Testimony of
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United States House of Representatives

On

H.R. 4624, the Investment Adviser Oversight Act of 2012

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Introduction

Good morning, Mr. Chairman, Ranking Member Frank, and members of the Committee. I am Dale Brown, President & CEO of the Financial Services Institute (FSI), and I am pleased to be here today to express our support for H.R. 4624, the Investment Adviser Oversight Act of 2012.

As you know, H.R. 4624 would authorize the Securities and Exchange Commission (SEC) to approve one or more National Investment Adviser Associations (NIAAs) to register member firms and associated persons, to set regulatory standards for their activities and operations, and to monitor compliance with these standards through routine and for cause examinations. The creation of this new regulatory structure is designed to close an unacceptable regulatory gap that leaves investors exposed to potential fraud and abuse at the hands of unscrupulous investment advisers.

FSI applauds this legislation as an essential step in creating and enhancing the trust essential for financial stability, and in making sure that all American investors receive equal protections, regardless of whether they do business with a broker-dealer or an investment adviser. FSI has supported the creation of such an organization for some time, and we applaud you, Chairman Bachus, and Representative McCarthy for your work in drafting this bipartisan approach to this important investor protection issue.

Improving the regulatory oversight of investment advisers is very important to the members of FSI. The independent broker-dealer (IBD) community we represent has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and, most importantly for today's discussion, provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.[1]

[1] The term "financial advisor" is used throughout this testimony to refer to individuals who provide financial advice, products and services as either a registered representative of a broker-dealer, or as an investment adviser representative of an investment adviser firm, or both.

In the U.S., more than 201,000 independent financial advisors – or approximately 64% percent of all practicing registered representatives – operate in the IBD channel.[2] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of financial advisors affiliated with IBDs is comprised of clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[3] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong

[2] Cerulli Associates at http://www.cerulli.com/.
[3] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisers.

incentive to put the interests of their clients first and to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent financial advisors play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Confidence in Our Financial Markets is Essential to Our Nation

Nearly all financial advisors realize that their livelihoods depend on earning the trust of their clients and sustaining their reputations in their community. As a result, they obtain information on each client's investment objectives, risk tolerance, financial situation, and other needs. They educate their clients on the various product and service options available to them through in-person meetings, disclosure documents, and other communications. Once the client is familiar with the options available, the

financial advisor makes suitable recommendations based upon the information provided by the client and facilitates the implementation of the client's informed decision-making.

After the initial investment, the financial advisor insures that their client understands the account statements and other information related to their investments. The financial advisor also keeps abreast of market developments, reviews the client's portfolio periodically, and recommends changes as appropriate. The financial advisor, along with the broker-dealer or investment adviser with which he is affiliated, designs a system of supervision to insure compliance with state and federal statutory and regulatory requirements. In other words, these financial advisors dedicate themselves to act in the best interests of their clients. It is simply how they operate as financial advisors.

Unfortunately, a small number of financial advisors take advantage of their clients' trust by directing clients to high-priced options intended to generate more compensation for the financial advisor or, worse still, simply converting client funds to their own use. When one unscrupulous financial advisor abuses an investor's confidence in this fashion, the reputation of all financial advisors is sullied. When one investor is harmed, the trust and confidence in our markets and financial advisors is shaken in all investors. Thus, recent market events, including the emergence of several high profile

Ponzi schemes, indicate that a careful reexamination of our current financial services regulatory framework is needed.

We know that both policymakers and our members share a common goal: to secure the American public's financial future. We believe this can best be accomplished by improving the public's confidence in our financial markets and the financial professionals who work in those markets. Investor confidence will improve our nation's savings rate, fuel economic growth and provide stability and independence to American families and individuals.

Trust is the foundation of the business relationship between investors and financial professionals, and success for all parties depends on investors' ability to rely on those professionals' competence and integrity. Studies have shown that investors save significantly more when they seek professional advice.[4] In addition, those who receive professional advice avoid many common investor pitfalls (e.g., buying high and selling low based upon emotional reactions to the market). Therefore, it is in the best interest of both individual investors and the economy as a whole if our system of regulatory supervision protects and encourages those who seek out this professional advice. We support H.R. 4624 because it will create a structure that enhances trust and confidence in the supervisory system.

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[4] For example, an analysis by Aon Hewitt and Financial Engines of eight large defined contribution plans between 2006 and 2010 demonstrated that workers who received some form of professional advice experienced higher returns averaging 2.92 percentage points, net of fees, than those who managed their retirement assets on their own.

The Need for an Effective Supervisory System

In your letter of invitation, Mr. Chairman, you asked specifically whether the current oversight and inspection of registered advisers is sufficient. FSI believes that it is most emphatically not. On January 21, 2011, the SEC published a Study on Enhancing Investment Adviser Examinations (Study). The Study was required under Title IX, Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which President Obama signed into law on July 21, 2010. Section 914 of Dodd-Frank required the SEC to review and analyze the need for enhanced examinations and enforcement resources for investment advisers. Congress mandated the Study because it recognized that investment advisers and broker-dealers are subject to very different levels of regulatory supervision. The Study confirmed Congress' concerns by concluding "the [SEC] likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency."[5]

Since the release of the Study, the situation has deteriorated further. Broker-dealers continue to face routine examinations on a regular and consistent basis; in 2011, FINRA examined 58% of the broker-dealer firms it

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[5] See STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS, U.S. SECURITIES AND EXCHANGE COMMISSION (January 19, 2011) at pages 38-39.

is responsible for regulating. Unfortunately, investment adviser firms are not subject to routine examination. The SEC recently testified before Congress that it had examined only eight percent of registered investment advisers in 2011 – an average exam cycle of once every 13 years. Even more troubling, the SEC told Congress that nearly 40 percent of advisers registered with the SEC have never been examined – not once.[6]

The risks inherent in the current regulatory system have become only too clear in recent years. Bernard Madoff was able to operate his Ponzi scheme through an unsupervised investment adviser. In addition, many "mini-Madoffs" have been flushed out by the recent recession.[7] Frauds such as Madoff's do immeasurable damage to confidence in our capital markets, with a ripple effect that goes far beyond the individual investors impacted. A retail investor may look at the Madoff case and believe him or herself better off without professional advice or decide that the financial markets are rigged for the benefit of a few. These individuals will not only expose themselves to greater risk of failing to achieve their financial goals, but will also hurt our national economy by keeping their assets on the sidelines.

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[6] See testimony of Caro di Florio, SEC Director of the Office of Compliance Inspections and Examinations, before the U.S. Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance, and Investment (November 16, 2011) at http://sec.gov/news/testimony/2011/ts111611rk.htm.

[7] See the following recent examples: SEC CHARGES PHOENIX-BASED INVESTMENT ADVISER FIRM WITH FRAUD, SEC RELEASE 2012-105 (May 30, 2012), at http://www.sec.gov/news/press/2012/2012-105.htm and EX-NAPFA HEAD HIT WITH FRAUD RAP, INVESTMENTNEWS.COM, May 20, 2012, available at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20120520/REG/305209973.

It is almost impossible to weigh the costs of trust betrayed or destroyed by a few rogue investment advisers. FSI's members cannot set a dollar value on the loss of business and opportunity caused by the Madoff fraud, but we have spent untold resources on efforts to rebuild that trust and restore confidence in investment advisers. We are our customers' allies and partners in the most serious decisions and goals of their lives: how and when to buy a home, where to send their children to college, whether they'll be able to retire. Effective supervision gives us the backing we need to justify our clients' confidence in us.

The investing public deserves better protection than our current regulatory system provides. They deserve more robust oversight and supervision of the professionals to whom they have entrusted their hard-earned money. The creation of an independent regulator under SEC oversight will help close this unacceptable regulatory gap, by assuring regular examinations for a sector of the industry that currently has almost no meaningful oversight.

We will explore the benefits provided by H.R. 4624 to investors and the industry in the sections that follow below.

Benefits to Investors from The Investment Adviser Oversight Act

The passage of H.R. 4624 and the authorization of a NIAA under the

auspices of the SEC will provide several immediate benefits to the investing public. First, it will greatly enhance investor protection by replacing the current patchwork of regulation with a set of uniform examination and enforcement standards, so that all financial advisors, regardless of registration status, will be subject to routine regulatory examinations. Our nation's overlapping and sometimes conflicting financial regulatory infrastructure allows unscrupulous individuals to look for opportunities to avoid supervision, or to exploit gaps in regulation. Regulatory gaps and inconsistencies create temptations for honest people to make bad decisions. They provide safe havens in which unscrupulous individuals can do great harm to the unsuspecting. Regulatory reforms are needed to close these safe havens for those who would commit fraud. H.R. 4624 will do so by insuring regular and routine examinations of all financial advisors.

Second, H.R. 4624 will enhance investor confidence in our financial markets. The average investor should not need to be an expert in the arcane details of securities industry registration in order to have confidence that their financial advisor is subject to effective regulatory oversight. Customers have the right to expect a uniform standard of oversight; indeed, they do expect regular and routine regulatory oversight. Unfortunately, the current structure is unable to deliver these expected protections. H.R. 4624 will solve this problem. This is why we believe the Consumer Federation of

America has endorsed the concept of an independent self-regulatory organization for retail investment advisers.[8]

Third, the layered regulatory framework resulting from the adoption of H.R. 4624 will allow the SEC to review the quality of the supervisory work performed by the NIAA, resulting in a more effective system of supervision than otherwise available. Under the supervision of the SEC, the NIAA would focus on the routine examination and supervision of retail investment advisers. The SEC would thus be free to focus on capital markets concerns, the development of appropriate regulations for all regulated entities, the supervision of the new NIAA, and the fulfillment of other appropriate regulatory goals. By working together, the NIAA and SEC can consistently improve the quality of investment adviser supervision and investor protection.

Finally, passage of H.R. 4624 and the authorization of an NIAA will impose the cost associated with the new regulator on the regulated, not the taxpayer. The bill does so by specifying that the NIAA must be funded

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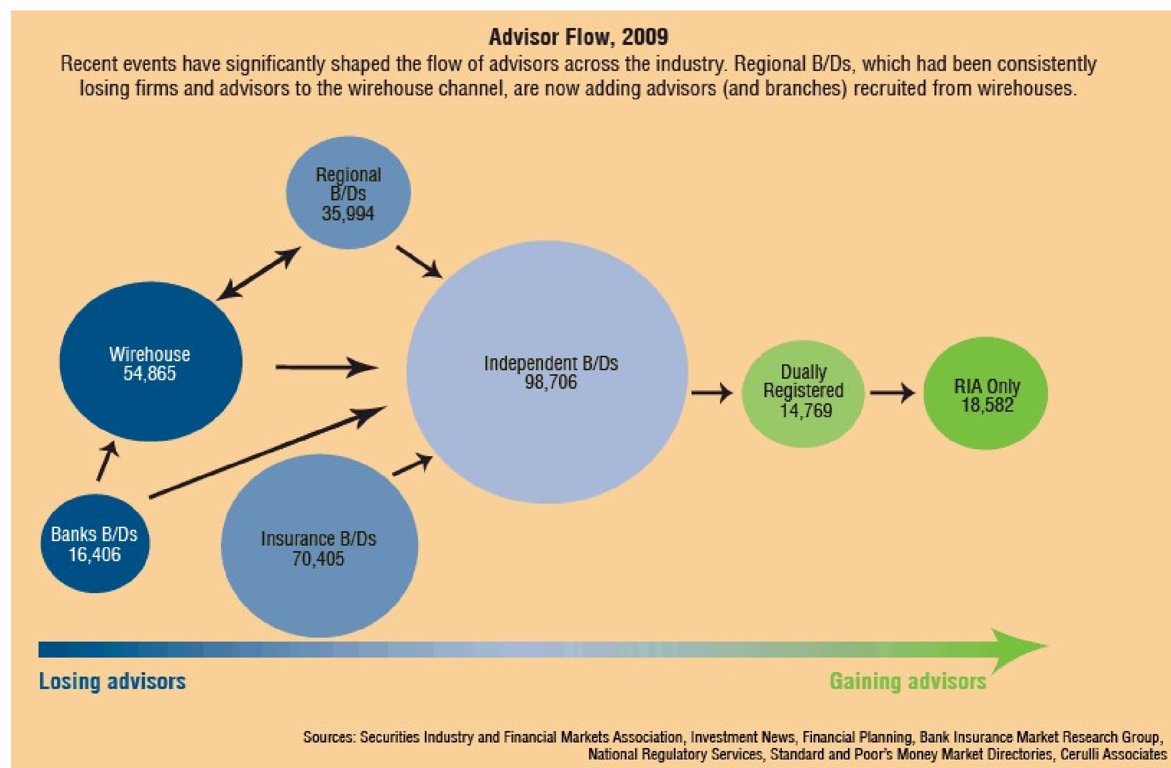
[8] See testimony of Barbara Roper, Director of Investor Protection at the Consumer Federation of America, before the Capital Markets and Government Sponsored Entities Subcommittee of the U.S. House Financial Services Committee (September 13, 2011) at http://financialservices.house.gov/UploadedFiles/091311roper.pdf. "In the past, CFA has categorically opposed delegating investment adviser oversight to an SRO, particularly one dominated by broker-dealer interests and particularly if that SRO were given rule-making authority. However, having spent the better part of two decades arguing for various approaches to increase SEC resources for investment adviser oversight with nothing to show for our efforts, we have been forced to reassess our opposition to the SRO approach. Specifically, we have concluded that a properly structured SRO proposal would be a significant improvement over the status quo."

through an equitable allocation of fees and charges among its members and users. This system mirrors that used by FINRA to fund its supervision of broker-dealer firms. The result is that RIAs will pay for their own supervision through a well-established and equitable system rather than placing the financial burden on the American taxpayer.

Benefits to the Industry from the Investment Adviser Oversight Act of 2012

The passage of H.R. 4624 and the authorization of a NIAA under the auspices of the SEC will also provide several immediate benefits to the financial services industry. First, the bill will provide a balanced playing field for all financial advisors. In recent years, financial advisors have been fleeing broker-dealer and FINRA supervision to become registered investment advisers. The chart below graphically depicts this growing phenomenon: [9]

[9] See at http://retirementincomejournal.com/upload/567/advisor-flow-2009.jpg.



While there are many reasons for the movement of financial advisors from wirehouse, regional, insurance, bank, and independent broker-dealers to investment advisers, avoidance of regulatory oversight is clearly one significant factor.[10] Under the current regulatory system, financial advisors who wish to operate their business free from vigorous regulatory scrutiny have a viable option – investment adviser registration.

The flight of financial advisors from the heavily regulated broker-dealer channel to the under-regulated investment adviser channel is projected to

[10] For example, Mike Byrnes and Brooke Southall ADVISOR SPOTLIGHT: HOW A BIG-TIME IBD REP ENDED UP AS A SCHWAB RIA, RIABIZ.COM, October 25, 2010, *available at* http://www.riabiz.com/a/2885078.

continue in the near future. The chart below represents projections provided to FSI by Cerulli Associates:

Projected Advisor Headcount Market Share by Channel, 2009-2014

Channel	2009	2010	2011	2012	2013	2014	2009-2014 Market Share Change
Bank	4.8%	4.6%	4.5%	4.3%	4.2%	4.0%	-0.7%
Wirehouse	15.0%	15.2%	15.0%	14.8%	14.4%	14.1%	-1.0%
Regional	11.5%	11.2%	10.9%	10.7%	10.4%	10.1%	-1.4%
Insurance broker/dealer	29.0%	28.1%	27.2%	26.3%	25.4%	24.5%	-4.5%
IBD	29.6%	29.6%	29.6%	29.6%	29.6%	29.5%	-0.1%
Dually registered	4.2%	4.8%	5.4%	6.1%	6.9%	7.7%	3.5%
RIA	5.9%	6.6%	7.3%	8.2%	9.1%	10.1%	4.2%

The flow of financial advisors from to the investment adviser channel has significant consequences for investors. Chief among these is the lack of routine regulatory examinations of the entities responsible for managing the investors' portfolios. In addition, it limits investor access to investment advice by reducing the availability of low cost commission compensation options. It also has an impact on the small businesses operated by FSI members who bear the cost of close regulatory supervision while their competitors are free to operate free from that burden. This is inherently unfair since retail financial advisors operating in the broker-dealer and investment adviser business channels offer very similar services to investors.

Secondly, H.R. 4624 will benefit the industry by streamlining the examination process for dual registrant firms – those operating as both broker-dealers and investment advisers. Dual registration is prevalent in the industry. There are approximately 2,500 firms that are dually registered as broker-dealers and investment advisers or are broker-dealers with one or more affiliated investment advisers. In addition, the vast majority of investment adviser representatives also offer brokerage services. In fact, approximately 88 percent of all investment advisory representatives are also registered representatives of a broker-dealer.

Currently these firms and individuals are subject to frequent broker-dealer examinations by the SEC, FINRA and state securities divisions and occasional investment adviser exams by the SEC and the states. If FINRA were to serve in the role of NIAA, as FSI believes is appropriate, the result would be a consolidated exam program for dual registrant firms. Such a system would limit business disruptions caused by regulatory exams thereby reducing the related costs that are passed onto investors, allowing for the hiring of additional staff and the development of innovative methods of delivering financial products, services and advice. Investor protection would also be greatly enhanced by subjecting firms to more frequent and meaningful regulatory examinations that are not constrained by jurisdictional boundaries that have outlasted their usefulness.

Finally, H.R. 4624 will benefit the industry by removing a significant source of uncertainty. The adoption of the legislation would provide firms with clarity as to how this universally recognized investor protection problem will be resolved. Firms cannot control costs if they do not know what will be expected of them in the future. Passage of H.R. 4624 provides the certainty and clarity desired by the industry.

Answering the Critics

Despite these tremendous benefits to investors and the financial services industry, some have criticized H.R. 4624. We respond to the most common arguments against the adoption of H.R. 4624 below:

- Funding SEC Oversight is the Better Option – The SEC's Section 914 Study suggested that one option for solving the regulatory gap would be to assess an appropriate "user fee" on investment advisers to be used solely to fund additional exams of investment advisers. Others have suggested increasing the SEC's budget to allow for the hiring of additional examination staff. We disagree with each of these approaches.

  In its own study under the requirements of Dodd-Frank, the SEC concluded that it lacks the necessary resources to oversee the nation's 12,600 federally registered investment advisers. SEC Commissioner

Elisse B. Walter has indicated that the Commission would need to hire more than 2,000 examiners to its advisory program to increase RIA exam frequency to the level achieved by FINRA in its oversight of broker-dealer firms.[11] Staffing up to take on this responsibility would require that Congress either authorize additional funds for this purpose or impose taxes in the form of user fees on investment adviser firms, an effort that, frankly, seems impossible in the current legislative and fiscal environment. Even if these funds were authorized by Congress or obtained via user fees, it would be almost impossible to ensure that they were spent solely on the supervision of retail investment advisers. The SEC has a broader mandate, and allocates resources toward its most urgent priorities. Supervision of retail investment advisers has not proven to be an urgent priority for the SEC to date, nor is it likely to remain a priority once Congress turns its attention to other issues. As a result, we believe funding the SEC is not a viable option for improving investor protection.

- Establishing FINRA as the Regulator of Dual Registrants is a Better Option - The SEC's Section 914 Study suggested that another viable option for solving the regulatory gap would be to authorize FINRA to

[11] See SEC Commissioner Elisse B. Walter's STATEMENT ON STUDY ENHANCING INVESTMENT ADVISER EXAMINATIONS (REQUIRED BY SECTION 914 OF TITLE IX OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT) (January 21, 2011) at http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.

examine dual registrants for compliance with the Investment Advisers Act. We also disagree with this recommendation.

Authorizing FINRA to supervise only the investment adviser activities of dual registrant firms will drive up the regulatory burden and costs on these firms and financial advisors while providing further incentive to firms and financial advisors who are seeking less regulatory supervision to escape to the under-supervised investment adviser world. H.R. 4624 avoids this problem by requiring all financial advisors to be subject to regular and routine regulatory examinations from an independent regulatory organization.

- <u>Expense of an NIAA Unnecessarily Burdens Small Business Owners</u> – Some critics argue that the NIAA model imposes a costly additional layer of regulation and bureaucracy on RIAs without providing a commensurate benefit to investor protection. We disagree.

  FSI has endorsed FINRA as the best organization to establish and administer a NIAA for retail investment advisers. As the nation's largest independent regulator of securities firms, FINRA already has a long and productive working relationship with the SEC and an infrastructure in place that can be rapidly adapted to the supervision and examination of retail investment advisers.

Figures recently released by FINRA show that it would incur one-time startup costs of $12 million to $15 million to create a self-regulatory structure for retail investment advisers, with ongoing annual examination costs of between $150 million and $155 million.

These figures are considerably below those estimated in a study conducted by the Boston Consulting Group (BCG), which predicted startup costs of as much as $255 million, with annual costs of up to $510 million. FINRA has extensive experience and firsthand knowledge of the costs of running an independent regulatory organization. BCG does not and failed to leverage FINRA's knowledge in compiling their own cost projections. As a result, we consider FINRA's estimates far more reliable than those of BCG.

Finally, the question of cost, while important, is by no means the only or even the most important criterion for choosing the appropriate regulatory organization for the retail investment industry. The most important priority must be effectiveness in providing supervision and consumer protection, and FINRA has a proven track record as an effective supervisor of financial service firms. FSI believes that FINRA is the strongest and most cost efficient organization available to serve as a unified supervisor for both segments of the financial services industry (i.e., broker-dealers and registered investment advisers). We

conclude that the anticipated costs are reasonable and that the benefits to investors, and the industry, will prove substantial.

- FINRA is an Inappropriate Choice for NIAA – Critics of H.R. 4624 argue that FINRA, the most likely NIAA option, would prove to be an inappropriate choice due to its alleged conflicts of interest, lack of accountability, lack of transparency and enforcement track record. We disagree.

As stated above, FSI has gone beyond merely supporting H.R. 4624 option to specifically endorse FINRA to serve in the role of NIAA. While H.R. 4624 would not immediately designate FINRA as an NIAA, FSI believes FINRA is particularly well suited for the role of retail investment adviser regulator because it has:

- An existing comprehensive examination program with dedicated resources of more than 1,000 employees.
- Experience operating an independent regulator whose structure is designed to ensure its governing body, committees, and staff act independently in the public interest.
- Experience with a private funding model capable of equitability allocating the cost of the examination, enforcement, surveillance, and technology resources needed to do the job among regulated entities at no cost to the taxpayer.

- Knowledge of the overlapping nature of the financial products and services offered by broker-dealers and investment advisers.
- Experience in performing regulatory examinations of a wide variety of financial service providers, including thousands of dual registered entities.
- Demonstrated the ability to handle a complex expansion of their regulatory responsibilities through the recent NASD/NYSE merger.
- Successfully developed and operated the Investment Adviser Registration Depository (IARD), a key resource for any investment adviser regulator.

In addition, H.R. 4624 specifically addresses the critics concerns about FINRA by insuring effective SEC oversight of the NIAA. The bill permits the SEC to suspend or revoke the NIAA's registration, or censure or impose limits on the NIAA's activities and operations, if the SEC finds that the NIAA has violated the Investment Advisers Act, SEC rules or its own rules. The SEC would also be able to suspend or revoke an NIAA's registration if the association has failed to enforce compliance with any provision by an NIAA member firm or associated person.

The bill also requires the SEC to determine whether the NIAA has the capacity to carry out the purposes of the Investment Advisers

Act and to enforce compliance by its members and their employees with the Investment Advisers Act, the SEC's rules, and the NIAA's rules before the association can register as an NIAA.

In addition, the bill ensures effective oversight by requiring the SEC to determine that the NIAA's rules:

- are designed to prevent fraud and protect investors;
- are consistent with the Advisers Act and fiduciary duties under the Act and state law;
- do not impose any burden on advisers that is not in the public interest or for investor protection;
- provide for periodic examinations of members and their related persons, and for coordination of those examinations with the SEC and state securities authorities;
- assure a fair representation of the public interest and the investment adviser industry in its selection of directors and administration of its affairs, and provide that a majority of its directors do not come from the securities industry; and
- provide for equitable allocation of dues and fees and establish appropriate disciplinary procedures for members and their associated persons that violate the Advisers Act, SEC rules or NIAA rules.

As a result, we conclude that the Investment Adviser Oversight Act has sufficient protections to address the concerns critics have raised with FINRA.

- States Have the Resources to Examine Smaller Investment Advisers – Some critics argue that state registered investment advisers should not be obligated to register with the NIAA because state securities regulators have sufficient resources to examine these advisers on an acceptable schedule. We disagree.

H.R. 4624 recognizes the authority given to the states over small investment advisers in Title IV of the Dodd-Frank Act by preserving the states' sole authority over investment advisers with fewer than $100 million in assets under management, so long as the state conducts periodic on-site examinations on at least a 4 year cycle.

This is important because the inspection, examination, and enforcement capabilities of state securities regulators vary significantly from state-to-state. Approximately 8 state securities regulators do not currently conduct routine examinations of the brokers-dealers or investment advisers under their jurisdiction.[12] The remaining 42 states that do conduct routine examinations have significant resource

[12] Elizabeth MacBride, *It's looking official: Advisors switching to state oversight to face many more audits*, RIABIZ.COM, September 28, 2010, *available at* http://www.riabiz.com/a/2323150.

constraints that prevent them from completing robust and comprehensive examinations.

Some examples of the challenges at the state level may prove helpful. The State of New York does not routinely examine broker-dealers or investment advisers registered in the State. The Investor Protection Bureau of the State of New York is charged with enforcing the Martin Act, which is the New York State blue-sky law. Article 23-A,[13] sections 352 and 353 of the Martin Act give the Attorney General broad law-enforcement powers to conduct public and private investigations of suspected fraud in the offer, sale, or purchase of securities. Where appropriate, the Attorney General may commence civil and/or criminal prosecutions under the Martin Act to protect investors. The Bureau also protects the public from fraud by requiring broker-dealers and investment advisers to register with the Attorney General's Office. However, the Bureau does not have the authority to conduct routine examinations of the broker-dealers or investment advisers registered in the State.

The lack of a routine examination program in New York has had consequences for investors. Bernard Madoff operated his massive Ponzi scheme from his firm's office on Third Avenue in New York

[13] N.Y. Gen. Bus. § 23-A (McKinney 2009), *available at* http://law.justia.com/newyork/codes/general-business/idx_gbs0a23-a.html.

City.[14] In addition, Cohmad Securities Corporation brought investors into the Ponzi scheme from offices located within the Madoff firm.[15] There is no indication that the New York Investor Protection Bureau ever conducted an examination of the offices or activities of Bernard L Madoff Investment Securities or Cohmad Securities Corp. As a result, valuable opportunities to uncover the ongoing frauds were lost.[16]

In contrast to the State of New York, the Texas State Securities Board does conduct examinations of broker-dealers and investment advisers. According to the Texas State Securities Board Strategic Plan for Fiscal Years 2009 – 2013,[17] Texas has 19 full time employees who conduct examinations for the Agency.[18] As of August 31, 2009, Texas

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[14] *See* BrokerCheck report of Bernard L. Madoff Investment Securities LLC at http://brokercheck.finra.org/.

[15] *See* page 5 of the REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES (September 2009) at http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf.

[16] The SEC and FINRA also failed to uncover the Madoff Ponzi scheme and Cohmad's involvement in it despite examining each firm's activities. However, each of these regulators engaged in a thorough public review of the failures of their exam programs and has made specific commitments to improve them based upon the lessons learned. The New York Investor Protection Bureau has not.

[17] TEXAS SECURITIES BOARD, AGENCY STRATEGIC PLAN FOR THE FISCAL YEARS 2009 – 2013 PERIOD, (2008), *available at* http://www.ssb.state.tx.us/About_Us/StratPlan2008.pdf.

[18] *Id.* It should be noted that in 2007, the Texas State Securities Board experienced an employee turnover rate of approximately 20%. The Texas Securities Commissioner has indicated that they plan to add 10 additional staff positions in the near future to accommodate the investment advisers that will now fall under state jurisdiction because of the Dodd-Frank Act. In addition, it should be noted that the headquarters of Stanford Financial Group was located in Houston, TX. On February 17, 2009, the SEC put the company under management of a receiver alleging it operated a massive Ponzi scheme. There has been no public indication that Stanford Financial Group was ever the subject to a Texas State Securities Board examination. The SEC and FINRA also failed to uncover Stanford's Ponzi scheme despite examining the firm's activities. However, each of these

had approximately 2,700 registered broker-dealers (both FINRA and non-FINRA member firms), 1,200 state registered investment advisers, and 3,500 SEC-registered Notice filers subject to their jurisdiction.[19] As previously mentioned, the number of RIAs regulated by the states, including Texas, has risen given as investment advisers who manage $100 million or less are now subject to state regulation.[20] Texas appears to be a well-funded state,[21] however, they cannot match the frequency of broker-dealer examinations conducted by FINRA. In fact, Texas states that their current examination program amounts to trying "to get to every adviser once every five years."[22] It remains to be seen what impact the jurisdictional change will have on Texas' examination program.

Based on the lack of routine examination programs in every state and the budget problems being experienced by most state

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regulators engaged in a thorough public review of the failures of their exam programs. The Texas State Securities Board has not.

[19] *Id.*

[20] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

[21] Texas State Securities Board was appropriated funding of $5,712,676 for Fiscal Year 2008 and again for Fiscal Year 2009. *See* TEXAS SECURITIES BOARD, *supra* note 124, at 7.

[22] Kara Scannell, *States will be Hedge-Fund Police*, Wall St. J., August 19, 2010, *available at* http://online.wsj.com/article/SB10001424052748704557704575437663904234590.html?KEYWORDS=denise+crawford+TX. It is important to note that Section 410 of the Dodd-Frank Act will further stress state securities regulators by shifting oversight responsibility for some 4,000 registered investment advisers to the states.

governments,[23] we believe that the states are not universally prepared to take on the inspection, examination, and enforcement role assigned to them under the Dodd-Frank Act.[24] Ultimately, investor protection will be diminished if state regulators are unable to increase substantially the quality and frequency of RIA examinations.

Fortunately, H.R. 4624 offers a solution by giving the NIAA authority to conduct periodic examinations of investment advisers except in states in which the investment adviser is regulated and maintains its principal office and place of business and the state has adopted a plan to conduct on-site examinations of all such investment advisers on average at least once every 4 years. In this way, H.R. 4624 insures a reasonable exam cycle by providing resources to those states that are unable to achieve the goal on their own. Because we believe routine examinations will enhance investor confidence in our capital markets, we believe H.R. 4624 adopts an appropriate balance between respect for the states' jurisdiction over smaller investment advisers and the very real investor protection needs.

Conclusion

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[23] *See* NATL. CONF. ST. LEGISLATORS, *supra* note 119; *see also* SUNSHINE REVIEW, *supra* note 119.

[24] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

Nearly 4 years since Bernie Madoff's investment adviser fraud was exposed, the safe harbor in which he operated remains open to others to exploit. Passage of the Investment Adviser Oversight Act of 2012 would bring this unconscionable situation to an end. Congress has shown, in adopting the Dodd-Frank Act and introducing H.R. 4624 that it understands the importance of maintaining and enhancing individual investors' confidence in our financial system and in the investment advice they receive. The coordinated system of enhanced supervisory oversight provided by the regulatory system proposed by the bill will offer investors an additional measure of confidence, and will ensure that all Americans have access to competent, affordable financial advice, products and services with the highest level of consumer protection.

Main Street investors deserve an efficient, effective and unified system of oversight, whether they are working with investment advisers or broker-dealers – a smarter system that ensures true consumer protection. H.R. 4624 will help to create such a system. We commend you, Chairman Bachus, and you, Representative McCarthy, for taking this important bipartisan step toward better regulation and supervision, and we urge you to pass this bill as quickly as possible.

I would be happy to answer any questions the Committee may have.