**Testimony of Steven D. Irwin**

**Pennsylvania Securities Commissioner and**

**Chairman, Federal Legislation Committee**

**North American Securities Administrators Association, Inc.**

**Before the**

**House Subcommittee on Capital Markets and Government Sponsored Enterprises**

**"Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight"**

**September 13, 2011**

Good morning Chairman Garrett, Ranking Member Waters, and members of the Committee, I'm Steve Irwin, Commissioner of the Pennsylvania Securities Commission and Chairman of the Federal Legislative Committee of the North American Securities Administrators Association, Inc. ("NASAA"), the association of state and provincial regulators. I am honored to be here today to discuss the appropriate regulatory oversight of broker-dealers and legislative proposals to improve investment adviser oversight.

State securities regulators have protected Main Street investors from fraud for the past 100 years, longer than any other securities regulator. State securities regulators have continued, more than any other regulators, to focus on protecting retail investors. Our primary goal is to act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

The securities administrators in your states are responsible for enforcing state securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents. Ten of my colleagues are appointed by state Secretaries of State, five fall under the jurisdiction of their states' Attorneys General, some are appointed by their Governors and Cabinet officials, and others, like me, work for independent commissions or boards. Many call us "local cops on the securities beat." In fact, in the last two weeks NASAA released its annual list of the top ten most prevalent scams and frauds in the U.S. We announced that con artists are even using social media sites as a means to defraud investors. I think of my state colleagues at NASAA as a national network of local crime fighters working to protect investors.

Securities regulation is a complementary regime of both state and federal securities laws, and the states work closely together to uncover and prosecute securities law violators.

## The Distinguished Enforcement Record of the States

States have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious penalties for securities-related crimes.

In 2010 alone, state securities regulators conducted more than 7,000 investigations, leading to nearly 3,500 enforcement actions, including more than 1,100 criminal actions. Moreover, in 2010, more than 3,200 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended or conditioned due to state action.

The enforcement actions performed by state securities regulators last year represent a 51 percent increase over the number of investigations reported for the previous year; however, this impressive record builds upon an already strong foundation of regulation at the state level. Indeed, since 2004, state securities regulators have conducted over 14,100 enforcement actions, and secured convictions for securities laws violators resulting in more than 5,600 years in prison.

Traditionally, state securities regulators have pursued perpetrators at the local level who are trying to defraud "mom and pop" investors in your states, leaving the SEC to focus on larger, more complex fraudulent activities involving the securities market at a national level. States have investigated violations on a national level such as the successful state effort to expose and force Wall Street to correct rampant conflicts of interest among stock analysts. We led all regulators on late trading and market timing in mutual funds. And state securities regulators continue to lead the nationwide effort to address problems related to the offer and sale of auction rate securities, an effort that has resulted in the largest return of funds to investors in history; more than $61 billion.

As regulators, states are guided by the principle that every investor deserves protection and an even break, and has the right to not to be cheated or lied to.

Let me now turn to the first of the several topics of today's hearing.

## Section 914: Enhancing the Oversight of SEC Registered Investment Advisers

One of the purposes of the Subcommittee's hearing today is to review the Section 914 study and consider steps to improve the oversight of federally regulated SEC-registered investment advisers. As the Subcommittee is aware, Section 914 of the Dodd-Frank Act directed the SEC to study various options designed to improve the agency's oversight of federally regulated investment advisers.

The SEC produced a comprehensive report. The staff made three recommendations to improve oversight of federally regulated investment advisers: 1) authorize the SEC to impose user-fees on SEC-registered investment advisers to fund their examinations; 2) authorize one or more self regulatory organizations (SROs) to examine, subject to SEC oversight, all SEC-registered investment advisers; and 3) authorize FINRA to examine dual broker-dealer and investment adviser registrants for compliance with the Investment Adviser's Act. It is important to note that the SEC report did not consider, or make recommendations regarding, state regulated investment advisers.

## State Regulatory Authority Must be Preserved

Currently, the states are the sole regulators of investment advisers with less than $25,000,000 in assets under management, which upon implementation of Dodd-Frank in mid-2012, will increase to $100,000,000.

## Oversight of Investment Advisers Should Remain a Government Responsibility

For reasons that I will detail in my testimony, NASAA vigorously opposes creation of a self regulatory organization, or "SRO," for state regulated investment advisers and their associated persons. Moreover, NASAA reiterates its significant and longstanding concerns regarding any effort to establish a self regulatory organization for investment advisers.

NASAA's primary position regarding investment adviser regulation is that it should continue to be the responsibility of state and federal governments, and that these regulators must adequately carry out their responsibilities. When it comes to regulation of investment advisers, government regulators bring to the table decades of experience unmatched by any entity in existence. We see little benefit in constructing a new layer of bureaucracy, with its incumbent expense. If the goal is strengthening investor protection through improvements to the oversight of SEC regulated investment advisers, then the shortest distance to the goal is to ensure that federal regulators are adequately funded and have the resources to properly oversee investment advisers for the protection of main-street investors. Most importantly, government regulators are answerable to our constituents, and not to a Board of Directors.

Given our experience in working directly with various self regulatory organizations, there are numerous issues that must be addressed and resolved before a SRO for SEC-registered investment advisers should even be considered.

NASAA urges Congress not to enact an SRO model for investment advisers; however, in light of the Chairman's discussion draft, which would authorize the SEC to establish a SRO for advisers, NASAA offers the following comments.

## Comments on the Chairman's Draft Legislation

First and foremost, it appears that the Chairman's draft would nationalize the regulation of small and mid-sized investment advisers. This would be a significant mistake that does not benefit mainstream investors, nor promote small business interests.

We appreciate the Chairman's desire to enhance regulation for investment advisers, but as we read the Chairman's discussion draft, it would require the small and mid-sized firms to register with the new investment adviser SRO. Small and mid-size investment advisers are primarily located in one state and shifting the regulation of these advisers to a SRO headquartered in Washington, DC would increase costs without substantially enhancing investor protection. This would subject these small businesses to duplicative regulation and add new and unnecessary costs. The members of the association pay the costs of regulation, and small and mid-size advisers should not pay unnecessary fees.

Securities regulators are the local "cops on the beat" and best positioned to be the primary regulator for these small and midsize firms. We are more likely to be visiting the offices in the small towns and cities across America, than the SEC or a large organization headquartered in New York or Washington, DC. Congress recognized this fact when it restored state authority last year over investment advisers with up to $100,000,000 in assets under management.

Let me further address additional key areas of concern with the present SRO structure.

- **Address Conflicts of Interest and Industry Capture**

The existing securities industry SRO model –as typified by FINRA - is replete with conflicts of interest. Members of the industry serve on the SRO's board and occupy other positions of prominence such as serving on various advisory committees.

Even where there is an independent Board of Directors, SROs remain organizations built on the premise of self-rule and are, as a matter of first principle, accountable to their members, not the investing public. Any SRO that depends on its members as its primary funding source faces a heightened susceptibility to industry capture. If FINRA denies an application, or expels a member in an enforcement matter, FINRA loses money. The Section 914 Report made this very observation when it noted that a SRO funded by its members and containing "industry representatives" in its governance structure could have an enhanced susceptibility to industry capture.

No matter how many safeguards are instituted, a SRO has substantial and inherent conflicts of interest that governmental regulators do not. This is particularly true where industry and investor interests' conflict, as in the case of mandatory pre-dispute arbitration clauses and the disclosure or expungement of prior settlements, judgments and investor claims.

As a membership organization, FINRA answers firstly to its members and not to the investing public. Regardless of safeguards that may be put in place, the conflicts will still exist.

- **Remove Barriers Inhibiting Collaboration Between SROs and Government Regulators**

The sharing of information among state and federal regulators is essential to ensuring that investors are protected. Collaboration and cooperation are required for an effective regulatory system. The SRO model brings with it a barrier to collaboration and cooperation in the form of the “State-Actor Doctrine”. The term “State-Actor Doctrine’ is often used interchangeably with “Government-Actor Doctrine.”

The State-Actor doctrine considers whether the conduct or activities of a private party can be considered a “government action,” and thus force private entities to comply with the Constitution’s due process provision. Because SRO’s are private corporations that do not have subpoena power, member firms are required to “voluntarily” cooperate with SRO investigators and provide testimony and documents to a SRO. This has given rise to claims by FINRA that when it cooperates with governmental regulators, by providing information, testimony, or documents related to its members, it is acting as a quasi-governmental actor, or “state-actor.” FINRA uses the “state-actor doctrine” as a basis for non-cooperation with state securities regulators, and consistently cites its desire to avoid being labeled a “state-actor” as an excuse to refuse state regulator’s requests for investigatory cooperation.

Unfortunately, to avoid a classification as a “government actor,” FINRA has restricted the release of information to the government and has affirmatively taken the position that it is prohibited from cooperation with governmental regulators, including the governmental entity responsible for its oversight. As such, it has become increasingly difficult for the governmental regulators to meaningfully control oversight or investigations over registrants subject to the current SRO model.

NASAA is not alone in its recognition of the need for improved collaboration between SRO’s and government regulators, or in its contention that the synergy necessary to such collaboration has in recent years broken down.

Indeed, in its recent report mandated by Section 967 of the Dodd-Frank Act, the Boston Consulting Group noted that the relationship between SRO’s and government securities regulators has “become strained,” and that *“SROs should…allow regulators access to all*

*relevant data without making individual requests. This capability would streamline investigations and enforcements relating to broker-dealers."*[1]

Congress should refrain from considering expansion of the SRO model until such time as FINRA correctly interprets the state actor issue, or until the issue is adequately addressed by legislation. Settling the question of whether or not FINRA or any other SRO is or is not a "state-actor" is of vital importance to effective regulation.

FINRA's interpretation of the "state actor" doctrine and its legal strategy, however, have had profound practical consequences that Congress must appreciate. Indeed, FINRA's extreme sensitivity to being labeled a state-actor has in some instances precluded it from engaging in basic and vital types of regulatory coordination and information-sharing with state regulators. NASAA has recently undertaken an effort with FINRA in an effort to remediate this issue, however, the underlying "state-actor" issue remains problematic.

FINRA cannot legitimately claim that the mere sharing of information makes it a state actor. By doing so, FINRA is creating an unnecessary regulatory inefficiency that results in a heavy burden on investor protection.

- **Improve Transparency of SROs**

Collaboration issues aside, the regulatory work performed by SROs lacks transparency. SROs are not subject to the Freedom of Information Act (FOIA) or other similar public records requirements, as are state securities regulators and the SEC. Even where there is public disclosure by SROs regarding members, as in the case of *BrokerCheck*, the SRO has placed limitations and filters on regulatory records that far exceed FOIA provisions, and this results in less public disclosure of information than state securities regulators routinely make publically available. The end result is that important information is withheld by the SRO from the investing public.

Without greater transparency, investors cannot obtain the information they need to make informed decisions. In considering the transparency of SRO's, the Boston Consulting Group echoed this view, stating that *"regulators can benefit from better visibility into the surveillance systems and activities conducted by SROs. Bolstering regulators ability to oversee surveillance systems should improve the quality of audits and inspections conducted on SRO surveillance system."*[2]

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[1] The Boston Consulting Group. "U.S. Securities and Exchange Commission Organizational Study and Reform." p. 65. March 10, 2010. Available at http://www.sec.gov/news/studies/2011/967study.pdf
[2] The Boston Consulting Group. SEC Study. p. 238.

## ■ Enhance Accountability

Time and experience have demonstrated that SROs simply cannot match the accountability of government regulators, nor the proximity to and familiarity of state regulators with the investment advisers when considering investor protection and regulatory thoroughness.

The challenge of ensuring accountability of a SRO is linked to the question of whether a SRO is a "state actor." If a SRO's rules are viewed as equivalent to federal securities regulations by not being subject to oversight from state securities regulators, they will displace state laws and rules.

States are understandably sensitive to the prospect of federal preemption. The prospect of federal preemption occurring at the whim of a *private corporation* such as FINRA, acting pursuant to its authority as a federally designated SRO, is, for obvious reasons, contrary to the public interest and to basic tenets of democratic society.

In its analysis, the Boston Consulting Group was forceful and direct in its call for improving SRO accountability, stating that, in view of *"the important role SROs play in the governance of securities markets today, it is critical that the SEC maintain a robust level of oversight over their regulatory operations."*[3] The study went on to say that *"the SEC should develop careful guidelines to SROs for overseeing investment advisers and ensure that those guidelines are followed meticulously."*[4]

Notably, the BCG report placed particular emphasis on the need for more accountability in the relationship between the government and the largest SRO – FINRA. Citing FINRA's ongoing efforts *"to further expand the scope of its regulatory activities,"* the BCG report stated flatly that *"the current level of oversight over FINRA should be enhanced."*[5]

In summary, Investment adviser regulation is a governmental function that should not be delegated to a SRO. Even if Congress adopts a SRO model, state securities regulators and the SEC must be maintained as the primary regulators of investment advisers. FINRA should be answerable to the appropriate government regulators, not the other way around, as both a legal matter and as a matter of fact.

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[3] Id. at 237
[4] Id. at 151
[5] Id. at 135

## Section 913: Fiduciary Duty

The second purpose of the subcommittee's hearing today is to consider the question of whether the SEC should utilize the authority provided by the Dodd-Frank Act to promulgate rules that would apply the same duty of care to broker-dealers as to investment advisers.

My NASAA colleagues and I believe that financial professionals who provide investment advice ought to be held to the fiduciary duty currently applicable to investment advisers under the Investment Advisers Act of 1940. We are not alone in this belief. In a 2010 survey of investors, 97 percent of investors said that financial professionals who provide investment advice should put the investor's interest first and disclose upfront any fees, commissions or conflicts of interest that may influence that advice.[6]

The arguments against one fiduciary standard ring hollow. These arguments focus on costs, but the focus should be on what is best for investors.

Any increase in compliance costs, which we believe would be minimal, unless a SRO is imposed into the mix, will be greatly outweighed by the direct benefits to investors. Investors who seek and receive advice about securities expect their interests to come first, and they deserve to have their interests come first, not the interests of brokers, since it is the investors money, and not brokers' money.

For example, the strongest opposition to the fiduciary duty standard has come from insurance agents, who receive a full up-front commission for every variable annuity sale. Expensive variable annuities, for example, would be a lot harder to sell if agents were required to disclose their high commissions upfront. Broker-dealers who provide investment advice should be required to disclose similar conflicts of interest -- for example, when they recommend a high-cost product that generates greater commissions for the salesman when a low-cost product with a smaller commission would serve the investor better or just as well.

### The §913 Report Got it Right; Now the Commission Should Act

[6] See "Survey: Vast Majority of U.S. Investors Support Clear "Fiduciary Standard' for Financial Professionals; Widespread Confusion Seen Linked to Current SEC Rules." The research was commissioned by a coalition including AARP, NASAA, and other financial planning professional trade associations, and was submitted to SEC Chairman Shapiro on September 15, 2011. Available at http://www.sec.gov/comments/4-606/4606-2748.pdf

In January, acting under Dodd-Frank §913(g), the Securities and Exchange Commission issued a report on the harmonization of the duty of care required for broker-dealers and investment advisers who provide investment advice to retail customers.

NASAA was very pleased to see the SEC report recommend a "uniform fiduciary standard" for broker-dealers and investment advisers. Specifically, the SEC study recommended rules that would provide for:

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.[7]

The investor has spoken, and the facts have spoken. State securities regulators now encourage the SEC to do the right thing and apply the fiduciary duty of the Investment Advisers Act to those who provide investment advice about securities.

State securities regulators have 100 years of experience and expertise to contribute to a cohesive regulatory system, and we welcome the opportunity to work with other regulators to achieve our common investor protection goals.

## The Dodd-Frank Act and the Investment Adviser Switch

As the Committee is aware, Congress recognized the distinguished record of the states in investment adviser oversight when it enacted Section 410 of Dodd-Frank Act, by partially restoring state authority previously removed by Congress in 1996 over mid-sized investment advisers with $25 million to $100 million in assets under management.[8] By the time this provision takes effect in mid-2012, state securities regulators will register and regulate approximately 75% of all registered investment adviser firms.

In the performance of their mission, state securities regulators will continue to utilize the examination and enforcement resources necessary to effectively regulate the investment adviser population subject to state oversight.

[7] U.S. Securities and Exchange Commission. "Study on Investment Advisors and Broker-Dealers." p. v. January 2011. Available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.
[8] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 410, 124 Stat. 1393-2223 (2010)

State investment adviser examination programs and resources are documented in significant detail in the comprehensive report that NASAA provided to the Securities and Exchange Commission in support of the Act's Section 913 study. I would like to call the Committee's to several of the most significant items today:

**Memorandum of Understanding (MOU) for the Sharing of Resources**

The need for additional resources is a natural consequence of the partial restoration of our authority and responsibility. Even a highly skilled workforce cannot succeed absent adequate resources. To that end, the fifty states have agreed through a formal MOU to work together and share resources to regulate the expanded state investment adviser population. Pursuant to this MOU, all states will work to ensure that examination resources are augmented, and that schedules are coordinated, to allow for maximum coverage and consistent audits. The MOU also provides for the possibility of joint exams funded by NASAA. The MOU will bridge the gap while and until state regulators acquire any necessary additional resources.

**Frequency of Examinations**

In recent years, the states have increased the overall frequency of investment adviser examinations. In 2006, states reported 2,054 examinations of investment advisers, while in 2007 and 2008 that number increased to 2,136 and 2,389 examinations respectively. In 2009, state regulators performed 2,378 on-site examinations of investment advisers, not including the countless number of regular desk, registration, and other examinations that states perform every day. As of August 2010, the states had performed 2,463 investment adviser audits, already an increase of the total number of investment adviser examinations compared to the previous years. This upward trend has continued for five consecutive years.

The states stand ready and able to take on these greater examination duties, and state securities administrators have been proactive in their preparation, as further outlined below.

**Refinement of Uniform Exam Procedures**

Another important step that the states have recently undertaken to prepare for the switch-over has been to accelerate their refinements of uniform examination procedures. These enhanced procedures will strengthen a consistent and high standard of examination at the state level, effectively ensuring that all state examinations – whether conducted in New Jersey or California – ask the same questions of investment advisers.

**Utilization of New Risk Analysis Tools**

NASAA has developed risk analysis tools that will enable state regulators to rapidly review their investment adviser registrants, and rank the individual risk factors associated with each registrant. These tools will enable states to better evaluate the risks associated with various firms and allocate their examination resources accordingly.

**Industry Outreach Campaign**

Since the enactment of Dodd-Frank, NASAA members have initiated an aggressive industry outreach campaign to educate the industry about state oversight and to prepare new registrants to help them set up their operations properly in order to avoid noncompliance with the securities laws. The goal of this outreach campaign is to bring the legitimate investment advisers, the state regulators, and NASAA together, prior to the switch-over, so that the switch goes smoothly and to further cement a positive and constructive working relationship with the regulated community. By facilitating a partnership among the states and the many investment advisers who conduct their businesses in a legitimate and professional manner, this initiative will minimize the costs and regulatory burdens on the investment advisers and maximize the time and resources that state regulators can devote to protecting investors.

Thank you, Mr. Chairman and Ranking Member Waters, for the opportunity to appear before the subcommittee today. I will be pleased to answer any questions you may have.