INVESTMENT ADVISER ASSOCIATION

Statement of

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

Hearing on Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

House Committee on Financial Services

October 6, 2009

Executive Summary

The IAA strongly supports the Administration's recommendation in its white paper to require "broker-dealers who provide investment advice about securities to investors to have the same fiduciary obligations as registered investment advisers." Investment advisers are fiduciaries to all of their clients under the Investment Advisers Act of 1940. As fiduciaries, advisers must at all times act in the best interests of their clients, placing their clients' interests above their own. Advisers have an "affirmative duty of utmost good faith, and full and fair disclosure of all material facts as well an affirmative obligation to employ reasonable care to avoid misleading its clients." We strongly believe that all persons who are performing investment advisory activities should be subject to the same standard of care.

We are concerned, however that the Administration's proposed legislative language in Section 913 of the Investor Protection Act would open the door to weaken

the current fiduciary duty standard for advisers and would not effectuate the recommendation made in the white paper. The proposed text would amend the Advisers Act to grant broad rulemaking authority to the SEC to promulgate different standards of care than the fiduciary standard that already applies to all investment advisers with respect to all of their clients under the Advisers Act.

We are particularly concerned that the proposal could impose a fiduciary duty only with respect to retail clients and would water down or eliminate the fiduciary obligations that advisers owe all of their clients – whether individual or institutional (*e.g.* pension plans, endowments, mutual funds, or trusts). It would be a mistake to alter or narrow the fiduciary standard. One of the greatest strengths of a fiduciary standard is precisely its breadth – the standard has allowed the regulation of advisers to remain dynamic and relevant in changing business and market conditions.

In addition, the IAA continues to strongly support the SEC as the direct regulator for investment advisers. The SEC must be adequately funded to carry out its important missions of protecting investors, maintaining fair and orderly markets, and facilitating capital formation. Congress and the SEC should take steps to bolster the SEC's resources:

- There must be full funding for the SEC's regulatory, inspection, and enforcement efforts. We believe Congress should examine alternatives to allow the agency to achieve longer-term and more stable funding, including self-funding mechanisms and user fees.

- The SEC should increase the $25 million threshold that separates federally registered and state-registered advisers. An increase in the threshold would reduce the number of SEC-registered advisers and permit the SEC to focus on the appropriate universe of advisers on a risk-adjusted basis in its examination program.

- The SEC should improve its inspection program for investment advisers. There are a number of steps the SEC can take to better leverage its resources, including use of better technology, enhanced training, and additional data. We would be pleased to work with the Committee and the SEC to explore ways to ensure that investment advisers are subject to appropriate and timely examinations.

- The idea of establishing a self-regulatory organization (SRO) for investment advisers has been raised and rejected a number of times over the years. We continue to oppose the creation of an SRO for the advisory profession. The drawbacks to an SRO – including inherent conflicts of interest, questions about transparency, accountability, and oversight, and added costs and bureaucracy – continue to outweigh any alleged benefits.

Introduction

The Investment Adviser Association (IAA)[1] greatly appreciates the opportunity to appear before the Committee today to address the Treasury Department's proposed legislation, the Investor Protection Act of 2009, and issues related to SEC resources.

We commend the Committee for convening this hearing. Both as entities subject to regulation and as investors in the securities markets on behalf of their clients, the IAA's investment adviser members bring important perspectives to the regulatory reform discussion. We expressed our general views on regulatory reform at a hearing of the Senate Banking Committee earlier this year. Among other issues, we expressed our support for Congressional action to address true gaps in the current regulatory structure, notably the regulation of hedge fund managers and derivatives, including credit default

[1] The Investment Adviser Association (IAA) is a not-for-profit trade association that exclusively represents the interests of federally registered investment advisory firms. Founded in 1937, the IAA's membership consists of more than 450 investment advisory firms that collectively manage in excess of $8 trillion for a wide variety of clients, including individuals, trusts, endowments, foundations, corporations, pension funds, mutual funds, state and local governments, and hedge funds. For more information, please see www.investmentadviser.org.

swaps. We applaud your work in addressing these and other problems that were directly related to the financial crisis that began last year.[2] The IAA stands ready to assist the Committee in undertaking the critical tasks of renewing investor confidence and addressing failures of and weaknesses in the current regulatory framework.

The Administration's White Paper and Proposed Legislation on Investor Protection

In June, the Administration released its white paper for financial services regulatory reform.[3] The document includes a discussion of initiatives "to empower the SEC to increase fairness for investors."[4] Citing the confusion of retail investors about the differences between investment advisers and broker-dealers, the Administration's white paper contains the following recommendations:

> *New legislation should bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:*
>
> - *requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;*
> - *providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and*
> - *prohibiting certain conflict of interests and sales practices that are contrary to the interests of investors.*[5]

---

2 For additional views on financial services regulatory reform, *see Enhancing Investor Protection and the Regulation of Securities Market Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs* 111th Cong. (March 26, 2009) (statement of David G. Tittsworth, Executive Dir. and Executive Vice President, Investment Adviser Association).

3 U.S. Dept. of the Treasury, *A New Foundation: Rebuilding Financial Supervision and Regulation* (2009), available here.

4 *Id.* at 71.

5 *Id.* at 72.

In July, the Treasury Department released proposed legislation, entitled the "Investor Protection Act of 2009," to implement these recommendations and other issues set forth in the white paper. Section 913 contains parallel amendments to the Securities Exchange Act of 1934 (the primary law governing broker-dealers) and the Investment Advisers Act of 1940 (the primary law governing investment advisers) that would authorize the SEC to conduct various rulemakings under both statutes relating to standards of conduct, disclosures, sales practices, conflicts of interest, and compensation schemes.[6]

The IAA strongly supports the Administration's recommendation to require broker-dealers who provide investment advice to have the same fiduciary obligations as investment advisers. The Advisers Act fiduciary duty is the appropriate standard for protecting investors who rely on investment advice provided by investment advisers and other financial services providers. As noted below, the fiduciary duty under the Advisers Act is well-established and has been applied consistently over the years by courts and the SEC. It requires those who provide investment advice to put the interests of their clients ahead of their own interests. The Advisers Act fiduciary duty has worked well to protect investors and should not be revised, re-interpreted, watered down, or eliminated.

The IAA has long supported the view that persons providing the same services should be subject to the same laws and standards.[7] Accordingly, we have for many years argued in favor of subjecting brokers and others who provide investment advice about

[6] We note that Rep. Kanjorski released a 114-page discussion draft of the Investor Protection Act of 2009 late last week which, in certain respects, includes significant differences from the Treasury's proposal. Although it includes some improvements, Section 103 of the draft is substantially similar to Section 913 of the Treasury Department's draft legislation and continues to implicate many of the concerns addressed in our testimony regarding Section 913.

[7] *See, e.g., Letter from David G. Tittsworth, Executive Dir., Investment Counsel Association of America, to Jonathan G. Katz, Secretary, Securities and Exchange Commission*, (Jan. 12, 2000) (on file with SEC) in re *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Exchange Act Release No. 34-42099, Investment Advisers Act Release No. 1845, 64 Fed. Reg. 61226 (proposed Nov. 4, 1999) (The IAA "agrees with the Commission that a functional test focusing on the nature of services provided (rather than the form of the broker-dealer's compensation) is appropriate in determining whether and under what circumstances a brokerage account may be excluded from provisions of the Advisers Act.") available here.

securities to the same laws and standards that apply to investment advisers. This is a commonsense and reasonable approach. Unfortunately, as broker-dealers have migrated toward the investment advisory model, they have not been subject to the same standards.

To understand the issues underlying the Administration's current proposal, an examination of the legal and regulatory framework governing investment advisers, the migration of broker-dealers toward the investment advisory model, and developments related to the broker-dealer exclusion under the Advisers Act is required.

Background

The Investment Adviser Profession and Applicable Regulatory Framework

The investment advisory profession is robust and dynamic. Investment advisers serve a wide variety of clients, including individuals, trusts, endowments, foundations, corporations, government and private pension funds, mutual funds, hedge funds, and other types of pooled investment vehicles. In general, investment advisers are required to register with the SEC if they manage more than $25 million in assets. As of April 2009, there were 11,257 investment advisers registered with the SEC.[8] These advisers collectively reported assets under management of $34 trillion.

Contrary to public perception, the overwhelming majority of investment advisory firms are small businesses. As of April 2009, more than 8,000 investment advisers (71 percent of all SEC-registered investment advisers) reported managing between $25 million and $1 billion in assets. More than 10,000 advisers (90 percent) reported 50 or fewer employees. A few large investment advisory firms manage a disproportionate share of total assets: fewer than 500 advisory firms (about 4 percent of all SEC-registered

---

[8] *See* Investment Adviser Association and National Regulatory Services, *Evolution/Revolution 2009: A Profile of the Investment Advisory Profession,* (Oct. 2, 2009), available at the IAA web site, www.investmentadviser.org, under "Publications/News" and "Reports & Brochures."

investment advisers) reported managing more than $10 billion in assets, yet collectively accounted for more than 80 percent of all assets ($27.9 trillion).

While investment advisers employ a broad range of business strategies, the core activity of most investment advisers is providing investment advice on a discretionary basis to clients, that is, they are granted authority by their clients to make investment decisions for their clients' portfolios on an ongoing basis.[9] In addition to providing investment advisory services for individual or institutional clients, some investment advisers engage in other related activities, such as financial planning services, assisting in selection and monitoring of other advisers, serving as subadvisers to funds offered by other advisers, or providing wealth management services.

The legal and regulatory regime for the advisory profession must be flexible in order to address the enormous diversity among advisers. Consistent with this concept, the Advisers Act provides a largely principles-based statutory framework governing the conduct of those who provide investment advice. The Advisers Act sets forth a broad definition of "investment adviser": an investment adviser is a person who, for compensation, is in the business of rendering advice regarding securities. There are a number of exclusions from the definition, including the broker-dealer exclusion discussed below.[10]

The basic statutory framework of the Advisers Act is relatively simple and straightforward. Certain investment advisers are required to register with the SEC and are subject to regulations issued and enforced by the Commission.[11] The statute makes it

---

[9] *Id.* at 5. Of the $34 trillion assets under management reported by advisers in 2009, only $3.1 trillion were reported as non-discretionary. 89% of all investment advisers reported having discretionary authority over client accounts. *Id.* At 24. 75% reported providing portfolio management for individuals or small businesses. *Id.* at 21. 63% reported that they provide portfolio management for businesses or institutional clients, other than mutual funds. *Id.*

[10] *See* Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11) (2008). Other exclusions cover, under certain circumstances, banks, attorneys, accountants, publishers, and those who provide only incidental investment advice.

[11] *See* Investment Advisers Act of 1940 §§ 203, 209; 15 U.S.C. §§ 80b-3, 80b-9 (2008).

unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client," to engage in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and to engage in principal trades without receiving the consent of the client.[12] The law authorizes the Commission to promulgate rules and regulations that define and prescribe ways to prevent any act, practice, or course of business by an adviser that is "fraudulent, deceptive, or manipulative."[13] As discussed below, fundamental to the Advisers Act is the principle that an investment adviser is a fiduciary that must act in the best interests of its clients at all times. As former SEC Chairman Arthur Levitt has stated:

> *[T]he Act broadly prohibits fraud and holds advisers to rigorous fiduciary standards when dealing with clients. Investment advisers have two choices under the Act. They must rid themselves of all conflicts of interest with their clients – conflicts that might influence them to act in their own best interest rather than in the best interest of their clients. Or, they must fully disclose any conflicts to clients and prospective clients.*[14]

In addition to this overarching principles-based regulatory framework and the ongoing duties that flow from it, investment advisers are subject to specific rules and disclosure requirements. All SEC-registered investment advisers are required to submit a registration form and investor disclosure document (Form ADV) and update it at least

[12] Investment Advisers Act of 1940 § 206(1)-(3), 15 U.S.C. § 80b-6(1)-(3) (2008).

[13] Investment Advisers Act of 1940 § 206(4), 15 U.S.C. § 80b-6(4) (2008). The Commission also is given authority to exempt persons or transactions from the Advisers Act or regulations thereunder, "to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." Investment Advisers Act of 1940 § 206A, 15 U.S.C. § 80b-6a (2008).

[14] Arthur Levitt, Chairman, Sec. and Exch. Comm'n, *Amendments to Form ADV: Opening Statement*, (April 5, 2000); *see also SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 190-192 (1963) ("[t]he Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested").

annually and promptly for material changes.[15] Form ADV, Part 1 disclosures are publicly available and reveal extensive information regarding each investment adviser.[16]

Under SEC rules and pronouncements, investment advisers are subject to a variety of requirements relating to insider trading, proxy voting, books and records, custody, privacy, best execution, business continuity, advertising, and referral arrangements.[17] 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.[18] Advisers must also 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 their adequacy and effectiveness of their implementation, and designate a chief compliance officer responsible for administering the policies and procedures.[19] Further, investment advisers are subject to inspections and oversight by the SEC.

The Broker-Dealer Exclusion and the Migration of Broker-Dealers to the Investment Advisory Model

The Advisers Act includes an exclusion from the definition of investment adviser for "any broker or dealer whose performance of such services is solely incidental to the

[15] Advisers are required to disclose detailed information about their firms and executives, including: the educational and business background of each person who determines general investment 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 the adviser has 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.

[16] *See Investment Adviser Public Disclosure Web Site:* *www.adviserinfo.sec.gov*. The IAA has been urging the SEC to issue final rules amending Form ADV, Part 2 to provide greater clarity and enhanced disclosure to investors.

[17] *See, e.g.,* Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. §§ 275.204-1, 275.204-2, 275.206(4)-1, 275.206(4)-2, 275.206(4)-3, 275.206(4)-6, 275.206(4)-7 (2008), Regulation S-P, 17 C.F.R. § 248.1 et. seq.

[18] 17 C.F.R. § 275.204A-1 (2008).

[19] 17 C.F.R. § 275.206(4)-7 (2008).

conduct of his business as a broker or dealer and who receives no special compensation therefor." The term "special compensation" is intended to cover non-commission-based compensation.

When brokers charged only commissions, the broker-dealer exclusion provided a consistent, bright-line test separating the activities of brokers from investment advisers. However, over the past two decades, broker-dealers began charging asset-based fees, rendering application of the exclusion increasingly uncertain.

The migration of broker-dealers toward the investment advisory model, and the resulting investor confusion, has been well-documented. For example, the 2008 RAND report, a report commissioned by the SEC, compared how the different regulatory systems that apply to broker-dealers and investment advisers affect investors, and found that "…over the past two decades, broker-dealers have begun to drift subtly into a domain of activities that (at least under the regulatory regime) have historically been the province of investment advisers."[20] Based on interviews conducted with investors, the report also found investor confusion resulting from broker-dealers providing similar activities as investment advisers:

> *Participants mentioned that the line between investment adviser and broker-dealers has become further blurred, as much of the recent marketing by broker-dealers focuses on the ongoing relationship between the broker and the investor and as brokers have adopted such titles as "financial advisor" and "financial manager."*[21]

---

[20] Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, *RAND Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* 14 (Jan. 3, 2008) [hereinafter *RAND Report*].

[21] *Id.* at 19; *see also, Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Servs*., 111th Cong. 16-17 (July 17, 2009) (statement of Paul Schott Stevens, President and CEO, Investment Company Institute) (noting that "over the last decade, brokers have significantly shifted their business model to include providing investment advice and charging fees based on assets under management, rather than commissions for each transaction. This model previously had been used solely by investment advisers").

This confusion has resulted in a mismatch between client expectations and reality: investors now expect that brokers are acting in the investors' best interests when there is no obligation to do so.[22] Thus, these activities have raised significant issues under the broker-dealer exclusion. The exclusion was the subject of a protracted rulemaking commenced by the SEC in 1999, which sought to deal with the migration of broker-dealers toward the traditional investment advisory model. Under the proposed rule, a broker-dealer providing investment advice to a customer would be excluded from the definition of adviser, regardless of the type of compensation received, as long as three conditions were met: (i) the advice provided was non-discretionary; (ii) the advice was solely incidental to brokerage services provided; and (iii) the broker-dealer disclosed to its customers that the account was a brokerage account. The SEC's rule adopting changes to the exclusion in 2005 was subsequently vacated after a legal challenge.[23]

The application and interpretation of the broker-dealer exclusion continues to be problematic. As noted below, one simple solution to this problem would be to remove the exclusion for broker-dealers in the Advisers Act. The Treasury Department, however, has opted to address the issue through a different approach.

The Investor Protection Act of 2009 – Fiduciary Duty

The Administration's proposed Investor Protection Act, Section 913, titled "Establishment of a Fiduciary Duty for Brokers, Dealers, and Investment Advisers, and Harmonization of the Regulation of Brokers, Dealers, and Investment Advisers," would amend both the Investment Advisers Act and the Securities Exchange Act to permit the SEC to promulgate rules to provide "in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may

[22] *RAND Report*, *supra* note 20, at 31-32.

[23] *Financial Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice." Although the title explicitly uses the term "fiduciary duty," the statutory language does not.

The IAA strongly supports extending an investment adviser's fiduciary duty to brokers who provide investment advice. Virtually every regulator, consumer, and industry group that has commented on this issue agrees.[24] The Administration's white paper on financial services reform includes the stated goal of "requiring that broker-dealers who provide investment advice about securities to investors have <u>the same fiduciary obligations as registered investment advisers</u> (underlining added)" and *raising* the standard for brokers "to the fiduciary standards to align the legal framework with advisers." The IAA has consistently advocated that all persons who perform investment advisory activities should be subject to the same standard of care. We strongly believe that investors deserve the protections afforded by the fiduciary standard under the Advisers Act.

[24] *See, e.g., Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. On Fin. Servs.,* 111th Cong. 16 (July 17, 2009) (statement of Paul Schott Stevens, President and CEO, Investment Company Institute) ("the standard that governs the provision of investment advice must be one that explicitly incorporates the fiduciary duty that governs investment advisers' dealings with their clients."); *Enhancing Investor Protection and the Regulation of Securities Markets – Part II, Hearing Before the S. Comm. On Banking, Housing and Urban Affairs,* 111th Cong. 12 (March 26, 2009) (statement of Fred J. Joseph, Colorado Securities, Comm'r and President North American Securities Administrators Association, Inc.) ("NASAA urges Congress to apply the fiduciary duty standard of care to all financial professionals who give investment advice regarding securities—broker-dealers and investment advisers alike."); Mary L. Schapiro, Chairman, Sec. and Exch. Comm'n, *Speech Before the Financial Services Roundtable — 2009 Fall Conference* (Sept. 24, 2009) ("I also support the administration's efforts to apply a fiduciary standard of conduct to financial service professionals that provide investment advice about securities, regardless of whether those professionals carry the label "broker-dealer" or "investment adviser."); *Enhancing Investor Protection and the Regulation of Securities Markets – Part II, Hearing before S. Comm. On Banking, Housing and Urban Affairs,* 111th Cong. (March 26, 2009) (statement of Barbara Roper, Consumer Federation of America) ("all those who offer investment advice should be required to put their clients' interests ahead of their own … that fiduciary duty should govern the entire relationship"); *Letter from IAA, Consumer Federation of America, Fund Democracy, NASAA, Financial Planning Association, National Association of Personal Financial Advisers, and CFP Board of Standards to the Honorable Barney Frank and the Honorable Spencer Bachus, House Committee on Fin. Servs., U.S. House of Representatives* (July 14. 2009) available here.

Fiduciary Duty under the Advisers Act is Well-Established and Consistently Applied

Fiduciary duty under the Advisers Act is a cornerstone upon which the regulation of investment advisers is built. In a seminal decision by the U.S. Supreme Court in 1963, the Court held that the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisers.[25] The Court found embodied in the Advisers Act an adviser's affirmative duty of utmost good faith and full and fair disclosure of all material facts to its clients as well as an affirmative obligation to employ reasonable care to avoid misleading its clients.[26] Under this federal fiduciary standard, [27] investment advisers must, among other things, act in the best interest of their clients and place the interests of their clients before their own. This well-established standard has been consistently interpreted and applied by the SEC and the courts to require investment advisers to serve their clients with the highest duty of loyalty and duty of care.[28]

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."[29] 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

[25] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

[26] *Id.* These duties of a fiduciary were applied by the SEC and the courts long before the Supreme Court in the *Capital Gains* case found them to be embodied in the anti-fraud provisions of the Advisers Act. *See, e.g., In the Matter of Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

[27] *See Transamerica Mortgage Advisors Inc. v. Lewis*, 444 U.S. 11 (1979) ("Section 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers"); *Laird v. Integrated Resources, Inc*. (5th Cir. 1990) (in a 10b-5 action against an investment adviser, the court looked to the federal fiduciary standard and stated that its "holding encompasses a developed federal standard"). *See also Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No.2910, 74 Fed. Reg. 39840 (proposed Aug. 3, 2009) ("The Supreme Court has construed section 206 as establishing a federal fiduciary standard governing the conduct of advisers").

[28] *See, e.g., Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2059, 68 Fed. Reg. 6586 (Sept. 20, 2002) ("An adviser's fiduciary duty includes the duty of care and the duty of loyalty to clients").

[29] Lemke & Lins, *Regulation of Investment Advisers*, 169 (2009).

to clients' needs, objectives, and financial circumstances; and (4) the duty to make full and fair disclosure to clients of all material facts, particularly regarding potential conflicts of interest.[30]

For more than 45 years, state and federal courts as well as the SEC have consistently required investment advisers to satisfy this fiduciary standard.[31] The standard by which investment advisers are judged – to act in the best interests of the client – is unquestionably clear and should be maintained for the benefit of investors.

Application of the Advisers Act Fiduciary Duty is Broad and Flexible

The fiduciary standard is based on common law principles arising from the relationship of trust between the adviser and the client. The application, however, of the fiduciary standard is based on particular facts and circumstances. Some outside the advisory profession who are unwilling to take on this duty on behalf of their clients have criticized this aspect of fiduciary duty as being ill-defined and amorphous and have

---

[30] *See 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*, Investment Advisers Act Release No. 1092, 46 Fed. Reg. 41771 (Oct. 16, 1987) (discussing fiduciary duties); S*uitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients*, Investment Advisers Act Release No. 1406, note 3 (Mar. 16, 1994) (noting duty of full disclosure of conflicts of interest, duty of loyalty, duty of best execution, and duty of care and citing various sources).

[31] *See Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11 (1979); Laird v. Integrated Resources, Inc*. (5th Cir. 1990) (in a 10b-5 action against an investment adviser, the court looked to the federal fiduciary standard and stated that its "holding encompasses a developed federal standard"); *Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d (E.D. Va. 2003) (section 206 "establishes fiduciary duties for investment advisers). *See also In re Sterling Capital Planners, Inc.*, Investment Advisers Act Release No. 2797, (October 8, 2008) (breach of fiduciary duty through transfer of funds without client consent, failure to disclose significant conflicts of interest); *In re Invesco Funds Group, Inc.*, Investment Advisers Act Release No. 2311 (Oct. 8, 2004) (breach of fiduciary duty through market timing, failure to act at all times in the best interests of the client and provide full and fair disclosure of all material facts); *In re David A. King*, Investment Advisers Act Release No. 1391 (Nov. 9, 1993); *In re George Sein Lin*, Investment Advisers Act Release No. 1174 (June 19, 1989); *In re Westmark Financial Services Corp.*, Investment Advisers Act Release No. 1117 (May 16, 1988). Broker-dealers, on the other hand may be subject to inconsistent standards because they are not considered fiduciaries by operation of law. Rather, courts have looked to the nature of the relationship between the client and the broker-dealer to determine whether a broker-dealer is a fiduciary in a particular case. Any concerns about the consistency of judicial analysis of broker-customer relationships would be remedied by applying the Advisers Act fiduciary duty to broker-dealers providing investment advice by operation of law.

argued that more precision is necessary. We disagree. The overarching protection afforded investors under the fiduciary standard is essential. Because the duty is a principle-based standard and investment advisers must place the interests of their clients before their own in every circumstance, obligations of investment advisers cannot be circumscribed by a rule book no matter how voluminous. The Advisers Act and the rules adopted under the Act are only the starting point for investment advisers to ensure that they act in the best interest of their clients and place clients' interests above their own. These fiduciary obligations must guide every action taken by an investment adviser.

The criticism that all of these obligations have not been or cannot be reduced to a checklist misses a core strength of the fiduciary standard. As the IAA and other organizations expressed in a letter to the SEC's recently established Investor Advisory Committee:

> *We believe that it would be no more appropriate to insist on a precise definition of fiduciary duty than it would be to insist on a precise definition of the duty not to commit fraud. . . . Attempting to provide specific definition of all aspects of fiduciary duty, or to enumerate precisely how it applies and what it entails, would have the perverse consequence of diluting protections for investors.*[32]

It would be contrary to the interests of investor protection to attempt to define precisely all elements of the Advisers Act fiduciary duty. Doing so would diminish the protections of the fiduciary standard.[33] Moreover, the breadth and flexibility of the fiduciary duty of investment advisers have allowed the regulation of investment advisers

---

[32] *See Letter from Kevin R. Keller, CEO, CFP Board, Marvin W. Tuttle Jr., Executive Director and CEO, Financial Planning Association, David G. Tittsworth, Executive Director, Investment Adviser Association, and Ellen Turf, CEO, National Association of Personal Financial Advisors to Richard Hisey and Hye-Won Choi, Co-Chairs of Investor Advisory Committee* (Aug. 6, 2009), available on the IAA web site under "Publications/News" and "Comments & Statements."

[33] *See* Michael Koffler, *Six Degrees of Separation: Principles to Guide the Regulation of Broker-Dealers and Investment Advisers*, 41 Sec. Reg. & Law Rep. 776 (April 27, 2009) ("Given the equitable nature of fiduciary law, it is not tenable to set forth a fiduciary's responsibilities in a detailed manner or to specify a convention to govern their activity. Nor would it be in the public interest to do so. And it certainly would not be consistent with the way fiduciary law has evolved and been interpreted for hundreds of years").

to remain dynamic and relevant in changing business and market conditions. SEC Commissioner Luis A. Aguilar echoed this sentiment when he stated:

> *[Fiduciary duty] is a fundamental investor protection…The fiduciary standard is a dynamic, living principle that provides investors with true protection….A fiduciary standard has real teeth because it is an affirmative obligation of loyalty and care that continues through the life of the relationship between the adviser and client, and it controls all aspects of their relationship. It is not a check-the-box standard that only periodically applies.*[34]

Section 913 of the Proposed Investor Protection Act Should Be Revised to Extend the Advisers Act Fiduciary Standard to Broker-Dealers Providing Investment Advice

The fiduciary standard established under the Advisers Act continues to provide a strong level of protection for all investment advisory clients. The proposed legislation should, as intended, extend the same protection to clients of broker-dealers receiving investment advice. We are concerned, however, that the specific text of the current legislation may open the door to watering down or weakening the current fiduciary standard.

If the proposed legislation is intended to fulfill the Administration's regulatory reform goal – *i.e.*, "requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers" – it should explicitly incorporate the Advisers Act fiduciary standard. Instead, the proposed legislation authorizes the SEC to adopt standards of conduct that are "in substance…to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." By using the term "in substance," the proposed legislation could allow for rules that may be less protective than the current Advisers Act fiduciary standard.

[34] Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, *SEC's Oversight of the Adviser Industry Bolsters Investor Protection* (May 7, 2009).

In addressing issues relating to Section 913, it is important to remember the context in which these issues have arisen. Brokers have been migrating toward the investment advisory business, not the other way around. However, some brokers would prefer to avoid being governed by the Advisers Act fiduciary duty due to concerns about certain requirements applicable to advisers. Given the migration of brokers to the advisory business, we believe it would be inappropriate to water down or weaken the strong investor protection standards and provisions embodied by the Advisers Act to accommodate certain broker practices.

In addition, we are concerned that Section 913 proposes to authorize the SEC to adopt rules under the Advisers Act for "retail customers or clients (and such other customers or clients as the Commission may by rule provide)." This provision of the proposed legislation could lead to different standards for different advisory clients. The current Advisers Act fiduciary duty applies equally to all advisory clients, whether individual or institutional (*e.g.* pension plans, endowments, mutual funds, or trusts). The IAA strongly believes that all investment advisory clients deserve the protections afforded by the Advisers Act fiduciary duty. We oppose efforts to impose a different standard of care under the Advisers Act for investment advisers providing services to different types of clients.

Instead, we recommend that Section 913 be revised to provide unambiguously for the extension of the Advisers Act fiduciary duty to brokers that provide investment advice and to ensure that the fiduciary duty that already exists under the Advisers Act is preserved. These goals and the Administration's stated intent could be achieved without amendments to the Advisers Act. Thus, Section 913 should be amended to apply the Advisers Act fiduciary duty to brokers under the Exchange Act and to delete references to the SEC's establishing fiduciary standards under the Advisers Act. Another simple approach that has been suggested to extend the fiduciary duty under the Advisers Act to broker-dealers providing investment advice is to remove the exclusion for broker-dealers in the Advisers Act. Under this approach, broker-dealers who meet the definition of "investment adviser" (*i.e.*, who provide investment advice) would be subject to the provisions of the Advisers Act, including the fiduciary standard.

We intend this recommendation to apply only to broker-dealers who are providing investment advice as defined under the Advisers Act. Although the debate relating to the fiduciary standard has focused on broker-dealer activities relating to investment advice to individuals, broker-dealers are engaged in other activities, including execution of securities transactions, underwriting, investment banking, advising issuers regarding the structure of securities offerings, market-making, or other lines of business that do not involve advice about securities investments to clients. Our recommendation would not subject broker-dealers to a fiduciary duty in those other lines of business or activities.

A "New Federal Standard" Would be Detrimental to Investors

The broker-dealer industry, through SIFMA, its trade association, has proposed that a "new federal standard" should be established for broker-dealers and investment advisers that would supersede the existing fiduciary standard.[35] We strongly oppose any suggestion to replace the Advisers Act standard for the following reasons:

- Advisers are already subject to a federal fiduciary standard, as discussed above. Beyond perpetuating misunderstandings of the existing fiduciary duty, SIFMA has failed to describe how the "new federal standard" would improve upon the Advisers Act fiduciary duty.
- SIFMA argues that the "new federal standard" would "provide firms with appropriate relief from the SEC's current prohibitions against principal trading." Section 206(3) of the Advisers Act includes restrictions on principal trades (*i.e.*, buying and selling from one's own account). It is clear that one of the primary reasons that broker-dealers (who typically buy and sell from and to their own

[35] *See Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. (July 17, 2009) (statement of Randall Snook, Executive Vice President, SIFMA).

accounts) resist coverage under the Advisers Act is to avoid the principal trading restrictions. But the fact remains that principal trades involve significant potential conflicts of interest involving self-dealing. If there are situations in which exemptions from the prohibition on principal transactions are appropriate, the SEC already has the authority to provide such exemptions.

- SIFMA argues that a new standard is necessary so that financial services firms can continue to provide investor choice of investment products. Frankly, we are not aware of any meaningful investor choices that are prevented or impeded under the existing fiduciary standard – or why imposing a "new federal standard" would allow for greater investor choice. To the extent that "investor choice" refers to availability of proprietary products, we note that the fiduciary duty under the Advisers Act does not prohibit particular products, but rather provides a high standard for fully disclosing and resolving potential conflicts in the best interest of the client.
- SIFMA has professed concern regarding judicial protection of investors under an adviser's fiduciary duty. That concern is unfounded. As discussed above, "the SEC has been bringing cases on behalf of investors for the last 70 years prosecuting fiduciaries for breaching their duties and for failing to mitigate or disclose conflicts to their clients."[36] In addition, advisers are subject to breach of fiduciary duty claims by clients under common law. Fiduciary duty has been a powerful and flexible remedy that has worked well.

The Investor Protection Act of 2009 – Other Provisions

Other "Harmonizing" Changes in the Investor Protection Act

In addition to suggesting legislative changes related to the fiduciary duty standard, Section 913 of the proposal contains parallel amendments to the Exchange Act and the Advisers Act that would authorize the SEC: (1) to provide for "simple and clear disclosure

[36] *See supra* note 341.

to investors" and (2) to examine, and where appropriate, adopt rules prohibiting certain sales practices, conflicts of interest, and compensation schemes for financial intermediaries.

As discussed above, investment advisers already are subject to extensive disclosure obligations, both with respect to required regulations (*e.g.,* Form ADV) and the overarching fiduciary obligations that apply under the Advisers Act. Further, the SEC already has broad statutory authority under the Advisers Act to prohibit fraudulent, deceptive, and manipulative acts or practices.[37]

While we believe the SEC already has the ability to act in these areas under its broad anti-fraud authority, we understand that it may be beneficial to promulgate rules that are not anti-fraud rules. We are concerned, however, that Section 913 could be used to shift away from the current principles-based regime under the Advisers Act to a more inflexible conduct regime. Further, the proposal's requirement that the SEC consult with other financial regulators on best practices under the Advisers Act but not under the Exchange Act does not make sense. We would be pleased to work with the Committee to better understand the issue that the proposed legislation seeks to address and to consider whether additional statutory amendments to the Advisers Act are necessary.

Mandatory Arbitration

The Administration's regulatory reform proposal would give the SEC authority to prohibit or impose conditions on agreements that require customers of broker-dealers or clients of investment advisers to arbitrate future disputes arising under the federal securities laws or the rules of an SRO if it finds that such action is in the public interest

[37] *See* Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2008

and for the protection of investors.[38] The Administration notes that "although arbitration may be a reasonable option for many consumers to accept after a dispute arises, mandating a particular venue and up-front method of adjudicating disputes – eliminating access to courts – may unjustifiably undermine investor interests."[39]

The IAA supports the Administration's proposal. While we fully appreciate the goals and efficiencies of alternative dispute resolution, we believe that investors should be provided with choice in their selection of a dispute resolution forum. In particular, mandating that investors participate in an industry-run arbitration system creates the perception of unfairness, regardless of the actual results of such a system. In addition, arbitration may not present the best venue for certain types of claims. If the SEC exercises the authority it will be given to prohibit or limit mandatory arbitration, we suggest the SEC develop investor education materials that would assist customers or clients in determining whether to participate in alternative dispute resolution on a voluntary basis. We would be pleased to assist in such efforts.

SEC Enforcement Tools

The Administration's proposed legislation would provide the SEC with a number of expanded enforcement tools. First, the SEC would be able to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant monetary sanctions. The SEC currently may compensate sources in insider trading cases and would be able to extend that ability to other types of actions. We support this provision. Encouraging insiders and others with substantial evidence of securities violations voluntarily to provide that evidence to the SEC would enhance the SEC's ability to pursue wrongdoers.

---

[38] We submit that the legislation's proposed language to amend the Advisers Act regarding arbitration be revised to eliminate reference to "rules of a self-regulatory organization." As discussed below, advisers are not subject to the jurisdiction of an SRO, nor should they be.

[39] *See Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward Legislation for Strengthening Investor Protection Delivered to Capitol Hill* (July 10, 2009) available here.

Second, the proposal would expand the SEC's authority to impose collateral bars on individuals who violate the securities laws. Currently, a person the SEC has barred from being an investment adviser could still act as a broker-dealer. The SEC should be given authority to bar individuals who commit serious misconduct from all segments of the regulated securities industry in one proceeding. We agree with SEC Chairman Mary Schapiro that this proposal "would enable the SEC to more effectively protect investors and the markets while more efficiently using SEC resources."[40]

Finally, the Administration's proposal addresses inconsistencies in the SEC's ability to bring cases against those who aid and abet securities fraud. Currently, the SEC has authority to bring actions for aiding and abetting violations of the Exchange Act and the Advisers Act in civil enforcement actions. The proposal would extend such authority to actions under the Securities Act of 1933 and the Investment Company Act of 1940. In addition, the proposal would clarify that the Advisers Act permits imposition of penalties on aiders and abettors. We support consistent standards governing aider and abettor liability.[41]

Investor Advisory Committee

Earlier this summer, the SEC established a new Investor Advisory Committee to provide investors with a greater voice in the Commission's work. The committee's charter permits it to address broad goals of enhancing investor protection, including: advising the SEC on matters of concern to investors in the securities markets; providing the SEC with investors' perspectives on current, non-enforcement, regulatory issues; and serving as a source of information about, and recommendations for, regulatory programs from an investor perspective. The Committee is comprised of 15 individuals selected by the SEC chairman representing a broad spectrum of investors.

---

[40] *See Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 9 (July 22, 2009) (statement of Mary Schapiro, Chairman, Sec. and Exch. Comm'n). *See also* U.S. Treasury Department Title IX Section by Section Analysis at Section 925, available here.

Section 911 of the Administration's proposed legislation would make this Committee permanent. We strongly support giving investors a more robust, continuing presence in the dialogue on the SEC's investor protection agenda. Insights from the Committee will assist the SEC in considering the effects of new products and services, trading venues and practices, and various disclosure regimes.

Consumer Testing

Section 912 would amend the Advisers Act (as well as the other securities laws) to authorize the SEC to "gather information, communicate with investors or other members of the public . . . as it in its discretion determines is in the public interest or for the protection of investors." These amendments would appear to provide the SEC with the explicit authority to obtain information from investors, such as clients of investment advisers. We fully appreciate that the SEC may need information directly from the public or investors to carry out its mandate, including the protection of investors. We are concerned, however, that the information obtained from clients may include personal or financial information that should be protected from further dissemination.

Therefore, we ask that the provisions be amended to require that all information provided to the SEC under this section be confidential, not subject to civil discovery or other legal process, and exempt from disclosure under the Freedom of Information Act or otherwise.

The SEC's Resources

While not the subject of Administration proposals, the adequacy of the SEC's resources to appropriately oversee and examine investment advisers is a legitimate and compelling concern that deserves serious consideration and action by policy makers. We support a strong and effective SEC as the direct regulator of investment advisers.

[41] While we support the concept of this proposal, we may have comments on the specific language.

However, the SEC does not have sufficient resources to appropriately conduct examinations of the more than 11,000 advisers under its jurisdiction. We recommend a number of measures to address the SEC's resources and to ensure a robust and appropriate oversight program of the investment advisory profession.

Give the SEC Appropriate Resources to Fulfill Its Mission

First, as long-supported by the IAA, there must be full funding for the SEC's regulatory and enforcement efforts. While we applaud the Administration's recommended budget increase for the SEC, more resources are still needed. In addition to the appropriations process, we believe Congress should examine alternatives to allow the agency to achieve longer-term and more stable funding.

Authorizing self-funding for the SEC would be optimal. In August, SEC Chairman Schapiro discussed her views on the subject, stating that "Self-funding has been discussed over the years but I think it may now well be the moment. Some stability in funding would be an enormous benefit because it would help with long-term planning in such areas as technology and staffing."[42]

The IAA issued a statement in support of Chairman Schapiro's comments, stating that "[t]he IAA is in strong agreement with Chairman Schapiro that the SEC would be better able to fulfill its investor protection mission if it was able to operate as a self-funded agency like other financial regulators."[43] SEC Commissioner Aguilar also has spoken in favor of a self-funding mechanism for the SEC, stating that self-funding

[42] *Financial Times* (Aug. 5, 2009).

[43] As Sen. Schumer has noted, "the SEC raises millions more dollars every year in registration and transaction fees (not including enforcement penalties or settlements) than it is allocated through the appropriations process, but its budget is limited to the amount approved by Congress. In 2007, though the SEC brought in $1.54 billion in fees, it secured just $881.6 million in funding." Press Release, Sen. Schumer (Sept. 3, 2009). At a minimum, a self-funding mechanism would permit the SEC to retain the funds it currently collects.

"would greatly enhance the SEC's ability to advance its mission."[44] As he noted earlier this year:

> *Being self-funded is not a novel idea. In addition to the Federal Deposit Insurance Corporation, other regulators that are independently funded include the Office of Thrift Supervision, Office of the Comptroller of the Currency, and the Federal Reserve, to name a few. There is no logical reason to treat the SEC differently, and many reasons to similarly empower the Commission. Congress should consider providing the SEC with the ability to budget and self-fund its operations. In this challenging environment, the SEC should be able to set long-term budgets, be able to react to changing markets and new products and services, and be able to adjust its staffing as appropriate.*

While self-funding is the optimal means to address the SEC's resource constraints, there are a number of other options, including user fees. We would be pleased to work with the Committee to further develop these measures to ensure that the SEC is fully funded.

The SEC Should Increase the $25 Million Dividing Line Separating SEC-Registered and State-Registered Investment Advisers

Second, we recommend that the SEC increase the $25 million threshold that separates federally registered and state-registered advisers. An increase in the $25 million level would reduce the number of SEC-registered advisers and allow the SEC to focus on larger investment advisory firms. Smaller investment advisers, which typically have a strong local presence, would be subject to regulation and oversight by the state securities regulators.

The $25 million level was established by Congress in 1996 under the Investment Advisers Supervision Coordination Act.[45] The Coordination Act allocated responsibility

[44] Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, *Speech at North American Securities Administrators Association's Winter Enforcement Conference: Empowering the Markets Watchdog to Effect Real Results,* (Jan. 10, 2009).

for investment advisers between the SEC and the states, with the SEC regulating larger advisers and the states regulating smaller advisers. [46] This allocation of regulatory responsibility between the SEC and the states has worked well to enhance investor protection, provide for more efficient use of limited regulatory resources, and reduce burdensome, inconsistent, and unnecessary regulatory costs.

The Coordination Act explicitly contemplated that the threshold would be regularly re-evaluated and adjusted. Although the SEC has authority to do so, in the 13 years since enactment of the law, the SEC has never, to our knowledge, initiated any formal review or proceeding to determine whether the threshold should be increased. In considering such action, the SEC obviously needs to coordinate closely with the North American Securities Administrators Association (NASAA).

In a recent speech, Denise Crawford, NASAA president, indicated support for increasing the level to $100 million:

> *[T]he current dividing line between federal and state regulation of investment advisory firms is $25 million of assets under management. The SEC might increase this to $100 million of assets under management. Given the difficulty the SEC has in examining such a large number of investment advisory firms, I think this is a good idea. NASAA has endorsed such a change and will work closely with the SEC to make this happen.*[47]

---

[45] *See Title III, National Securities Markets Improvement Act of 1996,* Pub. L. 104-290.

[46] The $25 million threshold was intended to provide a bright line test for allocating regulatory responsibility of advisers between the SEC and the states, representing a rough cut between advisers that generally do business in interstate commerce and those that generally have more localized practices. The report accompanying the Senate-passed bill notes that the Commission "may also use its exemptive authority under the bill to raise the $25 million threshold higher as it deems appropriate in keeping with the purposes of the Investment Advisers Act." S. Rpt. 104-293, p. 5 (June 26, 1996).

[47] Denise Voigt Crawford, Texas Sec. Comm'r, *Speech to Annual Meeting, North American Securities Administrators Association* (Sept. 15, 2009). The full text of the speech is available on NASAA's web site: www.nasaa.org.

Raising the level to $100 million from $25 million would shift approximately 4,200 investment advisers from SEC regulation to various state regulators. The resulting number of SEC-registered investment advisers (about 7,000) would be consistent with the number of advisers after the Coordination Act was initially implemented.

The IAA Supports Greater Effectiveness of the SEC's Inspection Program

Third, the SEC should improve its inspection program for investment advisers. The SEC's examination and oversight of investment advisers, broker-dealers, and investment companies is a critical part of the SEC's mission. The stated purpose of examinations is "to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the Commission is continually made aware of developments and areas of potential risk in the securities industry."[48]

SEC Chairman Schapiro already has taken many meaningful steps to enhance the current oversight program. In her recent testimony before this Committee, Chairman Schapiro cited the following initiatives:

- Providing more staff training on fraud detection;
- Hiring staff with expertise in securities trading, portfolio management, valuation, derivatives, risk management, and other important areas;
- Conducting exams more focused on firms with higher risk profiles and practices;
- Providing examiners with more tools and methodologies to detect fraud, including improved pre-exam work protocols;
- Leveraging the work performed by a firm's independent auditor;
- Improving systems for surveillance and risk-based targeting; and

---

[48] *See* home page of SEC Office of Compliance Inspections and Examinations, at http://www.sec.gov/about/offices/ocie.shtml (July 20, 2009).

- Improving the handling of tips and complaints.[49]

We have written to Chairman Schapiro to applaud these initiatives, which represent positive steps to strengthen the Commission's examination program.[50] We have expressed our willingness to work with the Commission toward the shared goal of enhancing the effectiveness of investment adviser exams.

The IAA Supports the SEC's Mission to Oversee Investment Advisers and Opposes a Self-Regulatory Organization for Investment Advisers

The idea of establishing a self-regulatory organization (SRO) for investment advisers is not new; it has been raised and rejected a number of times over the years. An SRO for investment advisers is not currently under consideration by Congress and, notably, the SRO issue was not addressed in the Administration's financial regulatory reform white paper or draft legislation.[51] Nevertheless, the issue has been raised again recently, in part as a way to address the SEC's resource constraints.[52]

The IAA strongly supports robust and appropriate oversight and regulation of the investment advisory profession by a fully-funded SEC. We believe the SEC has the necessary expertise and experience to be the primary regulator of the investment advisory profession. Given the great diversity among advisory firms – including firms with a wide range of business models, strategies, and clients – this expertise and experience is critical in regulating and overseeing the profession.

---

[49] *See SEC Oversight: Current State and Agenda, Hearing Before the H. Sub. Comm. on Capital Markets, Insurance and Government Sponsored Enterprises Hearing*, 111th Cong. (July 14, 2009) (statement by Mary L. Schapiro, Chairman, Sec. and Exch. Comm'n).

[50] *Letter from David G. Tittsworth, Investment Adviser Association to The Hon. Mary L. Schapiro, Chairman, Securities and Exchange Commission* (July 29, 2009).

[51] U.S. Dept. of the Treasury, *A New Foundation: Rebuilding Financial Supervision and Regulation* (2009), available here.

[52] *See*, e.g., *Assessing the Madoff Ponzi Scheme and Regulatory Failures, Hearing Before the H. Sub. Comm. On Capital Markets, Insurance and Government Sponsored Enterprises*, 111th Cong. 5 (Feb. 4, 2009) (statement of Stephen I. Luparello, Interim CEO, FINRA). *See also Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform, Hearing Before the S. Comm. on Banking, Housing & Urban Affairs* 111th Cong. (August 17, 2009) (statement of Daniel Sibears, Executive Vice President, Member Regulations Programs, FINRA).

Since its inception, the SEC has been an effective regulator with a strong enforcement arm in the areas of disclosure and fiduciary duty, the bedrock principles underlying investment adviser regulation. In the face of recent difficulties, the SEC has taken prompt and comprehensive action to revitalize its enforcement efforts and enhance its investigative capabilities.[53] While the current system of regulation and oversight of investment advisers can and should be improved, adding a new layer of bureaucracy and cost on the profession through an SRO will not significantly enhance investor protection. As noted by Commissioner Aguilar, an SRO is "an illusory way of dealing with the problem of resources. The issue is really one of hiring, training, and overseeing an adequate program to examine advisers."[54] Further, as Commissioner Aguilar has indicated, 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."[55]

Further, the effectiveness of the SRO model has not been demonstrated. When SROs have pursued major cases or sought fundamental changes, they typically have been following investigations by others (*e.g.* state attorney generals, media reports, prosecutors). Indeed, recently some have called for the MSRB to be merged into the SEC due to its ineffectiveness.[56] Similarly, SROs have been discredited

[53] *See Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance, Hearing before S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (Sept. 10, 2009) (statement of Robert Khuzami, Director, Division of Enforcement, Sec. and Exch. Comm'n, and John Walsh Acting Director, Office of Compliance Inspections and Examinations, Sec. and Exch. Comm'n)

[54] Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, *SEC's Oversight of the Adviser Industry Bolsters Investor Protection* (May 7, 2009), available here.

[55] *Id.*

[56] *See* Andrew Ackerman, *MSRB Won't Amend Rule G-37*, Bond Buyer, April 7, 2009 (noting that in testimony before the Senate Banking Committee, former SEC chairman Arthur Levitt said "that self regulation through the MSRB does not work and that it should be folded into the SEC."); *see also Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance, Hearing Before the H. Comm. On Fin. Servs.*, 111th Cong. (May 21, 2009) (statement of Keith D. Curry, Past Pres., Nat'l Ass'n of Indep. Pub. Fin. Advisors); *Enhancing Investor Protection and the Regulation of Securities*

internationally.[57] For example, in the late 1990's, the U.K. government transferred SRO regulatory powers to the FSA due to the complexities and inefficiencies of the U.K. SRO system.[58]

We therefore continue to oppose the creation of an SRO for the advisory profession. Ultimately, the drawbacks to an SRO continue to outweigh any alleged benefits. These drawbacks include inherent conflicts of interest based on industry funding and influence, questions regarding transparency, accountability and oversight, due process issues in disciplinary proceedings, and added cost and bureaucracy. In addition, as noted by Tulane Law Professor Onnig Dombalagian, who testified at a Senate Banking Committee hearing in August, "[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."[59]

While self-regulation may appeal to those who wish to shift taxpayer-funded regulation costs to industry, we also note that appropriate government oversight is required in any SRO structure and thus requires expanded dedication of government

---

Markets; Hearing Before the S. Comm. On Banking, Housing & Urban Affairs, 111th Cong. 7 (March 10, 2009) (statement of Thomas Doe, founder and CEO of Municipal Market Advisors) ("End the MSRB as an SRO").

[57] "Whereas [SROs] are rather significant in the United States, they do not play any role in the United Kingdom and are hardly of any importance in Germany. In the EU, priority is given to the statutory approach to regulation." *See Securities Market Regulation: International Approaches*, Deutsche Bundesbank Monthly Report. (January 2006), available here. As a further example, Australia does not have SROs under the true definition, although exchange organizations have limited self-regulatory powers. *See* Prof. Berna Collier, Comm'r, ASIC, *Ensuring Capacity, Integrity and Accountability of the Regulator* (2005) available here.

[58] Even the chairman of the Securities and Investments Board, the most important of the SROs, "acknowledged that self-regulation had failed in the U.K. and seemed unable to restore investor confidence." *See Enhancing Investor Protection and the Regulation of Securities Markets, Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 35-36 (March 10, 2009) (statement of Prof. John C. Coffee, Jr., Columbia Univ. Law School).

[59] *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) available here. The concerns we have raised about SROs generally are particularly relevant with respect to FINRA. FINRA has been pursuing a role in supervising investment advisers for some time. We have serious concerns about FINRA's governance structure, cost structure, areas of expertise, and track record.

resources. Most investment advisory firms are small businesses with limited resources. The costs of any SRO are borne by the regulated entities and will obviously impact all investment advisers, including thousands of small advisory firms. Ultimately, those costs may be passed on to investors. If pricing resistance is such that the costs cannot be passed on, they will have a significant impact on job retention and creation in these small businesses - in which human resources account for the vast portion of cost structure. It would be more cost effective to use the industry's funds that would be spent on an SRO to bolster the SEC's oversight efforts, for example through a self-funding structure as discussed above. Moreover, a single, governmental regulator - operating without confusion of overlapping regulation, regulators and "stovepipes" - is also directly accountable to Congress and the public.

Further, the reasons that persuaded Congress to authorize the creation of an SRO for broker-dealers in 1939 – including the high level of interconnectivity between broker-dealers as well as highly technical issues related to settlement, execution, and reconciliation involving broker-dealer transactions – simply do not exist in the investment advisory profession.

Finally, the diversity of the investment adviser industry makes a rules-based SRO model unworkable. There is not sufficient commonality among the various types of adviser business models – traditional asset management firms, financial planners, wealth managers, advisers that are part of global financial institutions, small advisers with a limited number of high net worth clients, asset allocators, hedge fund managers, mutual fund managers, pension consultants, and others – to achieve fair and flexible self-regulation. Command-and-control requirements that seek to impose a one-size-fits-all solution for various legal and regulatory issues do not lend themselves to this widely divergent community of advisers. As Professor Dombalagian stated, "there would be little benefit to using the financial resources and operational expertise of industry members to develop and enforce industry standards" due to the "considerable variety in the conduct of their business, the handling of customer funds and securities, and the risks their activities pose to clients."[60]

Therefore, continued oversight of the advisory profession by the SEC under the current structure of the Advisers Act – and its reliance on disclosure and broad anti-fraud authority rather than specific and rigid regulatory requirements – is both appropriate and effective.[61]

* * * * *

The IAA appreciates the opportunity to discuss our views on regulatory reform and specific issues that have been raised with respect to the Advisers Act. Our testimony does not include detailed comments regarding Capital Markets Subcommittee Chairman Kanjorski's recently circulated discussion draft of the Investor Protection Act. We are currently analyzing the draft and would be pleased to provide comments as soon as possible. We look forward to working with the Committee in the coming weeks and months in efforts that are designed to enhance and improve the effective and appropriate regulation of the financial services industry, to restore the vitality of the U.S. economy, and to renew investor confidence in our markets.

October 6, 2009

---

[60] *Id*.

[61] Given its clear preference for broker-dealer rules, we believe it would be inappropriate and counterproductive to establish FINRA as the SRO for investment advisers. Any regulator for investment advisers should, at a minimum, acknowledge and reflect the practices, culture, regulation, and oversight of the advisory profession. In light of its explicit statements favoring the broker-dealer regulatory model, FINRA clearly cannot serve in this capacity. Establishing FINRA as the SRO for investment advisers would eviscerate the "self" in self-regulation. Instead, it would lead to an extension of the broker-dealer regulatory model to the advisory profession.