INVESTMENT ADVISER ASSOCIATION

Statement of

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Enhancing Investor Protection and the Regulation of Securities Markets – Part II

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Executive Summary

Profile of Investment Advisory Profession. There are about 11,000 SEC-registered investment advisers. These firms collectively provide investment management and other advisory services to a wide range of clients, including individuals, trusts, and families, as well as institutional clients, such as endowments, foundations, charitable institutions, state and local governments, pension funds, corporations, mutual funds, and hedge funds. There are relatively few large firms in the investment advisory profession, but they manage the lion's share of total assets. Most investment advisers are small businesses. About 7,500 employ 10 or fewer employees and 90% employ fewer than 50 people.

Principles for Regulatory Reform. Restoring the vitality of the U.S. economy, renewing investor confidence, and addressing failures of and weaknesses in the current regulatory framework are clearly the highest priority for this Committee. To that end, the IAA offers the following principles for the Committee's consideration:

- First, the IAA supports the efforts of the Congress, the Administration, regulators, and others to address the root causes of the economic crisis, including subprime mortgages, securitization of mortgage-related instruments, and the degree to which leverage contributed to the crisis.

- Second, systemic risk oversight must be strengthened. Such oversight should complement but not replace robust functional regulation of financial institutions. In that vein, Congress must preserve and adequately fund the Securities and Exchange Commission's core missions of protecting investors, maintaining fair and orderly markets, and facilitating capital formation.

- Third, we believe Congress and regulators must address the true regulatory gaps that exist in our current system. Any systemic risk initiatives are destined for failure until and unless these gaps are addressed.

- The IAA continues to support centralized registration and regulation of hedge fund managers by the SEC. Investors, the marketplace, and regulators will benefit from the disclosure, compliance protocols, recordkeeping, exams, and other requirements that accompany SEC registration and regulation of hedge fund managers.

- We also support stronger oversight and transparency of credit default swaps and other complex financial derivatives. The role of these products in the economic crisis has been demonstrated all too clearly. Action must be taken to ensure that these products can no longer be traded outside of a regulatory system that promotes transparency and accountability.

- The IAA supports efforts to provide greater regulatory oversight of credit rating agencies. Congress should address conflicts of interest inherent in the rating agencies' compensation structures and bring greater transparency to the process.

• Congress should consider enhancing investor protection by applying the core principles of the Investment Advisers Act of l940 as integral elements of a regulatory framework for other financial service providers.

Investment Adviser Issues. In the current debate, two issues have been raised that directly implicate the Investment Advisers Act, the law governing investment advisory firms.

• Testimony before this Committee has raised the concept of "harmonizing" laws and regulations governing brokers and investment advisers, including proposals to replace an investment adviser's fiduciary duty with some other standard. The IAA agrees that market and regulatory developments – primarily the migration of brokers toward more traditional advisory services – has created investor confusion about the respective roles and obligations of brokers, advisers, and others who provide investment advice. But we disagree that extending the sale-of-products structure governing brokers would be appropriate for investment advisers providing professional services. Instead, we believe any "harmonization" of laws and regulations governing brokers and investment advisers should extend the investor protection benefits of investment adviser fiduciary standards to anyone who offers investment advice. Fiduciary duty requires firms to act in the best interest of their clients and to place client interests ahead of their own. Other standards may require only a commercial duty of fair dealing in arm's-length transactions. Such standards are not commensurate with the trust and confidence placed by investors in their financial services professional. Earlier this week, our organization joined the North American Securities Administrators Association and the Consumer Federation of America in a joint letter to this Committee that underscores the need to apply fiduciary standards to all who provide investment advice.

- 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. We particularly oppose the idea of FINRA as the SRO for investment advisers, given its governance structure, costs, track record, and advocacy of the broker-dealer model of regulation.

- We believe the SEC has the necessary expertise and experience to govern the activities of the investment advisory profession. However, the adequacy of the SEC's resources to exercise proper oversight of investment advisers is a legitimate question that deserves serious attention by policy makers. Instead of focusing on an SRO as the response to this question, 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.

- 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 can and should improve its inspection program for investment advisers. There are a number of steps the SEC can take to better leverage its resources with respect to examinations. For example, the SEC should consider revamping its inspection program to focus more on finding fraud as opposed to technical rules violations. Better technology, enhanced training, and additional data could assist in these efforts as well. We would be pleased to work with the Committee and the SEC to explore additional ways to ensure that investment advisers are subject to appropriate and timely examinations.

Introduction

The Investment Adviser Association (IAA)[1] greatly appreciates the opportunity to appear before the Committee today to address significant issues and developments relating to enhancing investor protection and the regulation of securities markets.

The IAA's members bring important perspectives to the regulatory reform discussion both as entities subject to regulation and as investors in the securities markets on behalf of their clients. The continuing economic crisis, as well as recent events such as the Madoff scandal, have focused attention on issues relating to how the financial services industry is regulated. These developments have prompted a re-evaluation of whether current oversight structures should be strengthened and modernized. The crisis provides both regulators and the industry with an opportunity to enhance investor protection and establish more effective regulatory oversight.

The IAA stands ready to assist the Committee in undertaking the critical tasks of restoring the vitality of the U.S. economy, renewing investor confidence, and addressing failures of, and weaknesses in, the current regulatory framework.

I. Regulatory Reform

Before discussing our views on matters that specifically relate to investment adviser regulation, we wish to emphasize our views regarding broader issues of regulatory reform.

- The Congress, Administration, regulators, and other policy makers should focus their collective attention on the root causes of the economic crisis: subprime

[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 as the Investment Counsel Association of America (ICAA), the IAA's membership consists of investment advisory firms that provide investment advice to 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.
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mortgages, securitization of mortgage-related instruments, and the degree to which leverage contributed to the crisis. These issues clearly represent the highest priority for legislative and regulatory action. Indeed, the issues discussed below relating to potential changes in investment adviser regulation, while important to investor protection, do not address the underlying causes and related regulatory and structural changes that need to be put in place to respond to the economic crisis.

- Systemic risk oversight is long overdue. The present fragmented financial regulatory system does not enable adequate coordination and cooperation among a complex network of market participants and regulators and no one regulatory body is responsible for monitoring and assessing system-wide risk. While systemic risk oversight must be strengthened, such oversight should not replace robust functional regulation of financial institutions.

    - As part of the review of financial regulatory systems, restructuring certain government agencies (such as merging the Commodity Futures Trading Commission into the Securities and Exchange Commission) should be considered to ensure more effective regulation, efficiency, and accountability. The SEC is the primary regulator charged with the mission of protecting investors. In reforming the current regulatory structure, Congress must preserve and adequately fund the SEC's core missions of protecting investors, maintaining fair and orderly markets, and facilitating capital formation.

- Congress and regulators should close regulatory gaps and appropriately regulate relatively new services and products that have expanded exponentially over the last decade, significantly impacting the financial system. Any systemic risk initiatives are destined for failure until and unless these gaps are addressed:

- *Hedge Funds.* The IAA continues to support centralized registration and regulation of hedge fund managers by the SEC. The SEC is the appropriate functional regulator for investment advisers to hedge funds and other unregulated pooled investment vehicles. We do not agree with suggestions by some that hedge funds simply be required to provide information periodically to a systemic risk regulator. Investors and the marketplace will benefit from the disclosure, compliance protocols, recordkeeping, examinations, and other requirements that will accompany SEC registration and regulation of hedge fund managers.

- *Derivatives.* The IAA supports far stronger oversight and transparency of credit default swaps and other complex financial derivatives. These products played a significant role in the recent market disruptions. Congress should consider ways to regulate securities and economic substitutes for securities in a similar fashion. Current efforts to establish central counterparties to clear credit default swaps, while laudable, are not sufficient, particularly because participation is voluntary.

- *Credit Rating Agencies.* The IAA supports efforts to provide greater regulatory oversight of credit rating agencies, which have increasingly played an important role in the markets. Congress should address conflicts of interest inherent in the rating agencies’ compensation structures and bring greater transparency to the process.

• Congress should consider enhancing investor protection by applying the core principles of the Investment Advisers Act of l940 as integral elements of a regulatory framework for other financial service providers.

– The core principles of the Advisers Act are fiduciary duty, which includes the duty to place the interests of your client above your own interests at all times, coupled with broad anti-fraud authority and full and fair disclosure obligations overseen by a single direct regulator (SEC). Congress should extend the investor protection benefits of investment adviser fiduciary standards to all entities that offer investment advice.

In effecting regulatory reform of the financial services industry, policy makers should be mindful of three maxims. First, shuffling boxes (*i.e.*, creating new regulatory authorities or merging or eliminating existing regulators) does not necessarily constitute regulatory reform. Effective regulation requires direct and appropriate statutory authority, clear and reasonable regulations, and intelligent enforcement.

Second, policy makers should "do no harm" in addressing regulatory reform. Some financial service providers already are appropriately regulated and did not contribute to the current crisis. Where such situations exist, policy makers should not attempt to reinvent the wheel or create new and additional regulatory requirements.

Third, the changes under consideration by this Congress are significant and have the potential to dramatically reshape the regulatory landscape for decades. Even in this environment, getting it right is much more important than acting in haste.

II. Investment Advisers Act Issues

In addition to the regulatory reforms under consideration that directly pertain to the ongoing financial crisis, two primary issues have been raised that relate to the Investment Advisers Act:

- The concept of "harmonizing" laws and regulations governing broker-dealers and investment advisers, including a brokerage industry proposal to replace an investment adviser's fiduciary duty with a universal "fair dealing" standard.

- Establishment of a self-regulatory organization (SRO) for investment advisers.

As we discuss in greater detail below, we believe that any "harmonization" of laws and regulations governing broker-dealers and investment advisers should extend the investor protection benefits of investment adviser fiduciary standards to anyone who offers investment advice. In particular, pursuant to fiduciary duty standards, the obligation to disclose conflicts of interest should apply to all those who provide investment advice. In addition, any "harmonization" should not result in subjecting investment advisers to inappropriate broker-dealer rules, including those of a self-regulatory organization.

In considering these issues, it is critical to understand the investment advisory profession.

A. Profile of the Investment Adviser Profession

There are about 11,000 SEC-registered investment advisers, representing a broad spectrum of firms. There are a few relatively large firms that oversee the lion's share of assets under management. According to information filed with the SEC, as of April 2008, 82 investment advisory firms (less than .7%) had investment management authority with respect to more than half of the $38.67 trillion in discretionary assets managed by all SEC-registered advisers. Some of these larger firms are affiliated with other investment advisers, banks, broker-dealers, and insurance companies. However, the vast majority of investment advisory firms are small, unaffiliated businesses.[2] According to information filed with the SEC, 90% of all federally registered investment adviser firms have fewer

[2] More than 91% of SEC-registered advisory firms manage less than $1 billion in assets. *See IAA/NRS, Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (2008), available on our web site, at 3. Further, approximately 43.7% (4,820) of all investment advisers are not affiliated with any other financial industry entity. *Id.* at 11.

than 50 employees and 68% (more than 7,500 firms) have ten or fewer employees.[3] Firms with five or fewer employees make up nearly half (49%) of all advisers.

Investment advisers manage assets for a wide array of individual and institutional investors, including high net worth individuals, educational institutions, endowments, foundations, corporations, pension plans, mutual funds, hedge funds, private equity funds, bank collective trusts, insurance companies, and state and local governments. The overwhelming majority of SEC-registered investment advisers have discretionary authority to make investment decisions on behalf of their clients, consistent with the terms of the advisory contract and any client guidelines. Advisory firms employ a variety of investment strategies on behalf of their clients. Given the enormous diversity and complexity among different types of investment adviser firms, it is notable that 67% of the more than 11,000 investment advisers that were federally registered as of April 2008 were not engaged in any business activity other than giving investment advice. Only 644 investment advisers (5.8 %) were dually registered as broker-dealers.

The diverse and small business nature of the investment advisory profession benefits the wide range of investors – both individuals and institutions – seeking investment advice and should be preserved.

B. "Harmonization" of Investment Adviser and Broker-Dealer Laws and Regulations

Background

Although the concept of "harmonization" of broker-dealer and investment adviser regulation has been advanced recently, few details have emerged describing what harmonization actually means.[4] The term surfaced last year in the Treasury Department's

[3] *Id.* at 8.
[4] The IAA has been actively involved in discussions and proceedings relating to the potential "harmonization" of broker and adviser rules for many years. We filed numerous comment letters responding to the SEC's rulemakings (first proposed in 1999) relating to the circumstances under which the provision of investment advice by brokers subjects their activities to the Advisers Act. *See, e.g.,* Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan G. Katz, Secretary,

"Blueprint for a Modernized Financial Regulatory Structure." Among its "intermediate-term" findings, the Blueprint contains a discussion of the "ongoing debate regarding broker-dealer regulation and investment adviser regulation," and states:

> Treasury notes the rapid and continued convergence of the services provided by broker-dealers and investment advisers and the resulting regulatory confusion due to a statutory regime reflecting the brokerage and investment advisory businesses of decades ago. An objective of this report is to identify regulatory coverage gaps and inefficiencies. This is one situation in which the U.S. regulatory system has failed to adjust to market developments, leading to investor confusion. Accordingly, Treasury recommends statutory changes to harmonize the regulation and oversight of broker-dealers and investment advisers offering similar services to retail investors.[5]

Despite suggesting statutory harmonization, the Treasury Blueprint did not include any specific recommendations about what this might entail.

The Blueprint followed on the heels of a report commissioned by the SEC that examined marketing practices and financial products and services provided to individual investors by broker-dealers and investment advisers and evaluated investor understanding of the differences between investment adviser and broker-dealer products, services, duties, and obligations.[6] The so-called RAND report found that "trends in the financial service market since the early 1990s have blurred the boundaries" between broker-dealers and investment advisers and that "the typical retail investor finds it difficult to understand

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Securities and Exchange Commission (Jan. 12, 2000); Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Feb. 7, 2005). In those rulemakings, the IAA supported applying a consistent, functional regulatory approach so that the same rules apply to the same activities. We also supported functional regulation with respect to other market participants. *See, e.g.,* Letter from David G. Tittsworth, Investment Counsel Association of America,, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, re: Exemption for Thrifts Under the Investment Advisers Act (Dec. 27, 2001).

[5] *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (Mar. 2008), at 125-126.

[6] *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, LRN-RAND Center for Corporate Ethics, Law, and Governance (pre-publication copy Dec. 2007).

the nature of the business from which he or she receives investment advisory or brokerage services." The RAND report did not set forth any specific policy recommendations relating to its findings.

Fiduciary Duty

Consistent with our long-standing support for a functional approach, we believe that brokers, advisers and others should be held to the same high standards depending not on the statute under which they are registered, but upon the role they are playing. If the service being offered bears the core characteristics of investment advisory services from the investor's perspective, it should be subject to the same high standards and duties. That high standard is fiduciary duty.

Investment advisers are subject to a strict fiduciary duty. This duty has been upheld by the U.S. Supreme Court[7] and espoused by the SEC for over half a century.[8] Fiduciary duty is the highest standard of care recognized under the law and serves as a bedrock principle of investor protection. This duty is one of the primary distinctions between investment advisers and others in the financial services industry. 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."[9] Fiduciary duty is not susceptible to strict definition or formulaic application but rather is dependent upon facts and circumstances. However, certain core principles of an adviser's fiduciary duty have been well-established, as reflected in our organization's *Standards of Practice*.[10]

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[7] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).
[8] *See, e.g., In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).
[9] Lemke & Lins, *Regulation of Investment Advisers*, at 2:33 (2008).
[10] The first article of the IAA *Standards of Practice*, entitled "Fiduciary Duty and Professional Responsibility," provides as follows: "An investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients. As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients." The *Standards* describe some of the parameters of fiduciary duty, available at: http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=StandardsPractice.

There has been some dissent from the view that the highest standard should be applied to all those who give investment advice. At a recent hearing before the Senate Banking Committee, the Securities Industry and Financial Markets Association (SIFMA), in echoing calls for "harmonization" of investment adviser and broker-dealer regulation, concluded that a different legal standard should be applied:[11]

> SIFMA recommends the adoption of a "universal standard of care" that avoids the use of labels that tend to confuse the investing public, and expresses, in plain English, the fundamental principles of fair dealing that individual investors can expect from all of their financial services providers. Such a standard could provide a uniform code of conduct applicable to all financial professionals.

We urge the Committee to consider ways to extend an investment adviser's fiduciary duty to other financial services professionals who offer investment advice – not to eliminate it or water it down with some new "fair dealing" standard. Investors deserve nothing less than the fiduciary duty owed to them under the Investment Advisers Act. Our views on this important subject are shared by others. Earlier this week, the IAA joined the North American Securities Administrators Association and the Consumer Federation of America in a joint letter to this Committee that supports the extension of an investment adviser's fiduciary standard to others that provide advisory services:

> Surely we can all agree that, in the current climate, there must be no weakening of investor protections. We therefore urge you to resist the call to water down the standards applicable to advisory activities and instead to extend application of the fiduciary duty to all those engaged in advisory services.

[11] *Testimony of T. Timothy Ryan, Jr., President and Chief Executive Officer, Securities Industry and Financial Markets Association, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing on "Enhancing Investor Protection and the Regulation of the Securities Markets"* (Mar. 10, 2009) ("*March 10 Banking Committee Hearing*").

A number of witnesses made similar statements at the Committee's first hearing on this subject.[12]

Other Harmonization Issues

Other than extending fiduciary duty to other financial services providers, the Committee should scrutinize carefully any further specific "harmonization" proposals. We believe that the basic structure of the Investment Advisers Act – including an overarching fiduciary duty, broad anti-fraud provisions, and single regulator – provides an appropriate structure best designed to promote investor protection. The duties of a fiduciary are significantly different from those involved in commercial transactions, including brokers that sell financial products.

Many of the differences in the regulations governing brokers and advisers appropriately reflect the different business models and services of brokers and advisers. Those calling for harmonization do not appear to recognize these differences. For example, at a recent hearing before the Senate Banking Committee, FINRA testimony regarding harmonization focused on products and transactions, rather than professional fiduciary services.[13] Broker-dealer rules have derived 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"). Investment adviser rules have derived from the historic 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").

[12] *See* Testimony of Paul Schott Stevens, Investment Company Institute, at p. 13; Testimony of Damon A. Silvers, AFL-CIO, at p. 8; Testimony of Mercer E. Bullard, Fund Democracy, at p. 38; *March 10 Banking Committee Hearing.*

[13] *Testimony of Stephen Luparello, Interim Chief Executive Officer, FINRA, before the Senate Committee on Banking, Housing, and Urban Affairs,* at p. 6-7 (Jan. 27, 2009) ("*Luparello Testimony")* (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).

Traditionally, brokers have been compensated by commissions derived from sales of securities, and any related financial advice provided was non-discretionary (***i.e.,*** requiring customer consent). In contrast, advisers traditionally have been compensated by fees (typically based on assets under management) and have provided discretionary advice to clients. In a typical contract for discretionary investment management services, the client grants the adviser authority to decide which securities to purchase or sell on its behalf. The client also typically grants the adviser authority to select brokers as appropriate to execute trades for the client's account. The investment adviser is then responsible for determining the overall investment strategy for the client or the portion of client assets it is retained to manage, consistent with its fiduciary duty to make decisions in the best interest of the client and with any written investment guidelines established by the client. Brokers typically have custody of customer funds and securities, whereas most investment advisers use the services of independent third-party custodians to hold client assets.

We agree that, in some situations, the lines between traditional brokerage and investment advisory services have been blurred in recent years, primarily as a result of the migration of brokers toward more traditional advisory services. Accordingly, in adopting business models that include investment advisory services, brokers should be subject to the fiduciary advice regulatory structure of the Advisers Act, rather than attempting to subject advisers to the inapt product-sales approach of the Exchange Act.

We also agree with the RAND report that the migration of brokers toward more traditional advisory services – in combination with their use of misleading titles (***e.g.,*** financial advisor and financial consultant) and a lack of meaningful enforcement of current rules governing the broker-dealer exemption from the Advisers Act – has created investor confusion about the respective roles and obligations of brokers, advisers, and others who provide investment advice. It would be a perverse result, however, if this confusion leads to a diminution in the duties of financial professionals to their clients. Instead, *all* financial services firms and their personnel should be required to provide clear information at the inception of the relationship about the services they provide, the fees they charge, and any conflicts of interest. Registered investment advisers already are required to provide such information to their clients at or before the time they enter into the advisory relationship.

Investor Education

Strengthening investor protection by imposing the highest standards is only a part of the solution. Educated and informed investors will not only reduce confusion regarding types of service providers but can also serve as an effective guard against fraudsters seeking to take advantage of their clients. At a minimum, we believe the SEC and FINRA, as well as financial services firms, should do more to assist investors in understanding and assessing differences between various investment services professionals. In 2006, we participated with the North American Securities Administrators Association (NASAA), Consumer Federation of America (CFA), and others in publishing a brochure that is designed to help educate investors about the differences between investment advisers, brokers, and financial planners, the legal duties and standards applicable to each, and questions that investors should ask in seeking an investment services professional. Entitled, "*Cutting Through the Confusion: Where to Turn for Help with Your Investments*," the brochure is an example of the type of investor education that is necessary to assist individuals who seek investment assistance.[14]

C. Self-Regulatory Organizations and the Advisory Profession

Background

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. For example, in 1989,[15] the SEC transmitted a legislative proposal to Congress to provide for

[14] *Cutting Through the Confusion: Where to Turn for Help with Your Investments*, published by the Coalition for Investor Education (IAA, CFA, NASAA, Financial Planning Association, and CFA Institute), available at: http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=Confused.
[15] Questions relating to the establishment of a self-regulatory organization for the investment advisory profession were raised well before 1989. For example, on June 11, 1962, our organization responded to a

the establishment of one or more self-regulatory organizations for registered investment advisers.[16] The impetus for the 1989 proposal was the growth of registered investment advisers – and corresponding increases in the number of advisory clients and assets under management – and the lack of adequate SEC resources to conduct effective oversight of the profession.[17] In responding to the proposed legislation, our organization supported the goal of more effective oversight of the advisory profession, but strongly opposed the establishment of a self-regulatory organization for investment advisers. As is the case today, we commented that the problem is not one of structure, but rather how to better fund inspections, and noted that the same increased fees that would fund self-regulations would fund needed enhancements to the SEC's inspection program.[18]

The 1989 SRO proposal was not pursued. However, a few years later, Congress took action to strengthen oversight of the investment advisory profession. The Investment Advisers Supervision Coordination Act was enacted in 1996.[19] The Coordination Act was the most significant revision of the Investment Advisers Act since 1940. The law allocated responsibility for investment advisers between the SEC and the states, with the SEC regulating larger advisers and the states regulating smaller advisers.

The IAA strongly supported enactment of the Coordination Act, which prohibits an investment adviser from registering with the SEC unless it has more than $25 million in assets under management (AUM)[20] or is an adviser to a registered investment company

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series of questions from Milton H. Cohen, Director of the SEC's Special Study of the Securities Markets, which included a question as to whether we would consider it desirable in the public interest for our organization to "obtain official status as an industry self-governing body."

[16] ***See*** Letter from David S. Ruder, Chairman, U.S. Securities and Exchange Commission to The Honorable Dan Quayle, President of the U.S. Senate. (June 19, 1989).

[17] In 1980, there were 5,600 SEC-registered investment advisers. By 1990, the number had grown to more than 17,000. When the Investment Advisers Supervision Coordination Act was enacted in 1996 (Title III of the National Securities Markets Improvement Act), the number of SEC-registered investment advisers was more than 22,500.

[18] Letter from Charles E. Haldeman, Jr., President, Investment Counsel Association of America, Inc. to Senators Christopher J. Dodd and John Heinz (Sept. 22, 1989).

[19] Title III, National Securities Markets Improvement Act, Pub. Law No. 104-290.

[20] 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

or fits within another exemption. The Coordination Act's allocation of regulatory responsibility between the SEC and the states enhances investor protection, provides for more efficient use of limited regulatory resources, and reduces burdensome, inconsistent, and unnecessary regulatory costs.

The 2008 Treasury Blueprint also raised the SRO issue by recommending that Congress should subject investment advisers to a "self-regulatory regime similar to that of broker-dealers." The Blueprint asserted that "self-regulation of the investment advisory industry should enhance investor protection and be more cost-effective than direct SEC regulation."[21] This recommendation presumably was prompted by FINRA – the only commenter on the Blueprint to recommend an SRO for advisers.[22] More recently, FINRA has cited the Madoff scandal as further justification for its longstanding desire to extend its jurisdiction to investment advisers.[23] This argument is misplaced.

The Madoff Scandal

We share the outrage of the Committee and all investors about the Madoff scandal. The Madoff case has raised justifiable concerns about the ability of regulators to uncover and prevent fraudulent activities. Such fraudulent activities cast a shadow over legitimate enterprises and thus underscore our continued support for effective regulatory, inspection, and enforcement activities to ensure investor confidence and protection.

We believe the Madoff scandal represents a failure of enforcement, not of investment adviser regulation. Bernard Madoff operated his Ponzi scheme for decades through Bernard Madoff Investment Securities LLC, a brokerage firm. He only became subject to investment adviser regulation in September 2006 when his firm dually-

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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).

[21] *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (Mar. 2008) at 125-126.

[22] *Letter from Mary L. Schapiro, CEO, FINRA, to the Department of the Treasury re: Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions* (Dec. 19, 2007), at 5.

[23] *Luparello Testimony, supra* note 13 at p. 5.

registered with the SEC as an investment adviser.[24] Neither before nor after September 2006 were his investment advisory activities ever operated though a subsidiary or any other legal entity separate from his brokerage firm.

According to information that has been made available thus far, both the SEC and FINRA conducted numerous inspections of the Madoff firm over a period of many years. This fact alone negates any argument that the failure to uncover Madoff's fraudulent activities was the result of insufficient resources or lack of oversight since both the SEC and FINRA (and its predecessor organization NASD) had clear authority to inspect all aspects of the Madoff enterprise and used their resources to inspect the firm on numerous occasions. Unfortunately, these examinations failed to uncover the fraudulent activities of the firm.

Despite FINRA's claims to the contrary, FINRA had ample authority to examine all aspects of the Madoff firm. Professor John C. Coffee, Jr., a witness at the Committee's January 27 hearing and a widely-acknowledged authority on securities law, specifically addressed whether FINRA had jurisdiction to examine all accounts of the Madoff firm and definitively concluded that FINRA/NASD had clear and unequivocal authority to do so.[25]

We thus find it troublesome that FINRA is using the Madoff scandal as an example of why investment advisers should be subjected to its jurisdiction as a self-

[24] Until September 2006, Madoff was registered only as a broker-dealer. Because his firm received no separate fees for his advisory services, Madoff apparently availed himself of the broad exemption under the Advisers Act for broker-dealers whose advisory services are "solely incidental" to their brokerage activities and who do not charge "special compensation" for advice. However, on January 31, 2006, full compliance with the new SEC "Broker-Dealer Rule" was required. Among other things, the new Rule (vacated by court decision on March 30, 2007) clarified that discretionary management of clients' accounts – as provided by Madoff – could not be considered "solely incidental" to brokerage activities. Accordingly, Madoff could no longer claim an exemption from the Advisers Act on this basis and, reportedly at the direction of the SEC, registered as an investment adviser. Even after Madoff dually-registered in September 2006, his investment advisory function was not operated though a separate entity.

[25] *Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, before the Senate Committee on Banking, Housing and Urban Affairs* (Jan. 27, 2009).

regulatory organization.[26] Rather than using Madoff as a pretext to expand its jurisdiction, we urge FINRA to instead take steps – similar to those the SEC is taking – to seriously examine why its inspections of Madoff failed to uncover the Ponzi scheme and how it can avoid such failures in the future.

The "solution" to Madoff – solely a broker-dealer for most of its existence – is not to create a new regulatory structure for advisers, but to enhance the SEC's tools to prevent and detect fraud. For example, sharing of information between FINRA and the SEC – especially with regard to dually registered broker-dealers like Madoff – should be formalized. Further, in recent testimony SEC staff noted that it is considering ways to "strengthen the custody and audit requirements for regulated firms." We recently submitted a letter to SEC Chairman Schapiro that sets forth a number of recommendations for the Commission to consider in issuing an expected proposed rulemaking addressing self-custody issues.[27] The SEC's Office of Inspector General is conducting an investigation relating to the agency's handling of the Madoff case (including issuing a request for proposal to review the SEC's inspection program[28]) and the results of that investigation may provide additional recommendations the agency should consider to detect similar frauds in the future.

The SEC is the Appropriate Direct Regulator of Investment Advisers

The IAA strongly supports robust and appropriate oversight and regulation of the investment advisory profession. We believe the SEC has the necessary expertise and experience to govern the activities of the investment advisory profession. Given the great

[26] Instead, the Madoff scandal "demonstrates the problem of leaving solely to broker regulation the kinds of advisory activities that are clearly in need of investment adviser oversight. The SEC has corrected the regulatory gap that allowed brokers who provided discretionary advice to avoid advisory regulation. As discussed below, the Commission should take steps to ensure that *all* individualized investment advice is subject to advisory regulation." *Testimony of Mercer Bullard, President and Founder of Fund Democracy, Inc. and Associate Professor of Law at University of Mississippi School of Law,March 10 Banking Committee Hearing.*

[27] *Letter from Karen L. Barr, General Counsel, Investment Adviser Association to The Hon. Mary L. Schapiro, Chairman, SEC* (Mar. 6, 2009) ("*IAA Letter").* The letter is available on our web site under "Publications/News" and "Comments & Statements."

[28] *See* SEC's Request for Quotation for Examination Inspection Review (Feb. 12, 2009), available at: https://www.fbo.gov/download/300/300792fafb8a21b909f4b5e1b9d4c0f4/Amend_3_SECHQ1-09-Q-0125_Examination_Inspection_Review.pdf.

diversity among advisory firms – including a relatively small number of large firms and thousands of small businesses – this expertise and experience is critical in regulating and overseeing the profession.

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. While the current system of regulation and oversight of investment advisers can and should be improved, adding a new and additional layer of bureaucracy and cost on the profession via an SRO will not significantly enhance investor protection.

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.

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 resources. Further, 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. 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 below.

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, advisers that sell products, 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. We thus believe that 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.

FINRA as Adviser SRO

Putting aside the merits of the SRO model as such, we strongly believe that FINRA would be an inappropriate SRO for investment advisers. As noted above, FINRA has been pursuing a role in supervising investment advisers for some time. We have serious concerns about FINRA, its governance structure, costs imposed on its members,[29] areas of expertise, and track record.

Perhaps most important, FINRA has demonstrated an agenda favoring the extension of its broker-dealer rules and requirements to investment advisers. As a result of this bias, we are extremely concerned that establishing FINRA as the SRO for investment advisers would result in a complete overhaul of investor protections set forth

[29] For example, FINRA collected more than $680 million in members fees alone in 2007. It charges a variety of other fees as well. *See* data from FINRA 2007 Annual Financial Report, available at http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p038602.pdf ; ***see also*** By-Laws of FINRA, Inc., available at: http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4598&record_id=5998

in the Investment Advisers Act, including fiduciary duty, requirements to disclose conflicts of interest, and restrictions on principal trading.[30]

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.

In any case, it is far too premature to consider the possibility of an SRO for investment advisers. Instead, as discussed below, there are several other steps that should be taken to bolster the resources of the SEC, which is in a much better position to regulate and oversee the advisory profession consistent with its mission of investor protection.

The SEC's Resources Should be Bolstered

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 believe there are steps – other than the establishment of an adviser SRO – that should be taken to address the SEC's resources

[30] In written testimony before this Committee, FINRA specifically referenced its belief that broker-dealer rules should be extended to the investment advisory profession: "The absence of FINRA-type oversight of the investment adviser industry leaves their customers without an important layer of protection inherent in a vigorous examination and enforcement program and the imposition of specific rules and requirements. It simply makes no sense to deprive investment adviser customers of the same level of oversight that broker-dealer customers receive." *Luparello Testimony*, *supra* note 13 at p. 5. FINRA's recent testimony echoes arguments made by NASD in written comments submitted to the SEC in 2005 relating to the broker-dealer exclusion under the Investment Advisers Act. *See Letter of Mary L. Schapiro and Elisse B. Walter, NASD to Annette Nazareth and Meyer Eisenberg, SEC* (Apr. 4, 2005): "[A] careful analysis of the relative regulatory standards shows that the substantive protections afforded broker-dealer customers are equivalent to, and in many cases exceed, those afforded to adviser customers."

and to ensure a robust and appropriate oversight program of the investment advisory profession.

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. We believe Congress should examine alternatives to allow the agency to achieve longer-term and more stable funding. SEC Commissioner Luis Aguilar, for example, has spoken in favor of a self-funding mechanism for the SEC, stating that self-funding "would greatly enhance the SEC's ability to advance its mission."[31] As he noted in a recent speech:

> 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.[32]

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.[33]

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 (such advisers would

[31] *"Empowering the Markets Watchdog to Effect Real Results"* by Commissioner Luis A. Aguilar, SEC, at North American Securities Administrators Association's Winter Enforcement Conference (Jan. 10, 2009). He also noted in that speech that "the return on investment in the SEC is extremely high."
[32] *Reinvigorating the Enforcement Program to Restore Investor Confidence,* Speech by SEC Commissioner Luis A. Aguilar before the District of Columbia Bar (Mar. 18, 2009).
[33] *See Testimony of Lynn Turner, March 10 Banking Committee Hearing,* at p.16 ("The SEC has been chronically underfunded. A dedicated, independent financing arrangement, such as that enjoyed by the Federal Reserve, would be useful and is long overdue").

be subject to regulation and oversight of state securities regulators).[34] The allocation of responsibility between the states and the SEC set forth in the Coordination Act has worked well, and the Act explicitly contemplated that the threshold would be regularly re-evaluated and adjusted.[35] Although the SEC has authority to do so, in more than 12 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) to ensure that state securities regulators are comfortable with any increased AUM level.

Third, we believe the SEC can and should improve its inspection program for investment advisers. We recognize that the number of investment advisers has outgrown the SEC's ability to conduct frequent examinations of the adviser population. In addition to the funding and threshold recommendations discussed above, there are steps the SEC can take to make more effective use of its resources with respect to examinations. For example, the SEC should consider revamping its inspection program to focus more on finding fraud and misappropriation of client funds as opposed to technical rules violations. In this vein, the SEC's inspection office has recently begun a series of focused examinations related to custody-related issues. SEC staff testified recently that it is considering a number of potential changes and improvements to its oversight program, including the "examination frequencies for investment advisers."[36]

These and other measures should be fully explored to implement meaningful reforms designed to effectuate an inspection program that focuses on activities that harm investors and pose the greatest risks. Chairman Schapiro recently testified that the Commission plans to "use additional technology funding to improve our ability to identify emerging risks to investors." She noted that the SEC needs better mechanisms to

[34] To illustrate the effect of such a change, as of April 2008, there were more than 3,700 SEC-registered advisers that reported assets under management (AUM) between $25-100 million.
[35] *See* S. Rpt. 104-209, *supra* note 20.
[36] *Testimony of Andrew J. Donohue, Lori Richards, Erik Sirri, Linda Chatman Thomsen, Andrew Vollmer, U.S. Securities and Exchange Commission, before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, Concerning Investor Protection and Securities Fraud* (Feb. 4, 2009).

gather, link, and analyze data "to determine which firms or practices deserve a closer look."[37] In our recent letter to Chairman Schapiro on self-custody issues,[38] we recommended enhanced disclosures by investment advisers regarding custody arrangements, indicating, among other things, that the SEC could use this more specific data in its risk assessment process. In that letter, we also recommended that the SEC consider joint examinations of dually registered firms. Steps such as enhanced training, better technology, and more specific, focused data could assist the SEC in better leveraging its inspection resources.

We would be pleased to work with the Committee and the SEC to explore additional ways to ensure that all investment advisers are subject to appropriate and timely inspections.

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The IAA appreciates the opportunity to discuss our views on regulatory reform and specific issues that have been raised with respect to the Investment Advisers Act. We look forward to working with the Committee in the coming weeks and months in efforts 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.

March 26, 2009

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[37] *Testimony of March L. Schapiro, before the Subcommittee on Financial Services and General Government, House Committee on Appropriations,* (Mar. 11, 2009).
[38] *See IAA Letter, supra* note. 27.