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Executive Summary

H.R. 4624, the "Investment Adviser Oversight Act of 2012," mandates membership in a self-regulatory organization (SRO) for SEC- and state-registered investment advisers. The bill would subject thousands of advisory firms to an additional layer of regulation by a private regulator with broad rulemaking, inspection and enforcement authority – and, in all likelihood, that private regulator would be FINRA.

The IAA strongly opposes H.R. 4624. The substantial drawbacks to an SRO significantly outweigh any potential benefits. These drawbacks include minimal transparency and accountability, insufficient oversight by the SEC and Congress, conflicts of interest, excessive costs, and the lack of meaningful due process protections and cost-benefit analysis restraints.

H.R. 4624 unfairly targets small businesses. Because of exemptions in the bill, smaller advisers are singled out for additional regulation and costs. The substantial costs and bureaucracy of an additional, unnecessary layer of SRO regulation and oversight of advisory firms would have a significant adverse impact on small businesses and job creation. Further, the bill would result in inconsistent regulation and regulatory arbitrage.

Supporters indicate that the bill responds to an SEC report mandated by the Dodd-Frank Act studying various options to enhance SEC examinations of investment advisers. If enhancing investment adviser examinations is the objective, however, H.R. 4624 represents both the least effective and the most costly option. H.R. 4624 ventures far beyond the focus on investment adviser examinations to extend an additional layer of unnecessary regulation on advisers. Supporters also claim that the bill would "level the playing field" for brokers and advisers. They do not, however, commend the benefits of FINRA regulation. Rather this is an attempt to impose on investment advisers the same regulatory framework that currently exists for brokers. Far from leveling the playing field, this bill would create a dramatically tilted playing field by burdening those investment advisers captured by this bill with additional, unnecessary regulation.

We particularly oppose extending FINRA's jurisdiction to investment advisers due to its lack of transparency and accountability, questionable track record, the costs involved, and its experience and bias favoring the broker-dealer regulatory model.

We support effective and appropriate measures to enhance the SEC's examination program for investment advisers. The SEC, a governmental regulator that is accountable to Congress and the public, has more than seven decades of experience and expertise regulating and inspecting investment advisers. The SEC is best-positioned to provide effective oversight for all SEC-registered investment advisers, irrespective of asset size and type of clients served. To ensure that the SEC has sufficient resources for adviser oversight, and as an alternative to an SRO, the IAA supports the assessment of an appropriate "user fee" on SEC-registered investment advisers to be used solely to fund additional examinations by the SEC. Legislation to authorize user fees should include provisions that: (1) specifically preclude any investment adviser SRO if such fees are imposed; (2) clarify that such user fees will be dedicated to an increased level of investment adviser examinations (instead of simply being used as substitute funding for the existing level of examinations); and (3) set forth specific SEC reporting requirements and review of any such user fees by Congress and the public.

The user fee approach provides many benefits. User fees would provide stable yet scalable resources to support and strengthen the SEC's examination of investment advisers. The fees collected would be used solely to fund enhancements to the investment adviser examination program and increase the frequency of adviser examinations. Importantly, the reporting and accountability embedded in the user fee approach would provide substantial transparency and opportunity for congressional oversight and public input.

As demonstrated by a recent Boston Consulting Group report, the costs of user fees would be significantly less than the costs of SRO oversight. Further, if an investment adviser SRO were mandated, the resulting new oversight responsibilities would require the SEC to expend significant additional resources.

We look forward to participating fully in the discussion of how best to protect the interests of investors by ensuring effective and efficient oversight of investment advisers. We strongly believe there are better answers than the option presented by H.R. 4624 and look forward to working with the Committee to implement the best solution.

Introduction

The Investment Adviser Association (IAA)[1] greatly appreciates the opportunity to appear before the Committee today to discuss H.R. 4624, the Investment Adviser Oversight Act of 2012.

Investment advisers manage assets for a wide array of individual and institutional investors. Currently, approximately 12,500 investment advisers are registered with the SEC, collectively managing assets totaling about $49 trillion for millions of individual and institutional

[1] The IAA is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937 as the Investment Counsel Association of America, the IAA's membership consists of more than 500 firms that collectively manage in excess of $10 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit our web site: www.investmentadviser.org.

clients.[2] Investment advisers engage in a wide range of advisory activities and implement investment strategies on behalf of their clients, including constructing securities portfolios pursuant to client directives, recommending asset allocation, providing portfolio analysis and evaluation, assisting in selecting and monitoring other advisers, and providing wealth management and financial planning services. In addition, investment advisers manage assets for individuals, families, trusts, mutual funds, hedge funds, private equity funds, pension plans, state and municipal entities, banks, insurance companies, charitable endowments, foundations, and corporations, and serve as sub-advisers to funds or accounts managed by other advisers. These activities play a critical role in helping investors, both individually and through pooled investment vehicles, achieve their financial goals.

While investment advisory firms range from small, local or regional firms to large global financial institutions with varying business models, the overwhelming majority of investment advisory firms are small businesses. Indeed, more than half of all federally-registered advisers employ fewer than ten employees and more than 85 percent employ fewer than 50 non-clerical employees. In addition, most of the 15,500 state-registered investment advisers are small businesses.[3] H.R. 4624 would disproportionately affect these small businesses, subjecting them to expansive rulemaking, inspection and enforcement authority by a private regulator.

H.R. 4624 would mandate SRO membership for SEC-registered and state-registered investment advisers, subject to broad exemptions. Specifically, the legislation would exempt an advisory firm if it has a single mutual fund as a client – no matter the fund's size and regardless of other firm characteristics. The legislation would also exempt an advisory firm if 90 percent or more of the firm's assets under management ("AUM") is attributable to "qualified purchasers" (*i.e.*, individuals with $5 million in investments or institutions with $25 million in investments),

[2] These statistics are taken from information investment advisers filed with the SEC as of June 1, 2012. They include data from advisers that indicated they are switching from SEC to state registration pursuant to provisions of the Dodd-Frank Act, as well as data from firms that failed to make their required filing. When those advisers complete their switch to state registration, there will be approximately 10,500 advisers registered with the SEC.

[3] This data is taken from information investment advisers filed with the states as of June 1, 2012. As noted above, it is anticipated that 2,000 additional investment advisers will be registered with the states once smaller advisers complete their switch from SEC to state registration.

hedge funds, private equity funds, venture capital funds, non-U.S. clients, other investment advisers and broker-dealers, and other entities, including certain non-profit clients, real estate funds, issuers of asset-backed securities, and tax-qualified retirement funds. In addition, investment advisers that are affiliated with these exempt advisory firms would be largely excluded from the SRO membership requirement. The SEC, however, would be tasked with determining on a case-by-case basis whether an affiliate is sufficiently independent from the exempt adviser such that SRO membership should be required.

The bill would require that SRO rules be designed to prevent fraudulent and manipulative acts, to promote "business conduct standards" for its members consistent with advisers' obligations to investors, to be consistent with the fiduciary standards applicable to advisers under the Investment Advisers Act of 1940 ("Advisers Act") or state law, and to not unnecessarily duplicate, overlap or conflict with such laws. The SRO would have authority to enforce the Advisers Act and any SRO rules and to establish disciplinary procedures to do so. The bill would require SRO rules to establish appropriate procedures to "register persons associated with members" and to require "supervisory systems" for members and their associated persons.

Under the bill, the SRO would be required to provide for "periodic" examinations of its members and their associated persons to determine compliance with the Advisers Act and SRO rules. However, the SRO would not conduct periodic exams of a state-regulated adviser in a state that has adopted a plan to conduct an on-site examination of all state-regulated advisers on average once every four years. In addition, the SRO would be permitted to conduct "for cause" exams of all members of the SRO, including state-registered advisers.

The bill would require the SEC to conduct annual inspections of the SRO to ensure it complies with the Advisers Act and its rules and regulations. Further, the bill would require the SRO to issue a publicly available annual report to the SEC on its operations, performance, and financial condition. Although the legislation would allow for more than one "national investment adviser association" to apply to become an adviser SRO, the bill is structured to most readily enable FINRA to act in that capacity.

I. The IAA Strongly Opposes H.R. 4624.

The IAA strongly opposes mandating an SRO for investment advisers. The SEC's regulation and oversight of investment advisers should not be outsourced to a private regulator unaccountable to Congress or the public. We believe that the SEC is the most efficient and effective regulator of SEC-registered investment advisers. There is simply no compelling reason to outsource oversight of investment advisers to either a new SRO or any existing entity that has no expertise with the investment adviser industry or its regulatory framework.

The SRO regime that would be established by H.R. 4624 is flawed. It would result in inconsistent regulation of the same or similar activities and encourage regulatory arbitrage. In addition, the SRO model is not cost effective. It would specifically target small businesses for unnecessary costs and burdens, exacerbate the SEC's challenges in allocating its resources, and result in unnecessary expansion of burdensome regulations and bureaucracy. The legislation is clearly designed to favor FINRA's organizational model. We particularly oppose extending FINRA's jurisdiction to investment advisers, due to FINRA's lack of investment adviser expertise, lack of accountability, lack of transparency, excessive costs, and questionable track record.

A. <u>The SRO Model Is Flawed.</u>

The self-regulatory organization model of regulation suffers from significant flaws. SROs are not accountable to Congress or the public, and are not subject to requirements related to the Administrative Procedure Act ("APA"), the public records laws, due process, the Freedom of Information Act, cost-benefit analysis, and other critical protections. Moreover, the effectiveness of SROs has not been demonstrated. These deficiencies in the SRO model have been identified in meaningful reports and studies, including those from the SEC staff, the Government Accountability Office ("GAO"), the U.S. Chamber of Commerce, and the Boston Consulting Group ("BCG").

Congress, in Dodd-Frank Act Section 914, directed the SEC to conduct a study to review and analyze the need for enhanced examination and enforcement resources of investment advisers. The SEC issued a staff report expressing concern that it will not have sufficient capacity to conduct effective examinations of investment advisers with adequate frequency, and setting forth three options for addressing this concern: (1) assess user fees on SEC-registered investment advisers to fund their examinations by the SEC; (2) authorize one or more SROs to examine all SEC-registered investment advisers; and (3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.[4] The Section 914 Report identifies significant drawbacks to the SRO model, notably including conflicts of interest inherent in self-regulation and the costs and funding involved.

A recent GAO report studying a potential SRO for private fund advisers similarly found serious drawbacks to the SRO model, including its potential to "(1) increase the overall cost of regulation by adding another layer of oversight; (2) create conflicts of interest, in part because of the possibility for self-regulation to favor the interests of the industry over the interests of investors and the public; and (3) limit transparency and accountability, as the SRO would be accountable primarily to its members rather than to Congress or the public."[5] In addition, the report noted that the SRO model "expose(s) firms to duplicative examinations and costs."[6]

Consistent with these studies, the U.S. Chamber of Commerce focused in a recent report on the lack of accountability by certain nongovernmental policymakers with significant and growing influence, including FINRA:

[4] Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011) ("Section 914 Report").

[5] *Private Fund Advisers: Although a Self-Regulatory Organization Could Supplement SEC Oversight, It Would Present Challenges and Trade-Offs*, U.S. Gov't Accountability Office, at 20 (July 2011) ("2011 GAO Report"). Section 416 of the Dodd-Frank Act required the GAO to study the feasibility of forming an SRO to provide primary oversight of private fund advisers.

[6] *Id.*

> "Despite their tremendous influence over the workings of the capital markets, these organizations are generally subject to few or none of the traditional checks and balances that constrain government agencies. This means they are devoid of or substantially lack critical elements of governance and operational transparency, substantive and procedural standards for decision making, and meaningful due process mechanisms that allow market participants to object to their determinations."[7]

The Chamber of Commerce report further observes that SROs are not bound by the congressional appropriations process or other comparable checks on their power.[8]

Moreover, in a study required by Section 967 of the Dodd-Frank Act of the SEC's structure, organization, and need for reforms, BCG found numerous problems in the SEC's relationship with SROs, including inadequate oversight and lack of standards to measure SRO effectiveness. BCG found that "[g]iven the role of SROs in the regulatory framework, it is vital that the SEC develop both a clear set of standards for how SROs are to regulate and a means for assessing whether SROs are complying with those standards… To strengthen its oversight of SROs, however, there are additional actions that can be taken," including: "[e]nhance SRO disclosures regarding their regulatory operations; institute metrics to monitor SROs and minimum standards for their regulatory activities; and enhance FINRA oversight."[9]

The BCG Section 967 Report observed that SROs are not accountable to the SEC and that the agency and SROs are not coordinating effectively. The report noted that if the SEC were to be funded adequately, rather than expanding the role of SROs, "there are strong arguments

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[7] *U.S. Capital Markets Competitiveness: The Unfinished Agenda*, U.S. Chamber of Commerce (Jul. 19, 2011) ("Chamber of Commerce Report"), *available at* htttps://www.uschamber.com/sites/default/files/reports/1107_UnfinishedAgenda_WEB.pdf.

[8] *Id. See also* The Boston Consulting Group, Inc., *U.S. Securities and Exchange Commission Organizational Study and Reform*, at 25 (Mar. 10, 2011) ("BCG Section 967 Report"), *available at* http://www.sec.gov/news/studies/2011/967study.pdf (identifying common critiques of SROs, including lack of accountability).

[9] BCG Section 967 Report, *supra* note 8, at 134. The SEC selected BCG, a well-established consulting firm, to conduct the mandated study.

and global precedents to consolidate more regulatory activities from SROs into the national regulator. This will reduce real and/or perceived conflicts of interest that SROs may have, ensure greater control and visibility into market information for the SEC, and clarify the governance of securities regulation."

Further, the BCG Section 967 Report found that the SEC has not been able to fully leverage and oversee SROs due to certain legal issues. For example, FINRA has been reluctant to share examination and other information with the SEC, asserting that under the "state actor" doctrine, such sharing could cause FINRA to be deemed a government actor for various purposes, including the constitutional rights of defendants in enforcement actions.[10]

H.R. 4624 does not adequately address any of these deficiencies in the SRO model. For example, although it would require the SRO to explain and respond to comments received regarding the costs and benefits of a proposed rule, the bill does not require the SRO to affirmatively conduct its own cost-benefit analysis. Further, it would provide no direct remedies for an SRO's failure to adequately do so; interested parties would not be able to bring suit against the SRO to ensure it conducts an appropriate cost-benefit analysis. Presumably, the SEC would be required to determine that the SRO met its obligations to conduct cost-benefit analysis with respect to each of its proposals, but historically the SEC has not scrutinized SRO proposals in this way. Such analysis by the SEC would require substantial additional effort and resources.

Similarly, the bill does not address the transparency typically lacking in the SRO model. An SRO designated pursuant to this legislation would not be required to hold open meetings, to respond to Freedom of Information Act requests, or otherwise comply with the APA. Although the bill requires an SRO to submit an annual report, it does not require congressional or SEC oversight of the SRO's budget or governance.[11] Nor does it address concerns regarding due

[10] *Id.* at 65. Section (g)(2) of H.R. 4624 provides that the sharing of information by an adviser SRO with state or federal agencies will not be "construed to be the action of such agency." It is not clear whether this provision adequately addresses the constitutional analysis of state action. Further, while it permits the sharing of information, it does not compel an SRO to actually do so.

[11] *See also* Section 914 Report, *supra* note 4, at 37 (comparing the PCAOB and FINRA governance models and noting that the PCAOB model requires SEC review of the annual budget and SEC appointment of board members);

process protections during disciplinary hearings.[12] The bill references notice-and-comment rulemaking under the APA, but does not clearly apply the APA to an SRO's consideration of its rules and rule changes, nor does it provide direct recourse if APA procedures are not followed. In addition, the SEC's oversight of SRO rulemaking may be largely deferential: the SEC only need find that the rule "is consistent with the requirements of this title, the rules thereunder, and the rules and regulations applicable" to the SRO. Thus, the SEC is not required to pass judgment on the wisdom or merits of the SRO rules.[13]

B. H.R. 4624 Would Result in Inconsistent Regulation and Regulatory Arbitrage.

The SRO regime mandated by H.R. 4624 would be particularly inappropriate for investment advisers. Indeed, the Section 914 Report catalogues numerous problems inherent in designating an SRO for the diverse investment advisory profession, including questions regarding governance, scope of authority, membership, conflicts of interest, and funding. For example, the report observes that an adviser SRO presents unique governance issues given the diversity of the industry, because it will be challenging to ensure that no business model dominates or is given a competitive advantage by the SRO. The report also notes the concern that an SRO might have access to unique data and could seek to sell related services to the members it regulates.

The Section 914 Report particularly notes the challenges presented in considering the scope of a potential SRO, stating that "crafting exclusions for certain types of investment advisers could be difficult in practice because, as discussed above, many investment advisers

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see also Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority, U.S. Gov't Accountability Office, at 16 (May 2012) ("2012 GAO Report") (noting that the SEC historically has not overseen FINRA's budget, executive compensation, or governance issues).

[12] Testimony of Paul S. Atkins, Visiting Scholar, American Enterprise Institute and former SEC Commissioner, before the House Committee on Financial Services, at 10 (Sept. 15, 2011) ("Atkins Testimony") (raising due process concerns regarding FINRA disciplinary hearings and noting that FINRA's claim that it is not a "state actor" may deny defendants the right to invoke the Fifth Amendment).

[13] *See also* BCG Section 967 Report, *supra* note 8, at 65 (noting limited nature of SEC's review of SRO rules).

have diverse client bases and business lines. Moreover, exclusions could provide opportunities for regulatory arbitrage."[14] These challenges are amply demonstrated by H.R. 4624.

H.R. 4624 evidently attempts to distinguish between "retail" investment advisory firms and "institutional" advisory firms; the former would be subject to SRO requirements, while the latter would remain solely under SEC regulation and oversight. The bill, however, does not appropriately draw these lines.[15] Instead, the legislation's exemptions from SRO requirements will result in inconsistent treatment of investment advisers that are engaged in similar activities – including different registration and licensing requirements, different substantive regulations, and substantially different costs. In addition to the SRO membership requirements, similar or identical advisers would likely be subject to different disclosure, advertising, or supervision rules. One set of advisers would be subject only to SEC or state rules. Another similar or identical set of advisers would be subject to both SEC or state rules and a new set of technical, detailed "business conduct" rules. These disparities are not justified by reasoned analysis.

For example, the bill exempts from SRO membership any investment adviser if one or more of its clients is a mutual fund. This means that two nearly identical firms (types of clients, assets under management, number of employees, investment style, revenues, profitability, *etc.*) will be treated differently if one firm has a single mutual fund client and the other does not. An adviser that manages assets for high net worth individuals[16] and one mutual fund would be subject to a different set of rules than an adviser that manages assets for high net worth clients and one hedge fund or one pension plan.

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[14] Section 914 Report, *supra* note 4, at 35.

[15] There is no settled notion of a "retail" investment advisory firm. For example, an advisory firm may specialize in advising highly wealthy individuals (*e.g.*, with $2-4 million in investable assets) and small or mid-sized businesses, pension plans, or endowments (*e.g.*, with $10-20 million in assets). Even though most would not consider such a firm to be "retail" oriented, it would not qualify for the SRO exemption under H.R. 4624 because its clients do not meet the "qualified purchaser" threshold ($5 million in investable assets for individuals and $25 million for entities).

[16] Most SEC-registered advisers (more than 60 percent) manage assets for high net worth individuals, according to data filed on Form ADV, Part 1, which defines "high net worth" individual generally as those with $2 million or more in net worth excluding primary residence. Note that H.R. 4624 only includes *ultra*-high net worth individuals ($5 million or more in investments) in its list of exempted clients.

The 90 percent test in H.R. 4624 produces similarly anomalous results. An advisory firm that manages $150 billion in assets would be exempt from the SRO requirements of H.R. 4624, even though a very large amount of assets (up to $15 billion) could be attributable to thousands of "retail" clients. At the same time, an advisory firm that manages $150 million in assets would be subject to SRO requirements if only $16 million of its assets are attributable to relatively few "retail" clients. Similarly, an adviser that manages assets, 11 percent of which are attributable to "retail" clients will be subject to different rules than an identical adviser that manages assets 9 percent of which are attributable to such clients. Further, an adviser with one client base and investment strategy could be subject to a different set of rules than an adviser with an identical client base and investment strategy simply because it is affiliated with an exempt adviser.

The legislation likely will encourage regulatory arbitrage as firms restructure their businesses and/or dismiss individual and small business clients to avoid the costs and additional regulatory burdens of an SRO. The bill would drive business models and create structural incentives. For example, many investment advisers that would otherwise be subject to SRO regulation may decide to establish or sub-advise a small mutual fund. Similarly, advisers may choose to affiliate with other investment advisers that either advise a mutual fund or manage sufficient "institutional" assets to absorb the adviser within its aggregated 90 percent AUM threshold for exemption from SRO membership. Advisers may also avoid having the AUM of smaller clients attributed to them by structuring arrangements to sub-advise or provide model portfolio management to other advisers with those clients.

These structural changes would lead to even more advisers remaining under SEC oversight than the bill currently contemplates that have the same core business and clients as the advisers subject to SRO jurisdiction, further exacerbating the inconsistent regulation of similar businesses. The Section 914 Report identified similar concerns, noting that if an SRO is limited in its membership by clientele type or other characteristics, many advisers will still be left under the SEC's oversight. The report observed that if the SEC and an SRO (or multiple SROs) share regulatory authority over advisers, the regime will be vulnerable to regulatory arbitrage.

C. H.R. 4624 Is Not Cost Effective.

Establishing and maintaining a new SRO will impose substantial costs and burdens on investment advisers, with a disproportionate impact on smaller advisers. It will exacerbate rather than ameliorate the SEC's resource constraints. Further, it will create an unnecessary additional layer of regulation on advisers. At a time when small businesses, including advisers, are becoming overwhelmed with new regulatory burdens, this Committee should search for the least costly and most effective alternative to directly address the specific problem identified.

1. *The Bill Inappropriately Targets Small Businesses with Additional Costs and Regulations.*

H.R. 4624 will disproportionately burden thousands of small businesses that serve small and mid-sized investors with the costs of a duplicative and unnecessary layer of regulation and bureaucracy.

The bill's exemptions for advisers to mutual funds, private funds, "qualified purchasers," and certain other clients mean that the vast majority of larger advisory firms will not be subject to SRO membership requirements. Instead, thousands of smaller advisory firms will be required to shoulder the costs of establishing and maintaining an SRO. As one commentator recently noted, H.R. 4624 "would impose a tax on small advisory businesses and, indirectly, the mainstream investors they advise, from which large advisors and their high net worth clients would be exempt."[17] Further, there is no evidence that imposing an SRO on these small firms, which represent a small fraction of the assets managed by advisers, will address the SEC's resource constraints or uncover problems of substantial magnitude.[18]

[17] Bullard, Mercer. *The New Self-Regulator for Advisors: A Taxing Affair for Small Businesses and Small Investors*, available at www.news.morningstar.com (May 10, 2012) ("Bullard article").

[18] Indeed, the stated poster-child for this legislation, Bernard Madoff's brokerage firm, which had been subject to SEC and FINRA inspections for decades before it registered as an investment adviser in September 2006, would likely have been exempt from the SRO membership requirements in H.R. 4624. *See* Bullard article, *supra* note 17.

As discussed below, the costs on small business to establish and maintain an SRO will be substantial. In addition, the impact of an additional layer of regulation and bureaucracy on these small firms will result in a significant and unnecessary burden. Compliance with SEC regulations, as well as other applicable regulations (including Department of Labor regulations) currently requires significant dedication of resources by investment advisory firms. If the substantial costs of this additional layer of regulation on these small businesses are passed on to investors, it will negatively affect retirement savings and investment.[19] If pricing resistance is such that all of the costs cannot be passed on, the costs will have a significant impact on job retention and creation in these small businesses – in which human resources account for the vast portion of the cost structure.

2. *The Bill Would Exacerbate, Not Ameliorate, the SEC's Resource Issues.*

H.R. 4624 will not ease the SEC's resource constraints but will instead place additional burdens on the agency. Appropriate government oversight is required in any SRO structure and thus requires dedication of significant government resources. The Section 914 Report observes that an SRO would not free all of the resources the SEC currently devotes to investment adviser examinations: "SEC resources would still be required to oversee the operations of any SRO by… 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 [the inspection staff and the policy staff] are currently employed to oversee the activities of FINRA."[20] For example, the SEC employs more than 300 staff to examine, and oversee FINRA's examination program of, broker-dealers (in addition to close to 50 inspection staff who currently focus on

[19] *See, e.g.*, BCG Section 967 Report, *supra* note 8, at 151 (noting potential for SRO costs to be passed on "to investors in a way that makes investing unaffordable for many").

[20] Section 914 Report, *supra* note 4, at 30; *See also* Bullard article, *supra*, note 17.

FINRA and other SRO oversight).[21] Additional substantial SEC expenditures will be required in the future just to oversee effectively the current SROs under its jurisdiction.[22]

These current challenges would be magnified not only by the extension of SRO jurisdiction to SEC-registered advisers but also to thousands of state-registered advisers. The SEC would be obligated to exercise appropriate supervision over the SRO's activities regarding thousands of state-registered advisers with respect to which the SEC currently has no regulatory responsibility. As a result, H.R. 4624 likely would exacerbate the SEC's resource constraints. Indeed, the legislation may result in a double layer of expenditures – investment advisers would be required to pay substantial fees to an SRO for regulation and the SEC would have to re-allocate substantial funds to fulfill extensive additional oversight responsibilities for the SRO.

In addition, this bill would require the SEC to conduct a firm-by-firm analysis of which companies under common control should be subject to SRO jurisdiction and which should remain solely under SEC jurisdiction due to their affiliations with other entities solely under SEC jurisdiction. There are almost 4,000 SEC-registered advisers with affiliated investment advisers. The analysis of these firms will consume substantial SEC resources, not only initially, but on an ongoing basis as firms affiliate or change their affiliations over time.

SEC Chairman Mary Schapiro recently testified regarding the strain that review of SRO rulemaking places on the agency. She stated that the "Dodd-Frank Act's imposition of new procedural requirements with respect to the SEC's processing of proposed SRO rule changes has placed further demands on an already complex and resource-intensive process. The volume of annual requests has increased by over 80 percent in the last five years, with the Commission receiving over 2,000 requests for approval or guidance in 2011."[23] The addition of oversight

[21] BCG Section 967 Report, *supra* note 8, at 64; Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011) ("913 Report") at A-15.

[22] BCG Section 967 Report, *supra* note 8, at 39-41.

[23] *Oversight of the U.S. SEC; Hearing before the H. Sub. on Capital Markets and Government Sponsored Enterprises,* 112th Cong. (Apr. 25, 2012) (testimony of Chairman Mary L. Schapiro) ("SEC 2012 Testimony").

duties for an adviser SRO with rulemaking authority will only compound these concerns and further strain SEC resources.

3. *An SRO Would Result in Unnecessary and Costly Regulation*.

The current regulatory framework for investment advisers is robust and protects investors. There is no evidence that a second layer of regulation imposed by an SRO is needed. Investment advisers are comprehensively regulated through the rules and requirements promulgated by the SEC and are subject to inspections and oversight by the agency. Investment advisers are subject to an overarching fiduciary duty requiring them to act in their clients' best interest and disclose all material facts and conflicts of interest.

Pursuant to the Investment Advisers Act, as a fiduciary, "an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions."[24] In practical terms, fiduciary duty means that, in the course of providing advice to clients, advisers must disclose all material information and conflicts of interest to their clients, including the fees that they charge, how they plan to recommend securities to clients, and any material disciplinary information involving the firms or their investment personnel. Moreover, as fiduciaries, advisers must treat their clients fairly and not favor one client over another, especially if they would somehow benefit from favoring one particular client or type of client. Most important, whenever the interests of investment advisers differ from those of their clients, advisers must explain the conflict to the clients and act to mitigate or eliminate it, ensuring they act in the interests of the client and not for their own benefit.

This well-established standard has been consistently interpreted and applied by the SEC and the courts to require investment advisers to serve their clients with the highest duty of loyalty

[24] Thomas P. Lemke and Gerald T. Lins, *Regulation of Investment Advisers*, at 2:33 (2012); *see also* SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) ("Capital Gains").

and duty of care.[25] Among the specific obligations that flow from an adviser's fiduciary duty are: (1) the duty to have an adequate, reasonable basis for its investment advice; (2) the duty to seek best execution for clients' securities transactions where the adviser directs such transactions; (3) the duty to render advice that is suitable to clients' needs, objectives, and financial circumstances; (4) the duty not to subrogate clients' interests to its own; (5) the duty not to use client assets for itself; (6) the duty to maintain client confidentiality; and (7) the duty to make full and fair disclosure to clients of all material facts, particularly regarding conflicts of interest.[26]

In addition, all SEC-registered investment advisers are required to submit detailed registration information (Form ADV, Part 1), which is publicly available, and update it at least annually and promptly for material changes. Advisers are also required to provide clients with a plain English brochure and brochure supplement (Form ADV, Part 2). The brochures are filed with the SEC and are publicly available. The brochure and brochure supplement provide extensive information regarding each investment adviser and key advisory personnel. Advisers are required to disclose detailed information about their firms, including: the educational and business background of each person who determines or provides advice to clients; the adviser's basic fee schedule (including how fees are charged and whether such fees are negotiable); types of investments and methods of securities analysis used; how the adviser reviews client accounts; the adviser's other business activities; material financial arrangements with a wide variety of entities; certain referral arrangements; and numerous other disclosures that describe activities that may pose potential conflicts of interest with the adviser's clients, including specific disclosures relating to trading and brokerage practices. In addition, advisers to private funds must soon submit extensive information to the SEC about their holdings, counterparty exposures, performance, and leverage on new Form PF.

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[25] Capital Gains, *supra* note 24.

[26] *See* Amendments to Form ADV, Investment Advisers Act Rel. No. IA-3060, (July 28, 2010); Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Rel. No. IA-1406, n.3 (Mar. 16, 1994) (noting duty of full disclosure of conflicts of interest, duty of loyalty, duty of best execution, and duty of care); Applicability of Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Rel. No. IA-1092 (Oct. 16, 1987) (discussing fiduciary duties); *see also* Capital Gains, *supra* note 24.

Investment advisers also are subject to a variety of requirements relating to proxy voting, books and records, insider trading, custody, privacy, best execution, advertising, and referral arrangements. Importantly, the assets managed by investment advisers must be held at registered broker-dealers or banks.[27] Investment advisers must adopt written codes of ethics, which must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel. Advisers also must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review the policies and procedures at least annually to determine the adequacy and effectiveness of their implementation, and designate a chief compliance officer responsible for administering the policies and procedures. Under these rules, advisers have the flexibility to tailor their policies and procedures to the nature of their business and clientele.

This regulatory framework is appropriate to the nature, scope, and risks of the investment advisory business. No additional layer of regulation is warranted. Further, SRO-style business conduct rules are typically very detailed command-and-control requirements that seek to impose a one-size-fits-all solution for various legal and regulatory issues. In contrast to the principles-based SEC framework, these SRO "check-the-box" regulations do not lend themselves to the widely divergent community of advisers.

In addition, the SEC staff's Section 914 Report raised concerns that subjecting advisers to an SRO could lead to inconsistent interpretations and applications of the Advisers Act. The report noted that the possibility of multiple SROs – which, though unlikely, H.R. 4624 would permit – could result in SROs over time developing "different approaches to applying the Advisers Act and their own rules to similar activities," prevention of which would require

[27] In response to the Madoff case, the SEC strengthened the "custody" rule to enhance protection of client assets. *See Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges, Hearing before the H. Sub. on Capital Markets, Insurance and Government Sponsored Enterprises*, 111th Cong. (Jul. 20, 2010) (testimony of SEC Chairman Mary L. Schapiro) ("The rule leverages our own resources by relying on independent, third-party accountants to confirm client assets and review custody controls in situations where the possibility for misappropriation of client assets is most acute because of the adviser's possession of, or control over, client assets").

"vigorous oversight" by the SEC. The report also highlighted the difficulties involved in requiring the SEC to oversee an SRO that has enforcement authority with respect to a broad range of state regulatory requirements, which would be the case if H.R. 4624 were enacted.

D. The IAA Opposes Designation of FINRA as an SRO for Advisers.

The legislation appears to have been designed to favor FINRA as the presumptive designated SRO for advisers. The bill is modeled on, and largely replicates, the Maloney Act, which established the SRO structure pursuant to which FINRA now operates. FINRA – a self-described "non-governmental regulator" with 3,000 employees and more than $1.1 billion in total revenues – was designed and developed to oversee broker-dealer activity.[28] FINRA has clearly indicated its desire to extend its jurisdiction to include oversight and regulation of investment advisers.[29] The IAA strongly opposes extending FINRA's jurisdiction to investment advisers due its lack of adviser expertise, lack of accountability, lack of transparency, excessive costs,[30] and questionable track record.[31]

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[28] *See* FINRA, 2010 Year in Review and Annual Financial Report (June 2011) *available at* http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p123836.pdf ("FINRA 2010 Report").

[29] *See, e.g., Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. (Oct. 6, 2009) (oral testimony of Richard Ketchum, Chairman and CEO, FINRA).

[30] *See* FINRA, Report of the Amerivet Demand Committee of the Financial Industry Regulatory Authority, Inc. (Sept. 13, 2010), *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p122217.pdf , at 86 (FINRA benchmarks its senior management compensation based on levels in the financial services industry and states that "non-profit organizations and governmental agencies were inadequate comparables for compensation purposes"). As disclosed in FINRA's 2010 Annual Report, salaries and bonuses for FINRA's top executives average $1,057,787. *See* FINRA 2010 Report, *supra* note 28.

[31] *See, e.g.*, Letter from Project on Government Oversight (POGO) to House Committee on Financial Services Chairman Bachus and Ranking Member Frank opposing Self-Regulation of Investment Advisers (May 29, 2012) *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20120529-finra-investment-advisers.html; Letter from Project on Government Oversight (POGO) to Congress calling for increased oversight of financial self-regulators (Feb. 23, 2010), *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html;*see also* FINRA Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes (Sept. 2009) at 5, *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf ("FINRA examiners did come across several facts worthy of inquiry associated with the Madoff scheme that, with the benefit of hindsight, should have been pursued."); *The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. (Jan. 27, 2009) (testimony of John C. Coffee, Jr., professor at Colum. Univ. Law School) (noting that Madoff's advisory activity

Designation of FINRA as the adviser SRO would raise conflicts of interest with potential adverse competitive implications for advisers.[32] Broker-dealers are the "sell side" of the securities industry, while advisers are the "buy side." The potential for conflict is demonstrated by FINRA's explicit advocacy of extending the broker-dealer regulatory framework to advisers.[33] Conflicts may arise in that broker-dealers engage in arms-length transactions with investment advisers in various capacities, including as service providers, counterparties, market makers, and syndicators and underwriters. An association representing private fund advisers has observed that these competing relationships "would present challenges to an SRO responsible for overseeing these types of firms fairly and equitably."[34]

FINRA's lack of accountability makes it particularly ill-suited to extend its reach to investment advisers. The BCG Section 967 Report repeatedly stated that SROs are not accountable to the SEC and that the agency and SROs were not coordinating effectively.[35] In this regard, it stated that FINRA "merits particular attention given its size and scope." For

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was within the NASD's and FINRA's jurisdiction); *SRO Regulation in the Dodd-Frank Era*, by Stewart D. Aaron, Elissa J. Preheim, and William Miller, Arnold & Porter LLP, published in Law360 (April 11, 2011) ("public perceptions about the effectiveness of self-regulation were not helped by events such as FINRA's failure to detect Lehman Brothers' controversial Repo 105 accounting, or FINRA declaration of Bear Stearns' capital adequacy on the very day Bear Stearns collapsed"); Letter from Pickard & Djinis, LLP to Elizabeth M. Murphy, Secretary, SEC (Jan. 2011) ("Pickard & Djinis Section 914 Letter") ("there is no question that the NASD/FINRA had both the authority and the responsibility to investigate Madoff's fraudulent conduct").

[32] *Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform, Hearing Before the S. Comm. on Banking, Housing and Urban Affairs,* 111th Cong. (August 17, 2009) (statement of Prof. Onnig H. Dombalagian, Tulane University) ("[t]he conflicts of interest between the brokerage industry and the investment advisory industry… are too great for FINRA to exercise a meaningful role in the oversight of investment advisers").

[33] *See* Letter from Marc Menchel, General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, SEC re: File Number 4-606 Study Regarding Obligations of Brokers, Dealers and Investment Advisers (Aug. 25, 2010). *See also* Letters from NASD to Jonathan G. Katz, Secretary, SEC re: *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Rel. No. 34-50980; File No. S7-25-99 (Feb. 11, 2005 and Apr. 4, 2005).

[34] Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC (Dec. 16, 2010) ("MFA Section 914 Letter") at 10.

[35] BCG Report, *supra* note 8, at 65-67, 237-38.

example, the report observes that "FINRA conducts extensive risk assessment activities in support of its examinations," but does not share its analysis with the SEC.[36]

Further, in a report released last week, the GAO found that neither the SEC nor FINRA has conducted any formal retroactive review of FINRA rules to assess their actual impact after implementation.[37] The report also found that the SEC historically has not conducted oversight of FINRA's governance, conflicts of interest, funding, executive compensation, or cooperation with state regulators. Further, FINRA recently opposed an attempt by its members to subject FINRA's rulemakings and amendments to economic and cost-benefit analysis.[38]

According to the Chamber of Commerce Report discussed above, FINRA's members no longer have a meaningful role in establishing its policies and priorities, and the organization is not moving toward greater transparency and accountability.[39] The report states that "[t]ransparency into FINRA's governance, compensation, and budgeting practices is extremely limited and superficial. Furthermore, FINRA is not subject to the Freedom of Information Act or the APA, nor is it required to conduct a cost-benefit analysis when it engages in rulemaking or exercises its policy-making functions."[40] Unlike the SEC, FINRA is not subject to the Government in the Sunshine Act and its board of directors does not hold open meetings. On the other hand, FINRA claims that it is a governmental or quasi-governmental regulator when it suits

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[36] *Id.* at 67.

[37] 2012 GAO Report, *supra* note 11, at 12-15.

[38] *See, e.g.*, Letter from Stephanie M. Dumont, Senior Vice President and Dir. of Capital Markets Policy, FINRA, to Elizabeth M. Murphy, Secretary, SEC re: SR-FINRA-2011-058-Response to Comments, at 7-8 n.27 (Dec. 23, 2011) ("After all, no SRO is required to undertake an economic analysis of its rule proposals . . . . there is no statutory or Exchange Act Rule requirement to undertake an economic analysis because a commenter makes such demand and we are unaware of any requirement on the part of the Commission to oblige such commenters.").

[39] Chamber of Commerce Report, *supra* note 7. *See also* Brief for the CATO Institute as Amicus Curiae, p. 6-7, 9, 11, Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, 637 F.3d 112 (2d Cir. 2011) ("CATO Brief") ("Constitutional accountability typically stems from either of two sources: political accountability or legal accountability… Here, political accountability is de minimis due to the layers of authority separating FINRA from executive branch officers… Unfortunately, legal accountability—judicial review—has also eroded, leaving FINRA and similarly situated SROs almost entirely unaccountable.").

[40] Chamber of Commerce Report, *supra* note 7, at 23.

its interests, such as claiming sovereign immunity when sued. Similarly, FINRA is not accountable to any entity with respect to its budget – neither to Congress nor to the SEC.[41]

Because of these numerous shortcomings, the Cato Institute recently concluded that "FINRA's extra-constitutional operation has fostered significant policy failures including agency capture, lax regulation, and biased arbitration…The proliferation of substantial financial industry scandals over the past decade is evidence that FINRA is, at best, a hands-off regulator and, at worst, a corrupt and self-serving company."[42] These concerns are underscored by FINRA's recent settlement of civil charges by the SEC for repeatedly misleading the SEC by altering documents sought by the agency during routine inspections.[43]

II. User Fees Paid by SEC-Registered Advisers Are Preferable to an SRO.

The Committee should consider appropriate legislation authorizing the SEC to require that federally registered investment advisers pay user fees, rather than subjecting them to an SRO. Such user fees should be dedicated for the sole purpose of enhancing the SEC's investment adviser inspection program over and above current inspection levels. Legislation authorizing investment adviser user fees should include provisions that will provide for appropriate reporting and audit requirements to enable Congress, the public, and the investment advisory community to ensure that the funds are being used for their intended purposes and to provide accountability and transparency. User fees would be a more effective and efficient means than an SRO to enhance the oversight of investment advisers and would be less costly. Investment advisers strongly support oversight by the SEC, which continues to improve its examination program.

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[41] *See* Atkins Testimony, *supra* note 12, at 10-11; 2012 GAO Report, *supra* note 11.

[42] CATO Brief, *supra* note 39, at 6-7, 9, 11.

[43] *SEC Accuses Brokers Group of Deception*, The Washington Post (Oct. 28, 2011); SEC Press Rel. 2011-227: *SEC Orders FINRA to Improve Internal Compliance Policies and Procedures* (Oct. 27, 2011), *available at* http://sec.gov/news/press/2011/2011-227.htm.

A. User Fees Are More Effective and Efficient than an SRO.

User fees would be far more effective and efficient in enhancing examinations of advisers than establishing an unnecessary additional layer of bureaucracy and cost. The SEC has more than seven decades of experience regulating and overseeing the investment advisory profession. Moreover, the SEC is directly accountable to Congress and the public with regard to its budget and performance. As SEC Commissioner Luis Aguilar stated in 2009, "I do not believe that the answer is to create another SRO – particularly when it would be one without any experience in dealing with the investment advisory industry and the Advisers Act regulatory tradition. Moreover, this current crisis has illustrated the dangers of regulatory fragmentation where the primary regulator is not able to quickly obtain, assess, and analyze information. Now is not the time to fragment even more, but to consolidate and employ smart regulation. The SEC is the only public agency charged with regulating our capital markets and maintaining a keen sense of the entire market on behalf of investors. To create another regulator at this time without the experience in regulating a principle-based system of regulation would be too costly for the industry and the public in terms of both dollars and investor protection."[44]

The Section 914 Report provides many reasons why user fees would be a preferable approach to an SRO or other options. The Section 914 Report notes that investment adviser user fees would provide a stable source of funding that would be scalable to increases or decreases in the adviser population and could be set at a level designed to achieve the SEC's desired examination frequency and scope.[45]

User fees are already an important source of funding for inspections and examinations of other financial institutions and regulated entities by many federal agencies, including the

[44] *See SEC's Oversight of the Adviser Industry Bolsters Investor Protection*, Speech by SEC Commissioner Luis A. Aguilar (May 7, 2009) (also noting that the SEC is "the only entity with experience overseeing investment advisers, an industry governed by the Advisers Act, which is based on a principles-based regime. By contrast, broker-dealer SROs primarily regulate through the use of very detailed, specific sets of rules and are not well versed in the oversight of principles-based regulation").

[45] Section 914 Report, *supra* note 4, at 25.

Comptroller of the Currency.[46] In addition, the SEC previously supported user fees in testimony related to legislation under consideration in 1990. Further, investment advisers already pay user fees to support the Investment Adviser Registration Depository ("IARD"), the electronic system through which investment advisers make filings with state and federal regulators.[47] The IARD system therefore provides an existing infrastructure to collect user fees at a small marginal cost.

The Section 914 Report found that the user fee option would permit the SEC's Office of Compliance Inspections and Examinations ("OCIE") to improve the effectiveness of its examinations through long-term strategic planning that would better use modern technology and its workforce. A stable source of funding would permit use of technology-based solutions that can take years to develop and implement.[48] Stable resources would also provide the examination program with increased flexibility to react to emerging risks and better target staffing and strategic resources as appropriate. The staff observed that knowledge gained from the investment adviser examination program would continue to greatly assist in gathering the intelligence and expertise critical to the regulatory process.[49] Further, ongoing improvements to the examination program could be further leveraged with the funding provided by user fees. The SRO model would not provide such benefits to the SEC.

Indeed, in its analysis of the various options to increase examinations, the Section 914 Report found that user fees present the greatest number of advantages and the least number of disadvantages.[50] The report observes that "imposing user fees would avoid the difficult scope of

[46] The Section 914 Report notes that "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 the Department of Agriculture." *Id.* at 25-26.

[47] *Id.* at 26.

[48] *Id.* at 26-28.

[49] *Id.*

[50] *See, e.g., Statement on Study Enhancing Investment Adviser Examinations*, by Commissioner Elisse B. Walter (Jan. 2011) at 7 (noting with disappointment that the "study attributes virtually no disadvantages to the user fee option, but many disadvantages to the SRO and FINRA dual registrant options").

authority, membership, governance, and funding issues raised by an SRO…It would avoid the need for the Commission to use resources to staff an expanded SRO examination program."[51] The Section 914 Report also noted that funding from adviser user fees would give the SEC greater flexibility and may be a less costly option than establishing an SRO.

Indeed, the report notes that in many ways, user fees may be a smarter, more efficient use of funds.[52] Allowing OCIE to charge user fees would empower it to build on the expertise and infrastructure it has already established in examining advisers.[53] Within the SEC, OCIE examination staff benefit from close working relationships with other SEC legal and policy staff.[54] In contrast, an SRO would be an isolated cost center that would require extra resources and personnel to build even a preliminary infrastructure.

Further, as noted above, an SRO would still require an increase in the SEC's management and coordination costs in order to oversee the SRO.[55] In fact, the SEC staff expressed concern that the SRO oversight may one day be underfunded because there is no certainty that the level of resources available to the Commission over time will provide for effective oversight.[56] In addition, with the user fee option, "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."[57]

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[51] Section 914 Report, *supra* note 4, at 27.

[52] *See* Section 914 Report, *supra* note 4, at 27; *see also* Letter from David G. Tittsworth, Exec. Dir., IAA, to Elizabeth Murphy, Secretary, SEC, re: SEC Study on Enhancing Investment Adviser Examinations under Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Oct. 19, 2010) ("IAA Section 914 Letter"); MFA Section 914 Letter, *supra* note 34, at 10; *Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence, Before the H. Sub. on Capital Markets and Government Sponsored Enterprises*, 112th Cong. (June 24, 2011) (statement of Paul Schott Stevens, President and CEO, Investment Company Institute).

[53] Section 914 Report, *supra* note 4, at 28, 30.

[54] *Id.* at 28.

[55] *Id.* at 27.

[56] *Id.* at 28.

[57] *Id.*

B. User Fees Would Be Less Costly than an SRO.

In considering legislation to enhance investment adviser examinations, Congress should consider the costs and benefits of the various alternatives. We are not aware of any analysis or empirical data demonstrating that the costs associated with H.R. 4624 would be outweighed by the benefits. To the contrary, there is compelling evidence that the costs of outsourcing regulation and oversight of thousands of investment advisers to an SRO (likely FINRA) would be far greater than the comparable costs of enhancing the SEC's inspection program.

In this regard, a study commissioned by the IAA, the Certified Financial Planner Board of Standards, Inc., the Financial Planning Association, the National Association of Personal Financial Advisors, and TD Ameritrade Institutional, is highly relevant.[58] These groups commissioned BCG to produce a report determining the costs of the options outlined in the Section 914 Report on enhancing investment adviser examinations.

The December 2011 BCG economic analysis analyzed the costs of: (1) increasing the level of SEC examinations; (2) set-up and operation of an investment adviser SRO by FINRA; and (3) set-up and operation of an entirely new SRO for advisers. BCG's economic analysis was based on the assumption that advisers would be examined by the SEC or an SRO on average once every four years.

The economic analysis found that the costs to investment advisers of adequately funding the SEC to conduct additional examinations would be far less than paying FINRA or another SRO to do so. It underscores the conclusion that the best and most efficient way to enhance investment adviser oversight is to ensure that the SEC has sufficient resources.

Key findings of the BCG economic analysis include the following:

[58] The December 2011 BCG economic analysis is appended to this testimony for the record.

1. Creating an SRO for advisers would likely cost at least twice as much as funding an enhanced SEC examination program.

    - The incremental cost of the SEC hiring the additional adviser examiners needed to increase the inspection rate for advisers to on average once every four years (including supporting expenses) would be $100-110 million per year.

    - The total cost of an enhanced SEC examination program (including both the costs of the existing program and the incremental costs related to hiring the additional examiners) is projected to be $240–270 million per year.

    - In contrast, a FINRA SRO (examination, enforcement, and SEC oversight) is projected to cost $550–610 million per year; and a new SRO is projected to cost $610–670 million per year.

2. The cost savings to the SEC of creating an SRO is likely to be minimal because the SEC would need to spend significant resources ($90–105 million per year) overseeing an SRO.
3. The startup costs of an SRO alone ($200–310 million) could fund an enhanced SEC examination program for an entire year ($240–270 million).
4. Shifting primary oversight of dually registered broker-dealers and investment advisers (those regulated by both the SEC and FINRA) to FINRA alone is not expected to result in significant costs savings to the SEC.

Further, as discussed above, H.R. 4624 is structured such that the substantial costs of establishing an SRO for advisers will be imposed on small businesses rather than being shared across the industry, as assumed in the BCG economic analysis. In other words, the fixed costs of establishing an SRO with rulemaking, examination, and enforcement authority will be assessed on a smaller group of advisers with limited resources. Accordingly, the actual costs that would be incurred by these small businesses will be even higher than under an industry-wide or user fee approach.

BCG released an addendum to this analysis on May 10, 2012 to discuss FINRA's estimate – a one-and-a-half page document titled "Investment Estimate for FINRA IA SRO" – that was released concurrent with the introduction of H.R. 4624 on April 25.[59] According to BCG's analysis, FINRA's estimate of the cost to set up, operate, and oversee a self-regulatory organization for investment advisers greatly underestimates the overhead costs and overestimates investment adviser examiner productivity.[60]

C. Investment Advisers and Other Commenters Strongly Support Continued SEC Oversight of Advisers.

In addition to the IAA, a number of other organizations and commenters have voiced numerous concerns about establishing an SRO for investment advisers and instead have expressed support for ensuring adequate resources for the SEC.[61] For example, the Managed Funds Association ("MFA") has expressed multiple concerns about an SRO for investment

[59] *See FINRA's Cost Estimates Challenged; Leading Financial Services Organizations Respond to FINRA's Estimates*, IAA press release (May 10, 2012), *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/PressReleases/PressCur/120510prs.pdf.

[60] Specifically, BCG found that: (1) FINRA's estimate omits the cost of SEC oversight of the IA SRO ($90-$100 million) and the cost of enforcement ($60-70 million), both of which are required by H.R. 4624; (2) FINRA's estimate of $12-$15 million in setup costs does not include staff costs incurred during the 12-month setup period, specifically the cost of examiners and support staff. Rather, FINRA only includes these expenses as part of its ongoing investment once the SRO is up and running. This omission accounts for $180-$230 million of the difference between the BCG and FINRA estimates; (3) FINRA's estimate of the ongoing annual cost of examining 14,500 IA firms once every four years assumes that FINRA's IA examiners would be able to nearly double the productivity rate of SEC IA examiners by performing 5 or more examinations per examiner per year. This compares to SEC IA examiner productivity of 3.0, and FINRA broker-dealer examiner productivity of 2.8. This productivity assumption accounts for $150-$170 million of the difference between the BCG and FINRA estimates; and (4) FINRA's estimate does not include overhead costs in its estimate of $150-$155 million of ongoing annual investment. Overhead costs account for $135-$140 million of the difference between the BCG and FINRA estimates. *Id.*

[61] *See, e.g.*, Pickard & Djinis Section 914 Letter (from a law firm with extensive experience representing both advisers and brokers), *supra* note 31, at 4 ("While the costs of designating one or more SROs for investment advisers are clear the benefits are less so. In analyzing the question of benefits, we submit that the number of adviser examinations that an SRO could conduct is less important than the quality of those examinations. SROs' lack of familiarity with the extensive regulatory regime imposed on advisers raises serious concerns about such organizations' ability to oversee the implementation of that regime effectively. Moreover, as the Madoff and Stanford scandals show, SRO examinations can be ineffective even where the activities being examined are squarely within the purview of the organization's jurisdiction and expertise.").

advisers[62] and its support for ensuring that the Commission has adequate resources, including appropriate user fees.[63] Similarly, the American Institute of Certified Public Accountants ("AICPA") has expressed its strong opposition to an SRO, and FINRA in particular,[64] and instead indicated its support for providing appropriate resources to the SEC, including user fees.[65] The Alternative Investment Management Association ("AIMA") has opposed an SRO and instead supports "full and proper regulation and oversight of investment advisers by the Commission and believes the Commission should be given adequate resources to fulfill its objectives of protecting investors, maintaining fair, orderly, and efficient markets and facilitating capital formation."[66] The North American Securities Administrators Association ("NASAA") has expressed its strong opposition to outsourcing important government regulatory functions to a third party.[67] Further, the Financial Planning Coalition has noted the many drawbacks to an

[62] *See* MFA Section 914 Letter, *supra* note 34 ("[A]n SRO would lack experience in regulating private fund managers, create inconsistent regulation for investment advisers, face difficult conflicts of interest, increase regulatory costs, and ultimately diminish the quality of regulatory oversight of the industry.").

[63] *See* Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC (Sept. 22, 2010), at 5 ("{W]e would support appropriate fees on investment advisers to help ensure that OCIE has the resources they need to conduct examinations of the investment adviser industry.").

[64] *See* Letter from Barry C. Melancon, CPA, President & CEO, AICPA, to Elizabeth M. Murphy, Secretary, SEC (Nov. 24, 2010), at 2 ("We strongly oppose the creation of a self-regulatory organization (SRO) for investment advisers. An SRO is inherently conflicted and is not the right answer for regulation of investment advisers. We believe that FINRA would bring a broker-dealer perspective, and bias, to investment adviser examinations and that its rules-based, check-the-box approach is not conducive to adequate regulation of the investment advisory profession nor is it in the public's best interest.").

[65] *Id.* at 1-2 ("AICPA strongly believes that the principles-based regulatory approach of the Investment Advisers Act and its related rules should continue to govern investment advisers and further, that regulatory oversight remain exclusively with the SEC and/or states. Providing the SEC with resources to properly enforce their rules, even if it means assessing additional fees on investment advisers, is the best solution for investment advisers and the public.").

[66] *See* Letter from Mary Richardson, Director of Regulatory & Tax Department, Alternative Investment Management Association to Securities and Exchange Commission (Jan. 12, 2011), at 3.

[67] *See* Letter from David L. Massey, NASAA President and North Carolina Deputy Securities Administrator to Elizabeth M. Murphy, Secretary, SEC (Nov. 22, 2010), at 2-3 ("[I]nvestment adviser regulation is a governmental function that should not be outsourced to a private, third-party organization that does not have expertise or experience with investment adviser regulation. Securities regulation in general and investment adviser regulation in particular is best left with governmental regulators that are transparent and directly accountable to the investing public. One can readily conclude that the designation of an SRO for the oversight of investment advisers, with its attendant direct and indirect costs, its opaque structure and attendant lack of accountability and transparency, would outweigh any perceived benefits to the investing public.").

SRO for investment advisers, and to FINRA in particular,[68] and stated its support for continuation of the SEC's regulation and oversight of the advisory profession.[69]

D. The SEC Has Improved its Investment Adviser Examination Program and Should Continue its Oversight of All SEC-Registered Advisers.

The IAA has consistently supported the SEC's efforts to strengthen its examination program for investment advisers. We testified last year before this Committee in support of efforts to strengthen the SEC's investment adviser examination program conducted by OCIE.[70] Adequate resources for, and a commitment to, an effective SEC examination program for investment advisers should be a high priority for policy makers and for the SEC.

Over the last three years, the SEC has focused on revitalizing and restructuring its enforcement and examination functions.[71] The mission of the examination program is to improve compliance, prevent fraud, inform policy, and monitor industry-wide and firm-specific risks.[72] The SEC has implemented a more risk-focused examination program to provide information for SEC enforcement investigations and to inform the financial industry about risky

[68] *See* Letter from Kevin R. Keller, Chief Executive Officer, CFP Board, Marvin W. Tuttle, Jr., Executive Director/CEO, FPA, and Ellen Turf, Chief Executive Officer, NAPFA to Elizabeth M. Murphy, Secretary, SEC (Dec. 16, 2010), at 5 ("Creating a new layer of bureaucracy and cost in order to improve the frequency of investment adviser examinations is not a wise use of limited regulatory resources. Aside from the additional infrastructure costs involved with creating an SRO oversight structure for investment advisers, outsourcing oversight could result in inconsistent or redundant regulation and enforcement (as both the SRO and the Commission interpret and enforce the relevant rules)."

[69] *Id.* at 3 ("We believe it would be much quicker and more efficient to leverage the Commission's existing investment adviser examination staff, which is already fully conversant with all of the legal and regulatory issues that pertain to investment advisers, than to create an entirely new SRO from scratch to oversee investment advisers.").

[70] *Regulation and Oversight of Broker-Dealers and Investment Advisers; Hearing before the H. Sub. on Capital Markets, Insurance and Government Sponsored Enterprises*, 112th Cong. (Sept. 13, 2011) (testimony of David G. Tittsworth, Executive Director, Investment Adviser Association) ("IAA 2011 Testimony"). *See also, e.g.*, Letter from David G. Tittsworth, Exec. Dir., IAA, to The Hon. Mary L. Schapiro, Chairman, SEC re: SEC Exams of Investment Advisers (July 29, 2009), available on our web site under "Comments and Statements."

[71] SEC 2012 Testimony, *supra* note 23.

[72] *Address at the Private Equity International Private Fund Compliance Forum*, Speech by Carlo V. Di Florio, Director of OCIE, SEC (May 2, 2012) ("2012 Di Florio Speech").

practices. The program continually collects and analyzes a wide variety of data about investment advisers using quantitative techniques.[73]

OCIE has continued to refine its examination tools and techniques to better allocate and leverage limited resources to their highest and best use.[74] In 2011, OCIE created a centralized risk assessment and surveillance office to evaluate risks across all markets and registrant categories. OCIE's risk office has enhanced the ability of the SEC to perform data analytics to identify firms that present the "greatest risks" to investors, markets and capital formation and to determining which firms to examine.[75] OCIE now provides a risk-rating to *all* new and existing investment adviser registrants based on data collected from the newly expanded Form ADV and other public data. In addition, OCIE has increased its outreach to senior management and mutual fund boards along with the examination process regarding risk and regulatory issues.[76] OCIE has also developed a large firm monitoring program whereby OCIE collaborates with SEC divisions and offices in monitoring risks at certain large firms.[77] Under this new process, OCIE's examinations are tailored to a firm's risk rating and risk areas such as business model and revenue streams, affiliations and conflicts of interest, and compliance controls. OCIE also uses tips, complaints and referrals and surprise custody audits to help determine which advisers to examine and the scope of the exams.[78]

The SEC has also continued to take important steps to increase the examination staff's expertise in the securities markets including recruiting experts with knowledge of hedge funds, private equity, derivatives, complex structured products, and valuation, as well as strengthening

[73] SEC 2012 Testimony, *supra* note 23.

[74] 2012 Di Florio Speech, *supra* note 72.

[75] *Id.; See also Examinations by the Securities and Exchange Commission, Office of Compliance Inspections and Examinations*, (Feb. 2012) ("OCIE Examinations"), *available at* http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[76] 2012 Di Florio Speech, *supra* note 72.

[77] *Id.*

[78] *Id.*

current examiner skill sets and developing an examiner certification program.[79] In addition, OCIE is developing information management systems to help better organize and evaluate the extensive new information that the SEC collects on Form ADV and Form PF.[80] These systems will provide the SEC with substantial additional detailed information about advisers' business practices to assist in risk-targeted examinations, enforcement, and oversight of advisers.[81]

In fiscal year 2011, OCIE examined approximately 8 percent of advisers out of the 11,000 or so SEC-registered investment advisers, representing 30 percent of the total assets under management by all SEC-registered investment advisers.[82] While the number of advisers examined can and should be increased, the SEC's breadth in covering 30 percent of investors' assets managed by advisers is substantial.[83] Further, as noted above, OCIE reviews data and information about *all* investment advisers. Both at a national and regional level, the examination staff then cull from the adviser universe the set of advisers with the most "risky" profiles and subject those advisers to in-depth examinations. The SEC will be adding examination staff in fiscal year 2012 to improve the rate of examination of advisers, including those advisers that have not been examined.[84] Even now, however, OCIE conducts outreach to new advisers and

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[79] *Id.* *See also* Section 914 Report, *supra* note 4, at 15, 28; *The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud, Before the H. Sub. on Oversight and Investigations,*, 111th Cong. (May 13, 2011) (testimony of Robert Khuzami, Dir. of SEC Div. of Enforcement, and Carlo di Florio, Dir. of SEC Office of Compliance Inspections and Examinations); *Budget and Management of the U.S. Securities and Exchange Commission; Hearing before the H. Sub. on Capital Markets, Insurance and Government Sponsored Enterprises,* 112th Cong. (Mar. 10, 2011) (testimony of Carlo di Florio).

[80] 2012 Di Florio Speech, *supra* note 72.

[81] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Rel. No. IA-3145 (Jan. 26, 2011).

[82] SEC 2012 Testimony, *supra* note 23.

[83] We note, however, that the frequency of examination per adviser is only one factor in an effective examination and oversight program. *See* Section 914 Report, *supra* note 4, at 26 n.46. *See also* 156 Cong. Rec. S5920 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd stating with respect to Section 913: "in this review, the paramount issue is effectiveness. If regulatory examinations are frequent or lengthy but fail to identify significant misconduct – for example, examinations of Bernard L. Madoff Investment Securities, LLC – they waste resources and create an illusion of effective regulatory oversight that misleads the public").

[84] SEC 2012 Testimony, *supra* note 23.

those that have never been examined. The SEC requests information from such advisers and, based on that information and other data, prioritizes such advisers for review. Contrary to the perceptions created by some statistics, *all* investment advisers are on OCIE's radar screen.

We continue to encourage the SEC to consider ways in which it can increase the frequency of investment adviser examinations under its current allocation of resources and any future allocated resources. However, we are prepared to support user fees to the SEC to increase its frequency of examinations of investment advisers. User fees would be a far more effective approach than outsourcing the SEC's responsibilities to a non-governmental organization.

Conclusion

The IAA supports appropriate measures to ensure that the SEC conducts a strong and effective examination program of investment advisers. We strongly oppose establishment of an SRO for investment advisers and urge the Committee to instead consider appropriate user fee legislation.

We appreciate the opportunity to share our views with the Committee. We look forward to working with Congress and the SEC on these important issues.

BCG

THE BOSTON CONSULTING GROUP

APPENDIX

Investment Adviser Oversight

Economic Analysis of Options

December 2011

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The Boston Consulting Group ("BCG"), a global management consulting firm, was engaged by a group of organizations with Investment Adviser ("IA") stakeholders to conduct an economic analysis of IA oversight scenarios. These scenarios are based on recommended options contained in the Securities and Exchange Commission's ("SEC") study released in January 2011, which was conducted per Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The objective of this report is to establish an economic fact base, informed by publicly available information.

The economic analysis relied upon publicly available research, studies, and reports, as well as more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts. The BCG team involved in this effort was not involved in any prior BCG work for related organizations. Further, the BCG team conducted this analysis independently of any prior related work performed by the firm. The SEC and the Financial Industry Regulatory Authority ("FINRA") were not interviewed or consulted as part of this effort. They did not provide any input, feedback or guidance on the materials or on the analysis contained in this report.

This report does not consider, evaluate, or comment on the benefits of any specific IA oversight scenario, in terms of effectiveness, ease of implementation, or other relevant criteria. This report, any statement made therein, or any statements made by BCG or by any other organization regarding this report, does not constitute a BCG endorsement or recommendation of any of the specific IA oversight scenarios referenced in this report or of any specific approach to IA oversight more generally, and should not be interpreted as such.

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I. Executive summary

As required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Securities and Exchange Commission ("SEC") released a study in January 2011 ("SEC Section 914 Study") that identified three recommended options to Congress regarding examination of SEC-registered Investment Advisers ("IAs"), all of which would require federal legislation before they could be implemented[1]. To inform the discussion on this issue, a group of organizations with IA stakeholders ("Clients") commissioned The Boston Consulting Group ("BCG") to perform an independent and objective economic analysis including an estimate of the level of funding required for each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[2]

BCG profiled and modeled three core scenarios, informed by the first two recommended options in the SEC Section 914 Study. The three core scenarios are:

1. Enhance SEC examination capabilities ("Enhanced SEC"): Achieve an acceptable frequency of IA examinations by hiring additional Office of Compliance Inspections and Examinations ("OCIE") staff, funded by user fees;[3]

2. Authorize a FINRA SRO for IAs ("FINRA-IA SRO"): Authorize the Financial Industry Regulatory Authority ("FINRA"), the self-regulatory organization ("SRO") for Broker-Dealers ("B-Ds"), to develop an IA SRO capability with an IA examination and enforcement mandate,[4] funded by membership fees, and overseen by the SEC; and

3. Authorize a new SRO for IAs ("New-IA SRO"): Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The estimated cost of each of the three core scenarios is summarized in Table 1 below.[5,6,7] The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years:

[1] The implementation timelines cited in this report are independent of any timelines related to legislative action.
[2] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 and is examined as an additional scenario in Section III.3.3.
[3] Only the cost of examination is funded via user fees, and the SEC would continue to rely on pre-existing sources of funds to support other aspects of its administration of the Investment Advisers Act of 1940 (SEC Section 914 Study, p. 25). However, the estimated costs of enforcement are included in Section III.1.2 for comparative purposes.
[4] SROs typically have rulemaking, examination, and enforcement authority. An enforcement mandate is included along with examination in this analysis, as it is reasonable to assume that an SRO would have authority to discipline its members. Rulemaking is considered separately in section III.3.1 due to possible exclusion from an SRO's mandate.
[5] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[6] Enhanced SEC scenario costs are shown both as incremental OCIE IA costs (i.e., additional IA examiners needed to achieve the target frequency of examinations) and full OCIE costs (i.e., both existing and incremental OCIE IA costs).
[7] Estimates reflect the direct costs of regulatory operations and not the total cost of compliance to IA firms.

Table 1: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Setup costs	$6 – 8M (7)	$6 – 8M (7)	$200 – 255M (230)	$255 – 310M (280)
Estimated setup time	6 – 12 months		12 – 18 months	18 – 24 months
Ongoing mandate costs	$100 – 110M (105)	$240 - 270M (255)	$460 – 510M (485)	$515 – 565M (540)
SEC oversight of an SRO costs	Not required		$90 – 100M (95)	$95 – 105M (100)
Total annual costs	**$100 – 110M (105)**	**$240 – 270M (255)**	**$550 – 610M (580)**	**$610 – 670M (640)**

The estimated costs are described below, and further elaborated on in Section III of the report:

Setup costs[8]

- Setup of the Enhanced SEC scenario involves the hiring of additional IA examination staff, and may be achieved in 6-12 months at an estimated cost of $6-8M.
- Setup of a FINRA-IA SRO may be achieved in 12-18 months at an estimated cost of $200-255M. A FINRA-IA SRO could leverage some existing infrastructure that supports B-D oversight activity (e.g., corporate functions, senior management, and potentially some regional offices).
- Setup of a New-IA SRO may be achieved in 18-24 months at an estimated cost of $255-310M. A New-IA SRO is assumed to have no existing infrastructure to leverage.

Ongoing mandate costs[9]

- Per the SEC Section 914 Study, the ongoing costs of the Enhanced SEC scenario are limited to examination costs and do not include enforcement costs. Estimated ongoing examination costs are $240-270M in total or $100-110M more than the current cost of OCIE's IA examination program.
- Ongoing costs of a FINRA-IA SRO or a New-IA SRO include both examination and enforcement costs and are estimated at $460-510M and $515-565M, respectively. Estimated overhead costs per examiner are higher in these two scenarios than in the Enhanced SEC scenario based on current FINRA overhead costs. The estimated ongoing mandate cost of a FINRA-IA SRO reflects scale benefits not available to a New-IA SRO.

Costs of SEC oversight of an SRO

- Cost of SEC oversight of an SRO (either FINRA-IA SRO or a New-IA SRO) are estimated at $90-105M, and includes oversight of SRO examination and enforcement activities. This activity is not required under the Enhanced SEC scenario.

[8] Estimated setup times are the point at which roughly half of examination staff will be hired and the SRO will begin examination of IAs, based on the reference points cited in Appendix Section IV.4.
[9] Ongoing mandate costs are adjusted to allocate the benefits of scale provided by additional IA personnel to all non-administrative staff across the entire organization to reflect standard accounting practice.

User fees paid to the SEC and/or membership fees paid to an SRO are assumed to provide the funding source for setup and ongoing mandate costs; no assumption is made regarding the source of funding for the costs of SEC oversight of an SRO. Fees are identified in the SEC Section 914 Study as a potential source of funding. Fees collected during the setup period might be relied upon to fund the setup costs.

The estimated level of funding and associated average fee per IA firm is indicated in Table 2 below.[10] This report does not evaluate the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to setting fees.

Table 2: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated funding required for ongoing mandate costs	$100 – 110M (105)	$240 – 270M (255)	$460 – 510M (485)	$515 – 565M (540)
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[11]

Beyond the three core scenarios, BCG also examined three additional scenarios:

- Rulemaking mandate for an SRO: If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of an SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC costs for SRO oversight by an estimated ~$10M.[12] Given rulemaking is within the current SEC mandate, this variation is not relevant to the Enhanced SEC scenario.
- Investment Adviser Oversight Act of 2011 draft ("IAO Draft"): If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond estimates in Table 2 under the two SRO scenarios, as ~1,810 currently-registered IA firms (16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (38% of total ADV-reported assets), would be removed from the funding base.[13]

[10] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[11] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[12] An SRO rulemaking organization is assumed to be similar in size to that of the SEC for IA rulemaking today.
[13] This total does not include ~780 additional private investment fund advisers that will be added in 2012, as per the Dodd-Frank Act. This scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Only IA firms with more than $100M AuM are

- Dual-registered IA / B-Ds (third recommended option of the SEC Section 914 Study): If the IA examination mandate for dual-registered IAs / B-Ds, of which there are ~580, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC, the estimated costs of IA examination are $30M for FINRA and $240M for the SEC. In this scenario, the average annual fee per IA firm is estimated to be $53,900 for firms under the jurisdiction of FINRA, and $27,300 for firms under the jurisdiction of an Enhanced SEC (full OCIE costs). As dually-registered firms are estimated to represent 6% of the IA population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. In this scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

considered in this calculation, as per the Dodd-Frank Act. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison across the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the 4% increase in the core SRO scenarios. See Section III.3.1 for more details.

II. Context and methodology

II.1 Context

As required by Section 914 of the Dodd-Frank Act, the SEC released a study in January 2011 (the SEC Section 914 Study) that made recommendations to Congress regarding examination of SEC-registered IAs. The SEC Section 914 Study examined the growth in the investment adviser industry over the last six years and the SEC's challenges in maintaining an acceptable level of examination frequency of SEC-registered IAs. The Study determined that the anticipated growth of IAs would outstrip the SEC's resources absent additional funding. The Study recommended consideration of three options to ensure more stable and scalable funding for IA examinations, all of which would require federal legislation before being implemented:

- Impose user fees on IAs (to fund the SEC), set at a level appropriate for achieving an acceptable frequency of IA examinations (by the SEC);
- Authorize one or more SROs to examine all SEC-registered IAs, subject to SEC oversight; or
- Permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 ("Advisers Act").[14]

A group of organizations with IA stakeholders commissioned BCG to perform an independent and objective economic analysis of the recommended options in the SEC Section 914 Study, with a focus on the first two.

II.2 Objectives

The objective of this report is to perform an independent and objective economic analysis including an estimate of the level of funding required under each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[15]

The economics of each scenario reflect:

- Direct Costs incurred to:
  - Setup IA examination infrastructure to achieve an acceptable frequency of examinations under each scenario and includes the costs of moving from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
  - Ongoing IA examination for all scenarios, at an acceptable frequency, and ongoing enforcement in the FINRA-IA SRO and New-IA SRO scenarios and includes the costs of salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
  - SEC oversight of SRO examination and enforcement activities in the FINRA-IA SRO and New-IA SRO scenarios and includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities

[14] See footnote 2.

[15] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 is examined as an additional scenario in Section II.3.3.

as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).

- Level of funding and potential fees:
  - Level of funding for each scenario is composed of ongoing mandate costs. This report assumes that the funding will be covered by user fees paid by IA firms to the SEC or membership fees paid by IA firms to one or more SROs.
  - Fees paid by IA firms during the setup period might be used to fund setup costs.
  - No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).[16]

II.3 Methodology

BCG conducted an objective and fact-based analysis, drawing on relevant benchmarks and publicly available cost data (current and historical), research, and other studies and reports to estimate the setup costs, ongoing mandate costs, and the costs of SEC oversight of SRO examination and enforcement activity.

BCG validated the analysis with a bottom-up review of the primary cost components. BCG also conducted more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts to identify, corroborate, and better inform relevant assumptions and key sensitivities.

The three core scenarios modeled in this report are characterized along four key dimensions:

- Regulator options: Which regulatory body should oversee IAs?
  - Options: the SEC, a FINRA-IA SRO, or a New-IA SRO
  - In the SRO scenarios, the SEC oversees the SRO.
- Mandate: What mandate should the regulator possess?
  - Options: Examination or examination and enforcement
  - In all scenarios, the study assumes the regulator is authorized to examine and the SEC retains rulemaking authority. In the SRO scenarios, limited rulemaking authority incidental to the execution of examination or enforcement would likely be granted.[17]
  - A scenario whereby the SRO is given a full rulemaking mandate is explored in Section III.3.1.
- Jurisdiction: Which IAs will be required to register with the SEC or an SRO?
  - Default: IA registration requirement as per the Dodd-Frank Act[18]
  - A variation based on the IAO Draft, which exempts a sub-set of IAs from the jurisdiction of an SRO based on the type of assets and investors, is examined in Section III.3.2.

[16] Fees are just one potential funding source; we focus on fees in this report as the SEC Section 914 Study did so.

[17] The cost of limited rulemaking incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations) is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

[18] Includes IA firms with AuM above $100M plus those below $100M that are registered with the SEC (e.g., IA firms with principal offices in New York or Wyoming; those permitted to register with the SEC because they would otherwise be required to register with 15 or more states). Also includes private investment fund advisers with AuM of $150M or more.

- Funding: How much funding and what level of fees per IA firm may be required to cover the cost of ongoing examination and enforcement activities?
    - Funding level options: Cover all setup and/or all ongoing mandate costs
    - Fee level: Many approaches to apportioning fees to IA firms are available and will need to be considered. This report estimates the average fee per IA firm for illustrative purposes.

Based on these dimensions, and informed by the first two recommended options described in the SEC Section 914 Study, three core scenarios were defined and modeled in this report. The three core scenarios are:

1. Enhanced SEC: Achieve an acceptable frequency of IA examinations by hiring additional OCIE staff, funded by user fees;[19]

2. FINRA-IA SRO: Authorize FINRA, the SRO for B-Ds, to develop an IA SRO with an IA examination and enforcement mandate,[20] funded by membership fees, and overseen by the SEC; and

3. New-IA SRO: Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years. The analysis focuses on 2012, and does not estimate how the number of IAs and the associated ongoing mandate costs to the SEC or to IAs via user fees or membership fees might change over time.

[19] See footnote 3.
[20] See footnote 4.

III. Economic analysis

III.1 Cost analysis

This section details the direct setup costs, ongoing mandate costs, and the costs of SEC oversight of an SRO examination and enforcement activity, under each of the three core scenarios.[21] The indirect costs of compliance incurred by IA firms and how indirect costs might vary across the three core scenarios were not estimated or examined.

III.1.1 Assumptions and inputs

The economic analysis reflects the following inputs and assumptions, which are further elaborated upon in Appendix Section IV.2-IV.6:

- Size of the IA population to be examined: 9,440 IAs in 2012
  - Based on the number of IAs in 2011 adjusted for the estimated impact of the Dodd-Frank Act and projected growth from 2011 to 2012.
- Number of examiners required to achieve the target exam frequency: 787 examiners
  - Target exam frequency is once every four years per IA firm on average.
  - Rate of exams per examiner per year is assumed to be 3.0, which is the current average number of IA exams conducted by an SEC examiner per year.
- Setup costs are estimated based on benchmarks identified in recent SEC budget requests and the setup costs of other relevant, similarly located organizations.
- Ongoing mandate costs are estimated based on fully loaded costs per examination and enforcement employee derived from publicly available SEC and FINRA budget data for 2010, adjusted to account for scale and appropriate allocation of any scale benefits.
- Costs of SEC oversight of a SRO examination and enforcement activity are estimated based on current SEC oversight costs for FINRA B-D activity, but reduced by 50% to reflect reduced complexity of SEC oversight of an SRO in an IA context.[22]

[21] See Appendix Section IV.1 for more detail.
[22] See Appendix Section IV.6 for more detail.

III.1.2 Results of cost analysis

The estimated 2012 costs are detailed in Table 3, below:[23]

Table 3: Estimated range (mid-point)	**SEC** (existing)	**Enhanced SEC** (incremental OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Setup costs:	-	**$6-8M (10)**	**$200-255M (230)**	**$255-310M (280)**
– Examination	-	7	145 - 185	185 - 225
– *Enforcement*[A]	-	*3*	55 - 70	70 - 85
Ongoing mandate costs:	**$150M**	**$100-110M (105)**	**$460-510M (485)**	**$515-565M (540)**
– Examination	150	105	355	395
– *Enforcement*[A]	*60*	*40*	130	145
SEC oversight of an SRO:	-	-	**$90-100M (95)**	**$95-105M (100)**
– Examination	-	-	60	65
– *Enforcement*[A]	-	-	35	35
Total annual costs (excl. setup):	**$150M**	**$100-110M (105)**	**$550-610M (580)**	**$610-670M (640)**
– Examination	150	105	415	460
– *Enforcement*[A]	*60*	*40*	165	180

A. Examination and enforcement costs are shown in Table 3 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 3 under the Enhanced SEC scenario, enforcement costs are not included in the totals (Setup costs, Ongoing mandate costs, SEC oversight of SRO costs and Total annual costs), as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

Differences in setup costs across the three core scenarios are driven by the gap between current and required capabilities and capacity, as well as the time required to set up:

- The estimated up-front cost to enhance SEC IA capabilities is $6-8M. Increasing examiner capacity would drive the majority of the estimated setup costs. The SEC already holds the IA examination, enforcement, and rulemaking mandates, and the majority of the effort relates to increasing capacity of existing capabilities. The SEC may be able to set up in 6-12 months.
- FINRA-IA SRO setup costs are estimated at $200-255M. FINRA may be able to set up an IA SRO in 12-18 months. FINRA does not currently oversee IAs and would need to build a new and separate IA examination organization. FINRA may be able to leverage parts of its existing B-D-focused infrastructure (e.g., corporate functions, senior management, some regional offices).
- New-IA SRO setup costs are estimated at $255-310M. A New-IA SRO may be able to set up in 18-24 months. A New-IA SRO would have no existing infrastructure to leverage, instead needing to build, acquire, or outsource all capabilities.

Differences in ongoing mandate costs across the three core scenarios are driven by differing overhead costs and available scale benefits:[24]

- The incremental OCIE examination costs under the Enhanced SEC scenario are estimated at $100-110M, bringing total costs of OCIE examination to $240-270M. Enforcement costs would also likely increase as examination frequency increases.

[23] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[24] See footnote 9.

Overhead costs on a per-examiner basis under the Enhanced SEC scenario are estimated to be lower than under the SRO scenarios because current SEC overhead costs are lower than FINRA's overhead costs. Scale benefits from the existing SEC organization and infrastructure are estimated, but only a portion of the benefit is attributed to IA examinations, as the benefits would be shared across the SEC organization.

- FINRA-IA SRO ongoing annual examination and enforcement costs are estimated at $460-510M. Estimated overhead costs are lower than in a New-IA SRO scenario due to scale advantages resulting from leveraging FINRA's existing B-D infrastructure.
- New-IA SRO annual ongoing examination and enforcement costs are estimated at $515-565M.

Cost of SEC oversight of an SRO in either SRO scenario are estimated at $90-105M The costs include oversight of SRO examinations, direct examinations of IAs, and both SEC-initiated and SRO-referred enforcement actions as well as appeals from an SRO. Costs of SEC oversight of a FINRA-IA SRO are lower than for a New-IA SRO because the SEC already oversees the FINRA organization, providing some opportunity to share resources and costs that would not be available in the New-IA SRO scenario. SEC oversight is not required under the Enhanced SEC scenario.

III.2 Level of funding and fees

This section describes the estimated level of funding to support the ongoing mandate costs described in the previous section, at the IA industry- and firm-level through user fees paid to the SEC or membership fees paid to one or more SROs.

III.2.1 Assumptions and inputs

The estimated level of funding is driven by the ongoing mandate costs, which includes full OCIE examination costs for the Enhanced SEC scenario, including both baseline and incremental OCIE staff, and all examination and enforcement costs for a FINRA-IA SRO and a New-IA SRO. Setup costs are not included in the estimated level of funding, although fees collected during the setup period might be relied upon to fund the setup costs, similar to the approach used by the Public Company Accounting Oversight Board ("PCAOB").[25] The costs of SEC oversight of an SRO are also not included in the estimated level of funding. The source of funding for SEC oversight of an SRO is not examined in this report.

[25] The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

III.2.2 Results of funding analysis

The estimated level of funding under the three core scenarios are described in Table 4 below, with both the incremental and full OCIE cost scenarios shown for the Enhanced SEC scenario:[26]

Table 4: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated level of funding (ongoing mandate costs): – Examination – *Enforcement*[A]	$100 – 110M 105 *60*	$240 – 270M 255 *40*	$460 – 510M 355 130	$515 – 565M 395 145
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

A. Examination and enforcement costs are shown in Table 4 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 4 under the Enhanced SEC scenario, enforcement costs are not included in the total "Estimate level of funding (ongoing mandate costs", as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[27]

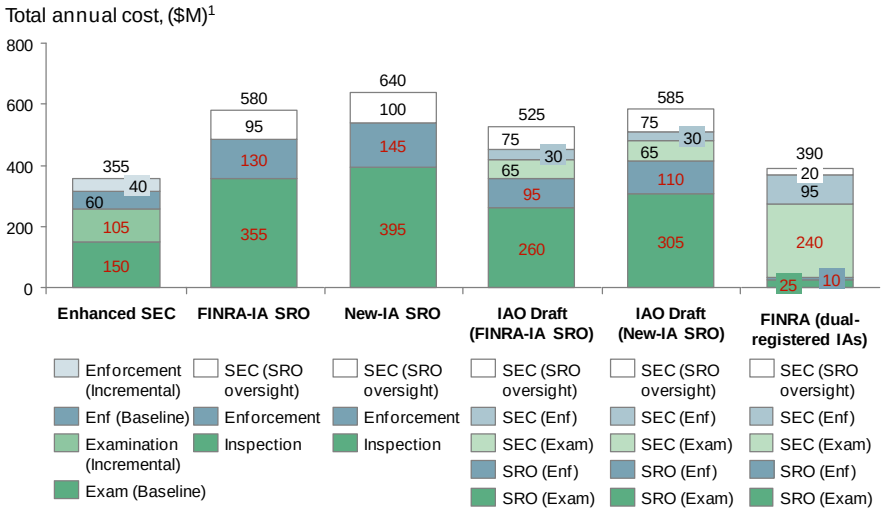
We estimate the level of funding needed for the FINRA-IA SRO and New-IA SRO scenarios to be 90% and 110% higher than the Enhanced SEC scenario's full OCIE cost scenario, respectively.[28]

[26] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[27] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[28] The difference in funding requirements would increase slightly if rulemaking was included in the SRO's mandate.

III.3 Other scenarios examined

In addition to the three core scenarios, BCG explored three additional scenarios, the latter two of which are included in Table 5, for comparison against the three core scenarios. For comparison purposes, full rulemaking authority is not included in the IAO Draft and FINRA dual-registered scenarios.

Table 5:



	Enhanced SEC	FINRA-IA SRO	New-IA SRO	IAO Draft (FINRA-IA SRO)	IAO Draft (New-IA SRO)	FINRA (dual-registered IAs)
Estimated level of fee-based funding ($M)	105 / 255[4]	485	540	355	415	240 & 30[3]
Estimated average fee per firm ($)	11,300 / 27,300	51,700	57,400	52,100	60,700	27,300 & 53,900
# of IA firms registered with SEC	9,440	0	0	2,590[2]	2,590[2]	8,860
# of firms registered with SRO	0	9,440	9,440	6,850	6,850	580

Note: Numbers may not add up due to rounding error. 1. Total annual cost is defined as the cost of examination and enforcement mandates as well as any SEC IA-SRO oversight costs. 2. Includes IA firms with >90% AuM attributable to private funds, mutual funds, clients with more than $25M in investments, and other type of IAs as discussed in the draft of "Investment Adviser Oversight Act of 2011". SRO-exempt firms include 1,810 currently registered firms as well as 780 newly register private funds. 3. $240M is funding needed for SEC-registered firms (non-dual reg. IAs) and $30M is funding needed for FINRA-registered firms (dual-reg. IAs). 4. $105M is the funding need to cover the SEC's incremental examination costs. $255M is the funding needed to cover the full examination costs.

III.3.1 Rulemaking mandate for an SRO

If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of the SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC oversight of the SRO costs by ~$10M. Given rulemaking is within the current mandate of the SEC, this variation is not relevant to the Enhanced SEC scenario. Full rulemaking is differentiated from the limited rulemaking that would be incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations), the cost of which is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

III.3.2 IAO Draft

If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond the estimates in Table in Table 4, under the two SRO scenarios, as ~1,810 currently registered IA firms (~16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that will be required to register with the SEC in 2012 as a result of the Dodd-Frank Act. However, those firms are included in the table above for comparative purposes. Only IA firms with more than $100M AuM are considered in this calculation, as per the Dodd-Frank Act. This

scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison to the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the estimated 4% increase under the core SRO scenarios.

III.3.3 FINRA jurisdiction over dual-registered IA / B-Ds

This additional scenario is the third recommended option of the SEC Section 914 Study, whereby the IA examination mandate for dually-registered IAs / B-Ds, of which there will be an estimated ~580 in 2012, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC.

In this scenario, the estimated costs of IA examination are ~$240M for the SEC and ~$30M for FINRA. The estimated average fee per IA firm is ~$27,300 for IA firms under the jurisdiction of an Enhanced SEC (full OCIE costs), and ~$53,900 for IA firms under FINRA jurisdiction.

As dually-registered firms are estimated to represent 6% of the IA firm population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. Also, under this additional scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

IV. Appendix

This section describes the methodologies and assumptions used in the analyses described in this report.

IV.1 Description of costs and required level of funding

- Setup costs: Includes the costs of moving the organization from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
- Ongoing mandate costs: Includes the ongoing annual costs of an IA examination program and the associated costs of enforcement. Ongoing mandate costs include salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
- SEC oversight of an SRO costs: Includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).
- Total annual costs: Includes ongoing mandate costs and the costs of SEC oversight of an SRO, and is referred to as total annual costs.
- Level of funding and potential fees: Level of funding for each scenario, is determined by ongoing mandate costs. This report assumes that the ongoing mandate costs will be covered by user fees (to the SEC) or membership fees (to one or more SROs). No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).

IV.2 Estimation of the number of SEC-registered IAs in 2012

The 2011 IA population is 11,529 (IAA/NRS Evolution Revolution report). 3,200 IAs with less than $90M AuM were removed from the population, based on estimates from the SEC Section 914 Study.[29] 750 private fund-oriented IAs with AuM greater than $150M were added to the population, based on the Dodd-Frank Act. Subsequently, an annual growth rate of 4% was applied based on the average 5-year compound annual growth rate (CAGR) for each major IA AuM segment, which results in a projected population of ~9,440 SEC-registered IAs in 2012.[30]

IV.3 Estimation of the number of IA examiners needed to meet a target examination rate

The target examination rate is assumed to be once every four years, on average. The current rate is once every 10-11 years, and the most frequent average examination rate achieved by the SEC in recent history is once every six years (SEC Section 914 Study). The average examiner productivity is assumed to be 3.0 examinations per examiner per year, based on the five year SEC average of 3.0 IA examinations per examiner per year.[31] In order to achieve an average

[29] $90M is used due to a buffer below the $100M threshold specified in the SEC Section 914 Study.
[30] IA firms were segmented by AuM into groups, to which the 5-year historical growth rate was calculated and utilized to project forward from 2011 to 2012, for the AuM segments that will remain in scope.
[31] The SEC examination rate of 3.0 is used because it is the best available reference point for the anticipated productivity level of examiners of IA firms. Examination rate benchmarks from other organizations were analyzed but, in the end, not included due to incomparability of exam populations, targeting methodology, scope, and other reasons.

examination frequency of once every four years, with examiner productivity of 3.0 examinations per examiner per year, 787 examiners are required.

IV.4 Estimation of the setup costs for each of the three core scenarios

IV.4.1 Enhanced SEC

The cost of adding incremental examination capacity under the Enhanced SEC scenario was estimated at $24,000 – 26,000, and was informed by the following:

- SEC 2012 budget request
- Public information regarding costs of other recent moves to Washington, D.C., by relevant organizations

IV.4.2 New-IA SRO

The setup costs of a New-IA SRO were informed by the following, after adjusting for size and resource requirements:

- PCAOB setup experience, and review of their 2003-2004 budget
    - PCAOB took two years to setup before reaching a steady state of ~240 examiners and 5 offices
    - PCAOB costs of $117M, normalized by adjusting cost items, (e.g., salary/benefits, office space, equipment, IT) for differences in size, scale and time period

- Consumer Financial Protection Bureau (CFPB July 2011 report) setup experience
    - CFPB incurred $60M in costs in its first eight months
    - Full setup costs for the CFPB estimated to be ~$125M, resulting in an organization of ~550 people, or about half of a New-IA SRO, normalized by adjusting cost items based on differences in size and scale

IV.4.3 FINRA-IA SRO

Interviews with subject matter experts suggested that the setup time for a FINRA-IA SRO would be roughly 6 months less than for a New-IA SRO. FINRA's ability to leverage existing physical, technological, and organizational infrastructure, could result in ~20% lower setup costs than for a New-IA SRO.

IV.5 Estimation of ongoing mandate costs

IV.5.1 Estimation of examination costs

Average examiner salary and benefits are estimated to be ~$189K. Overhead expenses per examiner are estimated to be ~$134K, or 27% of total SEC overhead expenses, based on the number of OCIE employees as a percent of total employees. The resulting fully loaded total average cost per employee was estimated to be ~$323K.

IV.5.2 Estimation of enforcement costs

Interviews with subject matter experts, including former SEC employees, resulted in estimated costs attributable to IAs of 14% of the Division of Enforcement's total costs and ~7% of the Division of Investment Management's total costs. Including overhead, this implies a cost per employee of ~$353K in the Division of Enforcement and ~$363K in the Division of Investment Management.

Applying the ratio of 2.8 IA examiners per IA enforcement full-time equivalent ("FTE") at the SEC provides an estimate of the additional enforcement FTEs required to handle an expected increase in enforcement activity.[32]

IV.5.3 Estimation of costs specific to a FINRA-IA SRO and a New-IA SRO

Costs associated with a FINRA-IA SRO and a New-IA SRO were informed by the following

- Examination and enforcement employee ratios and salary costs at the SEC
- Overhead cost per examiner at the SEC adjusted to reflect higher ratio of professional staff to administrative staff at FINRA than at the SEC
- FINRA's 2010 budget of fees (regulatory and user fees) from B-D examiners.

IV.5.4 Estimation of the impact of scale

A scale factor of 19% was applied to the overhead costs of the Enhanced SEC and FINRA-IA SRO scenarios. The scale factor was derived from BCG benchmarks and analysis of similar organizations that indicates that, as an organization doubles in size, overhead costs increase by 81%. The scale benefits were shared across the entire organization, so that the scale benefits attributed to the IA examination costs under the Enhanced SEC and FINRA-IA SRO were only 12% and 40% of the scale-driven savings, respectively.[33]

The New-IA SRO, starting from a base of zero employees, experiences some scale disadvantage relative to the SEC and FINRA. The scale disadvantages were measured in relation to FINRA's current organization size.

IV.6 Estimation of the costs of SEC oversight of an SRO

SEC oversight of FINRA today was used to estimate the costs of SEC oversight in the SRO scenarios. There are ~380 SEC examiners overseeing roughly 840 FINRA B-D examiners, indicating a ratio of 2.2 FINRA examiners per SEC oversight examiner.[34] IA examinations (and oversight of those examinations) are likely to be less resource-intensive, on average, than B-D examinations, so the ratio of examiners per SEC oversight examiner was adjusted accordingly.[35]

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[32] We assume the ratio holds constant rather than assume changes in productivity or operating procedures related to enforcement.

[33] See footnote 9.

[34] Includes oversight of operations of an SRO by conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee changes (SEC Section 914 Study).

[35] The SEC is expected to conduct primary investigations of IAs at a lower rate/level than is the case of B-Ds for two reasons: the SEC already has experience and familiarity with IA examinations as a result of its current mandate, and IA investigations tend to be less complex than B-D examinations and therefore less likely to warrant direct SEC involvement in the examination. If, in practice, the SEC conducts more

As such, for a New-IA SRO with 787 examiners, the SEC would need ~178 IA oversight examiners. Assuming similar average costs for these examiners as well as similar ratios for enforcement and rulemaking as stated above, the SEC would incur ~$100M in oversight costs. The costs of overseeing a FINRA-IA SRO are slightly less than for a New-IA SRO, because the SEC already oversees the FINRA organization.

IV.7 Other scenarios examined

IV.7.1 Rulemaking mandate for an SRO

SRO rulemaking cost estimates were informed by

- SEC rulemaking costs and subject matter expert interviews indicating that
  - IA-related rulemaking costs represent ~13% of the costs of the Division of Investment Management and ~14% of the costs of the General Counsel's office
  - Including overhead, per employee costs of ~$363K at the Division of Investment Management and ~$355K at the General Counsel's office
  - SEC IA examiner per IA rule maker ratio of ~15.7
- SRO overhead cost estimates per examiner

Resulting cost estimate for SRO rulemaking is $20M, or ~4% of the estimated ongoing mandate costs. SEC oversight of SRO rulemaking costs are estimated at ~$10M. In the enhanced SEC scenario, it is assumed that rulemaking costs would not change.

IV.7.2 IAO Draft

Under the IAO Draft, certain IAs would be excluded from the requirement to register with an SRO, and instead would be required to register with the SEC. The exclusion applies to all IA firms with 90% or more of their assets under management attributable to one or more of the following client types:

- Registered investment companies;
- Advisers to non-US clients;
- Clients with more than $25,000,000 in investments;
- 3(c)(10) funds (e.g., charitable trusts);
- 3(c)(11) funds (e.g., DB and DC plans);
- Private funds (e.g. hedge funds and private equity funds); and
- Venture capital funds.

An estimated ~1,810 currently registered IA firms (~16% of SEC-registered IAs), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that are required to register with the SEC in 2012 as a result of the Dodd-Frank Act.[36]

The level of funding needed for a FINRA-IA SRO is estimated at ~$435M and for a New-IA SRO at ~$485M. This estimate does not include the costs of rulemaking that is granted to an SRO in the IAO Draft, to enable direct comparison to the three core scenarios. The estimated funding

primary investigations of IAs than assumed in this analysis, then the costs of SEC oversight of an SRO will be higher than the current estimate.

[36] The ~750 private investment fund advisers estimated by the SEC in 2011 plus another 30 from normal annual growth in firm count.

level is slightly below the estimated funding level in the core SRO scenarios because of the exclusion of the ~1,810 IA firms described above. The resulting estimated average user fee per IA firm is ~$51,810 for a FINRA-IA SRO and ~$58,500 for a New-IA SRO.

While reduction in the IA firm population would reduce the costs of IA examination for an SRO, and estimated average fees per IA firm would not change significantly, the membership fees paid by the remaining IA firms would increase by ~20% if apportioned on a per AuM basis.