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# **Study on Enhancing Investment Adviser Examinations**

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**As Required by Section 914 of the  
Dodd-Frank Wall Street Reform  
and Consumer Protection Act**



**This is a study by the Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings or conclusions contained herein.**

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**January 2011**

## **Introduction and Executive Summary**

### **I. The Congressional mandate**

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).<sup>1</sup> Section 914 of Title IX of the Dodd-Frank Act (“Title IX”) mandates that the U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) conduct a study to review and analyze the need for enhanced examination and enforcement resources for investment advisers (the “Study”).<sup>2</sup> Section 914 requires the examination of: (1) the number and frequency of examinations of investment advisers by the Commission over the five years preceding the date of the enactment of Title IX;<sup>3</sup> (2) the extent to which having Congress authorize the Commission to designate one or more self-regulatory organizations (each, an “SRO”) to augment the Commission’s efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers;<sup>4</sup> and (3) current and potential approaches to examining the investment advisory activities of dually-registered broker-dealers and investment advisers (“dual registrants”) and registered investment advisers that are affiliated with a broker-dealer.<sup>5</sup> The Study must also include a discussion of the regulatory or legislative steps that are recommended or that may be necessary to address the concerns identified in the Study.<sup>6</sup>

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> *See* section 914(a)(1) of the Dodd-Frank Act. Section 914 calls for a review and analysis of the need for enhanced examination and enforcement resources for investment advisers, but each of the items under section 914(a)(2), which spells out the particular “areas of consideration” for the Study, refers to matters concerning examinations, which yield many of the Commission’s enforcement cases against investment advisers. Thus, although the Study speaks primarily to the Commission’s need for examination resources, to the extent the examination program is improved through one of the options recommended, the staff of the Commission’s Division of Investment Management expects it would have a positive impact on the Commission’s enforcement of the Advisers Act. Unless stated otherwise, the Study is limited to a review and analysis of the need for enhanced resources to oversee investment advisers that are registered with the Commission. An investment adviser that is exempt from registration with the Commission under section 203(b) of the Investment Advisers Act of 1940 (the “Advisers Act”) is not subject to inspection or examination by the Commission.

<sup>3</sup> *Id.* at section 914(a)(2)(A).

<sup>4</sup> *Id.* at section 914(a)(2)(B).

<sup>5</sup> *Id.* at section 914(a)(2)(C).

<sup>6</sup> *Id.* at section 914(b).

## II. Organization of the Study

The Study was prepared by the staff of the Commission's Division of Investment Management (the "Staff") with assistance from other Divisions and Offices,<sup>7</sup> and was approved for release by the Commission.<sup>8</sup> The views expressed in the Study are those of the Staff and do not necessarily reflect the views of the Commission or the individual Commissioners. The Staff reviewed 30 letters from 25 interested parties about the Study, including investment advisers, broker-dealers, state regulators, an SRO and professional and trade associations. The Staff also met with interested parties representing a range of perspectives.<sup>9</sup> The Staff considered the views of these parties and has incorporated them in the Study.

The Study is organized into five sections, beginning with a section discussing the Commission's examination of registered investment advisers through the Office of Compliance Inspections and Examinations ("OCIE") and ending with the recommendation of the Staff. Following is a summary of each of the five sections.

### A. Section I: Commission examinations of registered investment advisers

Section I discusses the process by which the Commission, through OCIE staff located at Commission headquarters and 11 Regional Offices, examines registered investment advisers' books, records and activities. Staff examinations are designed to: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform regulatory policy. Section I also discusses the current approach to examining dual registrants and registered investment advisers that are affiliated with a broker-dealer.

### B. Section II: Examinations of registered investment advisers over the past six years

Section II analyzes the number and frequency of examinations of registered investment advisers over the past six years.<sup>10</sup> The frequency with which OCIE can conduct examinations is

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<sup>7</sup> The Division of Trading and Markets, Division of Risk, Strategy, and Financial Innovation, Office of the General Counsel, Office of Compliance Inspections and Examinations, Office of Investor Education and Advocacy and Office of International Affairs assisted in the preparation of the Study.

<sup>8</sup> The Chairman of the Commission did not participate.

<sup>9</sup> The letters as well as memoranda concerning the meetings can be found at: <http://www.sec.gov/comments/df-title-ix/enhancing-ia-examinations/enhancing-ia-examinations.shtml>.

<sup>10</sup> The Study analyzes the number and frequency of the examinations of registered investment advisers over the Commission's past six fiscal years (October 1, 2004 to September 30, 2010) rather than the five years preceding the enactment of the Dodd-Frank Act as specified by section 914 of Title IX because the Commission's practice is to calculate and report data on examinations and OCIE staffing as of the end of each fiscal year. This six-year period includes the five years

largely a function of the number of registered investment advisers and the number of OCIE staff dedicated to examining them.<sup>11</sup> The amount of resources and time required to conduct an examination also depends on the size and complexity of an investment adviser’s operations and the level of cooperation provided to the examiners, as well as the scope, method and efficiency of examinations conducted by OCIE. Section II also discusses how the growth in the number of registered investment advisers and assets managed by them, as well as changes in the number of OCIE staff over the same period, have affected adviser examinations. While the number of registered investment advisers and the assets managed by them have grown significantly over the past six years, the number of OCIE staff has declined over the same period. The number and frequency of examinations of registered investment advisers have also declined during this period.

### **C. Section III: Impact of the Dodd-Frank Act on examinations of registered investment advisers**

Section III analyzes projected changes in the number of registered investment advisers and OCIE staff after the enactment of the Dodd-Frank Act, and how the changes are expected to affect the examinations of registered investment advisers. The anticipated decline in the number of registered investment advisers following the effective date of Title IV of the Dodd-Frank Act — the Private Fund Investment Advisers Registration Act (“Title IV”)<sup>12</sup> — could result in a greater percentage of registered investment advisers being examined. The amount of any potential increase in examination frequency, however, may be offset by the need to divert examination resources to fulfill new examination obligations that the Commission was given by the Dodd-Frank Act. Moreover, the Staff expects the number of registered investment advisers to grow in subsequent years. While the Commission’s resources and the number of OCIE staff may increase in the next several years, the number of OCIE staff is unlikely to keep pace with the growth of registered investment advisers.

As a result, the Staff believes that the Commission likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with

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preceding the enactment of the Dodd-Frank Act, as required by section 914. Unless stated otherwise, all references to data in a specific year refer to the period between October 1 and September 30 of that year.

<sup>11</sup> Unless stated otherwise, all references to OCIE staff in the Study are to staff who are dedicated to the examination of both registered investment advisers and registered investment companies. OCIE does not have staff who solely are dedicated to examining registered investment advisers. OCIE staff include examiners, accountants, supervisors, attorneys, information technology staff, training staff and support staff. All references to a number of staff include adjustments for part-time employees (for example, a part-time employee that works 20 hours per week counts as 0.5 staff).

<sup>12</sup> See *infra* note 30 for a discussion of ways in which Title IV amends the registration provisions of the Advisers Act.

adequate frequency. The Commission’s examination program requires a source of funding that is adequate to permit the Commission to meet the new challenges it faces and sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers (*i.e.*, it requires resources that are scalable to any future increase — or, for that matter, decrease — in the number of registered investment advisers).

#### **D. Section IV: Options to consider to address capacity constraints concerning examinations**

Section IV discusses three options that Congress should consider in order to strengthen the Commission’s investment adviser examination program. Specifically, it discusses: (1) imposing user fees on SEC-registered investment advisers to fund their examinations by OCIE; (2) authorizing one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; and (3) authorizing the Financial Industry Regulatory Authority (“FINRA”)<sup>13</sup> to examine dual registrants for compliance with the Advisers Act. In considering these alternatives, Section IV analyzes the ability of user fees and one or more SROs to augment the Commission’s efforts in overseeing investment advisers and improve the frequency of examinations of investment advisers. Section IV also analyzes alternatives to the current approach of examining dual registrants and registered investment advisers that are affiliated with a broker-dealer.

#### **E. Section V: Staff recommendation**

Section V presents the Staff’s recommendation, which is meant to address the examination capacity concerns identified earlier in the Study. The Staff recommends that Congress consider the three options discussed to strengthen the Commission’s investment adviser examination program.

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<sup>13</sup> FINRA is an SRO that regulates broker-dealers. It was created in 2007 through the consolidation of the National Association of Securities Dealers (the “NASD”) and the member regulation, enforcement and arbitration divisions of the New York Stock Exchange.

## **DISCUSSION**

### **I. Commission examination of registered investment advisers**

The Commission, through OCIE staff located at Commission headquarters and 11 Regional Offices, examines registered investment advisers' books, records and activities. Staff examinations are designed to: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform regulatory policy.

OCIE's investment adviser examination program utilizes a risk-based process, identifying higher-risk investment advisers for examination consideration and focusing examination resources on certain higher-risk activities at selected investment advisers. OCIE's risk-based approach to identifying examination candidates is an evolving process that is constantly refined as OCIE obtains information about registered investment advisers. Typically, higher-risk investment advisers are identified based on: (1) information contained in regulatory filings; (2) assessments made during past examinations; and/or (3) other criteria and available information (including, for example, news/media coverage, localized knowledge of advisers from examination staff and tips, complaints or referrals).

OCIE generally conducts three types of examinations: (1) examinations of higher-risk investment advisers;<sup>14</sup> (2) cause examinations resulting from tips, complaints and referrals; and (3) special purpose reviews such as risk-targeted examination sweeps and risk assessment reviews. Risk-targeted examination sweeps are generally limited in scope and focus on specific areas of concern within the financial services industry and cover a broad sample of regulated entities regarding those areas. Risk assessment reviews are limited scope examinations of an investment adviser's general business activities and a targeted set of the adviser's books and records that help OCIE better assess the risk profile of an investment adviser.

Examinations focus on various activities at investment advisers to detect violations of the federal securities laws, including the requirement that advisers have effective compliance controls in place. To the extent OCIE finds that controls in areas are weak or non-existent, OCIE examiners will devote more resources to examining those areas. When the Commission adopts new rules that are applicable to investment advisers, OCIE examiners generally inquire about the areas affected by such rules and review relevant documentation to assess how the adviser is complying with the new requirements. Other examination focus areas are determined by the business activities of the investment adviser and the adviser's compliance controls surrounding those activities. For example, if OCIE is concerned about insider trading at an investment adviser, OCIE examiners would focus on the adviser's trading activities and access to non-public

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<sup>14</sup> Examiners typically will focus on the following high-risk areas: conflicts of interest, portfolio management, valuation, performance, advertising and asset verification.

information. Examiners also would review the adviser's policies and procedures and assess the adequacy of the controls surrounding such activities.

OCIE also examines other market entities, such as exchanges and clearing agencies, as well as the operations of dual registrants and investment advisers that are affiliated with a broker-dealer.<sup>15</sup> The broker-dealer operations of these firms are examined primarily by FINRA, although OCIE also examines broker-dealer operations of these firms.<sup>16</sup> FINRA does not, however, have express statutory authority to enforce compliance with the Advisers Act by these firms.<sup>17</sup> These firms are examined for compliance with the Advisers Act exclusively by OCIE according to the process described above.<sup>18</sup> Between 2006 and 2009, OCIE allocated approximately 50% of its annual operating budgets to the oversight of registered investment advisers and investment companies.

OCIE conducts on-site examinations of investment advisers with teams of specialized staff. The number of examiners conducting an individual examination varies based on the type of examination and the particular characteristics of the adviser being examined. While a limited examination (*i.e.*, one that seeks to achieve a limited purpose) may be completed in only a few days, more comprehensive examinations can take several weeks or months to complete. Moreover, comprehensive examinations of larger advisers with more complex operations will take longer and require greater staffing. OCIE, for example, may assign only two examiners to conduct an examination of a smaller adviser with limited operations managing portfolios of equity securities for clients. More examiners, including those with special expertise, are required to conduct an examination of a larger adviser to a mutual fund complex or to a group of hedge funds pursuing complex investment strategies. In addition, examinations of higher-risk advisers may require additional time and staffing because OCIE staff may need to conduct a more searching inquiry into the operations relevant to the risks associated with such advisers. Finally, the enactment of new laws or adoption of new rules may require OCIE to commit additional

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<sup>15</sup> While dual registrants comprise a small percentage of registered investment advisers, a significant number of registered investment advisers, including many larger registered investment advisers, have an affiliated broker-dealer. According to data from the Investment Adviser Registration Depository (the "IARD"), the electronic filing system through which investment advisers register with and submit filings to the SEC and state regulators, as of October 1, 2010, there were 611 dual registrants and 2,636 registered investment advisers that had an affiliated broker-dealer. That represents 5% and 22% of all registered investment advisers, respectively.

<sup>16</sup> OCIE conducts examinations of broker-dealers that FINRA has already examined, such as oversight examinations that evaluate the effectiveness of FINRA examinations. OCIE also examines broker-dealers that FINRA has not examined. OCIE examined 661 broker-dealers in 2009 and 720 broker-dealers in 2008.

<sup>17</sup> Section 19(g) of the Securities Exchange Act of 1934 (the "Exchange Act") directs an SRO registered under section 19(a) of the Exchange Act to enforce compliance with its own rules, the Exchange Act, and the rules and regulations thereunder.

<sup>18</sup> Section IV of the Study discusses alternatives to examining these firms.

resources to each examination because OCIE must adjust its examination program to make additional inquiries concerning such laws or rules.

An examination typically has one of three possible outcomes, which are not mutually exclusive. OCIE may: (1) issue a letter to the adviser indicating that no deficiencies were identified; (2) issue a letter to the adviser describing any deficiencies and requesting that the adviser implement appropriate corrective actions and submit a written response describing those actions; or (3) refer deficiencies to the Division of Enforcement. A majority of examinations conducted by OCIE each year conclude with OCIE sending a letter to the registrant itemizing any deficiencies found in the course of the examination. In most cases, registered investment advisers will voluntarily correct any deficiencies identified by OCIE staff. This approach encourages compliance without costly and protracted enforcement action. Enforcement referrals allow OCIE staff to refer egregious or uncorrected violations of federal securities laws so the Commission can take action to prevent investors from being harmed.



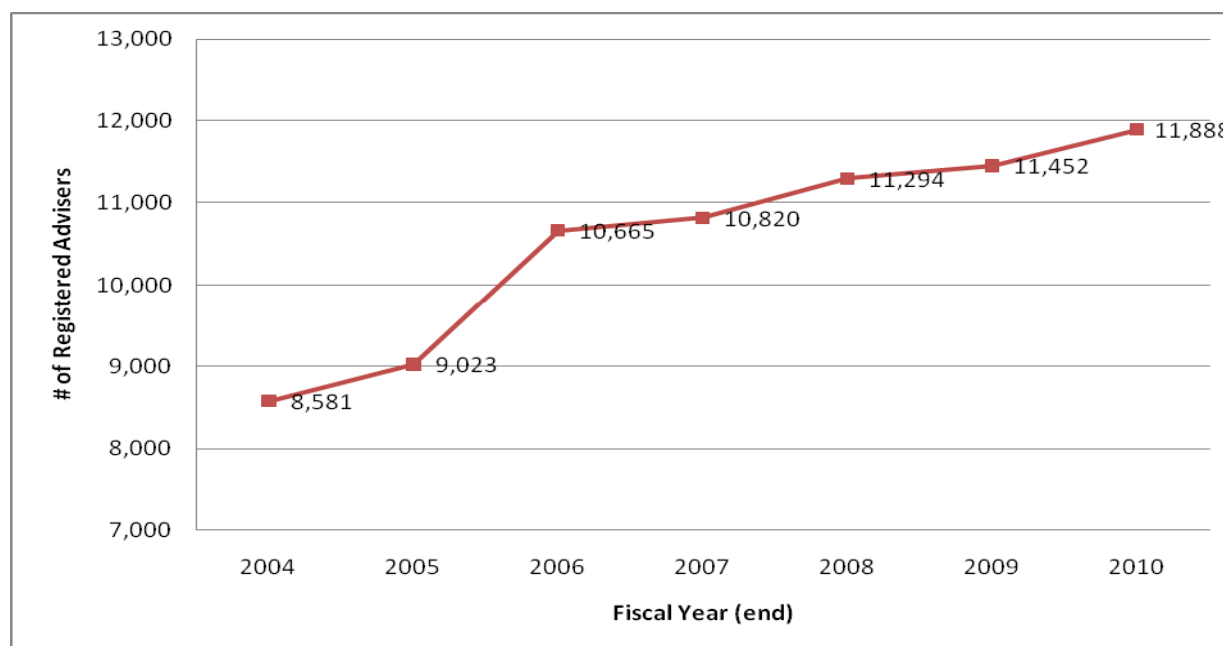
## II. Examinations of registered investment advisers over the past six years

The number and frequency of examinations of registered investment advisers are largely a function of the number of registered investment advisers and the number of OCIE staff. As the number of registered investment advisers has increased and the number of OCIE staff has decreased over the past six years, there has been a decrease in the number and frequency of examinations of registered investment advisers.

### A. Growth in registered investment advisers

The number of registered investment advisers has grown significantly over the past six years. Chart 1 below shows that, between October 1, 2004 and September 30, 2010, the number of registered investment advisers increased 38.5%, from 8,581 advisers to 11,888 advisers.<sup>19</sup> That represents an average annual growth rate of 5.7%.

**CHART 1: NUMBER OF REGISTERED INVESTMENT ADVISERS**



The assets managed by registered investment advisers have grown even faster than the number of registered investment advisers. The amount of assets under management typically correlates with the size and complexity of the operations of the adviser.<sup>20</sup> A larger adviser (*i.e.*,

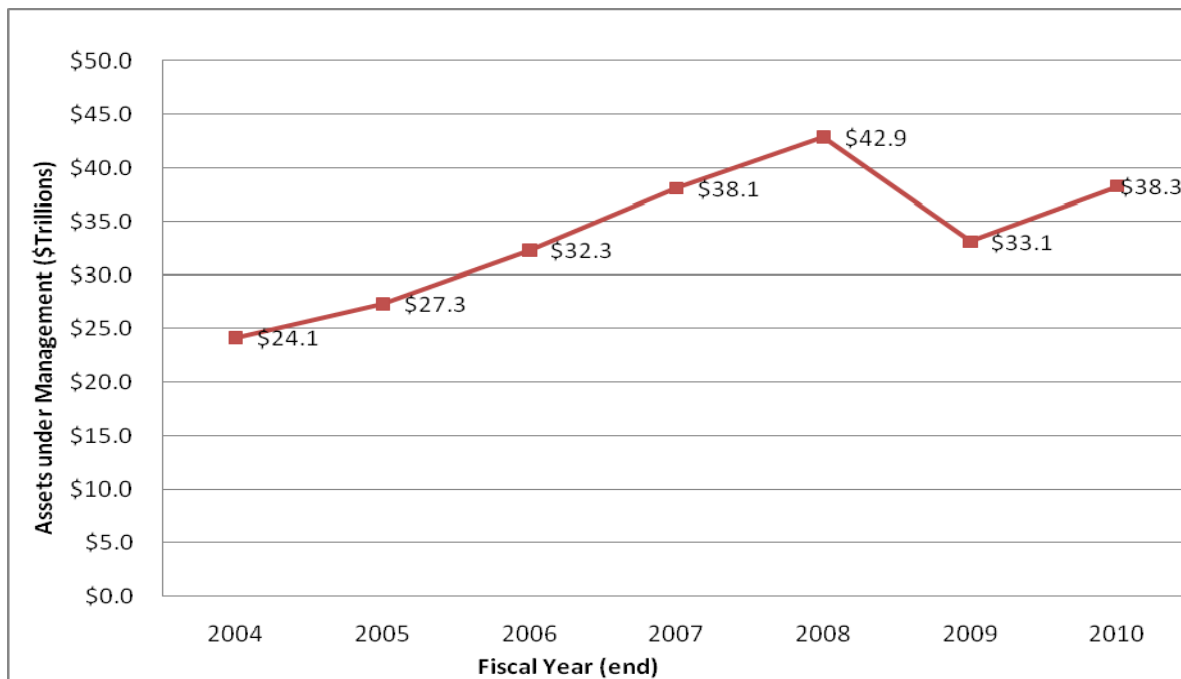
<sup>19</sup> All statistics presented in the Study concerning the number of registered investment advisers and their assets under management are from the IARD.

<sup>20</sup> Of course, an adviser whose assets under management increase solely as a result of market events will not necessarily thereby require additional resources for OCIE to examine.

one with a larger amount of assets under management) will, as a general matter, have more clients, affiliated business activities and employees, and will engage in more varied and complex investment strategies. A larger adviser also will more often advise registered investment companies that OCIE must examine for compliance with the Investment Company Act of 1940 (the “1940 Act”) and other federal securities laws. Accordingly, OCIE examinations of larger advisers require the participation of more staff and tend to take a greater amount of time and thus consume greater resources.

Chart 2 below illustrates that, over the past six years, assets managed by registered investment advisers grew 58.9%, from \$24.1 trillion to \$38.3 trillion. That represents an average annual growth rate of 9.1%.

### CHART 2: ASSETS UNDER MANAGEMENT OF REGISTERED INVESTMENT ADVISERS



The growth of the investment advisory industry during this period occurred despite the U.S. economic recession that officially began in December 2007 and officially ended in June 2009.<sup>21</sup> The number of registered investment advisers grew each year during the recession, increasing from 10,848 advisers on January 1, 2008 to 11,247 advisers on January 1, 2009 and 11,488 advisers on January 1, 2010. While the assets managed by registered investment advisers fell from a high of \$43 trillion on July 1, 2008 to \$33.1 trillion on October 1, 2009, they have since partially rebounded to \$38.3 trillion on September 30, 2010.

### **B. Fewer OCIE staff**

The growth of the investment advisory industry over the past six years has not been matched by corresponding growth in Commission resources committed to examining investment advisers; rather, there has been a decline in Commission resources. Chart 3 below illustrates that, between October 1, 2004 and September 30, 2010, the number of OCIE staff dedicated to examining registered investment advisers decreased 3.6%, from 477 staff to 460 staff, falling as low as 425 staff at certain points during the period from September 30, 2007 to September 30, 2008.<sup>22</sup>

This decline in the number of OCIE staff over the past six years would have been more significant but for the increase in the number of OCIE staff between 2008 and 2010. Partly as a consequence of increased appropriations for fiscal years 2008 through 2010, the number of OCIE staff increased 8.2% between October 1, 2008 and September 30, 2010, from 425 staff to 460 staff.<sup>23</sup>

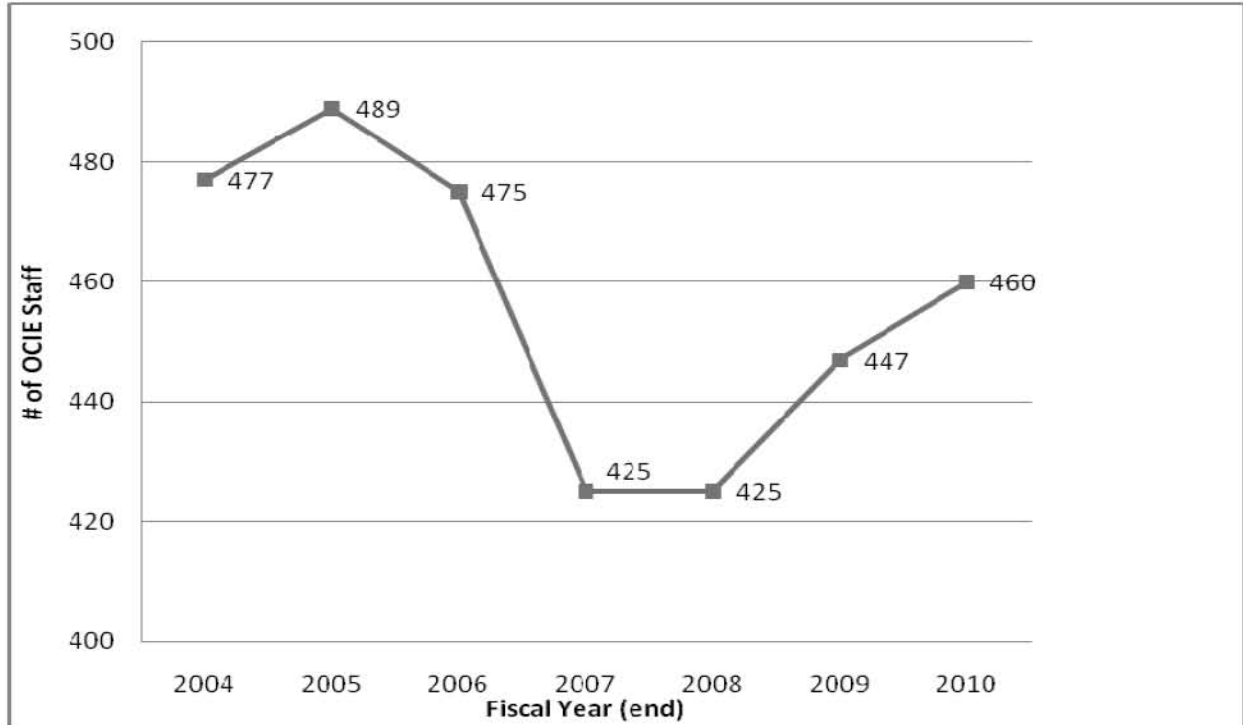
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<sup>21</sup> These dates are based on statements by the Business Cycle Dating Committee of the National Bureau of Economic Research, which is generally considered the authority for dating U.S. recessions.

<sup>22</sup> Unless stated otherwise, all data concerning the number and frequency of investment adviser examinations and the number of OCIE staff are based on data from the Commission's internal reporting systems. Decreases in OCIE staff responsible for examining investment advisers and investment companies were, in part, attributable to changes in the way OCIE classifies its staff and internal reallocations of OCIE staff to other examination units (*e.g.*, units responsible for examining broker-dealers and clearing agencies).

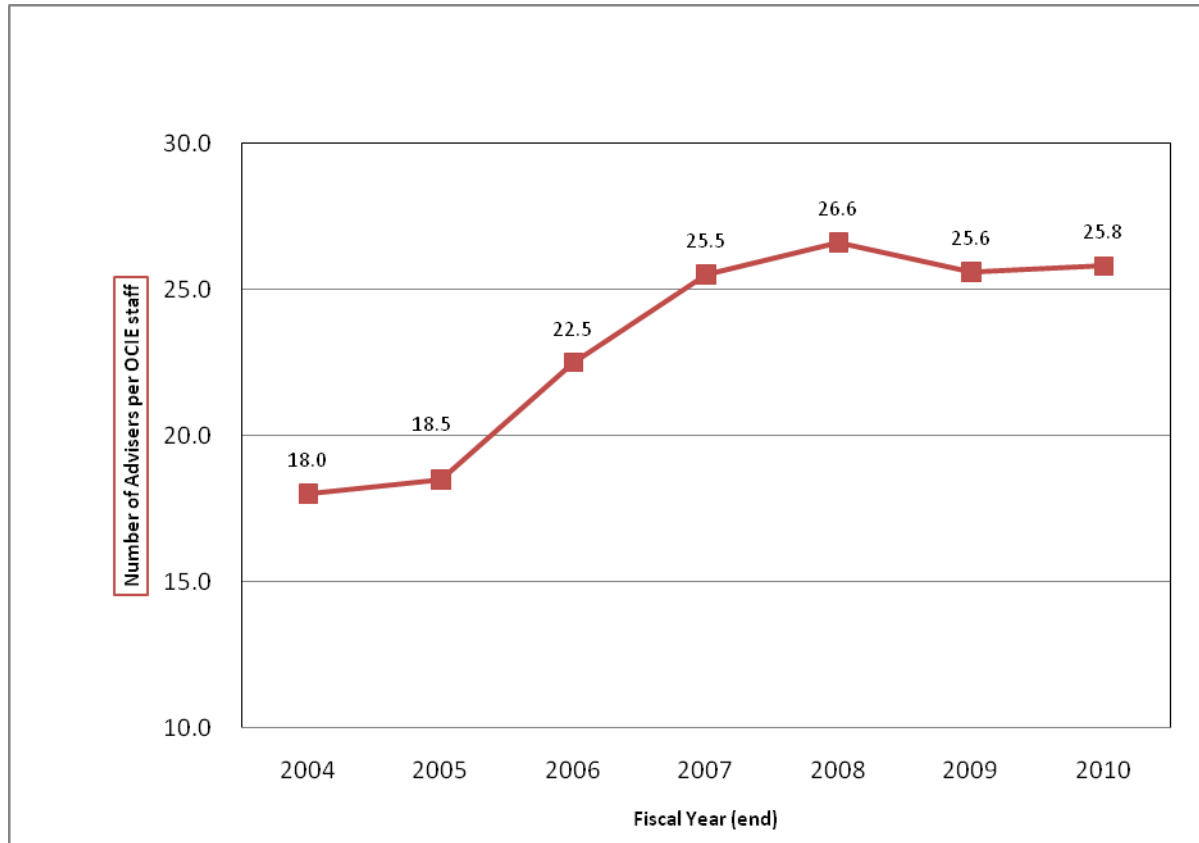
<sup>23</sup> The Commission's budget increased from \$905 million in 2008 to \$960 million in 2009 and \$1.12 billion in 2010.

**CHART 3: NUMBER OF OCIE STAFF DEDICATED TO EXAMINING REGISTERED INVESTMENT ADVISERS AND INVESTMENT COMPANIES**



Other relevant metrics highlight the growth of registered investment advisers relative to the resources committed to examining them. For example, as shown in Chart 4 below, the ratio of the number of registered investment advisers to the number of OCIE staff, which is a proxy for the relative changes in the resources available to examine investment advisers, increased 43.3% over the past six years, from 18.0 to 25.8.<sup>24</sup>

**CHART 4: RATIO OF NUMBER OF REGISTERED INVESTMENT ADVISERS TO NUMBER OF OCIE STAFF**

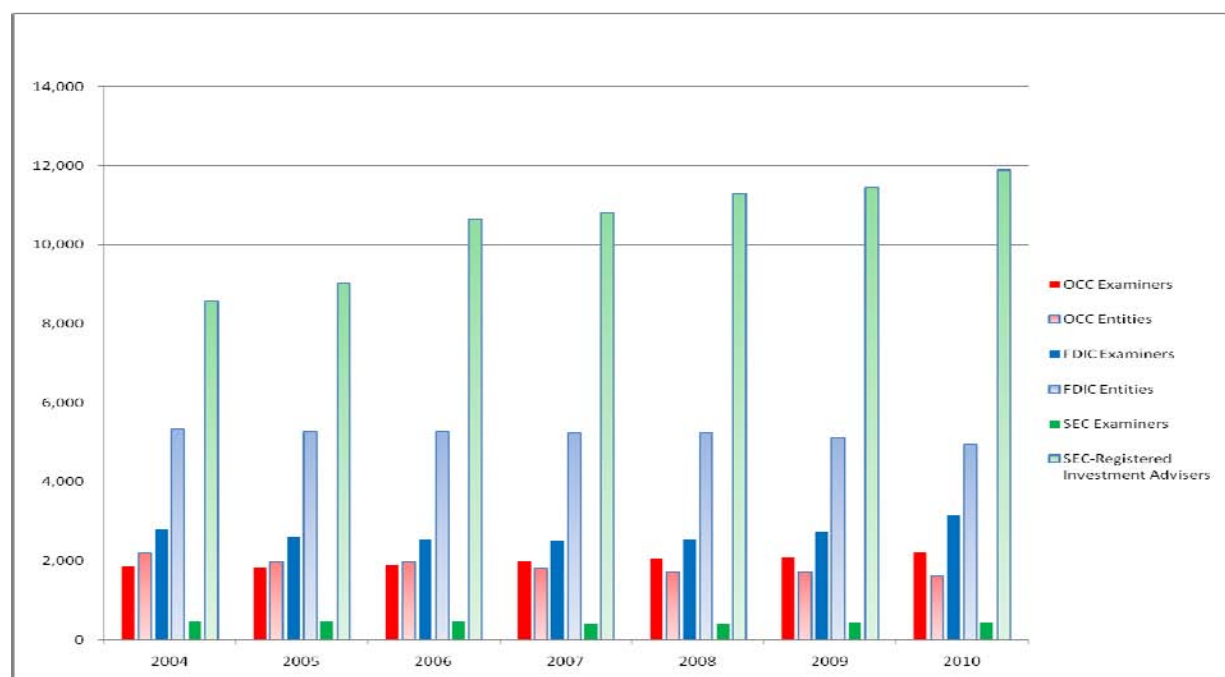


<sup>24</sup>

An increase in the ratio means that there are proportionately fewer resources committed to examining registered investment advisers.

Proportionately fewer resources are dedicated to examining registered investment advisers than are dedicated to examining regulated entities in the banking industry. Although the regulatory regimes applicable to banks differ from those applicable to investment advisers, Chart 5 below illustrates that the SEC has significantly fewer examiners relative to the number of entities it regulates than federal bank regulators.<sup>25</sup> Moreover, as shown below, the differences between the SEC and federal bank regulators in the number of examiners per entity regulated has widened over the past seven years.<sup>26</sup>

**CHART 5: COMPARISON OF EXAMINERS TO ENTITIES REGULATED<sup>27</sup>**



<sup>25</sup> The scope of examinations of investment advisers and banking entities differ due to differences in the Commission’s and federal bank regulators’ regulatory missions and approaches.

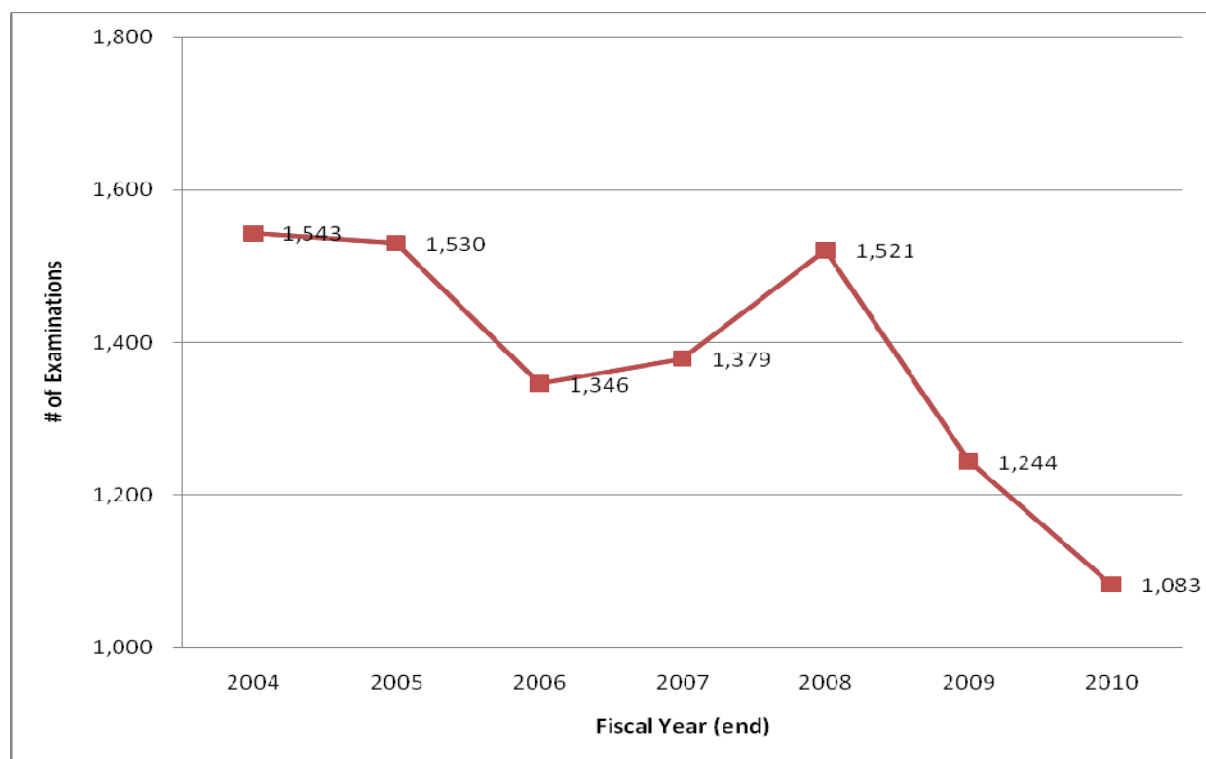
<sup>26</sup> For example, in 2004, the number of entities per examiner for each of the Office of the Comptroller of the Currency (the “OCC”), the Federal Deposit Insurance Corporation (the “FDIC”) and SEC were 1.2, 1.9 and 18.0, respectively. By 2010, the number of entities per examiner for each of the OCC, FDIC and SEC were 0.7, 1.6 and 25.8, respectively.

<sup>27</sup> The data in Chart 5 are based on internal SEC information and information presented in annual reports for the FDIC and the OCC. FDIC entities include FDIC-insured, state-chartered institutions (non-members of the Federal Reserve system). OCC entities include national banks and federal branches of foreign banks. SEC examiners include OCIE staff dedicated to examining both registered investment advisers and registered investment companies.

### C. Decline in the number and frequency of examinations

As the number of registered investment advisers and the assets managed by them have increased and the number of OCIE staff dedicated to examining registered investment advisers has decreased over the past six years, the number of examinations of registered investment advisers has decreased. Chart 6 below shows that the number of examinations of registered investment advisers conducted each year between 2004 and 2010 decreased 29.8%, from 1,543 examinations in 2004 to 1,083 examinations in 2010.

**CHART 6: NUMBER OF REGISTERED INVESTMENT ADVISER EXAMINATIONS**



The percentage of registered investment advisers examined each year has also decreased over the past six years. While 18% of registered investment advisers were examined in 2004, only 9% of registered investment advisers were examined in 2010.<sup>28</sup> At the rate that registered investment advisers were examined in 2010, the average registered adviser could expect to be examined less than once every 11 years, compared to approximately once every six years in 2004. The decrease in both the number and frequency of examinations is attributable, in part, to the growth in the number of registered investment advisers and the decline in the number of OCIE staff. The decrease also is attributable to other changes in the Commission's examination

<sup>28</sup> With respect to the intervening years, 17% of registered investment advisers were examined in 2005, 14% of registered investment advisers were examined in 2006, 13% of registered investment advisers were examined in 2007, 13% of registered investment advisers were examined in 2008 and 11% of registered investment advisers were examined in 2009.

program. For example, OCIE has devoted more resources to cause examinations and examinations of higher-risk advisers, which (as noted above) generally take longer to conduct than examinations of lower-risk advisers. OCIE also is performing additional, resource intensive procedures during examinations, such as enhanced asset verification to detect fraud and misappropriation of investor assets.<sup>29</sup>

The Staff acknowledges that important additional factors in the adequacy of the investment adviser examination program are the efficiency with which OCIE conducts examinations, which depends on OCIE's ability to identify compliance risks, its selection of examination candidates and the time it takes to conduct examinations, and the effectiveness of OCIE's examinations in identifying compliance failures. OCIE's efficiency also is affected by the amount of cooperation provided by advisers. OCIE has instituted several changes to its examination program during the past year and has plans for significant additional strategic initiatives, all to increase the effectiveness and efficiency of its examination program. In March 2010, OCIE launched an intensive nationwide self-assessment process, analyzing the strategy, structure, personnel, process and technology of its examination program. Since July 2010, OCIE has moved quickly to implement additional reforms from this self-assessment to improve the efficiency of its examination program.

### **III. Impact of the Dodd-Frank Act on examinations of registered investment advisers**

The Staff expects that the Dodd-Frank Act will result in a significant near-term decrease in the number of registered investment advisers. However, the Staff anticipates growth in the number of registered investment advisers after the effective date of Title IV's amendments to the registration provisions of the Advisers Act. In addition, while there could be an increase in the number of OCIE staff if the Commission receives appropriations from Congress, OCIE will need to divert adviser examination resources to fulfill new examination obligations that the Commission was given by the Dodd-Frank Act. This section analyzes the effects of these factors on examinations of investment advisers and discusses resource challenges to the Commission's examination program.

#### **A. Effect of Title IV on the number of registered investment advisers**

The Staff expects, based on experience discussed below, the number of registered investment advisers to decrease substantially after the effective date of amendments to the Advisers Act by Title IV and to increase thereafter, although the rate of increase is uncertain. This trend is similar to changes in the number of registered investment advisers that occurred after the enactment of the National Securities Markets Improvement Act of 1996 ("NSMIA").

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<sup>29</sup> OCIE began to conduct enhanced asset verification procedures for advisers with custody of client assets beginning in 2009.



NSMIA, like Title IV and as described below, reallocated federal and state responsibilities for the regulation of registered investment advisers.

### **1. Fewer registered investment advisers after the effective date of Title IV**

The Staff estimates that amendments to the registration provisions of the Advisers Act by Title IV<sup>30</sup> will result in 3,350 fewer SEC-registered investment advisers, representing a 28.2% decrease from the 11,888 SEC-registered investment advisers on September 30, 2010.<sup>31</sup>

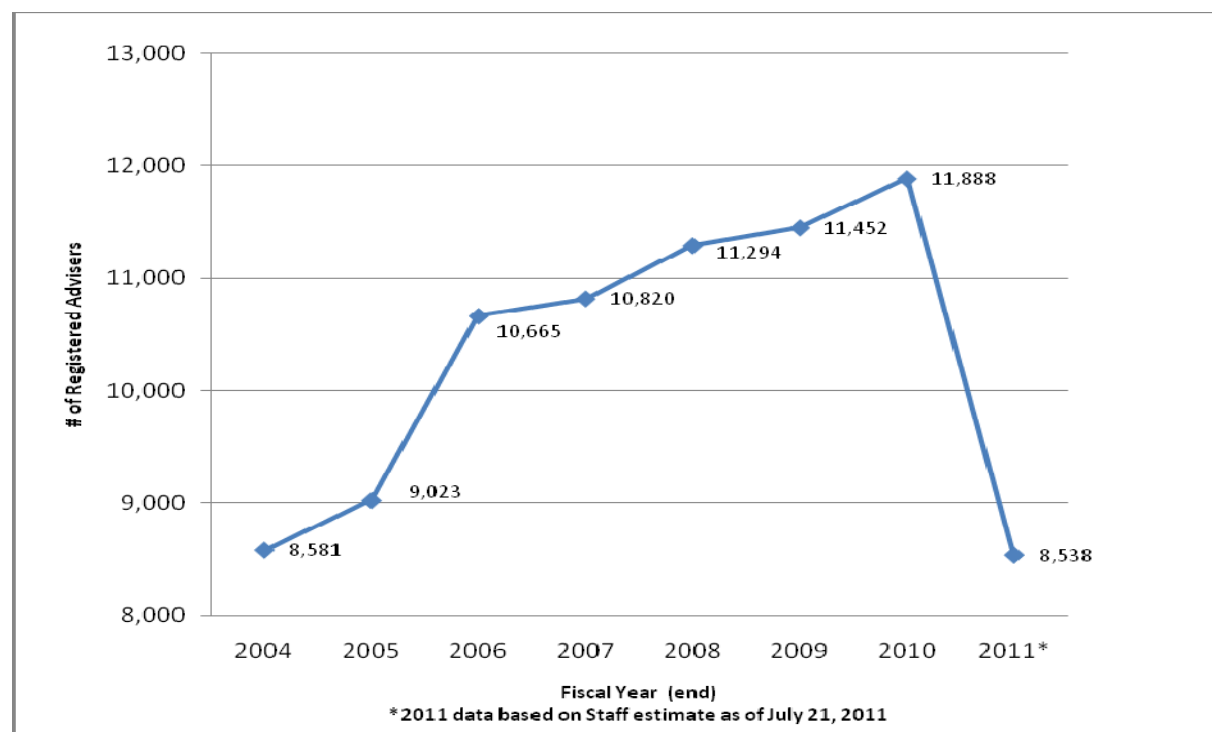
Chart 7 below shows that the number of registered investment advisers following the effective date of these amendments will be lower than the number of registered investment advisers on September 30, 2004.

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<sup>30</sup> Among other things, Title IV amends the registration provisions of the Advisers Act in the following three ways: (1) it prohibits many investment advisers with between \$25 million and \$100 million in assets under management from registering as investment advisers with the SEC (the “mid-sized adviser provision”); (2) it repeals a broad exemption from Advisers Act registration on which many private fund advisers and non-U.S. advisers rely; and (3) it adds new, narrower exemptions from Advisers Act registration.

<sup>31</sup> The Staff estimates that: (1) approximately 4,100 advisers registered with the Commission on September 1, 2010 will be required to withdraw their registration and instead register with one or more state securities authorities as a consequence of the mid-sized adviser provision; and (2) 750 investment advisers not currently registered with the SEC will register with the SEC as a result of changes to the exemptions from Advisers Act registration. This estimate assumes there is no change in the number of registered investment advisers between September 30, 2010 and July 21, 2011, and it therefore differs from an estimate used in the Commission’s November 2010 proposed rules implementing amendments to the Advisers Act. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110 (Nov. 19, 2010), at 116.

**CHART 7: NUMBER OF REGISTERED INVESTMENT ADVISERS AFTER ENACTMENT OF TITLE IV**



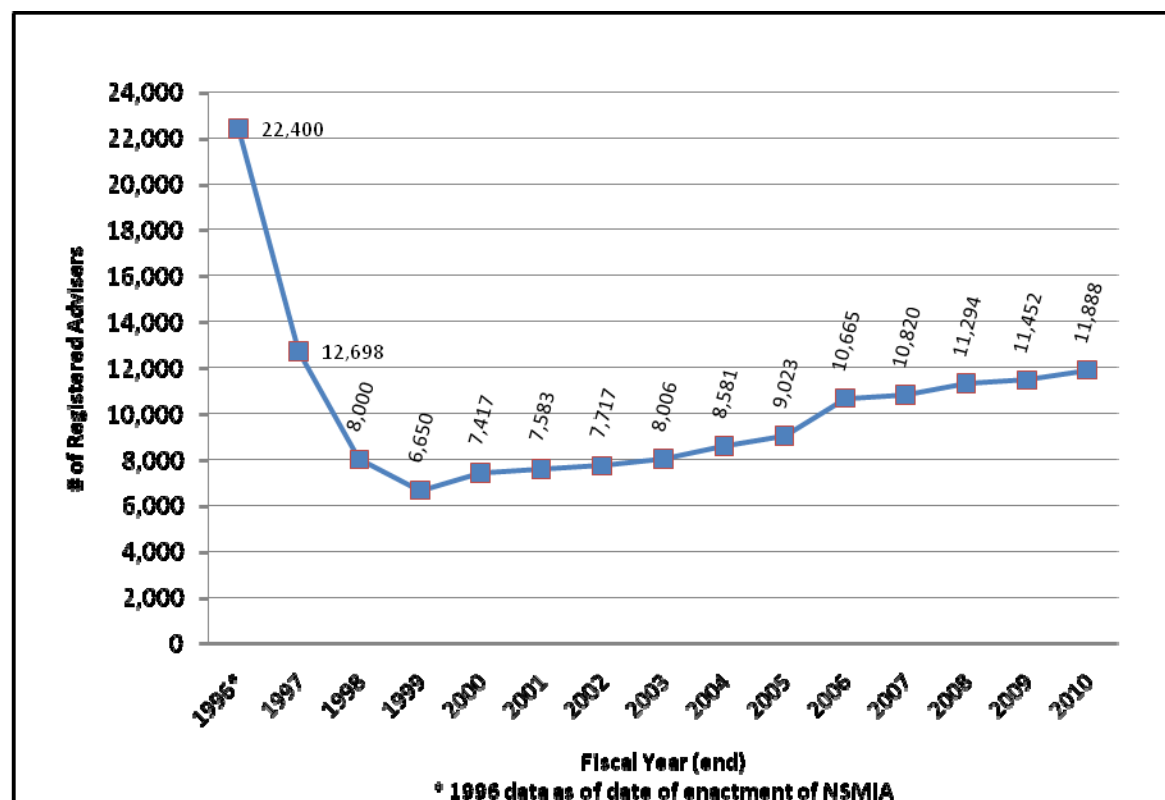
This expected decrease in the number of investment advisers is similar to the decrease in the number of registered investment advisers as a result of NSMIA. NSMIA reallocated federal and state responsibilities for the regulation of the approximately 22,400 investment advisers then registered with the Commission by generally prohibiting an investment adviser with less than \$25 million of assets under management from registering as an investment adviser with the SEC. Instead, those advisers were required to register with state securities regulators. The reallocation of regulatory responsibilities primarily grew out of Congress' concern that the Commission's resources were inadequate to supervise the activities of the growing number of registered investment advisers, many of which were small, locally-operated, financial planning firms.<sup>32</sup>

The enactment of NSMIA resulted in a substantial decrease in the number of SEC-registered investment advisers. Chart 8 below shows that, between the date of the enactment of NSMIA and September 30, 1999, the number of SEC-registered investment advisers decreased 70%, from 22,400 advisers to 6,650 advisers.

<sup>32</sup>

See S. Rep. No. 293, 104th Cong., 2d Sess. 34 (1996).

**CHART 8: CHANGE IN NUMBER OF REGISTERED INVESTMENT ADVISERS AFTER THE ENACTMENT OF NSMIA**



The decrease in the number of registered investment advisers after the enactment of NSMIA eased the problem identified by Congress that the Commission's resources were inadequate to supervise the activities of the growing number of registered investment advisers. There was a sizeable increase in the frequency of examinations of registered investment advisers after the enactment of NSMIA. In 1996, before the enactment of NSMIA, the Staff estimated that the average cycle for a routine adviser examination was once every 25 to 30 years. By 1998, OCIE was examining registered investment advisers once every five years and sought to examine newly-registered advisers early in their operations.

The relief provided by NSMIA, however, proved temporary due to the resurgent growth in the number of registered investment advisers and the assets managed by them, which coincided with both booming equity markets and rising personal wealth among high income households.<sup>33</sup> Although the assets managed by registered investment advisers were \$10.7 trillion in 1996, they grew to over \$20 trillion by 2003, an increase of nearly 100%. In addition, the

<sup>33</sup> For example, the S&P 500 increased approximately 142% from January 1, 1995 to December 31, 2003. In addition, according to data from the Internal Revenue Service, the adjusted gross income of the top 5% of U.S. households grew from \$1.22 billion in 1995 to \$1.96 billion in 2003.

number of registered advisers grew 19.9% between 1999 and 2003, from 6,650 advisers to 7,971 advisers.

## 2. Expected future growth in the number of registered investment advisers

The Staff anticipates that the number of registered advisers and the assets managed by them will increase over time after the effective date of Title IV's amendments to the registration provisions of the Advisers Act.<sup>34</sup> The rate of this increase, however, is difficult to predict.

Predicting growth based on periods of growth over the last six years, in the 16 years before NSMIA or in the years after NSMIA may be inaccurate due to extraordinary events that occurred during those periods. Although the number of registered advisers and the assets managed by them grew over the past six years at average annual growth rates of 5.7% and 9.1%, respectively, these growth rates may have been muted by the effects of the economic recession that officially began in December 2007 and officially ended in June 2009. In a larger sample covering the 16 years preceding the enactment of NSMIA (1980 to 1996), the number of registered advisers and the assets managed by them grew at average annual growth rates of 9.4% and 21%, respectively. While this longer period may be more reliable for predicting future growth, it coincided with the rapid development of the financial planning industry. Other data suggest that the growth during this period could have been extraordinary.<sup>35</sup> The growth in the number of registered investment advisers and the assets managed by them in the years following the effective date of NSMIA, which, as discussed above, appears to have been driven by rising equity markets and personal wealth among high income households, likewise may be extraordinary.

Nonetheless, based on historical growth rates, the Staff expects that the number of registered investment advisers and assets managed by them will increase over time following the effective date of the Dodd-Frank Act, even if not at the same rate they did during the post-NSMIA period. As illustrated in Chart 9 below, at an assumed annual growth rate of 5%, the number of SEC-registered advisers would grow from 8,358 advisers to 10,897 advisers in five

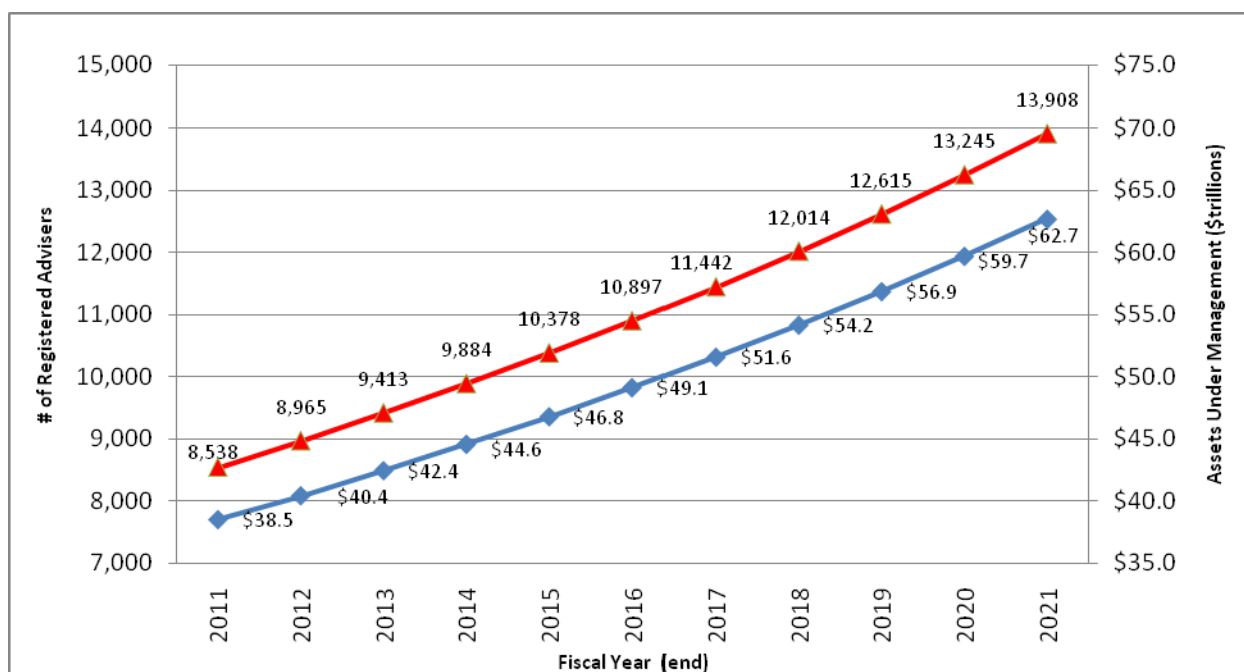
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<sup>34</sup> Assets under management growth is expected to be driven by, among other things: (1) increased demand for income-generating, risk management and outcome-oriented products; (2) inflows of assets from retiring baby-boomers and from Individual Retirement Account rollovers; (3) an increasing transition from defined benefit to defined contribution plans among large corporations; (4) the growing tendency among large employers to enroll their workers in 401(k) plans automatically and, increasingly, to ratchet up employee contribution rates in conjunction with pay increases; and (5) opportunities for expansion by U.S. investment advisers in international markets. *See, e.g.,* MCKINSEY & COMPANY, THE ASSET MANAGEMENT INDUSTRY IN 2010, available at [http://www.mckinsey.com/clientservice/bankingsecurities/latestthinking/The\\_Asset\\_Management\\_Industry\\_in\\_2010.pdf](http://www.mckinsey.com/clientservice/bankingsecurities/latestthinking/The_Asset_Management_Industry_in_2010.pdf).

<sup>35</sup> For example, between 1950 and 1990, the annual average rate of growth in the number of registered investment advisers was 7.6%.

years, and (based on the same assumed growth rate) the amount of assets they manage would grow from \$38.5 trillion to \$49.1 trillion. In 10 years, 13,908 advisers would be registered with the Commission and would manage \$62.7 trillion of client assets. This growth would outstrip the Commission's examination resources without the commitment of substantial new funding.

### CHART 9: ILLUSTRATION OF FUTURE GROWTH OF REGISTERED INVESTMENT ADVISERS AND ASSETS THEY MANAGE



#### B. Potential increase in the number of OCIE staff

The number of OCIE staff could increase in fiscal years 2011 through 2015. With respect to 2011, President Obama has requested a fiscal year funding level of \$1.26 billion for the Commission, which represents an increase of approximately \$139 million over the Commission's 2010 fiscal year funding level of \$1.12 billion. In addition, the Dodd-Frank Act authorizes annual increases in the SEC's budget between 2011 and 2015, when \$2.25 billion will be authorized.

Importantly, however, the increases in the Commission's authorized budget through 2015 will not necessarily result in increased funding because the amount appropriated to the Commission in each of these years must be approved by Congress. The amount appropriated could be significantly less than the amount authorized. In addition, even if the Commission receives increased funding for this year and future years, other Commission programs have competing and pressing needs for resources. Therefore, it is difficult to predict how much of this increased funding the Commission will be able to allocate toward examinations of registered investment advisers (if funds are appropriated).

### C. Near-term improvements in relative resources available for examinations

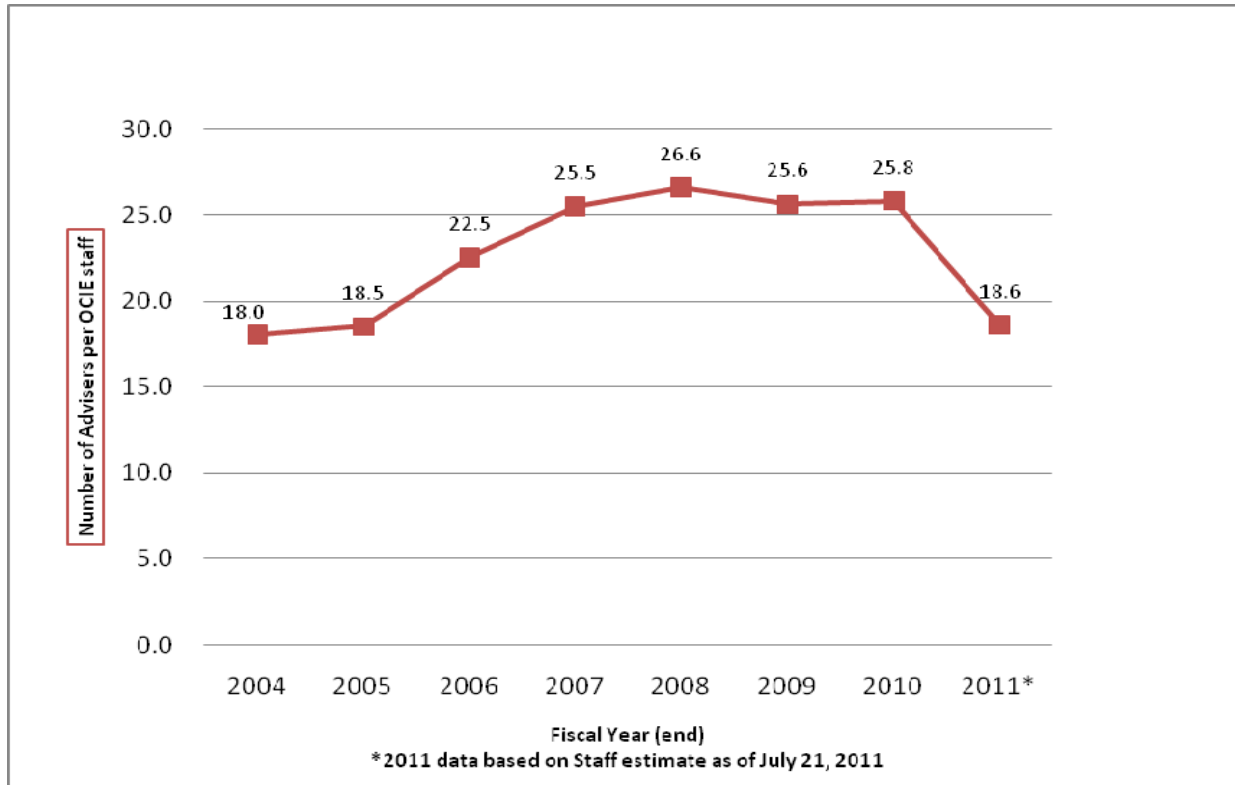
The anticipated decrease in the number of registered investment advisers, even without any increase in the number of OCIE staff, would reverse most of the growth over the past six years in the ratio of the number of registered investment advisers to the number of OCIE staff. Chart 10 below shows that the Staff expects the ratio of the number of registered investment advisers to the number of OCIE staff to be 18.6 on July 21, 2011, which represents a 27.9% decrease from that ratio as of September 30, 2010.<sup>36</sup> The estimated ratio on July 21, 2011 of 18.6 is also less than the ratio following the enactment of NSMIA, when it stood at 18.8 on September 30, 1999.<sup>37</sup> As discussed below, the Staff expects that the decrease in the number of registered investment advisers per OCIE employee could enable more frequent examinations of registered investment advisers in the near term.

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<sup>36</sup> This ratio assumes that the number of registered investment advisers on July 21, 2011 is 8,538 and the number of OCIE staff is 460. The number of advisers is derived as follows: 11,888 (total SEC-registered advisers on September 30, 2010) - 4,100 (SEC-registered advisers withdrawing SEC registration as a result of the mid-sized adviser provision) + 750 (private advisers registering with the SEC as a result of changes to Advisers Act exemptions) = 8,538. This assumes there is no change in the number of registered investment advisers between September 30, 2010 and July 21, 2011.

<sup>37</sup> On September 30, 1999, the number of registered investment advisers was 6,650 and the number of OCIE staff was 353. The number of registered investment advisers was at its lowest level in the last 20 years in 1999.

**CHART 10: RATIO OF NUMBER OF REGISTERED INVESTMENT ADVISERS TO NUMBER OF OCIE STAFF AFTER ENACTMENT OF TITLE IV**



#### **D. Effect on examinations in the near term**

The Staff believes that the frequency of examinations of registered investment advisers could increase during the years immediately following the effective date of Title IV as a result of a significant decrease in the number of registered advisers. The Staff's expectations are supported by data showing an increase in the number and frequency of examinations following the decrease in SEC-registered investment advisers after the enactment of NSMIA, described above. These expectations also are supported by data showing an increase in the frequency of examinations of large mutual fund complexes following an increase in OCIE staff assigned to inspecting registered investment companies and investment advisers between 2003 and 2005. Prior to the mutual fund market timing events that occurred in 2003, OCIE had fewer than 400 staff assigned to examining investment companies and investment advisers. By 2005, close to 500 OCIE staff were assigned to inspecting investment companies and investment advisers. This increase in OCIE staff contributed to an increase in the frequency of examinations of large mutual fund complexes. From 1998 to 2003, large mutual fund complexes were examined once every five years. By 2005, these funds were scheduled for examination once every two to three

years.<sup>38</sup>

The amount of any potential increase in the frequency of examinations, however, may be offset by the need to divert examination resources to fulfill new examination obligations that the Commission was given by the Dodd-Frank Act. The Dodd-Frank Act creates several new examination obligations for the Commission, which the Commission will have to meet by re-deploying OCIE staff currently committed to existing examination programs, including the investment adviser examination program. The Dodd-Frank Act requires municipal advisors and five categories of swap entities to register with the Commission, and mandates the frequency and/or establishes scoping for examinations of clearing agencies, credit rating agencies and FINRA. While the Staff is unable to estimate the full implication on the adviser examination program of this redeployment of resources at this time, OCIE already has begun to re-assign staff to new program areas in preparation for its new examination obligations.

#### **E. Resource challenges to examinations**

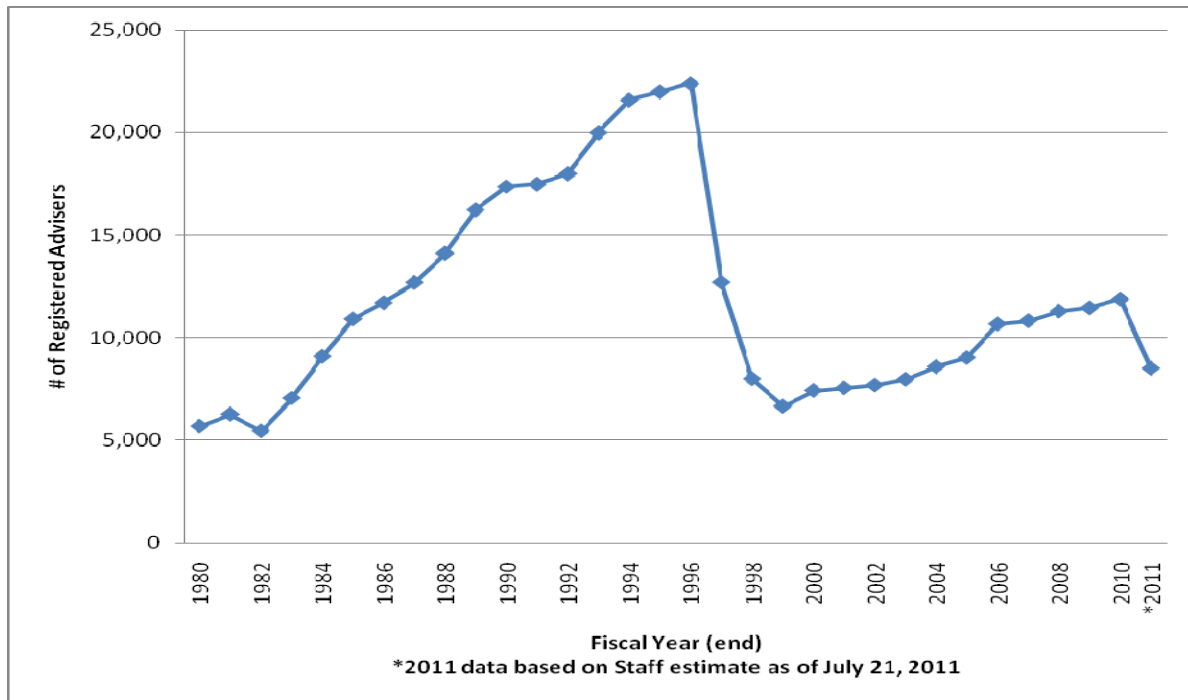
Even if the Commission is able to expand substantially the number of OCIE staff dedicated to inspecting registered investment advisers, based upon past experience and as discussed above, the number of OCIE staff is unlikely to keep pace with the future growth among advisers. Past experience following the enactment of NSMIA has shown that even a very substantial decrease in the number of registered investment advisers may result in only temporary increases in the number and frequency of examinations due to subsequent growth in the investment advisory industry that is not matched with growth in OCIE staff. Additionally, the Commission's new examination obligations under the Dodd-Frank Act will further strain resources that are available for examinations of investment advisers. This presents significant capacity challenges to the Commission's investment adviser examination program.

Chart 11 below shows that Congress twice has responded to capacity challenges to the Commission's investment adviser examination program by reallocating federal and state responsibilities for the regulation of registered investment advisers, first in 1996 with the enactment of NSMIA and next in 2010 with the enactment of the Dodd-Frank Act.

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<sup>38</sup> Mutual funds are no longer examined based on a frequency cycle. Instead, they are examined under a risk-based approach.



**CHART 11: NUMBER OF REGISTERED INVESTMENT ADVISERS – 1980 to 2011**

The Staff does not believe that the periodic reallocation of investment adviser regulatory responsibilities is a stable solution to these capacity challenges. State regulators may not have adequate resources to continue to assume increased regulatory responsibilities, and investor protection could be compromised if such resources are lacking. Stable funding that can increase in response to growth in the investment advisory industry, discussed in the next section of the Study, could address these examination capacity challenges.

#### IV. Options to consider to address capacity constraints concerning examinations

The Commission's registered investment adviser examination program faces significant capacity challenges. In order to meet these challenges, the examination program requires a source of funding that is adequate to permit the Commission to meet the new challenges it faces and sufficiently stable to prevent examination resources from periodically being outstripped by growth in the number of registered investment advisers (*i.e.*, it requires resources that are scalable to any future increase — or, for that matter, decrease — in the number of registered investment advisers). Three approaches to consider to address these challenges are to: (1) impose “user fees” on SEC-registered investment advisers that could be retained by the Commission to fund the investment adviser examination program; (2) authorize one or more SROs to examine, subject to SEC supervision, all SEC-registered investment advisers; or (3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.<sup>39</sup>

##### A. User Fees

User fees imposed upon registered investment advisers would provide scalable resources to support the Commission's examination of registered investment advisers. Under this approach, the Commission would continue to rely on appropriated funds to support its other programs, including other aspects of its administration of the Advisers Act. The fees collected from investment advisers would be available to the Commission without further appropriation, used solely to fund the Commission's investment adviser examination program, and set at a level designed to achieve an acceptable frequency of examinations.<sup>40</sup>

User fees are an important source of resources for many other federal government agencies. For example, user fees fund inspections of banks conducted by the Office of Comptroller of the Currency, examinations of credit unions by the National Credit Union Administration, inspections of nuclear facilities by the Nuclear Regulatory Commission, inspections of national marine fisheries by the National Oceanic and Atmospheric Administration, and quality examinations of agricultural commodities and processing plants by

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<sup>39</sup> Authorizing FINRA to examine dual registrants for compliance with the Advisers Act would not, however, completely address the examination resource challenges because it would not provide scalable resources for the examination of registered investment advisers that are not also registered as broker-dealers.

<sup>40</sup> The funds on which the Commission currently operates are separately appropriated by Congress. While the Commission collects transaction and registration fees under the securities laws from issuers of securities and other market participants, these fees currently are required to be deposited and credited as offsetting collections to the account providing appropriations to the Commission.

the Department of Agriculture.<sup>41</sup> Congress already provided the Commission with the ability to charge user fees to fund one limited aspect of the Commission's investment adviser oversight program.<sup>42</sup> User fees today support the IARD, the electronic registration system through which investment advisers make filings with the Commission and state regulators.<sup>43</sup> The IARD provides the infrastructure to permit the Commission to collect user fees from registered investment advisers.

The idea of funding the Commission's investment adviser examination program by charging user fees is not new. In 1992, a bill was introduced in the House of Representatives that, among other things, would have provided that registered investment advisers pay a user fee to finance their oversight by the Commission.<sup>44</sup> The Commission has previously supported user fees in testimony relating to legislation under consideration by Congress.<sup>45</sup>

User fees could provide OCIE with the resources to perform earlier examinations of newly-registered investment advisers and more frequent examinations of other registered investment advisers. The Staff believes that more frequent examinations would provide a greater level of deterrence of wrongdoing, which is at least partially the function of each investment adviser's perception of the probability of being examined.<sup>46</sup> Earlier examinations of advisers could help address problems at an earlier stage and, in some cases, limit the amount of client losses.

User fees also could provide resources that would permit OCIE to improve the effectiveness of its examinations through long-term strategic planning that could allow OCIE to

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<sup>41</sup> Regulatory fees to support more generalized regulatory activities also are paid to the Federal Communications Commission by cable operators and satellite services licensees.

<sup>42</sup> However, registered investment advisers do not pay registration fees and currently bear little of the cost of their regulatory oversight.

<sup>43</sup> Section 204(b) of the Advisers Act authorizes the Commission to require investment advisers to file applications and other documents through an entity designated by the Commission, and to pay reasonable costs associated with such filings. The IARD is operated for the Commission and state regulators by FINRA. Filing fees range from \$40 to \$225, depending on the amount of assets managed by the adviser.

<sup>44</sup> *See* Investment Adviser Regulatory Enhancement and Disclosure Act of 1992, H.R. 5726, 102nd Cong. (1992).

<sup>45</sup> *See* Commission testimony concerning H.R. 4441, The Investment Advisers Disclosure and Enforcement Act of 1990, before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, U.S. House of Representatives, July 18, 1990.

<sup>46</sup> The Staff acknowledges that while the number and frequency of examinations are important to an effective examination program, other factors, such as the effectiveness of examinations, selection of examination candidates and examination results, also are important.

better utilize both technology and its workforce. Training its staff and investing in technology could help OCIE better understand and evaluate increasingly sophisticated investment products and complex trading strategies pursued by investment advisers, including advisers to hedge funds. Critical technology-based solutions typically take years to implement and refine – a stable source of funding could allow OCIE to more easily implement and maintain such solutions.<sup>47</sup>

Stable resources also could provide the adviser examination program increased flexibility to react to developing and emerging risks associated with investment advisers, and to direct staffing and strategic responses that may help address critical areas or issues. Specifically, the examination program would be in a better position, once risks are identified, to allocate necessary resources, including adding staff with appropriate experience and developing specific training for existing staff, in order to address and mitigate the impact of such risks.

Imposing user fees to adequately fund OCIE’s examination program may be a less expensive option than an SRO, although the Staff has not evaluated the potential start-up or operational costs of an SRO.<sup>48</sup> User fees are an option that some advisory organizations and others support as an alternative to an SRO.<sup>49</sup>

Retaining exclusive responsibility of OCIE to conduct investment adviser examinations (funded by user fees) may avoid certain inefficiencies associated with delegation to one or more SROs. Costs of coordination between Commission staff and an SRO responsible for examinations — which might include, for example, not only direct costs like additional management costs required to oversee the SRO’s effectiveness, but also other costs that are even

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<sup>47</sup> Indeed, the Commission is well along in the process of developing its regulatory and examination regime for both private fund advisers and securities-based derivative instruments (over many of which it will newly have supervision pursuant to the Dodd-Frank Act). As Commission staff continue to build their expertise to regulate these firms and instruments, retaining responsibility for investment adviser examinations will better enable such staff to understand how these firms and instruments fit into the broader markets they oversee. Information on the operations of the general investment adviser population could play an important role in consolidating that expertise and institutionalizing knowledge critical to the regulatory process.

<sup>48</sup> These costs could vary substantially depending upon whether there were multiple SROs or a single SRO, and whether any SRO designated is already in operation and thus could potentially incur fewer start-up costs. As discussed below, the Commission also would continue to bear expenses associated with overseeing one or more SROs. Those costs likely would be higher if there were multiple SROs.

<sup>49</sup> *See, e.g.*, Letter from David G. Tittsworth, Executive Director, Investment Adviser Association, to Elizabeth M. Murphy, Secretary, SEC, dated November 23, 2010, at 2; Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC, dated September 22, 2010, at 5 (“September MFA Letter”); Letter from Barry C. Melancon, President and CEO, American Institute of Certified Public Accountants, to Elizabeth M. Murphy, Secretary, SEC, dated November 24, 2010, at 2 (“AICPA Letter”).

more difficult to quantify — might also argue in favor of the imposition of user fees to bolster the Commission’s investment adviser examination program. Further, as a user fee approach could avoid the need to delegate responsibility for examinations, the chance that inconsistencies would emerge in interpretation or application of the Advisers Act and its rules between a third-party examining body (such as an SRO) and the statute’s and rules’ primary administrator (the Commission) would be eliminated.

Relying on user fees to help fund an enhanced investment adviser examination program could also avoid a particular concern associated with delegating examination responsibilities to an SRO. Overseeing an SRO requires substantial resources. There is no certainty that the level of resources available to the Commission over time would be adequate to enable staff to effectively oversee the activities of the SRO. Therefore, a user fee approach, which would contribute directly to the Commission’s investment adviser examination program, would avoid the risk of underfunded oversight of an SRO.

The user fee approach would also leverage SEC examination staff with substantial experience and expertise in the oversight of investment advisers that is closely integrated with legal and policy staff that support their activities.<sup>50</sup> During the past year, OCIE has instituted important changes that can be leveraged to further improve the effectiveness and efficiency of the Commission’s investment adviser examination program.

OCIE has made various changes, including altering its governance structure, hiring specialized examiners, enhancing its risk assessments and coordinating its examinations of dual registrants. For example, OCIE has implemented a new governance structure, which now includes senior leaders from the Regional Offices, who manage both the enforcement and examinations programs in each Regional Office, and is intended to improve communication and accountability. It has also hired senior specialized examiners, and created multiple specialist working groups, which will help build examiner knowledge base, train examiners, develop exam modules and focus risk-based exam strategies. OCIE continues to refine its techniques to identify the areas of highest risk, is coordinating with the Commission’s Division of Risk, Strategy, and Financial Innovation to enhance its risk assessment analytics and modeling and is coordinating several initiatives with the Commission’s Division of Enforcement. OCIE also has instituted several measures to better coordinate its own broker-dealer and investment adviser examination programs. For example, under a new staffing model, a single team of examiners, drawn from the broker-dealer and investment management units of OCIE, will jointly examine selected dual registrants.

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<sup>50</sup> The Staff acknowledges that the user fee approach would not address the current inefficiencies created when a dual registrant is examined by FINRA for compliance with the Exchange Act and OCIE for compliance with the Advisers Act, but designation of an SRO other than FINRA would not address such inefficiencies either.

Importantly, imposing user fees would avoid the difficult scope of authority, membership, governance, and funding issues raised by an SRO, discussed below. It would avoid the need for the Commission to use resources to staff an expanded SRO examination program. User fees also would shift the cost of regulation to the advisers themselves. Registered investment advisers currently bear little of the cost of their regulatory oversight as compared to other groups of participants in the financial services markets.<sup>51</sup>

## **B. Self-regulatory organizations**

Congress could, alternatively, authorize one or more SROs for registered investment advisers in order to provide scalable resources to support the Commission's examination of registered investment advisers. SROs are privately funded entities with market specific expertise that, subject to Commission oversight, can have the authority to adopt rules, examine member firms for compliance with those rules and the federal securities laws, and enforce those rules and laws.<sup>52</sup> They play an important role in the regulation of the securities industry in the United States.<sup>53</sup>

The concept of an SRO for investment advisers is not new. Proposals to create one or more SROs for investment advisers have been considered by Congress, the Commission and members of the investment advisory industry for over 45 years. Many of these proposals were made in response to constraints on the Commission's capacity to examine the growing number of investment advisers registered under the Advisers Act.<sup>54</sup>

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<sup>51</sup> For example, registered investment companies and other issuers of securities pay registration fees that are designed to recover the costs to the government of the securities registration process, and costs indirectly related to that process, including enforcement activities, policy and rulemaking activities, administration, legal services and international regulatory activities. *See, e.g.*, section 24(f) of the 1940 Act; section 6(b) of the Securities Act of 1933. SRO members also pay fees that support SRO regulation. *See, e.g.*, Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2107 (Feb. 5, 2003), n.73 (“Other financial SROs, for example, are financed by fees imposed on members and users of their services rather than by public funds.”) (“Compliance Programs Release”).

<sup>52</sup> Commission oversight of SROs typically includes approval of SRO rules, examination of SRO activities and member firms, and review of appealed SRO disciplinary actions.

<sup>53</sup> For example, SROs help oversee the public securities markets, including the municipal bond market (the Municipal Securities Rulemaking Board (the “MSRB”)), the system of clearance and settlement of securities trades, the national securities exchanges, and broker-dealers (FINRA). An SRO also plays an important part in the oversight of the futures markets (the National Futures Association (the “NFA”)).

<sup>54</sup> The Commission first considered an investment adviser SRO in 1963 in its Report of Special Study of the Securities Markets. That report recommended that registered investment advisers be required to join an SRO that would assume responsibility for determining and imposing minimum standards for principals and appropriate categories of employees of registered investment adviser firms. The recommendation was not acted upon. In 1980, the Commission published a release

Funded by membership fees, one or more investment adviser SROs would provide scalable resources that could supplement the Commission’s oversight program for investment advisers. An SRO, like OCIE if it had additional resources, could use those resources to conduct earlier examinations of newly-registered investment advisers and more frequent examinations of other registered investment advisers.

An SRO would not, however, free the Commission to use all resources currently dedicated to adviser examinations to pursue other matters. Commission resources would still be required to oversee the operations of any SRO by, depending upon the scope of the SRO’s authority, conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee and rule changes. Substantial resources of both OCIE and the Commission’s Division of Trading and Markets are currently employed to oversee the activities of FINRA.

The Commission’s and the Commodity Futures Trading Commission’s experiences with SROs support the view that an SRO can augment government oversight programs through more frequent examinations. Chart 12 below shows that registered broker-dealer firm members of FINRA and active commodity pool operator (“CPO”) and commodity trading advisor (“CTA”) members of the NFA were examined more frequently than registered investment advisers were examined in 2008 and 2009.<sup>55</sup>

In 2008, FINRA conducted over 2,500 routine examinations and nearly 7,000 cause examinations, and examined 57% of its 5,564 registered broker-dealer firm members. In 2009,

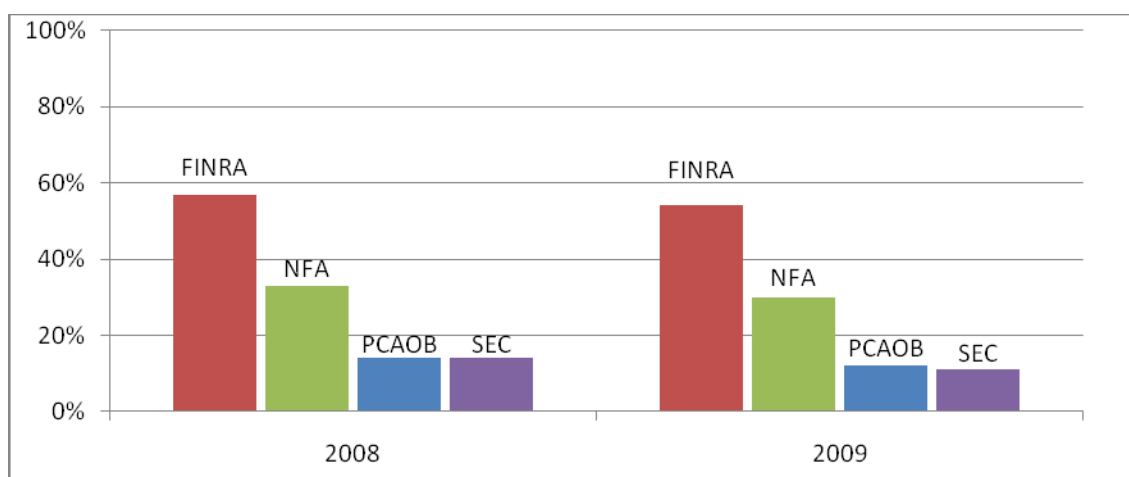
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seeking public comment on whether one or more SROs should be established to prescribe and administer the requirements under the Advisers Act, and whether membership in an SRO should be mandatory. In 1989, the Commission submitted legislation to Congress requesting authority to designate one or more SROs for investment advisers that would have rulemaking, examination and enforcement authority. In 1993, the House of Representatives passed a bill that, among other things, would have amended the Advisers Act to authorize the creation of an examination-only SRO for investment advisers. A similar bill was considered by the Senate but never passed. Most recently, in 2003 the Commission asked for comment on the formation of one or more SROs for registered investment advisers, including whether such an SRO should be limited to conducting examinations. For a discussion of the history of the Commission’s consideration of an investment adviser SRO, *see* Compliance Programs Release at 8-9.

<sup>55</sup> Whereas FINRA and the NFA have examined their member firms more frequently than OCIE has examined registered investment advisers, the frequency of examinations of member firms by the Public Company Accounting Oversight Board (the “PCAOB”) in 2008 (14% of member firms) and 2009 (12% of member firms) was similar to the frequency of examinations of registered investment advisers by OCIE. Comparing OCIE and PCAOB examination data, however, may have limited value because the PCAOB is required to conduct annual examinations of member firms that regularly provide audit reports for more than 100 issuers. This requirement depresses the percentage of member firms examined each year by the PCAOB because examinations of these member firms take longer and require more resources than examinations of other member firms.

FINRA conducted approximately 2,500 routine examinations and approximately 7,900 targeted examinations, and examined 54% of its 5,272 registered broker-dealer firm members. In 2008, the NFA examined 33% of its 727 active CPO and CTA members, and in 2009, the NFA examined 30% of its 656 active CPO and CTA members. OCIE examined 14% of registered investment advisers in 2008 and 11% of registered investment advisers in 2009.<sup>56</sup>

**CHART 12: EXAMINATION FREQUENCY OF FINRA MEMBER FIRMS, NFA ACTIVE CPOs/CTAs, PCAOB MEMBER FIRMS AND REGISTERED INVESTMENT ADVISERS<sup>57</sup>**



Authorizing an SRO for investment advisers is not without difficulties, which have been raised by various industry participants as reasons to seek alternative solutions.<sup>58</sup> The design and

<sup>56</sup> Although the number and frequency of examinations by FINRA and the NFA are informative to the analysis of whether an SRO would increase the frequency of examinations of registered investment advisers, the scope and types of examinations conducted by FINRA and the NFA differ from each other and from those conducted by OCIE. For example, FINRA examines its member firms for compliance with issues unrelated to the provision of personalized advice to clients, such as financial responsibility, market-making and exchange floor activities, underwriting and institutional sales, books and records, and operational issues. *See, e.g.*, Letter from Kevin R. Keller, Chief Executive Officer of the Certified Financial Planner Board of Standards, Inc., Marvin W. Tuttle Jr., Executive Director/CEO, Financial Planning Association, and Ellen Turf, Chief Executive Officer, National Association of Personal Financial Advisors, to Elizabeth M. Murphy, Secretary, SEC, dated August 30, 2010, at 14.

<sup>57</sup> All FINRA examination data include examinations of broker-dealers by both FINRA and the Commission and are based on internal Commission reporting systems and public statements by FINRA executives. NFA examination data are based on information provided to the Staff by the NFA. PCAOB examination data are based on information in PCAOB Annual Reports.

<sup>58</sup> *See, e.g.*, Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC, dated December 16, 2010, at 9 (“December MFA Letter”); Letter from David G. Tittsworth, Executive Director, Investment Adviser Association, to Elizabeth M. Murphy, Secretary, SEC, dated October 19, 2010 (“October IAA Letter”); Letter from Kevin R. Keller, Chief Executive Officer, Certified Financial Planner Board of Standards,



implementation of one or more investment adviser SROs would require resolution of a number of important issues regarding the number, scope of authority, membership, governance, and funding of the SRO or SROs. These issues are complicated by the diversity of the investment adviser industry, strong opposition among investment advisers, investment company and accounting trade associations, state regulators and investor advocates to any SRO, and tensions about the prospect of FINRA, which has expressed an interest in becoming an SRO for investment advisers. In addition, an investment adviser trade association has noted that SROs for investment advisers do not exist in any other major financial jurisdiction, and has raised other potential coordination concerns.<sup>59</sup>

*Number of SROs.* Statutory authority could contemplate multiple SROs or a single, unified SRO for investment advisers. Provisions of the Exchange Act pursuant to which FINRA operates authorize designation of multiple “national securities associations,” but FINRA is the only national securities association that has been registered.<sup>60</sup> Provisions of the Commodity Exchange Act similarly anticipate the possibility of multiple “futures associations,” although only one, the NFA, has been registered.<sup>61</sup> In contrast, provisions of the Sarbanes-Oxley Act of 2002 (“SOX”), under which the PCAOB operates, contemplate a single regulatory organization for public accountants.<sup>62</sup>

The diversity of the investment advisory industry, ranging from small, locally-operated financial planning firms to money managers that are part of global financial institutions, suggests the potential for multiple SROs, each of which could oversee a different type or types of investment advisers as long as each adviser is a member of one SRO.<sup>63</sup> Thus, for example, financial planners could be members of a financial planning SRO, while money managers could be members of an asset manager SRO, the focus and expertise of which would significantly

Inc., Marvin W. Tuttle Jr., Executive Director/CEO, Financial Planning Association, and Ellen Turf, Chief Executive Officer, National Association of Personal Financial Advisors, to Elizabeth M. Murphy, Secretary, SEC, dated December 16, 2010; AICPA Letter; Letter from John D. Rogers, President and Chief Executive Officer, CFA Institute, to Elizabeth M. Murphy, Secretary, SEC, dated December 3, 2010; Letter from David Massey, President, North American Securities Administrators Association, Inc., to Jennifer B. McHugh, Acting Director, Division of Investment Management, SEC, dated December 13, 2010.

<sup>59</sup> See Letter from Mary Richardson, Director of Regulatory & Tax Department, Alternative Investment Management Association, to SEC, dated January 12, 2011.

<sup>60</sup> Section 15A of the Exchange Act authorizes the Commission to register one or more national securities associations to regulate the activities of broker-dealers.

<sup>61</sup> Section 17 of the Commodity Exchange Act authorizes the Commodity Futures Trading Commission to register one or more futures associations.

<sup>62</sup> See Section 101 of SOX.

<sup>63</sup> See December MFA Letter at 9.

differ.<sup>64</sup>

Multiple SROs could focus expertise and better accommodate industry diversity, but also could more likely lead to SRO “capture” by the discrete industry group from which SRO staff are drawn and to which they may return after their service. Even a single SRO, because it is not only funded by the industry it oversees, but also may include industry representatives in its governance structure or otherwise have a different relationship with industry than an independent government regulatory agency, could possibly have enhanced susceptibility to industry capture. Another concern is the possibility that an SRO, which is likely to possess not only substantial industry expertise, but also unique data and perspectives, might seek to sell services to its members while functioning as their regulator.

Multiple SROs also could lead to regulatory arbitrage, as SROs seek to attract members by offering a more accommodating regulatory and oversight program or by charging lower fees leading to inadequate funding for regulatory programs.<sup>65</sup> Multiple SROs also could be more costly than a single SRO because they would be less likely than a single SRO to achieve economies of scale.<sup>66</sup> Moreover, different SROs would likely, over time, develop different approaches to applying the Advisers Act and their own rules to similar activities. Prevention of these consequences would require vigorous oversight by the Commission. Adequate oversight would require Commission resources, and multiple SROs would require a corresponding greater amount of resources.

For the reasons discussed above, therefore, designation of a single SRO for advisers, rather than multiple SROs, could be advantageous. On the other hand, a single SRO other than FINRA would result in dual registrants being subject to multiple SROs (a broker-dealer SRO and an investment adviser SRO), a result that is likely to be resisted by broker-dealers and one that could maintain the current inefficiencies that may exist which are associated with separate oversight of broker-dealers and advisers. Thus, determination to designate a single SRO to achieve economies of scale and efficiencies could have significant implications on the outcome of the SRO selection process.

*Scope of Authority.* Congress could provide for an SRO with broad or more limited

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<sup>64</sup> Two other sections of the Dodd-Frank Act require studies of the oversight of discrete sectors of the investment advisory industry. Section 416 requires the U.S. Government Accountability Office (the “GAO”) to conduct a study of the feasibility of forming an SRO to oversee “private funds.” The Staff understands that the GAO interprets this provision to require a study of the feasibility of forming an SRO for “private fund advisers.” Section 919C requires the U.S. Comptroller General to conduct a study of, among other things, the state and federal oversight structure and regulations for financial planners.

<sup>65</sup> See Concept Release Concerning Self Regulation, Release No. 34–50700 (Dec. 8, 2004), at 10 (“Concept Release”).

<sup>66</sup> See December MFA Letter at 10.

authority. FINRA, the NFA and the PCAOB have broad authority to adopt business and conduct rules, including (in the case of FINRA) minimum education or experience standards for broker-dealers and their supervised persons, as well as to examine and enforce their members' compliance with them. The MSRB, in contrast, historically had only authority to adopt rules, which the Commission and FINRA have responsibility to enforce.<sup>67</sup> Congress considered authorizing the creation of a limited, examination-only investment adviser SRO in 1993.<sup>68</sup>

Still Congress could opt for an intermediate approach and grant an SRO limited examination authority over investment advisers, while maintaining the Commission as the sole holder of authority to develop regulatory policy under the Advisers Act. Such an SRO also could have limited rulemaking authority to address matters collateral to the exercise of examination authority (such as authority to require maintenance of records).

*Membership.* For the SRO approach to be successful, membership in at least one investment adviser SRO would need to be mandatory for investment advisers in order to permit investment advisers to be subject to effective SRO examination.<sup>69</sup> Membership could be required of only SEC-registered advisers or it could extend to state-registered advisers. Many of the state securities regulators, which as a result of the Dodd-Frank Act will acquire an expanded pool of investment advisers over which they have primary responsibility, may lack sufficient resources to oversee investment advisers. However, it would be difficult for the Commission to oversee an SRO that enforced different state regulatory requirements.

Certain types of advisers could be excluded from those that must join an SRO. For example, advisers to registered investment companies that are subject to examination under the 1940 Act could be excluded.<sup>70</sup> Or specific SRO exclusions could be provided for investment

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<sup>67</sup> *But see* section 975 of the Dodd-Frank Act (providing that the MSRB can provide guidance and assistance in the enforcement of, and examination for, compliance with MSRB rules to the SEC, FINRA or the appropriate bank regulators). Prior to the enactment of the Dodd-Frank Act, the MSRB had no examination or enforcement authority. Bank regulators also enforce MSRB rules with respect to banking organizations.

<sup>68</sup> *See supra* note 54.

<sup>69</sup> The Commission would have to exercise direct oversight of advisers that declined to become members of an SRO. Before requiring mandatory membership in the NASD, the Exchange Act gave broker-dealers the option of either joining the NASD or being subject to direct regulation by the Commission. *See* Securities Act Amendments of 1964. Pub. L. No. 88-467, 78 Stat. 565 (1964). This option was terminated in 1982 because of a concern that non-member broker-dealers were not being adequately regulated.

<sup>70</sup> Legislation submitted by the Commission to Congress in 1989 that requested the authority to designate one or more SROs for investment advisers provided that registered investment advisers whose clients were solely registered investment companies did not have to join the SRO. *See* S. 1410 and H.R. 3054, 101st Cong. (1989).

advisers to private funds (such as hedge funds) or advisers that do not have retail clients.<sup>71</sup> The Staff estimates that a broad exclusion from membership in an SRO for investment advisers without retail clients would leave the Commission with direct regulatory responsibility for approximately 34% of investment adviser registrants.<sup>72</sup> Crafting exclusions for certain types of investment advisers could be difficult in practice because, as discussed above, many investment advisers have diverse client bases and business lines. Moreover, exclusions could provide opportunities for regulatory arbitrage.

*Governance.* The governance of any investment adviser SRO is critical because governance is the primary mechanism through which an SRO can manage the conflicts of interest that exist when an organization regulates its own members that also compete with each other (and, if the case, engage in commercial activities with each other).<sup>73</sup> Given the diversity in the investment advisory industry, an appropriate governance structure is important to prevent one business model from dominating the SRO or the SRO from providing a competitive advantage to particular business models.

Differences in current governance structures of existing SROs provide Congress (or, if Congress gives broad authority to the Commission, the Commission) with alternatives to consider when structuring the governance of one or more investment adviser SROs. Historically, SROs were governed by boards composed of industry representatives who brought to the SRO years of industry expertise that informed its activities and facilitated “buy in” from other industry members. One SRO, the NFA, is governed by a board comprised of a majority of industry representatives.<sup>74</sup> However, in recent years other SROs have evolved away from such a self-governance model, largely to address conflicts of interest. Both FINRA’s and the MSRB’s boards have a majority of directors not associated with the industries they regulate.<sup>75</sup>

Congress recently considered the appropriate structure of an SRO’s governance, and has come to different conclusions in each circumstance. In 2002, Congress specifically provided for Commission appointment of each of the five members of the PCAOB.<sup>76</sup> In doing so, Congress rejected the governance of existing SRO models because it viewed Commission-appointed board

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<sup>71</sup> See Letter from Cynthia M. Clarke, General Counsel, Wellington Management Company, LLP, to Elizabeth M. Murphy, Secretary, SEC, dated November 12, 2010, at 2-3.

<sup>72</sup> This estimate is as of July 21, 2011, the effective date of the Dodd-Frank Act’s amendments to the registration provisions of the Advisers Act.

<sup>73</sup> See Concept Release at 5. Vigorous Commission oversight also would be necessary.

<sup>74</sup> See NFA Articles of Incorporation, Article VII. The NFA is governed by a 25 member board, which currently includes seven public representatives. The number of public representatives is scheduled to be increased to ten representatives at the NFA’s 2011 annual board meeting.

<sup>75</sup> See FINRA Bylaws, Article VII.4(A); section 975 of the Dodd-Frank Act; MSRB Rule A-3.

<sup>76</sup> See section 101 of SOX.

members as a more effective means of addressing conflicts of interest.<sup>77</sup> More recently, in the Dodd-Frank Act, Congress reconstituted the MSRB's board to consist of a majority of public members, but did not require that board members be appointed by the Commission.<sup>78</sup>

Determination of an appropriate governance structure could have implications for the feasibility of other features of an investment adviser SRO. Requiring a Commission-appointed board also could have implications for whether FINRA could serve as an investment adviser SRO without changes to the Exchange Act to provide a similar governance structure for national securities associations. In this regard, and as noted above, investment advisers have expressed concern that designating FINRA as the investment adviser SRO would have adverse competitive consequences to them because of FINRA's "bias" towards the broker-dealer business model.<sup>79</sup> Hedge fund managers view broker-dealers as service providers with which they have an arm's length contractual relationship and are concerned about conflicts they believe would be present if the SRO for the "sell side" were to function as the SRO for the "buy side."<sup>80</sup>

*Funding.* Operation of an investment adviser SRO would involve substantial costs that would be funded largely by membership fees paid by investment advisers, which may be resistant to the fees.<sup>81</sup> Congress could assure the availability of adequate funding by requiring that the SRO meet broad functional requirements such as those set out in the Exchange Act and

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<sup>77</sup> See S. Rep. No. 107-205 (2002), at 6.

<sup>78</sup> See section 975 of the Dodd-Frank Act.

<sup>79</sup> See October IAA Letter at 8; AICPA Letter at 2.

<sup>80</sup> See December MFA Letter at 8-9. FINRA has stated that if it were to seek authorization as an investment adviser SRO, it would create a separate affiliate, with its own board of governors, to ensure that the SRO has a governance structure and establishes programs appropriate to the adviser industry. See Letter from Richard G. Ketchum, Chairman & CEO, FINRA, to Elizabeth M. Murphy, Secretary, SEC, dated November 2, 2010, at 3. This approach is not utilized by any existing SRO of which the Staff is aware and, therefore, its effectiveness in addressing conflicts associated with competing business models is difficult to evaluate. Alternatively, legislation could require that the industry seats on FINRA's board be allocated proportionately among investment advisers and broker-dealers.

<sup>81</sup> See, e.g., October IAA Letter at 8 ("There is no evidence that an SRO for advisers would be cost effective for investors or the SEC. An SRO would impose duplicative regulation as well as significant membership and other fees on investment advisers, which may be passed on to advisory clients."); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated October 26, 2010, at 2 ("[W]e do not believe that the cost of developing an adviser SRO (or building the capacity in an existing SRO, such as FINRA), much of which would likely be borne by advisers (in the form of member fees) and likely passed on to their clients, is an efficient use of resources."); September MFA Letter at 6 ("We are also concerned, given the significant variation in business models among investment advisers, from small firms that advise private funds to the largest global banks that advise retail clients, that a single SRO for investment advisers would be ill-equipped to handle the diversity of issues without being cost prohibitive.").

which FINRA must meet.<sup>82</sup> Alternatively, Congress could require that the SRO's budget be approved annually by the Commission, as the Commission is required to do for the PCAOB's budget.<sup>83</sup>

### **C. Authorize FINRA to examine dual registrants for compliance with the Advisers Act**

A third, albeit less comprehensive, approach could be to amend the Exchange Act so that it expressly permits FINRA to examine all of its members that are also registered as investment advisers for compliance with the Advisers Act.<sup>84</sup> Currently, the Exchange Act provides FINRA with authority to enforce its members' compliance with the Exchange Act (and rules the Commission has adopted under that Act), but does not provide it with express authority to enforce compliance with the Advisers Act.<sup>85</sup> Thus, OCIE staff conducts examinations of dual registrants for compliance with the Advisers Act in addition to, and separate from, FINRA's examinations.<sup>86</sup>

While only about five percent of investment advisers registered under the Advisers Act are broker-dealers and thus members of FINRA, almost all of the largest retail broker-dealers are also registered as investment advisers. These dual registrants have a substantial portion of retail advisory clients and employ a significant number of investment adviser representatives. Authorization of FINRA to enforce the Advisers Act would free existing Commission resources spent examining dual registrants to be re-directed to other investment advisers. Moreover, it would partially address the inefficiencies that result from subjecting a dual registrant to two separate examinations, one by FINRA and the other by OCIE. Finally, it would permit a single regulator (FINRA, subject to existing SEC oversight), having obtained a more holistic view of dual registrants' client activities and compliance environment, to conduct a more effective examination of a dual registrant. Such examinations also could be more cost efficient.

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<sup>82</sup> The Exchange Act grants FINRA broad discretion when determining its funding level, subject to the requirement that FINRA be "so organized and [have] the capacity to be able to carry out the purposes" of the Exchange Act and "to comply, and ... to enforce compliance by its members, and persons associated with its members, with the provisions" of the Exchange Act. *See* section 15A(b)(2) of the Exchange Act. Larger member firms of FINRA pay proportionately greater fees than smaller member firms. *See* section 15A(b)(5) of the Exchange Act.

<sup>83</sup> *See* section 109 of SOX.

<sup>84</sup> This could be accomplished by amending section 19(g) of the Exchange Act to explicitly provide a national securities association with the authority to enforce compliance with the "securities laws" as defined under the Exchange Act, which would include, among other laws, the Advisers Act. Section 914(a)(C) of the Dodd-Frank Act requires the Commission to consider in the Study "current and potential approaches to examining" dual registrants.

<sup>85</sup> *See* section 19(g) of the Exchange Act.

<sup>86</sup> As discussed above, the Commission has instituted several measures to coordinate its own broker-dealer and investment adviser examination programs.

FINRA has suggested that it be given authority to act as the SRO not only for its members that are investment advisers, but also for advisers that are affiliates of its members.<sup>87</sup> Such an approach would preclude a broker-dealer from reorganizing its advisory services to escape FINRA oversight. But it would also broadly extend the jurisdiction of FINRA to large money managers, many of which have affiliated broker-dealers to, for example, distribute interests in mutual funds or hedge funds they manage, but otherwise have nothing to do with advisory services. One approach to addressing this concern would be to limit FINRA's jurisdiction to affiliates that provide advisory services to clients in connection with brokerage services also provided to them.

As discussed above, authorizing FINRA to examine all operations of dual registrants is not without drawbacks. The Commission staff may lose experience examining these large retail advisers, and may not gain important information about their activities. Furthermore, there would be a risk that, over time, different and inconsistent approaches to applying the Advisers Act to dual registrants and other advisers could develop. The Commission would have to exercise vigilant oversight to prevent this from occurring.

## **V. Staff recommendation**

The number and frequency of examinations of registered investment advisers have declined over the past six years. This can be explained, in part, by substantial growth in the number of registered investment advisers and a decrease in the number of OCIE staff. The Staff expects that the frequency of examinations of registered investment advisers could increase following the effective date of Title IV as a result of a substantial decrease in the number of registered investment advisers, many of whom will transition from federal to state registration. The amount of any potential increase in examinations, however, may be offset by the need to divert examination resources to fulfill new examination obligations that the Commission was given by the Dodd-Frank Act.

Although the number of registered investment advisers is expected to decrease substantially upon the enactment of Title IV, the Staff expects the number of registered investment advisers and the assets managed by them to grow in subsequent years. The rate of growth, however, is uncertain. While the Commission's resources and the number of OCIE staff may increase in the next several years, the number of OCIE staff is unlikely to keep pace with the growth of registered investment advisers. Based on these uncertainties, the Commission faces significant capacity challenges in examining registered investment advisers.

Thus, the Staff believes that the Commission likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with

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<sup>87</sup> As discussed in Section I of the Study, as of October 1, 2010, there were 2,636 registered investment advisers that had an affiliated broker-dealer. That represents 22% of all registered investment advisers.

adequate frequency. The Commission's examination program requires a source of funding that is adequate to permit the Commission to meet the new challenges it faces and sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers.

The Staff recommends that Congress consider the following three approaches to strengthen the Commission's investment adviser examination program:

- (1) Authorize the Commission to impose user fees on SEC-registered investment advisers to fund their examinations by OCIE;
- (2) Authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or
- (3) Authorize FINRA to examine dual registrants for compliance with the Advisers Act.