estimated based on current SEC oversight costs for FINRA B-D activity, but reduced by 50% to reflect reduced complexity of SEC oversight of an SRO in an IA context.[22]

[21] See Appendix Section IV.1 for more detail.
[22] See Appendix Section IV.6 for more detail.

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III.1.2 Results of cost analysis

The estimated 2012 costs are detailed in Table 3, below:[23]

Table 3: Estimated range (midpoint)	SEC (existing)	Enhanced SEC (incremental OCIE)	FINRA-IA SRO	New-IA SRO
Setup costs:	-	**$6-8M (10)**	**$200-255M (230)**	**$255-310M (280)**
– Examination	-	7	145 - 185	185 - 225
– *Enforcement*[A]	-	3	55 - 70	70 - 85
Ongoing mandate costs:	**$150M**	**$100-110M (105)**	**$460-510M (485)**	**$515-565M (540)**
– Examination	150	105	355	395
– *Enforcement*[A]	*60*	*40*	130	145
SEC oversight of an SRO:	-	-	**$90-100M (95)**	**$95-105M (100)**
– Examination	-	-	60	65
– *Enforcement*[A]	-	-	35	35
Total annual costs (excl. setup):	**$150M**	**$100-110M (105)**	**$550-610M (580)**	**$610-670M (640)**
– Examination	150	105	415	460
– *Enforcement*[A]	*60*	*40*	165	180

A. Examination and enforcement costs are shown in Table 3 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 3 under the Enhanced SEC scenario, enforcement costs are not included in the totals (Setup costs, Ongoing mandate costs, SEC oversight of SRO costs and Total annual costs), as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

Differences in setup costs across the three core scenarios are driven by the gap between current and required capabilities and capacity, as well as the time required to set up:

- The estimated up-front cost to enhance SEC IA capabilities is $6-8M. Increasing examiner capacity would drive the majority of the estimated setup costs. The SEC already holds the IA examination, enforcement, and rulemaking mandates, and the majority of the effort relates to increasing capacity of existing capabilities. The SEC may be able to set up in 6-12 months.
- FINRA-IA SRO setup costs are estimated at $200-255M. FINRA may be able to set up an IA SRO in 12-18 months. FINRA does not currently oversee IAs and would need to build a new and separate IA examination organization. FINRA may be able to leverage parts of its existing B-D-focused infrastructure (e.g., corporate functions, senior management, some regional offices).
- New-IA SRO setup costs are estimated at $255-310M. A New-IA SRO may be able to set up in 18-24 months. A New-IA SRO would have no existing infrastructure to leverage, instead needing to build, acquire, or outsource all capabilities.

Differences in ongoing mandate costs across the three core scenarios are driven by differing overhead costs and available scale benefits:[24]

- The incremental OCIE examination costs under the Enhanced SEC scenario are estimated at $100-110M, bringing total costs of OCIE examination to $240-270M. Enforcement costs would also likely increase as examination frequency increases.

[23] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[24] See footnote 9.

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Overhead costs on a per-examiner basis under the Enhanced SEC scenario are estimated to be lower than under the SRO scenarios because current SEC overhead costs are lower than FINRA's overhead costs. Scale benefits from the existing SEC organization and infrastructure are estimated, but only a portion of the benefit is attributed to IA examinations, as the benefits would be shared across the SEC organization.

- FINRA-IA SRO ongoing annual examination and enforcement costs are estimated at $460-510M. Estimated overhead costs are lower than in a New-IA SRO scenario due to scale advantages resulting from leveraging FINRA's existing B-D infrastructure.
- New-IA SRO annual ongoing examination and enforcement costs are estimated at $515-565M.

Cost of SEC oversight of an SRO in either SRO scenario are estimated at $90-105M The costs include oversight of SRO examinations, direct examinations of IAs, and both SEC-initiated and SRO-referred enforcement actions as well as appeals from an SRO. Costs of SEC oversight of a FINRA-IA SRO are lower than for a New-IA SRO because the SEC already oversees the FINRA organization, providing some opportunity to share resources and costs that would not be available in the New-IA SRO scenario. SEC oversight is not required under the Enhanced SEC scenario.

III.2 Level of funding and fees

This section describes the estimated level of funding to support the ongoing mandate costs described in the previous section, at the IA industry- and firm-level through user fees paid to the SEC or membership fees paid to one or more SROs.

III.2.1 Assumptions and inputs

The estimated level of funding is driven by the ongoing mandate costs, which includes full OCIE examination costs for the Enhanced SEC scenario, including both baseline and incremental OCIE staff, and all examination and enforcement costs for a FINRA-IA SRO and a New-IA SRO. Setup costs are not included in the estimated level of funding, although fees collected during the setup period might be relied upon to fund the setup costs, similar to the approach used by the Public Company Accounting Oversight Board ("PCAOB").[25] The costs of SEC oversight of an SRO are also not included in the estimated level of funding. The source of funding for SEC oversight of an SRO is not examined in this report.

[25] The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

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III.2.2 Results of funding analysis

The estimated level of funding under the three core scenarios are described in Table 4 below, with both the incremental and full OCIE cost scenarios shown for the Enhanced SEC scenario:[26]

Table 4: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated level of funding (ongoing mandate costs): – Examination – *Enforcement*[A]	$100 – 110M 105 *60*	$240 – 270M 255 *40*	$460 – 510M 355 130	$515 – 565M 395 145
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

A. Examination and enforcement costs are shown in Table 4 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 4 under the Enhanced SEC scenario, enforcement costs are not included in the total "Estimate level of funding (ongoing mandate costs", as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[27]

We estimate the level of funding needed for the FINRA-IA SRO and New-IA SRO scenarios to be 90% and 110% higher than the Enhanced SEC scenario's full OCIE cost scenario, respectively.[28]

[26] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[27] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[28] The difference in funding requirements would increase slightly if rulemaking was included in the SRO's mandate.

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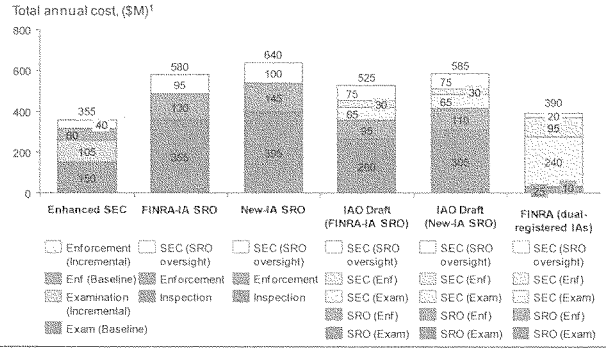
III.3 Other scenarios examined

In addition to the three core scenarios, BCG explored three additional scenarios, the latter two of which are included in Table 5, for comparison against the three core scenarios. For comparison purposes, full rulemaking authority is not included in the IAO Draft and FINRA dual-registered scenarios.

Table 5:



	Enhanced SEC	FINRA-IA SRO	New-IA SRO	IAO Draft (FINRA-IA SRO)	IAO Draft (New-IA SRO)	FINRA (dual-registered IAs)
Estimated level of fee-based funding ($M)	105 / 255[4]	485	540	355	415	240 & 30[3]
Estimated average fee per firm ($)	11,300 / 27,300	51,700	57,400	52,100	60,700	27,300 & 53,900
# of IA firms registered with SEC	9,440	0	0	2,590[2]	2,590[2]	8,860
# of firms registered with SRO	0	9,440	9,440	6,850	6,850	580

Note: Numbers may not add up due to rounding error. 1. Total annual cost is defined as the cost of examination and enforcement mandates as well as any SEC IA-SRO oversight costs. 2. Includes IA firms with >90% AuM attributable to private funds, mutual funds, clients with more than $25M in investments, and other type of IAs as discussed in the draft of "Investment Adviser Oversight Act of 2011". SRO-exempt firms include 1,810 currently registered firms as well as 780 newly register private funds. 3. $240M is funding needed for SEC-registered firms (non-dual reg. IAs) and $30M is funding needed for FINRA-registered firms (dual-reg. IAs). 4. $105M is the funding need to cover the SEC's incremental examination costs. $255M is the funding needed to cover the full examination costs.

III.3.1 Rulemaking mandate for an SRO

If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of the SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC oversight of the SRO costs by ~$10M. Given rulemaking is within the current mandate of the SEC, this variation is not relevant to the Enhanced SEC scenario. Full rulemaking is differentiated from the limited rulemaking that would be incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations), the cost of which is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

III.3.2 IAO Draft

If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond the estimates in Table in Table 4, under the two SRO scenarios, as ~1,810 currently registered IA firms (~16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that will be required to register with the SEC in 2012 as a result of the Dodd-Frank Act. However, those firms are included in the table above for comparative purposes. Only IA firms with more than $100M AuM are considered in this calculation, as per the Dodd-Frank Act. This

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scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison to the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the estimated 4% increase under the core SRO scenarios.

III.3.3 FINRA jurisdiction over dual-registered IA / B-Ds

This additional scenario is the third recommended option of the SEC Section 914 Study, whereby the IA examination mandate for dually-registered IAs / B-Ds, of which there will be an estimated ~580 in 2012, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC.

In this scenario, the estimated costs of IA examination are ~$240M for the SEC and ~$30M for FINRA. The estimated average fee per IA firm is ~$27,300 for IA firms under the jurisdiction of an Enhanced SEC (full OCIE costs), and ~$53,900 for IA firms under FINRA jurisdiction.

As dually-registered firms are estimated to represent 6% of the IA firm population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. Also, under this additional scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

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IV. Appendix

This section describes the methodologies and assumptions used in the analyses described in this report.

IV.1 Description of costs and required level of funding

- Setup costs: Includes the costs of moving the organization from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
- Ongoing mandate costs: Includes the ongoing annual costs of an IA examination program and the associated costs of enforcement. Ongoing mandate costs include salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
- SEC oversight of an SRO costs: Includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).
- Total annual costs: Includes ongoing mandate costs and the costs of SEC oversight of an SRO, and is referred to as total annual costs.
- Level of funding and potential fees: Level of funding for each scenario, is determined by ongoing mandate costs. This report assumes that the ongoing mandate costs will be covered by user fees (to the SEC) or membership fees (to one or more SROs). No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).

IV.2 Estimation of the number of SEC-registered IAs in 2012

The 2011 IA population is 11,529 (IAA/NRS Evolution Revolution report). 3,200 IAs with less than $90M AuM were removed from the population, based on estimates from the SEC Section 914 Study.[29] 750 private fund-oriented IAs with AuM greater than $150M were added to the population, based on the Dodd-Frank Act. Subsequently, an annual growth rate of 4% was applied based on the average 5-year compound annual growth rate (CAGR) for each major IA AuM segment, which results in a projected population of ~9,440 SEC-registered IAs in 2012.[30]

IV.3 Estimation of the number of IA examiners needed to meet a target examination rate

The target examination rate is assumed to be once every four years, on average. The current rate is once every 10-11 years, and the most frequent average examination rate achieved by the SEC in recent history is once every six years (SEC Section 914 Study). The average examiner productivity is assumed to be 3.0 examinations per examiner per year, based on the five year SEC average of 3.0 IA examinations per examiner per year.[31] In order to achieve an average

[29] $90M is used due to a buffer below the $100M threshold specified in the SEC Section 914 Study.
[30] IA firms were segmented by AuM into groups, to which the 5-year historical growth rate was calculated and utilized to project forward from 2011 to 2012, for the AuM segments that will remain in scope.
[31] The SEC examination rate of 3.0 is used because it is the best available reference point for the anticipated productivity level of examiners of IA firms. Examination rate benchmarks from other organizations were analyzed but, in the end, not included due to incomparability of exam populations, targeting methodology, scope, and other reasons.

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examination frequency of once every four years, with examiner productivity of 3.0 examinations per examiner per year, 787 examiners are required.

IV.4 Estimation of the setup costs for each of the three core scenarios

IV.4.1 Enhanced SEC

The cost of adding incremental examination capacity under the Enhanced SEC scenario was estimated at $24,000 – 26,000, and was informed by the following:

- SEC 2012 budget request
- Public information regarding costs of other recent moves to Washington, D.C., by relevant organizations

IV.4.2 New-IA SRO

The setup costs of a New-IA SRO were informed by the following, after adjusting for size and resource requirements:

- PCAOB setup experience, and review of their 2003-2004 budget
  - PCAOB took two years to setup before reaching a steady state of ~240 examiners and 5 offices
  - PCAOB costs of $117M, normalized by adjusting cost items, (e.g., salary/benefits, office space, equipment, IT) for differences in size, scale and time period

- Consumer Financial Protection Bureau (CFPB July 2011 report) setup experience
  - CFPB incurred $60M in costs in its first eight months
  - Full setup costs for the CFPB estimated to be ~$125M, resulting in an organization of ~550 people, or about half of a New-IA SRO, normalized by adjusting cost items based on differences in size and scale

IV.4.3 FINRA-IA SRO

Interviews with subject matter experts suggested that the setup time for a FINRA-IA SRO would be roughly 6 months less than for a New-IA SRO. FINRA's ability to leverage existing physical, technological, and organizational infrastructure, could result in ~20% lower setup costs than for a New-IA SRO.

IV.5 Estimation of ongoing mandate costs

IV.5.1 Estimation of examination costs

Average examiner salary and benefits are estimated to be ~$189K. Overhead expenses per examiner are estimated to be ~$134K, or 27% of total SEC overhead expenses, based on the number of OCIE employees as a percent of total employees. The resulting fully loaded total average cost per employee was estimated to be ~$323K.

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IV.5.2 Estimation of enforcement costs

Interviews with subject matter experts, including former SEC employees, resulted in estimated costs attributable to IAs of 14% of the Division of Enforcement's total costs and ~7% of the Division of Investment Management's total costs. Including overhead, this implies a cost per employee of ~$353K in the Division of Enforcement and ~$363K in the Division of Investment Management.

Applying the ratio of 2.8 IA examiners per IA enforcement full-time equivalent ("FTE") at the SEC provides an estimate of the additional enforcement FTEs required to handle an expected increase in enforcement activity.[32]

IV.5.3 Estimation of costs specific to a FINRA-IA SRO and a New-IA SRO

Costs associated with a FINRA-IA SRO and a New-IA SRO were informed by the following

- Examination and enforcement employee ratios and salary costs at the SEC
- Overhead cost per examiner at the SEC adjusted to reflect higher ratio of professional staff to administrative staff at FINRA than at the SEC
- FINRA's 2010 budget of fees (regulatory and user fees) from B-D examiners.

IV.5.4 Estimation of the impact of scale

A scale factor of 19% was applied to the overhead costs of the Enhanced SEC and FINRA-IA SRO scenarios. The scale factor was derived from BCG benchmarks and analysis of similar organizations that indicates that, as an organization doubles in size, overhead costs increase by 81%. The scale benefits were shared across the entire organization, so that the scale benefits attributed to the IA examination costs under the Enhanced SEC and FINRA-IA SRO were only 12% and 40% of the scale-driven savings, respectively.[33]

The New-IA SRO, starting from a base of zero employees, experiences some scale disadvantage relative to the SEC and FINRA. The scale disadvantages were measured in relation to FINRA's current organization size.

IV.6 Estimation of the costs of SEC oversight of an SRO

SEC oversight of FINRA today was used to estimate the costs of SEC oversight in the SRO scenarios. There are ~380 SEC examiners overseeing roughly 840 FINRA B-D examiners, indicating a ratio of 2.2 FINRA examiners per SEC oversight examiner.[34] IA examinations (and oversight of those examinations) are likely to be less resource-intensive, on average, than B-D examinations, so the ratio of examiners per SEC oversight examiner was adjusted accordingly.[35]

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[32] We assume the ratio holds constant rather than assume changes in productivity or operating procedures related to enforcement.

[33] See footnote 9.

[34] Includes oversight of operations of an SRO by conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee changes (SEC Section 914 Study).

[35] The SEC is expected to conduct primary investigations of IAs at a lower rate/level than is the case of B-Ds for two reasons: the SEC already has experience and familiarity with IA examinations as a result of its current mandate, and IA investigations tend to be less complex than B-D examinations and therefore less likely to warrant direct SEC involvement in the examination. If, in practice, the SEC conducts more

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As such, for a New-IA SRO with 787 examiners, the SEC would need ~178 IA oversight examiners. Assuming similar average costs for these examiners as well as similar ratios for enforcement and rulemaking as stated above, the SEC would incur ~$100M in oversight costs. The costs of overseeing a FINRA-IA SRO are slightly less than for a New-IA SRO, because the SEC already oversees the FINRA organization.

IV.7 Other scenarios examined

IV.7.1 Rulemaking mandate for an SRO

SRO rulemaking cost estimates were informed by

- SEC rulemaking costs and subject matter expert interviews indicating that
  - IA-related rulemaking costs represent ~13% of the costs of the Division of Investment Management and ~14% of the costs of the General Counsel's office
  - Including overhead, per employee costs of ~$363K at the Division of Investment Management and ~$355K at the General Counsel's office
  - SEC IA examiner per IA rule maker ratio of ~15.7
- SRO overhead cost estimates per examiner

Resulting cost estimate for SRO rulemaking is $20M, or ~4% of the estimated ongoing mandate costs. SEC oversight of SRO rulemaking costs are estimated at ~$10M. In the enhanced SEC scenario, it is assumed that rulemaking costs would not change.

IV.7.2 IAO Draft

Under the IAO Draft, certain IAs would be excluded from the requirement to register with an SRO, and instead would be required to register with the SEC. The exclusion applies to all IA firms with 90% or more of their assets under management attributable to one or more of the following client types:

- Registered investment companies;
- Advisers to non-US clients;
- Clients with more than $25,000,000 in investments;
- 3(c)(10) funds (e.g., charitable trusts);
- 3(c)(11) funds (e.g., DB and DC plans);
- Private funds (e.g. hedge funds and private equity funds); and
- Venture capital funds.

An estimated ~1,810 currently registered IA firms (~16% of SEC-registered IAs), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that are required to register with the SEC in 2012 as a result of the Dodd-Frank Act.[36]

The level of funding needed for a FINRA-IA SRO is estimated at ~$435M and for a New-IA SRO at ~$485M. This estimate does not include the costs of rulemaking that is granted to an SRO in the IAO Draft, to enable direct comparison to the three core scenarios. The estimated funding

primary investigations of IAs than assumed in this analysis, then the costs of SEC oversight of an SRO will be higher than the current estimate.

[36] The ~750 private investment fund advisers estimated by the SEC in 2011 plus another 30 from normal annual growth in firm count.

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level is slightly below the estimated funding level in the core SRO scenarios because of the exclusion of the ~1,810 IA firms described above. The resulting estimated average user fee per IA firm is ~$51,810 for a FINRA-IA SRO and ~$58,500 for a New-IA SRO.

While reduction in the IA firm population would reduce the costs of IA examination for an SRO, and estimated average fees per IA firm would not change significantly, the membership fees paid by the remaining IA firms would increase by ~20% if apportioned on a per AuM basis.

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Statement of the Investment Company Institute
Hearing on "H.R. 4624, the Investment Adviser Oversight Act of 2012"

Committee on Financial Services
United States House of Representatives

June 6, 2012

The Investment Company Institute[1] is pleased to provide this written statement in connection with the hearing of the Committee on Financial Services on the oversight of investment advisers.

The fund industry has a significant interest in the subject of oversight of investment advisers. ICI and its members strongly support a vigilant and effective examination program for investment advisers. The trust that over 90 million investors place in registered funds is in no small part due to the rigorous regime under which funds and their advisers operate. We recognize, however, that the capacity limitations of the Securities and Exchange Commission ("SEC") have prevented retail clients from benefitting to the same extent as fund investors from SEC oversight of investment advisers because registered fund complexes tend to have more frequent examinations than smaller advisory firms.[2] This bill is intended to address the differences in oversight and to strengthen the examination program for advisers to retail clients. The bill would authorize the creation of a self-regulatory organization ("SRO") for advisers to retail clients, which was one of the primary options the SEC staff presented in a study last year to enhance adviser examinations as mandated by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[3]

ICI supports the goal of meaningful oversight of all investment advisers. We also understand the need to address the difference between the examination of smaller, retail-facing advisers, which may not be inspected at regular intervals by SEC staff, and fund advisers, which are subject to more frequent and rigorous examinations and SEC oversight.[4] This bill retains the SEC as the primary regulator for

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[1] The Investment Company Institute is the national association of U.S.-registered investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs) (collectively, "regisrered funds"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of registered funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.4 trillion and serve over 90 million shareholders.

[2] *See, e.g.,* United States Securities and Exchange Commission, *2010-2015 Strategic Plan*, at 13, available at http://www.sec.gov/about/secstratplan1015f.pdf (For its performance metrics, the SEC sets the target examination of registered investment companies at 15% each year compared to 9% for registered investment advisers).

[3] Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, *Study on Enhancing Investment Adviser Examinations* (January 2011), available at http://www.sec.gov/news/studies/2011/914srudyfinal.pdf ("914 Study").

[4] *See supra* note 2 and *infra* note 10.

investment advisers to registered funds and their affiliates while authorizing an SRO to provide greater oversight of advisers to retail clients.[5] We believe that preserving the SEC as the primary regulator for advisers to registered funds is critical to avoid depriving fund investors of the benefits of continued and direct oversight of fund advisers by the SEC – the only regulator that can adequately oversee compliance both with the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act"). We provide our views in more detail below.

I. The SEC Must Remain the Primary and Direct Regulator for Investment Advisers to Registered Funds

ICI strongly believes that the SEC must continue to be the primary regulator of investment advisers to registered funds because of the broad oversight the SEC provides to registered funds, their advisers and fund service providers. Because funds generally do not have employees and rely on third party service providers – primarily the fund's investment adviser – to invest fund assets and carry out other business activities, the SEC's continued examination and inspection of fund advisers is essential to provide appropriate oversight of registered funds. Investment advisers to registered funds, in addition to being regulated under the Advisers Act, must ensure funds' compliance with the Investment Company Act and its rules, which – along with a robust body of formal and informal guidance from the SEC staff – create a comprehensive regulatory framework governing all aspects of the registered fund business. In plain terms, the SEC could not provide effective oversight of registered funds without examining the fund adviser, which is the most important service provider to a fund.[6]

Therefore, the provision in the bill preserving the SEC as the primary and direct regulator of advisers to funds is of paramount importance to meaningful oversight of registered funds.[7] The failure to preserve this provision in the bill would result either in the SEC yielding examination authority over fund advisers to an SRO or in the duplication of examination functions by the SEC and the SRO. Neither outcome would serve the interest of funds and their shareholders.

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[5] In prior testimony to Congress, we have expressed concerns with delegation of SEC oversight of all registered investment advisers to one or more SROs. Statement for the Record of Paul Schott Stevens, President and CEO of the Investment Company Institute, Hearing on "Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight," before the Subcomm. on Capital Markets and Government Sponsored Enterprises, United States House of Representatives (Sept. 13, 2011), available at http://www.ici.org/pdf/11_house_fiduciary_stndrd_tmny.pdf.

[6] The SEC staff, in its examinations of registered fund complexes, typically reviews not only the registered funds, but all of their service providers, including advisers, principal underwriters, administrators and transfer agents.

[7] Given the importance of registered funds, we believe it is appropriate that the exemption for advisers to registered funds is provided independently from the exemption for advisers with 90% assets under management attributable to institutional clients. The bill also provides that other institutional advisers that already are subject to substantial SEC regulation, along with their affiliates, remain under SEC oversight. The institutional advisers that would remain subject to SEC examination include those that advise private funds, ERISA plans, collective trust funds, endowments, foundations, non-U.S. clients, and other institutional clients.

A. Requiring SRO Membership Would Weaken or Result in Duplicative Regulation of Fund Advisers

Requiring fund advisers to be members of an SRO could result in the SEC deferring its oversight responsibilities to an SRO, which would detract from the SEC's ability to obtain a complete picture of the fund and its service providers and to assess potential risks. Because funds are operated by their service providers, only looking at the fund and not its adviser would provide the SEC with a very limited picture of the fund's activities and would make it extremely difficult, if not impossible, for the SEC to exercise effectively its regulatory responsibilities. To ensure that the regulatory framework continues to remain robust, the SEC's examination staff and its rulemaking staff must have a close working relationship that facilitates the application of existing rules and the development of new or different ones. The SEC benefits from having its examination staff "on the ground" and reporting back on potential concerns or rulemaking suggestions, while SEC examiners benefit from the guidance of the rulemaking staff and knowledge of its policies and objectives.[8] Imposing another regulator would weaken the oversight of the fund industry, which could have adverse consequences for fund shareholders.

On the other hand, if advisers to registered funds are subject to both SEC and SRO oversight, registered funds and their shareholders would be significantly harmed by the imposition of duplicative examinations that will only result in additional costs without any corresponding benefits. We understand that membership fees for an SRO may be significant based on studies by other organizations.[9] This extra cost would ultimately be borne by fund shareholders. In addition, funds and their advisers could face conflicting regulations by the SEC and the SRO or struggle with regulatory hodgepodge – where the SRO pursues its perceived regulatory mandate without regard to the implications of divergent standards. Managing these regulatory conflicts also will result in compliance costs that would be passed on to fund shareholders.

B. Costs of Duplicative Regulation Cannot be Justified by Any Potential Benefits

The additional costs cannot be justified or outweighed by any potential benefit of imposing an additional regulator on fund advisers. As discussed above, because the SEC's examination of funds would be ineffective without inspections of their advisers, any oversight by an SRO of fund advisers would be inherently duplicative. Given that the bill is intended to address a gap in oversight – the lack of effective oversight of retail advisers – requiring duplicative inspections of fund advisers would not address any perceived supervisory need. Moreover, given that the SEC has allocated its limited resources to examining registered funds in recognition of the importance of funds, there would be little or no benefits to the additional costs that would be imposed by SRO membership. In fact, in fiscal year

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[8] Indeed, Section 965 of the Dodd-Frank Act requires compliance examiners to be placed in the Divisions of Investment Management and Trading and Markets, likely to further facilitate this important relationship.

[9] The Boston Consulting Group, *Investment Adviser Oversight: Economic Analysis of Options* (Dec. 2011) (The study estimates an average cost of over $50,000 per investment adviser for membership in an SRO.)

2011, registered funds were examined by the SEC 62% more often than registered investment advisers.[10]

C. The SEC Has Proven to be an Effective Regulator of Funds and Their Advisers

We strongly encourage Congress, in attempting to provide more effective oversight of smaller advisory firms, not to affect negatively the SEC's comprehensive regulatory framework and oversight of registered funds and their advisers. This robust regime has served fund investors well for many years. While not immune from problems, this regulatory framework has proven to be extraordinarily successful for the last 70 years in safeguarding the interests of investors while allowing the industry to grow, innovate, and be competitive in a global marketplace. Today, the fund industry serves more than 90 million shareholders and has more than $13 trillion in assets, including $4.7 trillion of retirement assets invested in mutual funds.[11] Maintaining the SEC as the primary and direct regulator for fund advisers (regardless of whether these advisers also advise other clients) permits a single regulator to ensure compliance with both the Investment Company Act and the Investment Advisers Act in a consistent and thoughtful manner.[12] This approach ensures the highest level of protection for funds and their shareholders, which must be preserved in light of the size and importance of these funds in helping millions of Americans meet their long-term financial goals.

II. The SEC Must Remain the Primary and Direct Regulator for Investment Advisers Under Common Control with Investment Advisers to Registered Funds

Similarly, the SEC must remain the primary regulator for advisers that are affiliated with fund advisers, an approach which is incorporated into the bill. ICI believes that this approach would ensure consistent regulation of advisers under common control and would avoid inconsistencies that would result if commonly controlled advisers were subject to examination by two different regulators. For example, advisory complexes often have common compliance policies, procedures and personnel and may use one trading desk for all their affiliates' trading activity. Having advisers potentially subject to different interpretations of the adequacy of the procedures or operations of their trading desks, for example, likely would create confusion and the potential for inadvertent compliance violations.

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[10] *See* United States Securities and Exchange Commission, *FY 2011 Performance and Accountability Report*, at 40, available at http://www.sec.gov/about/secpar/secpar2011.pdf#performancesummary (For fiscal year 2011, 13% of the registered investment companies were examined versus 8% of registered investment advisers); 914 Study, *supra* note 2 at 22-23 ("From 1998 to 2003, large mutual fund complexes were examined once every five years. By 2005, these funds were scheduled for examination once every two to three years."); United States Securities and Exchange Commission, *2004-2009 Strategic Plan*, at 32, available at http://www.sec.gov/about/secstratplan0409.pdf ("The SEC will fully implement a risk-based methodology for selecting and setting examination and inspection cycles for investment advisers and funds. Larger or higher risk entities will be examined more frequently to ensure that the agency quickly identifies problems before they affect large pools of savings.").

[11] *See ICI 2012 Investment Company Fact Book*, 52nd Edition, available at http://www.ici.org/pdf/2012_factbook.pdf.

[12] Having an SRO examine the non-fund advisory business of such fund advisers would be inefficient and would raise the same concerns as discussed below with respect to advisers that are affiliated with fund advisers.

* * *

We appreciate the opportunity to share our views with the Committee on enhancing oversight of investment advisers to retail clients, and we look forward to working with Congress in addressing these important issues in a manner that maximizes protections for the millions of American investors who rely on registered funds to achieve their investing goals.

Consumer Federation of America

June 4, 2012

The Honorable Spencer Bachus
Chairman
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Barney Frank
Ranking Member
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Bachus, Ranking Member Frank and Members of the Committee:

I am writing in advance of this week's scheduled hearing on H.R. 4624, "The Investment Adviser Oversight Act of 2012," to share CFA's views on the problem of inadequate investment adviser oversight and potential solutions to that problem. CFA has long been concerned with the lack of adequate funding for investment adviser oversight, a problem that stretches back at least two decades and that we believe poses a significant risk to investors. We are therefore gratified that the Committee has chosen to focus on this long-festering problem, but disappointed that it has chosen to devote this hearing to just one of the several options available to Congress to address the issue.

CFA shares the view expressed by SEC Commissioner Elisse Walter that "the current resource problem is severe, that the problem will only be worse in the future, and that a solution is needed now."[1] For this reason, we are open to considering a variety of approaches, including designation of an investment adviser SRO, to improve regulatory oversight of investment advisers. Because of its serious short-comings, however, we cannot support H.R. 4624 as currently drafted. Moreover, we believe investors will be best served if Congress carefully considers all the available options before jumping to the conclusion that an SRO is the best approach. The goal should be to determine which approach has the potential to deliver the highest quality of oversight at a reasonable cost to the investment adviser community and the investors who will ultimately bear those costs. It does not appear that any such analysis has yet been conducted by this Committee, nor does it appear that this hearing, with its preponderance of broker-dealer industry witnesses, will significantly expand our understanding of the potential impact of this legislation on the investment adviser community it will most directly affect.

As a matter of principle, CFA believes in funding government adequately to fulfill the functions it is mandated to perform. We see no reason why Congress should not adopt that approach in this case, since adequate funding for investment adviser oversight could be provided

[1] Commissioner Elisse B. Walter, "Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act)," January 2011.

either through the normal appropriations process or through special user fees at no additional cost to taxpayers and without adding to the deficit. Moreover, representatives of the investment adviser community have indicated their willingness to pay user fees to fund more robust SEC oversight. Nonetheless, we are realists. Having advocated both of these funding approaches for over two decades without results, we are prepared to consider an SRO as a meaningful improvement over the status quo if that SRO is appropriately designed. After all, one of the advantages of an SRO is that it is not subject to the vagaries of the congressional appropriations process.

Unfortunately, as currently drafted, H.R. 4624 does not meet the standard of an appropriately designed SRO. Its central problem is the numerous exemptions it provides for various groups of investment advisers. As you are doubtless aware, essentially all broker-dealers who deal with the public are required to be members of the Financial Industry Regulatory Authority (FINRA). As a result, the costs of that regulatory oversight can be spread equitably across firms both large and small. In contrast, H.R. 4624 provides an exemption from SRO membership for any investment adviser that manages a mutual fund, even if the adviser also has an extensive retail client base, as well as any adviser for whom 90 percent of their assets under management are attributable to charitable funds, hedge funds, retirement plans, mortgage pools, investment advisers and broker-dealers, and individuals with at least $5 million in investments.[2] One result is that the largest advisers, and those with the wealthiest client base, will continue to receive direct SEC oversight at no additional cost, while the smaller advisers with less wealthy clients will be subject to a new added expense for regulatory oversight. Without the ability to spread a portion of those costs to larger, wealthier firms, the costs for small firms could be considerable.

Because so many advisers would continue to be subject to direct SEC oversight under this bill – including those advisers with the large, complex, high-risk operations that are most difficult to oversee and who manage the vast majority of assets – it is not even clear whether this legislation would solve the basic SEC resource problem it is intended to address. Before we can answer that question with any degree of confidence, we would need to know how many advisory firms would remain under direct SEC jurisdiction and understand the characteristics of those firms in order to be able to determine what inspection frequency the agency would likely be able to maintain at its expected funding level. It is not at all clear that, without a funding increase, the Commission would be able to achieve the once-every-four-years inspection schedule that the bill authors appear to view as minimally acceptable.[3] Moreover, both the Boston Consulting Group study commissioned to examine SEC operations[4] and a recent GAO study examining SEC's oversight of FINRA[5] have concluded that the SEC needs to do a better job of overseeing the

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[2] Ironically, had it been in place, this latter provision almost certainly would have exempted Madoff from registration in an SRO that is being promoted as a solution to the regulatory failure that allowed his fraud to go undetected for so long.

[3] Advisers registered in states that maintain a plan for routine inspections once every four years would be exempt from routine SRO inspections under the bill, though not from SRO membership. (It is not clear what the result would be under this bill if a state maintained a plan for a four-year inspection cycle but did not achieve that goal.)

[4] Boston Consulting Group, "U.S. Securities and Exchange Commission Organizational Study and Reform," March 10, 2011.

[5] U.S. Government Accountability Office, "Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority," (GAO-12-625), May 2012.

SROs that operate under its supervision. Designating an SRO for investment advisers could be expected to increase the challenges the Commission faces in this area and could require that additional agency resources be devoted to this task. The legislation does nothing to address this issue.

Another argument that has been made in favor of designating an SRO for investment advisers is that it would harmonize regulatory oversight for brokers and advisers. The argument goes that investors who cannot distinguish between brokers and investment advisers are no more likely to understand the differences in regulatory oversight that apply to these two classes of financial professional than they are to understand that different legal standards apply to the advice they offer. But this legislation does even less to achieve that goal of harmonization than it does to solve the resource problem. Because of the bill's expansive exemptions, many advisers with an extensive retail client base would likely escape regulation by the SRO. Thus, the same disparity that currently exists with regard to oversight of brokers and investment advisers would be perpetuated between one class of retail advisers and another under this bill. This would likely be even more confusing for investors than the current system. The only way to truly harmonize regulatory oversight, if that is your goal, is to ensure at a minimum that any investment adviser with more than a de minimis number of retail clients be subject to oversight by the SRO.

While we applaud the Committee for focusing on the issue of investment adviser oversight, this legislation is not the answer. Rather than moving forward with a bill that clearly fails to solve the issues it is intended to address, we urge the Committee to conduct an objective review of the available alternatives in order to arrive at an approach that increases the quality of oversight at a reasonable, and equitably shared, cost to the investment adviser community and their clients. We look forward to working with the Committee to achieve that goal.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

STATEMENT OF

THE FINANCIAL PLANNING COALITION

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

ON

THE INVESTMENT ADVISER OVERSIGHT ACT OF 2012

June 6, 2012

Mr. Chairman, Ranking Member Frank, and Members of the Committee, thank you for the opportunity to submit this statement as part of the record for the Financial Services Committee hearing on June 6, 2012, concerning H.R. 4624, the Investment Adviser Oversight Act of 2012. We appreciate the opportunity to share our views on the most-pressing issues regarding the regulation of broker-dealers and investment advisers.

The Financial Planning Coalition (the Coalition),[1] is comprised of Certified Financial Planner Board of Standards, Inc. (CFP Board), the Financial Planning Association® (FPA®), and the National Association of Personal Financial Advisors (NAPFA). The three organizations represent over 75,000 financial planning professionals in the United States. The Coalition provides the financial planning profession with a strong, unified voice in advancing the recognition and regulation of the financial planning profession, and advocating for enhanced consumer financial protection. Most financial planners are registered as investment adviser representatives of a registered investment adviser firm.

I. Executive Summary

The Coalition respectfully opposes the Investment Adviser Oversight Act of 2012 (hereinafter "H.R. 4624"). The Coalition agrees that the status quo, in which the U.S. Securities and Exchange Commission ("SEC") is able to examine only approximately 8% of SEC-registered investment advisers annually, is bad both for investors and for investment advisers. However, the Coalition believes the creation of a mandatory self-regulatory organization ("SRO") for investment advisers as proposed in the H.R. 4624 is the wrong solution for this problem. H.R. 4624 would create a new, permanent bureaucracy which would cost at least twice as much as increased SEC examinations – a cost that would be borne disproportionately by retail investors and the mid- and small-sized investment advisory firms who serve them. The specific SRO proposed in H.R. 4624, which could exempt up to half the registered investment advisers, will not achieve its stated policy goals of increasing examinations for all investment advisers and will

[1] CFP Board is a non-profit organization that acts in the public interest by fostering professional standards in personal financial planning through setting and enforcing education, examination, experience, and ethics standards for financial planner professionals who hold the CFP® certification. CFP Board's mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for personal financial planning. CFP Board currently oversees more than 66,000 CFP® professionals who agree, on a voluntary basis, to comply with our competency and ethical standards and subject themselves to the disciplinary oversight of CFP Board under a fiduciary standard of care. For more information on CFP Board, visit www.cfp.net.

FPA® is the leadership and advocacy organization connecting those who provide, support, and benefit from professional financial planning. FPA demonstrates and supports a professional commitment to education and a client-centered financial planning process. Based in Denver, Colo., FPA has close to 100 chapters throughout the country representing more than 23,000 members involved in all facets of providing financial planning services. Working in alliance with academic leaders, legislative and regulatory bodies, financial services firms, and consumer interest organizations, FPA is the community that fosters the value of financial planning and advances the financial planning profession. For more information on FPA®, visit www.fpanet.org.

Since 1983, NAPFA has provided fee-only financial planners across the country with some of the strictest guidelines possible for professional competency, comprehensive financial planning, and fee-only compensation. With more than 2,400 members across the country, NAPFA has become the leading professional association in the United States dedicated to the advancement of fee-only comprehensive financial planning. For more information on NAPFA, visit www.napfa.org.

result in many more problems that it purports to resolve. The long history of the SRO regulatory model has demonstrated its limitations in protecting investors. This includes FINRA, the organization most likely to be recognized as the SRO for investment advisers should H.R. 4624 become law.

The Coalition supports the obvious, simple and much less expensive alternative, which is to enhance the SEC's existing oversight program so that it can examine all SEC-registered investment advisers at least once every four years. Other than simply raising transaction fees, granting the SEC authority to assess user fees on all SEC-registered investment advisers is a more direct and effective solution to fund a more robust examination program. The Coalition would support a reasonable user fee as a better alternative than a new SRO. The fees could be more quickly, directly and effectively put to use leveraging the existing SEC examination program, rather than building a whole new organization.

II. The Coalition Agrees that Investment Advisers Must Be Examined Regularly

The Coalition agrees that all SEC-registered investment advisers should be regularly examined for compliance with the federal securities laws. In FY 2011, the SEC reported that it examined only approximately 8 percent of the investment advisers registered with the SEC. This percentage was down from approximately 9 percent in FY 2010. Because the large majority of SEC examinations of investment advisers are "cause" exams (triggered by a customer complaint or other suggestion of a potential problem), or "sweep" exams (industry-wide exams on a particular issue), it is possible for an SEC-registered investment adviser to go as long as fifteen years or longer without a regular or "cycle" examination. While the Dodd-Frank Act made adjustments to the number and type of investment advisers subject to SEC oversight,[2] the SEC's investment adviser examination workload will not substantially decrease.

For the past 70 years, investment advisers, because of the strong fiduciary duty standard to which they are held, and because of a business model that limits potential conflicts of interest, have been one of the segments of the securities industry least likely to violate the federal securities laws and rules. However, the Coalition strongly believes that the current level of examinations of SEC-registered investment advisers is insufficient. Investors are better protected if there are a sufficient number of "cops on the beat," and examinations less than once every ten years are simply insufficient to protect investors and maintain investor confidence in the integrity of the investment advisory profession. Just as increased confidence in federal review of securities offerings and federal registration of securities professionals helped pull the United States out of the Great Depression, the Coalition believes that enhanced examination of investment advisers will have a positive impact not only for investors, but for the investment advisory profession itself. In the current budget environment, we understand that any such increase in regulatory expenditures must be paid for, and investment advisers would rather pay reasonable user fees to the SEC than to fund a new SRO to achieve this objective. The question is not whether

[2] Congress reallocated responsibility for mid-sized investment advisers (those with between $25 million and $100 million in assets under management) from the SEC to the states. However, Congress also gave the SEC new responsibility for investment advisers to hedge funds and private equity funds, which were previously exempt from registration. Although the private funds advisers now subject to SEC registration are fewer in number than the mid-sized advisers now subject to state registration, their operations are more complex to examine.

investment advisers should be subject to regular examinations; the only question is how to achieve that objective most effectively and efficiently.

III. H.R. 4624 Would Not Achieve its Intended Policy Goals and Would Create Significant Problems

H.R. 4624 is not the right solution for the narrow problem of increasing investment adviser examinations, and it would create many more problems than it purports to resolve. As discussed in more detail below, H.R. 4624 would not resolve the issue of inadequate SEC resources or achieve an acceptable level of examinations for all advisers. At the same time the legislation would create an entirely new bureaucracy, where a structure already exists that would cost twice as much as funding an enhanced examination program at the SEC. It would single out small business owners by imposing fees and regulatory burdens on mid- and small-sized advisory firms that are not imposed on large firms. It would impose increased layers of regulation and cost on state registered investment advisers. Finally, it would discourage investment advisers from serving retail clients. In sum, H.R. 4624 would create significant investor protection issues in its efforts to resolve a simple resource gap at the SEC.

A. H.R. 4624 Would Not Solve the Policy Problems It is Intended to Address

H.R. 4624 would not solve the problem that it is intended to address: the lack of sufficient SEC resources to examine investment advisers and the need for increased examinations for all investment advisers. H.R. 4624 would exempt the largest and best-funded investment advisers: those which advise mutual funds, and those for which 90 percent of their assets under management consist of assets managed on behalf of "qualified investors" (individuals with $5 million or more in assets), institutional customers or private equity and hedge funds. Because of these broad exemptions for these larger investment advisers, the SEC would remain exclusively responsible for a large number of investment advisers, with an even larger percentage of the profession's total assets under management.

H.R. 4624 would therefore leave the SEC with the responsibility for continued oversight of the largest advisory firms, but it would do little to address the SEC's existing resource problem. The SEC, with its existing level of resources, would still lack sufficient resources to increase examinations of those firms that would remain under their direct oversight authority to an acceptable level. Starting with the SEC's current 8 percent annual examination rate, and even assuming that the SEC theoretically could double that annual examination rate to 16 percent with its continued responsibility for the largest advisers under H.R. 4624, the result would be an average examination cycle of less than once every six years. Yet, this examination rate does not take into consideration that the SEC-only investment advisers are larger and more complex to examine; nor does it account for the additional resources the SEC will have to devote to examining the new SRO. A study conducted by the Boston Consulting Group estimated that it would cost the SEC $90 to $105 million to oversee an investment adviser SRO.[3] The new

[3] See Investment Adviser Oversight Economic Analysis, December 2011, Study by the Boston Consulting Group, Appendix 1 at p. 5 and at http://www.cfp.net/downloads/BCG_Investment_Adviser_Oversight_Economic_Analysis.pdf (hereinafter referred to as "BCG Economic Analysis").

oversight responsibility by itself would require roughly two-thirds of the SEC's current investment adviser examination budget of $150 million.[4] Very simply, H.R. 4624 leaves the SEC with examination responsibility for the largest advisory firms without additional resources to examine these firms every four years[5] and with the additional unfunded responsibility to oversee a new SRO.

Such a result would be perverse from a public policy perspective. Under H.R. 4624, smaller investment advisers subject to the new SRO would be examined once every four years. But the larger SEC-only investment advisers, who manage far more assets and affect the lives of far more investors, would be examined at a far lower frequency. A risk-based policy would suggest the opposite approach. The new SRO would not have addressed the only significant national regulatory problems involving investment advisers in the past decade - market timing and late trading at mutual funds, and insider trading at hedge funds - because both of those problems occurred at investment advisers who would be exempt from the new SRO. Moreover the new SRO would not have helped expose the Bernard Madoff Ponzi scheme because Mr. Madoff's firm would likely have been exempt from the SRO under H.R. 4624.[6] Congress should design a system that would examine larger and more complex investment advisers, who affect the lives of more investors and pose a greater risk to the financial system at least as often as mid- to small-sized firms.

B. H.R. 4624 Would Create an Unnecessary and Costly New Bureaucracy

As discussed in more detail in Part VI below, there is already an experienced, capable organization that examines investment advisers – the SEC's own investment adviser examination staff, within the SEC's Office of Compliance Inspections and Examinations (OCIE). Rather than providing the existing organization with the resources it needs to keep pace with the growth of investment advisers and holding it accountable to do the job, H.R. 4624 would create an entirely new and duplicative bureaucracy to examine investment advisers. Just calling this new bureaucracy an SRO does not change the fact that it would be a new, federally-imposed mandate.[7]

According to an independent and objective economic analysis conducted by the Boston Consulting Group ("BCG"), this new federally imposed mandate would be at least twice as expensive as simply expanding the existing SEC OCIE investment adviser examination program. (The full BCG Economic Analysis is attached in Appendix 1.)[8] BCG, a global management

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[4] See BCG Economic Analysis Table 3, p. 12, for existing SEC examination costs.

[5] A four-year examination cycle is used as an appropriate frequency based on the provision in H.R. 4624 that would require the SRO to examine state registered investment advisers in states that do not have a four-year examination program in place.

[6] Because it relied almost exclusively on investments from private "feeder funds," "qualified purchasers" (investors with over $5 million in assets) and foreign investors, it likely would have been exempt under the 90 percent test in Section 2(b)(2) of the bill.

[7] Indeed, under the applicable precedent, it is clear that because membership in the new SRO would be mandatory for the affected investment advisers, the new SRO would be considered a government agency. *See Free Enterprise Fund v. PCAOB*, 561 U.S. __, 130 S. Ct. 3138 (2010) (holding that PCAOB is a government agency); *Lebron v. National Passenger Railroad Corp.*, 513 U.S. 374 (1995) (holding that Amtrak is a government agency).

[8] BCG is a recognized expert in the analysis of securities regulatory organizations. The SEC chose BCG to conduct the review of the SEC's own operations mandated by Section 967 of the Dodd-Frank Act. SeeU.S.

consulting firm, conducted an economic analysis of options to increase investment adviser examinations recommended to Congress by the SEC in a study required under Section 914 of the Dodd-Frank Act (hereinafter "Section 914 Study").[9] BCG was engaged by a group of organizations with investment adviser stakeholders to help inform the discussion on investment adviser regulatory oversight.[10]

BCG modeled three core scenarios informed by the Section 914 Study: (1) Enhanced SEC (i.e., the costs associated with an increased level of SEC examinations) (2) FINRA-IA SRO (i.e., the costs associated with FINRA developing an IA SRO with an examination and enforcement mandate); and (3) New-IA SRO (i.e., the costs associated with creation of an entirely new SRO with an examination and enforcement mandate). The cost analysis was based on the assumption that investment advisers would be examined on average once every four years. BCG relied on publicly available data, research, studies and reports as well as in-depth interviews with investment advisory firms and former regulatory officials, among others. The SEC and FINRA did not sponsor the study and were not asked to participate in it.

The analysis, which estimated the total annual costs for each scenario by calculating setup costs, ongoing mandate costs and SEC oversight costs, where applicable, is summarized in Table 1 below.

Securities and Exchange Commission Organizational Study and Reform (March 10, 2011) (available at http://www.sec.gov/news/studies/2011/967study.pdf).

[9] See SEC Division of Investment Management, Study on Enhancing Investment Adviser Examinations (January 2011) (available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf).

[10] The Certified Financial Planner Board of Standards, Inc., Financial Planning Association, Investment Adviser Association, National Association of Personal Financial Advisors and TD Ameritrade Institutional commissioned BCG to conduct an independent and objective analysis of the recommended options in the Section 914 Study.

Table 1: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Setup costs	$6 – 8M (7)	$6 – 8M (7)	$200 – 255M (230)	$255 – 310M (280)
Estimated setup time	6 – 12 months		12 – 18 months	18 – 24 months
Ongoing mandate costs	$100 – 110M (105)	$240 - 270M (255)	$460 – 510M (485)	$515 – 565M (540)
SEC oversight of an SRO costs	Not required		$90 – 100M (95)	$95 – 105M (100)
Total annual costs	**$100 – 110M (105)**	**$240 – 270M (255)**	**$550 – 610M (580)**	**$610 – 670M (640)**

Among other things, the findings of the economic analysis show that:

- Creating an SRO for investment advisers would likely be twice as expensive as funding an enhanced SEC examination program. A FINRA SRO would cost an estimated $550 - $610 million per year. In comparison, the incremental annual cost of the SEC hiring the additional examiners necessary to examine advisory firms once every four years would be $100 - $110 million and the total annual costs of an enhanced SEC examination program (the current examination program plus the incremental cost) would be $240 - $270 million.

- The cost of overseeing a FINRA-IA SRO alone is $90 - $100 million. This is roughly the same cost as providing the SEC with the incremental resources it needs to increase its examination of all investment advisers to an average of once every four years, which is $100 - $110 million.

The BCG study also looked at what investment advisers would have to pay to fund each scenario. Table 2 shows the average annual fee that an investment advisory firm would be required to pay.

Table 2: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated funding required for ongoing mandate costs	$100 – 110M (105)	$240 – 270M (255)	$460 – 510M (485)	$515 – 565M (540)
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

As indicated in Table 2, investment advisory firms would be required to pay membership fees to support an SRO that would be roughly twice the cost of user fees to the SEC for increased examinations. The average annual fee per investment advisory firm is projected to be $27,300 if the SEC retains oversight and fees were assessed on the full cost of the examination program. This is compared to $51,700 for a FINRA-IA SRO and $57,400 for a new SRO.[11]

BCG's estimated SRO membership fee per firm was based on spreading the fixed costs of establishing and operating an SRO on all investment advisory firms. As discussed above, H.R. 4624 could remove from the SRO funding base a substantial number of the largest firms. As discussed in more detail below, this would require the fixed costs of operating the SRO to be borne exclusively by the mid and small advisory firms, thereby increasing their potential membership fees beyond those estimated by BCG.

FINRA responded to BCG's cost analysis with a one-and-one-half page document that estimated their costs for an investment adviser SRO at significantly less than those estimated by BCG.[12] In contrast to BCG's comprehensive 21-page economic analysis, which detailed all the assumptions underlying the data and the publicly available sources for the data, FINRA's cost estimates lack clear assumptions, backup data and details of their analysis.

BCG conducted a review of the FINRA cost estimates at the request of the original sponsors of the study, which is contained in Appendix 2.[13] The review identifies fundamental differences

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[11] See BCG Economic Analysis, Appendix 1, p. 6. BCG simply determined the average fee per investment advisory firm. It did not attempt to develop a mechanism to apportion fees to reflect firm size (e.g., assets under management, revenue, number of clients), firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.

[12] See "Investment Estimate for FINRA IA SRO" (available at http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p126542.pdf.)

[13] See "FINRA's Cost Estimates Challenged" released by Certified Financial Planner Board of Standards, Inc., Financial Planning Association, Investment Adviser Association, National Association of Personal Financial Advisors and TD Ameritrade Institutional, May 10, 2012 with attached Boston Consulting Group Review of FINRA's Cost Estimates ("BCG FINRA Review") and Comparison Chart: FINRA Investment Estimate and

between the BCG and FINRA cost estimates related to set up costs, ongoing operation costs and oversight costs that account, in part, for the significantly lower FINRA estimates. A Comparison Chart in Appendix 2 highlights some key differences between the FINRA and BCG estimates:

- FINRA's cost estimates do not accurately capture the full setup costs involved in establishing a FINRA SRO. FINRA admits that its $12 - $15 million estimate to start up an SRO only contains technology, training and governance costs, but omits staffing costs incurred during the start up. In contrast, BCG's set up costs (at $180 - $230 million) include staffing costs.[14]

- FINRA's cost estimates do not accurately reflect ongoing operation costs. For example, FINRA's cost estimates are based on an investment adviser examiner productivity rate that has not been achieved either by the SEC or by FINRA in its current examinations. FINRA's estimate for examining 14,500 investment advisory firms once every four years with 900 staff suggests a productivity factor that may be as high as 5.5 examinations per examiner per year. This is nearly double the productivity rate of current SEC investment adviser examiners, which is 3.0, and FINRA's current broker-dealer examiner productivity rate of 2.8 examinations per examiner per year.[15] In contrast, the BCG analysis assumed an IA examiner productivity of 3.0, equal to the SEC's current rate for examining investment advisers.

- FINRA's cost estimate omits the cost related to SEC oversight of the SRO – a cost that must be included to assess the full annual cost of the SRO option. BCG estimates that these costs will be $90-$100 million annually.[16]

The cost estimates released by FINRA, which are significantly lower that BCG's fully documented cost estimates, suggest an intent to heavily subsidize the new IA SRO with its current broker-dealer SRO and heavily draw upon its current broker-dealer examiners, managers and executives in its operation of the new IA SRO. Leveraging of existing resources beyond the 19 percent that BCG estimated for purposes of its study gives advisers pause about the extent to which a FINRA-created IA SRO would be able to operate independently of its broker-dealer SRO.

Until FINRA provides Congress with the backup to its one and one-half page cost estimate – with a full articulation of its assumptions and supporting data, it will not be possible to fully account for all the differences between the comprehensive BCG analysis and the FINRA estimates. In the meantime, Congress must evaluate which estimates it finds more reliable – estimates derived from an independent, objective, transparent and fully supported analysis by a respected international consulting firm or a one and one-half page cost estimate that lacks backup assumptions and supporting data.

Analysis by the Boston Consulting Group ("Comparison Chart") (also available at http://www.CFP.net/downloads/BCG_Response_to_FINRA_Estimate.pdf).

[14] See Appendix 2, BCG FINRA Review at p. 0 and Comparison Chart

[15] See Appendix 2, BCG FINRA Review at p. 1 and Comparison Chart.

[16] See Appendix 2, BCG FINRA Review at p. 2 and Comparison Chart.

In sum, the Coalition believes that that the independent economic analysis conducted by BCG is the most reliable cost analysis available and should be considered by Congress in evaluating the merits of establishing a new SRO to oversee investment advisers. We strongly urge Congress to reject the option, which would be at least twice as expensive to investment advisers and ultimately the clients they serve, as simply expanding the existing SEC OCIE investment adviser examination program.

C. H.R. 4624 Would Single Out Smaller Investment Advisers, Imposing Higher Fees and Regulatory Burdens

Moreover, H.R. 4624 would impose these new and unnecessary fees disproportionately on smaller, retail-oriented investment advisers and their clients. The legislation would exempt the largest and best-funded investment advisers: those which advise mutual funds, and those for which 90 percent of their assets under management consist of assets managed on behalf of high net worth and institutional customers or private equity and hedge funds. These larger investment advisers would not pay membership fees to fund the new SRO and would not face the costs of being regulated and examined by the new SRO. All of the costs and burdens of the new SRO would be borne by smaller, retail-oriented investment advisers, including the mid-sized investment advisers which the Dodd-Frank Act moved to state jurisdiction. Of course, many of these smaller, retail-oriented investment advisers would have to pass the costs of the new SRO on to their clients.

In short, H.R. 4624 would impose fees and compliance burdens solely upon smaller businesses, while exempting larger investment advisers. It is smaller businesses that create the most jobs, and are responsible for the most innovation, in the American economy. And it is the smaller, retail-oriented investment advisers that are able to provide quality investment and financial advice for an affordable cost to the middle-income clients whom large, institutionally-oriented firms traditionally do not serve. Raising the costs and regulatory burdens exclusively on the smaller and less profitable investment advisers will make it more difficult for them to compete with the large institutional firms; it will also raise the cost of those smaller firms' services to middle-income clients with the result that some middle-income clients could lose access to high-quality financial and investment advice altogether.[17]

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[17] The Massachusetts Securities Division surveyed state-registered investment advisers in that state. Of the respondents, 69% characterized the financial impact of an investment advisers SRO on their businesses as "severe" (9 on a scale of 1 to 9) and 41% of the respondents volunteered that they were concerned that they would be forced out of business altogether. *See* Staff of the Massachusetts Securities Division, Report on the Potential Impact of the Investment Adviser Oversight Act of 2012 on Small Advisers (May 31, 2012) (available at http://www.sec.state.ma.us/sct/sctpdf/Report_on_IA_Impact.pdf).

D. H.R. 4624 Would Put the Heaviest Burdens on Small and Mid-Sized State Registered Investment Advisers and Their Retail Clients

H.R. 4624 would put state-registered investment advisers at a particular disadvantage. As discussed above, the Dodd-Frank Act moved the oversight of mid-sized investment advisers, those with from $25 million to $100 million in assets under management, from the SEC to their respective states. This shift recognizes that most investment advisers of this size have a predominantly local practice, and are best regulated by a state securities regulator closest to their business and their clients.

H.R. 4624 would disrupt this recent policy decision made by Congress by placing state-registered investment advisers, who are under the authority of their state government, under the additional control of a new federal SRO over which the states have no control or authority. The legislation would require all state-registered investment advisers to be a member of the new SRO and pay a membership fee to the SRO. In all states, the state-registered investment advisers would be subject to the regulations of and disciplinary proceedings of the new SRO, in addition to being subject to the regulations and disciplinary proceedings of their state securities regulator. In some states (those who have not "adopted a plan to conduct an on-site examination of . . . investment advisers on average at least once every four years") the state-registered investment advisers would be subject to both state and SRO examinations.[18]

Moreover, FINRA (the likely investment adviser SRO) has consistently refused to coordinate its activities with state securities regulators, to avoid being deemed a "state actor" subject to due process and other constitutional protections. As a result, state-regulated investment advisers will be subject to duplicative and potentially inconsistent regulation. Once again, the overall result of the H.R. 4624 would be to subject smaller businesses, who serve the smaller customers in need of high quality financial and investment advice to the highest levels of fees and regulatory burdens, while exempting their larger, national competitors from any additional costs or burdens. These additional costs and burdens will have to be absorbed by the small advisers or be borne by their predominantly retail clients.

E. H.R. 4624 Would Discourage Investment Advisers From Serving Retail Clients

H.R. 4624 would create incentives for investment advisers to reject or offload retail clients. Investment advisers with a predominantly retail client base would be subject to the new SRO's membership fees, regulations, examinations and disciplinary proceedings. Meanwhile, all investment advisers to investment companies, and all investment advisers whose asset base is more than 90 percent institutional clients, would be exempt from the SRO, including the

[18] NASAA indicates that in 2010, 89 percent of states examined state-registered investment advisers on a cycle of every six years or less, or in other words more frequently than the SEC would be able to examine the larger, more complex SEC-only investment advisers that would remain its responsibility under H.R. 4624. NASAA estimates that after the March 2012 shift in responsibility for mid-sized advisers, more than half the states will examine their state-registered investment advisers more frequently than every four years. Written Testimony of John Morgan, Securities Commissioner of Texas, on behalf of the North American Securities Administrators, Inc. before the House Financial Services Committee, H.R. 4624, The Investment Adviser Oversight Act of 2012 (June 6, 2012).

membership fees, rules, and more frequent examinations imposed by the new SRO. This structure would create strong incentives for predominantly institutional investment advisers to reject or off- load retail accounts, so they can stay above the 90 percent institutional threshold.[19]

Institutional investment advisers also would have an incentive to steer retail clients toward non-discretionary advisory accounts with periodic rebalancing, which do not count as "assets under management," even though discretionary accounts might be more appropriate for those clients. Similarly, the structure would encourage predominantly institutional investment advisers to steer retail clients toward hedge funds, because investments in hedge funds count as "institutional," even if individual managed accounts might be more appropriate for those clients. Finally, H.R 4624 would create incentives for investment advisers to create small, high-expense mutual funds for their clients, because any adviser who advises even a single mutual fund is exempt from the new SRO, even if the majority of that adviser's assets under management are from individual retail clients.

All of these incentives to evade SRO oversight unnecessarily create potential conflicts of interest for investment advisers that do not otherwise exist if all advisers remain under direct SEC oversight. Rather than protect investors, H.R. 4624 would discourage many investment advisers from serving the retail clients who are most in need of sound, un-conflicted investment advice and would create conflicts of interest for investment advisers in their delivery of advice to investors.

IV. An SRO Model Is Not the Solution for Regulation of Investment Advisers

An SRO is not the appropriate solution for regulation of investment advisers.[20] Unlike broker-dealers, which have had SEC regulated SROs since the 1930s, the investment advisory profession has been directly regulated by the SEC for more than 70 years. When the SEC recommended to Congress that it adopt what became the Advisers Act, it made a conscious and informed decision that an SRO model—which the SEC and Congress had relied on only the year before for over-the-counter broker-dealers—would not be as effective for investment advisers.

A. Broker-Dealer SROs Have an Uneven Track Record

The self-regulatory membership model has demonstrated uneven effectiveness in regulating the broker-dealer industry over the years. These are exemplified in a series of major failures in SRO oversight, at least once every decade since the creation of broker-dealer SROs. These SRO failures include: the conviction of New York Stock Exchange (NYSE) President Richard

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[19] *See* Bullard, The New Self-Regulator for Advisors: A Taxing Affair for Small Businesses and Small Investors, Morningstar.com (May 30, 2012) (available at http://news.morningstar.com/articlenet/HtmlTemplate/PrintArticle.htm?time=113738971).

[20] A properly governed SRO may have a place in the U.S. securities regulatory scheme. For example, during the legislative process on the Dodd-Frank bill, the Coalition advocated that Congress establish federal regulation of financial planners by allowing the SEC to recognize a financial planner oversight board that would set professional standards for, and oversee the activities of, individual financial planners. This oversight board would be distinctly different from the existing broker-dealer SROs, including FINRA, and would be more closely aligned with the PCAOB model. In addition, unlike the SRO proposed in H.R. 4624, there is no existing regulatory structure in place to oversee financial planners.

Whitney for embezzlement in the 1930s;[21] the collapse of regulation at the American Stock Exchange (as detailed in the SEC's 1963 Special Study of the Securities Markets);[22] the failure of broker-dealer SROs to prevent the paperwork crisis of the late 1960s; Nasdaq's failure to prevent price-fixing among market-makers (including NASD's inexplicable defense of such practices at first);[23] and the collusion among the options exchanges to prevent multiple listings in the 1990s;[24] the failure of the NYSE and regional exchanges to prevent off-floor trading by floor brokers[25] and trading ahead by specialists[26] early in the last decade; and the failure by the NASD and Nasdaq to detect wash sales that benefitted those SROs in terms of market data revenues.[27] In 2010, the SEC sanctioned the former Chair of the American Stock Exchange for failing to enforce the federal securities laws and rules and the rules of exchange.[28] Last fall the SEC sanctioned FINRA, finding that for the third time in eight years, it had provided altered or misleading documents to the SEC.[29]

These repeated problems, together with the conversion of many SROs to for-profit, shareholder-owned status, led the SEC to issue a Concept Release on SRO governance in 2004.[30] As the SEC recognized at that time, while SROs can be effective, they have inherent conflicts of interest that need to be addressed by carefully designed governance mechanisms. However, the SEC has not yet acted on the issues in that Concept Release by adopting rules to address proper SRO governance and oversight. The SEC organizational study mandated by Section 967 of the Dodd-Frank Act concluded that the SEC still inadequately oversees SROs, lacks standards to evaluate their effectiveness, and in particular needs a more tailored oversight process for FINRA.[31] As discussed below, H.R. 4624 does not address the issues identified in the SEC's Concept Release or the Section 967 Study; nor does it address the fundamental conflicts of interest that result in a track record of uneven investor protection.[32]

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[21] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 156–79 (Aspen Pub. 3rd ed. 2003).

[22] *See id.* at 281–86.

[23] *See* In the Matter of National Association of Securities Dealers, Inc.; Exchange Act Release No. 37,538, August 8, 1996; Administrative Proceeding File No. 3-9056 ("21(a) Administrative Order"); Report and Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market (August 8, 1996) and Exchange Act Release No. 37,538 (August 8, 1996) ("21(a) Report").

[24] *See* Exchange Act Release No. 43,268 (September 11, 2000) ("Options Settlement").

[25] New York Stock Exchange, Inc., Exchange Act Release No. 41,574 (June 29, 1999).

[26] New York Stock Exchange, Inc., Exchange Act Release No. 51,524 (Apr. 12, 2005).

[27] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act") Regarding The Nasdaq Stock Market, Inc. ("Nasdaq"), as Overseen By Its Parent, The National Association of Securities Dealers, Inc. ("NASD"), Exchange Act Release No. 51,163 (Feb. 9, 2003).

[28] Salvatore Sodano, Exchange Act Release No. 61,562 (Feb. 22, 2010).

[29] *See* Financial Industry Regulatory Authority, Inc., Exchange Act Rel. No. 65,643 (Oct. 27, 2011).

[30] *See* Exchange Act Release No. 50,700 (Nov. 18, 2004).

[31] *See* U.S. Securities and Exchange Commission Organizational Study and Reform (March 10, 2011) (available at http://www.sec.gov/news/studies/2011/967study.pdf).

[32] For similar reasons, in a study mandated by Section 416 of the Dodd-Frank Act, the GAO concluded that creation of an SRO for private fund advisers likely would fragment regulation, leading to regulatory gaps, duplication and inconsistencies. GAO, Private Fund Advisers: Although a Self-Regulatory Organization Could Supplement SEC Oversight, It Would Present Challenges and Trade-Offs (July 2011) (available at http://www.gao.gov/products/GAO-11-623).

C. The SRO in H.R. 4624 Lacks Important Administrative and Constitutional Protections for Investors and Investment Advisers

The SRO created by H.R. 4624 would not be required to be a transparent body. The proposed new SRO would not be subject to the Freedom of Information Act (FOIA), the Government in the Sunshine Act, or other open government laws. This lack of transparency will make it more difficult for either investors or investment advisers to have confidence in the new SRO. Although H.R. 4624 contains a provision that would require rulemaking to be conducted according to the Administrative Procedure Act, it appears that this provision applies to the SEC's adoption of rules concerning the SRO, but not to the SRO's own rule-making process. Despite the clear holding of the U.S. Supreme Court just two years ago in *Free Enterprise Fund v. PCAOB*, 561 U.S. __, 130 S. Ct. 3138 (2010), H.R. 4624 does not allow the Commissioners of the SEC, who are politically accountable because they are nominated by the President and confirmed by the Senate, any input into the selection of the board of the new SRO.[33] As a result, the new SRO would be constitutionally suspect from day one.

Moreover, the new SRO is not required to provide its member firms and their associated persons with basic constitutional protections, such as due process rights. FINRA, the most likely candidate for the role of the new SRO, has consistently taken the position that it is not required to provide such constitutional rights to its members.[34] While the SEC has approval authority over the SRO's fees, there are no clear limits or restrictions on the structure or amount of fees, potentially creating an unrestrained financial burden on the mid to small investment advisory firms who are required to join the new SRO. Unlike the Public Company Accounting Oversight Board (PCAOB), the SEC would not oversee or approve the annual budget of the new SRO, which would leave Congress with essentially no authority over the SRO's budget or activities. All of these shortcomings reduce the confidence that investors, as well as investment advisers themselves, will have in an SRO.

D. SROs Often Have Not Been Effective at Detecting Fraud

Moreover, SROs have not been effective at detecting fraud. Although the SEC examination process has sometimes failed to detect ongoing frauds, including the Bernie Madoff and Allen Stanford Ponzi schemes, the same is true for SROs. Madoff conducted his scheme for over twenty years while operating a registered broker-dealer, subject to SRO oversight.[35] Indeed, Nasdaq, an SRO which was at the time an affiliate of the predecessor to FINRA, selected Bernie Madoff as its chairman during the middle of his Ponzi scheme.[36] The Allen Stanford Ponzi scheme was, in the U.S., entirely conducted through a registered broker-dealer that was a

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[33] The Investment Adviser Oversight Act would allow the SEC to remove board members of the new SRO (although only for cause after a lengthy administrative proceeding), but not to appoint the new members.

[34] *See* Frank P. Quattrone, Exchange Act Release No. 53547 (Mar. 24, 2006).

[35] Bernard L. Madoff Investment Securities LLC did not register with the SEC as an investment adviser until 2006; the Ponzi scheme unraveled in 2008.

[36] Last year, the SEC also brought an enforcement action against Alfred Berkeley, the former Vice-Chair and President of Nasdaq, for activities after he left Nasdaq. *See* Pipeline Trading Systems LLC, Exchange Act Release No. 65,609 (Oct. 24, 2011).

member of FINRA and its predecessors.[37] FINRA and its predecessor did not uncover Mr. Stanford's Ponzi scheme despite multiple customer arbitrations alleging fraud, anonymous tips about the Ponzi scheme and FINRA's own for-cause examinations of Stanford's U.S. broker-dealer that sold the fraudulent certificates of deposit.[38] Nothing in the Madoff or Stanford frauds suggests that SROs are more effective at detecting fraud than is the SEC - even with broker-dealer where SROs have the most experience. Moreover, as noted above, the particular SRO proposed in H.R. 4624 would likely not have helped expose the Bernard Madoff Ponzi scheme since Mr. Madoff's firm would likely have been exempt from the SRO because it relied on high net-worth investors and feeder funds. In sum, it is not clear that an SRO will substantially enhance investor protection, certainly not to a degree that warrants changing 70 years of adviser oversight at a significant cost.

V. A FINRA-IA SRO Raises Additional Investor Protection Problems

The Coalition does not support FINRA's goal to become the SRO for investment advisers. FINRA is already the only national securities association, as defined in the Securities Exchange Act of 1934, which is recognized by the SEC, and under Section 15(b)(8) of that Act. All broker-dealers who do business with the public must become members of FINRA.[39] Although FINRA has discussed specific governance and advisory structures that it would put in place to oversee advisers, the Coalition has serious concerns about the ability of FINRA to create a completely independent SRO for investment advisers. FINRA - an organization resulting from the 2007 merger of the former National Association of Securities Dealers (NASD) and the regulatory arm of the NYSE, is at its core a membership organization for broker-dealers, not investment advisers. The senior executives and industry members of the board of governors at FINRA have backgrounds in the brokerage industry. We question whether a governance structure that is affiliated with FINRA would allow for the type of truly independent governance that will be critical to ensuring oversight that is not subject to conflicts of interest.

Moreover, FINRA's experience is with a rules-based approach designed for the broker-dealer world. FINRA is responsible for oversight of salespeople, sales practices, products, and financial/operational concerns, as well as market integrity, under the Securities Exchange Act of 1934 (and to a limited degree, the Securities Act of 1933). FINRA lacks experience examining or enforcing the Investment Advisers Act.[40] Nor does FINRA have any experience in broad-based financial planning beyond the securities products offered by broker-dealers. More generally, FINRA lacks experience in interpreting and applying concepts of fiduciary duty and enforcing a principles-based fiduciary standard of care. This knowledge and experience is essential for the effective oversight of investment advisers.

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[37] *See* Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes (Sept. 2009) (available at http://www.madcowprod.com/wp-content/uploads/2012/03/FINRA.pdf).

[38] Id.

[39] Section 15(b)(8) has a limited exception from FINRA membership for exchange floor brokers, specialists and proprietary traders, all of whom only transact on the floor of the exchange. In other words, any broker-dealer who does business with members of the public must be a FINRA member.

[40] FINRA does have some experience reviewing mutual fund advertising and marketing materials under the Investment Company Act of 1940 - but advisers to investment companies are specifically excluded from the jurisdiction of the new IA SRO.

As discussed above, only last fall the SEC sanctioned FINRA, for the third time in eight years, for providing altered or misleading documents to the SEC.[41] Within the ten years before the formation of FINRA, both of its predecessor firms (the NASD and NYSE) had major scandals involving lack of oversight of key market participants (market-makers and specialists, respectively).[42] FINRA has been enmeshed in litigation with its own members over the accuracy of the information it provided to those members at the time of the NASD-NYSE Regulation merger.[43] FINRA has been widely criticized for its executive compensation practices, which more closely resemble those of large investment banks than of government regulatory organizations (a cost that would have to be borne by the investment advisers it would oversee).[44] FINRA has also been criticized for the lack of transparency in the process by which it nominates and elects members of its board of governors and other key advisory and oversight functions.[45] As the Government Accountability Office (GAO) recently noted, FINRA has no program to conduct a retrospective review of its rules to determine if they are still effective or warranted.[46] FINRA has taken the position that it *cannot* coordinate many of its activities with the SEC or state securities regulators, for fear that it will deemed a "state actor" and will have to give its member firms and their associated persons constitutional protections.[47] Our skepticism about FINRA is increased by its cost estimates for setting up and operating an investment adviser SRO. To achieve the suggested cost efficiencies would apparently require a substantial level of cross-subsidization from its broker-dealer SRO operations.[48]

Concerns about FINRA oversight are reflected in a survey of investment advisers conducted by BCG in conjunction with its economic analysis of investment adviser oversight options. In November 2011, BCG administered an online survey of investment advisers across the country.[49]

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[41] *See* Financial Industry Regulatory Authority, Inc., Exchange Act Release No. 65,643 (Oct. 27, 2011).

[42] *See* In the Matter of National Association of Securities Dealers, Inc.; Exchange Act Release No. 37,538, August 8, 1996; Administrative Proceeding File No. 3-9056 ("21(a) Administrative Order"); Report and Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market (August 8, 1996) and Exchange Act Release No. 37,538 (August 8, 1996) ("21(a) Report"); New York Stock Exchange, Inc., Exchange Act Release No. 41,574 (June 29, 1999); New York Stock Exchange, Inc., Exchange Act Release No. 51,524 (Apr. 12, 2005).

[43] *See* Standard Investment Chartered, Inc. v. National Association of Securities Dealers, Inc., et al., No. 07-2014, and Benchmark Financial Services, Inc. v. Financial Industry Regulatory Authority, Inc., et al., No. 08-11193, S.D.N.Y.).

[44] *See* Aulden Burcher, FINRA Executive Compensation Challenged by Member Firms, RegBlog (Aug. 15, 2011) (reporting on Amerivet Securities case filed against FINRA seeking inspection of FINRA's books and records to support excessive compensation claim) (available at http://www.law.upenn.edu/blogs/ regblog/2011/08/finra-executive-compensation-challenged-by-member-firms.html).

[45] *See, e.g.,* David Sobel, The FINRA Election Process, The SIPA.com (Oct. 30, 2009) (available at http://www.thesipa.com/blog/2009/10/30/finra-election-process/).

[46] *See* GAO, Opportunities Exist to Improve SEC's Oversight of Financial Industry Regulatory Authority, Inc., GAO-12-625 (May 2012) (available at http://www.gao.gov/products/GAO-12-625). The GAO also found that the SEC had never attempted to examine FINRA's executive compensation practices, corporate governance or cooperation with state securities regulators.

[47] *See, e.g.,* Frank P. Quattrone, Exchange Act Release No. 53547 (Mar. 24, 2006), among many other cases.

[48] *See* Section III.A above.

[49] See Investment Adviser Oversight, Survey of Investment Adviser Preferences, November 2011, ("BCG IA Preference Survey") in Appendix 3 (and available at http://www.cfp.net/downloads/BCG_Investment_Adviser_Oversight_Adviser_Preferences.pdf)

The results, which reflect the views of 424 respondents (who held decision making positions within their firms), provide a statistically significant representative sample of investment advisers throughout the country.

Respondents were asked their preferences between the SEC and a FINRA-IA SRO as the inspection/examination body for their firm. They were asked to assume that both would examine their firm once every four years. They were also provided with a base case annual user fee they would have to pay the SEC and membership fee they would have to pay a FINRA-IA SRO, which were based on BCG's economic analysis.

Respondents expressed an overwhelming preference for SEC oversight over a FINRA-IA SRO. 81 percent of the respondents stated that they would prefer to pay user fees to the SEC for increased examinations than pay membership fees to a FINRA-IA SRO. The preference for SEC oversight remained strong even under scenarios in which the user fees for the SEC exceeded the membership fees for a FINRA-IA SRO.[50] BCG isolated the data for the dually registered broker-dealers and investment advisers, whose broker-dealer firms were currently subject to FINRA oversight. 61 percent of the dually registered broker-dealer/investment adviser respondents expressed a preference for the SEC over a FINRA-IA SRO. When asked further whether they would prefer a FINRA-IA SRO or a new IA SRO, 50 percent of the dually registered broker-dealer firms, currently subject to FINRA, would prefer a new IA SRO.

These data reinforce the Coalition's view that FINRA is not the appropriate choice to serve as the SRO for the investment advisers. For all the reasons discussed above, a FINRA-IA SRO raises significant concerns for the investors as well as the investment advisers.

VI. Enabling the SEC to Examine All Investment Advisers is the Best Investor Protection Solution

The Coalition strongly believes the SEC is the appropriate national regulator of investment advisers. Leveraging the SEC's existing infrastructure, expertise and experience is the most effective and efficient way to enhance examinations of investment advisers.

A. SEC Oversight Will Provide Effective Investor Protection

The SEC, which has overseen investment advisers for over 70 years, has a substantial, professional, and experienced staff of investment adviser examiners already in place. The SEC staff is already fully conversant with the Advisers Act and the rules, case law, guidance and legal precedent that have developed in the Act's 70-year history. SEC examiners are located in each of the SEC's regional offices and at its headquarters. This examination staff works closely with the SEC's Division of Investment Management, which has primary responsibility for issuing regulations concerning investment advisers, and the SEC's Division of Enforcement, which has a dedicated asset management unit that focuses on investigations of investment advisers. The fact that all three groups are located within the SEC makes each of them more effective than if the

[50] Among those who preferred the SEC, 68 percent would continue to choose the SEC if their user fees were 1.5 times higher than FINRA's fees and 58 percent would continue to chose the SEC if their user fees were 2 times higher than FINRA's fees.

examination function were moved to a separate SRO.[51] Most importantly, the SEC has extensive experience in enforcing the obligations of investment advisers to provide services to investors under a fiduciary – client-first – standard of conduct.

In addition, providing the SEC with the resources needed to enhance its examination program will ensure that all advisers will be examined once every four years and will ensure that all advisers share equally in the cost of oversight. As discussed above, the SRO proposed in H.R. 4624 would allow the broad institutional investment advisers to be exempt from the SRO, but would not provide the SEC with sufficient resources to conduct regular examinations of the SEC-only investment advisers.

B. SEC Oversight Is the Most Cost Effective Solution to Increase Adviser Examinations

As discussed in Part III.B above, providing the SEC with the resources it needs to increase investment adviser examinations is the most cost effective solution. As the BCG economic analysis shows, creating an SRO for investment advisers would likely be twice as expensive as funding an enhanced SEC examination program. In comparison, the incremental annual cost of the SEC hiring the additional examiners necessary to examine investment advisory firms once every four years would be only 18 percent the cost of a creating a FINRA-IA SRO, and the total annual costs of an enhanced SEC examination program would be 44 percent of the creating a FINRA-IA SRO.[52] As noted above, the annual cost required for the SEC just to oversee a IA SRO ($90 - $100 million) is roughly the same cost as providing the SEC with the incremental resources it needs ($100 - $110 million) to increase its examination of all investment advisers to an average of once every four years.

Moreover, the SEC can more quickly leverage its existing investment adviser examination staff, which is already fully conversant with all of the legal and regulatory issues, to ramp up its capacity to increase examinations. The BCG study determined that the SEC could hire the additional examination staff in 6 – 12 months at a cost of $6 - $8 million. In contrast, BCG estimated that a FINRA-IA SRO would take 12 – 18 months to set up at a cost of $200 - $250 million. Starting an SRO from scratch would be much less efficient and more time-consuming than leveraging existing SEC resources. And because FINRA has committed that it would separate the proposed investment adviser SRO function from the broker-dealer SRO function, there would be little if any synergy between the two.

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[51] Just as FINRA has been reluctant to coordinate its work with the states for fear of being deemed a "state actor", it has been reluctant to coordinate with the SEC. If investment adviser regulation is split between the SEC and an SRO, the necessary result will be a lack of coordination and lack of effectiveness. See Testimony of Steven D. Irwin, Pennsylvania Securities Commissioner and Chairman, Federal Legislation Committee, NASAA, Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight (Sept. 13, 2011) (discussing "state actor" issue) (available at http://www.nasaa.org/5587/ ensuring-appropriate-regulatory-oversight-of-broker-dealers-and-legislative-proposals-to-improve-investment-adviser-oversight/); see also Written Testimony of John Morgan, Securities Commissioner of Texas, on behalf of the North American Securities Administrators, Inc. before the House Financial Services Committee, H.R. 4624, The Investment Adviser Oversight Act of 2012 (June 6, 2012).

[52] See BCG Economic Analysis at 5.

C. SEC Oversight Will Retain Clear Delineation Between Federal and State Oversight of Investment Advisers

Similarly, the SEC has a clearly delineated boundary between its responsibilities and those of the state securities regulators, who (as of March 30, 2012) are responsible for mid-sized investment advisers. No such clear delineation would exist between the new SRO and the state securities regulators, and this confusion would create additional possibilities for lack of coordination and lack of effectiveness. We do not believe there is sufficient reason for a change in the policy of direct federal regulation, combined with state regulation over small and mid-sized firms, that has largely been effective for such an extended period of time in favor of a costly outsourcing of investment adviser oversight to a new SRO.

D. The Coalition Supports a Reasonable User Fee as a Better Alternative to an Investment Adviser SRO.

The Coalition strongly urges Congress to provide the SEC with the resources needed to enhance its current direct oversight of SEC-registered investment advisers and create a robust and effective examination and enforcement program for those investment advisers. Allowing the SEC to fund its investment adviser examination function through fees assessed on all SEC registered investment advisers is a way to provide the SEC with the resources needed to increase investment adviser examination with no impact on taxpayers and no impact on the federal deficit.

Unlike the SRO proposed in H.R, 4624, authorizing the SEC to assess user fees to increase examinations will actually achieve the targeted policy goals – it will allow the SEC to increase examinations for all investment advisers – large and small and it will do so in a way that distributes the cost equitably on all advisory firms. Moreover it would allow Congress to hold the SEC accountable for achieving these investor protection goals. Because the SEC would continue to be subject to an annual authorization and appropriations process, Congress would retain full annual oversight of the SEC's use of all of its resources - in contrast to a new SRO, which would not be subject to the authorization and appropriation process, and over which Congress would have much more limited oversight. Moreover, authorizing the SEC to collect user fees is supported by adviser community. As the BCG IA Preference Survey showed, 81 percent of investment advisers would prefer to pay user fees to the SEC than to pay membership fees to a FINRA-IA SRO.

As an alternative to an SRO, the Coalition would support the assessment of an appropriate user fee on investment advisers to be used only to fund additional adviser examinations above the current level. In authorizing the SEC to assess user fees, we urge Congress to put in place proper administrative safeguards and Congressional oversight, including requirements that the fees be established through a formal SEC rulemaking process, that the fees can only be used for increased adviser examinations, that the fees be reviewed and adjusted on a regular basis.

VII. Conclusion

Some have argued that authorizing the SEC to collect user fees is not a politically viable option. We would encourage Members of Congress to consider seriously what is *not* viable about a solution that:

- would address the SEC's lack of resources with no impact on taxpayers or the federal deficit,
- would increase examinations for all investment advisers to an acceptable level to protect investors,
- would be the most cost-effective and efficient solution,
- would not require establishing a whole new regulatory bureaucracy,
- would treat large, mid-sized and small investment advisers consistently,
- would be supported by investment advisers who have stated a strong preference for paying user fees to the SEC as an alternative to a FINRA-IA SRO, and
- would allow Congress to retain direct oversight and accountability over the SEC.

The Coalition urges Congress to reject the SRO approach in H.R. 4624 and put in place a solution that will work to truly protect investors.

STATEMENT OF

THE FINANCIAL PLANNING COALITION

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

ON

THE INVESTMENT ADVISER OVERSIGHT ACT OF 2012

APPENDICES

APPENDIX 1: INVESTMENT ADVISER OVERSIGHT, ECONOMIC ANALYSIS OF OPTIONS

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June 6, 2012

APPENDIX 1

INVESTMENT ADVISER OVERSIGHT, ECONOMIC ANALYSIS OF OPTIONS

BCG

THE BOSTON CONSULTING GROUP

Investment Adviser Oversight

Economic Analysis of Options

December 2011

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The Boston Consulting Group ("BCG"), a global management consulting firm, was engaged by a group of organizations with Investment Adviser ("IA") stakeholders to conduct an economic analysis of IA oversight scenarios. These scenarios are based on recommended options contained in the Securities and Exchange Commission's ("SEC") study released in January 2011, which was conducted per Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The objective of this report is to establish an economic fact base, informed by publicly available information.

The economic analysis relied upon publicly available research, studies, and reports, as well as more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts. The BCG team involved in this effort was not involved in any prior BCG work for related organizations. Further, the BCG team conducted this analysis independently of any prior related work performed by the firm. The SEC and the Financial Industry Regulatory Authority ("FINRA") were not interviewed or consulted as part of this effort. They did not provide any input, feedback or guidance on the materials or on the analysis contained in this report.

This report does not consider, evaluate, or comment on the benefits of any specific IA oversight scenario, in terms of effectiveness, ease of implementation, or other relevant criteria. This report, any statement made therein, or any statements made by BCG or by any other organization regarding this report, does not constitute a BCG endorsement or recommendation of any of the specific IA oversight scenarios referenced in this report or of any specific approach to IA oversight more generally, and should not be interpreted as such.

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I. Executive summary

As required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Securities and Exchange Commission ("SEC") released a study in January 2011 ("SEC Section 914 Study") that identified three recommended options to Congress regarding examination of SEC-registered Investment Advisers ("IAs"), all of which would require federal legislation before they could be implemented[1]. To inform the discussion on this issue, a group of organizations with IA stakeholders ("Clients") commissioned The Boston Consulting Group ("BCG") to perform an independent and objective economic analysis including an estimate of the level of funding required for each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[2]

BCG profiled and modeled three core scenarios, informed by the first two recommended options in the SEC Section 914 Study. The three core scenarios are:

1. Enhance SEC examination capabilities ("Enhanced SEC"): Achieve an acceptable frequency of IA examinations by hiring additional Office of Compliance Inspections and Examinations ("OCIE") staff, funded by user fees;[3]

2. Authorize a FINRA SRO for IAs ("FINRA-IA SRO"): Authorize the Financial Industry Regulatory Authority ("FINRA"), the self-regulatory organization ("SRO") for Broker-Dealers ("B-Ds"), to develop an IA SRO capability with an IA examination and enforcement mandate,[4] funded by membership fees, and overseen by the SEC; and

3. Authorize a new SRO for IAs ("New-IA SRO"): Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The estimated cost of each of the three core scenarios is summarized in Table 1 below.[5,6,7] The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years:

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[1] The implementation timelines cited in this report are independent of any timelines related to legislative action.
[2] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 and is examined as an additional scenario in Section III.3.3.
[3] Only the cost of examination is funded via user fees, and the SEC would continue to rely on pre-existing sources of funds to support other aspects of its administration of the Investment Advisers Act of 1940 (SEC Section 914 Study, p. 25). However, the estimated costs of enforcement are included in Section III.1.2 for comparative purposes.
[4] SROs typically have rulemaking, examination, and enforcement authority. An enforcement mandate is included along with examination in this analysis, as it is reasonable to assume that an SRO would have authority to discipline its members. Rulemaking is considered separately in section III.3.1 due to possible exclusion from an SRO's mandate.
[5] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[6] Enhanced SEC scenario costs are shown both as incremental OCIE IA costs (i.e., additional IA examiners needed to achieve the target frequency of examinations) and full OCIE costs (i.e., both existing and incremental OCIE IA costs).
[7] Estimates reflect the direct costs of regulatory operations and not the total cost of compliance to IA firms.

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Table 1: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IASRO**	**New-IA SRO**
Setup costs	$6 – 8M (7)	$6 – 8M (7)	$200 – 255M (230)	$255 – 310M (280)
Estimated setup time	6 – 12 months		12 – 18 months	18 – 24 months
Ongoing mandate costs	$100 – 110M (105)	$240 - 270M (255)	$460 – 510M (485)	$515 – 565M (540)
SEC oversight of an SRO costs	Not required		$90 – 100M (95)	$95 – 105M (100)
Total annual costs	**$100 – 110M (105)**	**$240 – 270M (255)**	**$550 – 610M (580)**	**$610 – 670M (640)**

The estimated costs are described below, and further elaborated on in Section III of the report:

Setup costs[8]

- Setup of the Enhanced SEC scenario involves the hiring of additional IA examination staff, and may be achieved in 6-12 months at an estimated cost of $6-8M.
- Setup of a FINRA-IA SRO may be achieved in 12-18 months at an estimated cost of $200-255M. A FINRA-IA SRO could leverage some existing infrastructure that supports B-D oversight activity (e.g., corporate functions, senior management, and potentially some regional offices).
- Setup of a New-IA SRO may be achieved in 18-24 months at an estimated cost of $255-310M. A New-IA SRO is assumed to have no existing infrastructure to leverage.

Ongoing mandate costs[9]

- Per the SEC Section 914 Study, the ongoing costs of the Enhanced SEC scenario are limited to examination costs and do not include enforcement costs. Estimated ongoing examination costs are $240-270M in total or $100-110M more than the current cost of OCIE's IA examination program.
- Ongoing costs of a FINRA-IA SRO or a New-IA SRO include both examination and enforcement costs and are estimated at $460-510M and $515-565M, respectively. Estimated overhead costs per examiner are higher in these two scenarios than in the Enhanced SEC scenario based on current FINRA overhead costs. The estimated ongoing mandate cost of a FINRA-IA SRO reflects scale benefits not available to a New-IA SRO.

Costs of SEC oversight of an SRO

- Cost of SEC oversight of an SRO (either FINRA-IA SRO or a New-IA SRO) are estimated at $90-105M, and includes oversight of SRO examination and enforcement activities. This activity is not required under the Enhanced SEC scenario.

[8] Estimated setup times are the point at which roughly half of examination staff will be hired and the SRO will begin examination of IAs, based on the reference points cited in Appendix Section IV.4.
[9] Ongoing mandate costs are adjusted to allocate the benefits of scale provided by additional IA personnel to all non-administrative staff across the entire organization to reflect standard accounting practice.

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User fees paid to the SEC and/or membership fees paid to an SRO are assumed to provide the funding source for setup and ongoing mandate costs; no assumption is made regarding the source of funding for the costs of SEC oversight of an SRO. Fees are identified in the SEC Section 914 Study as a potential source of funding. Fees collected during the setup period might be relied upon to fund the setup costs.

The estimated level of funding and associated average fee per IA firm is indicated in Table 2 below.[10] This report does not evaluate the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to setting fees.

Table 2: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated funding required for ongoing mandate costs	$100 – 110M (105)	$240 – 270M (255)	$460 – 510M (485)	$515 – 565M (540)
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[11]

Beyond the three core scenarios, BCG also examined three additional scenarios:

- Rulemaking mandate for an SRO: If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of an SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC costs for SRO oversight by an estimated ~$10M.[12] Given rulemaking is within the current SEC mandate, this variation is not relevant to the Enhanced SEC scenario.
- Investment Adviser Oversight Act of 2011 draft ("IAO Draft"): If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond estimates in Table 2 under the two SRO scenarios, as ~1,810 currently-registered IA firms (16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (38% of total ADV-reported assets), would be removed from the funding base.[13]

[10] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[11] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[12] An SRO rulemaking organization is assumed to be similar in size to that of the SEC for IA rulemaking today.
[13] This total does not include ~780 additional private investment fund advisers that will be added in 2012, as per the Dodd-Frank Act. This scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Only IA firms with more than $100M AuM are

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- Dual-registered IA / B-Ds (third recommended option of the SEC Section 914 Study): If the IA examination mandate for dual-registered IAs / B-Ds, of which there are ~580, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC, the estimated costs of IA examination are $30M for FINRA and $240M for the SEC. In this scenario, the average annual fee per IA firm is estimated to be $53,900 for firms under the jurisdiction of FINRA, and $27,300 for firms under the jurisdiction of an Enhanced SEC (full OCIE costs). As dually-registered firms are estimated to represent 6% of the IA population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. In this scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

considered in this calculation, as per the Dodd-Frank Act. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison across the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the 4% increase in the core SRO scenarios. See Section III.3.1 for more details.

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II. Context and methodology

II.1 Context

As required by Section 914 of the Dodd-Frank Act, the SEC released a study in January 2011 (the SEC Section 914 Study) that made recommendations to Congress regarding examination of SEC-registered IAs. The SEC Section 914 Study examined the growth in the investment adviser industry over the last six years and the SEC's challenges in maintaining an acceptable level of examination frequency of SEC-registered IAs. The Study determined that the anticipated growth of IAs would outstrip the SEC's resources absent additional funding. The Study recommended consideration of three options to ensure more stable and scalable funding for IA examinations, all of which would require federal legislation before being implemented:

- Impose user fees on IAs (to fund the SEC), set at a level appropriate for achieving an acceptable frequency of IA examinations (by the SEC);
- Authorize one or more SROs to examine all SEC-registered IAs, subject to SEC oversight; or
- Permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 ("Advisers Act").[14]

A group of organizations with IA stakeholders commissioned BCG to perform an independent and objective economic analysis of the recommended options in the SEC Section 914 Study, with a focus on the first two.

II.2 Objectives

The objective of this report is to perform an independent and objective economic analysis including an estimate of the level of funding required under each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[15]

The economics of each scenario reflect:

- Direct Costs incurred to:
  - Setup IA examination infrastructure to achieve an acceptable frequency of examinations under each scenario and includes the costs of moving from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
  - Ongoing IA examination for all scenarios, at an acceptable frequency, and ongoing enforcement in the FINRA-IA SRO and New-IA SRO scenarios and includes the costs of salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
  - SEC oversight of SRO examination and enforcement activities in the FINRA-IA SRO and New-IA SRO scenarios and includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities

[14] See footnote 2.
[15] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 is examined as an additional scenario in Section II.3.3.

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as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).

- Level of funding and potential fees:
  - Level of funding for each scenario is composed of ongoing mandate costs. This report assumes that the funding will be covered by user fees paid by IA firms to the SEC or membership fees paid by IA firms to one or more SROs.
  - Fees paid by IA firms during the setup period might be used to fund setup costs.
  - No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).[16]

II.3 Methodology

BCG conducted an objective and fact-based analysis, drawing on relevant benchmarks and publicly available cost data (current and historical), research, and other studies and reports to estimate the setup costs, ongoing mandate costs, and the costs of SEC oversight of SRO examination and enforcement activity.

BCG validated the analysis with a bottom-up review of the primary cost components. BCG also conducted more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts to identify, corroborate, and better inform relevant assumptions and key sensitivities.

The three core scenarios modeled in this report are characterized along four key dimensions:

- Regulator options: Which regulatory body should oversee IAs?
  - Options: the SEC, a FINRA-IA SRO, or a New-IA SRO
  - In the SRO scenarios, the SEC oversees the SRO.
- Mandate: What mandate should the regulator possess?
  - Options: Examination or examination and enforcement
  - In all scenarios, the study assumes the regulator is authorized to examine and the SEC retains rulemaking authority. In the SRO scenarios, limited rulemaking authority incidental to the execution of examination or enforcement would likely be granted.[17]
  - A scenario whereby the SRO is given a full rulemaking mandate is explored in Section III.3.1.
- Jurisdiction: Which IAs will be required to register with the SEC or an SRO?
  - Default: IA registration requirement as per the Dodd-Frank Act[18]
  - A variation based on the IAO Draft, which exempts a sub-set of IAs from the jurisdiction of an SRO based on the type of assets and investors, is examined in Section III.3.2.

[16] Fees are just one potential funding source; we focus on fees in this report as the SEC Section 914 Study did so.

[17] The cost of limited rulemaking incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations) is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

[18] Includes IA firms with AuM above $100M plus those below $100M that are registered with the SEC (e.g., IA firms with principal offices in New York or Wyoming; those permitted to register with the SEC because they would otherwise be required to register with 15 or more states). Also includes private investment fund advisers with AuM of $150M or more.

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- Funding: How much funding and what level of fees per IA firm may be required to cover the cost of ongoing examination and enforcement activities?
    - Funding level options: Cover all setup and/or all ongoing mandate costs
    - Fee level: Many approaches to apportioning fees to IA firms are available and will need to be considered. This report estimates the average fee per IA firm for illustrative purposes.

Based on these dimensions, and informed by the first two recommended options described in the SEC Section 914 Study, three core scenarios were defined and modeled in this report. The three core scenarios are:

1. Enhanced SEC: Achieve an acceptable frequency of IA examinations by hiring additional OCIE staff, funded by user fees;[19]

2. FINRA-IA SRO: Authorize FINRA, the SRO for B-Ds, to develop an IA SRO with an IA examination and enforcement mandate,[20] funded by membership fees, and overseen by the SEC; and

3. New-IA SRO: Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years. The analysis focuses on 2012, and does not estimate how the number of IAs and the associated ongoing mandate costs to the SEC or to IAs via user fees or membership fees might change over time.

[19] See footnote 3.
[20] See footnote 4.

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III. Economic analysis

III.1 Cost analysis

This section details the direct setup costs, ongoing mandate costs, and the costs of SEC oversight of an SRO examination and enforcement activity, under each of the three core scenarios.[21] The indirect costs of compliance incurred by IA firms and how indirect costs might vary across the three core scenarios were not estimated or examined.

III.1.1 Assumptions and inputs

The economic analysis reflects the following inputs and assumptions, which are further elaborated upon in Appendix Section IV.2-IV.6:

- Size of the IA population to be examined: 9,440 IAs in 2012
  - Based on the number of IAs in 2011 adjusted for the estimated impact of the Dodd-Frank Act and projected growth from 2011 to 2012.
- Number of examiners required to achieve the target exam frequency: 787 examiners
  - Target exam frequency is once every four years per IA firm on average.
  - Rate of exams per examiner per year is assumed to be 3.0, which is the current average number of IA exams conducted by an SEC examiner per year.
- Setup costs are estimated based on benchmarks identified in recent SEC budget requests and the setup costs of other relevant, similarly located organizations.
- Ongoing mandate costs are estimated based on fully loaded costs per examination and enforcement employee derived from publicly available SEC and FINRA budget data for 2010, adjusted to account for scale and appropriate allocation of any scale benefits.
- Costs of SEC oversight of a SRO examination and enforcement activity are estimated based on current SEC oversight costs for FINRA B-D activity, but reduced by 50% to reflect reduced complexity of SEC oversight of an SRO in an IA context.[22]

[21] See Appendix Section IV.1 for more detail.
[22] See Appendix Section IV.6 for more detail.

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III.1.2 Results of cost analysis

The estimated 2012 costs are detailed in Table 3, below:[23]

Table 3: Estimated range (midpoint)	SEC (existing)	Enhanced SEC (incremental OCIE)	FINRA-IA SRO	New-IA SRO
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

A. Examination and enforcement costs are shown in Table 3 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 3 under the Enhanced SEC scenario, enforcement costs are not included in the totals (Setup costs, Ongoing mandate costs, SEC oversight of SRO costs and Total annual costs), as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

Differences in setup costs across the three core scenarios are driven by the gap between current and required capabilities and capacity, as well as the time required to set up:

- The estimated up-front cost to enhance SEC IA capabilities is $6-8M. Increasing examiner capacity would drive the majority of the estimated setup costs. The SEC already holds the IA examination, enforcement, and rulemaking mandates, and the majority of the effort relates to increasing capacity of existing capabilities. The SEC may be able to set up in 6-12 months.
- FINRA-IA SRO setup costs are estimated at $200-255M. FINRA may be able to set up an IA SRO in 12-18 months. FINRA does not currently oversee IAs and would need to build a new and separate IA examination organization. FINRA may be able to leverage parts of its existing B-D-focused infrastructure (e.g., corporate functions, senior management, some regional offices).
- New-IA SRO setup costs are estimated at $255-310M. A New-IA SRO may be able to set up in 18-24 months. A New-IA SRO would have no existing infrastructure to leverage, instead needing to build, acquire, or outsource all capabilities.

Differences in ongoing mandate costs across the three core scenarios are driven by differing overhead costs and available scale benefits:[24]

- The incremental OCIE examination costs under the Enhanced SEC scenario are estimated at $100-110M, bringing total costs of OCIE examination to $240-270M. Enforcement costs would also likely increase as examination frequency increases.

[23] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[24] See footnote 9.

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Overhead costs on a per-examiner basis under the Enhanced SEC scenario are estimated to be lower than under the SRO scenarios because current SEC overhead costs are lower than FINRA's overhead costs. Scale benefits from the existing SEC organization and infrastructure are estimated, but only a portion of the benefit is attributed to IA examinations, as the benefits would be shared across the SEC organization.

- FINRA-IA SRO ongoing annual examination and enforcement costs are estimated at $460-510M. Estimated overhead costs are lower than in a New-IA SRO scenario due to scale advantages resulting from leveraging FINRA's existing B-D infrastructure.
- New-IA SRO annual ongoing examination and enforcement costs are estimated at $515-565M.

Cost of SEC oversight of an SRO in either SRO scenario are estimated at $90-105M The costs include oversight of SRO examinations, direct examinations of IAs, and both SEC-initiated and SRO-referred enforcement actions as well as appeals from an SRO. Costs of SEC oversight of a FINRA-IA SRO are lower than for a New-IA SRO because the SEC already oversees the FINRA organization, providing some opportunity to share resources and costs that would not be available in the New-IA SRO scenario. SEC oversight is not required under the Enhanced SEC scenario.

III.2 Level of funding and fees

This section describes the estimated level of funding to support the ongoing mandate costs described in the previous section, at the IA industry- and firm-level through user fees paid to the SEC or membership fees paid to one or more SROs.

III.2.1 Assumptions and inputs

The estimated level of funding is driven by the ongoing mandate costs, which includes full OCIE examination costs for the Enhanced SEC scenario, including both baseline and incremental OCIE staff, and all examination and enforcement costs for a FINRA-IA SRO and a New-IA SRO. Setup costs are not included in the estimated level of funding, although fees collected during the setup period might be relied upon to fund the setup costs, similar to the approach used by the Public Company Accounting Oversight Board ("PCAOB").[25] The costs of SEC oversight of an SRO are also not included in the estimated level of funding. The source of funding for SEC oversight of an SRO is not examined in this report.

[25] The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

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III.2.2 Results of funding analysis

The estimated level of funding under the three core scenarios are described in Table 4 below, with both the incremental and full OCIE cost scenarios shown for the Enhanced SEC scenario:[26]

Table 4: Estimated range (mid-point)	Enhanced SEC (incremental OCIE)	Enhanced SEC (full OCIE)	FINRA-IA SRO	New-IA SRO
Estimated level of funding (ongoing mandate costs): – Examination – *Enforcement*[A]	$100 – 110M 105 *60*	$240 – 270M 255 *40*	$460 – 510M 355 130	$515 – 565M 395 145
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

A. Examination and enforcement costs are shown in Table 4 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 4 under the Enhanced SEC scenario, enforcement costs are not included in the total "Estimate level of funding (ongoing mandate costs", as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[27]

We estimate the level of funding needed for the FINRA-IA SRO and New-IA SRO scenarios to be 90% and 110% higher than the Enhanced SEC scenario's full OCIE cost scenario, respectively.[28]

[26] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[27] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[28] The difference in funding requirements would increase slightly if rulemaking was included in the SRO's mandate.

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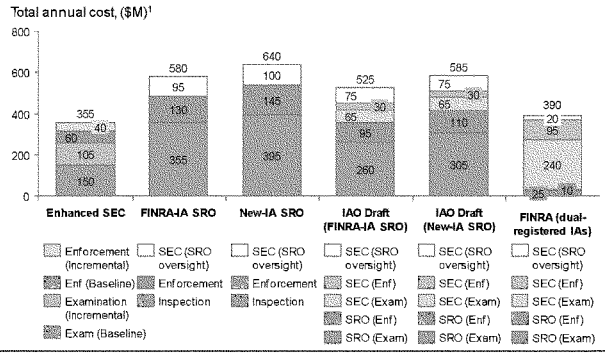
III.3 Other scenarios examined

In addition to the three core scenarios, BCG explored three additional scenarios, the latter two of which are included in Table 5, for comparison against the three core scenarios. For comparison purposes, full rulemaking authority is not included in the IAO Draft and FINRA dual-registered scenarios.

Table 5:



Estimated level of fee-based funding ($M)	105 / 255[4]	485	540	355	415	240 & 30[3]
Estimated average fee per firm ($)	11,300 / 27,300	51,700	57,400	52,100	60,700	27,300 & 53,900
# of IA firms registered with SEC	9,440	0	0	2,590[2]	2,590[2]	8,860
# of firms registered with SRO	0	9,440	9,440	6,850	6,850	580

Note: Numbers may not add up due to rounding error. 1. Total annual cost is defined as the cost of examination and enforcement mandates as well as any SEC IA-SRO oversight costs. 2. Includes IA firms with >90% AuM attributable to private funds, mutual funds, clients with more than $25M in investments, and other type of IAs as discussed in the draft of "Investment Adviser Oversight Act of 2011". SRO-exempt firms include 1,810 currently registered firms as well as 780 newly register private funds. 3. $240M is funding needed for SEC-registered firms (non-dual reg. IAs) and $30M is funding needed for FINRA-registered firms (dual-reg. IAs). 4. $105M is the funding need to cover the SEC's incremental examination costs. $255M is the funding needed to cover the full examination costs.

III.3.1 Rulemaking mandate for an SRO

If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of the SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC oversight of the SRO costs by ~$10M. Given rulemaking is within the current mandate of the SEC, this variation is not relevant to the Enhanced SEC scenario. Full rulemaking is differentiated from the limited rulemaking that would be incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations), the cost of which is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

III.3.2 IAO Draft

If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond the estimates in Table in Table 4, under the two SRO scenarios, as ~1,810 currently registered IA firms (~16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that will be required to register with the SEC in 2012 as a result of the Dodd-Frank Act. However, those firms are included in the table above for comparative purposes. Only IA firms with more than $100M AuM are considered in this calculation, as per the Dodd-Frank Act. This

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scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison to the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the estimated 4% increase under the core SRO scenarios.

III.3.3 FINRA jurisdiction over dual-registered IA / B-Ds

This additional scenario is the third recommended option of the SEC Section 914 Study, whereby the IA examination mandate for dually-registered IAs / B-Ds, of which there will be an estimated ~580 in 2012, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC.

In this scenario, the estimated costs of IA examination are ~$240M for the SEC and ~$30M for FINRA. The estimated average fee per IA firm is ~$27,300 for IA firms under the jurisdiction of an Enhanced SEC (full OCIE costs), and ~$53,900 for IA firms under FINRA jurisdiction.

As dually-registered firms are estimated to represent 6% of the IA firm population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. Also, under this additional scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

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IV. Appendix

This section describes the methodologies and assumptions used in the analyses described in this report.

IV.1 Description of costs and required level of funding

- Setup costs: Includes the costs of moving the organization from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
- Ongoing mandate costs: Includes the ongoing annual costs of an IA examination program and the associated costs of enforcement. Ongoing mandate costs include salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
- SEC oversight of an SRO costs: Includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).
- Total annual costs: Includes ongoing mandate costs and the costs of SEC oversight of an SRO, and is referred to as total annual costs.
- Level of funding and potential fees: Level of funding for each scenario, is determined by ongoing mandate costs. This report assumes that the ongoing mandate costs will be covered by user fees (to the SEC) or membership fees (to one or more SROs). No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).

IV.2 Estimation of the number of SEC-registered IAs in 2012

The 2011 IA population is 11,529 (IAA/NRS Evolution Revolution report). 3,200 IAs with less than $90M AuM were removed from the population, based on estimates from the SEC Section 914 Study.[29] 750 private fund-oriented IAs with AuM greater than $150M were added to the population, based on the Dodd-Frank Act. Subsequently, an annual growth rate of 4% was applied based on the average 5-year compound annual growth rate (CAGR) for each major IA AuM segment, which results in a projected population of ~9,440 SEC-registered IAs in 2012.[30]

IV.3 Estimation of the number of IA examiners needed to meet a target examination rate

The target examination rate is assumed to be once every four years, on average. The current rate is once every 10-11 years, and the most frequent average examination rate achieved by the SEC in recent history is once every six years (SEC Section 914 Study). The average examiner productivity is assumed to be 3.0 examinations per examiner per year, based on the five year SEC average of 3.0 IA examinations per examiner per year.[31] In order to achieve an average

[29] $90M is used due to a buffer below the $100M threshold specified in the SEC Section 914 Study.
[30] IA firms were segmented by AuM into groups, to which the 5-year historical growth rate was calculated and utilized to project forward from 2011 to 2012, for the AuM segments that will remain in scope.
[31] The SEC examination rate of 3.0 is used because it is the best available reference point for the anticipated productivity level of examiners of IA firms. Examination rate benchmarks from other organizations were analyzed but, in the end, not included due to incomparability of exam populations, targeting methodology, scope, and other reasons.

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examination frequency of once every four years, with examiner productivity of 3.0 examinations per examiner per year, 787 examiners are required.

IV.4 Estimation of the setup costs for each of the three core scenarios

IV.4.1 Enhanced SEC

The cost of adding incremental examination capacity under the Enhanced SEC scenario was estimated at $24,000 – 26,000, and was informed by the following:

- SEC 2012 budget request
- Public information regarding costs of other recent moves to Washington, D.C., by relevant organizations

IV.4.2 New-IA SRO

The setup costs of a New-IA SRO were informed by the following, after adjusting for size and resource requirements:

- PCAOB setup experience, and review of their 2003-2004 budget
  - PCAOB took two years to setup before reaching a steady state of ~240 examiners and 5 offices
  - PCAOB costs of $117M, normalized by adjusting cost items, (e.g., salary/benefits, office space, equipment, IT) for differences in size, scale and time period

- Consumer Financial Protection Bureau (CFPB July 2011 report) setup experience
  - CFPB incurred $60M in costs in its first eight months
  - Full setup costs for the CFPB estimated to be ~$125M, resulting in an organization of ~550 people, or about half of a New-IA SRO, normalized by adjusting cost items based on differences in size and scale

IV.4.3 FINRA-IA SRO

Interviews with subject matter experts suggested that the setup time for a FINRA-IA SRO would be roughly 6 months less than for a New-IA SRO. FINRA's ability to leverage existing physical, technological, and organizational infrastructure, could result in ~20% lower setup costs than for a New-IA SRO.

IV.5 Estimation of ongoing mandate costs

IV.5.1 Estimation of examination costs

Average examiner salary and benefits are estimated to be ~$189K. Overhead expenses per examiner are estimated to be ~$134K, or 27% of total SEC overhead expenses, based on the number of OCIE employees as a percent of total employees. The resulting fully loaded total average cost per employee was estimated to be ~$323K.

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IV.5.2 Estimation of enforcement costs

Interviews with subject matter experts, including former SEC employees, resulted in estimated costs attributable to IAs of 14% of the Division of Enforcement's total costs and ~7% of the Division of Investment Management's total costs. Including overhead, this implies a cost per employee of ~$353K in the Division of Enforcement and ~$363K in the Division of Investment Management.

Applying the ratio of 2.8 IA examiners per IA enforcement full-time equivalent ("FTE") at the SEC provides an estimate of the additional enforcement FTEs required to handle an expected increase in enforcement activity.[32]

IV.5.3 Estimation of costs specific to a FINRA-IA SRO and a New-IA SRO

Costs associated with a FINRA-IA SRO and a New-IA SRO were informed by the following

- Examination and enforcement employee ratios and salary costs at the SEC
- Overhead cost per examiner at the SEC adjusted to reflect higher ratio of professional staff to administrative staff at FINRA than at the SEC
- FINRA's 2010 budget of fees (regulatory and user fees) from B-D examiners.

IV.5.4 Estimation of the impact of scale

A scale factor of 19% was applied to the overhead costs of the Enhanced SEC and FINRA-IA SRO scenarios. The scale factor was derived from BCG benchmarks and analysis of similar organizations that indicates that, as an organization doubles in size, overhead costs increase by 81%. The scale benefits were shared across the entire organization, so that the scale benefits attributed to the IA examination costs under the Enhanced SEC and FINRA-IA SRO were only 12% and 40% of the scale-driven savings, respectively.[33]

The New-IA SRO, starting from a base of zero employees, experiences some scale disadvantage relative to the SEC and FINRA. The scale disadvantages were measured in relation to FINRA's current organization size.

IV.6 Estimation of the costs of SEC oversight of an SRO

SEC oversight of FINRA today was used to estimate the costs of SEC oversight in the SRO scenarios. There are ~380 SEC examiners overseeing roughly 840 FINRA B-D examiners, indicating a ratio of 2.2 FINRA examiners per SEC oversight examiner.[34] IA examinations (and oversight of those examinations) are likely to be less resource-intensive, on average, than B-D examinations, so the ratio of examiners per SEC oversight examiner was adjusted accordingly.[35]

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[32] We assume the ratio holds constant rather than assume changes in productivity or operating procedures related to enforcement.

[33] See footnote 9.

[34] Includes oversight of operations of an SRO by conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee changes (SEC Section 914 Study).

[35] The SEC is expected to conduct primary investigations of IAs at a lower rate/level than is the case of B-Ds for two reasons: the SEC already has experience and familiarity with IA examinations as a result of its current mandate, and IA investigations tend to be less complex than B-D examinations and therefore less likely to warrant direct SEC involvement in the examination. If, in practice, the SEC conducts more

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As such, for a New-IA SRO with 787 examiners, the SEC would need ~178 IA oversight examiners. Assuming similar average costs for these examiners as well as similar ratios for enforcement and rulemaking as stated above, the SEC would incur ~$100M in oversight costs. The costs of overseeing a FINRA-IA SRO are slightly less than for a New-IA SRO, because the SEC already oversees the FINRA organization.

IV.7 Other scenarios examined

IV.7.1 Rulemaking mandate for an SRO

SRO rulemaking cost estimates were informed by

- SEC rulemaking costs and subject matter expert interviews indicating that
  - IA-related rulemaking costs represent ~13% of the costs of the Division of Investment Management and ~14% of the costs of the General Counsel's office
  - Including overhead, per employee costs of ~$363K at the Division of Investment Management and ~$355K at the General Counsel's office
  - SEC IA examiner per IA rule maker ratio of ~15.7
- SRO overhead cost estimates per examiner

Resulting cost estimate for SRO rulemaking is $20M, or ~4% of the estimated ongoing mandate costs. SEC oversight of SRO rulemaking costs are estimated at ~$10M. In the enhanced SEC scenario, it is assumed that rulemaking costs would not change.

IV.7.2 IAO Draft

Under the IAO Draft, certain IAs would be excluded from the requirement to register with an SRO, and instead would be required to register with the SEC. The exclusion applies to all IA firms with 90% or more of their assets under management attributable to one or more of the following client types:

- Registered investment companies;
- Advisers to non-US clients;
- Clients with more than $25,000,000 in investments;
- 3(c)(10) funds (e.g., charitable trusts);
- 3(c)(11) funds (e.g., DB and DC plans);
- Private funds (e.g. hedge funds and private equity funds); and
- Venture capital funds.

An estimated ~1,810 currently registered IA firms (~16% of SEC-registered IAs), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that are required to register with the SEC in 2012 as a result of the Dodd-Frank Act.[36]

The level of funding needed for a FINRA-IA SRO is estimated at ~$435M and for a New-IA SRO at ~$485M. This estimate does not include the costs of rulemaking that is granted to an SRO in the IAO Draft, to enable direct comparison to the three core scenarios. The estimated funding

primary investigations of IAs than assumed in this analysis, then the costs of SEC oversight of an SRO will be higher than the current estimate.

[36] The ~750 private investment fund advisers estimated by the SEC in 2011 plus another 30 from normal annual growth in firm count.

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level is slightly below the estimated funding level in the core SRO scenarios because of the exclusion of the ~1,810 IA firms described above. The resulting estimated average user fee per IA firm is ~$51,810 for a FINRA-IA SRO and ~$58,500 for a New-IA SRO.

While reduction in the IA firm population would reduce the costs of IA examination for an SRO, and estimated average fees per IA firm would not change significantly, the membership fees paid by the remaining IA firms would increase by ~20% if apportioned on a per AuM basis.

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APPENDIX 2

BOSTON CONSULTING GROUP REVIEW OF THE FINRA COST ESTIMATES

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

FOR IMMEDIATE RELEASE
May 10, 2012

Contact: Dan Drummond
202-379-2252 (O) or 202-550-4372 (M)
ddrummond@cfpboard.org

FINRA's Cost Estimates Challenged

Leading Financial Services Organizations Respond to FINRA's Estimates

Washington, D.C. (May 10, 2012) – The Financial Industry Regulatory Authority's (FINRA) estimate of the cost to setup, operate and oversee a self-regulatory organization (SRO) for investment advisers (IA) underestimates overhead costs and overestimates IA examiner productivity, according to a new review of FINRA's one-and-a-half page document titled, "Investment Estimate for FINRA IA SRO".

The review was conducted by The Boston Consulting Group (BCG) on behalf of the Certified Financial Planner Board of Standards, Inc., Financial Planning Association, Investment Adviser Association, National Association of Personal Financial Advisors and TD Ameritrade Institutional. BCG also provided a report in December 2011 that estimated the cost of options to increase examinations of investment advisers, including the creation of one of more new IA SROs. For a copy of that report, click here.

FINRA released its cost estimate on April 25 – the same day Rep. Spencer Bachus (R-AL) and Rep. Carolyn McCarthy (D-NY) introduced legislation authorizing the creation of an IA SRO.

BCG's review finds:

- FINRA's estimate omits the cost of SEC oversight (**$90 - $100 million**) and the cost of enforcement (**$60 - $70 million**), both of which are required by the legislation;

- FINRA's estimate of $12-$15 million in setup costs does not include staff costs incurred during the 12-month setup period, specifically the cost of examiners and support staff. FINRA only includes these expenses as part of its ongoing investment once the SRO is up

and running. This omission accounts for **$180-$230 million** of the difference between the BCG and FINRA estimates;

- 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 5 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-$170 million** of the difference between the BCG and FINRA estimates; and

- FINRA's estimate does not include overhead costs in its estimate of $150-$155 million of ongoing annual investment. Overhead costs account for **$135-$140 million** of the difference between the BCG and FINRA estimates.

"We believe that the review of FINRA's cost estimates confirms the independent economic analysis conducted by BCG last year. We think it would be a mistake to add an unnecessary layer of regulation and cost on small businesses that deliver sound advice to investors," the group sponsoring the BCG review said. "We continue to believe that oversight of investment advisers should stay with the Securities and Exchange Commission, the most cost-effective alternative."

A side by side comparison of the cost estimates can be found here.

###

Setup Costs

<u>Setup costs</u> – Two fundamental differences between FINRA's $12-15M estimate of setup costs and BCG's estimate of $200-255M of setup costs:

1. Staff costs during setup period
   - BCG analysis included staff costs incurred during the setup period in its estimate of setup costs. These costs include salaries, benefits and overhead incurred during the setup period. Setup activities include hiring examiners, developing examination process and guidelines, and new examiner training.
   - FINRA reflects all staff costs in its ongoing annual investment costs, and not in its estimate of setup costs
   - Staff costs during the ~12 month setup period are **$180-230M**.
2. New employee on-boarding costs
   - BCG analysis assumes that employee on-boarding expenses are ~$25,000 per employee, and is based on recent SEC budget request for new OCIE employees. On-boarding expenses include recruiting costs, trainer costs, required equipment and access, etc.
   - FINRA estimate assumes that employee on-boarding expenses are ~$13,000-17,000 per employee. Comparability is unclear, as FINRA's setup costs include training costs, initial organization, governance and technology costs.
   - The difference in on-boarding cost per new employee is estimated to account for **$8-12M** of the difference between the BCG and FINRA estimates of setup costs.

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Ongoing mandate costs

<u>Ongoing mandate costs</u> – Three fundamental differences between FINRA's $150-155M estimate of ongoing annual investment and BCG's estimate of $460-510M of on-going mandate costs

1. Examiner Productivity
   - BCG Analysis assumed IA Examiner productivity of 3.0, equal to recent SEC IA Examiner productivity, above current FINRA B-D Examiner productivity of 2.8
   - FINRA Estimate does not directly reference IA Examiner productivity, but may be as high as 5.5 in order to examine 14,500 IA firms, once every four years on average, with an IA SRO population that does not exceed 900 and includes Enforcement and support staff.
   - The difference in Examiner productivity is estimated to account for **$150-170M** of the difference between the BCG and FINRA estimates.
2. Examiner Costs
   - BCG's estimate of Examiner Costs includes Examiner compensation, benefits and overhead and is informed by recent SEC Examiner costs. To reflect scale benefits BCG applied a 19% Scale Factor to the FINRA-IA SRO scenario, meaning that if the organization doubled in size, overhead costs would only increase by 81%.
   - FINRA Estimate does not reference overhead costs. Ongoing annual investment of $150-155M for 900 employees suggests that on-going annual per employee costs are $170,000, which is unlikely to include overhead.
   - Excluding Examiner overhead costs is estimated to account for **$135-140M** of the difference between the BCG and FINRA estimates.

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Ongoing mandate costs & Costs of SEC oversight of an SRO

3. Enforcement Costs
   - BCG Analysis estimated that enforcement activity would cost $130M per year, based on 1.0 IA Enforcement FTEs for every 2.8 IA Examiners, the current SEC examination to enforcement FTE ratio.
   - FINRA Estimate does not reference Enforcement personnel, but the Enforcement to Examiner FTE ratio may be as high as 5 if the staff population does not exceed 900.
   - The difference in the ratio of Enforcement to Examiner FTE is estimated to account for **$60-70M** of the difference between the BCG and FINRA estimates.

Costs of SEC oversight of an SRO

- The FINRA Estimate makes no reference to the Costs of SEC oversight of an SRO. BCG estimates these costs at $90-100M annually.

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Comparison Chart: FINRA "Investment Estimate" and analysis by The Boston Consulting Group

Category	FINRA's "Investment Estimate"	BCG Analysis	Reason for Differences
1. *Setup of IA SRO*	$12-$15 million	$200-$255 million	FINRA's estimate of $12-$15 million in setup costs does not include staff costs incurred during the 12-month setup period, specifically the cost of examiners and support staff. This omission accounts for $180-$230 million of the difference between the BCG and FINRA estimates.
2. *On-Boarding of New Employees*	$13,000-$17,000 per employee	$25,000 per employee	FINRA estimates $8-$12 million less in on-boarding costs than BCG. BCG based its on-boarding costs on the official SEC budget request.
3. *SEC Oversight*	Not included in FINRA's document	$90-$100 million/year	FINRA doesn't include the cost of SEC oversight of a new IA SRO, even though current federal law and the proposed legislation both require continued SEC oversight.
4. *Total Ongoing Annual Oversight Mandate (Breakdown of costs below)*	$150-$155 million/annually	$460-$510 million/year	BCG estimates include proven productivity assumptions, overhead costs for examiners and enforcement costs.
4a.Examiner Costs	Not broken out in FINRA document	$135-$140 million/year	FINRA's estimated ongoing investment of $150-$155 million with 900 additional employees equates to a $170,000 per employee cost, which is unlikely to include overhead.
4b. Enforcement Costs	Not broken out in FINRA document	$130 million/year	No specific reference in FINRA estimates to enforcement personnel. BCG estimated enforcement activity at $130 million per year. Differences in enforcement costs are estimated to account for $60-$70 million between the BCG and FINRA estimates.
4c. Examiner Productivity	Not broken out in FINRA document	$150-$170 million/year	FINRA's estimated costs assume nearly double the per-employee productivity of current FINRA broker-dealer examinations as well as current SEC IA examiner productivity.

APPENDIX 3

INVESTMENT ADVISER OVERSIGHT, SURVEY OF INVESTMENT ADVISER PREFERENCES

BCG

Investment Adviser Oversight

Survey of Investment Adviser Preferences

November 2011

THE BOSTON CONSULTING GROUP

Survey context and objectives

The Boston Consulting Group ("BCG"), a global management consulting firm, was engaged by a group of organizations with Investment Adviser ("IA") stakeholders to help inform the discussion on IA regulatory oversight. The Securities and Exchange Commission's ("SEC") Section 914 study, which was required by the Dodd-Frank Wall Street Reform and Consumer Protection Act and released in January 2011, outlined three recommended options for increasing oversight of IAs. The specific objectives of this study are to establish an economic fact base, informed by publicly available information. In addition, a broad base of IAs based in the United States were surveyed to better understand their preferences . This document contains the survey results, while the results of the economic analysis are described in the accompanying prose report: "Investment Adviser Oversight: Economic Analysis of Options".

BCG designed the questions for the survey, managed its execution, and analyzed the results. The survey was administered online in November 2011. A survey link was distributed via email to the targeted population of IAs. 424 survey responses were received. The profile of respondents was compared to the US IA population to ensure adequate representation across relevant IA sub-segments.

The BCG team involved in this effort was not involved in any prior BCG work for related organizations. Further, the BCG team conducted this analysis independently of any prior related work performed by the firm. The SEC and the Financial Industry Regulatory Authority ("FINRA") were not interviewed or consulted as part of this effort. They did not provide any input, feedback or guidance on the materials or on the analysis contained in this report.

The results contained in this document reflect the views of the survey respondents only. This report, any statement made therein, or any statements made by BCG or by any other organization regarding this report, does not constitute a BCG endorsement or recommendation of any of the specific IA oversight scenarios referenced in this report or of any specific approach to IA oversight more generally, and should not be interpreted as such.

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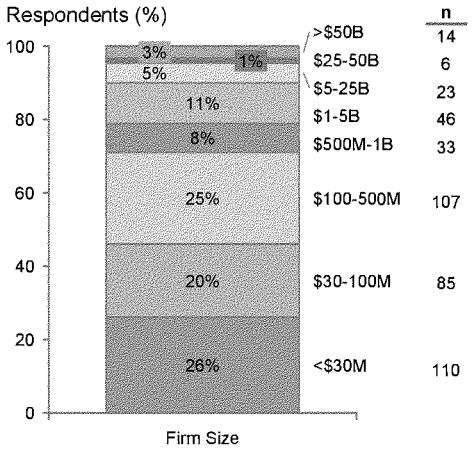
Respondent profile (I)

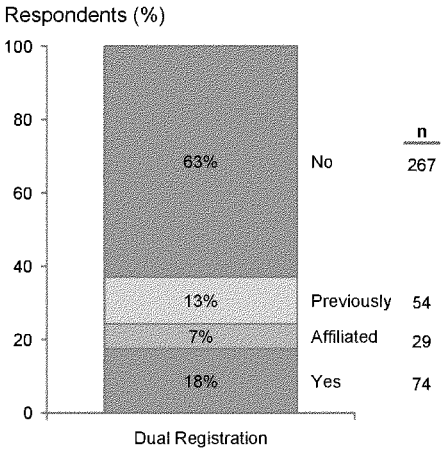
Respondent Firm Size

What are the total assets under management (AuM) at your firm? (n=424)



Respondent Registration: Dually Registered

Is your firm registered with FINRA as a broker-dealer? (n=424)



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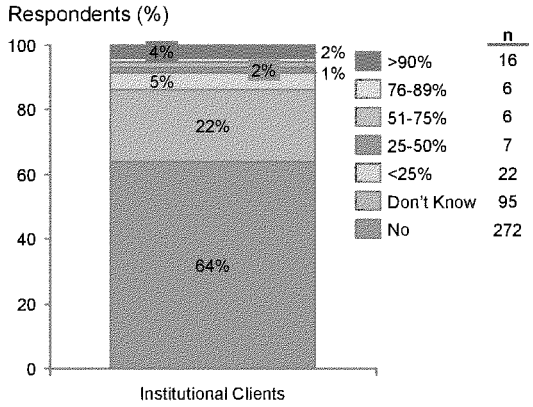
Respondent profile (II)

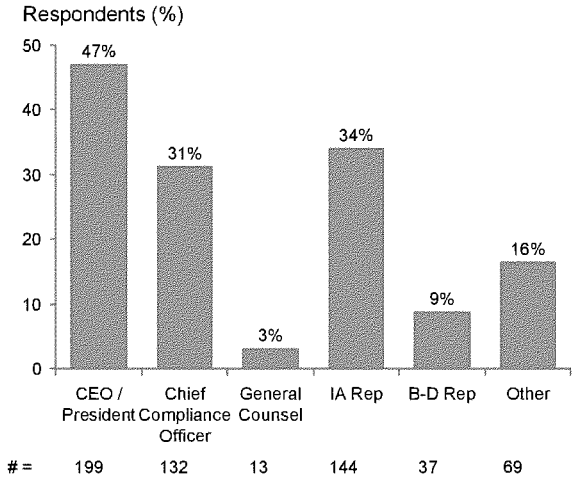
Respondent Client Mix: Institutional Clients

Does your firm advise institutional clients (e.g., mutual funds, hedge funds, private investment funds, venture capital funds) and/or individuals with total investments of at least $25 million? If you answered "Yes" to the above question, what % of your firm's AuM are owned by institutional clients and/or individuals with total investments of at least $25 million? (n=424)



Respondent Roles

What is your role at your firm? Please select all that apply. (n=424)



Note: Sum of responses exceeds 424, as many respondents selected more than one role

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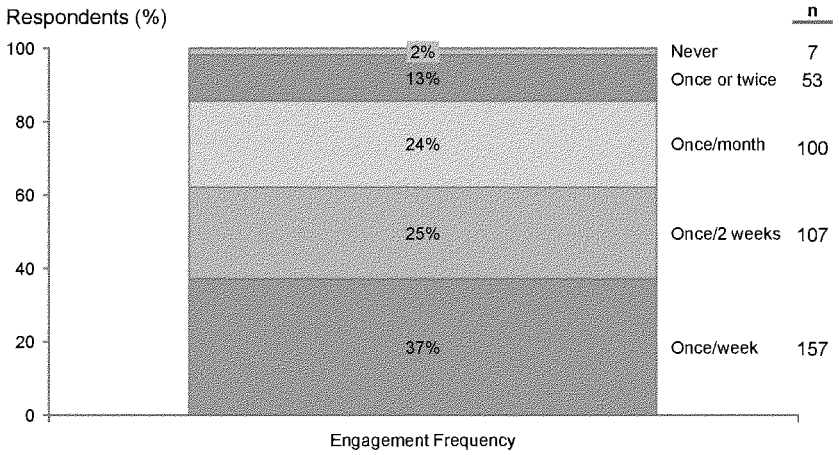
Respondent profile (III)

Respondent engagement level

How actively have you followed the ongoing discussions surrounding regulatory oversight of investment advisers? (n=424)



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User/membership fee scenarios provided to respondents depending on respondent firm size

SEC vs. FINRA-IA SRO

Respondent Firm Size, AuM	SEC	FINRA-IA SRO
<$30M	$160	$210
$30M - $100M	$350	$460
$100M - $500M	$1,600	$2,100
$500M - $1B	$4,000	$5,250
$1B - $5B	$16,000	$21,000
$5B - $25B	$80,000	$105,000
$25B - $50B	$200,000	$262,500
$50B+	$265,000	$350,000

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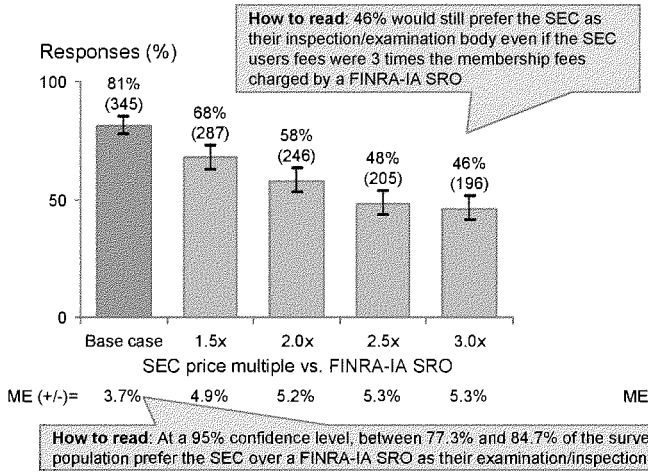
Respondent preference for SEC vs. FINRA-IA SRO

All respondents

Base case: *Given the following annual user/membership fees, would you personally prefer the SEC or FINRA as the inspection/examination body for your firm? (n=424)*

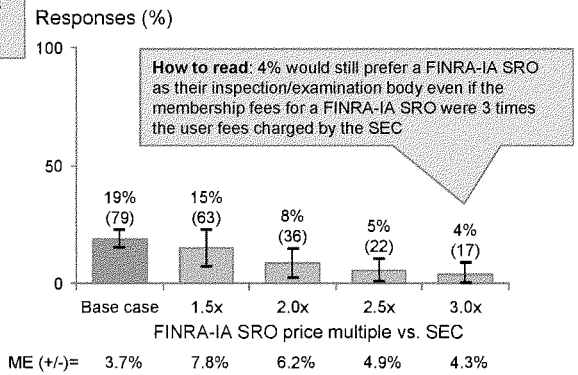
81% express preference for SEC

After base: *If the annual fees for the SEC were higher, while the annual fees for FINRA remained the same, would your preference shift from the SEC to FINRA? (n=345)*



19% express preference for FINRA-IA SRO

After base: *If the annual fees for FINRA were higher, while the annual fees for the SEC remained the same, would your preference shift from FINRA to the SEC? (n=79)*



How to read: At a 95% confidence level, between 77.3% and 84.7% of the surveyed population prefer the SEC over a FINRA-IA SRO as their examination/inspection body

Note: Respondents were initially asked to select the SEC or FINRA at a base case, after which they were queried about their willingness to pay for the previously selected organization at increasing relative price levels. Margin of error (ME) was calculated at the 95% confidence level.
Source: BCG IA Survey (2011)

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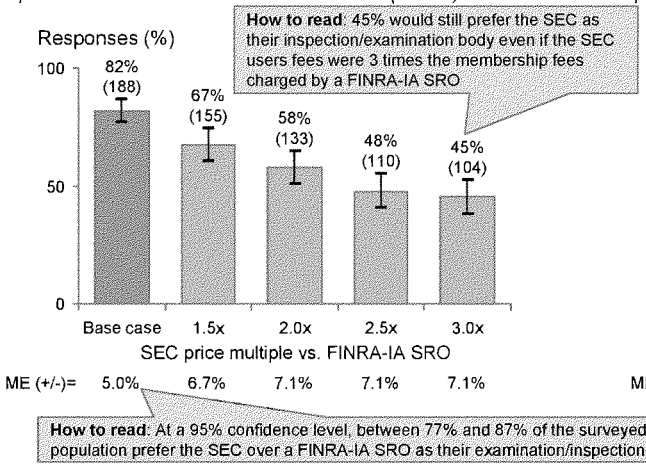
Respondent preference for SEC vs. FINRA-IA SRO

>$100M AuM respondents

Base case: *Given the following annual user/membership fees, would you personally prefer the SEC or FINRA as the inspection/examination body for your firm? (n=230)*

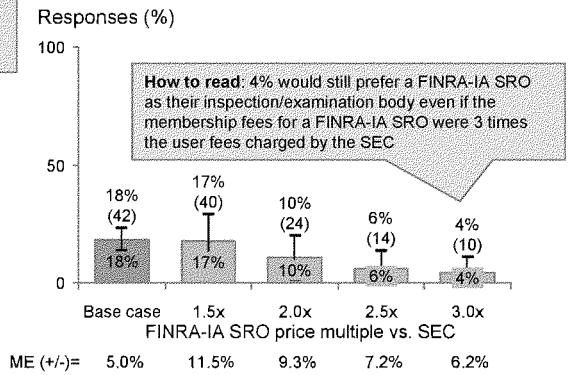
82% express preference for SEC

After base: *If the annual fees for the SEC were higher, while the annual fees for FINRA remained the same, would your preference shift from the SEC to FINRA? (n=188)*



18% express preference for FINRA-IA SRO

After base: *If the annual fees for FINRA were higher, while the annual fees for the SEC remained the same, would your preference shift from FINRA to the SEC? (n=42)*



How to read: At a 95% confidence level, between 77% and 87% of the surveyed population prefer the SEC over a FINRA-IA SRO as their examination/inspection body

Note: Respondents were initially asked to select the SEC or FINRA at a base case, after which they were queried about their willingness to pay for the previously selected organization at increasing relative price levels. Margin of error (ME) was calculated at the 95% confidence level.
Source: BCG IA Survey (2011)

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User/membership fee scenarios provided to respondents depending on respondent firm size

FINRA-IA SRO vs. New-IA SRO

Respondent Firm Size, AuM	FINRA-IA SRO	New-IA SRO
<$30M	$210	$250
$30M - $100M	$460	$550
$100M - $500M	$2,100	$2,500
$500M - $1B	$5,250	$6,300
$1B - $5B	$21,000	$25,200
$5B - $25B	$105,000	$126,000
$25B - $50B	$262,500	$315,000
$50B+	$350,000	$420,000

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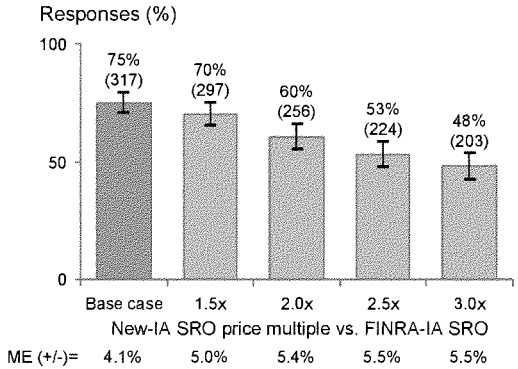
Respondent preference for FINRA-IA SRO vs. New-IA SRO

All respondents

Base case: *Given the following annual user/membership fees, would you personally prefer FINRA-IA SRO or a new IA-specific SRO as the inspection/examination body for your firm? (n=424)*

75% express preference for New-IA SRO

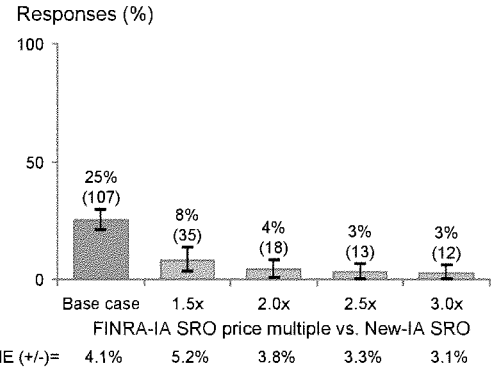
After base: *If the annual fees for the SRO were higher, while the annual fees for FINRA remained the same, would your preference shift from the SRO to FINRA? (n=317)*



ME (+/-)=	4.1%	5.0%	5.4%	5.5%	5.5%

25% express preference for FINRA-IA SRO

After base: *If the annual fees for FINRA were higher, while the annual fees for the SRO remained the same, would your preference shift from FINRA to the SRO? (n=107)*



ME (+/-)=	4.1%	5.2%	3.8%	3.3%	3.1%

Note: Respondents were initially asked to select FINRA or a new IA-specific SRO at a base case, after which they were queried about their willingness to pay for the previously selected organization at increasing relative price levels. Margin of error (ME) was calculated at the 95% confidence level.
Source: BCG IA Survey (2011)

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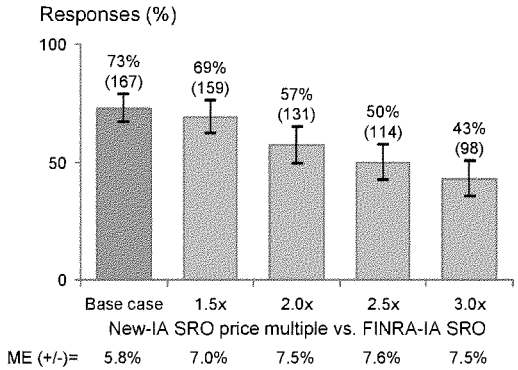
Respondent preference for FINRA-IA SRO vs. New-IA SRO

>$100M AuM respondents

Base case: *Given the following annual user/membership fees, would you personally prefer FINRA-IA SRO or a new IA-specific SRO as the inspection/examination body for your firm? (n=230)*

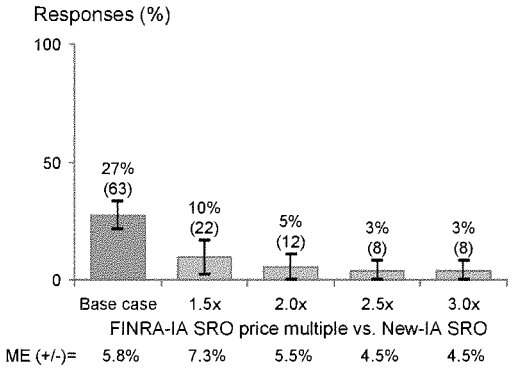
73% express preference for New-IA SRO

After base: *If the annual fees for the SRO were higher, while the annual fees for FINRA remained the same, would your preference shift from the SRO to FINRA? (n=167)*



27% express preference for FINRA-IA SRO

After base: *If the annual fees for FINRA were higher, while the annual fees for the SRO remained the same, would your preference shift from FINRA to the SRO? (n=63)*



Note: Respondents were initially asked to select FINRA or a new IA-specific SRO at a base case, after which they were queried about their willingness to pay for the previously selected organization at increasing relative price levels. Margin of error (ME) was calculated at the 95% confidence level.
Source: BCG IA Survey (2011)

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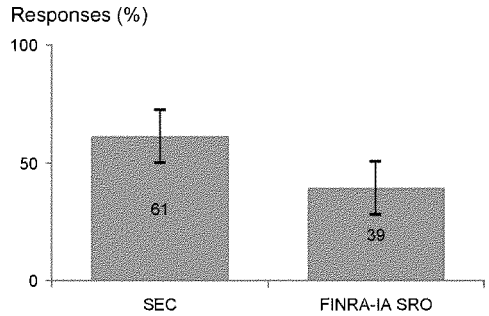
Dually registered broker-dealer respondent preferences

All dually registered broker-dealer respondents

61% of dually registered B-D respondents express preference for SEC over FINRA-IA SRO

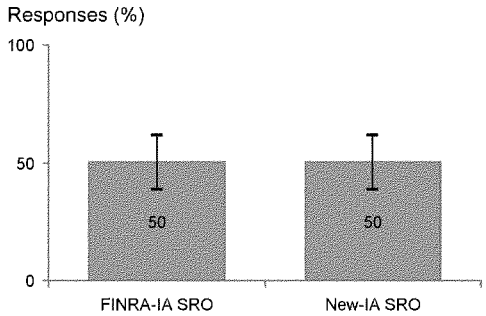
Base: *Given the following annual fees, would you personally prefer the* ***SEC or FINRA*** *as the inspection/examination body for your firm? (n=74)*



	SEC	FINRA-IA SRO
ME (+/-)=	11.1%	11.1%

50% of dually registered B-D respondents prefer a FINRA-IA SRO over a New-IA SRO

Base: *Given the following annual fees, would you personally prefer* ***FINRA-IA SRO or a new IA-specific SRO*** *as the inspection/examination body for your firm? (n=74)*



	FINRA-IA SRO	New-IA SRO
ME (+/-)=	11.4%	11.4%

Note: Respondents were initially asked to select the SEC or FINRA at a base case, after which they were queried about their willingness to pay for the previously selected organization at increasing relative price levels. Margin of error (ME) was calculated at the 95% confidence level.
Source: BCG IA Survey (2011)

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May 29, 2012

House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus and Ranking Member Frank:

We appreciate your consideration of possible reforms to the existing regulatory structure for investment advisers in the aftermath of the financial crisis that continues to cause uncertainty about the investing environment in America. However, we write to raise concerns about the Investment Adviser Oversight Act of 2012 (H.R. 4624), co-sponsored by Chairman Bachus and Representative McCarthy, which would delegate governmental authority for the oversight of investment advisers to one or more industry-funded self-regulatory organizations (SROs).

The Project On Government Oversight (POGO) is a nonpartisan independent watchdog that champions good government reforms. POGO's investigations into corruption, misconduct, and conflicts of interest achieve a more effective, accountable, open, and ethical federal government. As such, POGO believes that industry regulation is most effective when carried out by a governmental agency that is transparent, independent, ethical, and accountable.

POGO has joined others in raising serious concerns about the Financial Industry Regulatory Authority (FINRA), the largest SRO for the securities industry. FINRA's regulatory effectiveness is undermined by its inherent conflicts of interest, its lack of transparency and accountability, its lobbying expenditures, and its executive compensation packages, among other issues. A recent analysis by the Boston Consulting Group underscored the costs associated with authorizing FINRA or a new SRO to regulate investment advisers.[1]

For these reasons, we oppose H.R. 4624, which would authorize one or more SROs to oversee the investment adviser industry.

Conflicted mission leads to cozy ties with industry
FINRA collects fees from its member firms and invests in the securities industry, while also assuming responsibility for regulating and disciplining these firms, raising concerns about an inherent conflict of mission.

[1] Boston Consulting Group, *Investment Adviser Oversight: Economic Analysis of Options*, December 2011, p. 5. http://pogoarchives.org/m/fo/bcg-ia-report-20111201.pdf (Hereinafter "BCG Analysis")

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If H.R. 4624 is enacted into law, it remains to be seen whether the task of regulating investment advisers would be assigned to FINRA or to other SROs. But there could be serious conflicts of interest in either case, as highlighted in a recent study by the Securities and Exchange Commission's (SEC) Division of Investment Management:

> Multiple SROs could focus expertise and better accommodate industry diversity, but also could more likely lead to SRO "capture" by the discrete industry group from which SRO staff are drawn and to which they may return after their service. Even a single SRO, because it is not only funded by the industry it oversees, but also may include industry representatives in its governance structure or otherwise have a different relationship with industry than an independent government regulatory agency, could possibly have enhanced susceptibility to industry capture.[2]

Along these lines, a recent report by the Government Accountability Office (GAO) noted that when "the system of self-regulation was created, Congress, regulators, and market participants recognized that this structure possessed inherent conflicts of interest because of the dual role of SROs as both market operators and regulators."[3]

In the case of FINRA, POGO believes that the organization's inherently conflicted self-funding model has contributed to an incestuous relationship between FINRA and the industry it is tasked with regulating. There has been abundant evidence of this relationship in recent years, including the ties between current and former FINRA officials and firms that were later investigated or charged with fraud involving major investor losses:

- Several members of Bernard Madoff's family held leadership roles at FINRA and its predecessor, the National Association of Securities Dealers (NASD), as acknowledged in an internal study conducted by FINRA's board after Madoff's Ponzi scheme was exposed.[4]

- Bernerd Young, a former director of NASD's Dallas office, became a compliance officer at a bank run by convicted Ponzi schemer R. Allen Stanford. Young may soon face civil charges from the SEC, including a lifetime ban on working in the securities industry, according to *Reuters*.[5] At least two other Stanford executives also had previous

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[2] Securities and Exchange Commission, Division of Investment Management, *Study on Enhancing Investment Adviser Examinations*, January 2011, p. 33. http://www.sec.gov/news/studies/2011/914studyfinal.pdf (Downloaded May 23, 2012) (Hereinafter "SEC Study")

[3] Government Accountability Office, *Private Fund Advisers: Although a Self-Regulatory Organization Could Supplement SEC Oversight, It Would Present Challenges and Trade-offs* (GAO-11-623), July 2011, p. 10. http://www.gao.gov/new.items/d11623.pdf (Downloaded May 23, 2012) (Hereinafter "GAO Report")

[4] Despite these ties, the internal report found "no information to suggest that the Madoff firm received preferential or lenient treatment because of Madoff's prominence or his family's history of service to NASD and FINRA." Financial Industry Regulatory Authority, *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes*, September 2009, p. 46. http://www.finra.org/AboutFINRA/Leadership/Committees/P120076 (Downloaded May 23, 2012)

[5] Murray Waas, "How Allen Stanford kept the SEC at bay," *Reuters*, January 26, 2012. http://www.reuters.com/article/2012/01/26/us-sec-stanford-idUSTRE80P22R20120126 (Downloaded May 23, 2012)

experience at FINRA.[6]

- Jon Corzine, the former CEO and Chairman of MF Global, used to be a member of NASD's board.[7] A recent article in *Forbes* suggested that FINRA might have waived some of Corzine's registration requirements when he joined MF Global,[8] which filed for bankruptcy after losing up to $1.6 billion in customer funds.[9] More recently, Suzanne Elovic, former chief counsel in FINRA's Department of Enforcement,[10] became MF Global's head of U.S. regulatory inquiries shortly after leaving FINRA.[11]

- Susan Merrill, FINRA's former head of enforcement, left the organization and went on to represent JPMorgan[12] in its widely criticized settlement with the SEC for allegedly structuring and marketing a complex mortgage securities deal just as the housing market was starting to plummet, without informing investors that the hedge fund Magnetar had essentially created the deal and bet against it.[13]

To be sure, there are conflict-of-interest problems in government regulatory agencies as well as SROs.[14] As described below, however, government employees are at least required to comply with federal ethics laws and agency regulations designed to mitigate potential conflicts of interest. FINRA and other SRO employees, on the other hand, are only required to follow their organization's decidedly anemic ethics policies.

POGO is concerned that the inevitable conflicts of interest between an investment adviser SRO and its members will not only limit the SRO's actual effectiveness, but also damage the public's confidence in the organization's enforcement activities, thereby further limiting its regulatory impact.

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[6] Anna Driver, "Stanford workers had ties to regulator FINRA," *Reuters*, February 24, 2009. http://www.reuters.com/article/2009/02/24/us-stanford-finra-idUSTRE51N5RO20090224 (Downloaded May 23, 2012)

[7] National Association of Securities Dealers, "Jon S. Corzine Elected to NASD Board of Governors," June 26, 1997. http://www.finra.org/Newsroom/NewsReleases/1997/P010484 (Downloaded May 23, 2012)

[8] Bill Singer, "Did Someone at FINRA Do Corzine A Favor And Waiver His Registration Requirements?" *Forbes*, November 4, 2011. http://www.forbes.com/sites/billsinger/2011/11/04/did-someone-at-finra-do-corzine-a-favor-and-waive-his-registration-requirements (Downloaded May 23, 2012)

[9] House Committee on Financial Services, "Subcommittee Investigates MF Global's Final Days," March 23, 2012. http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=286900 (Downloaded May 25, 2012)

[10] Financial Industry Regulatory Authority, "Letter of Acceptance, Waiver and Consent, No. 20080144507," February 16, 2010, p. 11. http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p121484.pdf (Downloaded May 23, 2012)

[11] "Suzanne Elovic," LinkedIn. http://www.linkedin.com/pub/suzanne-elovic/21/726/a8a (Downloaded May 23, 2012)

[12] Project On Government Oversight, "JPMorgan Represented by Former Senior SEC Officials in SEC Settlement," June 28, 2011. http://pogoblog.typepad.com/pogo/2011/06/jpmorgan-represented-by-former-senior-sec-officials-in-sec-settlement.html

[13] Jonathan Weil, "JPMorgan Gets a Break Where Goldman Got Nailed," *Bloomberg*, June 23, 2011. http://www.bloomberg.com/news/2011-06-23/jpmorgan-gets-a-break-where-goldman-got-nailed-jonathan-weil.html (Downloaded May 23, 2012)

[14] Project On Government Oversight, *Revolving Regulators: SEC Faces Ethics Challenges with Revolving Door*, May 13, 2011. http://www.pogo.org/pogo-files/reports/financial-oversight/revolving-regulators/fo-fra-20110513.html

Lack of transparency and accountability
POGO and other groups from across the political and ideological spectrum have raised concerns about the lack of transparency and accountability at FINRA. We strongly urge the Committee to probe these issues before delegating any additional governmental authority to FINRA or another SRO.

The GAO recently noted that one of the potential drawbacks of creating an SRO for private funds is that it would "limit transparency and accountability, as the SRO would be accountable primarily to its members rather than to Congress or the public."[15] In the case of FINRA, even industry groups have expressed frustration with the organization's lack of transparency and accountability. The Chamber of Commerce, for instance, has noted that FINRA is not bound by the system of checks and balances that applies to government agencies:

> Transparency 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 [Administrative Procedure Act], nor is it required to conduct a cost-benefit analysis when it engages in rulemaking or exercises its policy-making functions.[16]

Several recent episodes have illustrated the vast differences between FINRA and government agencies with respect to transparency and accountability.

FINRA's board has consistently rejected calls for more transparency and accountability, even when the proposals come from the organization's own member firms. In 2010, for instance, FINRA's board rejected a series of proposals approved by FINRA's member firms that would have required the organization to provide transcripts of board meetings, employ an independent private sector inspector general to oversee the organization, and give FINRA members a non-binding "say on pay" for the most highly compensated FINRA employees, among other things.[17] In addition, POGO has argued that FINRA's recently introduced revolving door rule is woefully inadequate to protect against conflicts of interest.[18]

Even though FINRA is not subject to many basic oversight measures, the organization is still protected by a special type of legal immunity that normally applies to governmental entities. Last year, POGO joined with several public interest groups in an amicus brief asking the Supreme Court to consider whether FINRA and other groups acting with quasi-governmental authority

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[15] "GAO Report," p. 20
[16] Chamber of Commerce, Center for Capital Markets Competitiveness, *U.S. Capital Markets Competitiveness: The Unfinished Agenda*, Summer 2011, p. 23.
http://www.uschamber.com/sites/default/files/reports/1107_UnfinishedAgenda_WEB.pdf (Downloaded May 23, 2012)
[17] Project On Government Oversight, "POGO letter to FINRA calling for open Board meetings," December 8, 2010. http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20101208.html
[18] Project On Government Oversight, "Self-Regulatory Group Introduces Revolving Door Rule—But Does It Go Far Enough?" July 14, 2011. http://pogoblog.typepad.com/pogo/2011/07/self-regulatory-group-introduces-revolving-door-rule-but-does-it-go-far-enough.html

should enjoy the same kind of sovereign immunity that applies to government agencies, even when the SRO is sued for misconduct related to its private business. The brief stated that:

> The extension of sovereign immunity to SROs...produces the bizarre result that a corporate entity—which lacks the democratic accountability that legitimizes our federal and state governments—can avail itself of the same protections as actual governments subject to oversight via the democratic process.[19]

The Supreme Court declined to consider this matter,[20] but we urge the Committee to examine the potential legal ramifications of granting new powers to FINRA or another SRO.

POGO has also heard from many investors and current and former employees of broker-dealers about the lack of transparency and accountability in FINRA's mandatory arbitration system. In one recent case, Mark Mensack, a former financial adviser at Morgan Stanley, filed a suit in the New Jersey Superior Court alleging that Morgan Stanley retaliated against him after he raised concerns internally about a "pay-to-play" scheme involving 401(k) assets administered by the firm. Morgan Stanley was able to get the case moved to a FINRA arbitration proceeding, where it also filed a claim against Mensack seeking return of his signing bonus. The arbitrators ruled in Morgan Stanley's favor, ordering Mensack to pay $1.2 million and forcing him into bankruptcy.

But when Mensack and his attorney requested an audio copy of the arbitration hearing, they discovered that eight hours' worth of testimony had mysteriously gone missing. Earlier this year, a FINRA regional director apologized for the fact that "portions of testimony returned to us by the panel are missing from the records," but informed Mensack and his attorney that "FINRA has no authority to reverse the award."[21] Mensack has indicated that the missing recordings would have provided evidence of additional misconduct in the arbitration hearing. Several commentators have pointed to Mensack's case as an example of "sham justice" before a "kangaroo court."[22]

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[19] "Brief of Amici Curiae Public Citizen, Consumer Action, Project On Government Oversight, and U.S. PIRG in Support of Petition for a Writ of Certiorari," *Standard Investment Chartered, Inc. v. National Association of Securities Dealers, et al.*, October 2011, p. 15. http://pogoarchives.org/m/fo/standard-amicus-20111025.pdf

[20] James Vicini, "Supreme Court won't hear FINRA immunity case," *Reuters*, January 17, 2012. http://newsandinsight.thomsonreuters.com/Legal/News/2012/01_-_January/Supreme_Court_won_t_hear_FINRA_immunity_case (Downloaded May 23, 2012)

[21] Letter from Katherine M. Bayer, Regional Director, Financial Industry Regulatory Authority, to Robert Lakind, Szaferman, Lakind, Blumstein & Blader, P.C., regarding FINRA Dispute Resolution Arbitration Case Number 10-01687, *Morgan Stanley Smith Barney LLC, vs. Mark D. Mensack vs. Morgan Stanley & Co., Inc., Peter Prunty and Rich Maratea*, January 13, 2012. http://pogoarchives.org/m/fo/finra-response-20120113.pdf

[22] Al Lewis, "Broker bankrupted in kangaroo court," *MarketWatch*, March 14, 2012. http://articles.marketwatch.com/2012-03-14/commentary/31163067_1_finra-financial-industry-regulatory-authority-morgan-stanley (Downloaded May 23, 2012); William D. Cohan, "Whistleblower Gets Sham Justice From Wall Street Court," *Bloomberg*, March 18, 2012. http://www.bloomberg.com/news/2012-03-18/whistleblower-gets-sham-justice-from-wall-street-court.html (Downloaded May 23, 2012)

Mensack's case is also troubling in light of another recent episode in which the SEC alleged that a FINRA regional director "caused the alteration of three records of staff meeting minutes just hours before producing them to the SEC inspection staff, making the documents inaccurate and incomplete."[23]

Excessive spending on lobbying and executive compensation

FINRA has also distinguished itself from governmental regulatory agencies through its excessive spending on lobbying and executive compensation. The organization spent nearly $4 million on lobbying between 2008 and 2011, according to the Center for Responsive Politics,[24] not to mention its significant expenditures on advertising and "public interest" spots in national media outlets.[25] These figures do not include the significant lobbying expenditures and campaign contributions made by FINRA's member firms.

In addition, FINRA provides lucrative compensation packages for its top executives and board members. In 2010, FINRA's top 10 executives received nearly $13 million in pay and benefits, according to FINRA's annual report.[26] POGO believes these compensation packages are excessive for a non-profit regulatory organization, especially one that failed to crack down on the abusive market activities that fueled the financial crisis. POGO is also concerned that these lavish pay packages may have exacerbated the organization's inherent conflicts of interest, as top officials become even more indebted to the industry they are supposed to oversee.

POGO believes that FINRA should be benchmarking its compensation packages against those provided by federal agencies such as the SEC, which already has the authority to pay its top employees at rates beyond the normal governmental pay scale.[27]

Furthermore, POGO is concerned that some SEC officials may generally be biased in favor of the SRO model due to the extravagant pay packages they received while working at FINRA. In its press release announcing the introduction of H.R. 4624, the Committee cited several key leaders who have supported creating an SRO for investment advisers.[28] It is worth noting that many of these leaders used to work for FINRA and recently received generous pay packages from the organization. For instance, SEC Chairman Mary Schapiro received a final distribution of nearly $9 million when she stepped down as the head of FINRA.[29] SEC Commissioner Elisse

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[23] Securities and Exchange Commission, "SEC Orders FINRA to Improve Internal Compliance Policies and Procedures," October 27, 2011. http://sec.gov/news/press/2011/2011-227.htm (Downloaded May 23, 2012)

[24] Center for Responsive Politics, "Lobbying: Financial Industry Regulatory Authority." http://www.opensecrets.org/lobby/clientsum.php?id=D000021564&year=2011 (Downloaded May 23, 2012)

[25] Sarah Lynch, "New Finra Ad Campaign Talks Tough On Fraud," *Dow Jones Newswires*, June 15, 2009.

[26] Financial Industry Regulatory Authority, *FINRA 2010 Year in Review and Annual Financial Report*, p. 18. http://www.finra.org/AboutFINRA/AnnualReports (Downloaded May 23, 2012)

[27] Securities and Exchange Commission, *Pay Parity Implementation Plan and Report*, March 6, 2002. http://www.sec.gov/news/studies/payparity.htm (Downloaded May 23, 2012)

[28] House Committee on Financial Services, "Chairman Bachus and Rep. McCarthy Propose Bipartisan Bill for More Effective Oversight of Investment Advisers," April 25, 2012. http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=292499 (Downloaded May 23, 2012)

[29] Financial Industry Regulatory Authority, *Report of the Amerivet Demand Committee of the Financial Industry Regulatory Authority, Inc.*, September 13, 2010, p. 92. http://www.finra.org/AboutFINRA/Leadership/Committees/P122215 (Downloaded May 23, 2012)

Walter, another former FINRA executive, received more than $3.7 million in salary and bonuses when she left the organization.[30]

It is hard to see how these officials could provide truly objective advice about SROs given their recent professional and financial ties to FINRA.

Costs of creating and overseeing an investment adviser SRO

The SEC staff study on investment adviser oversight pointed out that "[o]verseeing an SRO requires substantial resources," even though "[t]here is no certainty that the level of resources available to the Commission over time would be adequate to enable staff to effectively oversee the activities of the SRO."[31] Although SROs are typically funded by fees imposed on their members, SEC resources would still be required for "conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee and rule changes," according to the study.[32]

A recent analysis by the Boston Consulting Group found that the annual costs of authorizing FINRA or a new SRO to oversee investment advisers would be anywhere from $550 million to $670 million, compared to an annual cost of $100 million to $270 million to enhance the SEC's capacity to examine investment advisers.[33]

There is no question that the SEC—which is already working with limited resources to implement a wide range of requirements under the Dodd-Frank Act—would have to set aside significant budgetary and staffing resources to oversee an investment adviser SRO. In some cases, these oversight duties may even result in a duplication of efforts between the SEC and the SRO. POGO agrees with SEC Commissioner Luis Aguilar's statement that creating an investment adviser SRO would be an "illusory way of dealing with the problem of resources."[34]

One possible reform outlined in the SEC staff study would authorize the agency to collect user fees from registered investment advisers to support the SEC's examination program.[35] If Congress decides that user fees are an appropriate measure to enhance investment adviser oversight, it should take steps to ensure that the fees are collected and managed by the SEC, not

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[30] Financial Industry Regulatory Authority, Form 990, 2008, p. 32. http://pogoarchives.org/m/er/merrill-2008-compensation.pdf. But unlike Chairman Schapiro, who recused herself from voting on the SEC staff study regarding investment adviser oversight, Commissioner Walter issued an unusual statement criticizing the study and calling on Congress to authorize an investment adviser SRO. Sarah N. Lynch, "SEC to unveil studies on brokers, advisers," *Reuters*, January 12, 2011. http://www.reuters.com/article/2011/01/12/us-sec-fiduciary-idUSTRE70B60W20110112 (Downloaded May 23, 2012); Securities and Exchange Commission, "Commissioner Elisse B. Walter: Statement on Study Enhancing Investment Adviser Examinations," January 2011. http://sec.gov/news/speech/2011/spch011911ebw.pdf (Downloaded May 23, 2012)

[31] "SEC Study," p. 28

[32] "SEC Study," p. 30

[33] "BCG Analysis," p. 5

[34] Securities and Exchange Commission, "Speech by SEC Commissioner: SEC's Oversight of Adviser Industry Bolsters Investor Protection," May 7, 2009. http://www.sec.gov/news/speech/2009/spch050709laa.htm (Downloaded May 23, 2012)

[35] "SEC Study," p. 39

an SRO, prevent investment advisers from negotiating the fees, and mitigate other potential conflicts of interest.[36]

Regardless of how the funding is provided to enhance the SEC's oversight of investment advisers, it is ultimately Congress's responsibility to ensure that the SEC and other financial regulatory agencies have the resources they need to effectively carry out their mission, including their expanded responsibilities under Dodd-Frank.

Recommendations

POGO believes there is no substitute for governmental regulation of the investment adviser industry. Therefore, we urge the Committee to reject H.R. 4624.

FINRA's inherent conflict of mission, its lack of transparency and accountability, and its excessive expenditures on executive compensation and lobbying illustrate why creating an SRO for investment advisers will not serve the interests of investors, shareholders, consumers, or other stakeholders. In addition, creating a private self-regulatory group for investment advisers would create significant costs and oversight challenges for the SEC.

Instead of delegating additional authority to private self-regulatory groups, Congress should reduce the SEC's current reliance on FINRA and other SROs, work to improve FINRA's transparency and accountability policies, and provide sufficient funding to the SEC to ensure that it is able to carry out its important regulatory duties on its own. If we have learned anything from the financial crisis of the past few years, it is that inadequate federal regulation of the financial industry leads to excessive risk and instability in our economy.

[36] POGO and its allies have also urged Congress to consider authorizing user fees as a way to increase funding for the Commodity Futures Trading Commission (CFTC). These fees would be set across the board at a level needed to offset the agency's budget, mitigating the potential conflicts of interest that might arise if the CFTC was able to independently assess fees on individual firms. Project On Government Oversight, "POGO and Allies Urge Congress to Provide Full Funding to CFTC," May 4, 2012. http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20120504-congress-funding-cftc.html

We would be pleased to discuss this issue in more detail with you or your staff. If you have questions or would like any additional information, please contact us at 202-347-1122 or acanterbury@pogo.org or msmallberg@pogo.org.

Sincerely,

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Director of Public Policy

Michael Smallberg
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cc: Members of the House Committee on Financial Services
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June 4, 2012

The Honorable Spencer Bachus
Chairman
House Financial Services Committee
Washington, DC 20515

The Honorable Barney Frank
Ranking Member
House Financial Services Committee
Washington, DC 20515

Re: HR 4624, the "Investment Advisers Oversight Act of 2012"

Dear Chairman Bachus & Ranking Member Frank,

I write to express concern about aspects of HR 4624, the "Investment Advisers Oversight Act of 2012," that would infringe separation of powers principles and undermine the role of state regulators. I am a professor of constitutional law and federal jurisdiction at Duke Law School, and both my teaching and scholarship focus on the sorts of structural issues implicated by HR 4624. As a constitutional scholar, I am hardly the best person to speak to whether the bill makes sense as a policy matter; rather, my focus is on the extent to which HR 4624 offends constitutional principles of separation of powers and federalism. From that standpoint, I have three primary concerns about the bill:

1. HR 4624 purports to subordinate state securities regulators to one or more federally-created self-regulatory organizations (SROs), thereby offending state sovereignty and imposing unwarranted practical burdens on state regulators.
2. The extensive regulatory authority that HR 4624 delegates to a private industry body raises concerns under longstanding principles holding that Congress may not delegate legislative power to private actors.
3. The structure of the SROs authorized by HR 4624—and particularly the insulation of the SROs' officers from presidential removal—appears to duplicate the provisions of the Public Company Accounting Oversight

Board (PCAOB) found unconstitutional by the Supreme Court in *Free Enterprise Fund v. PCAOB*, 130 S. Ct. 3138 (2010).

In my view, there is a significant risk that, if enacted, HR 4624 would not survive judicial review. But the more important point is that, as the first-line defenders of constitutional values in the legislative process, Congress itself ought to be vigilant to correct aspects of legislation that threaten constitutional principles of federalism and separation of powers.

The Federalism Issue: Under current law, investment advisers with less than $100 million in assets under management are regulated primarily under state law. HR 4624 would intrude on this state jurisdiction by requiring state-regulated advisers to join a federally-created SRO and comply with the rules promulgated by the group. Even worse, it would require state regulators to make annual reports to the SRO, through the State securities administrators association, and to formulate a "state examination plan" in order to avoid redundant federal inspections. Finally, HR 4624 would exert considerable pressure on state regulators to conform their examinations of investment advisers to the four-year period required under the bill to avoid federal inspections—whether or not state regulators deem this "one size fits all" approach to be sensible in their particular state regulator context.

Federal law frequently enlists state participation in various "cooperative federalism" schemes, whereby states play an important role in the implementation of federal law and their implementation efforts must conform to certain federal standards. HR 4624 is highly unusual, however, in that it subordinates state regulators not to federal agency officials, but rather to *private* entities exercising federal authority. The information-gathering and reporting obligations imposed on the states in this bill are substantial, and the mandatory nature of those obligations may well amount to unconstitutional "commandeering" of state officials under *Printz v. United States*, 521 U.S. 898 (1997).[1] Moreover, requiring

[1] In *Printz*, the Court held that "Congress cannot compel the States to enact or enforce a federal regulatory program," and "Congress cannot circumvent that prohibition by conscripting the State's officers directly. The Federal Government may neither issue directives requiring the States to address particular problems, nor command the States' officers . . . to administer or enforce a federal regulatory program." 521 U.S. at 935.

those obligations to be carried out under the auspices of a private organization is a significant—perhaps even unprecedented—affront to state sovereignty.

I cannot overemphasize, moreover, how the federalism problem here is compounded by the separation of powers problems discussed later in this letter. The Supreme Court has emphasized that the primary protection for state sovereignty in our constitutional system is the representation of states within the federal political process. As the Court explained in *Garcia v. San Antonio Metropolitan Transit Authority*,

> [T]he Framers chose to rely on a federal system in which special restraints on federal power over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power.

469 U.S. 528, 552 (1985). For that reason, it is critical that laws limiting state regulatory autonomy come from Congress itself, in which the states are directly represented, and that those laws respect the separation of powers principles that render executive officials accountable both to Congress and an elected president. Critically, HR 4624 would take important regulatory decisions bearing directly on state regulation out of the hands of federal political officials accountable to the states and transfer those decisions to a largely unaccountable private entity. Although, as I discuss below, that transfer is arguably unconstitutional under separation of powers principles alone, it also exacerbates the federalism problem posed by the bill.

The Private Delegation Issue: Most courts and scholars have concluded that the general nondelegation doctrine, which limits Congress's ability to delegate legislative authority to administrative agencies and other executive actors, has very few teeth remaining under current law. But a subsidiary aspect of that doctrine—that Congress generally may not delegate governmental authority to *private* actors—retains considerable force. That principle traces to *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936), which struck down a provision of the Bituminous Coal Conservation Act that allowed a majority of coal producers to set maximum hours for workers in the industry. The Court said that "[t]his is legislative delegation in its most obnoxious form; for it is not even delegation to an official or an official body, presumptively disinterested, but to private persons

whose interests may be and often are adverse to the interests of others in the same business." *Id.* at 311.[2]

This principle retains considerable vitality notwithstanding the general acceptance of broad delegation to *public* agencies. The Constitution thus limits *private* delegations much more strictly than public ones.[3] One reason is that while Congress maintains important levers by which it may hold agency officials accountable—including confirmation of agency officials, oversight hearings, and control of agency budgets—those mechanisms have little purchase on private bodies. That is especially true here: HR 4624 does not appear to provide for any public role in the appointment of SRO officers or control over the SRO's budget, and it provides no intelligible principle to guide the SEC in approving or disapproving the rules that the SRO promulgates.[4]

The private entities that have survived delegation challenges, moreover, have generally exercised far narrower powers. The lower courts have approved private entities entrusted with official power to manage government-mandated funds, such as the Coal Act's "combined fund" for retired coal miners, *Pittston Co. v. United States*, 368 F.3d 385, 394-98 (4th Cir. 2004), or the Beef Promotion Act's industry-wide assessment for beef marketing activities, *United States v. Frame*, 885 F.2d 1119, 1128-29 (3rd Cir. 1989). In sustaining these measures, the courts have described permissible powers exercised by private entities as "advisory" and "ministerial." *Frame*, 885 F.2d at 1129. In *Frame*, for example, the Third Circuit

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[2] Although *Carter Coal* was decided prior to the Supreme Court's famous "switch in time" of 1937, after which the Court became more sympathetic to federal regulation generally, subsequent cases have been careful to maintain the line between permissible delegations to governmental agencies and impermissible delegations of legislative authority to private bodies. *See, e.g., Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381, 399 (1940) (rejecting a delegation claim after finding that the challenged act did not, in fact, confer legislative authority on private actors); *Currin v. Wallace*, 306 U.S. 1, 15-16 (1939) (same).

[3] *See, e.g., Pittston Co. v. United States*, 368 F.3d 385, 394 (4th Cir. 2004) ("Any delegation of regulatory authority 'to private persons whose interests may be and often are adverse to the interests of others in the same business' is disfavored.") (quoting *Carter Coal*).

[4] *See, e.g., Association of American Railroads v. U.S. Dept. of Transportation*, 2012 WL 1949010 (D.D.C. 2012) (rejecting private delegation challenge to Amtrak on the grounds that federal law dictated Amtrak's goals, the federal government appointed the majority of Amtrak's board, and Congress exercised extensive oversight over operations and control of Amtrak's budget). Significantly, Amtrak exercised no rulemaking authority over private actors.

stressed that "the amount of government oversight of the program is considerable, and . . . no law-making authority has been entrusted to the members of the beef industry." *Id.* at 1128.

The same cannot be said of HR 4624: Government oversight of the SRO is quite attenuated, the SRO's authority includes the power to make binding rules regulating investment advisers, and the statute lays out few guidelines concerning the content of those rules. Basically, the proposed SRO exercises precisely the same sort of broad governmental authority that the SEC would exercise were it to bolster regulation of investment advisers more directly. Notwithstanding courts' general reluctance to strike down federal statutes on nondelegation grounds, the breadth of this delegation and the fact that it gives power to private actors may well raise significant concerns in the courts. But more importantly, it is primarily *Congress*'s responsibility to ensure that its statutes adequately constrain the discretion of delegatees, and that power only be delegated to entities that are publicly accountable.

The Removal Issue: Section (h)(4) of HR 4624 states the standard under which the SEC may remove officers of the SRO. It provides:

> [T]the Commission may, by order, remove from office or censure any officer, director or any person performing similar functions of a national investment adviser association, if the Commission finds, on the record after notice and opportunity for hearing, that such person has willfully violated any provision of this title, the rules or regulations thereunder, or the rules of the national investment adviser association, willfully abused his authority, or without reasonable justification or excuse has failed to enforce compliance with any such provision by any member or person associated with a member.

This removal standard is virtually identical to the original structure of the PCAOB, which similarly insulated officers of that body from removal by the Securities Exchange Commission.[5] Moreover, SEC members themselves "cannot

[5] As the Court noted in *Free Enterprise Fund*, removal of a PCAOB member required "a Commission finding, 'on the record' and 'after notice and opportunity for a hearing,' that the Board member

themselves be removed by the President except under the *Humphrey's Executor* standard of 'inefficiency, neglect of duty, or malfeasance in office,'" *Free Enterprise Fund*, 130 S. Ct. at 3148 (quoting *Humphrey's Executor v. United States*, 295 U.S. 602, 620 (1935)).

HR 4624 thus creates the same double-layer of insulation from presidential control that *Free Enterprise Fund* found unconstitutional. As the Court noted,

> This novel structure does not merely add to the Board's independence, but transforms it. Neither the President, nor anyone directly responsible to him, nor even an officer whose conduct he may review only for good cause, has full control over the Board. The President is stripped of the power our precedents have preserved, and his ability to execute the laws—by holding his subordinates accountable for their conduct—is impaired.

130 S. Ct. at 3154. As in *Free Enterprise Fund*, a reviewing court is certain to find that the removal provisions of HR 4624 are "contrary to Article II's vesting of the executive power in the President" and thus "incompatible with the Constitution's separation of powers." *Id.* at 3154, 3155.

As I have said, the separation of powers concerns that I have described become all the more pressing in light of HR 4624's impact on federalism and state sovereignty. The proposed bill not only takes the largely unprecedented step of subjecting state regulators to a private SRO, but it also delegates considerable lawmaking power to that private institution and insulates that SRO both from congressional oversight and presidential removal. Ordinarily, the States' representation in the political process provides a voice for state regulatory concerns, but HR 4624's circumvention of ordinary governmental processes of oversight and accountability robs the "political safeguards of federalism" of their

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'(A) has willfully violated any provision of th[e] Act, the rules of the Board, or the securities laws;

'(B) has willfully abused the authority of that member; or

'(C) without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by any registered public accounting firm or any associated person thereof.'"

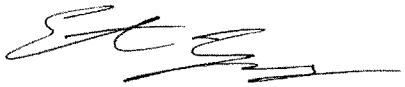
130 S. Ct. at 3148.

ordinary force. Again, whether or not a federal court would strike HR 4624 down on these grounds,[6] Congress remains charged with the primary responsibility to respect constitutional values of state sovereignty and state autonomy.

The end of increasing supervision of investment advisers is a worthy one, and many of the problems I have identified may well be avoided by adjustments in the proposed bill's coverage and operation. In particular, the bill should be amended to reflect and maintain the current reality tht state regulators are partners with Congress and the SEC in regulating investment advisers, not subordinate to a private SRO. And the bill should be careful to maintain the separation of powers safeguards reflected in the President's removal power and the Constitution's limits on private delegations. These are likely not insuperable obstacles, but it is nonetheless important to respect these principles as Congress moves forward on this issue.

Thank you for considering these points. If I may be of any further assistance on this matter, please do not hesitate to let me know.

Sincerely,



Ernest A. Young
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[6] *Cf. Massachusetts v. U.S. Dept. of Health & Human Services*, 2012 U.S. App. LEXIS 10950 (1st Cir., May 31, 2012) (striking down the federal Defense of Marriage Act in part on the ground that the Act's interference with the operation of state law exacerbated the equal protection problems that it posed).

No. 11-381

IN THE
Supreme Court of the United States

STANDARD INVESTMENT CHARTERED, INC.,
Petitioner,
v.
NATIONAL ASSOCIATION OF SECURITIES DEALERS, ET AL.,
Respondents.

On Petition for a Writ of Certiorari
to the U.S. Court of Appeals for the Second Circuit

BRIEF *AMICI CURIAE* OF THE CATO INSTITUTE AND THE COMPETITIVE ENTERPRISE INSTITUTE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Respondent National Association of Securities Dealers (NASD)—now known as the Financial Industry Regulatory Authority (FINRA)—is a private entity that engages in proprietary activities as well as certain regulatory activities of its members as a "Self-Regulatory Organization" (SRO). Petitioner, a securities dealer, is a FINRA member. Petitioner and other members lost significant voting control over FINRA through a proxy solicitation. Petitioner then brought this state-law suit alleging that FINRA had lied to the membership in the proxy statement by significantly understating the compensation they could legally receive in exchange for giving up some of their voting rights.

The Second Circuit held, in conflict with other circuits, that SROs have absolute, non-statutory immunity for any illegal acts that are "incident to" their regulatory activities. In this case, the court reasoned, the voting-rights changes were "incident to" FINRA's regulatory activities because they were part of a broader plan by FINRA to acquire assets from a competitor and to form a larger entity that would also have certain SRO responsibilities.

The Question Presented is:

Are SROs entitled to the absolute immunity given to government actors even for actions separate from the regulatory duties that shroud them in those quasi-governmental clothes for other purposes?

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INTEREST OF *AMICI CURIAE*[1]

The Cato Institute believes that sound public policy requires, as the Framers understood, a limited federal government composed of properly divided branches. Cato was established in 1977 as a nonpartisan public policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the principles of limited constitutional government that are the foundation of liberty. Toward those ends, the Cato Institute publishes books and studies, conducts conferences, publishes the annual *Cato Supreme Court Review*, and files *amicus* briefs with the courts. This case is of central concern to Cato because it implicates the core constitutional structures that secure our liberty.

The Competitive Enterprise Institute is a nonprofit public interest organization dedicated to advancing the principles of individual liberty and limited government. CEI engages in research, education, and advocacy on a broad range of regulatory and legal issues, including constitutional and administrative law, and financial regulation. CEI attorneys served as co-counsel for the petitioners in the recent separation-of-powers case, *Free Enterprise Fund v. Pub. Co. Acc'ting Oversight Bd.*, 130 S. Ct. 3138 (2010).

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ARGUMENT

This petition presents an opportunity for this Court to clarify the judiciary's role in enforcing accountability of its coequal branches. Although the public has long had the power to challenge abuses of government authority through private suit, *see generally* Jerry L. Marshaw, *Civil Liability of Government Officers: Property Rights and Official Accountability*, 42 Law & Contemp. Probs. 8 (1978), the Second Circuit's decision below threatens to curtail this check on government power.

Accountability within and among branches of government is a central tenet of our constitutional structure. The principle of accountability is inextricable from such foundational theories as separation of powers, checks and balances, and federalism, and has even been labeled the "sine qua non of legitimacy in government action." Rebecca L. Brown, *Accountability, Liberty, and the Constitution*, 98 Colum. L. Rev. 531, 532 (1998).

This Court has repeatedly stressed the need for political accountability whenever government power is exercised. *See, e.g.*, *Free Enterprise Fund v. Pub. Co. Acc'ting Bd.*, 130 S. Ct. 3138, 3155-57 (2010); *Edmond v. United States*, 520 U.S. 651, 660 (1997). But direct accountability to the public by way of the judiciary is no less important. *See* Gillian E. Metzger, *Privatization as Delegation*, 103 Colum. L. Rev. 1367, 1401-02 (2003); *see also infra* part IA(1). Now is the time for this Court to explicitly recognize the role of the judiciary in holding quasi-governmental bodies accountable.

I. SROS MUST BE AMENABLE TO PRIVATE SUIT TO COUNTERACT THE POWER THEY HAVE BEEN DELEGATED.

Self-regulatory organizations reside within the same space in our constitutional framework that agencies and other regulatory bodies occupy. *See* Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 Stan. J.L. Bus. & Fin. 151, 196-97 (2009) (concluding that SROs should be treated as agencies despite remaining somewhat private). The SRO in question here, the Financial Industry Regulatory Authority,[2] is not accountable to the executive and, after the decision below, is no longer accountable to the public through private suit. Not only are groups like FINRA acquiring expansive power through their own private dealings, but judicial and executive decisions have vested tremendous power in these entities while simultaneously stripping away key oversight structures.

Two arguments cut in favor of reversing the decision of the Second Circuit because of its effect on SRO accountability. First, the Constitution demands checks on delegated power. Second, absolute immunity itself is a serious abdication of oversight and is not appropriate in this case.

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[2] Throughout this brief, the National Association of Securities Dealers will be referred to by its current and more common name, the Financial Industry Regulatory Authority.

A. Our Constitutional Framework Demands That All Entities Exercising Delegated Authority Be Held Accountable.

Three characteristics of our constitutional framework require judicial oversight of SROs: (1) core principles of the non-delegation doctrine, (2) the nature of SROs as quasi-private actors, and (3) the executive branch's demonstrated lack of oversight.

1. Principles of non-delegation advise against delegating wide swaths of power without accompanying oversight or accountability.

The non-delegation doctrine cautions against expanding the scope of SRO immunity. Although the delegation of significant legislative and executive functions to agencies and SROs is a well-established practice, courts have retained a key role in overseeing agencies and policing abuses of authority. Metzger, *supra*, at 1401-02 ("A defining characteristic of the U.S. constitutional order is the authority it gives to judges to enforce constitutional constraints against other government officials at the instance of private individuals claiming injury from unconstitutional action.").[3]

Even more than in delegation to public agencies, delegation of power to private actors should be construed narrowly and reviewed with an eye toward ensuring that exercises of regulatory authority remain rooted in the enumerated powers of the Constitution. As long ago as 1936, this Court has

[3] The non-delegation doctrine emerged from the Constitution's three vesting clauses. U.S. Const. art. I, § 1 (legislative); U.S. Const. art. II, § 1 (executive); U.S. Const. art. III, § 1 (judicial).

recognized the uneasy alliance created between public and private actors when private parties receive grants of legislative authority. *See Carter v. Carter Coal Co.*, 298 U.S. 238, 311 (1936). In *Carter Coal*, this Court famously declared that delegating power to one group of citizens for rule over another was "legislative delegation in its most obnoxious form." *Id.* Despite its strong opposition to delegation, this Court quickly retreated from that categorical position in favor of a flexible standard that is familiar to agencies today. *See, e.g.*, *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940); *Currin v. Wallace*, 306 U.S. 1 (1939).[4]

The move away from the categorical position laid out in *Carter Coal* occurred simultaneously with the rise of new limitations on the delegation of authority to agencies. In fact, the decline of the non-delegation doctrine occurred precisely "*because* the Court established certain safeguards surrounding the [delegation] of these powers." *Fed. Mar. Comm'n v. S.C. State Ports Auth.*, 535 U.S. 743, 773 (2002) (Breyer, J., dissenting) (citing *A.L.A. Schecter Poultry Corp. v. United States*, 295 U.S. 495 (1935) and *Crowell v. Benson*, 285 U.S. 22 (1932)) (emphasis added). Simply put, as the non-delegation doctrine weakened, safeguards against administrative abuses became proportionally more substantive.[5]

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[4] For a review of early non-delegation doctrine cases, see George L. Liebmann, *Delegation to Private Parties in American Constitutional Law*, 50 Ind. L.J. 650, 662-67 (1975) (analyzing cases in the 1930s and early 1940s).

[5] While the categorical approach to the non-delegation doctrine has largely been superseded, its spirit continues to affect our understanding of administrative law. *See* Antonin Scalia, *A Note on the Benzene Case*, 4 Regulation, July-Aug. 1980, at 28

One of those safeguards is judicial review. A grant of quasi-legislative power to agencies, or even entirely private organizations, is made more legitimate where judicial review is also available to serve as a check on the use of that authority.[6] The judicial review requirement is not absolute, however; in many cases, such as where appropriations or taxation are involved, the "operative political checks are sufficient." George L. Liebmann, *Delegation to Private Parties in American Constitutional Law*, 50 Ind. L.J. 650, 715 (1975). In the absence of political checks, or where political checks are so weak as to be functionally meaningless, judicial review and legal liability are necessary to ensure proper oversight.

Judicial review of agency behavior is an important mechanism for ensuring legal accountability. *See* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 Notre Dame L. Rev. 975, 1062 (2005) (noting the importance of judicial review for accountability in the administrative state). Constitutional accountability typically stems from either of two sources: political accountability or legal accountability. Metzger, *supra*, at 1401-02.

("So even with all its Frankenstein-like warts, knobs, and (concededly) dangers, the unconstitutional delegation doctrine is worth hewing from the ice.") *Id.* ("In truth, of course, no one has ever thought the unconstitutional delegation doctrine did not *exist* as a principle in our government."); *see also* Cass R. Sunstein, *Nondelegation Canons*, 67 U. Chi. L. Rev. 315 (2000) (noting that the principles of the delegation doctrine are still widely applied, albeit in several different forms).

[6] Notably, one of the first instances of judicial review, *Dr. Bonham's Case*, 77 Eng. Rep. 646 (1610), entails review of a private board that was delegated licensing authority. *See* Liebmann, *supra*, at 700.

Here, political accountability is *de minimis* due to the layers of authority separating FINRA from executive branch officers. *See Free Enterprise Fund* 130 S. Ct. *at* 3154 ("Without the ability to oversee the [agency], or to attribute the [agency's] failings to those whom he *can* oversee, the President is no longer the judge of the [agency's] conduct."). Unfortunately, legal accountability—judicial review—has also eroded, leaving FINRA and similarly situated SROs almost entirely unaccountable.

2. SROs continue to operate as private organizations and face the same pressures as other private actors.

The second reason SROs require judicial oversight is because of their largely private status. SROs, and especially those in the financial sector, typically maintain the ethos of a private actor. *See* Steven J. Cleveland, *The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations,* 55 Am. U. L. Rev. 1 (2005) (concluding that SROs are generally not governmental actors based on their incentive structure and decisionmaking processes); Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 Duke L.J. 389 (2003) (applying tools of economic analysis to explain decisionmaking of private regulators).

The history of both the New York Stock Exchange and the NASD suggests that both component parts of FINRA have evolved as largely private organizations. *See* Karmel, *supra*, at 159-70 (describing the history of both organizations from 1792 through the formation of FINRA). The NYSE

formed in 1792 in reaction to a scandal in the government bond market and the NASD, FINRA's predecessor, formed in 1936 as the reorganization of a trade group. *Id.*; *see also* Dale Arthur Oesterle, *Securities Market Regulation: Time to Move to a Market-Based Approach*, 374 Cato Inst. Policy Analysis, at 3 (2000), *available at* http://www.cato.org/pubs/pas/pa374.pdf. Even today, despite their role as front-line regulators, many are "looking for ways to shed their self-regulatory responsibilities and join the ranks of their erstwhile members as for-profit competitors." Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 Brook. J. Corp. Fin. & Com. L. 317, 317 (2007); *see also id.* at 331-35 (explaining how the self-interest of SROs and their officials is pushing those organizations into an increasingly for-profit model). The pressure on many SROs to dabble in both public and private activities is certainly understandable, but courts and the public should not be blind to these forces. *See* Oesterle, *supra*, at 5 ("The SRO regime does not comport with common sense about basic human incentives in economic markets."). More importantly, however, courts and the public should not conflate SROs' private and public activities as the Second Circuit did here.

3. Executive oversight has been largely non-existent.

Finally, the lack of executive oversight militates for judicial review of FINRA's behavior. As oversight from the highest levels of the executive branch is nearly impossible due to the layered hierarchy of the executive branch, only other agencies and the courts are available to provide meaningful oversight of

FINRA. Although formal oversight procedures may exist, executive agencies cannot be relied upon to police these powerful organizations.

In the present case, for example, the SEC declined to rule on the fraud claim brought by petitioners, noting that a decision on the merits of the state law claim was for the courts. *See* Petition for Certiorari at 14-15. Furthermore, deferment of key questions of law is far from unusual: the SEC routinely defers to courts for the substance of state law claims. *See, e.g.*, *Application of Beatrice J. Feins*, 51 S.E.C. 918, 922 n.14 (1993) ("We do not reach Ms. Feins' claim [for] . . . violations of the federal Age Discrimination Act of 1975 . . . and New York State's Human Rights Law [because] [a]dministration and interpretation of these statutes are outside our jurisdiction, and redress, if any, under these statutes must be pursued in other forums."); Petition for Certiorari at 8 (citing Exchange Act Release No. 51252, 70 Fed. Reg. 10,442, 10,444 (Feb. 25, 2005)). The SEC's functional abandonment of its oversight authority should give courts pause when determining whether to also relinquish their oversight powers.

B. SROs' Lack of Accountability Has Created Significant Policy Failures.

Checks and balances created by the separation of powers are designed to prevent abuses of power. FINRA's extra-constitutional operation has fostered significant policy failures including agency capture, lax regulation, and biased arbitration.

1. Lack of accountability has led to agency capture.

Although FINRA is a quasi-private organization, the principle of "agency capture" still plagues its operations. *See generally* Rachel Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 Tex. L. Rev. 15 (2010); George J. Stigler, *The Theory of Economic Regulation*, 2 Bell J. Mgmt & Econ. Sci. 3 (1971). Courts should not extend absolute immunity to SROs any time they act "incident to" their regulatory authority, because those organizations are already exempt from traditional tools for monitoring agencies.[7]

FINRA exhibits one of the telltale signs of capture: a persistent revolving door among its senior leadership. *See, e.g.*, Barkow, *supra*, at 23. Many FINRA executives arrive from large financial firms and return as company executives or counsel when they depart. *See, e.g.*, Ashby Jones, *Susan Merrill Exiting Finra for Bingham Partnership*, Wall St. J., Apr. 12, 2010, at C3. This routine practice is symptomatic of favoritism toward large companies, as executives strive to retain or earn favor with past and future employers. Recent research on the SEC suggests, even with its increased levels of accountability, the revolving door principle influences disciplinary proceedings in favor of large institutions. Stavros Gadinis, *Is Investor Protection the Top Priority of SEC Enforcement? Evidence From*

[7] FINRA is exempt from many of the most common mechanisms of preventing capture. *See* Mark Seidenfeld, *Bending the Rules: Flexible Regulation and Constraints on Agency Discretion,* 51 Admin. L. Rev. 421, 429 (1999); *see also* Barkow, *supra*, at 26-41 (identifying "traditional lodestars of independence").

Actions Against Broker Dealers, Harv. Olin Ctr. Discussion Series (2009), *available at* http://www.ssrn.com/abstract=1333717.

2. Lack of accountability has resulted in relaxed regulation.

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. *See* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have A Better Idea?,* 95 Va. L. Rev. 707, 760 (2009).

The cases of Bernard Madoff and Stanford Financial provide evidence of this lax enforcement; in-house reports addressed FINRA's responsibilities in each. *See* FINRA, Special Review Comm., *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes*, *available at* http://www.finra.org/web/corporate/p120078.pdf. While FINRA conveniently concluded that the Madoff Ponzi scheme fell outside its jurisdiction, it made recommendations to expand and clearly define its jurisdiction to prevent such incidents in the future. *Id.* at 64, 71-75. Further evaluation of the Stanford CD scheme, however, revealed that FINRA missed key points of factual analysis and communication that would have unearthed fraud earlier and prevented substantial losses. *Id.* at 3.

Another gross failure of regulation is apparent from the auction-rate securities breakdown of 2008. Several major banks misrepresented auction-rate securities to customers as liquid assets without

disclosing the risks involved. Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75,* 95 Va. L. Rev. 785, 801-02 (2009). When the market demand dropped significantly, many investors were unable to sell their ARSs. FINRA has been criticized for failing to prevent or at least soften this collapse. Danielle Brian, *POGO Letter to Congress Calling for Increased Oversight of Financial Self-Regulators,* Project on Government Oversight, *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html; *see also* Fisch, *Top Cop, supra*, at 801.

FINRA turned a blind eye to the questionable advertising practices of these banks, despite its knowledge of the potential pitfalls of ARSs. Fisch, *Top Cop, supra*, at 801-02. During the years immediately preceding the collapse, FINRA acquired a substantial amount of ARSs. Darrell Preston, *FINRA Oversees Auction-Rate Arbitrations After Exit*, Bloomberg, (Apr. 29, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agMSn6deL3I. By July of 2006, FINRA held over $860 million in ARS investments. *Id.* FINRA referred to its ARSs explicitly as non-cash assets on its annual reports for the duration of holding, exhibiting its understanding of the non-liquid nature of ARSs. *Id.* FINRA divested itself of all ARS investments in 2007 without any warning to consumers. Brian, *supra.* Furthermore, when the ARS market froze, FINRA lagged behind the Attorney General of New York in investigating and recovering the lost investments. Fisch, *Top Cop, supra*, at 801-02 (citing Lynn Hume & Andrew Ackerman, *SEC, FINRA Probing ARS Sales: Misrepresentations of Risk Alleged, Bond Buyer*, Apr. 11, 2008, at 1). Whether these lapses were derivative

of negligence or corruption is not a matter for resolution here. It is apparent, however, that FINRA failed in its goal of protecting investors.

3. Lack of accountability has led to biased arbitration.

FINRA arbitration stands as the sole means for resolving broker-customer disputes within the FINRA community. These disputes often include matters of misrepresentation and fraud, matters historically reviewable in criminal or civil court. Despite heavy criticism, the process remains less than transparent. Fisch, *Top Cop*, *supra*, at 802-03.

FINRA's mandatory arbitration has shown itself biased in favor of the industry as well as inefficient for individual disputes and market stability. Jill I. Gross & Barbara Black, *Perceptions of Fairness in Securities Arbitration: An Empirical Study*, U. Cin. Pub. L. Research Papers (2008), *available at* http://ssrn.com/abstract=1090969; *see also* Bradley R. Stark & Ronald W. Cornew, *Compulsory Arbitration: Its Impact On The Efficiency Of Markets*, 1754 PLI/Corp 399, 406-07 (2009). A recent study in fairness of the arbitration process shows that a majority of small members recently involved in FINRA arbitration feel that the process is biased to the large industry groups. Gross, *supra*.

Biased mandatory arbitration can have a crippling effect on the overall efficiency of the market. The present arbitration structure favors leniency in adjudication for sizable members of FINRA, thereby creating a vacuum where fraud and meltdown flourish. Stark, *supra*, at 407. The opportunity for small players to bring complaints in

civil litigation would serve as a litmus test for the health of the market and a check to prevent future meltdown. *Id.* Indeed, scholars have suggested that the general absence of private litigation was a contributing factor in the 2008 market crash. *See, e.g.*, Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. Chi. L. Rev. 923, 937-38, 957 (2010). Decreasing arbitrary barriers to litigation would make fraud and insider trading more costly, thus deterring corruption from the outset.

II. ABSOLUTE IMMUNITY IS A DANGEROUS WITHDRAWAL OF ACCOUNTABILITY, AND THE SECOND CIRCUIT ERRED IN EXPANDING IT.

The Second Circuit expanded the circumstances under which absolute immunity applies to include actions merely "incident to" a SRO's regulatory function. This expansion is unjustifiable in light of the historic justification for extensions of absolute immunity: namely, that without absolute immunity an organization would be unable to serve a vital social purpose.

A. The Second Circuit Erred in Extending Absolute Immunity to the Conduct at Issue.

Individuals occupying a handful of public offices wield such sensitive power that courts must balance the evils associated with impunity against the harms that spring from administrative paralysis. *See Gregoire v. Biddle,* 177 F.2d 579, 581 (2d Cir. 1949), *cert. denied*, 339 U.S. 949 (1950) (Whether to grant

absolute immunity requires a "balance" of "evils" between encouraging impunity and "dampen[ing] the ardor of all but the most resolute, or the most irresponsible, in the unflinching discharge of their duties."); *Imbler v. Pachtman*, 424 U.S. 409, 427-28 (1976) (Absolute immunity should be granted to prosecutors only because to withhold it would "prevent the vigorous and fearless performance of a prosecutor's duty that is essential to the proper functioning of the criminal justice system."). But an invitation to impunity is always an evil. Absolute immunity therefore should never extend "further than its purposes require." *Forrester v. White*, 484 U.S. 219, 224 (1988). Yet the Second Circuit's ruling here extends immunity far beyond what the circumstances require.

1. Grants of absolute immunity apply only to narrow circumstances that follow functional considerations.

This Court has recognized that grants of absolute immunity are to be construed according to the functional considerations that give rise to them. *See Van de Kamp v. Goldstein*, 129 S. Ct. 855, 861 (2009); *Burns v. Reed*, 500 U.S. 478, 486 (1991) (collecting cases). Even in cases where functional considerations dictate that the range of action covered by the immunity be broad, the circumstances of the immunity's applicability are narrow. Absolute immunity from civil suit applies to members of Congress through the Speech and Debate clause of the Constitution, *see* U.S. Const. art. I, § 6, cl. 1, to judges and prosecutors because the exercise of their offices demands it, *see Imbler*, 424 U.S. at 422-23, and to administrative agencies because they are

functionally similar to judges and prosecutors when acting in their adjudicative capacity, *see Butz v. Economou*, 438 U.S. 478, 511-12 (1978).

For all, absolute immunity applies only when they are acting under circumstances that necessitate their protection. *See Gravel v. United States*, 408 U.S. 606, 626 (1972) (Absolute immunity applies only to actions by members of Congress that are "part and parcel of the legislative process."); *see also Mireles v. Waco*, 502 U.S. 9, 11 (1991) (". . . [A] judge is not immune from liability for nonjudicial actions, *i.e.*, actions not taken in the judge's judicial capacity."); *Imbler*, 424 U.S. at 430 (Prosecutors only possess absolute immunity for actions "intimately associated with the judicial phase of the . . . process."); *cf. id.* (If administrative agencies receive immunity for the same reasons as judges and prosecutors, those agencies should only receive immunity in like circumstances.).

Administrative agencies are granted absolute immunity because their capacity as quasi-judicial officers makes them functionally comparable to judges and prosecutors and therefore likely to suffer the same pressures. *See Butz*, 438 U.S. at 511-12. Consequently, an administrative agency's immunity as a quasi-judicial officer is coterminous with that of judges and prosecutors. Actions not "intimately associated with the judicial phase of the . . . process," *Imbler*, 424 U.S. at 430, should not fall under the immunity's protection.[8]

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[8] Instead of applying sovereign immunity principles relating to FINRA's role as an executive-branch entity, *see Barr v. Mateo*, 360 U.S. 564, 573 (1959), the Second Circuit awarded FINRA an absolute immunity stemming from its regulatory—and thus

2. Absolute immunity should not be granted for actions solely incident to an SRO's regulatory power.

When courts have found that SROs require absolute immunity, they have done so in the belief that SROs' function as a regulatory enforcer requires that it be given immunities of the same sort given to fully-governmental regulatory organizations under the Exchange Act. *See, e.g.*, *D'Alessio v. NYSE*, 258 F.3d 93, 105 (2d Cir. 2001) ("The NYSE, as a SRO, stands in the shoes of the SEC in interpreting the securities laws for its members and in monitoring compliance with those laws. It follows that the NYSE should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it under the SEC's broad oversight authority."); *see also In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 96 (2d Cir. 2007); *D.L. Capital Group v. Nasdaq Stock Market, Inc.*, 409 F.3d 93, 95 (2d Cir. 2005); *see generally* Rohit A. Nafday, *Comment, From Sense to Nonsense and Back Again: SRO Immunity, Doctrinal Bait-and-Switch, and a Call for Coherence*, 77 U. Chi. L. Rev. 847, 858-59. (2010). But administrative agencies have absolute immunity to shield them from paralyzing retaliation by targeted parties. *See Butz*, 438 U.S. at 511-12. By this logic, an SRO's immunity should extend no further than the limit necessary to shield it from retaliation for the exercise of its delegated regulatory functions. *See Weissman v. Nat'l Ass'n of Sec. Dealers*, 500 F.3d 1293, 1297 (11th Cir. 2007).

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adjudicatory—power. *See Standard Inv. Chartered v. Nat'l Assn. of Sec. Dealers*, 637 F.3d 112, 116 (2d Cir. 2011). As such, the animating principles which govern extensions of immunity to judges and prosecutors should rule here, too.

Nevertheless, the Second Circuit has, over the last 15 years, shifted the immunity granted to SROs from that which administrative agencies have because they act like judges and prosecutors to sovereign immunity granted to administrative agencies as part of the government. *See, e.g., Barbara v. NYSE,* 99 F.3d 49, 59 (2d Cir. 1996); Nafday, *supra*, at 847. (The Second Circuit's approach creates an immunity chimera with the privileges of both absolute and sovereign immunities but the justifications of neither. *Id.* at 862-68.

Moreover, private actors' immunity is more narrow than it would be for government officials exercising the same authority. *See Richardson v. McKnight*, 521 U.S. 399, 412 (1997) (noting that "*Wyatt* [*v. Cole*, 504 U.S. 158 (1992)] makes clear that private actors are not *automatically* immune (i.e., § 1983 immunity does not automatically follow § 1983 liability)." Whatever immunity remains for private actors is exceptionally narrow.

But here again, in this case, the Second Circuit has greatly widened the ambit of shielded action. According to the Second Circuit, an SRO may act with impunity in all actions only "incident to" regulation. *See Standard Inv. Chartered, Inc. v. Nat'l Assn. of Sec. Dealers*, 637 F.3d 112, 116 (2d Cir. 2011). This would be the equivalent of shielding a judge who ran down a pedestrian on his way to the courthouse simply because his travel there eventually will lead to his exercising judicial power. Such a finding would plainly contradict the purpose behind the absolute immunity judges enjoy. Surely a self-regulatory organization, run for-profit by a private board, does not have a broader immunity when it commits fraud in circumstances only

tangentially related to its regulatory power than would a judge who acts in his non-judicial capacity as a private person. The standard must be higher.[9]

In fact, the standard is higher, but only in the Eleventh Circuit. Likening SROs to municipal corporations, that court found in *Weissman* that SROs only enjoy absolute immunity from claims involving conduct that "constitutes a delegated quasi-governmental prosecutorial, regulatory, or disciplinary function." 500 F.3d at 1297. Actions whose "objective nature and function" are not prosecutorial, regulatory, or disciplinary are not covered by the immunity. *Id.* This understanding is much more compatible with the Court's precedent on when immunity should apply.

B. Absolute Immunity, Combined With SRO Structures, Makes Abuse of Power Almost Certain.

SROs are no longer the private, opt-in clubs that once regulated the markets before the Great Depression. *See* William I. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace-Revisited*, 23 Ann. Rev. Banking L. 727, 730 (2004). SROs' power has grown beyond merely regulating market participants and, in some cases, has gone so

[9] The Second Circuit's logic is identical to that which was rejected by this Court in *Burns*, 500 U.S. at 495. There, the United States argued in an *amicus* brief that a prosecutor was shielded from suit because his actions were "in some way related to the ultimate decision whether to prosecute," and thus to the judicial process. *Id.* The Court rejected this reasoning, holding that a prosecutor's actions are absolutely immune only if they are "closely associated with the judicial process." *Id.*

far as to circumvent the due process of criminal proceedings—this despite congressional action in the 1970s to curb SROs' power and increase oversight. *Id.*; *see also* Karmel, *supra*, at 152.

SROs such as FINRA have also used their financial largess to influence the regulations that govern them and their members. *Id.* at 160. Modern SROs donate huge sums of money to interest groups and educational funds with an eye towards influencing the policy that governs them. For example, FINRA has donated over $63 million to "education and protection initiatives through a combination of grants and targeted projects." *About the Financial Industry Regulatory Authority*, FINRA, (last visited Oct. 24, 2011), http://www.finra.org/AboutFINRA/. FINRA also takes advantage of the broad interpretation of its immunity powers by claiming that a wide variety of behavior falls within its regulatory authority. For example, it claims that education is the "best form of investor protection," *id.*, in order to bring donations to education funds under its regulatory umbrella. *See* John Beshears, et al., *How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?*, Nat'l Bureau of Econ. Research, Working Paper No. 14859 (2009).

As a private organization, FINRA's transparency is, in essence, voluntary. FINRA is not subject to the Freedom of Information Act and publishes records in keeping with the practice of private companies. *See* John H. Walsh, *Regulatory Supervision by the Securities and Exchange Commission: Examinations in a Disclosure-Enforcement Agency*, 51 Admin. L. Rev. 1229, 1241-43 (1999) (noting that financial regulators are typically exempt from disclosure requirements that apply to most agencies). FINRA

has certainly not volunteered much of the information members and investors have requested. Joseph A. Giannone, *Members Urge FINRA to Increase Disclosure*, Reuters, (Aug. 13, 2010), http://www.reuters.com/article/2010/08/13/finra-proposals-idUSN1321845820100813. The decision below makes it increasingly difficult to obtain any documents from SROs like FINRA.

As a result of FINRA's lack of transparency, many of its investments cannot be scrutinized. Any conflicts of interest between FINRA and the groups it oversees are invisible to all but FINRA itself because of its special status as a quasi-governmental entity. *See* Walsh, *supra*. These interests remain undisclosed to the public despite FINRA's growing position as a regulator and its infamous revolving door.

FINRA's off-the-record, non-regulatory activities are disconcerting, but equally alarming is the group of individuals within FINRA who are given the responsibility of making non-regulatory decisions. FINRA executives are hand-picked by the brokerage industry to regulate and have historically short regulating careers before returning to the very market they were hired to enforce standards upon. *E.g.*, Susanne Craig, *Finra's Susan Merrill to Exit as Enforcement Chief*, Wall St. J., Mar. 18, 2010, at A1 ("The executive hired by Wall Street to enforce its rules is stepping down after nearly three years in which the organization's disciplinary actions and fines against the brokerage industry have declined."). SROs' very structures thus create incentives for abuses of immunity—abuses that extend beyond the actions of individual executives.

Indeed, SROs regulating the brokerage market have claimed absolute immunity for allegations as egregious as outright fraud. *See D.L. Capital Group*, 409 F.3d at 96. Immunity is granted to other "regulating" bodies such as judges and prosecutors to allow them to better fulfill their duties as a matter of public policy. *See supra* part IIA(1). But those government entities are not immune from scrutiny in that they are bound by checks such as more stringent transparency standards that SROs' status as private corporations allow them to avoid. Fin. Indus. Regulatory Auth., *Notice of Annual Meeting of FINRA Firms and Proxy* (2010), *available at* http://www.finra.org/notices/p121716.pdf. FINRA reasons that transparency would "hinder the ability of the FINRA board to engage in a candid discourse." *Id.* However, transparency has not been found to be a hindrance to the government agencies that operate under public scrutiny. Rather, the combination of absolute immunity and an unwillingness to disclose create an inappropriate shield from public accountability.

In short, immunity is inappropriate for SROs, which are already alleviated of their responsibility to the public. Nafday, *supra*, at 885. The lack of transparency and blatant non-regulatory interests of SROs as they currently exist is unprecedented when compared with other regulatory bodies that enjoy immunity. *Id.* Granting immunity to SROs without requiring transparency allows FINRA to abuse that very immunity by denying the right to legitimate litigation at its executives' discretion.

CONCLUSION

The Constitution requires that the judicial branch, through private suit, review the actions of independent agencies. In this case, judicial review is especially important because the agencies in question have great incentive to act in their own interests as private corporations. Their quasi-private status also allows them to benefit from lax transparency standards.

The independent agencies are also largely shielded from executive control; the SEC has failed to properly exercise its role in checking SRO power. All these structural problems make clear that judicial review is the essential remaining check. Because the Second Circuit erred in refusing to check FINRA's power, the petition should be granted.

Respectfully submitted,

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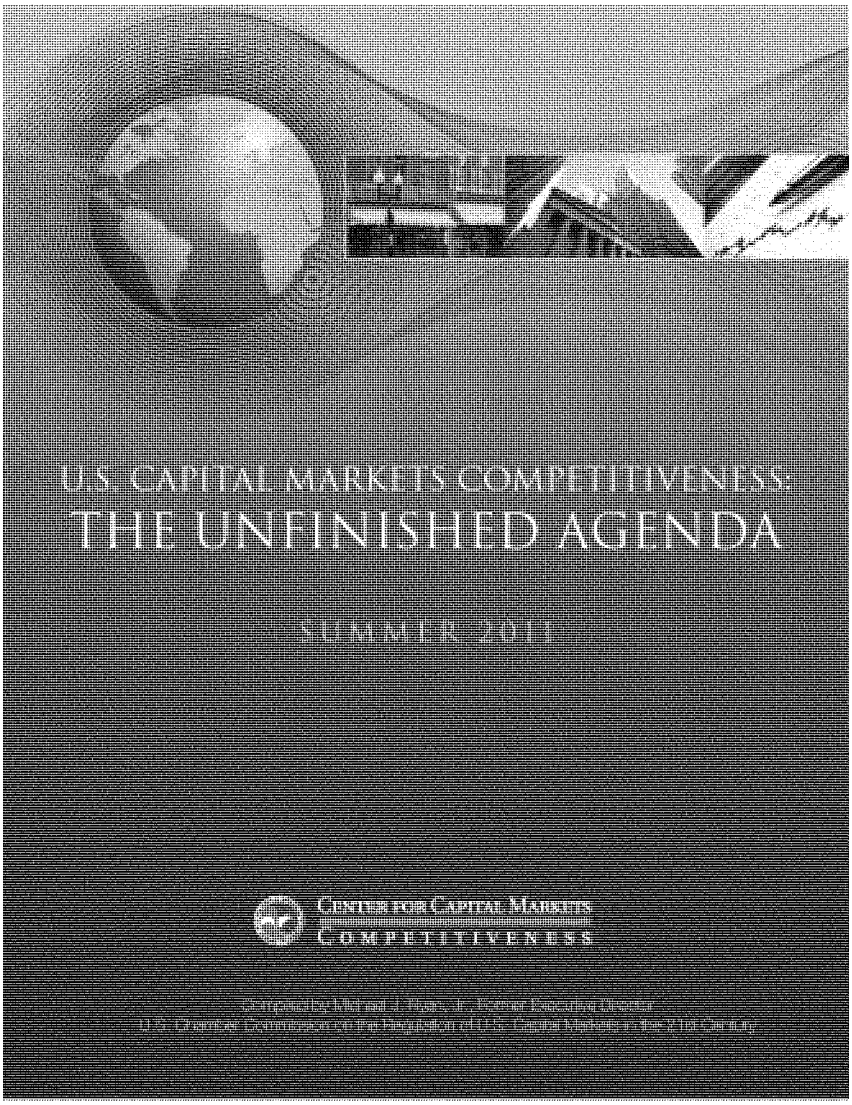
U.S. CAPITAL MARKETS COMPETITIVENESS:
THE UNFINISHED AGENDA
SUMMER 2011
CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

Since its inception, the U.S. Chamber's Center for Capital Markets Competitiveness (CCMC) has led a bipartisan effort to modernize and strengthen the outmoded regulatory systems that have governed our capital markets. Ensuring an effective and robust capital formation system is essential to every business from the smallest start-up to the largest enterprise.

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U.S. CAPITAL MARKETS COMPETITIVENESS: THE UNFINISHED AGENDA

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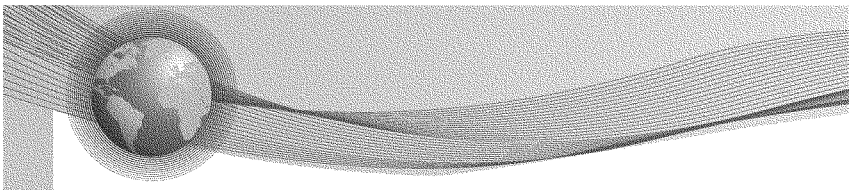


EXECUTIVE SUMMARY

For the past year, more than a dozen U.S. financial regulators have scrambled to write hundreds of new rules to implement the hastily adopted Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the most sweeping financial regulatory legislation in nearly 75 years. Implementation of the Dodd-Frank Act has exposed unaddressed weaknesses in the U.S. financial regulatory system.

We still have the same old system—only more of it. We still have an inexplicable structure with multiple federal, state, and nongovernmental regulators, which often have overlapping jurisdictions and propose conflicting regulations on similar activities, products, and services. Regulators still do not have the technology, staff expertise, or operational capacity to regulate today's markets. Worse yet, there is no clear plan or strategy to address these fundamental problems.

In many key areas where markets operate globally, the United States has failed to reach agreement on a global approach to regulation. Further, and perhaps more troubling, foreign regulators have told us they will not follow our lead. And other significant barriers to entrepreneurial capital formation in the United States, including our litigation system, remain unaddressed. In short, the Dodd-Frank Act failed to solve many of the core problems that have eroded the stability, effectiveness, and global competitiveness of the U.S. capital markets.

For most of the 20th century, the U.S. capital markets were the envy of the world. Our financial services legal and regulatory system fostered the world's most favorable environment for investing and accessing entrepreneurial capital. Issuers and investors alike were attracted to the U.S. markets because they understood that they would be participating in markets that were transparent, efficient, and well-regulated.

But regulators and the basic regulatory structure have failed to keep pace with changing markets. Indeed, the current U.S. foundation was put in place at a time that was closer to the Civil War than it is to today. The failure to keep pace has led to huge gaps in regulation in some areas, duplicative and conflicting layers of regulation in others, and regulators who do not have the expertise or technology to regulate modern markets. Even before the financial crisis, the U.S. Chamber of Commerce and many other organizations warned of the need for fundamental regulatory reform to ensure the long-term vibrancy and competitiveness of our domestic capital markets and our economy.

Despite all the activity in recent years, these concerns are only becoming more elevated. The problem with U.S. regulation is not its quantity, but its quality. Well-run businesses depend on well-regulated markets, and no legitimate business can compete in a marketplace that is not fair and transparent. The goal should never be less or more regulation, it should be better regulation. Our common goal must continue to be getting regulation right.

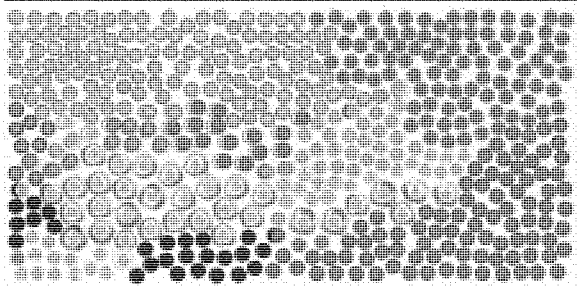
With the benefit of some reasoned and dispassionate reflection, the U.S. Chamber believes it is critically important to reevaluate the form and substance of U.S. financial services regulation. Unfortunately, our assessment is that we have made very little progress in recent years and, instead, are continuing to move along a troubling path.

Some characterize the Dodd-Frank Act as the largest and most sweeping financial regulatory reform since the Great Depression. Certainly, at 2,319 pages, the Dodd-Frank Act is the most far-reaching financial regulatory undertaking since the 1930s, authorizing or requiring agencies to enact 447 new rules and complete 63 reports and 59 studies (see Figure 1).

Certainly, at 2,319 pages, the Dodd-Frank Act is the most far-reaching financial regulatory undertaking since the 1930s, authorizing or requiring agencies to enact 447 new rules and complete 63 reports and 59 studies. However, the Dodd-Frank Act should never be confused with sweeping regulatory reform.

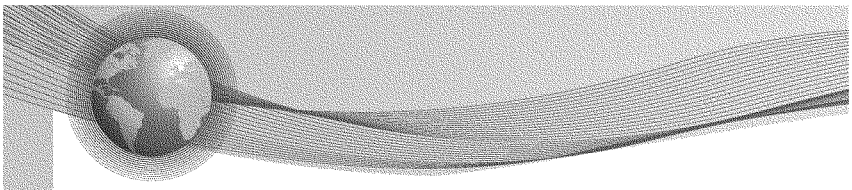
FIGURE 1

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010 REGULATORY AUTHORITY



CENTER FOR CAPITAL MARKETS COMPETITIVENESS

Consumer Financial Protection Bureau	●	Financial Stability Oversight Council	●
Federal Trade Commission	●	Office of the Comptroller of the Currency	●
U.S. Securities and Exchange Commission	●	National Credit Union Administration	●
Commodity Futures Trading Commission	●	Federal Housing Finance Agency	●
Department of Treasury	●	Office of Thrift Supervision	
Federal Energy Regulatory Commission	●	State Insurance Regulator	●
Federal Deposit Insurance Corporation	●	Other	●
Federal Reserve	●		



However, the Dodd-Frank Act should never be confused with sweeping regulatory reform. Rather, it layered more processes, people, and prohibitions on the cracked and crumbling 75-year-old regulatory foundation. It has failed to provide the modern financial services regulatory structure that is so crucial to ensuring that U.S. businesses have domestic access to deep and diverse sources of capital.

Rather than making the essential structural reforms desperately needed, the Dodd-Frank Act doubled down on a system conceived in the years following the Great Depression. Eliminating only one small regulatory agency from the vast array of federal, state, and nongovernmental financial regulatory authorities, the Dodd-Frank Act's legacy will be several new regulatory bodies with vague but far-reaching authority grafted onto the existing patchwork of financial regulators.

This paper highlights the five principal areas where our regulatory structure and processes are reducing the quality and efficiency of the U.S. capital markets. Unaddressed, these issues are undermining the long-term vitality of the U.S. economy. Regardless of its size or industry, every business depends on entrepreneurial capital to fund expansion and create jobs. Therefore, the concerns set forth below have direct and immediate implications for every business.

Rationalizing the U.S. Regulatory Structure

The foundation of the U.S. financial services regulatory structure was laid more than 75 years ago, with only periodic, reactive changes since. The result is a patchwork of regulatory agencies

Regardless of its size or industry, every business depends on entrepreneurial capital to fund expansion and create jobs.

that have been cobbled together over time, with no comprehensible vision for the marketplace of the 21st century. Unfortunately, the Dodd-Frank Act did not overhaul this labyrinth of regulators but rather increased their numbers and overlapping mandates.

While the Dodd-Frank Act created a new umbrella, the Financial Services Oversight Council (FSOC), over the existing broken structure, there is no clear process to address conflicts and competition among regulators. The long-term goal for the regulatory system—which may yet be implemented through the FSOC—should be to fundamentally reorganize and simplify the regulatory structure. In the short term, the FSOC should undertake, or failing to do so on its own, be tasked by Congress to address the most egregious conflicts and duplication among the maze of existing regulators.

Fundamentally Reforming Regulatory Agencies

The overhaul and modernization of outdated regulatory agencies is long overdue. The needed reform identified here applies to all financial regulators in varying degrees, with the U.S. Securities and Exchange Commission (SEC) at the epicenter of this problem. The fundamental weaknesses of the individual regulators parallel the need for systemic reform. Nearly all of these

agencies were established to oversee and regulate markets and market activity that are vastly different from those of today. While the markets have changed dramatically, these agencies have remained relatively static in their structure and operations, including their failure to implement major technology upgrades.

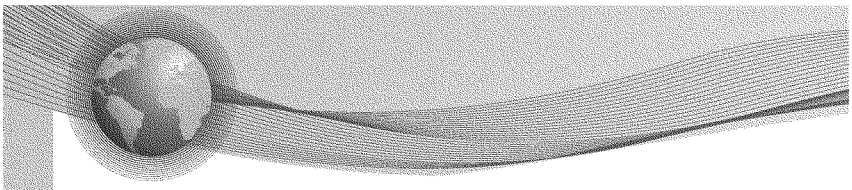
The fundamental weaknesses of the individual regulators parallel the need for systemic reform.

Meanwhile, these agencies' mandates have expanded greatly. As a result, priority and resource allocations are skewed toward following the path of least resistance, rather than toward activities that are in the best long-term interests of the markets. Shifting significant resources to an immediate crisis is standard operating procedure. Meanwhile, the effort devoted to long-term, fundamental improvement of our regulators is gravely deficient.

Making Nongovernmental Policy Makers Accountable

Nongovernmental policy makers should adopt regulatory due process standards that meet or exceed those of government agencies. The debate around financial services regulation and its impact on businesses and our economy focuses on the operations and activities of the multitude of government agencies responsible for regulatory policy and oversight. Several large nongovernmental agencies, however, also have a significant and growing influence on financial services public policy that warrants much closer scrutiny.

These organizations—most notably the Financial Industry Regulatory Authority (FINRA), the Self-Regulatory Organization (SRO) for securities firms, and Institutional Shareholder Services (ISS), the influential for-profit proxy advisory firm—fulfill many functions of government agencies and have either explicit or implicit delegated authority from government. 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. As government delegates regulatory authority, explicitly or implicitly, it should also impose Administrative



As government delegates regulatory authority, explicitly or implicitly, it should also impose Administrative Procedures Act or similar due process and transparency requirements on SROs and other nongovernmental organizations.

Procedures Act (APA) or similar due process and transparency requirements on SROs and other nongovernmental organizations.

Restoring Integrity to Litigation and Enforcement Practices

Fair and consistent enforcement of the law and reasonable opportunities for private parties to seek redress for intentional or reckless violations of the law are fundamental parts of our financial regulatory system. Strong, reliable capital markets depend on the ability to identify and stop wrongdoers from undermining confidence in the financial system. We need to further strengthen the capacity of regulators to detect and deter fraud.

While aggressively pursuing efforts to stop fraud and punish wrongdoers to the maximum extent possible, regulators must avoid the temptation to use enforcement as an alternative to transparent and open rulemaking. Without the benefit of public input, regulations imposed through enforcement settlements often produce significant unintended consequences. In addition, the U.S. system increasingly provides incentives to regulators, trial lawyers, and even corporate personnel to pursue narrow self-interests at the expense of the integrity of the capital markets. Foreign companies have cited unpredictability in litigation and enforcement as one of the primary reasons they now avoid accessing the U.S. public markets.

U.S. Competitiveness and Engagement

The long-term interests of the U.S. economy require that U.S. policy makers have an influential role in establishing international financial regulatory standards. U.S. regulators should continue to seek common approaches to global challenges, without ceding control. Similarly, the United States should delay implementation and consider alternative approaches in areas where the rest of the world has already indicated it is unlikely to follow the U.S. approach, such as the Volcker Rule.

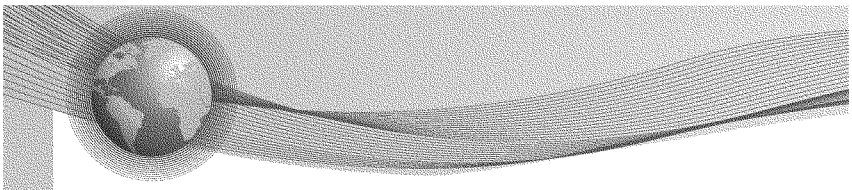
This does not mean waiting for the world to act or seeking global harmonization in every area. The United States can and should have different or even higher standards if the result is better and more effective regulation. However, when the United States unilaterally adopts regulations in an attempt to address global problems, it only serves to isolate the United States, weakening our capital markets and, in the end, failing to achieve the desired regulatory result.

For the better part of the 20th century, the depth, liquidity, and efficiency of the U.S. capital markets were unmatched. Businesses around the world accessed the U.S. capital markets at rates vastly greater than any other market. After decades of global leadership in capital markets regulatory

policy, regrettably, the United States appears to be conceding its place to increasingly more efficient global markets. This concession is not just in terms of business activity, but also in regulatory thought leadership.

Today, the United States is no longer the sole capital markets superpower. Markets are now global and interconnected, allowing businesses to select from several alternatives, including accessing capital in their home markets. Today, misguided and unilateral regulatory initiatives influence where firms take their capital markets business. For the United States to have a meaningful role influencing global regulatory policy in the future, U.S. policy makers must coordinate effectively with their counterparts. Continued failure will result in the erosion of our domestic capital markets base, shifting capital markets activity to more efficient markets abroad.

Today, misguided and unilateral regulatory initiatives influence where firms take their capital markets business. For the United States to have a meaningful role influencing global regulatory policy in the future, U.S. policy makers must coordinate effectively with their counterparts.



INTRODUCTION

The engines that drive America's innovation economy are as diverse as our entrepreneurial spirit. Regardless of a business's size or the sector in which it competes, capital is the common and essential element that fuels these engines. It is the full range of entrepreneurial activities—from the seemingly small idea being supported by family, friends, and the local community bank, to the long-term research and development activities of multinational corporations—that create the quality jobs that sustain American families and provide a quality of life unmatched in the world. Private capital, in short, is a central component for a great deal of economic, cultural, and social activity.

Historically, America's supply of capital has grown more plentiful over time, thanks in no small part to an efficient and effective legal and regulatory framework for capital markets activity. In the past, policy makers recognized the central role capital plays in the lives of every American. In overseeing our markets, they made decisions by balancing three very important objectives: protecting investors; promoting fair and orderly markets; and facilitating capital formation.

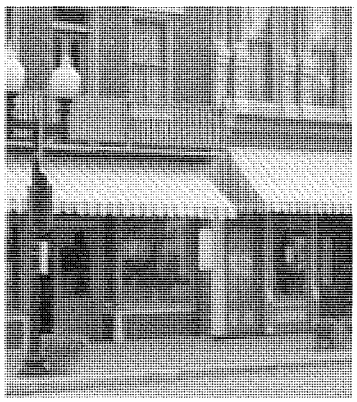
Rapid changes over the past 25 years are challenging the traditional structures put in place more than 75 years ago to support our capital markets. Today, market participants have a presence in many regions around the globe. Complex financial transactions in multiple currencies are agreed to quickly and executed instantaneously. Never-ending technological advances are constantly changing the dynamics of business and regulation. Failure to keep pace with these changes is putting the U.S. legal and regulatory structure under significant strain and eroding the strength and quality of the U.S. capital markets relative to new, more modern regulatory structures.

Historically, America's supply of capital has grown more plentiful over time, thanks in no small part to an efficient and effective legal and regulatory framework for capital markets activity.

In February 2006, the U.S. Chamber of Commerce launched the bipartisan, independent Commission on the Regulation of the U.S. Capital Markets in the 21st Century (the Commission) to evaluate the legal and regulatory framework of the U.S. capital markets. The U.S. Chamber "undertook this effort because of the concern that burdensome and duplicative regulatory schemes and an inefficient and unfair legal system were making U.S. capital markets increasingly less attractive to foreign and domestic companies alike."[1]

In March 2007, the Commission issued its report. The Commission found that "the competitive position of our capital markets is under strain—

1 Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations (March 2007), p.1, available at http://www.centerforcapitalmarkets.com/resources/publications/.



from increasingly competitive international markets and the need to modernize our legal and regulatory frameworks."[2] Also during this period, a number of other reports reflected similar concerns about the U.S. legal and regulatory structure for financial services.[3]

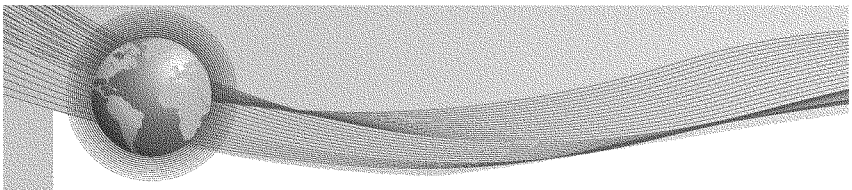
Since that period, we have experienced a massive global financial crisis. In response, regulators and Congress have scrambled to address the problem, often adopting "solutions" before completing objective and dispassionate analyses.

Further, these solutions have been adopted within or on top of the same regulatory framework that has been in place for more than 75 years.

The U.S. Chamber is deeply concerned that recent changes will have unintended consequences that will not be understood for years to come and that they have only exacerbated the fundamental problem. A year into the rollout of the Dodd-Frank Act, the Chamber believes that it is imperative that the continuing problems with the U.S. system be exposed and addressed.

2 Ibid, p.4.

3 Committee on Capital Markets Regulations, Interim Report of the Committee on Capital Markets Regulation (November 2006), available at http://www.capmkteg.org/; Michael Bloomberg and Charles Schumer, Sustaining New York's and the US' Global Financial Services Leadership (January 2007), available at http://www.nyc.gov/html/om/pdf/ny_report_final.pdf; Financial Services Roundtable, The Blueprint for U.S. Financial Services Competitiveness, available at http://www.fsround.org/cec/blueprint.htm; Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (March 2008), available at http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf; United States Government Accountability Office, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (January 2009), Available at http://www.gao.gov/new.items/d09216.pdf.



RATIONALIZING THE U.S. REGULATORY STRUCTURE

The past two decades saw marketplace changes substantially greater than those of the previous six decades. This accelerated rate of change reflects the increasing sophistication of the needs of businesses and investors. The markets and financial professionals kept pace with these changes by introducing new products and services and retooling their operations to remain competitive.

The aftermath of the financial crisis offered the opportunity to adopt true regulatory reform to modernize the U.S. regulatory infrastructure. Instead of seizing the moment, the Dodd-Frank Act simply layered—in historic proportions—more mandates and complexity onto the regulatory foundation that was established more than seven decades ago, a time that was closer to the Civil War than it is to today.

Although that system served investors and the U.S. economy well throughout most of its existence, it has not kept pace with the rapid evolution and needs of the U.S. capital markets. Markets and the businesses have built-in incentives to continually reinvent themselves and evolve to meet the changing demands of the marketplace.

Regulators, on the other hand, do not have built-in incentives to modernize and retool, leaving the U.S. regulatory systems largely static. While we tend to implement changes to account for the most recent crisis, these so-called reforms only put patches on the old, cracked foundation. The system was long past due for an overhaul before the passage of the Dodd-Frank Act, and it remains so.

Instead of seizing the moment, the Dodd-Frank Act simply layered—in historic proportions—more mandates and complexity onto the regulatory foundation that was established more than seven decades ago, a time that was closer to the Civil War than it is to today.

Prior to the crisis, a growing chorus of investors, businesses, and policy makers were sounding alarms that the U.S. system for financial service regulation was becoming dangerously overcomplicated, due to the layering-on of new structures over the years in response to each new crisis. Unfortunately, the recent financial crisis created a chaotic legislative environment and the ideal opportunity to include many ill-conceived regulatory mandates in the so-called "reform" legislation instead of rationalizing the U.S. regulatory structure.

Little in the Dodd-Frank Act addresses this fundamental concern. In fact, most of the

legislation adds to the problem. The mandate that resulted in the Dodd-Frank Act could have gone another way. A year before its enactment, Treasury Secretary Timothy Geithner recognized in congressional testimony the dire need for reform: "And [the administration's regulatory reform proposal] will streamline our out-of-date regulatory structure so that our regulatory system matches the size, shape and speed of our modern financial system."[4]

Unfortunately, a deliberate approach to true financial reform was not taken. Lawmakers did not address the outdated financial regulatory system from the ground up. The Dodd-Frank Act failed to clarify regulators' responsibilities. The Act does not ensure that firms, persons, products, or services, that require regulation, would be overseen by a coherent system that minimizes regulatory overlap or provides mechanisms for resolving conflicts between regulators. Such a system would have made great strides in eliminating the all-too-common problem that different regulators, each possessing some degree of authority over a particular segment of the financial industry, apply different and often conflicting criteria.

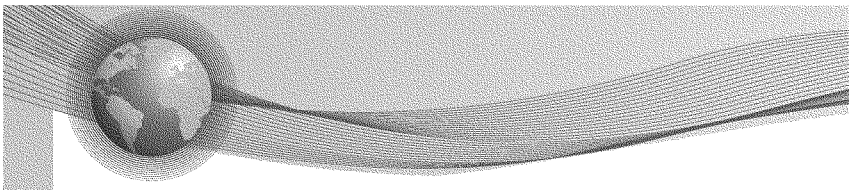
The hallmark of the Dodd-Frank Act has been the creation of two new regulatory bodies—the Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (CFPB). By any measure, the launch of these two bodies has been an early disappointment. A year after the enactment of the Dodd-Frank Act, the FSOC and CFPB have only added to the confusion by introducing more overlap into the mix of federal and state authorities. Interestingly, the prospects for these two new agencies are very different. While disappointing to date, the FSOC does appear to be equipped with the tools that could resolve conflicts between regulators and reduce counterproductive regulatory duplication. The CFPB's approach to the regulation of consumer financial products, on the other hand, presents new overlap difficulties that threaten to overshadow its important mission.

While disappointing to date, the FSOC does appear to be equipped with the tools that could resolve conflicts between regulators and reduce counterproductive regulatory duplication.

Financial Stability Oversight Council

The principal subject of Title I ("Financial Stability"), the Financial Stability Oversight Council, was conceived to be a collaborative body representing the expertise of the heads of the federal financial regulators, an insurance expert appointed by the President, and state regulators. It has ten voting members and five nonvoting members. In addition to chairing the FSOC, the secretary of the Treasury holds an effective veto over the body's most critical decisions—major FSOC decisions are finalized by the affirmative vote of two-thirds of the voting members, with the chair in the majority. Among the FSOC's

4 Testimony, Treasury Secretary Timothy F. Geithner, Before the Senate Committee on Appropriations, Subcommittee on Financial Services and General Government (June 9, 2009).



authorities is "to facilitate information sharing and coordination among the member agencies regarding domestic financial services policy development rulemaking, examinations, reporting requirements, and enforcement actions."[5] If the first year of implementation is any indication, this authority will be given secondary consideration.

Additional Layering

The FSOC has demonstrated that it will approach its mission with a strong propensity to regulate systemic risk by layering more regulators on perceived problems. For instance, the FSOC can designate nonbank financial companies as "systemically important" to the financial system, thus subjecting them to prudential regulation by the Federal Reserve. These companies, however, will continue to be regulated by their primary federal, state, and nongovernmental regulators, without any clear responsibility or mechanism for the FSOC or these other agencies to resolve or eliminate overlapping or inconsistent regulations (see Figure 2).

Rather than introduce a new, modern system, these changes layered additional regulatory agencies, mandates, prohibitions, and oversight mechanisms onto the old, broken system. Furthermore, the failure to develop a comprehensive oversight mechanism with meaningful authority to address conflict and overlap has made the implementation of these changes costly, confusing, and uncoordinated.

Rather than introduce a new, modern system, these changes layered additional regulatory agencies, mandates, prohibitions, and oversight mechanisms onto the old, broken system.

Lack of Coordination

As a body made up of the heads of the financial regulators and industry representatives, the FSOC appears to possess the tools to streamline financial markets regulation and, crucially, to serve as a forum to resolve jurisdictional disputes. The FSOC's primary focus, however, has been the worthy but narrower goal to "eliminate gaps and weaknesses within the regulatory structure." This focus fails to give the serious attention needed to eliminate the redundant and often inconsistent regulation inherent in a system of multiple federal and state regulatory bodies.

Achieving coordination among the regulators must be an FSOC priority. While eliminating gaps is a worthy goal, equally important is achieving regulatory coordination to ensure that the regulations that are put in place protect investors and consumers, ensure fair and orderly markets, and promote capital formation and a healthy business environment.

A recent example of the need for a regulatory dispute resolution forum centers on the extent to which states are preempted by federal regulations

5 U.S. Department of the Treasury, *Frequently Asked Questions on the Financial Stability Council*, available at http://www.treasury.gov/initiatives/Documents/FAQ%20%20FinancialStabilityOversightCouncilOctober2010FINALv2.pdf.

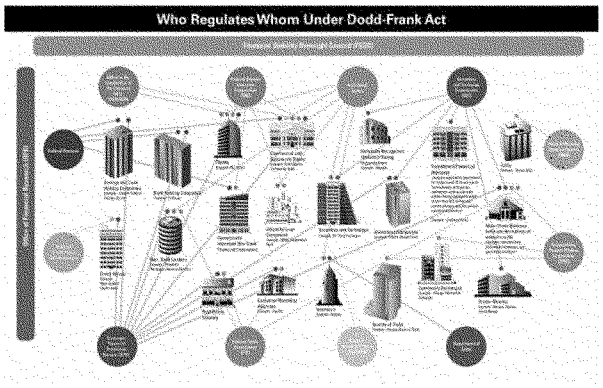
Achieving coordination among the regulators must be an FSOC priority.

from enforcing their own rules against national banks. In a proposed rule, the Office of the Comptroller of the Currency (OCC) indicated that, in its opinion, the Dodd-Frank Act did not permit states to impose state laws that conflict federal laws. The Treasury, arguing that the Dodd-Frank Act does give states overlapping authority, opposed the OCC interpretation in a public letter.[6] It is just this sort of dispute among regulators where the FSOC, either on its own initiative or acting on new authority, could provide a forum to head off conflicts that undermine the efficiency of the U.S. capital markets.

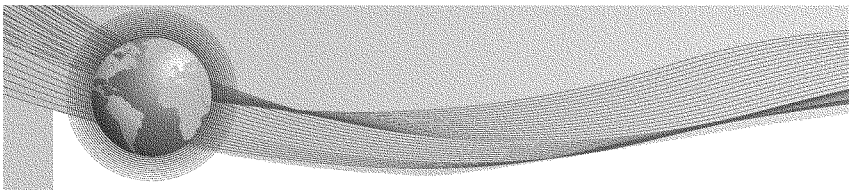
Consumer Financial Protection Bureau

A second keystone provision of the Dodd-Frank Act is the creation of the Consumer Financial Protection Bureau (CFPB). The Dodd-Frank Act grants this new federal agency unprecedented power and authority to regulate consumer financial products and services. This includes consumer financial products and services offered outside the financial services sector and, in some cases, the service providers to those companies. The CFPB's broad mandate adds a unique element of unpredictability to a compliance landscape that was already fraught with litigation risks from many different angles.

FIGURE 2



6 Victoria McGrane, "Treasury Assails OCC on Draft Rule," *Wall Street Journal* (June 29, 2011).



Compared with other financial services regulators, the CFPB is immensely and uniquely powerful. Rather than being led by an independent bipartisan commission, the CFPB will be headed by a single director. Rather than being subject to the checks and balances of congressional oversight through the appropriations process, the director of the CFPB has access to up to 10% of the Federal Reserve's total operating budget.

Equally concerning is a lack of clarity surrounding the limits of the CFPB's reach. The CFPB has a very broad mandate to enforce the prevention of "unfair, deceptive, or abusive acts or practices" in the consumer financial products markets. Exactly what constitutes "unfair, deceptive, or abusive acts or practices" remains undefined, forcing the market to speculate as to what established business lines may be construed as subject to enforcement.

In addition to being broad and vague, the CFPB's jurisdiction over consumer financial products raises more of the regulatory overlap issues discussed above. While billed as an overarching regulator of consumer financial products, the CFPB will often exercise that authority alongside—but not necessarily in coordination with—the Federal Trade Commission (FTC), the banking regulators, and state regulators. Another layer of dual regulation brings with it the likelihood that different regulators will take conflicting stances, leading to inefficient use of regulatory resources and uncertainty for businesses.

The overlap of CFPB and FTC enforcement authority is particularly significant. To mitigate confusing or conflicting enforcement activities, the CFPB and FTC should draw clear lines dividing jurisdiction of the industry. The CFPB should be responsible for companies whose principal business is to provide consumer credit, and the FTC should be responsible for "Main Street" businesses that provide a consumer financial product as an adjunct to their otherwise nonfinancial business.

Many details of the CFPB's reach in the market and the standards it will enforce are not clearly defined. Therefore, close scrutiny of its implementation will be critical. This will mean ensuring that the promises of transparency, access, due process, and other procedural safeguards are honored in meaningful and substantive ways. Still, given the lack of structural safeguards, combined with the lack of transparency and an exceedingly broad mandate, the CFPB appears set to inject new uncertainty into the compliance process that may lead to fewer, more expensive credit options for consumers and small businesses.

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FUNDAMENTALLY REFORMING REGULATORY AGENCIES

The Dodd-Frank Act left nearly every pre-crisis regulator intact and failed to address long-standing, fundamental weaknesses in the system. While increasing the workloads of the existing agencies, the Act did not introduce the critical infrastructural and process changes within agencies needed to restore regulatory efficiency and effectiveness.

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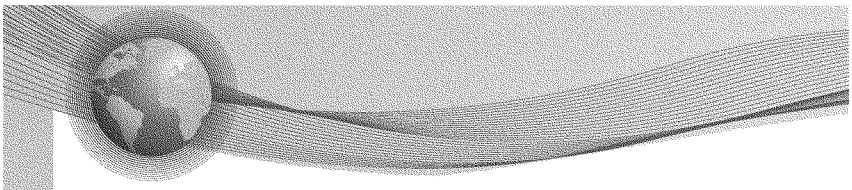
America's investors and businesses need effective regulators that understand the markets and businesses they oversee. As noted earlier, the U.S. regulatory foundation was put in place in the 1930s and since then has been updated only through an uncoordinated series of changes. Similarly, the basic structure of the legacy regulators was designed to regulate the markets of the 1970s, with only modest and incremental changes since then.

The financial crisis was a global and system-wide wakeup call to modernize the regulatory agencies, but fundamental and long-overdue internal reform within the myriad regulators has not followed. These agencies need a serious commitment to technology upgrades and process enhancements, a commitment that will receive sustained support by the highest levels of the executive branch and Congress. While the SEC is by no means the only financial services regulatory agency that requires an overhaul, its case illustrates the multitude of problems that persist throughout our regulatory system.

Manually Operated

Every day, businesses compete by using advances in technology and operational practices to improve their efficiency. This allows today's products and services to be offered more quickly and at a lower cost than in the past, making room for the investment in new and innovative products and services that fuel a new wave of efficiency. Driven largely by this greater efficiency within the financial services community, the past several decades have seen a significant increase in financial products and services available to businesses to meet their often specialized needs and demands.

A modern, well-regulated market is one in which the regulators also use current technologies and techniques to keep pace with marketplace developments. Unfortunately, the U.S. regulatory strategy relies heavily on manual processing and forcing businesses to slow down to the pace of government. This comes in the form of delayed action on exemption requests, approval orders, and rulemaking, to name a few. Meanwhile, financial services providers are limited in their



ability to meet businesses' demands for innovative products and services.

Without the appropriate tools to analyze the vast amounts of market information, regulators cannot help moving slowly. Delayed regulatory decision making stifles efficient delivery of the financial products and services today's investors and businesses demand. The demand for these products and services is real, and this "slow down" strategy can have only two consequences for businesses—in the best case, it forces them to go overseas to fulfill their needs, and in the worst case, it results in the unavailability of the products they need to manage risk, fuel expansion, and create jobs.

Simply allocating more money to the problem is not the solution. Indeed, the SEC's budget has increased 300% since 2000, but serious operational challenges persist. With a coherent strategy and investment in technology, the agency could substantially leverage its already significant investment in human capital. A greater focus on micro- and macroeconomic data and analytical analysis could dramatically improve the identification of troubling trends and reduce response times. The benefits would be twofold. First, detecting and addressing a problem more quickly reduces the amount of damage the problem causes. Second, addressing problems quickly serves as a much better deterrent than a long, drawn-out process.

The Madoff case is particularly instructive on both these points. Had U.S. regulators deployed relatively simple analytical tools to compare Madoff's market activity to the broader market activity, Madoff's activities would have raised serious red flags long ago. Rather than the tragedy that unfolded, an expedited result to terminate the fraud could have sent a much stronger deterrence signal to others—perhaps even Allen Stanford.

Inefficient Structure, Siloed Operations, and Staid Culture

The old reality of relatively mundane business and financial activity long ago gave way to the modern world of global economic activity, complex financial arrangements, and instantaneous execution of transactions. When times were simpler, banking, securities, and insurance activities were easily distinguished, and the assignment of regulatory oversight responsibility was straightforward and much more easily allocated among and within the various state and federal regulators. Distinctions were clear, overlap was minimal, and conflicts were quickly resolved.

Today, however, the overlaps, complexity, and interactions are overwhelming. The regulatory silos that once made sense now often serve as safe havens for regulatory power and undermine desperately needed coordination. Meanwhile, market participants are demanding and developing new products and services to meet growing

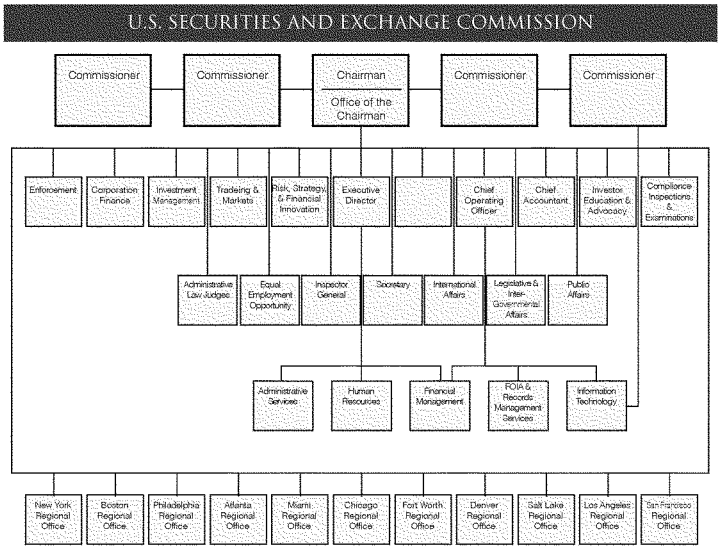
The regulatory silos that once made sense now often serve as safe havens for regulatory power and undermine desperately needed coordination.

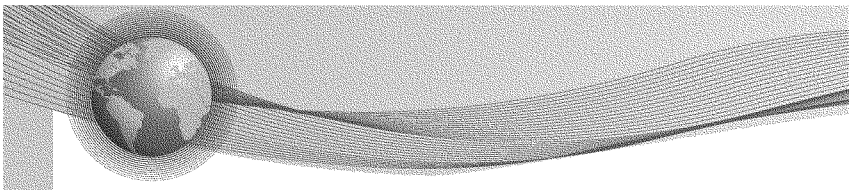
opportunities and challenges in the marketplace, and many of these new products and services—designed to fit a market need rather than a regulatory capacity—do not fit neatly within decades-old regulatory silos.

Organizational structures and reporting relationships play a vital role in the effectiveness of an organization. They send important internal and external messages about the organization's priorities and inevitably influence the allocation of critical resources. The SEC organizational structure does not reflect a clear mission. The chairman of the SEC has 23 direct reports, which does not include the directors of the SEC's 11 regional offices (see Figure 3).

Organizational structures and reporting relationships play a vital role in the effectiveness of an organization.

FIGURE 3





Streamlining Structures

U.S. financial services regulators need to give serious consideration to their organizational structures, focusing on their statutory mandates, organizational mission, and the grossly under-addressed need for regulatory coordination. This effort, however, needs to transcend lines and boxes on an organization chart and recognize that organization restructuring is just one step toward achieving a much greater objective.

For instance, although the SEC created the position of chief operating officer (COO) in 2010 with the purpose of "enhancing the agency's efforts to refocus its resources and make the agency more efficient and effective," the COO shares core operational responsibilities with the Office of the Executive Director. As noted by the Boston Consulting Group in its recent *Organizational Study and Reform* report for the SEC, "[t]his situation weakens the authority of both roles and limits them from providing relevant guidance to the operating divisions and adopting a broader approach to improving efficiency across the agency's support functions."[7]

Reforming Culture

Effective reform also includes developing a culture that embraces and fosters change. Too often, entrenched regulatory staff become comfortable with their responsibilities and unwilling to accept—much less drive—the change that is needed to keep current with marketplace developments. Adding new divisions or realigning responsibilities to meet the changing marketplace dynamics requires existing staff to adapt and, sometimes, accept a different or even lesser role.

Given today's marketplace complexities, financial regulators need to develop much better communication and decision-making protocols to address overlapping responsibilities. For example, it is unacceptable that policy-making functions within an agency have one interpretation of a rule and the team of inspectors assigned to review for compliance has a completely different interpretation. The result is an incoherent regulatory environment in which market participants cannot rely on rules created through the established policy-making and interpretation process to inform and guide their compliance programs. This problem existed long before the financial crisis, and the layering-on of new agencies and increased responsibilities only exacerbates it.

Confused Priorities

Successful regulation places a high priority on avoiding problems in the first place. Prosecuting fraud after the damage is done is important, but rarely do harmed investors receive a meaningful recovery. Likewise, hastily adopting new rules and restrictions in response to a market crisis only adds to the reactionary patchwork of regulation. The allocation of resources within an agency tends to indicate its priorities. For example, in 2010, the SEC devoted more than half of its budget to inspections and enforcement. The budget of the Office of Risk, Strategy and Financial Innovation, which is responsible for anticipating market problems before they occur, was less than half that of any of the policy-making divisions and

7 U.S. Securities and Exchange Commission, *Organizational Study and Reform*, pp.163–64, available at http://www.sec.gov/news/studies/2011/967study.pdf. (March 10, 2011)

approximately 3 percent of the inspections and enforcement budget (see Figure 4).

To head off problems, regulators must provide market participants with clear rules and guidance that spell out the regulators' expectations for market behavior, and diligently update these expectations to account for changes in the marketplace. These steps, however, must be in accordance with the requirements under the Administrative Procedure Act (APA).

Clear, up-to-date guidelines will provide the overwhelming majority of market participants who approach regulatory compliance diligently and in good faith the best opportunity to achieve compliance and identify bad actors early, before serious problems arise. In this environment, less reliance would be placed on enforcement actions, and the allocation of resources between policy-making and enforcement functions would favor proactive and informed engagement by regulators.

Successful regulation places a high priority on avoiding problems in the first place. Prosecuting fraud after the damage is done is important, but rarely do harmed investors receive a meaningful recovery.

FIGURE 4

U.S. SECURITIES AND EXCHANGE COMMISSION BUDGET ALLOCATION

	2006		2009	
Enforcement Activities				
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Policy-Making Activities				
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Program Activities				
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Overhead				
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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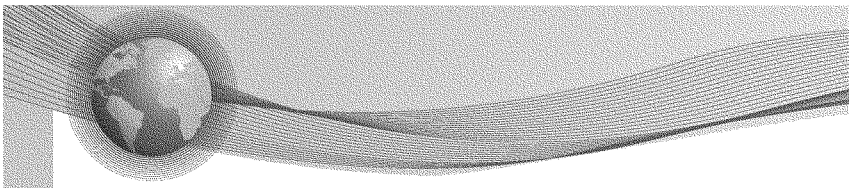

Missed Opportunities

The private sector invests tens of billions annually in establishing, implementing, and monitoring governance, legal, and compliance programs to ensure that the capital markets are fair, safe, and liquid. Financial regulators must do more to leverage these commitments and efforts. The relationship between regulators and the compliance professionals they oversee must be extremely professional; that is, neither too comfortable nor adversarial.

Regulators and compliance professionals should have open lines of communication so that each is confident that they can seek and share information about emerging issues or challenges they are facing and work collaboratively to resolve the issues. Open two-way communication is critical so that regulators can learn more about changes in the marketplace and compliance professionals can better understand the perspectives and expectations of regulators.

A related issue concerns the impact of whistleblower bounty programs on the integrity of internal compliance programs. As discussed below, the increased reliance on these types of efforts ultimately undermines efforts to foster a corporate culture committed to legal and regulatory compliance.

Balancing Regulatory Goals

Finally, when it comes to rulemaking, Congress and the regulators must take care to find a balance among important regulatory goals. The pursuit of one regulatory goal cannot be allowed to completely undermine another.

A glaring example of this problem emerged as Section 1502 in Title XV ("Miscellaneous Provisions") of the Dodd-Frank Act, which requires companies registered in the United States to disclose and report to the SEC whether certain "conflict" minerals used in the conduct of their business originated in conflict zones in the Democratic Republic of Congo or an adjoining country. Under this requirement, companies will have to, among other things, describe the measures taken to exercise due diligence on the source and chain of custody of the minerals in their products. Even if they do not use conflict minerals, the process required to discover that fact is extremely costly. The SEC's analysis of the economic impact of the rule claimed the cost of implementation would be approximately $71 million, an amount calculated without reference to competitive burdens or compliance costs that would be borne by upstream companies not directly covered by the rule, but whose products are used by companies that would be subject to the rule.

Implementation difficulties have proven so great that the SEC delayed the final rule. The conflict minerals experience demonstrates the compliance difficulties that can result from regulators' failure to appropriately balance priorities and take into account all consequences of a rule. By failing to provide a true estimate of the costs of implementing the conflict minerals rule, the SEC failed to find a reasonable balance in its threefold mission to protect investors, promote fair and orderly markets, and foster capital formation.

MAKING NONGOVERNMENTAL POLICY MAKERS ACCOUNTABLE

Nongovernmental organizations' influence has grown dramatically over the past few decades, but their level of accountability to their constituents has not kept pace.

Nongovernmental organizations' influence has grown dramatically over the past few decades, but their level of accountability to their constituents has not kept pace. Rules established and enforced by nongovernmental organizations—principally the Financial Industry Regulatory Authority (FINRA), and Institutional Shareholder Services (ISS)—impact the capital markets much the same way as those of government agencies, yet they are not similarly bound by the APA, the congressional appropriations process, or other comparable checks on their power.

Marketplace changes over the previous decade—including the emergence of vibrant market centers outside the United States, stock exchange mergers, and initial public offerings—have fundamentally altered the nature and role of nongovernmental policy makers. The triggering events range from prescriptive legislative action, to exchange consolidation, to inertia and complacency by various market participants. In all cases, these organizations have grown in size, power, and influence.

Unchallenged and largely unchecked, the influence of these organizations can be very detrimental to the development of vibrant capital markets. These organizations can, with few practical limitations, establish significant policies by arbitrary means and without any sound public policy or factual basis.

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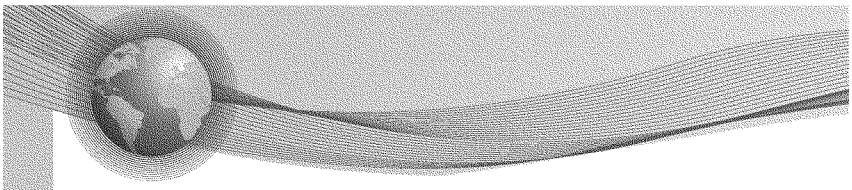
As these organizations grow and come to dominate the policy-making function, they can also have the dangerous effect of insulating—and isolating—congressional and government policy makers from the marketplace and changes in market activity and dynamics, thus undermining a central purpose for establishing independent expert agencies of the government. In most cases, the increased role of nongovernmental organizations in the U.S. capital markets is placing greater demands on the government regulators responsible for overseeing



these organizations. While this oversight is critical, it absorbs more time of government regulators, buffers them from the day-to-day activities of market participants, and exacerbates the growing problem of their being out of touch with the changing marketplace.

Despite the governing role these organizations play in U.S. capital markets, they are not subject to the traditional checks and balances associated with the American governmental structure. Certain core principles central to the operation and oversight of the U.S. capital markets should apply uniformly to government and nongovernmental policy makers alike, given their comparable roles and authorities over the marketplace. **Whether government or nongovernmental, all policy-setting organizations should have certain clearly articulated standards:**

- Substantive standards or principles upon which policy-making decisions are based;
- Procedural standards to be followed when engaging in policy-making activities; and
- Due process standards to allow private parties to challenge decisions.

For government agencies, these principles are generally found in their enabling statutes and in the APA. These laws set forth the substance and process for government decision making and the procedures for when an aggrieved third party seeks to challenge an agency's decision or determination. It is against these standards and procedures that the courts assess the activities of government agencies.

For nongovernmental policy makers, adherence to these principles is substantially reduced or, in some cases, nonexistent. In the past, for the most part, these organizations typically had governance structures and operational practices that were much more transparent to the public and policy-making influences that were far less significant and subject to greater control by the affected parties. Today, however, much of that has changed.

The Financial Industry Regulatory Authority and the Regulation of Broker-Dealers

In the case of FINRA, the primary regulator of broker-dealers or securities firms, change began in the mid-1990s with an SEC-initiated organizational restructuring that substantially removed FINRA's members from involvement in the operations and policy-making functions of the organization. Prior to that time, FINRA—or the National Association of Securities Dealers, as it was then known—had been a member-run organization, whose officials gained their regulatory mandate from the members it regulated. Rather than a board comprised of experienced members from across the financial services industry, today's FINRA board consists of a majority of independent directors with limited or no experience working for a financial services firm.

More recently, FINRA's size, power, and influence grew tremendously when it combined with NYSE Regulation, the regulatory function previously affiliated with the New York Stock Exchange. Rather than having two independent regulators offering different perspectives, today's securities firms are overseen by one enormous nongovernmental regulator with substantial oversight by the SEC, but with substantially

reduced engagement with—and responsibility to—its own members.

As result of these changes, FINRA has moved away from the traditional notions of what it means to be a self-regulator. In the past, FINRA members exercised substantial influence and control over the organization's operations, policy-making functions, and regulatory and enforcement priorities and determinations. Today, FINRA's members no longer have a meaningful role in establishing policies and priorities.

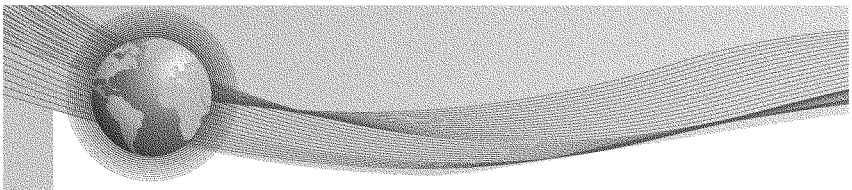
While the trend for publicly traded companies and financial services firms has been toward greater transparency and accountability, FINRA has largely escaped these changes. Similarly, FINRA's shift away from the traditional notions of a member-owned and controlled self-regulatory organization to a more governmental role has not brought with it the traditional checks and balances placed on government agencies. Transparency 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.

Institutional Shareholder Services and the Establishment of Corporate Governance Standards

Of equal concern is the growing power and influence of Institutional Shareholder Services, the dominant provider of proxy voting advisory services to institutional shareholders, predominantly mutual funds and pension funds. ISS's evolution into a de facto regulator has taken a very different path than that of FINRA. ISS's growing influence has been without any direct involvement with government regulators, but rather has emerged as a business response to government policies. Also unlike FINRA, ISS is a for-profit enterprise that is currently owned by a publicly traded company.

> Rather than having two independent regulators offering different perspectives, today's securities firms are overseen by one enormous nongovernmental regulator with substantial oversight by the SEC, but with substantially reduced engagement with—and responsibility to—its own members.

ISS's business opportunity materialized when regulators of institutional investors—the Department of Labor with regard to pension plans and the SEC with regard to mutual funds—determined that voting corporate proxies was among the fiduciary duties of institutional investors. This, in effect, turned corporate governance and proxy voting into a compliance function within many institutional investors, and enabled ISS to develop one-size-fits-all governance policies and check-the-box voting practices to meet institutional shareholders' compliance needs.



From the institutional investors' perspective, ISS's service allows them to outsource the function to a third party, whose purpose is to ensure that the institution votes all corporate governance matters consistently and that no votes are missed. From the perspective of a company about which ISS makes proxy voting recommendations, ISS represents a regulator whose policies must be complied with, because a negative vote recommendation from ISS can be outcome determinative in many corporate decisions that must be voted on by shareholders.[8] As a result, public company boards, under pressure to receive a favorable recommendation from ISS, are moving to a much more monolithic profile that is consistent with ISS's policy preferences.

FINRA and ISS are just two examples of nongovernmental agencies wielding substantial power. Others include the Financial Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB). The FASB and PCAOB play central roles in establishing and interpreting accounting and auditing standards in the United States.

Regardless of the historical origin or the evolutionary path of these organizations, the need for them to abide by certain core principles becomes more critical as they grow in size and influence. When the authority to set policy standards and assess fees is delegated, in fact or in effect, then concomitant responsibilities must also be assumed, including the obligation to abide by certain minimum administrative procedures, to conduct and make decisions based on sound cost-benefit analysis, to operate in a transparent manner, and to provide aggrieved parties due process.

ISS's growing influence has been without any direct involvement with government regulators, but rather has emerged as a business response to government policies.

Lack of Substantive Standards for Policy Making

As noted above, the enabling statutes for government agencies generally establish the substantive standards by which the agency is to engage in decision making and rulemaking. These standards set forth the factors to be considered and the objectives to be sought. In many cases, multiple factors and objectives are to be considered, and the agency must balance competing interests and exercise informed judgment. Regardless, it is against these standards that the courts assess whether the agency met its statutory mandate.

Nongovernmental organizations engaged in similar rulemaking activities or influences, even if de facto, should be required to establish and adhere to substantially similar standards. Any nongovernmental organization engaged in activities that establish or substantially impact the policies and practices of a wide range of companies should be required to adhere to rigorous, substantive

8 Stanford Graduate School of Business Corporate Governance Research Program, *Do ISS Vote Recommendations Create Shareholder Value?* available at http://www.stanford.edu/group/knowledgebase/cgi-bin/2011/05/13/do-iss-voting-recommendations-create-shareholder-value/.

policy-setting standards to go along with its delegated influence over the market.

Depending on the circumstances and role of the particular nongovernmental organization, these standards generally should be focused on achieving an appropriate balance among consumer protection, systemic integrity, and promoting economic growth. These standards should be carefully tailored to take into consideration the totality of the interests at stake and should not be set by arbitrary means or on a whim. Furthermore, these standards should be clearly articulated, and the nongovernmental organization should be held accountable for complying with them.

Lack of Procedural Standards for Policy Making

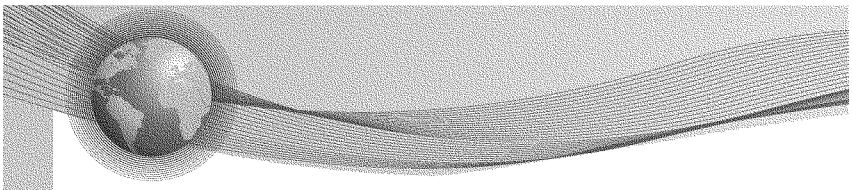
Along with clearly articulated, substantive policy-setting standards, nongovernmental agencies should be required to adopt and follow procedural standards substantially in line with those set forth in the APA. This includes providing reasonable public notice and the opportunity for the public to comment in an open manner and with the input of the full range of market participants that will be impacted by the policies. It also means that the policy maker should be required to articulate its basis for the new policy and why it is consistent with the policy-setting standard, including how it addresses the concerns raised by commenters or why it chose not to do so.

All too often, these organizations hold out "standards" and "processes" that mimic the form of procedural standards but are entirely lacking in substance. It is unacceptable that these nongovernmental policy-making organizations have governance, compensation, and disclosure practices that are less demanding and transparent than those they impose on third parties.

Inadequate Due Process

Central to the U.S. legal and political system are notions of due process that include presumptions that people act in good faith, that the burden to demonstrate wrongdoing is on the government or accuser, and that aggrieved parties have a reasonable right to appeal unfavorable outcomes. Any nongovernmental organization taking on a regulatory role of policy making and standard setting should be required to adhere to the same due process obligations. A nongovernmental organization making determinations and judgments about the policies and practices of private enterprises should be required to provide meaningful and prompt opportunity to challenge or appeal.

> Any nongovernmental organization engaged in activities that establish or substantially impact the policies and practices of a wide range of companies should be required to adhere to rigorous, substantive policy-setting standards to go along with its delegated influence over the market.



RESTORING INTEGRITY TO LITIGATION AND ENFORCEMENT PRACTICES

Strong, vibrant capital markets depend on the fair and consistent enforcement of marketplace rules. Similarly, it is important to have reasonable mechanisms to provide redress to investors when they have been harmed by intentional violations or a reckless disregard for the rules. Restoring the integrity of the litigation and enforcement processes in the United States is as critical as reforming the regulatory structure and insisting that regulatory agencies—government and nongovernmental alike—be operated efficiently, effectively, and fairly.

All enforcement mechanisms—from private litigation to criminal prosecution—must be stripped of the multitude of perverse incentives that seriously undermine the value and integrity of the enforcement process. These long-standing problems continue to plague the competitiveness of the U.S. capital markets and were not addressed by the Dodd-Frank Act.

Rulemaking Through Enforcement

Unlike the financial rewards available to the private bar to bring and settle class action lawsuits, the incentives for government regulators are more qualitative, but not necessarily less significant or troublesome. In too many cases, investigations are conducted by lawyers seeking to make a name for themselves in an agency that lacks sufficient internal oversight and self-restraint. Rather than closing an investigation with no action and addressing an emerging concern through the rulemaking process, too often it is considered expedient to force a settlement with substantive undertakings.

To restore the integrity of the enforcement processes, it is critical to maintain a clear distinction between "regulation" and "enforcement." Unfortunately, the terms are often confused and conflated. Put simply, regulation is the practice of adopting new rules to govern the future actions of market participants. Enforcement is the practice of holding market participants accountable for violating existing rules. While the distinction is well recognized in the law, it is too frequently blurred in practice.

To restore the integrity of the enforcement processes, it is critical to maintain a clear distinction between "regulation" and "enforcement."

Regulations are adopted to achieve a broad public policy purpose. When proposing and adopting regulations, government agencies are generally required to follow certain procedures to ensure that their decision making is transparent and inclusive.

These procedures include providing advance public notice and a meaningful opportunity for comment, giving consideration to the comments received and the costs and benefits of the proposed regulation, and ultimately, providing a statutory basis for the new rule.

In contrast, an enforcement action is—or is supposed to be—focused on the application of an existing rule to a particular set of facts. This is not to say that enforcement does not play an important public policy function. Indeed it does, including serving as a deterrent. In an enforcement action, however, the burden is on the government to demonstrate that the defendant violated existing law. Unlike the regulatory process, where transparency plays a paramount role, enforcement actions are kept confidential to ensure the integrity of the investigative process.

The concern arises when regulators use their enforcement powers to engage in what amounts to rulemaking. This occurs when the government agency uses the pressure of an enforcement action to extract from a defendant or multiple defendants "undertakings" that go beyond any reasonable interpretation of the requirements or prohibitions in existing laws. The problem is amplified when the inspection authorities in these agencies then proceed to issue inspection reports to others, recommending that they adopt policies and practices in line with the undertakings. Over a relatively short time, these undertakings become imposed as part of the standard business practice without ever having gone through the rulemaking process.

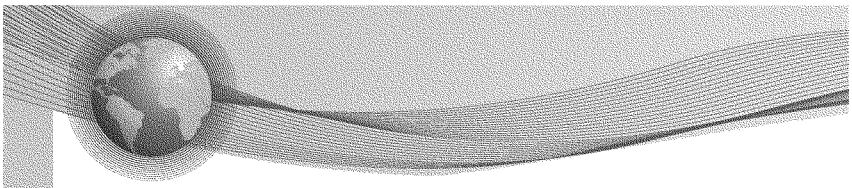
The concern arises when regulators use their enforcement powers to engage in what amounts to rulemaking.

In effect, these types of settlement agreements have all the force of rules, applicable to an entire industry. This approach negates the protections and benefits of the APA. Further, the negotiations around these settlements often take into consideration factors that are unique to the company under investigation, and its willingness to agree to certain terms is unlikely to be motivated by achieving a broad policy objective. As a result, the pros and cons of a regulatory requirement imposed in this manner are not fully considered. Further, less burdensome or more effective means of addressing the underlying concern do not receive full consideration.

Political Grandstanding

In legitimate private litigation, the fundamental question comes down to, can the parties come to an arrangement that will resolve the dispute? When dealing with elected and politically motivated prosecutors, however, the steps necessary to resolve an investigation often are far less clear.

Though most prosecutors act in good faith and honor their ethical commitment to pursue cases in the best interests of the citizens they are sworn to protect, there can be strong incentives to engage in delay, political grandstanding, and other theatrics



designed to capture media attention, rather than take steps that would be in the best interests of the public and the markets.

In a world of 24-hour news cycles, there are increasing incentives to repeatedly get one's name into the headlines. Because, for all practical purposes, there are rarely negative consequences for crossing the ethical line, the growing rewards for grandstanding are causing more and more prosecutors to seek the benefits of publicity. Unfortunately, the only check on this type of behavior is self-restraint, and untoward motivations are too easily masked with insincere public displays of outrage.

Misguided Litigation Incentives

The overall rise in the value of equity securities over the past several decades has brought with it plaintiffs' lawyers who use downturns in stock prices as opportunities to file shareholder class action lawsuits. Often with little or no evidence of any corporate wrongdoing, these "strike suits" serve as fishing expeditions where the plaintiff's lawyers use very aggressive—and often abusive—discovery tactics in the hope of finding some indication of wrongdoing and leveraging a settlement.

Unfortunately, the incentives to the plaintiffs' lawyers are so great—typically 30% of any award—and the burdens on the company so onerous—including the obligation to turn over vast amounts of corporate and business-sensitive documents—that many companies choose to settle rather than face the cost and distraction of litigation, much less risk potentially massive damage awards.

Frivolous securities litigation affects everyone—American businesses, investors, workers, retirees, and consumers. It transfers corporate assets from current shareholders to prior shareholders, depriving companies of valuable resources for business expansion and research and development. And all this occurs with the added privilege of paying a strike suit lawyer 30% for accomplishing the task.

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Whistleblowers

Contributing to the excessive litigation issue are the increasing incentives being offered to corporate whistleblowers and their opportunistic lawyers. Section 922 of the Dodd-Frank Act directed the SEC to provide monetary incentives for, and protections to, corporate whistleblowers who provide information leading to successful SEC enforcement actions. In crafting this provision, Congress sought to ensure that the SEC takes whistleblower complaints seriously.

The rules adopted by the SEC, however, do more to benefit trial lawyers and, very regrettably, undermine effective corporate compliance and governance programs. The new rules entitle whistleblowers to an award valued between 10% and 30% of the amount collected by authorities

in federal securities law enforcement actions that result in amounts of at least $1 million. The rules provide no incentive for whistleblowers to report allegations of wrongdoing internally and, in fact, provide incentives for them to bypass internal compliance programs altogether and reap the greatest reward possible. Moreover, legal, compliance, audit, and other fiduciaries can collect a whistleblower award despite the fact that they are the very people professionally obligated to detect and prevent wrongdoing.

The cumulative effect of the whistleblower rules is to undermine corporate compliance programs from the inside. Previously, whistleblowers were provided legal protections when reporting wrongdoing through internal compliance programs or similar reporting mechanisms. Now, they are offered serious financial incentives to keep companies in the dark by ignoring corporate compliance programs and going directly to the SEC with allegations of wrongdoing. This leaves expensive, robust compliance programs collecting dust, while violations continue, potentially increasing the value of the whistleblower's award, all to the detriment of shareholders and others who may be directly or indirectly harmed by the illegal activity.

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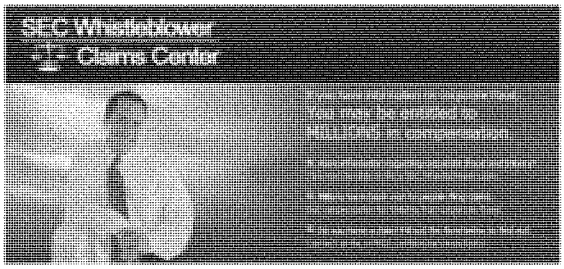
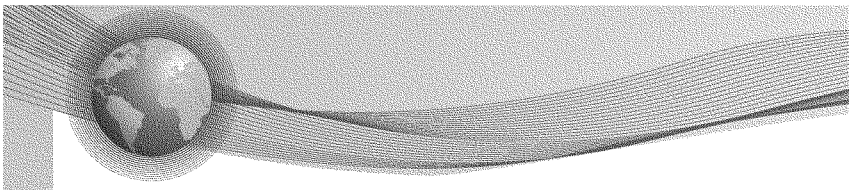
Without a doubt, the SEC should have access to the information it needs to detect and deter fraud. Further, if a company is unwilling or unable to engage in effective self-policing, then establishing a balanced whistleblower program that allows individuals to bring actionable information to the attention of the SEC is reasonable.

FIGURE 5





However, not requiring immediate and simultaneous reporting to both the company and the SEC prevents quick action to investigate and solve problems. Companies rely on anonymous whistleblowers to provide information about malfeasance or fraud. With this information source cut off, companies must wait weeks, months, or years for the SEC to notify them about potential wrongdoing. The company is in the best position to immediately investigate and mitigate any violations, not the SEC, which will be inundated with thousands of tips it will not be able to handle.

The SEC's flawed rules will inevitably lead to trial lawyers urging whistleblowers to keep the company in the dark as long as possible to maximize any available bounty. Already, trial lawyers are running advertisements and training seminars on how to profit from bounty programs adopted under these rules (see Figure 5).

This is bad news for the shareholders and workers of any company victimized by a truly fraudulent actor. True long-term protection of investors will be achieved first and foremost by supporting the development and use of strong and effective internal compliance programs, not by offering bounties as encouragement to subvert compliance programs. The recent shift toward reliance on whistleblowers is creating incentives that skew overwhelmingly in favor of direct reporting to the SEC, even when companies are willing and able to address reports through their internal compliance programs.

True long-term protection of investors will be achieved first and foremost by supporting the development and use of strong and effective internal compliance programs, not by offering bounties as encouragement to subvert compliance programs.

These results are directly contrary to the well-documented fact that companies and employees benefit, and scarce government enforcement dollars are preserved, when companies have the first chance to address corporate wrongdoing.

U.S. COMPETITIVENESS AND ENGAGEMENT

By nearly any measure, U.S. competitiveness has been in consistent, if not rapid, decline for more than a decade. Whether this is cause for alarm depends, however, on the forces driving this decline and the steps U.S. policy makers take in response to these forces.

For most of the 20th century, the vibrancy of the U.S. capital markets was unmatched anywhere in the world, providing the capital to transform both the U.S. and the global economies. Entering the second decade of the 21st century presents a very different picture. At the same time the vibrancy of foreign capital markets is rapidly rising, many U.S. financial services policies are placing an unnecessary drag on—and, therefore, increasing the cost of—the domestic supply of capital.

In the past, the depth and liquidity of the U.S. capital markets was unmatched. Over the past 20 years, foreign market centers have developed regulatory policies, legal institutions, and other important structures that support the growth and development of domestic capital markets. This increased international competition, however, is not a negative factor for the U.S. economy. To the contrary, vibrant capital markets outside the United States offer many benefits for U.S. businesses and consumers. This increased competition brings with it a wider range of products and services and a lower cost of capital for U.S. and foreign enterprises alike.

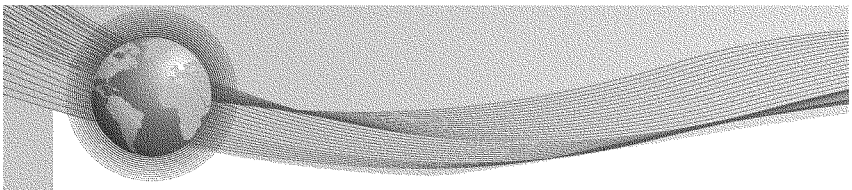
Given these developments, the critical challenge for U.S. policy makers is to chart a new course.

Unfortunately, too often the U.S. financial services legal and regulatory structures and policies unnecessarily force capital markets activity out of the United States.

As noted above, this requires adopting modern legal and regulatory rules, systems, and structures to support today's financial services activity. It also requires a new era of engagement with the international community to ensure that the U.S. capital markets do not become isolated and fall behind their international counterparts. The recent financial crisis demonstrated clearly the interconnectedness of the U.S. capital markets with the rest of the global financial community and highlighted the need for a new era of international engagement and cooperation.

Unfortunately, too often the U.S. financial services legal and regulatory structures and policies unnecessarily force capital markets activity out of the United States. Not only does this increase the cost of capital for U.S. businesses, it undermines the U.S. competitive position and long-standing reputation for thoughtful and visionary leadership in this critically important area.

To ensure that U.S. capital markets remain competitive, policy makers need to develop



a new approach to U.S. engagement with the global financial services regulatory community. Going forward, U.S. policy makers must adopt a more cooperative and collaborative stance. The days of the United States dominating financial services regulatory policy are past, and the quality, credibility, and innovativeness of foreign capital markets centers has earned them a seat at the policy-making table.

Financial Regulatory Cooperation

One of the failures leading to the implosion of the financial markets in September–October 2008 was the inability of financial regulators of various nations to cooperate with each other on cross-border issues. This was best illustrated by their failure to prevent the collapse of Lehman Brothers from almost triggering a shutdown of global capital markets.

> Cooperation will make regulators more effective, offer certainty to investors and businesses, and provide mechanisms to prevent a meltdown of international capital markets.

While it needs to be recognized that major capital markets are dependent upon one another, global financial regulatory harmonization—as opposed to coordination—is unrealistic. The depth and breadth of capital markets vary by nation, and domestic political interests play a role as well. The G-20 process has attempted to foster greater regulatory cooperation, and such efforts should continue. Cooperation will make regulators more effective, offer certainty to investors and businesses, and provide mechanisms to prevent a meltdown of international capital markets.

The Volcker Rule

One of the most important steps in moving toward a more harmonized approach to global regulation is to ensure that significant new rules are adopted in a coordinated fashion. The United States' recent adoption of the Volcker Rule has been a failure in this regard.

Seeking to limit unnecessary risk taking is reasonable. Achieving this requires measured steps without impeding the entrepreneurial spirit that is so central to our economy and fuels business expansion, development, and job creation. Equally imperative is that any domestic measures adopted must be generally accepted outside the United States and fit comfortably into the overall fabric of global financial regulation.

The Volcker Rule should be repealed. It is neither a measured response nor consistent with the steps being taken by other jurisdictions in an area that is fundamentally a global issue. The Volcker Rule creates a system that is too rigid for vibrant capital markets and has significant implementation issues.

The Volcker Rule is proving to be unworkable and is harming the U.S. financial services sector by placing American firms at a competitive disadvantage. Through the Volcker Rule, the United

The Volcker Rule creates a system that is too rigid for vibrant capital markets and has significant implementation issues.

States has instituted prohibitions on proprietary trading that other significant capital markets centers, including the European Union, have stated they will not adopt. Limiting the U.S. financial services sector in a manner that is incongruous with the international financial services sector will damage U.S. profitability and competitiveness. The majority of global financial regulators are taking a more measured approach, citing the inherent difficulty—if not impossibility—of defining proprietary trading as one of the many reasons to reject the Volcker Rule.

Global Financial Reporting

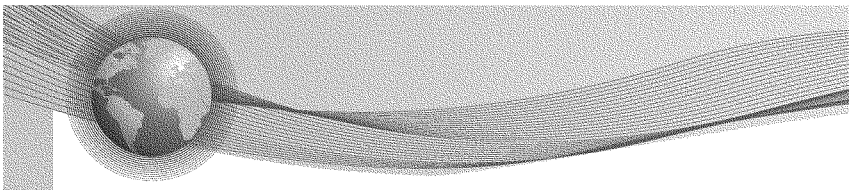
Central to maintaining vibrant capital markets is having readable, reliable, and comparable financial statements and ensuring the fair and accurate presentation of financial information. In a global marketplace, this ultimately means achieving uniform accounting and auditing standards that are fairly and consistently applied and enforced.

Significant emphasis continues to be placed on the convergence projects of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Convergence is a critical step toward a single set of global accounting standards that will enable investors, businesses, and other stakeholders to evaluate, compare, and use financial data through a common language. The convergence projects are important, and their proper implementation is vital to maintaining fair and orderly markets. The critical U.S. interest at stake is ensuring that global regulators—the IASB in this case—do not make unilateral decisions that could be imposed on U.S. businesses. The best way to avoid this situation is for the United States to provide leadership and become proactively engaged in developing these standards.

Over-the-Counter Derivatives

Businesses from many industries across the United States benefit from the availability of over-the-counter (OTC) derivatives as a reliable and efficient way to hedge certain business risks by locking in otherwise volatile interest rates, currency exchange rates, or commodity prices. Over the past two decades, the U.S. OTC derivatives market has grown by offering these commercial hedgers, or end users, customization not available in exchange-traded derivatives.

End users enter into OTC derivatives customized to various unique underlying business risks. By matching a derivatives contract to its specific business exposures, a company can create an effective and cost-efficient economic hedge. These products, in turn, allow companies to deploy capital much more effectively than they could before. OTC derivatives have been a significant contributor to increased economic productivity and play an important part in job growth and shareholder return.



Imposing burdensome requirements on end users, such as the obligation to post margin, could quickly increase the cost of capital and harm U.S. competitiveness. U.S. businesses find these financial services and products invaluable and may seek to take their business outside the United States, and foreign markets will actively pursue this business.

By their very nature, OTC derivatives are often developed to meet the unique needs of a specific business transaction or series of transactions. As a result, many OTC derivatives cannot be standardized. This means that imposing central quote and trade reporting requirements, central trading and clearing requirements, and subjecting dealers to margin and capital requirements for OTC derivatives could decimate this valuable tool and undermine U.S. competitiveness in industries beyond financial services.

Yet, the rulemaking currently under way runs the very real risk of doing this. Imposing burdensome requirements on end users, such as the obligation to post margin, could quickly increase the cost of capital and harm U.S. competitiveness. U.S. businesses find these financial services and products invaluable and may seek to take their business outside the United States, and foreign markets will actively pursue this business.

CONCLUSION

Significant risk looms over the U.S. economy—the illusion that the steps taken since the financial crisis have solved the problems that led to that crisis. The dramatic changes introduced by Congress and regulators must not be confused with progress. The gaps in the old system resulted from its complex matrix of overlapping and conflicting federal, state, and private regulators. Unfortunately, the response has been more of the same. The "new" regulatory system is the old system with more layers, regulatory mandates, and business prohibitions.

The response may have filled some of the gaps in the system, but this was accomplished with tremendous additional cost and reduced efficiency. Worse yet, some of the most significant changes undertaken by the United States were done unilaterally, creating an even greater gulf between the United States and other major financial centers around the world.

We have learned in stark terms that the health and vitality of our financial markets is closely linked to the health and vitality of our entire economy. Individuals and companies rely on the multitude of financial products and services available in the marketplace. The Dodd-Frank Act and other actions taken in response to the financial crisis are at best a giant step sideways, not forward. The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness is committed to exposing the weakness in our system and working to craft long-term solutions that restore U.S. leadership in the global capital markets.

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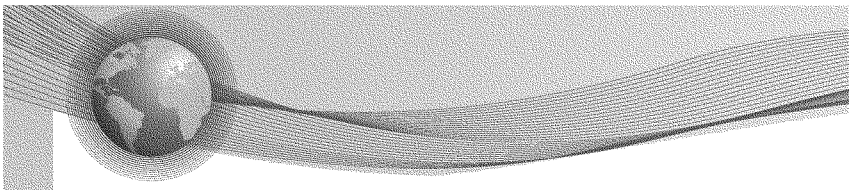

ABOUT THE AUTHOR

Michael J. Ryan, Jr.

This report is a compilation of the views of a wide range of financial services market participants—including investors, issuers, and financial services intermediaries—concerning many aspects of the U.S. financial services regulatory structure and the changes in that structure over the past five years. Michael J. Ryan, Jr. served as Executive Director to the U.S. Chamber's Commission on the Regulation of U.S. Capital Markets in the 21st Century from February 2006 to March 2007 and then as Executive Director for the U.S. Chamber's Center for Capital Markets Competitiveness from March 2007 to May 2008. Ryan has held a number of other capital markets-related positions, including president and chief operating officer of PROXY Governance, Inc., general counsel of the American Stock Exchange, counsel to the chairman of the NASD (nka FINRA), senior attorney at the U.S. Securities and Exchange Commission, and senior accountant with Price Waterhouse & Co.

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