

GAO

Testimony

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INVESTMENT ADVISERS

Oversight is Inadequate for
Investor Protection

Statement of Richard L. Fogel
Assistant Comptroller General
General Government Programs



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Mr. Chairman and members of the Subcommittee:

We are pleased to be here today to discuss the investment adviser regulatory program run by the Securities and Exchange Commission (SEC). We reported to this Subcommittee in June 1990, that the registration and inspection of investment advisers by SEC may do more harm than good by giving investors the illusion of strong SEC oversight where little exists. SEC attributed the weaknesses in its program to staffing shortages. Such shortages became more acute in 1991 when SEC reduced the investment adviser inspection staff by more than 25 percent in order to increase the staff for large investment company examinations. As a result, the condition of the program is no better than we found it in 1990 and may be worse.

You asked us to update our June 1990 report¹ and in the process respond to four specific issues--

- the scope of the regulatory problem for overseeing investment advisers;
- the kinds of problems that consumers encounter in dealings with unethical investment advisers;
- a dollar value estimate of the consumer harm from the existing regulatory weaknesses in the investment adviser program; and
- the states' role in policing abuses of investment advisers.

We are responding to these issues based on our 1990 report and more recent discussions with SEC, investment adviser professional groups such as the Investment Counsel Association of America, and consumer groups such as the American Association of Retired Persons and the Consumer Federation of America. We also discussed the matters of concern to you with officials of the North American Securities Administrators Association (NASAA) and with securities administrators of five states,² as mutually agreed with the Subcommittee.

WHAT REGULATION OF INVESTMENT ADVISERS INVOLVES

Investment advisers, as defined in the Investment Advisers Act of 1940 (1940 Act), generally include individuals or firms who are compensated for giving advice, making recommendations, issuing reports, or furnishing analyses on securities. Their services may include supervising clients' portfolios, publishing periodic

¹Investment Advisers: Current Level of Oversight Puts Investors at Risk (GAO/GGD-90-83, June, 1990.)

²Colorado, Connecticut, Florida, Maryland, and Virginia.

market reports for subscribers, selling financial products, and advising clients on insurance, taxes, real estate, and other financial matters. With a bewildering number of complex investment choices available, individual investors are increasingly relying on the assistance of these advisers to prepare for such things as their children's college education or their own retirement. Also, as interest rates on insured savings accounts have declined, individual investors, particularly retirees living off of accumulated savings, have shown increasing willingness to shift their funds to other investments offering higher risks but potentially greater returns to maintain their income levels. As a result, investors may now be more vulnerable to unscrupulous advice.

The 1940 Act requires investment advisers to disclose their background and business practices and to adhere to the high standards of honesty and loyalty expected of a fiduciary. In particular, conflicts of interest that could cause advisers to render less-than-impartial advice were to be eliminated or disclosed. SEC's program to oversee investment advisers includes two major components--registration and inspection.

SEC's Registration Processing Procedures Remain Unchanged

SEC requires that investment advisers register by submitting an application and paying a one-time fee of \$150. It does not prescribe professional qualifications for advisers. SEC continues to process adviser registrations in the same way that we described in our 1990 report. SEC approves an application from a potential investment adviser when the application is complete and SEC finds no disqualifying securities violations in its disciplinary files. SEC registers investment advisers without verifying the applicant's education and business background. It has no procedures to identify individuals who may be offering investment advice, but have not registered. In essence, an industry official told us that it is easier to be registered as an investment adviser than to be licensed to drive a car.

SEC Adviser Inspections Are Less Frequent

Using its registration information, SEC conducts inspections to determine whether investment advisers are conforming to laws and regulations in their routine business practices. During an inspection, regional SEC inspectors perform on-site reviews of investment advisers' activities. For the past decade, investment advisers have greatly outnumbered the SEC staff available to conduct inspections and the gap is widening. In 1981, there were 5,100 investment advisers and 36 SEC inspectors. By 1990, there were about 17,000 investment advisers and 64 inspectors. Since our report, the investment adviser population has grown to about 17,500 while the number of SEC inspectors has shrunk to 46.

Meanwhile, investment advisers appear to be managing more and more assets. In 1992, advisers managed a total of more than \$5 trillion in assets.

In 1990, we reported that this relationship between the number of investment advisers and SEC staff resulted in infrequent inspections of advisers' activities. We found that SEC first inspected investment advisers' business operations on average about 3 years after registration, if at all, in the 4 regions we reviewed. Almost 60 percent of the advisers who had been registered for more than 1 year had never been inspected. Even when SEC found deficiencies during its inspection of advisers, SEC officials told us that staff limitations prevented them from following up to assure that these deficiencies were corrected.

SEC officials told us they have made two key changes to the investment adviser program since our report was issued in June 1990. First, about one-fourth of the staff available to examine investment advisers was reassigned to investment company inspection, an area of growing risk in SEC's opinion. Second, SEC targeted the remaining inspection program staff to those investment advisers controlling \$1 billion or more in assets or those exhibiting some cause for inspection such as a specific customer complaint. This shift in resources reflects SEC's attempt to target its limited resources to investment companies and advisers who control the most assets because such companies and individuals have the greatest influence over investor funds. However, the shift in resources also severely limits the already insufficient oversight of almost 17,000 investment advisers who each manage less than \$1 billion in assets.

Overall, SEC completed 574 inspections of investment advisers in 1991 compared to the 1,257 completed in 1990. This decrease in the number of inspections can be attributed to the decrease in staff and the additional time required to inspect advisers that control large amounts of assets.

THE KINDS OF PROBLEMS CONSUMERS MAY ENCOUNTER FROM UNSCRUPULOUS ADVISERS

Of the investment advisers examined in 1991, SEC found about 85 percent to have deficiencies in their operations. Advisers' failure to report changes in their operations to SEC or disclose business relationships and fees to clients accounted for 29 percent of deficiencies. Problems with books and records totalled 16 percent of the deficiencies. Sometimes such deficiencies may be honest mistakes where no investor harm can be demonstrated. Other times, they may involve serious violations, such as breach of fiduciary obligations and clear conflicts of interest where investor harm was much more likely.

Cases that SEC has investigated or resolved show that investment advisers can and have harmed clients. For example, in May 1989, an adviser pleaded guilty to charges of mail, wire, and securities fraud after bilking clients of \$3 million by diverting client funds meant for stock purchases. In another case, an investment advisory firm misled clients about the uses of their funds, diverting them instead to companies owned by the advisory firm.

More recently, the alleged fraudulent practices of Institutional Treasury Management Inc. may have caused more than \$100 million in losses for more than 60 state and local government entities. This case, if substantiated, suggests that unscrupulous investment advisers can cause investors substantial losses.

DOLLAR HARM TO CONSUMERS FROM WEAK OVERSIGHT OF INVESTMENT ADVISERS

Authoritative information on the total costs to investors from the problems caused by unscrupulous investment advisers is extremely difficult to develop. Fraudulent and unethical practices are typically hidden by the perpetrator. Without active surveillance programs such as on-site examinations, any chance of detecting a problem is difficult, if not impossible. Furthermore, investors may be too embarrassed to report money lost from dealings with unscrupulous advisers.

We could find no estimates of fraud and abuse in the entire investment adviser industry. NASAA reported in July 1988 that fraud and abuse in the financial planning industry--a segment of the investment adviser industry--resulted in consumer losses of about \$200 million a year. We have no basis to verify the reasonableness of this estimate. However, as mentioned earlier, one recent alleged investment adviser fraud case alone may have caused more than \$100 million in losses.

STATES' ROLE IN INVESTMENT ADVISER OVERSIGHT

In 1990, we reported statistics obtained from state regulators on the character of their regulation of investment advisers.³ Thirty-nine of the 47 respondents had some form of adviser regulation. Eight reported that they conducted no regulation of investment advisers with two of these eight requiring no registration of advisers. Twenty-one respondents indicated that they carried out no routine inspections of investment advisers' activities. These 21 respondents generally reported doing fewer than 10 inspections a year, usually resulting from a customer complaint, a news article, an informant, or a referral from

³The District of Columbia and 46 state regulators responded to this questionnaire.

another government agency. These statistics gave us little confidence that state efforts could compensate for weaknesses in the federal oversight of investment advisers.

More recent information is a bit more encouraging. Based on information about the various states' investment adviser regulatory programs made available by NASAA and this subcommittee, we had discussions with officials from five states that seemed to provide a wide range of oversight activity. Officials in four of the five told us they had existing legislation that mandated investment adviser oversight, and the fifth, Colorado, had legislation pending. Connecticut and Virginia had active oversight programs, Maryland was just beginning, and Florida's oversight fell somewhere between.

Officials in the four states with existing legislation told us they placed considerable emphasis on registering those acting as advisers. For example, in all four states, they said they used information sources such as the yellow pages, newspaper ads, and customer complaints from a hot-line to identify advisers who should be registered. Virginia and Florida officials said they required registered advisers to pass a qualifying examination before becoming registered. In Connecticut, they said they did pre-registration interviews to inform advisers about legal requirements including on-site inspections. From the interviews, they assess potential risks to the consumer and determine an inspection schedule for the advisers.

The number of adviser inspections varied among the five states we reviewed. According to state officials, Connecticut did 47 inspections last year for about 280 registered advisers located and providing advice within the state, and Virginia did about 100 inspections for 800 registered advisers. Florida used its securities oversight resources for penny stock problems and only did 5 inspections for about 800 registered advisers. Maryland's law was passed just 2 years ago, and it is only beginning its inspection program.

While these states' programs seem to have some of the attributes of an acceptable registration and inspection oversight program, we have no way of knowing whether their activities are representative of other states' programs. However, NASAA has reported that the number of states with oversight legislation is increasing and that some states are modernizing and updating their approach to regulating advisers. Its president said the number of states regulating advisers increased to 43 in 1992 and will likely increase to 45 by year's end. He also said that many of these states have comprehensive oversight legislation that includes such components as (1) registration programs that require investment advisers to meet standards of education or experience or to successfully complete an examination; (2) written disclosure of advisers' conflicts of interest, fees

charged, and services offered; and (3) financial stability requirements that cause advisers to meet certain net capital, net worth, or net tangible asset standards. We did not determine whether these legislative components are being effectively implemented.

Whatever the current state oversight capabilities, any state activity adds to the total resources devoted to adviser oversight. It seems reasonable to us that both SEC and state regulators could enhance their oversight of the investment adviser industry and take maximum advantage of their limited resources by coordinating their activities. This includes coordination in advisers' registration, identifying unregistered advisers that should be registered, and inspecting advisers to determine whether they are conforming to laws and regulations. None of the five states had formal ongoing cooperative arrangements with SEC although Maryland and Virginia officials told us that informal cooperation was good.

IMPROVED FEDERAL OVERSIGHT NEEDED

SEC has direct responsibility to oversee investment advisers. The changes since our June 1990 report do not suggest that significant improvements have been made to their program. The Chairman of SEC told a Senate subcommittee last July that regulation of investment advisers by SEC was totally inadequate. While he believes a credible program is necessary for investor protection, he expressed concern about SEC's ability to regulate this industry effectively.

The bill before this subcommittee, if enacted, would improve oversight of investment advisers by implementing some of the recommendations we made in our report and by increasing fees to recover the costs of an enhanced registration and inspection program. Other provisions in this bill involve changes that we did not study such as suitability, fidelity bonding, and private right of action.

CONCLUSIONS

We continue to believe that unless the oversight of investment advisers is improved, the 1940 act may be doing more harm than good by giving investors the illusion that SEC registered advisers have a "seal of approval." Given the limited protection provided by the existing federal oversight program, we believe you should take action to strengthen regulatory oversight or consider repealing the requirements for federal regulation of investment advisers. If you decide to strengthen regulatory oversight, you should provide SEC additional resources and require SEC to enhance its registration and inspection programs.

This concludes my prepared statement. I will be happy to respond to any questions you or other members of the Subcommittee may have.

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