Statement of

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Hearing on Regulation and Oversight of Broker-Dealers and Investment Advisers

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Executive Summary

Investment advisers manage assets for a wide array of individual and institutional investors. Currently, approximately 11,500 investment advisers are registered with the SEC, collectively managing assets totaling $43.8 trillion for more than 14 million individual and institutional clients. Investment advisers engage in a wide range of advisory activities and investment strategies on behalf of their clients, including constructing securities portfolios pursuant to client directives, recommending a particular asset allocation plan, providing portfolio analysis and evaluation, assisting in selecting and monitoring other advisers, and providing wealth management or financial planning services. In addition to those activities, some of which are more oriented toward individual clients, investment advisers manage assets for 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 offered 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 run the gamut 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, half of all federally-registered advisers employ fewer than five and more than two-thirds employ fewer than ten non-clerical employees. The legal and regulatory regime for the advisory profession must be sufficiently robust and flexible to address the enormous diversity among advisers. This flexibility is provided for in the Investment Advisers Act of 1940 (Advisers Act), which prescribes a largely principles-based statutory framework governing the conduct of those who provide investment advice.

The core principle underlying the Advisers Act is the fiduciary duty imposed on investment advisers, in whom clients place their trust and confidence. As fiduciaries, investment advisers must act in their clients' best interests at all times, placing their clients' interests above their own. The fiduciary duty thus serves as a bedrock principle of investor protection. The IAA believes that the fiduciary standard of care should apply to the relationship with all clients who receive personalized investment advice about securities, regardless of which financial professional is providing the advice.

Section 913 of the Dodd-Frank Act directed the SEC to conduct a study of the standards of care applicable to investment advisers and broker-dealers. It also authorized the SEC to promulgate rules providing that the standard of conduct for brokers, dealers, and investment advisers when providing personalized advice about securities to retail customers shall be to act in the best interest of the client without regard to the financial or other interest of the broker, dealer, or investment adviser. Section 913 further specified that, if the SEC promulgates such rules, the standard of conduct be no less stringent than the fiduciary duty imposed by the Advisers Act.

After extensive study, the SEC released its Section 913 staff report recommending that it issue rules providing for a uniform fiduciary standard for both advisers and broker-dealers providing personalized advice about securities to retail clients, along with rulemaking or interpretive guidance addressing the components of the standard. We support the SEC staff's recommendation, but would oppose any measures that would weaken or water down the fiduciary standard for advisers in the process.

The Advisers Act fiduciary duty is well-established and has been consistently interpreted and enforced for decades by the SEC and the courts. While we appreciate the desire for specificity by brokers unfamiliar with fiduciary duties, we are concerned that in the process of providing that guidance, the SEC may inadvertently create an inflexible narrowly tailored regime antithetical to the principles-based underpinning of the fiduciary standard. One of the greatest strengths of the 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.

The IAA has consistently supported this overarching fiduciary duty as a core component of meaningful regulation of the investment advisory profession. However, effective examination of advisers is also a critical component of meaningful oversight. To achieve this goal, we continue to support strongly regulation and oversight by the SEC, a single governmental regulator, fully accountable to Congress and the public, subject to rules mandating transparency, and that places investor protection as its paramount mission.

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) imposing user fees on federally-registered investment advisers to fund their examinations by the SEC; (2) authorizing one or more SROs to examine all SEC-registered investment advisers; and (3) authorizing FINRA to examine dual registrants for compliance with the Advisers Act. In its analysis of these options, the report finds the greatest number of advantages, and the least number of disadvantages, with respect to user fees. It also includes a thorough discussion of the problems inherent in designating an SRO for the diverse investment advisory profession. Other reputable reports and studies – including by the Chamber of Commerce, the Government Accountability Office, and an independent consultant retained by the SEC – also catalogue the drawbacks, costs, and inefficiencies of the SRO model.

We strongly oppose an SRO for the advisory profession. The substantial drawbacks to an SRO outweigh any potential benefits. These drawbacks include insufficient transparency, accountability, and oversight by the SEC and Congress, due process issues in disciplinary proceedings, and the absence of any requirement for a cost-benefit analysis for proposed rules. Further, 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. For these reasons, we oppose the draft legislation circulated last week that would require investment advisers to become members of an SRO, subject to SRO rules, regulations, and oversight. We particularly oppose extending FINRA's jurisdiction to investment advisers for these reasons and due to its questionable track record and bias favoring the broker-dealer regulatory model.

The SEC, with its 70 years of substantive expertise and experience with the Advisers Act, is in the best position to govern the activities of advisers. We also believe that the costs of user fees would be significantly less than the costs to the industry for SRO oversight because the SRO would need to hire, train, and oversee inspection staff, develop investment adviser expertise, and incur significant start-up costs. Further, as documented in the recent Boston Consulting Group study required under Section 967 of the Dodd-Frank Act, the SEC would still have to expend significant resources to exercise appropriate oversight of the SRO; indeed, this independent study recently concluded that the SEC does not provide sufficient oversight of the SROs currently under its jurisdiction, particularly FINRA.

We believe that the SEC should continue its implementation of reforms designed to streamline and enhance its investment adviser examination program with existing resources. Further, the number of investment advisers under SEC jurisdiction will decrease substantially as a result of provisions in the Dodd-Frank Act. Should the combination of streamlined examinations and re-allocated SEC resources, together with the decrease in the number of advisers, fail to alleviate concerns about the examination program – and, as an alternative to an SRO - we believe that Congress should consider properly structured user fees. We would be pleased to assist the Subcommittee in drafting such legislation, which 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 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 Commission's examination of investment advisers. The fees collected would be used solely to fund enhancements to the investment adviser examination program, and set a level designed to achieve an acceptable frequency of examinations. This stable source of funding would enable the SEC staff to conduct long-term strategic planning, especially with respect to technological modernization that could enhance its risk assessment and monitoring capabilities. Importantly, the reporting and accountability embedded in the user fee approach would provide substantial transparency and opportunity for congressional oversight and public input.

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 and other financial services providers.

Introduction

The Investment Adviser Association (IAA)[1] greatly appreciates the opportunity to appear before the Subcommittee today to discuss the studies mandated by the Dodd-Frank Act on the standards of care applicable to broker-dealers and investment advisers and on the need for enhanced examination resources for investment advisers.

The IAA commends the Subcommittee for convening this hearing. We support appropriate rulemaking by the SEC to ensure that investors receive investment advice that is given in their best interest, regardless whether the advice is provided by an investment adviser or broker-dealer.[2] We also strongly support giving the SEC the tools it needs to conduct an effective investment adviser examination and oversight program.[3] The IAA stands ready to assist the Subcommittee in undertaking the critical task of ensuring robust protection for all investors.

I. The IAA Supports the SEC Staff Recommendation to Apply the Fiduciary Duty Standard to Advisers and Brokers.

Section 913 of the Dodd-Frank Act required the SEC to conduct a study and submit a report to Congress evaluating the current standards of care for broker-dealers and investment advisers providing personalized investment advice and recommendations about securities to

[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.

[2] Letter from David G. Tittsworth, Exec. Dir., IAA, to Elizabeth Murphy, Secretary, SEC re: Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Rel. No. IA-3058; File No. 4-606 (Aug. 30, 2010) ("IAA Section 913 Letter"), available on our web site under "Comments & Statements."

[3] 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"), available on our web site under "Comments & Statements." *See also Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office Hearing Before the H. Comm. on Fin. Services,* 111th Cong. (Oct. 6, 2009) (statement of David G. Tittsworth, Exec. Dir. and Exec.Vice President, IAA), available on our web site under "Comments and Statements."

retail customers. In the study, the SEC was required to assess whether there are gaps in the relevant law and regulations, evaluate the effectiveness of current standards of care, and consider many other topics such as the potential impact and cost of regulatory changes. Section 913 further authorizes the SEC to promulgate rules to provide that the standard of care for investment advisers and broker-dealers when providing personalized investment advice to retail customers is to act in the best interest of the customer without regard to the financial or other interest of the broker or adviser. The law provides that this standard is to be no less stringent than the fiduciary duty currently applicable to investment advisers under the Advisers Act.

Section 913 includes provisions specifically designed to address broker-dealers' concerns raised during congressional consideration of the Dodd-Frank Act about the application of fiduciary duty to their business practices. Among other things, these provisions confirm that charging commissions and offering proprietary products do not constitute breaches of fiduciary duty. In addition, Section 913 provides that application of the fiduciary duty does not in and of itself require brokers to have a continuing duty to a retail customer after providing investment advice.

The Commission established a cross-divisional staff task force to conduct the study and submitted its final report to Congress on January 22, 2011.[4] After extensive review and consideration of the factors set forth by Congress, the SEC released its staff report recommending that the SEC establish a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers that would require advisers and brokers to act in the best interests of their clients. The report recommends that this standard be consistent with, and no less stringent than, the standard applied to investment advisers under the Advisers Act. The report recommends that the Commission engage in rulemaking or guidance addressing the minimum components of the uniform fiduciary standard to provide guidance for brokers unfamiliar with the standard.

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[4] Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011) ("913 Report").

Importantly, the staff expressed its view that existing guidance and precedent under the Advisers Act regarding fiduciary duty will continue to apply. The staff report made a number of recommendations designed to address brokers' concerns about cost, investor choice, and the scope of the duty. Further, the staff considered but rejected alternatives to the uniform fiduciary standard that would result in imposing the entire investment adviser regulatory regime on broker-dealers. The staff, however, recommended consideration of harmonization of broker-dealer and adviser regulation in certain areas "to the extent that harmonization appears likely to add meaningful investor protection."[5]

SEC Commissioners Casey and Paredes issued a joint dissenting statement to the Section 913 Report expressing their view that the Report did not include sufficient analysis of the potential costs of changes to regulation or adequate discussion of whether there is in fact a problem with the current regulation of broker-dealers and advisers. On March 17, Chairman Garrett and other members of the Capital Markets Subcommittee sent a letter to Chairman Schapiro expressing similar concerns. SEC Chairman Schapiro has stated that she has requested the staff to conduct further analysis of these issues. We appreciate the need for thorough cost-benefit analysis in the rulemaking process and support the SEC's additional efforts in this regard.

1. <u>The Fiduciary Standard of Care Provides More Protection to Investors than the Suitability Standard.</u>

The IAA strongly supports the SEC staff recommendation to apply a fiduciary standard no less stringent than that currently applied to investment advisers to both investment advisers and brokers who provide personalized investment advice about securities to retail clients. The fiduciary duty is the highest standard of care recognized under the law and serves as a bedrock principle of investor protection.

Pursuant to the Advisers Act, as a fiduciary, "an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct

[5] *Id.* at 102.

than that used for mere commercial transactions."[6] In practical terms, fiduciary duty means that, in the course of providing advice to clients, advisers must disclose all material information and conflicts of interest to their clients, including the fees that they charge, how they plan to recommend securities to clients, and any material disciplinary information involving the firms or their investment personnel. Moreover, as fiduciaries, advisers must treat their clients fairly and not favor one client over another, especially if they would somehow benefit from favoring one particular client or type of client. Most important, whenever the interests of investment advisers differ from those of their clients, advisers must explain the conflict to the clients and act to mitigate or eliminate it, ensuring they act in the interests of the client and not for their own benefit.

This well-established standard has been consistently interpreted and applied by the SEC and the courts to require investment advisers to serve their clients with the highest duty of loyalty and duty of care.[7] 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.[8]

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[6] Thomas P. Lemke and Gerald T. Lins, *Regulation of Investment Advisers*, at 2:33 (2010); *see also* SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) ("Capital Gains").

[7] In a seminal decision in 1963, the U.S. Supreme Court held that the Advisers Act imposes a fiduciary duty on investment advisers. 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. Capital Gains, *supra* note 6. These duties of a fiduciary were applied by the SEC and the courts long before the Supreme Court in *Capital Gains* 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 Rel. No. 4048 (Feb. 18, 1948).

[8] *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, Investment Advisers Act Rel. No. IA-1406, note 3 (Mar. 16, 1994) ("Suitability Release") (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

Broker-dealers that manage assets for clients under discretionary authority or for a fee are already subject to the Advisers Act fiduciary duty.[9] The existing standard of care for broker-dealers that provide non-discretionary advice for a commission, such as making recommendations about securities to brokerage customers, is the suitability standard. Under FINRA Rule 2310, broker-dealers that provide investment advice to retail customers are required to ensure that the advice is "suitable" for the client. In addition, FINRA Rule 2010 requires broker-dealers when dealing with customers to "observe high standards of commercial honor and just and equitable principles of trade." The FINRA rules are essentially standards of fair treatment reflecting a commercial relationship rather than a relationship of trust and confidence.

The broker suitability standard differs significantly from the Advisers Act fiduciary duty. Indeed, the duty to provide suitable investment advice is merely one aspect of the fiduciary duty.[10] For example, brokers under a suitability duty may make recommendations or make investment decisions as long as they are "suitable" for that client under the client's particular circumstances, even if they are not in the best interests of the client. Moreover, even if brokers are motivated to provide particular advice because significant benefits accrue to them (such as receipt of a financial benefit for recommending a particular security), suitability does not require disclosure of such conflicts.

Virtually every regulator, consumer, and industry group that has commented on this issue agrees that the fiduciary standard provides more protection to investors than the suitability

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Advisory Services as a Component of Other Financial Services, Investment Advisers Act Rel. No. IA-1092, (Oct. 16, 1987) (discussing fiduciary duties); *see also* Capital Gains, *supra* note 6.

[9] The SEC has interpreted the exclusion for brokers from investment adviser regulation as not extending to broker-dealers that have discretionary authority over client assets. *See, e.g.*, Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940, Investment Advisers Act Rel. No. 2 (Oct. 28, 1940); Certain Broker-Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Rel. No. 2340 (Jan. 6, 2005); *see also* Letter from Christopher Gilkerson, Charles Schwab & Co., Inc. to Elizabeth Murphy, Secretary, SEC (Aug. 30, 2010).

[10] *See* Suitability Release, *supra* note 7 ("Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable advice").

standard.[11] The SEC, state regulators, consumer advocates, academics, financial commentators, and industry trade groups representing investment advisers, financial planners, investment companies, private fund advisers, and broker-dealers have written in support of extending fiduciary duty to all financial professionals giving advice.[12] Indeed, the major trade association representing broker-dealer firms supports the SEC staff recommendation as well.[13]

A vocal minority of brokers has argued that extending the Advisers Act fiduciary duty to brokers will disrupt business models and reduce investor choice. These arguments are not supported by any facts or evidence. The Advisers Act fiduciary duty has accommodated a broad

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[11] During an October 2009 hearing before the House Committee on Financial Services, Rep. Spencer Bachus asked each of the witnesses on the panel on Strengthening Investor Protection whether fiduciary duty or suitability was the higher standard. Each witness responded that fiduciary duty was the higher standard: Denise Voigt Crawford, Texas Securities Commissioner, Securities Administrators Board, on behalf of the North American Securities Administrators Association; Richard Ketchum, Chairman and CEO, Financial Industry Regulatory Authority; Mercer E. Bullard, Founder and President, Fund Democracy, Inc.; John Taft, Head of Wealth Management, RBC Wealth Management, on behalf of the Securities Industry and Financial Markets Association; David G. Tittsworth, Executive Director, IAA; Bruce W. Maisel, Vice President and Managing Counsel, General Counsel's Office, Thrivent Financial for Lutherans, on behalf of the American Council of Life Insurers; *see also* Statement of David G. Tittsworth, Exec. Dir. and Executive Vice President, IAA, *supra* note 3; *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); *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 (Mar. 26, 2009) (statement of Fred J. Joseph, Colorado Securities, Comm'r and President, North American Securities Administrators Association, Inc.); *Enhancing Investor Protection and the Regulation of Securities Markets – Part II, Hearing before S. Comm. On Banking, Housing and Urban Affairs,* 111th Cong. (Mar. 26, 2009) (statement of Barbara Roper, Consumer Federation of America); 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 Hon. Barney Frank and the Hon. Spencer Bachus, H. Comm. on Fin. Servs. (July 14, 2009), available on our web site under "Comments and Statements."

[12] *See* 913 Report, *supra*, note 4, at 107*; see also, e.g.,* Jane Bryant Quinn, *Will Brokers Have to Put Your Interest First?*, janebryantquinn.com, (May 6, 2010), *available at* http://janebryantquinn.com/2010/05/will-brokers-have-to-put-your-interests-first/*;* Tara Siegel Bernard, *Trusted Adviser or Stock Pusher? Finance Bill May Not Settle It*, N.Y. Times, Mar. 3, 2010, *available at* http://www.nytimes.com/2010/03/04/your-money/brokerage-and-bank-accounts/04advisers.html*;* Paul Sullivan, *Broker? Adviser? And What's the Difference*, N.Y. Times, Feb. 18, 2010, *available* http://www.nytimes.com/2010/02/18/your-money/financial-planners/18TRUST.html; Tara Siegel Bernard, *Struggling Over a Rule for Brokers*, N.Y. Times, Feb. 15, 2010, *available at* http://www.nytimes.com/2010/02/16/business/16adviser.html*;* Jason Zweig, *The Fight Over Who Will Guard Your Nest Egg*, Wall St. J., Mar. 28, 2009, *available at* http://online.wsj.com/article/SB123819596242261401.html.

[13] *See* Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Mary L. Schapiro, Chairman, SEC, re: Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act (July 14, 2011) ("SIFMA 913 Framework Letter'). *See also SEC Standard of Care Study Recognizes Strengths of Broker-Dealer Regulatory System*, Financial Services Institute Press Rel. (Jan. 24, 2011) (commending SEC staff for addressing FSI concerns regarding fiduciary standard).

spectrum of advisory-related activities and vastly different business models for many decades. One of the strengths of the fiduciary standard is its flexibility to apply to a range of activities and services. Extension of this flexible standard will not result in less investor choice or wholly infeasible requirements on those who choose to provide advice to individual clients.[14] For example, opponents of the fiduciary duty base their claims on the incorrect assumption that brokers would no longer be able to charge commissions or provide advice about proprietary products. That is not the case now under the Advisers Act fiduciary duty, and indeed Section 913 and the SEC staff report confirm that brokers will continue to be able to charge commissions and advise regarding proprietary products under the fiduciary standard.

It is also important to note that the SEC staff's recommendation will not impose the Advisers Act fiduciary duty on all broker-dealer activity. The recommendation narrowly addresses only the provision of personalized investment advice about securities to retail clients. The fiduciary duty would not, for example, apply to market-making or underwriting activities.

2. SEC Should Resist Efforts to Weaken the Advisers Act Fiduciary Duty.

We believe that the key issue is not whether brokers should have a fiduciary duty when giving personalized investment advice about securities to retail clients, but how that duty should be implemented. To that end, we applaud the SEC staff's recommendation that existing guidance and precedent under the Advisers Act fiduciary duty will continue to apply to investment advisers and be extended to broker-dealers, as applicable. The Advisers Act fiduciary duty is well-established, has been consistently interpreted by courts and the SEC for decades, and has worked well in protecting investors.

We strongly disagree with those who assert that the existing case law, guidance and other legal precedent developed under the Advisers Act should not apply to broker-dealers and that an entirely new body of law should be developed – in effect a new standard. These commenters

[14] *See, e.g.* Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Spencer Bachus, Chairman, H. Comm. on Fin. Svcs., et al., (May 9, 2011), available at http://www.consumerfed.org/pdfs/CFA-fiduciary-consequences-letter-5-9-2011.pdf.

argue that, because the fiduciary duty case law was not developed in the context of broker-dealer business models, they are not able to "gauge compliance with, or legal exposure under, the Advisers Act," and believe that existing fiduciary duty precedent would "undermine the broker-dealer model."[15] This assertion is not supported by the facts. Indeed, brokers that provide discretionary advice or advice for a fee, as well as financial planners, have operated under the fiduciary duty for many years. Further, as noted by the SEC staff report, brokers have been subject to fiduciary duty pursuant to state law under various circumstances.[16] We recognize, however, that certain issues unique to the broker-dealer business model, such as principal trading, may need to be addressed under the fiduciary standard. The SEC staff appropriately has indicated its intent to provide guidance regarding these issues. In so doing, it is not necessary to implement a new or different standard that potentially could weaken or alter the fiduciary duties owed by investment advisers or by brokers providing discretionary advice.

Further, preserving the interpretations and precedents under the Advisers Act brings with it the benefit of ensuring that the fiduciary duty applies equally to all investment advisory clients, whether individual or institutional. Section 913 authorizes the SEC to adopt rules for "retail customers or clients (and such other customers or clients as the Commission may by rule provide)." The provision's focus on applying the fiduciary duty to brokers when they give "personalized investment advice to retail customers" should not lead to modification of investment advisers' fiduciary duty applicable to all clients, both retail and institutional. The IAA strongly believes that all investment advisory clients deserve the protections afforded by the Advisers Act fiduciary duty. Different standards of care may result in lowering the current standard with regard to certain advisory clients and result in inconsistent application of the law to similar facts, an outcome we would oppose.

The SEC staff report recommends that the Commission provide guidance addressing the parameters (*e.g.,* definition of personalized investment advice) and components of the fiduciary duty, including identifying specific examples of conflicts of interest to assist brokers unfamiliar

[15] SIFMA 913 Framework Letter, *supra* note 13.

[16] 913 Report, *supra* note 4, at 54.

with the fiduciary duty. Although we do not take issue with this approach conceptually, we would urge the Commission in so doing not to reduce the obligations that flow from fiduciary duty to a checklist or prescriptive set of narrowly tailored rules.[17] The breadth and flexibility of the fiduciary duty of investment advisers have allowed the regulation of investment advisers to remain dynamic and relevant in changing business and market conditions.[18] Because the duty is a principles-based standard and investment advisers must place the interests of their clients before their own in every circumstance, the overarching fiduciary duty of investment advisers cannot - and should not - be circumscribed by a rule book, no matter how voluminous.

We have offered to work with the SEC to develop strong, sensible regulations that maintain the investor protection of advisers' current fiduciary duty under the Advisers Act and to extend this protection to all retail customers receiving personalized investment advice.

3. <u>Any "Harmonization" of Broker-Dealer and Investment Adviser Regulations Should Recognize that Adviser Regulation Is Specifically Designed for Advisory Activities.</u>

The SEC staff report extensively reviewed the investment adviser and broker-dealer regulatory frameworks and discussed a number of potential areas in which the Commission could consider harmonizing differences in these regimes. The staff took a thoughtful approach in recommending harmonization in both directions – that is, application of certain Advisers Act rules to brokers and application of certain broker rules to advisers. We nevertheless would encourage the Commission to continue to bear in mind that the Advisers Act rules and

[17] *See* Michael Koffler, *Six Degrees of Separation: Principles to Guide the Regulation of Broker-Dealers and Investment Advisers*, 41 Sec. Reg. & Law Rep. 776 (Apr. 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").

[18] Over the years, the SEC has favored a flexible approach to fiduciary duty. *See, e.g.,* Investment Adviser Codes of Ethics, Investment Advisers Act Rel. No. IA-2256 (July 9, 2004) ("proposal left advisers with substantial flexibility to design individualized codes that would best fit the structure, size and nature of their advisory businesses"); Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Rel. No. IA-2204 (Dec. 17, 2003) ("Commenters agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements."); Proxy Voting by Investment Advisers, Investment Advisers Act Rel. No. IA-2106 (Jan. 31, 2003) ("Investment advisers registered with us are so varied that a 'one-size-fits-all' approach is unworkable.").

regulations are specifically designed for the provision of investment advice, whereas the broker-dealer regime is designed for different core activities.

Despite the investment advisory profession's wide range of ownership structures, investment strategies, and business models, the core of the profession is portfolio management. Virtually all SEC-registered investment advisers have ongoing discretionary authority to make investment decisions on behalf of their clients. 68% of the more than 11,500 SEC-registered investment advisers are not engaged in any business activity other than giving investment advice. Only 561 SEC-registered investment advisers (4.86 %) are dually registered as broker-dealers.[19] While investment advisers are generally focused solely on managing client assets or financial planning, broker-dealers engage in a wider range of activities, including selling securities, mutual funds, and variable annuities; selling interests in limited offerings or private placements; margin lending; securities lending; taking custody of client funds or securities; executing trades; acting as a market maker, dealer, syndicator or underwriter; acting as a distributor for issuers; and engaging in stock exchange floor activities.

Many of the differences in the regulations governing brokers-dealers and investment advisers appropriately reflect their different business models and the services they provide. For example, different rules apply to disclosure, codes of ethics, proxy voting, contractual requirements, and advertising.[20] Broker-dealer rules derive from the historic role of brokers executing transactions and selling financial products to consumers (thus, the brokerage industry is commonly referred to as the "sell side").[21] Investment adviser rules derive from the historic

[19] In 2011, 87.7% of all investment advisers reported having discretionary authority over client accounts. Indeed, of the $43.8 trillion assets under management reported by SEC-registered advisers in 2011, only $5 trillion were reported as non-discretionary. *See* Investment Adviser Association and National Regulatory Services, *Evolution/Revolution 2011: A Profile of the Investment Advisory Profession* (August 2011) ("*Evolution/Revolution 2011"),* at 4. Data presented are as of May 1, 2011. In addition, approximately 75.6% of advisers provide portfolio management for individuals and/or small business, 63.7% of advisers provide portfolio management for business or institutional clients (other than mutual funds); 41.3% of advisers provide financial planning services; and 31% of advisers assist clients in selecting other advisers. *Id.* at 15.

[20] An exhaustive comparison of the various regulations applicable to broker-dealers and investment advisers when providing investment advice is attached as Appendix A to the IAA Section 913 Letter, *supra* note 2.

[21] Proponents of "harmonization" at times fail to discern basic differences between the sales-based, transaction-oriented brokerage industry and ongoing advisory services provided by the investment advisory profession. *See, e.g.*

role of advisers in providing investment advisory services to clients, including managing client portfolios (thus, the advisory profession is commonly referred to as the "buy side").

Despite major changes in both the brokerage and advisory industries during the past 70 years, there continue to be significant differences between the core activities of most broker-dealers and most investment advisers. The range in which brokers' and advisers' activities overlap is relatively narrow. Accordingly, we believe it would be inappropriate and counterproductive to import the sales-based broker-dealer regime for investment advisers or to impose Advisers Act protections on non-advisory activities of broker-dealers. We have offered to work with the Commission to analyze thoughtfully any areas in which enhancement of investment adviser regulation would provide additional meaningful protections to advisory clients.

II. <u>The IAA Supports Efforts to Strengthen the SEC's Investment Adviser Examination Program.</u>

The IAA has consistently supported meaningful regulation of the investment advisory profession, including an effective examination program. We support the SEC's efforts to strengthen the examination program for investment advisers.[22]

Section 914 of the Dodd-Frank Act required that the SEC conduct a study to review and analyze the need for enhanced examination and enforcement resources for investment advisers. Section 914 required the examination of: (1) the number and frequency of examinations of investment advisers by the SEC over the five years preceding the date of the enactment of the Dodd-Frank Act; (2) the extent to which having Congress authorize the SEC to designate one or

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Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform, Hearing Before S. Comm. on Banking, Housing and Urban Affairs, 111th Cong. (Jan. 27, 2009) (statement of Stephen Luparello, Interim Chief Executive Officer, FINRA) (the solution is "greater regulatory harmonization – creating a regulatory system that gives retail investors the same protections and rights no matter what *product* they *buy*," including that for every "*transaction*," there be consistent: (1) licensing requirements; (2) advertising requirements; (3) "appropriateness" standards for *products*, and (4) full disclosure for the "*products being sold*.") (emphasis added).

[22] *See, 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."

more SROs to augment the SEC's oversight of investment advisers would improve the frequency of examinations of investment advisers; and (3) current and potential approaches to examining the investment advisory activities of dually-registered broker-dealers and investment advisers and registered investment advisers that are affiliated with a broker-dealer.

In January, the staff of the SEC delivered the required report to Congress[23] reflecting concern regarding the SEC's capacity to inspect investment advisers and setting forth a range of options for enhancing investment adviser examinations, including: (1) imposing user fees on federally-registered investment advisers to fund their examinations by the SEC; (2) authorizing one or more SROs to examine all SEC-registered investment advisers; and (3) authorizing FINRA to examine dual registrants for compliance with the Advisers Act.[24]

In the report, the SEC staff found that the SEC's oversight capabilities had not kept pace with the recent growth in the investment advisory profession and that, as a result, the frequency of investment adviser examinations has decreased significantly. Although the number of SEC-registered investment advisers is expected to fall significantly due to changes mandated by Dodd-Frank,[25] the report projects that there could be as many as 13,908 registered advisers collectively managing more than $70 trillion by fiscal year 2021. The report further states that even if the SEC hires more examiners, the number of examination staff is unlikely to keep pace with future growth among advisers. Additionally, the staff notes that SEC's new examination obligations under Dodd-Frank will "further strain resources." These concerns form the basis for the staff's recommendation that Congress should consider the user fees and SRO options.

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

[24] Because fewer than 5% of registered investment advisers are members of FINRA, the savings the SEC would derive from delegating Advisers Act examination authority for these advisers to FINRA is limited. Therefore, this third option is acknowledged in the report as a less comprehensive solution and has not drawn wide support.

[25] The SEC staff estimated that after implementation of Title IV of the Dodd-Frank Act (increasing the threshold for federal registration of investment advisers from $25 million to $100 million in assets under management and requiring certain private fund advisers to register with the SEC) the number of registered advisers would drop 28.2% from 11,888 to 8,538. 914 Report, *supra* note 23, at 16-17. We note that these numbers will need to be revised. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Rel. No. IA-3221, at 9 (June 22, 2011) (estimating that 900 more advisers will remain SEC-registered); *Evolution/Revolution 2011*, *supra* note 19, at 2 (noting decline in number of SEC-registered advisers as of May 1, 2011).

The IAA recognizes that the SEC's examination staff currently does not have the capacity to conduct frequent examinations of investment advisers. As the SEC staff notes, however, in 2012, the investment adviser population will decrease to close to its 2004 levels as a result of Dodd-Frank changes. The staff expects that this decrease could enable more frequent examinations in the near term.[26] Further, we would encourage the SEC staff to re-examine its future projections in light of more recent data. This year – for the first time since 2001 – the umber of SEC-registered investment advisers has decreased, albeit slightly.[27] Given the maturity of the industry, the re-allocation of responsibilities between the SEC and states, and the increasing costs and barriers to entry, the historical annual increase in the number of SEC-registered advisers may not persist.

Further, we support the SEC's ongoing efforts to leverage its existing resources, streamline the examination program, and conduct more "smart" exams. As the staff recognizes, frequency of examinations is only one factor in an effective examination and oversight program.[28] An effective examination program focuses on preventing, detecting, and deterring fraud and other abusive practices rather than on numerical examination targets or technical violations that may not result in investor harm. Key components of an effective examination program include experienced staff with in-depth expertise, detailed information-gathering systems, selection of examination candidates, examination results, and robust risk assessment analysis.

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[26] 914 Report, *supra* note 23, at 21.

[27] *Evolution/Revolution 2011*, *supra* note 19, at 2.

[28] 914 Report, *supra* note 23, 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").

The SEC has been taking meaningful steps to enhance the effectiveness of the current oversight program of advisers and the examination staff's expertise in the securities markets[29] including: (1) placing a greater emphasis on fraud detection in addition to identifying potential violations of securities laws; (2) strengthening internal controls to maximize resources; (3) recruiting examiners with specialized skills; and (4) increasing examiner expertise through training.[30] Importantly, the examination staff has moved aggressively to implement reforms and has focused its strategy to "identify the areas of highest risk and deploy [its] examiners against these risks, in order to improve compliance, prevent fraud, monitor risk and inform policy-making."[31] In addition to these initiatives over the last several years, the examination staff will "improve surveillance and risk identification/assessment capabilities and the targeting of exams to areas and firms that present the greatest risk of harm to investors and the markets."[32]

The Commission recently has adopted significant changes to Form ADV (the registration form for advisers) and will soon adopt new Form PF (to gather information about private fund advisers). Both filings will provide the SEC with substantial additional detailed information about advisers' business practices to assist in risk-targeted examinations, enforcement, and oversight of advisers.[33] OCIE has also implemented a new governance structure intended to improve communication and accountability.[34] It has taken steps to better coordinate its broker-

[29] *See* 914 Report, *supra* note 23 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, Dir. of Office of Compliance, Inspections and Examinations, SEC) ("SEC Testimony").

[30] *See, e.g., Examinations by the Securities and Exchange Commission, Office of Compliance Inspections and Examinations*, (Feb. 2011) ("OCIE Examinations"), available at http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[31] *See* SEC Testimony, *supra* note 29, at 13.

[32] *See, e.g.,* SEC FY2012 Justification in Brief (Feb. 2011) at 5.

[33] 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).

[34] 914 Report, *supra* note 23, at 28.

dealer and investment adviser programs. In addition, the Division of Enforcement has implemented significant changes focused on investment advisers, including enhanced staff training with specialized skills. We applaud these positive steps to strengthen the Commission's enforcement and examination program.

Finally, we encourage the SEC staff to continue to review and assess its allocation of resources. For example, the staff report notes that the number of staff dedicated to examining registered investment advisers and investment companies has fallen from 477 to 460 employees since 2004.[35] It does not explain, however, why more examiners were not allocated to investment adviser examinations, given the high priority the SEC accords this program. Indeed, almost as many examiners (380)[36] were assigned to broker-dealer examinations as adviser exams, even though there are fewer than half as many broker-dealers as advisers and the SEC has delegated broker-dealer examinations to FINRA.

III. Congress Should Consider Imposing User Fees on Advisers In Lieu of an SRO.

Should the combination of streamlined and re-allocated SEC resources discussed above, together with the decrease in the number of advisers fail to alleviate concerns about the examination program, Congress should consider imposing user fees on investment advisers. Such fees would provide resources to strengthen and support the SEC's investment adviser examination program.[37] The fees would be a stable source of funding that is 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.

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[35] *Id.* at 10.

[36] 913 Report, *supra* note 4, at A-15.

[37] 914 Report, *supra* note 23, at 25.

User fees are already an important source of funding for inspections and examinations at many federal agencies.[38] The SEC has previously supported user fees in testimony related to legislation under consideration in 1990. Additionally, investment advisers already pay user fees to support the IARD, the electronic system through which investment advisers make filings with state and federal regulators.[39] The IARD system therefore provides an existing infrastructure to collect user fees at a relatively small marginal cost.

The SEC staff report found that the user fees option would permit 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.[40] Stable resources would also provide the examination program with increased flexibility to react to emerging risks associated with advisers and better target staffing and strategic resources as appropriate. The staff observed that retaining responsibility for investment adviser examinations will better enable the staff to understand how the private fund advisers and securities-based derivative instruments now under its jurisdiction fit into the broader markets.[41] Knowledge gained from the investment adviser examination program would greatly assist in gathering the intelligence and expertise critical to the regulatory process. Further, the improvements to the examination program discussed above could be further leveraged with the funding provided by user fees. These benefits would not accrue to the SEC from the SRO model.

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[38] The 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.

[39] *Id.* at 26.

[40] *Id.* at 26-28.

[41] *Id.* at n.47.

Indeed, in its analysis of the various options, the 914 Report finds the greatest number of advantages, and the least number of disadvantages, with regard to user fees.[42] The report observes that "imposing user fees would avoid the difficult scope of authority, membership, governance, and funding issues raised by an SRO…It would avoid the need for the Commission to use resources to staff an expanded SRO examination program."[43] Funding from adviser user fees would give the SEC greater flexibility and would be a less costly option than establishing an SRO.

The report notes that in many ways, user fees may be a smarter, more efficient use of funds.[44] Allowing OCIE to charge user fees would empower it to build on the expertise and infrastructure it has already established.[45] Within the SEC, OCIE examination staff benefit from close working relationships with other SEC legal and policy staff.[46] In contrast, an SRO would be an isolated cost center that would require extra resources and hiring to build even a preliminary infrastructure.

Further, an SRO would still require an increase in the SEC's management and coordination costs in order to oversee the SRO.[47] 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.[48] In addition, with the user fee option, "the chance that inconsistencies would emerge in

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[42] *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").

[43] 914 Report, *supra* note 23, at 27.

[44] *See* 914 Report, *supra* note 23, at 27; *see also* IAA Section 914 Letter, *supra* note 23; MFA 914 Letter, *infra* note 50, 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).

[45] 914 Report, *supra* note 23, at 28, 30.

[46] *Id.* at 28.

[47] 914 Report, *supra* note 23, at 27.

[48] *Id.*at 28.

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."[49]

For all of these reasons, the user fee option is far superior to the SRO option. We would be pleased to assist the Subcommittee in drafting legislative language, which 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 reporting requirements for the purposes of the review of any such user fees by Congress and the public.

IV. The IAA Strongly Opposes the SRO Option for Investment Advisers.

We strongly oppose an SRO for the advisory profession. Many other organizations, including those principally representing investment advisers, concur. For example, the Managed Funds Association, the Alternative Investment Management Association, the, Certified Financial Planner Board of Standards, Inc., the Financial Planning Association, the National Association of Personal Financial Advisors, the American Institute of Certified Public Accountants, the North American Securities Administrators Association, and the CFA Institute submitted letters to the SEC opposing an SRO for investment advisers.[50]

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[49] *Id.*

[50] *See* Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC, (Dec. 16, 2010) ("MFA 914 Letter"); Letter from Barry C. Melancon, President and CEO, American Institute of Certified Public Accountants, to Elizabeth M. Murphy, Secretary, SEC, (Nov. 24, 2010) ("AICPA 914 Letter"); Letter from David Massey, President, North American Securities Administrators Association, Inc., to Elizabeth M. Murphy, Secretary, SEC, 3 (Nov. 22, 2010) ("NASAA 914 Letter"); Letter from Kevin R. Keller, Chief Executive Officer, Certified Financial Planner Board of Standards, Inc., Marvin W. Tuttle Jr., Executive Director, Financial Planning Association, Ellen Turf, Chief Executive Officer, National Association of Personal Financial Advisors to Elizabeth M. Murphy, Secretary, SEC (Dec. 16, 2010); Letter from John D. Rogers, President and Chief Executive Officer, CFA Institute, to Elizabeth M. Murphy, Secretary, SEC (Dec. 3, 2010); Letter from Mary Richardson, Director of Regulatory & Tax Department, Alternative Investment Management Association, to SEC (Jan. 12, 2011) ("AIMA 914 Letter").

A number of other reputable studies and reports have shared these concerns regarding the SRO model, including those from the Government Accountability Office,[51] Boston Consulting Group,[52] and the U.S. Chamber of Commerce.[53] Indeed, the SEC staff report described significant shortcomings involved in the SRO option.[54]

1. <u>There Are Significant Drawbacks to the SRO Option</u>

There are numerous significant drawbacks to imposing an SRO on advisers. The 914 Report discussed many challenges to designing and implementing the SRO option, including questions regarding governance, scope of authority, membership, conflicts of interest, and funding.[55] For example, the report observes that an adviser SRO presents unique governance issues because of the diversity of the industry, in that it will be challenging to ensure that no business model dominates or is given a competitive advantage by the SRO.[56] The staff also notes the concern that an SRO might have access to unique data and could seek to sell related services to members it regulates. With respect to scope, if the SRO concentrates on investment advisers serving retail customers, or is limited in its membership by some other characteristic, many advisers will still be left under the SEC's oversight.[57] Exclusions from mandatory SRO membership would be difficult to craft given the diverse client bases of most advisers. In addition, significant exclusions from coverage could negatively affect the SRO's funding model.

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[51] *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 (July 2011) ("GAO Report").

[52] The Boston Consulting Group, Inc., *U.S. Securities and Exchange Commission Organizational Study and Reform*, 65-85 (Mar. 10, 2011) ("BCG Report"), available at http://www.sec.gov/news/studies/2011/967study.pdf.

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

[54] 914 Report, *supra* note 23, at 31-37.

[55] *Id. See also* AICPA 914 Letter, *supra* note 50; NASAA 914 Letter supra note 50, at 3 (citing "collaboration, transparency, accountability, and conflict issues" as well as a recent deterioration in government regulators' ability to oversee and collaborate with existing SROs).

[56] 914 Report, *supra* note 23, at 33-36; *see* MFA 914 Letter, *supra* note 50, at 9.

[57] 914 Report, *supra* note 23, at 35.

If the SEC and an SRO (or multiple SROs) share regulatory authority over advisers, the regime will be vulnerable to regulatory arbitrage and inconsistent interpretations and applications of the Advisers Act.[58]

The report noted that, like any SRO, an SRO for advisers will present the challenge of the conflict of interest inherent in self-regulation and a lack of accountability to the investing public.[59] Finally, delegating responsibility for adviser examinations to an SRO would eliminate the benefit to the SEC of its examination staff serving as a resource for legal, policy, and other SEC staff.[60] The exam staff may gradually lose its expertise and its ability to gain important information about advisers' activities and the markets generally.[61]

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."[62] In addition, the report noted that the SRO model "expose(s) firms to duplicative examinations and costs."[63]

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[58] *Id.* at 28, 35; *see also* MFA 914 Letter, *supra* note 50, at 8 (noting that an inexperienced SRO could lead to "inconsistent regulation and uncertainty for managers in operating their businesses").

[59] 914 Report, *supra* note 23, at 35; *see also* AICPA 914 Letter, *supra* note 50.

[60] 914 Report, *supra* note 23, at 27-28; *see also* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, (Oct. 25, 2010) ("ICI 914 Letter") at 4.

[61] 914 Report, *supra* note 23, at 38.

[62] GAO Report, *supra* note 51, at 20.

[63] *Id.*

2. <u>An SRO Would Impose Unnecessary Costs and Burdens on Taxpayers and Small Businesses.</u>

While self-regulation may shift some of the taxpayer-funded regulation costs to industry, appropriate government oversight is required in any SRO structure and thus requires dedication of significant government resources. The 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."[64] Indeed, much more substantial SEC expenditures are necessary in the future even to oversee effectively the current SROs under its jurisdiction.[65]

Further, most investment advisory firms are small businesses with limited resources.[66] The costs of any SRO are borne by the regulated entities and will obviously impact all investment advisers, including thousands of small advisory firms. The SEC staff report notes that these costs will be substantial. Ultimately, those costs may be passed on to investors. If pricing resistance is such that all of 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 the cost structure.

The IAA believes that 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 the user fees option discussed in the 914 Report.[67] Because user fees likely are a less expensive option

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[64] 914 Report, *supra* note 23, at 30.

[65] BCG Report, *supra* note 52, at 39-41.

[66] *Evolution/Revolution 2011, supra* note 19, at 2 (stating that half (49.8%) of all federally registered advisers have fewer than 5 non-clerical employees and more than 90% of all federally registered investment adviser firms have fewer than 50 non-clerical employees).

[67] *See* IAA Section 914 Letter, *supra* note 3; AICPA 914 Letter, *supra* note 50.

than an SRO, they will have a less severe effect on small businesses and the costs passed on to investors.

3. The SRO Model is Not Effective or Efficient.

We also submit that the effectiveness of the SRO model has not been demonstrated.[68] When SROs have pursued major cases or sought fundamental changes, they typically have been following investigations by others (*e.g.*, SEC, state attorneys general, media reports, *etc.*). As the 914 Report noted, major financial jurisdictions outside the U.S. do not rely on SROs for advisers.[69] 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.[70] For these and other reasons, the idea of establishing one or more SROs for investment advisers has been raised and rejected a number of times over the past 45 years.[71]

Most recently, in a study required by Section 967 of the Dodd-Frank Act, the Boston Consulting Group found numerous problems in the SEC's relationship with SROs including inadequate oversight of the SROs and a lack of standards to measure SRO effectiveness.[72] The

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[68] *See, e.g.*, Letter from Mari-Anne Pisarri, Pickard & Djinis LLP, to Elizabeth M. Murphy, Secretary, SEC (Jan. 12, 2011) ("Pickard and Djinis 914 Letter") available at: http://sec.gov/comments/df-title-ix/enhancing-ia-examinations/enhancingiaexaminations-36.pdf. During the Dodd-Frank Act debates, some called for the MSRB to be merged into the SEC due to its ineffectiveness. *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 Markets; Hearing Before the S. Comm. On Banking, Housing & Urban Affairs*, 111th Cong. 7 (Mar. 10, 2009) (statement of Thomas Doe, founder and CEO of Municipal Market Advisors) ("End the MSRB as an SRO").

[69] 914 Report, *supra* note 23, at 32 (citing AIMA 914 Letter). *See also* IAA Section 914 Letter, *supra* note 3, at 2.

[70] 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." *Enhancing Investor Protection and the Regulation of Securities Markets, Hearing Before the S. Comm. on Banking, Housing & Urban Affairs,* 111th Cong. 35-36 (Mar. 10, 2009) (statement of Prof. John C. Coffee, Jr., Columbia Univ. Law School).

[71] 914 Report, *supra* note 23, at 29.

[72] BCG Report, *supra* note 52.

Boston Consulting Group 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; each will strengthen the SEC's oversight of SROs:

- Enhance SRO disclosures regarding their regulatory operations
- Institute metrics to monitor SROs and minimum standards for their regulatory activities
- Enhance FINRA oversight."[73]

The BCG Report observed that SROs are not accountable to the SEC and that the agency and SROs are not coordinating effectively.[74] The report noted that were the SEC to be funded adequately, rather than expanding the role of SROs, "there are strong arguments and global precedents to consolidate more regulatory activities from SROs into the national regulator. This will reduce real and/or perceived conflicts of interest that SROs may have, ensure greater control and visibility into market information for the SEC, and clarify the governance of securities regulation."[75]

In addition, 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. Further, the SEC's ability to review SRO rules is limited in scope to assessing consistency with the Exchange Act.[76]

[73] *Id.* at 134.

[74] *Id.* at 65-67, 237-238 ("Given 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.").

[75] *Id.* at 150.

[76] *Id.* at 65.

4. The SEC is in the Best Position to Regulate Advisers.

We believe that the SEC has the necessary expertise and experience to continue to be the primary regulator of the investment advisory profession. For decades, the SEC has dealt extensively with disclosure requirements and the Advisers Act fiduciary standard – the bedrock principles underlying investment adviser regulation. Given the great diversity among advisory firms – from small financial planners to private fund advisers using complex investment strategies to global asset managers with operations worldwide – expertise and experience regarding the investment adviser industry and regulation is critical in regulating and overseeing the profession.

No other organization has expertise in investment adviser regulation and oversight. As SEC 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."[77]

Moreover, the SEC, as a single, governmental regulator – operating without confusion of overlapping regulation, regulators and "stovepipes" – is directly accountable to Congress and the public.

5. An SRO Would Result in Unnecessary Duplication of Regulations.

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. As

[77] *SEC's Oversight of the Adviser Industry Bolsters Investor Protection*, by Comm'n Luis A. Aguilar, SEC (May 7, 2009), available at http://sec.gov/news/speech/2009/spch050709laa.htm; *see also* IAA Section 914 Letter, *supra* note 3.

discussed above, the overarching fiduciary duty requires investment advisers to act in their clients' best interest and disclose all material facts and conflicts of interest.

In addition, all SEC-registered investment advisers are required to submit a very detailed registration (Form ADV, Part 1) and update it at least annually and promptly for material changes.[78] Advisers are also required to provide clients with a 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.[79] Advisers are required to disclose detailed information about their firms, including: the educational and business background of each person who determines 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 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. Form ADV, Part 2 requires advisers to prepare a plain English brochure and brochure supplement explaining many of these disclosures in a narrative format.[80] In addition, the SEC will soon require advisers to private funds to disclose extensive information about their holdings, counterparty exposures, and leverage on the new Form PF.

Investment advisers also 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.[81] Importantly, the assets managed by investment advisers

[78] *See* Investment Advisers Act of 1940 § 203, 15 U.S.C. § 80b-3; Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.203–1 (2010).

[79] *See Investment Adviser Public Disclosure Web Site: www.adviserinfo.sec.gov.*

[80] *See* Amendments to Form ADV, Investment Advisers Rel. No. IA-3060 (July 28, 2010).

[81] *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 (2010), Regulation S-P, 17 C.F.R. § 248.1 *et. seq.*

must be held at registered broker-dealers or banks. 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.[82] 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.[83] 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, the SRO-style 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.[84]

6. <u>The IAA Opposes Designation of FINRA as an SRO for Advisers.</u>

We particularly oppose extending FINRA's jurisdiction to investment advisers. FINRA – a self-described "non-governmental regulator" with 3,000 employees and an annual budget of almost $1 billion – was designed and developed to oversee broker-dealer activity.[85] Nonetheless, it has repeatedly indicated its desire to exercise oversight and regulation of investment advisers.[86] The IAA strongly opposes extending FINRA's jurisdiction to investment advisers due its lack of

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[82] 17 C.F.R. § 275.204A-1 (2010).

[83] 17 C.F.R. § 275.206(4)-7 (2010).

[84] *See, e.g.,* ICI 914 Letter, *supra* note 60, at 2; IAA 914 Letter, *supra* note 3; AICPA 914 Letter, *supra* note 50.

[85] *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").

[86] *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).

adviser expertise, lack of accountability, lack of transparency, excessive costs,[87] and questionable track record.[88]

Further, designation of FINRA as the adviser SRO would raise conflicts of interest with potential adverse competitive implications for advisers.[89] As noted above, brokers 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.[90] 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

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[87] *See* FINRA, Report of the Amerivet Demand Committee of the Financial Industry Regulatory Authority, Inc. 86 (Sept. 13, 2010), *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p122217.pdf (FINRA benchmarks its senior management compensation based on levels in the financial services industry and states that "non-profit organizations and governmental agencies were inadequate comparables for compensation purposes"). As disclosed in FINRA's 2010 Annual Report, salary and bonuses for FINRA's top executives average $1,057,787. *See* FINRA 2010 Annual Report, *supra* note 85.

[88] *See, e.g.*, 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 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"); Pickard & Djinis 914 Letter, *supra* note 68 ("there is no question that the NASD/FINRA had both the authority and the responsibility to investigate Madoff's fraudulent conduct").

[89] *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").

[90] *See* Letter from FINRA to SEC re: File Number 4-606 Study Regarding Obligations of Brokers, Dealers and Investment Advisers (Aug. 25, 2010). *See also* Letters from FINRA to 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).

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."[91]

FINRA's lack of accountability makes it particularly ill-suited to extend its reach to investment advisers. The BCG Report repeatedly stated that SROs are not accountable to the SEC and that the agency and SROs were not coordinating effectively.[92] In this regard, it stated that FINRA "merits particular attention given its size and scope." For example, the report observes that "FINRA conducts extensive risk assessment activities in support of its examinations," but does not share its analysis with the SEC.[93]

Similarly, the recent U.S. Chamber of Commerce report entitled "*U.S. Capital Markets Competitiveness: The Unfinished Agenda,*" released on July 19, 2011, focused on the lack of accountability by certain nongovernmental policymakers with significant and growing influence, most notably including FINRA:

> "Despite their tremendous influence over the workings of the capital markets, these organizations are generally subject to few or none of the traditional checks and balances that constrain government agencies. This means they are devoid of or substantially lack critical elements of governance and operational transparency, substantive and procedural standards for decision making, and meaningful due process mechanisms that allow market participants to object to their determinations."[94]

The U.S. Chamber of Commerce report observes that these organizations are not bound by the congressional appropriations process or other comparable checks on their power. According to the report, FINRA's members no longer have a meaningful role in establishing its

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[91] MFA 914 Letter, *supra* note 50, at 10.

[92] BCG Report, *supra* note 52, at 65-67, 237-238.

[93] *Id.* at 67.

[94] Chamber of Commerce Report, *supra* note 53, at 5.

policies and priorities, and the organization is not moving toward greater transparency and accountability. 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."[95] Unlike the SEC, FINRA is not subject to the Government in the Sunshine Act and its board of directors does not hold open meetings. On the other hand, FINRA claims that it is a governmental or quasi-governmental regulator when it suits its interests, such as claiming sovereign immunity when sued. Similarly, FINRA is not accountable to any entity with respect to its budget – neither to Congress nor to the SEC.

These shortcomings reflect that FINRA's organizational structure is, in some respects, the worst of both worlds: it is not fully accountable to the members that fund it, nor is it accountable to Congress or the public as a government entity.

V. The IAA Opposes Discussion Draft Legislation That Would Require Advisers to be Members of an SRO.

For the reasons discussed above, we oppose the draft legislation circulated last week that would require both federally- and state-registered investment advisers to be members of a registered national investment adviser association – *i.e.* an SRO. Regulation and oversight of investment advisers should not be outsourced to an quasi-government entity that is not accountable to Congress or the public, and is not subject to requirements related to the Administrative Procedures Act, the public records laws, due process, the Freedom of Information Act, the requirement to conduct cost-benefit analysis, and other critical protections.

Further, there is simply no compelling reason to outsource oversight of investment advisers to either a new or any existing entity that has no expertise with the investment adviser industry or its regulatory framework. We believe that the SEC is the most efficient and effective

[95] *Id*. at 23.

regulator of SEC-registered investment advisers. Where resources are an issue, our members are prepared to provide the SEC with resources specifically designated to investment adviser oversight.

We are not aware of any analysis or empirical data demonstrating the need for this legislation or that the costs of the legislation would outweigh the benefits. This draft legislation would disproportionately target thousands of small businesses that serve small and mid-size investors with the costs and burdens of a duplicative and unnecessary layer of regulation and bureaucracy. The substantial costs of this over-regulation on these small businesses will adversely impact job creation, and, if the costs are passed on to investors, negatively affect retirement savings and investment.

We also believe that the draft legislation's disparate treatment of investment advisers with different types of clientele would lead to inconsistent standards for advisers engaging in the same types of activities. Indeed, the draft legislation could result in regulatory arbitrage as firms restructure their businesses and/or dismiss retail and small business clients to avoid SRO over-regulation. And, as noted above, the SEC is facing challenges in overseeing the SROs already under its purview. These challenges would be magnified not only by the extension of SRO jurisdiction to SEC-registered advisers but also to the thousands of state-registered advisers which the SEC does not regulate.[96] As a result, this proposal likely would not address the SEC resource concerns underlying the issues Congress raised for consideration in the 914 Report.[97] Indeed, the draft 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 take on extensive additional oversight responsibilities for the SRO, as contemplated by numerous provisions of the draft legislation.

[96] *See* 914 Report, *supra* note 23, at 34 ("it would be difficult for the Commission to oversee an SRO that enforced different state regulatory requirements").

[97] Indeed, NASAA estimates that after investment advisers with less than $100 million switch to state registration in early 2012, there will be approximately 19,000 state-registered advisers. *See State Securities Regulators Report on Regulatory Effectiveness and Resources with respect to Broker-dealers and Investment Advisers*, submitted in response to SEC request for comments on Section 913 study (Sept. 24, 2010).

We would be pleased to provide the Subcommittee with additional information as we continue to study the recently released discussion draft.

Conclusion

The IAA supports the SEC staff's recommendation that it use the authority provided it by the Dodd-Frank Act to ensure that retail investors are protected by the same fiduciary standard of care whether they go to an investment adviser or a broker-dealer for investment advice. The IAA further 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 Subcommittee to instead consider the user fee approach.

We appreciate the opportunity to share our views with the Subcommittee. We look forward to working with Congress and the SEC on these important issues.