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U.S. House Panel Hears Divergent Opinions on SRO Oversight of Investment Advisers

Fund managers and other investment advisers should be aware that Congress is now considering legislation that would significantly alter regulation of the nation's registered investment advisers.

A key House subcommittee last week heard widely divergent views on the proposed legislation, entitled the "Investment Adviser Oversight Act of 2011," with certain regulators supporting the changes and industry associations opposing it. The testimony occurred before the House Capital Markets and Government Sponsored Enterprises Subcommittee of the House Committee on Financial Services.

The draft legislation would create a "registered national investment adviser association," essentially a self-regulatory organization (SRO) for investment advisers. Subject to certain exemptions, all investment advisers would be required to become a member of the association. This compulsory membership would apply to both SEC and state registered investment advisers.

The draft does not specify whether a new SRO should be created, or whether an existing SRO like the Financial Industry Regulatory Authority (FINRA) should take on the function of overseeing investment advisers. FINRA itself is both advocating passage of the legislation, and suggesting that it be the SRO for investment advisers.

At the federal level, regulation of investment advisers falls under the Investment Advisers Act of 1940 (the Act). Currently, investment advisers are registered with, and regulated by, either the SEC or a state, depending on the amount of assets they have under management, whether they serve as an investment adviser to a public (mutual) fund, or other specified factors. The SEC or state regulator is responsible for conducting examinations and bringing any enforcement actions against investment advisers subject to their jurisdiction.

A recent SEC study (mandated by the Dodd-Frank Act) noted that "the average [SEC-registered] adviser could expect to be examined less than once every 11 years." In 2010, the SEC conducted only 1,083 examinations of more than 11,000 investment advisers. The SEC has argued that it is becoming increasingly difficult for the agency to adequately oversee the investment adviser industry, due to a lack of resources.

The need for additional investment adviser oversight gained significant momentum in the aftermath of the Madoff and Stanford scandals, both of which involved, in part, failures to thoroughly examine investment advisers, including the advisor portion of entities “dually registered” as broker-dealers and investment advisers. In light of these and other concerns, FINRA has sought, for some time, to extend its jurisdiction to include certain classes of investment advisers. FINRA currently has jurisdiction over approximately 4,500 broker-dealers nationwide.

The House Panel heard testimony from, among others, FINRA’s CEO, Richard Ketchum. Mr. Ketchum, in advocating that FINRA be given jurisdiction over investment advisers, noted that in recent times the lines between broker-dealers and investment advisers have become increasingly blurry. He pointed out that there are approximately 2,500 broker-dealers that have some affiliation with an investment adviser, and that customers of those firms would have difficulty identifying which service they were receiving when they purchased a product from their adviser.

In stark contrast to the lack of regular examinations of investment advisers, he noted that 55% of broker-dealers are examined each year by FINRA or the SEC. Mr. Ketchum agreed with the concept from the SEC study that certain classes of investment advisers, such as advisers to investment companies subject to examination under the Investment Company Act of 1940, could be exempted from SRO registration. In his view, the appropriate focus of any adviser SRO should be on the retail side of the investment business.

Other witnesses supported, to varying degrees, Mr. Ketchum’s testimony that FINRA is uniquely positioned to effectively and efficiently regulate investment advisers under an SRO model.

However, other witnesses, representing a variety of constituents, testified in vigorous opposition to the creation of any SRO for investment advisers, and specifically opposed the concept of FINRA regulating investment advisory activities. Leading the opposition was David Tittsworth, the Executive Director for the Investment Adviser Association. Mr. Tittsworth questioned whether any SRO could adequately replace the SEC as an investment adviser regulator, given the SEC’s 70 years of experience with the Act, and argued that there would be significant start-up costs for any SRO. He also suggested that creation of a new SRO would create unnecessary duplication of regulations, because the advisers would still be subjected to SEC or a state regulation.

In addition to questioning the need for any new SRO, Mr. Tittsworth also expressed deep misgivings about designating FINRA as the SRO for investment advisers. FINRA, in his view, is not suitable because it is not accountable to the Congress or the public, is not required to engage in any cost-benefit analysis when engaging in rule-making and, based on certain recent studies, is not even accountable to its own current membership. Rather than create an SRO for advisers, Mr. Tittsworth instead advocated imposition of a user fee on investment advisers, similar to the concept used in the banking industry, to fund an adequate SEC examination program.

A number of witnesses provided similar testimony in opposition to the creation of any SRO for investment advisers.

The proposed legislation was introduced to the Subcommittee by House Financial Services Committee Chairman Spencer Bachus (R-Alabama). It can be found at http://financialservices.house.gov/UploadedFiles/BACHUS_017_xml.pdf. For his part, Chairman Bachus

opined that creating one or more SROs devoted to investment adviser examinations and oversight is the most efficient and effective way to ensure proper regulation of the investment advisory industry.

It appears that there are a number of members of the House Financial Services Committee who may be favorably disposed to the concept of an SRO for investment advisors. The full Committee held additional hearings on September 15, 2011, on issues relating to improving and enhancing the effectiveness of the SEC, which touched on the SEC's oversight of investment advisers. These hearings, in combination with the SRO hearings on September 13, could lead to Congress considering legislation on investment adviser regulation some time in the fall of 2011.

For questions or further information, please speak to your Bryan Cave contact, a member of our [White Collar Defense and Investigations](#) or [Securities Litigation and Enforcement](#) groups, or the authors of this client alert:

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