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On the Regulation of Investment Advisory Services: Where do we go from here?

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by

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On the Regulation of Investment Advisory Services: Where do we go from here?

Abstract

A controversy has arisen over the regulation of investment advisers in the United States. Traditionally, larger registered investment advisers (RIAs) have been regulated by the SEC and smaller ones by the states. The Investment Advisers Act of 1940 severely restricts the ability of RIAs to engage in principal trades with their customers. Brokers, on the other hand, are regulated by a self-regulatory organization, FINRA, as well as by the SEC. Brokers may engage in principal trades with their customers as long as the advice is merely "incidental" to their other activities. In recent years, the boundaries between RIAs and brokers have become blurred as brokers offer more advisory services, and there is substantial confusion among consumers as to the differences between brokers and RIAs.

In a study mandated under §914 of Dodd-Frank, the SEC documented that it is examining RIAs at a rate of approximately once every eleven years, and recommended the study of additional means to increase the frequency of examinations including user fees to fund more examinations by the SEC, or requiring RIAs to become part of an SRO. It should be noted that the SEC has assigned fewer employees to its Office of Compliance, Inspections, and Enforcement (OCIE) in 2010 than in 2004, despite an increase in overall FTE over this period. This SEC diversion of resources presumably reflects its belief that RIA examinations are less important than other SEC activities.

This study examines several alternatives for increasing the frequency of examinations. It is unlikely in the current political environment that the SEC will be able to charge users fees to RIAs or to get the budgetary resources it needs. Moving more RIAs from federal to underfunded state regulatory agencies is likewise unsatisfactory.

SROs do much more than just examine their members; they also create and enforce rules and other activities. As RIAs who are not also brokers lack the same degree of conflict of interest as brokers trading opposite their own customers, they do not need the same regulation. However, institutional dynamics at the SEC would result in a new adviser SRO acting just like FINRA.

The problem is that RIAs are not being examined frequently enough. No other serious deficiencies in RIA regulation have been documented. Exam frequency can be increased by requiring RIAs to engage independent auditors such as accounting or consulting firms or an SRO to examine their regulatory compliance on a more frequent basis. Precedents for this include the SEC's requiring corporate issuers to provide audited financial statements, and the SEC' s proposal to require broker-dealers to submitted independently audited compliance reviews. This would free up scarce SEC resources for more important activities, and provide the benefits of competition in the provision of examination services.

Executive Summary

Several controversies have recently arisen regarding the regulation of investment advisory services. Traditionally, U.S. regulatory policy has uniquely drawn a distinction between brokers and investment advisers: Brokers were compensated by commissions and provided advice "incidental" to the brokerage function. Investment advisers' primary product was advice, with compensation often based on assets under management. However, this distinction has blurred in recent years as brokerage firms have placed more emphasis on the advice that they provide to their customers. Some firms are registered as both brokers and advisers.

Brokers are regulated directly by FINRA, their SRO, which is overseen by the SEC. Smaller investment advisers are directly regulated by the states, while larger ones are directly regulated by the SEC. Banks are regulated by a different set of financial regulators, although some banks have separate subsidiaries that are regulated as broker-dealers and/or registered investment advisers. Both brokers and advisers are subject to the anti-fraud provisions of federal securities laws. Insurance salespersons are generally regulated by their state insurance departments with a completely different regulatory scheme.

There are two primary differences between the rules governing brokers and advisers. Advisers generally may not engage in principal trades with their customers (unless there is explicit written consent), while brokers can. Advisers have a higher standard of care in that their recommendations must be in the best interest of the client, whereas broker recommendations are held to a slightly weaker suitability standard.

The bulk of the debate between advisers and brokers is over internalization of trades. This is a reprise of the centuries-old debate in many jurisdictions over whether the conflict of interest stemming from trading with one's own customer is so dangerous that it should be banned. Brokerage firms view internalization as an important part of their business that helps to provide better service, while advisory firms view their lack of internalization as an additional safeguard for the client.

Even though the SEC budget has increased over the years, the SEC asserts that it has traditionally received insufficient funding to effectively carry out its mission. Indeed, the SEC's budget since its founding in 1934 has been less than investor losses from Madoff alone. The SEC is currently examining RIAs at the rate of approximately once every 11 years. The U.S. Congress' decision to move thousands of RIAs from federal to state jurisdiction just moves the problem to the state level. State regulatory agencies are generally underfunded and sometimes have fewer resources than the SEC.

The routine examinations themselves vary in quality. The SEC, as does FINRA, has a reputation for hiring as examiners fresh graduates from college or law school with little or no industry experience. With a scant understanding of the industry, such examiners tend to conduct perfunctory "check-the-box" examinations that are unlikely to uncover serious abuses. The regulators should continue their efforts to upgrade the skill levels of its examiners and should refrain from hiring personnel with no industry experience.

Current and likely funding levels do not provide the SEC with enough resources to properly examine and monitor investment advisers. Possible responses include moving more regulation to the state level, charging additional fees to the RIAs to cover their regulation by the SEC, moving regulation to another agency such as the CFPB, outsourcing regulation to an SRO such as FINRA, or outsourcing examinations to independent auditors.

Even if the SEC receives additional funding, it is unlikely that its culture would change much and the routine examinations would still be focused on the "compliance culture" of documentation and paperwork. State budgets are also severely stressed and it is unlikely that moving even more RIAs to state jurisdiction will improve their oversight. The CFPB is an as yet unproven agency with several flaws in its structure.

SROs are attractive in theory because the industry presumably has the expertise to regulate itself, and the cost does not show up in the government budget. However, designing an effective SRO is problematic. At one extreme, it could be a "Selfish Regulatory Organization" that functions as an industry cartel to the detriment of the consumer. At the other extreme, it could become an off-budget government agency with neither the industry expertise nor the checks and balances of the political system. Many countries such as the United Kingdom have abandoned the SRO model. FINRA has a long history of regulating broker dealers, and it is doubtful that the procedures and culture of FINRA would provide optimal regulation of advisory firms. A new SRO just for advisers would quickly run into the same issues facing FINRA and in practice become another FINRA.

Another traditional approach is to outsource routine examinations to external firms. The SEC does not routinely audit corporate issuers, but relies on independent auditing firms to assure compliance with accounting rules. The SEC already requires RIAs that hold custody of customer assets to have annual surprise audits. Furthermore, the SEC has proposed that broker dealers submit audited compliance reports.

Given that it is unlikely that the SEC will devote more resources to routine examinations, and the problems with SROs, routine examinations of RIAs should be outsourced to third parties such as accounting firms, consulting firms, or SROs. The audits would verify the information in the Form ADV and verify that the firm has procedures in place to comply with U.S. securities laws. Care must be taken that this does not turn into a Sarbanes-Oxley level of paperwork overkill. The frequency and depth of the exam would be based on a risk-adjusted basis. Small firms with a clean regulatory history would be subject to less frequent audit requirements than larger and riskier firms. This would free up SEC resources to conduct higher-level for-cause examinations. The SEC should continue to be the primary rule setter for the RIAs.

Introduction

> *For the most part, broker-dealers and investment advisers are regulated under different statutes and at times by different regulatory bodies. Yet, they often provide practically indistinguishable services to retail investors and direct them to the same products.*
>
> SEC Commissioner Elisse Walters (2009)

Consumers obtain financial advice from a variety of different sources that are regulated in a bewildering variety of ways. An investor can get advice from a securities broker. Brokers are regulated by a self-regulatory organization (SRO) known as the Financial Industry Regulatory Authority (FINRA). An investor may also get advice from a registered investment advisor (RIA) who may be regulated by either the Securities and Exchange Commission (SEC) or state regulators. Bankers, who are regulated by a different set of state and federal regulators, also provide advice, as do insurance agents, who are regulated by yet another set of state regulators.

Not only is there an overlapping (as well as under lapping) hodgepodge of regulators, some of the regulators themselves admit that they do not have the resources to properly examine their registrants. The SEC currently estimates that it examines RIAs approximately once every 11 years.[1]

Is there a better way to regulate the providers of investment advice? There is currently intense public debate over this question. Some propose extending the SRO model to investment advisers, either by forcing them to join FINRA or to join a new SRO. Others feel that such regulation rightfully belongs in the government and should be funded directly by fees paid by the advisers. An alternative approach is to use private sector suppliers such as accounting or consulting firms to provide routine examinations.

This paper attempts to answer this question. The paper starts off with a brief history of how we got to the present state of affairs. Congress has traditionally addressed financial regulation in a piecemeal manner and the result is a fragmented and incoherent regulatory system. Section II provides a brief glimpse of the advisory profession today. Most RIA shops are small operations, although there are some overlaps between brokerage firms and advisory firms.

Section III provides a background on the reasons for regulation and reviews some of the principles of regulation. Section IV look at the examination process in more detail and describes some of the matters that examiners look at. Section V discusses the pros and cons of the different proposals for examining investment advisers. Section VI summarizes and concludes: Since routine examinations by either the SEC or FINRA or a

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[1] See United States Securities and Exchange Commission, 2011, Study on Enhancing Investment Adviser Examinations, ("§914 study"), http://www.sec.gov/news/studies/2011/914studyfinal.pdf .

new SRO would likely be “check-the-box” exercises, such routine examinations can be more efficiently outsourced to competitive third party providers such as accounting firms or specialized compliance consulting firms.

I A Brief History of Investment Adviser Regulation in the United States.

The current US financial regulatory framework was built in a piecemeal fashion over several decades. In the nineteenth century, the regulation of financial institutions was considered a state matter, but in the early twentieth century the U.S. Congress passed a series of laws that built the current regulatory framework. The Securities Act of 1933 required issuers of new securities to issue prospectuses and register them with the Federal Trade Commission.

The Securities and Exchange Act of 1934 regulated trading on exchanges and established the Securities and Exchange Commission, which took over the FTC's role in regulating securities issuance. The '34 Act' appointed stock exchanges as self-regulatory organizations that would be the first level of regulation of the securities industry. The stock exchanges would police their own members, which they had already been doing to some extent.

This was a legislative compromise between an industry that did not want regulation and a Congress that wanted to regulate the industry. The logic was that the industry had the expertise and the resources to police itself, with the SEC serving as the watchdog of the watchdogs. National securities exchanges had to register with the SEC and prove that they were capable of enforcing not only their own rules, but also national securities laws as well. Brokers who were affiliated with stock exchange member firms would be regulated by the exchanges. This covered the majority of brokerage activity at the time. Companies listed on exchanges had to register with the SEC and provide periodic financial reports.

One of the results of federal regulation of stock exchanges and stock exchange-listed companies was that many regional stock exchanges closed and many corporations chose to have their stock traded in the unregulated over-the-counter market. Congress remedied this oversight with the Maloney Act amendments of 1938 that led to the establishment of the National Association of Securities Dealers (NASD) as the self–regulatory organization (SRO) for over-the-counter dealers who were not members of stock exchanges. Brokers who were not affiliated stock exchange member firms were required to join the NASD.

However, this regulatory scheme did not address abuses in investment companies and in the provision of financial advice. In 1935, Congress directed the SEC to study investment companies as part of the Public Utility Holding Company Act. The resulting study contained over 900 pages and presented a wealth of material regarding investment companies and investment trusts.[2] Problems in the unregulated industry included unscrupulous and fraudulent participants (including convicted fraudsters), insider trading, unfair selling practices, highly leveraged and thus risky investment companies, and poor disclosure practices.

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[2] See Securities and Exchange Commission, 1939, *Investment Trusts and Investment Companies*, US Government Printing Office, Washington DC,

As the House report stated, "In the absence of regulating legislation, individuals who lack integrity will continue to be attracted by the opportunity available for personal profit in the control of the liquid assets of investment trusts and investment companies."[3]

The Senate report succinctly summarized the situation:

> "Not only must the public be protected from the frauds and misrepresentations of unscrupulous tipsters and touts, but the bona-fide investment counsel must be safeguarded against the stigma of the activities of these individuals. Virtually no limitations exist with respect to the honesty and integrity of the individuals who may solicit funds to be controlled, managed, and supervised. Persons who may have been convicted or enjoined by the courts, because of the perpetration of securities fraud, are able to assume the role of investment advisers. Individuals assuming to act as investment advisers at present can enter into profit-sharing contracts which are nothing more than "heads I win, tails you lose" arrangements. Contracts with investment advisers which are of a personal nature may be assigned and the control of funds of investors may be transferred to others without the knowledge or consent of the client. [4]

Congress responded by giving SEC jurisdiction over investment companies and advisers with the Investment Company Act of 1940 and the Investment Advisers Act of 1940 which were both passed in the same law. However, Congress, which chose in 1934 and 1938 to require industry participants to become members of SROs, did not choose to extend the SRO model to investment advisers. Instead, it chose to have investment advisers register directly with the SEC. The original 1940 act required advisers to register with the SEC and provide reports to the SEC. It gave the SEC authority to ban miscreants from the industry, and it prohibited various practices such as profit sharing contracts, and, most importantly, principal trades with customers without written disclosure and agreement before the trade.

The Investment Advisers Act of 1940 is often interpreted to hold investment advisers to a fiduciary standard on behalf of their clients, meaning that advisers have to act in the best interest of their clients. However, the word "fiduciary" did not appear in the act. This interpretation stems from a series of court cases beginning with the 1963 Supreme Court decision in *SEC v. Capital Gains Research Bureau*.[5] Brokers, on the other hand, are held to a weaker suitability standard. Broker recommendations must be suitable for clients, but not necessarily the best for them.

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[3] US House of Representatives Report 2639, 76th Congress, 3rd Session, June 18, 1940 Investment Company and Investment Advisers Act, page 8.

[4] United States Senate, 76th Congress 3rd Session, Report 1775, Investment Company Act of 1940 and Investment Advisers Act of 1940, pages 21-22.

[5] See Laby, Arthur B., 2011, SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940, *Boston University Law Review*, 91, 1051-1104 for a thorough discussion of the case.

Congress substantially increased the oversight of SROs with the National Market System amendments to the ’34 Act in 1975. These amendments required SROs to get advance SEC approval of any rule changes, leading to a much deeper involvement of the SEC in the internal operations of the SROs. However, SRO rules are not held to the same legal standards as SEC rules. For example, there is no requirement for a cost-benefit analysis, and there is less ability to challenge SRO rules in court.

In 1996, Congress passed the National Securities Market Improvement Act (NSMIA). At the time, there was a concern that the SEC lacked the resources to examine RIAs properly. Among other things, NSMIA established a minimum threshold for SEC registration of $25 million in assets under management, effectively moving thousands of RIAs from SEC to state regulation. Yet over time, as market values have increased, the number of SEC registered advisers has increased to the point where the SEC is again having trouble examining them as frequently as desired.

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which had several direct impacts on the advisory profession. Among other things, the law:

- Increased the threshold for RIA registration with the SEC from $25 million to $100 million in assets under management, again moving thousands of RIAs from SEC to state jurisdiction
- Required larger hedge fund advisers that were previously exempt from registration to register as advisers
- Explicitly required the SEC to study the standards of care by brokers, dealers, and investment advisers with respect to retail financial advice and gave the SEC rulemaking authority to enact a harmonized standard
- Required the SEC to study the frequency of its examination of investment advisers and consider various alternatives such as an SRO for investment advisers
- Required the GAO to study the concept of an SRO for private fund advisers

II The Advisory Profession Today

Consumers can and do get investment advice from a number of sources, including banks, brokers, insurance salespersons, commodities brokers, accountants, lawyers, and others. As mentioned in the introduction, these different sources of advice are regulated in different ways by different regulators.

Today there are over 11,000 investment advisers registered with the SEC, with over 275,000 representatives.[6] The SEC expects this number to shrink as the Dodd-Frank law will move approximately 3,350 of these representatives to state regulation. Approximately 15,000 smaller investment advisers are regulated by the states.[7]

In contrast, there are 4,525 broker-dealer firms registered with FINRA, accounting for 633,390 registered representatives. There is some overlap between the brokerage and advisory businesses, and many firms are dually registered as both broker-dealers and investment advisers. Approximately five percent of SEC-registered RIAs are also registered as broker-dealers with FINRA. More than a third (37%) of FINRA registered broker-dealers had an investment advisory affiliate.

Most RIA firms are quite small. Roughly two-thirds of RIA firms have fewer than ten non-clerical staff. Only about 2,100 firms have more than $1 billion under management.

RIAs are generally compensated through fixed fees, hourly fees, or a percentage of the assets under management. If they are also registered as broker-dealers, they may receive commissions on products that they sell to clients.

RIAs are generally held to a fiduciary standard in that their advice is supposed to be in the best interest of the client. Brokers are not held to a fiduciary standard, but are instead held to a weaker suitability standard. Broker recommendation must be suitable for the client but not necessarily in the client's "best interest." Some brokers claim, however, that when they go to arbitrations that arbitrators hold them to a *de facto* best-interest fiduciary standard.

Despite the controversy over the standard of care, the major difference between brokers and advisers is not the standard of care, but the internalization of trades. Brokers routinely trade directly with their clients. RIAs are generally not permitted to trade with their clients. (An RIA can trade directly with a customer if there is an explicit written agreement for each trade.)

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[6] Numbers in this section are from the §914 study, the IARD data on the SEC web site, available at http://www.sec.gov/foia/docs/invafoia.htm), and FINRA's annual report, available at http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p123836.pdf.

[7] The number of state-registered advisers and representatives was supplied in private correspondence from the National Association of Securities Administrators Association.

Brokers view such proprietary trading with clients as an integral part of their business operations that permits them to provide faster and better service. They claim that their duty to provide "best execution" to clients offsets the conflict of interest from trading with their own clients. The revenue earned from such trading offsets their other costs of doing business, allowing them to provide better service or lower prices to their customers. They can also offer their clients access to proprietary products unavailable elsewhere.

The recent §914 report documented that the SEC examines RIA firms rather infrequently. At the current rate of examinations, an SEC-registered RIA would be examined approximately once every 11 years. The report documented that the number of SEC employees in the Office of Compliance, Inspections, and Enforcement (OCIE) who are assigned to examining RIAs and investment companies has declined from 477 FTE in FY2004 to 460 FTE in FY2010, while the number of RIAs was growing rapidly. However, during this time, the total number of FTE at the SEC increased from 3,442 in FY2004 to 3,748 in FY2010.[8] Thus, the drop in OCIE examiners appears to be a conscious decision by the SEC to allocate its scarce resources to other areas that it perceives to be more important. This could be a sign that the SEC views RIAs (or at least the ones who do not have custody of customer assets) as a low risk area, or that routine exams are an inefficient way to protect consumers.

[8] The number of Full Time Equivalents was obtained from the SEC's annual budget requests. For example, see http://sec.gov/about/secfy12congbudgjust.pdf.

III. The basics of regulation

There are a number of possible problems that the regulation of retail financial advice attempts to prevent. These include:

- Fraud and embezzlement
- Misrepresentation of qualifications
- Misrepresentation of performance
- Undisclosed conflicts of interest
- High pressure sales tactics
- Poor financial advice
- Trading ahead of customer orders
- Insider trading

What is the ideal regulatory environment?

Retail financial products are currently sold to consumers through the banking, insurance, brokerage, commodity, and advisor channels. Each of these channels is regulated differently with different standards of consumer protection. This fragmented system grew mainly as a result of a series of historical accidents. If the system disappeared, it is highly unlikely that we would recreate such a fragmented regulatory environment. If we were to start anew, what would the ideal framework look like?

First, the regulation of retail financial products should be considered in the overall context of financial regulation. Firms that offer financial products to retail clients also often cater to institutional customers as well. Indeed, differentiating between retail and institutional clients can be quite difficult. The investment activities of a billionaire may closely resemble those of an institution, even if the account is for one individual person. Likewise, the investment activities of a small foundation may closely resemble those of a retail investor, even though the account is for an institution.

There are three basic approaches to the organization of financial regulation. One approach is the institutional approach in which each type of institution has its own regulatory body. Banks are regulated by a banking regulator, while securities firms by a securities regulator and insurance by an insurance regulator. Closely related is the product approach in which different products such as insurance and banking are regulated by different regulators. This approach worked well when there were clear boundaries between product lines, and it has been the traditional approach in the United States. However, it has run into difficulties as the evolution of financial services has blurred product lines.

Very similar financial products may receive very different regulatory treatment based on the institutional label, even when their function is very similar. A "cash management account" at a brokerage firm looks, smells, and tastes to the consumer almost identical to a bank account, even though it is regulated in a different way. The provision of financial advice is one of the worst examples of this blurring, resulting in very different rules and procedures applied to the varied sellers of financial advice.

The functional approach (Merton, 1995) uses different regulatory bodies to regulate different functions, regardless of the institutional label of the provider. Thus, a solvency regulator would deal with institutional solvency, a consumer regulator with consumer protection issues, a markets regulator for market issues, and so forth.

In the unified approach, a single financial regulator is responsible for all financial regulation, while maintaining an independent central bank. This was the model for the Financial Services Authority in the U.K, and this unified approach has been copied in many countries.[9] However, the UK has since decided to move closer to a "twin peaks" approach with a separate consumer regulator while moving other financial regulation to a new subsidiary of the central bank.

In theory, it would seem ideal to have a regulatory setup for retail financial products that would consist of a single retail financial regulator with adequate funding to hire experienced personnel.

While having a unified consumer financial regulator is theoretically appealing, the design of the new Consumer Financial Protection Bureau (CFPB) leaves much to be desired. There are serious structural flaws in the design of the agency, such as its location within the Federal Reserve and the lack of Congressional budget oversight. While other financial regulators are starved for funds, the CFPB gets a percentage of the Fed's self-set budget. With a single powerful director, the CFPB lacks the bi-partisan commission structure of the SEC and CFTC. Policy may lurch from one policy extreme to another depending on the whim or competence of the individual at the helm. The CFPB does not regulate retail financial products in insurance, commodities, securities, or advice. It does regulate banking and other miscellaneous products. Until the CFPB is re-designed and proves that it is a competent agency, it would be a mistake to give it authority over all consumer financial regulation.

[9] See Masciandaro and Quintlyn (2009) for a global survey of recent changes in financial regulatory structures around the world.

Another perspective on the regulation of advisory services is to examine some of the basic principles of regulation. Executive Order 12866 provides a useful 12 point framework for examining regulations.[10] The framework is summarized here with comments regarding their application to retail financial advice:

1) *What specific market failure is involved?* The fact that consumers seek financial advice implies that they may lack the sophistication needed to judge the quality of the services provided. This leaves them vulnerable to misleading or abusive behaviors. Whenever there are strong asymmetries of information, regulation is often used to level the playing field.

2) *Have existing regulations or laws contributed to the problem?* The fragmentation of regulation between state and federal jurisdiction, as well as fragmentation across different SROs and federal regulators, has created a confusing situation with gaps in consumer protection.

3) *Are there alternatives to direct regulation, such as user fees or marketable permits?* There are many alternative sources of regulation, involving both direct government regulation at the state and federal level, quasi-private regulation through SROs, and voluntary industry associations such as the CFP Board. However, voluntary standards do little to deter malefactors who are truly unscrupulous.

4) *What are the risks?* Improper regulation creates multiple risks. The biggest risk is that of fraud. Consumers who signal their lack of sophistication through their advice-seeking make tempting targets. Even without blatant fraud, consumers may be shortchanged either by incompetent or biased advice. Other risks involve a misallocation of resources through needless regulatory burdens which can drive up the cost of advice. If the burdens make it too costly to provide advice, especially to smaller accounts, then the poorest people who need professional advice the most won't get it.

5) *Are the regulations the most cost-effective?* Cost-effectiveness is an important consideration in all regulatory decisions. Agencies are tasked with considering "incentives for innovation, consistency, predictability, the costs of enforcement and compliance (to the government, regulated entities, and the public), flexibility, distributive impacts, and equity."

6) *Do the benefits exceed the costs?* Even if a regulation is the most cost-effective way to achieve a particular regulatory goal, an attempt should be made to explicitly measure both the costs and the benefits, and regulation should only be put in place if the benefits exceed the costs. However, measuring the costs and

[10] See http://www.plainlanguage.gov/populartopics/regulations/eo12866.pdf.

benefits of proposed financial regulation is quite difficult. Although direct compliance costs are somewhat measurable, the cost of economic activity that is stifled by improper regulation is harder to observe. Likewise, the benefits from consumer trust in an industry are also hard to observe.

7) *Are the regulations based on the best reasonably obtainable information regarding the need for and consequences of the proposed regulations?* The SEC has come under major criticism in recent years regarding the economic analysis of its proposed rules. As former SEC Commissioner Paul Atkins testified before Congress:

> *The endemic problem is that economic analysis at the SEC has been performed as a post hoc exercise: the policy for rulemaking is mostly determined first by the lawyers and only near the end of the process are the economists brought in to justify the actions on a cost-benefit basis.*[11]

8) *Has the agency considered alternative forms of regulation, and do the regulations specify performance objectives rather than the method of compliance?* The SEC's §914 study did not examine some alternatives, including private sector initiatives or turning examination of RIAs over to other government agencies

9) *Have agencies solicited views and considered the impact on other jurisdictions?* The SEC's §914 study did discuss the movement of RIAs from SEC to state jurisdiction, although it did not really consider the impact of the discussed alternatives on those jurisdictions. Clearly, any major change in RIA regulation will have a large impact on the states as regulators of the smaller RIAs.

10) *Do the proposed regulations conflict with other regulations?* As financial regulation in the United States is a bewildering thicket of overlapping jurisdictions, conflicts are common. For example, bank regulators prefer not to divulge problems at specific banks to prevent bank runs, while securities regulators demand full disclosure of material events.

11) *Do these regulations impose the least burden on society?* This criterion is similar to the cost-benefit criteria above, but the importance of this criterion highlights that good regulatory policy looks not only at the easily observable direct costs and benefits, but also on the overall burden to society. With financial regulation, this burden comes from inhibited economic growth along as well as the cost of undeterred financial fraud.

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[11] See testimony of Paul Atkins before the House Financial Services Committee, September 15, 2011, http://financialservices.house.gov/UploadedFiles/091511atkins.pdf.

12) *Are the regulations clear and easy to understand?* The SEC generally makes a good faith effort to make its rules and regulations as easy to understand as possible, although the complexity of the law and of financial institutions sometimes makes this difficult.

IV Adviser Examinations

The basic purpose of an examination is to determine the adviser's compliance with federal securities laws and regulations. Section 204 of the Investment Advisers Act gives the SEC broad authority to examine the records of RIAs "as the Commission deems necessary or appropriate in the public interest or for the protection of investors." The SEC exams are conducted by its Office of Compliance, Inspections, and Enforcement (OCIE).

What an SEC Examination Entails

In the staff's perspective, RIA examinations have four goals: [12]

(1) improve compliance;
(2) prevent fraud;
(3) monitor risk; and
(4) inform regulatory policy.

The SEC now uses a risk-based approach to determine which firms to examine and how. Firms that it deems higher risk for various reasons (e.g. because of size, complexity, complaints or past enforcement issues) are likely to be examined at more frequent intervals. The SEC also conducts "sweep" exams where it will examine a number of firms on a particular issue. The SEC also conducts "desk" exams where the examiners do not actually visit the firm, but request various documents such as the compliance manual and a report of the latest annual compliance review.

One important rule is the compliance rule which the SEC promulgated in 2003.[13] This rule requires RIAs to 1) have written policies and procedures to ensure compliance (e.g. a compliance manual), 2) have a chief compliance officer, and 3) perform an annual compliance review.

In general, the SEC examiners will interview key executives and examine the compliance manual to see that the firm has the appropriate policies and procedures in place. They will then check documents (including the annual compliance review) to make sure that the firm is actually following those policies and procedures. The focus of a particular examination will vary based on the current regulatory focus of the SEC. For example,

[12] See §914 study, page 2

[13] See Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204; IC-26299; File No. S7-03-03 http://www.sec.gov/rules/final/ia-2204.htm. See also Donohue, Andrew J., and Robert Khuzami, Co-Chairs, 2010, The SEC Speaks in 2010, Corporate Law and Practice Course Handbook Series Number B-1784, Practising Law Institute, New York, Chapter 16, Examinations by the Securities and Exchange Commission, Office of Compliance, Inspections, and Examinations. P 487-516

when new rules have been promulgated, the focus will be on how those rules have been implemented.

A compliance exam may look at the following areas:

Compliance procedures

Does the firm have a written compliance manual that contains appropriate policies designed to assure compliance with the laws and regulations? Can the firm document that it adheres to those procedures? Does it have a qualified Chief Compliance Officer?

Privacy Policies

Does the firm have an adequate privacy policy? What procedures does it have in place to make sure the employees comply?

Disclosure Documents

Do the disclosure documents contain all of the required material? Are the customer agreements consistent with the disclosure documents?

Brokerage Practices

Does the adviser seek best execution of trades on behalf of clients? If it is using soft dollars, are the soft dollars being used properly for the benefit of clients?

Compensation / Client Fees

Is the compensation scheme consistent with the rules governing RIA compensation?

Custody of Client Funds and Securities

If the firm has custody of client assets, does the firm have procedures in place to protect those assets? As firms with custody are already required to have a surprise audit once a year, an examination would verify that the audit took place and review the results.

Internal Controls

Does the firm have appropriate internal controls in place?

Conflicts of Interest

Financial services are rife with conflicts of interest. Are these properly disclosed to the clients?

Insider Trading Policies

Does the firm have policies designed to prevent insider trading and monitor employee trading? Who in the firm monitors and enforces compliance with the policies?

Advertising, including Marketing/Performance Presentations and Website review

One temptation in financial services is to provide misleading advertising regarding the qualifications of the firm and its personnel, its past performance, and likely future performance. Does the firm have appropriate policies and procedures for the review of advertising before it is placed?

Books and Records

Is the firm keeping good track of what it is doing? Are the customer account records in order? Has it retained the information needed in case there is a problem later?

Proxy Voting Policies

The owners of securities have the right to vote in corporate elections. The SEC has long held that investment managers have a duty to vote shares in the best interests of their clients. Does the firm have a proxy voting policy? How does the firm vote proxies and does it have a record of how it voted?

Anti-Money Laundering (AML)

Federal laws to combat terrorism and organized crime place significant requirements on financial institutions. Is the firm in compliance with the AML requirements?

Business Continuity Planning

A major disruption such as a natural disaster could wipe out records of customer assets. Does the firm have a plan in place for dealing with disasters? Does it have adequate backups of important data?

Portfolio management

Are the firm's recommendations consistent with their disclosures and the client's investment needs? While in theory, the SEC could examine this, the paucity of SEC examiners with investment experience and who hold CFA charters, CFP ® credentials, or even MBAs makes it unlikely that the typical SEC examiner could do more than make a cursory comparison of the investment recommendations with a particular client's investment needs.

V. Possibilities for Investment Adviser Examinations

Status Quo

One possible policy solution is to do nothing. This would involve continuing to underfund the SEC, resulting in a lack of enough competent personnel to oversee the industry. RIAs would be examined on an infrequent basis by overworked staff. There are two large dangers to doing this. First, consumer protection will suffer. Although most firms are run by competent providers honestly attempting to provide good service to customers, the money involved does attract some dishonest and unscrupulous players. A lack of enforcement will encourage rogues to defraud investors, if not through Madoff-level fraud, at least through excessive undisclosed fees or incompetent advice.

It should be noted that the entire amount of funds spent on the SEC from its inception in 1934 through 2010, adjusted into current dollars, is approximately $19 billion. This is less than investors' losses from Bernie Madoff alone. We have paid dearly for underfunding the SEC.

Second, an underfunded agency runs the risk of badly misregulating the industry. Regulators lacking technical understanding of the field will promulgate well-meaning but misguided regulations that increase costs, restrict consumer choice, or otherwise result in a net harm to investors. Poorly trained and inexperienced examiners will miss serious warning signs while punishing honest firms for inconsequential paperwork glitches.

The agency, understanding that it does not have resources to deal with all of the problems, may instead go to a "fear strategy" of imposing well-publicized draconian penalties on the few firms that it does catch. This would be designed to throw enough fear into most advisers that they comply without being examined. The danger with this approach is that the truly bad guys will bank on the low probability of detection and willfully defraud customers. Furthermore, the good firms that honestly try to provide good customer service and comply with laws will, given the excessive and unpredictable nature of penalties for minor infractions, go to an unproductive level of excessive expense to ensure compliance with what they guess are the unwritten rules.

Move still more RIAs to the states

Closely related to the status quo is the approach that Congress used in 1996 and 2010: delegate responsibility for more RIA regulation onto the states. In the Dodd-Frank legislation, Congress increased the threshold from $25 million to $100 million in assets under management for RIA firms to register with the SEC. Why stop there? Why not raise the threshold to $1 billion in assets under management (or significant multi-state activity)? This would reduce the number of SEC registrants from the current level of over 11,000 to approximately 3,000.[14]

The advantage of this is that it would reduce the pressure on the SEC budget and permit the SEC to focus on large firms with multi-state operations. There have been relatively few consumer protection problems from the firms that have been moved to state regulation. Indeed, the fact that the SEC has chosen not to examine firms frequently but instead put its scarce resources into other areas is evidence that the SEC thinks that these smaller firms are a low risk area to begin with..

However, merely shifting responsibility to the states does not mean that customer protection will be improved. State budgets are under as much if not more stress than the federal government budget. It is not clear that the states will devote the resources necessary to examine even more firms. Some states will and some states likely will not.

[14] This number includes the approximately 2,100 RIAs with more than $1 billion in assets under management along with smaller RIAs with multi-state operations and RIAs from Wyoming, which does not have state level examinations of RIAs.

Additional SEC funding/ fee for IAs

One possibility for increasing the frequency of examinations is to increase the SEC's budget. This can be done either through the general budgeting process, or through a special fee assessed on the RIAs to cover the cost of the examinations.

How much additional funding would be necessary for the SEC to do a more thorough job of examining advisers? How large would such a fee be? One way to look at this is to examine the current resources the SEC devotes to RIA examinations and look at the cost of ramping that up to increase the examination frequency. Of course, this assumes that the current SEC examination approach is the right way.

Based on numbers from the §914 report, OCIE has 460 staff as of 2010, approximately half of whom are involved in examining RIAs, for both routine and higher level exams. OCIE in that year performed 1,083 exams. If we assume that the all-in cost of an OCIE examiner for wages, benefits, office space, and overhead is approximately $200,000, this leads to a cost per exam of approximately $42,475. Keep in mind that this rough estimate includes more extensive for-cause exams as well as routine exams.

If we assume that the SEC would examine approximately once every five years, this brings the annualized cost per RIA to about $8,500. Thus, the SEC would need to charge an average fee of $8,500 per RIA firm to cover the expenses of examining all of the firms. Dividing this by the average number of representatives per firm comes to an annualized amount of approximately $340 per representative.

Clearly, any user fee should be related to the cost of examining the firm. This will be a function of the complexity of the firm, including the number of representatives, number of branches, complexity of products, and assets under management. The appropriate fee structure should take all of these into account so that the more complex firms are charged appropriately.

In 1992 the House passed HR 5726, The Investment Adviser Regulatory Enhancement and Disclosure Act of 1992, which called for RIAs to pay fees to the SEC to cover the cost of their regulation.[15] The fee structure was based simply on assets under management. The bill died in the Senate.

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[15] The proposed fee schedule was based on assets under management as follows:

Assets under management ($ millions)	**Proposed Annual fee**
Less than $25	$300
$25 to $50	$500
$50 to $100	$1,000
$100 to $250	$2,500
$250 to $500	$4,000
More than $500	$5,000

Self-Regulatory Organizations

FINRA already regulates broker dealers, as well as operates the IARD registration system that RIAs must use to register with the SEC and many states. With a long history of overseeing brokers, it would seem to be a no-brainer for FINRA to be the SRO for RIAs, given the overlaps among the industries. This would provide operational simplicity to the larger firms who are dually registered as RIAs and broker-dealers. This section looks at the pros and cons of SROs in general and FINRA in particular for investment advisers.

In theory, a self-regulatory organization seems like an ideal solution to financial regulatory challenges: Taxpayers have traditionally been loath to pay for good quality financial regulation, and politically appointed government officials often lack understanding of financial markets. In self-regulation, an industry body has the legal authority to restrict entry into the industry to qualified participants, to impose conduct standards on those participants, and levy penalties on those who violate the standards. An industry body presumably has the expertise to do a competent job. Furthermore, as a private body that is nominally not part of the government, a self-regulatory organization can set its own fees to cover its cost of doing business, without the need to levy explicit taxes on the general population. This means that the industry pays for its own policing. As a nominally private organization, an SRO can avoid the bureaucratic encumbrances that Congress places on government agencies, such as the Administrative Procedures Act, the Regulatory Flexibility Act, and the Paperwork Reduction Act.

The financial services industry has a clear economic incentive to keep fraudsters and felons out of the business. Pure criminals impose losses not only on their clients but on the rest of the industry as well, both through direct losses as well as a loss of confidence in the industry.

Exchanges in particular have a strong financial imperative to restrict membership to honest and solvent participants. A dishonest broker who cheats customers may also cheat other brokers. Furthermore, since the settlement of a securities trade takes place sometime after the trade, it is important to make sure that all members have the financial resources to pay for the securities they buy.

However, self-regulation can also turn into "selfish" regulation. When faced with business practices such as cartelization that benefit industry participants to the detriment of consumers, an SRO has a strong financial incentive to side with the industry against the consumer. Examples include the long history of fixed commissions on the NYSE (which lasted until 1975) and the NASDAQ spread fixing scandal of the early 1990s.

The semi-private and semi-governmental nature of SROs can also lead to problems. There have been frictions between the FINRA and the SEC (as well as the states) over the sharing of investigatory data that FINRA does not believe it has the legal authority to share with the SEC.[16]

Indeed, the problems with SROs have led many countries to abandon the concept. In particular, the United Kingdom abandoned its SROs when it adopted a unified regulator in the Financial Services Authority. Even though the U.K. is revising its regulatory structure after the financial crisis, it is not bringing back SROs. SROs are not an integral part of the new financial regulatory framework being constructed in the European Union such as the European Securities and Markets Authority (ESMA).

Part of the trend away from SROs has to do with the trend of exchange demutualization. In a country with a dominant exchange and a history of that exchange wielding regulatory powers, it made sense for that exchange to be an SRO. However, electronic trading has eliminated the natural almost-monopolies that exchanges possessed and led to a more competitive industry structure. The conversion of exchanges from not-for-profit membership organizations into competing for-profit corporations also reduced the attractiveness of the exchange as SRO model. Indeed, this was one of the primary drivers of the transfer of NYSE-Regulation from the NYSE into FINRA.

Self-regulation sprang up naturally in U.S. financial markets through the evolution of stock exchanges. From their earliest days, stock exchanges realized the importance of conduct rules. Following a crash in the U.S. government bond market in 1792, 24 brokers got together under a buttonwood tree on Wall Street and founded an association that later became the New York Stock Exchange. The original agreement contained two key provisions: First, the brokers agreed to a conduct standard – they would fix commissions at no less than .25%. Second, they would restrict membership in their trading organization by giving preference to each other in trades.[17] Subsequent rulebooks created elaborate codes of conduct on trading and requirements for membership.

The Securities Exchange Act of 1934 officially anointed stock exchanges as self-regulatory organizations under the watchful eye of the newly created Securities and Exchange Commission. This was a compromise between an industry that did not want direct regulation and an administration that was determined to clean up abusive practices in the financial markets. Stock exchanges were tasked with enforcing not only their own rules and regulations, but also national securities laws as well. Stock exchanges regulated the activities of their member firms, but did not have jurisdiction over brokers in the over-the-counter (OTC) market who were not members of any stock exchange.

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[16] See the Boston Consulting Group report commissioned under §967 of Dodd-Frank, *United States Securities and Exchange Commission: Organizational Study and Reform*, http://www.sec.gov/news/studies/2011/967study.pdf.

[17] To be precise, the entire agreement read: "We the Subscribers, Brokers for the Purchase and Sale of the Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock, at least than one quarter of one percent Commission on the Specie value and that we will give preference to each other in our Negotiations. In Testimony whereof we have set our hands this 17th day of May at New York, 1792."

The Financial Industry Regulatory Authority (FINRA) originally grew out of the Investment Bankers Association of America (IBAA) which was founded as a voluntary industry organization in 1912.[18] In 1933, Congress passed the National Industrial Recovery Act (NIRA) as part of President Roosevelt's first 100 days of the New Deal. NIRA permitted industries to establish mandatory codes of "fair competition," with enforcement powers. This led the IBAA to spawn the Investment Banker's Code Committee (IBCC). Although the NIRA was declared unconstitutional in 1935, the successful experience with the IBCC gave Congress the confidence to delegate the regulation of over-the-counter dealers to a "national securities association" in the Maloney Act of 1938. The IBCC morphed into the National Association of Securities Dealers (NASD) and became the only registered national securities association for many years.

Following the NASDAQ spread-fixing scandal in which NASDAQ market makers allegedly colluded to keep bid-ask spreads wide, the structure of the NASD was changed. NASD Regulation, Inc., was separated from the Nasdaq Stock Market, Inc., which was later sold off to the members of the NASD. Following the demutualization of the NYSE, the NASD merged with the regulatory arm of the NYSE to become the Financial Industry Regulatory Authority (FINRA).

Today many critics claim that FINRA is no longer a true SRO, but instead has become an off-budget government agency without the checks and balances provided by the political process such as the Administrative Procedures Act.[19] For example, although FINRA rules must be approved by the SEC, such rules cannot be challenged in court, unlike SEC rules. Although FINRA's board, unlike the SEC, does have some industry representatives, the majority of the board consists of public, not industry members. Smaller firms complain that FINRA is dominated by the larger firms. Furthermore, the top management team mostly consists of lifelong regulators with little experience working in the for-profit side of the financial services industry. Some FINRA members complain about the lack of sophistication of FINRA examiners.

Speaking of examinations, FINRA had examined Bernard Madoff Investment Securities, Inc., which was a registered broker-dealer as well as an RIA. As the SEC Inspector General wrote in his report about the Madoff examinations[20]:

> *"Although reviewing recent NASD/FINRA Exam Reports was a standard part of an examination,[112] members of the exam team stated they generally found NASD/FINRA Exam Reports to be "not very helpful." Sollazzo Testimony Tr. at p. 52; Lamore Testimony Tr. at p. 52. Ostrow stated, "…I don't think [the Report] had any reference to the hedge fund account. So we also take, you know, these reports with a*

[18] See The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010, http://www.sechistorical.org/museum/galleries/sro/sro04b.php

[19] For example, see the U.S. Chamber of Commerce report, U.S. Capital Markets Competitiveness: The Unfinished Agenda, http://www.uschamber.com/sites/default/files/reports/1107_UnfinishedAgenda_WEB.pdf

[20] http://www.sec.gov/news/studies/2009/oig-509.pdf, page 176

grain of salt." Ostrow Testimony Tr. at p. 49. Ostrow explained that when he performed oversight examinations of NASD/FINRA examinations, he had found there were issues that "were completely missed." Ostrow Testimony Tr. at p. 51. He thought it was possible that the weaknesses in the NASD/FINRA Exam Reports were attributable to FINRA's connections to industry or examiner incompetence, but more likely the result of FINRA's examination procedures, which he described as "a check box system and they don't think outside the box." Id. at p. 50. Lamore had a similar view of the weaknesses of NASD/FINRA Exam Reports, stating, "Well, I think – in general I think the NASD exams are a little less in-depth. It's more … checklist-type reviews that they conduct. So they don't go into great detail about specific areas."

The Madoff incident highlights many of the difficulties of the current regulatory regime. Examiners at the SEC and FINRA had both examined Madoff and did not uncover the scandal.

If FINRA were to become the SRO for the RIAs, several questions would need to be answered. First, what duties would FINRA have? With respect to broker-dealers, FINRA provides several regulatory programs, including:

- Registrations of broker-dealer firms and their registered reps
- Licensing exams for industry personnel such as Series 7
- Rulemaking for member firms
- Routine examination of member firms
- Rule enforcement, including levying of penalties
- Arbitration of disputes between customers and members
- Market surveillance
- Advertising regulation
- Corporate financing regulation
- Public disclosure
- Investor education
- Transparency services

If FINRA were to become the SRO for the RIAs, it is not clear that it should do all of these activities. FINRA already provides some services to RIAs on an outsourced basis. For example, FINRA operates the IARD registration system for the SEC. FINRA also administers the Series 65 exam, the Uniform Investment Adviser Law Examination, which is generally required for most RIA representatives, both state and SEC registered.

Clearly, FINRA would likely continue to do these if it became the SRO for RIAs. As the SRO, it would also examine RIAs.

Adviser firms do not necessarily force disputes into arbitration, so the arbitration part may not be needed.

It is also not clear whether FINRA as an SRO would engage in rulemaking for RIAs. FINRA would not necessarily have to have the same rulemaking authority that it does for broker dealers, although it would pose challenges if it did not. The SEC rules for RIAs would likely differ from FINRA rules for brokers (unless the SEC forces identical rules on FINRA, making a mockery of the "self" in SRO). This would cause confusion among examiners as they may get confused as to how to apply similar but different rules to broker-dealers one day and RIAs the next.

It is also not clear whether FINRA would continue to have the same board structure, or whether it would have a separate board for the RIA SRO piece. A separate board might assuage the fear that small adviser firms would be lost in a large FINRA. On the other hand, the existence of multiple boards would also result in managerial confusion within the organization, especially if the boards disagreed on major issues. What if the different boards approved different rules regarding sales practices? With different marching orders from different boards, what would FINRA managers and examiners do?

Another problem with appointing FINRA as the SRO for RIAs stems from the statutory differences between broker-dealer and adviser regulation. Different statutes and different sets of SEC and FINRA rules apply to brokers than to advisers. The FINRA rulebook has been optimized with respect to brokers, and the FINRA culture is attuned to regulating the sales culture of brokerage firms. Many RIAs fear that FINRA would merely apply broker-style regulation to advisers without considering the differences in the statutory treatment of advisers and the nature of advising. They feel that the oversight needed to oversee brokers selling products is much higher than that needed for RIA firms because RIAs do not have the same conflicts of interest that brokers have.

Although the SEC now has the authority under Dodd-Frank to harmonize some of the rules regarding the standard of care in the giving of retail financial advice, some advisers fear that a harmonized standard (with harmonized regulation) would water down what they feel is a stricter standard for the RIAs, which would harm consumers and at the same time take away a perceived competitive advantage. Some RIAs also fear that FINRA regulation would create added compliance costs for RIAs without a commensurate increase in investor protection.

One crude approximation of the costs FINRA would charge would be to look at how much FINRA currently spends on regulating broker dealers. Based on numbers from the FINRA 2010 annual report, FINRA charged $582.6 million in regulatory and user fees. This is an average of $128,751 for each of the 4,525 member firms, or approximately $920 annually for each of the 633,290 registered reps. While FINRA's cost and fee structure would presumably be somewhat different for RIAs, this does give a rough idea of the approximate level of costs.

New Adviser SRO = a new FINRA

Given the criticisms of FINRA, and the reluctance of many RIAs to have FINRA as the SRO, there is a movement to have a separate SRO purely for investment advisers.[21] One issue is exactly what such an SRO would do. As discussed above, it is not clear that an SRO for advisers would perform all of the same roles that FINRA currently does for broker-dealers. It could continue to outsource the IARD to a data vendor such as FINRA as well as examinations. It would not necessarily have to do arbitrations or even rulemaking. It would at the very least examine RIAs and enforce existing SEC rules.

There are several high hurdles that a new SRO would face. First, it would take legislative changes to require RIAs to belong to an SRO. Although such legislation has been proposed, whether it will pass is quite uncertain in the current political climate. Representative Spencer Bachus, Chairman of the United States House of Representatives Financial Services Committee, has circulated a discussion draft of a proposed "Investment Adviser Oversight Act of 2011 " that would require RIAs to join a National Investment Adviser Association (NIAA). The bill is written very similar to the requirements for national securities associations (such as FINRA) in the current law. The draft bill would require a majority of independent directors, and has a rulemaking procedure very similar to FINRAs: All rules must be approved in advance by the SEC, and the SEC can amend them in any way it finds necessary and appropriate in the public interest.

Although the proposed law does not specify FINRA as the NIAA, it does make it hard for any other organization to qualify. Recall that the existing SROs in the traditional exchanges, along with the IBAA that was the predecessor of the NASD, were already pre-existing and had substantial self-regulatory experience before they became SROs. A brand new organization with no track record is likely to receive extremely lengthy and careful SEC scrutiny before receiving an SRO designation. Although the draft bill has deadlines for approval of applications, the statutory language gives the SEC enough leeway to take years to approve such an application, which the SEC usually takes in approving new SRO licenses for stock exchanges.

It is likely that, in order for the new SRO to prove that it is capable of being an SRO, the SEC would require it to bring in experienced regulators, and that means veterans of FINRA and the SEC. It is likely that these regulatory veterans would bring in exactly the same check-the-box mindset that many RIAs dislike about FINRA.

The proposed text also would enshrine many of the problems that currently exist with FINRA into a new SRO. With a majority of public members on the board, the new organization would have very little "self" in the organization. It would quickly become a mini-FINRA under the control of the SEC, which would dictate policies and procedures very similar to FINRA. In short, a new SRO for advisers could quickly become just another FINRA.

[21] For example, the Self-Regulatory Organization for Independent Investment Advisers, Inc. has been formed. See http://sroiia-us.org/.

How much would a new SRO cost? Given that the institutional inertia of the SEC mindset will probably result in a new SRO operating much like FINRA, the cost structure will quickly approach that of FINRA, which currently charges about $920 per representative per year.

One can also estimate the capital needed to get a nationwide SRO into operation by looking at the investment that FINRA has made. FINRA has assets of approximately $2.2 billion, of which $1.6 billion is in its investment portfolio (which was a result of the sale of NASDAQ) leaving about $600 million. As approximately 72.1% of operating revenue comes from broker dealer user and regulatory fees, this means that the assets in place related to broker-dealer regulation are approximately $455 million, or about $718 per representative. This implies that an SRO for the approximately 275,000 adviser representatives would need to have assets of about $198 million in full operation. Admittedly, this is a very rough estimate.

Bureau of Consumer Financial Protection

As the genesis of the current focus on adviser regulation is a concern over consumer financial protection, it also makes sense to consider the brand new Bureau of Consumer Financial Protection (CFPB) created under the Dodd-Frank bill.[22] The CFPB currently has jurisdiction over consumer financial regulation in the banking sector, such as Truth-in-Lending Act disclosures, but it has no jurisdiction over consumer financial products in securities, commodities, or insurance.

In theory, it might make sense for an agency that focuses on consumer financial products to also regulate financial advice for consumers. The CFPB's consumer focus on making disclosures understandable could be a useful skill in regulating disclosures to clients of investment advisers.

However, the agency is yet unproven, and it has several severe structural flaws that must be fixed before any serious consideration is given to moving consumer securities regulation from the SEC to the CFPB. The most important flaw is that the CFPB has a single powerful director, unlike the other financial regulatory bodies that have a bipartisan commission structure. The focus of the agency depends too much on the single director, and may change drastically with a change of director or a change of administrations. The bipartisan structure of the SEC and CFTC, with staggered terms for commissioners, provides a continuity of policy (both bad and good) from year to year.

Furthermore, the placement of the CFPB and its budget within the Federal Reserve removes it from the normal checks and balances that apply to other federal financial regulatory agencies. Although an independent central bank is essential for sound monetary policy, a similar argument cannot be made for consumer regulatory agencies. The agency should be an independent agency similar to the CFTC with its budget part of the normal budget process. Furthermore, the agency should come up for reauthorization every five years like the CFTC. In this way, Congress is forced to review the work of the agency and deal with any problems that arise.

If the CFPB proves that it can do an appropriate job of protecting consumers in a manner that does not place unnecessary burdens on providers of consumer services, and if the structural flaws in the CFPB are fixed, then it would make sense to consider moving more consumer financial products under its jurisdiction. However, this would likely be many, many years in the future.

[22] The Dodd-Frank law uses various names for the agency. The law refers to the agency as the Bureau of Consumer Financial Protection 96 times, and the Consumer Financial Protection Bureau seven times. Here I use the more official Bureau of Consumer Financial Protection along with the common acronym CFPB, even though the agency itself appears to ignore the law and go by the name Consumer Financial Protection Bureau.

Outsourced examinations

Although the §914 report documented that the SEC was unwilling to allocate its resources to examine RIAs as often as desired, it did not document that there were any deficiencies in the rulemaking process. It also did not document any other deficiencies in the industry that would necessitate additional regulation. One of the rationales for a self-regulatory organization is that the SRO's industry expertise makes it, in theory, a better rule-setter. The rules currently in place for the RIAs appear for the most part to be adequate, and the SEC has adequate rulemaking authority to remedy any further deficiencies. Establishing a new SRO with new rulemaking authority whose rules must be approved (and likely micromanaged) by the SEC merely adds another level of bureaucracy.

Examinations are another story. One possibility, not discussed in the §914 report, is that examinations could be outsourced to third parties such as consulting and accounting firms. Indeed, the SEC has already started down this path by requiring RIA firms that have custody of customer assets to have surprise audits once a year to make sure that the assets are there. This should prevent or catch future Ponzi schemes like Bernie Madoff. The SEC has also proposed a rule requiring broker-dealers that carry customer accounts to provide audited compliance reports.[23]

There is ample precedent for such outsourcing. The SEC for many decades has required corporate issuers to file audited financial statements in their S-1 and 10-K forms. Rather than audit every issuer's financial statements, the SEC relies upon external auditing firms to do the work.

Since the routine exams (as opposed to the for-cause exams) are mostly check-the-box exercises, these can and should be outsourced to other providers. The SEC could require RIA firms to submit audited compliance reports, much as it is proposing that broker-dealers do. The SEC has clear statutory authority under the Investment Adviser's Act of 1940 to required RIAs to submit whatever reports the SEC deems necessary and appropriate in the public interest.

There are several advantages to outsourcing routine compliance checking:

- Outsourcing routine compliance checking will free up SEC staff to do more important things, such as for-cause examinations of firms.
- Outsourcing will result in much more frequent examinations than are likely to occur with SEC routine examinations given the traditional funding levels of the SEC.
- RIAs will be able to choose their auditor. This will provide the benefits of competition, resulting in lower prices and better service.

[23] See the proposed rule on Broker Dealer Reports http://www.sec.gov/rules/proposed/2011/34-64676.pdf .

Of course, there are many issues involved in such outsourcing. It is likely to be easier for the SEC staff to deal with these issues than to oversee another SRO.   Most important is what should the outside auditor examine, how frequently, and what are the auditing standards? Accounting firms have well established procedures for auditing balance sheets, but not regulatory compliance reports. However, auditing firms now have experience auditing internal controls thanks to Sarbanes Oxley, so they should be able to develop expertise fairly quickly in auditing regulatory compliance.

Frequency and scope of compliance audits

Most RIA firms are small enterprises, and present smaller challenges to the regulators than larger firms. Accordingly, the frequency and scope of the regulatory regime should be tailored to the size and risk of the firms.

Auditing of form ADV

Much of the information in form ADV is straightforward and changes little from year to year. It would make sense to require an outside audit of Form ADV for a new firm and then once every five years unless there are reasons for a more frequent examination.   The scope of the ADV audit would be to check the accuracy of the information in the form.

External compliance reviews

Firms are already required to conduct their own annual compliance reviews. This requirement should continue. The firm should be required to have the annual compliance review performed by an outside auditor once every five years. A new firm would have such a review within a short time period of initial registration with the Commission.

The focus on the external compliance review should not be on coming up with a black-or-white determination that the firm is or is not in compliance, but should review the areas typically covered in an SEC exam and compare how the firm is performing in those areas compared with current best practices.

Qualifications for external compliance reviewers

A key issue is what the qualifications should be for the firms and personnel that conduct the external compliance reviews. Such firms could be

- PCAOB registered accounting firms
- Self-regulatory organizations such as FINRA or national stock exchanges
- Compliance consulting firms with qualified personnel
- Qualified individuals acting as compliance consultants

- Other RIA firms as part of a peer review process similar to that used in the accounting profession.

In addition, the lead examiner on each auditing engagement needs to have appropriate professional qualifications such as

- Chartered Financial Analyst (CFA), Certified Public Accountant (CPA) , or Certified Fraud Examiner (CFE) credentials
- Three years of experience as an examiner at either a state or federal financial regulatory agency including the SEC, FDIC, etc. or an SRO such as FINRA.

Dual registrants

Many firms are registered as both RIAs and broker-dealers. As broker-dealers, they are already examined by FINRA on a routine basis. It would make sense for such dual registrants to select FINRA as their RIA examiner to simplify the number of separate exams they would have to go through, and they should be permitted to do so.

Risks of this approach

One risk is that there will be a "race to the bottom" in which shoddy examining firms sell compliance reviews at the lowest price. For this reason, there needs to be an appropriate level of oversight of the outside examiners. If an RIA hires a low quality examiner that is later sanctioned by the SEC for poor quality work, all the RIA customers of that examiner would be put in a higher risk category requiring more frequent examinations.

Another risk is that experienced examiners from regulatory agencies may bring the same regulatory "check-the-box" mindset with them to outsourced examinations.

Another major risk is that, freed from budget constraints, the SEC will create a set of standards that leads to a Sarbanes-Oxley level of burden without commensurate value to consumers. This is one reason why it is so important that the outside examiners not be forced into making black-and-white determinations that a firm is in or out of compliance. Such binary thinking would force the external examiners into demanding an excessive level of unnecessary documentation just to protect themselves.

Conclusions and Recommendations

There is general consensus that RIAs should be examined more frequently than the current average rate of once every 11 years. The SEC has chosen to allocate its scarce resources away from the routine examinations of RIAs, an indicator that the SEC believes that this is an area of lower relative risk to consumers, or at least lower potential for scoring large fines and recovery amounts. The low frequency of routine examinations of investment advisors can be dealt with fairly quickly without the need for Congressional action by requiring RIAs themselves to pay for routine examinations by independent third parties such as accounting firms.

It is quite tempting to say "RIAs and BDs both provide advice, so they should all be regulated the same way by FINRA." It is also tempting to say, "RIAs and BDs both provide retail financial advice, so both should be regulated the same way by the SEC without FINRA." The resolution of this conundrum lies in a decision over the exactly what the role of an SRO such as FINRA should be. Conceived as a political compromise during the Great Depression, the SRO model seemed like the best of both worlds: An industry body with the expertise and resources of the industry can do a better job of regulating the industry than an underfunded government agency. An SRO has the right incentives to police an industry and keep the genuine criminals out who harm everyone in the industry, but not the right incentives when industry and consumer needs differ. This would imply that FINRA should concentrate on items where the incentives are aligned (IARD/CRD, capital requirements, settlement, insider trading, custody, exams, etc.) and the SEC should focus on consumer protection and sales practices. This would imply that RIAs should not be forced into any SRO, let alone FINRA.

Given the legal requirements for an SRO and the SEC's practices, it is likely that a new SRO for advisers would quickly become just like FINRA in terms of its culture and methods.

Whether routine examinations are done by the SEC, FINRA, a new SRO or someone else, it is likely that routine exams will always be routine "check-the-box" exams. Given this, it makes sense to conduct such exams in the most cost-effective way possible. Opening up the routine examination business to competition will result in the benefits of competition such as lower costs and having a choice of providers.

The SEC can specify that the advisers have various compliance reviews conducted by an outside entity, and that a copy of the review be submitted to the SEC. This is clearly within the authority of existing legislation. The reviewers could be public accounting firms, FINRA, another SRO, or some of the specialized consulting firms that currently conduct mock SEC examinations. There could also be a peer-review program similar to that used in the accounting industry. There is no need for the examiner to be a monopoly entity.

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