Testimony of

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Chairman Bachus, Ranking Member Frank and Members of the Committee:

I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today on H.R. 4624, the Investment Adviser Oversight Act of 2012.

There are approximately 4,800 broker-dealer firms registered with the Securities and Exchange Commission (SEC), and between the SEC and FINRA approximately 55 percent of those firms are examined annually. By contrast, according to the SEC, only 8 percent of registered investment advisers were examined in 2011 and approximately 38 percent of advisers registered with the SEC have never been examined. The average SEC-registered investment adviser is looked at by regulators only once every 10 to 13 years, and the frequency of SEC examinations of investment advisers has decreased 50 percent since 2004. No one involved in regulating securities and protecting investors can be satisfied with a system where only 8 percent of regulated firms are examined each year. It is completely unacceptable and represents a major gap in investor protection.

Given this dramatic lack of oversight and coverage, Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to review and analyze its need for enhanced examination and enforcement resources for investment advisers. The study, released in January 2011, clearly states that the SEC "will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency" and made several recommendations for Congress to consider, including allowing the SEC to authorize one or more self-regulatory organizations for the investment adviser industry.

H.R. 4624 represents a direct, bipartisan response to the SEC's study and recommendations, and is an important and thoughtful effort to help fill the gap in the protection of investment advisory clients. Specifically, the legislation addresses the current lack of Commission resources and allows self-regulatory organizations registered with and subject to strict SEC oversight to assist government regulators in providing closer and more regular oversight of

investment advisers who serve predominantly retail investors. The legislation also would free up resources for the SEC to examine investment advisers who primarily serve institutional clients.

FINRA

FINRA is the largest independent regulator for all securities firms doing business in the United States. FINRA provides the first line of oversight for broker-dealers and, through its comprehensive regulatory oversight programs, regulates both the firms and professionals that sell securities in the United States and the U.S. securities markets. FINRA oversees approximately 4,400 brokerage firms, 163,000 branch offices and 629,000 registered securities representatives. FINRA touches virtually every aspect of the securities business—from registering industry participants to examining securities firms; writing rules and enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms.

In 2011, FINRA brought 1,488 disciplinary actions, levied fines totaling $63 million and ordered the payment of $19 million in restitution to harmed investors. FINRA expelled 21 firms from the securities industry, barred 329 individuals and suspended 475 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,400 cycle examinations and 6,800 cause examinations.

FINRA has a Board of Governors composed of a majority of public governors, along with industry representation. FINRA's operations are designed to ensure that its Board, key committees and staff act independently and in the public interest. While the views of the industry are taken into account, FINRA-regulated firms have no authority to approve or disapprove FINRA rule proposals, interpretations or enforcement proceedings. FINRA's activities are overseen by the SEC, which approves all FINRA rules and has oversight authority over FINRA operations.

Evolution of Broker-Dealers and Investment Advisers

In recent years, increasing numbers of retail investors have sought the advice of financial professionals to plan for their retirement, help them through the financial crisis, prepare for their children's college education and meet their other financial goals. These investors have sought the advice of brokers and investment advisers. At one time, the investment adviser and broker-dealer businesses were distinct and separate. Today, while the services offered in each channel may differ, the businesses have converged in many ways. While broker-dealers and investment advisers are regulated differently, the reality is—as the Rand Corporation said in a study completed for the SEC in 2008—that "trends in the financial service market since the early 1990s have blurred the boundaries between them." Many customers now hold investment adviser and brokerage accounts with the same firm and rely on the same financial professional who is registered as both a broker-dealer and an investment adviser representative.

In fact, there are approximately 2,300 firms that are dually registered as broker-dealers and investment advisers or are broker-dealers with one or more affiliated investment advisers.

Beyond that, a vast majority of registered investment adviser representatives also offer brokerage services. Approximately 87 percent of all registered advisory representatives are also registered representatives of a broker-dealer.

This means that firms offer customers a combination of brokerage and advisory services in a product menu, and that, in many cases, financial professionals offer commercially indistinguishable brokerage and investment advisory services to the same customer. This makes it highly unlikely that the customer can distinguish between those services and the differing obligations and protections that are present in advisory and brokerage channels.

Despite this convergence in services, the regulation of investment advisers and broker-dealers remains quite different. The two industries are subject to different standards of conduct and different levels of oversight and enforcement. In light of the rising investor interest in seeking the advice of professionals, one would expect the convergence of the investment advisory and brokerage businesses to continue and even accelerate. This overlap in services has important implications for policy makers and regulators.

Because broker-dealers and investment advisers operate under vastly different levels of oversight due to resource constraints of government regulators, firms offering similar services can arbitrage regulation by choosing a form of registration that offers the least regulatory oversight and minimizes the risk of enforcement if the firm engages in misconduct.

In Dodd-Frank, Congress authorized two studies related to the regulation of broker-dealers and investment advisers that were completed by the SEC in January 2011. The first study examined the differences in the standards of care and other regulations for investment advisers and broker-dealers, and the second reviewed the SEC's frequency of investment adviser examinations and outlook for coverage going forward.

FINRA has been clear in its view that the standard of care in both channels should be a fiduciary standard for the provision of personalized investment advice to retail customers. However, just as critical as harmonizing standard of care is the need for a consistent oversight regime to ensure investors are being properly protected. As the SEC's study notes, "to fully protect the interests of retail investors, the Commission should couple the fiduciary duty with effective oversight."

Despite what some in the advisory industry often imply, the existence of a fiduciary standard alone is not a guarantee against misconduct. The risks to investors can be seen in the types of enforcement actions that have been taken against advisers. As we have seen all too often in headlines, registered investment advisers have been implicated in a number of Ponzi schemes. Other SEC actions involve a range of abusive behavior—such as trade recommendations that benefited the adviser over clients, misleading advertising, failure to disclose conflicts of interest, misappropriation of client funds, and inappropriate compensation and client referral arrangements. While there are certainly a great number of investment advisers committed to complying with the rules, it is clear that compliance with the fiduciary standard must be regularly and vigorously examined and enforced to ensure the protection of investors.

SEC Study on Enhancing Investment Adviser Examinations

The SEC's study on investment adviser exams concludes that the agency "will not have sufficient capacity in the near or long term to conduct effective examinations of registered

investment advisers with adequate frequency." The study further acknowledges that new examination responsibilities provided to the agency under Dodd-Frank means that an increase in agency examination staff "is unlikely to keep pace with the growth of registered investment advisers."

In order to address the lack of oversight resources for investment advisers, the SEC's study recommends that Congress consider three possible approaches: 1) authorize the Commission to impose user fees on SEC-registered investment advisers to fund their examinations; 2) authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or 3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.

The SEC oversees more than 12,000 investment advisers, but in 2010 conducted only 1,083 exams of those firms due to lack of resources. As such, the study notes, "the average registered adviser could expect to be examined less than once every 11 years." In contrast, more than 50 percent of broker-dealers are examined annually by the SEC and FINRA. As the SEC's study states, "the Commission's and the Commodity Futures Trading Commission's experiences with SROs support the view that an SRO can augment government oversight programs through more frequent examinations."

The frequency of SEC investment adviser examinations has declined 50 percent since 2004. The study notes that while there may be a short-term percentage increase due to the number of advisers being shifted to state oversight, any potential increase "may be offset by the need to divert examination resources to fulfill new examination obligations that the Commission was given by the Dodd-Frank Act." The SEC study estimates that it would need to double the numbers of examiners to increase the frequency of examinations to even 20 percent.

In a statement issued at the time of the study's release, SEC Commissioner Elisse Walter noted that based on that calculation, the SEC would need to add more than 2,000 examiners to its advisory program to increase the SEC's examination frequency to FINRA's current average for broker-dealers. Commissioner Walter noted that in addition to the 50 percent decrease in the frequency of examinations since 2004, the number of examinations also decreased 30 percent over that time. The Commissioner attributed the decreases in part to the growth in the number of investment advisers (38.5 percent) and in assets under management (58.9 percent) during the same timeframe. Walter explained that while there may be a near-term decrease in the number of advisers subject to Commission oversight due to Dodd-Frank's shifting of some of that population to state regulation, there will be an immediate increase in assets under management "as larger and more complex entities enter the Commission's oversight." She noted that these advisers are "more likely to be assessed as higher-risk advisers, requiring more resources," and highlights the staff estimate that "due to the Dodd-Frank Act, the number of large and complex entities registered with the Commission will increase from 38 percent of all advisers to 58 percent."

The gap in investment adviser oversight is a significant threat to the protection of advisory clients and should be addressed as quickly as possible. Providing the SEC authority to designate one or more SROs for investment advisers, subject to SEC oversight, is the most practical and efficient way to address this critical resource and investor protection issue. The bipartisan legislation introduced by Chairman Bachus and Congresswoman McCarthy would establish that authority and set a framework of requirements for any entity that would be designated as an adviser SRO. These requirements would ensure that the oversight by any such SRO reflect the nature and diversity of the investment adviser industry. We believe the

legislation is a thoughtful approach to addressing the critical need for increased adviser regulation.

Benefits of the SRO Model

Self-regulatory organizations have always been a cornerstone of the federal securities laws. Even before the securities laws were enacted, the securities exchanges regulated their members. In 1934, Congress codified and strengthened the governance requirements that applied to the exchanges even as it created the SEC. In 1938, Congress passed the Maloney Act, which extended the SRO model to broker-dealers who trade in the over-the-counter market. Congress preferred the SRO model because it recognized that reliance only upon direct regulation by the SEC "would involve a pronounced expansion of [the SEC's] organization . . . a large increase in the expenditure of public funds . . . and a minute, detailed, and rigid regulation of business conduct by law."[1] FINRA's predecessor, NASD, became a registered SRO as a result of the Maloney Act. In 1975, Congress again concluded that the SRO model "should be preserved and strengthened" as it amended the federal securities laws concerning the SEC's oversight responsibilities.[2]

FINRA serves as the front line of regulation, ensuring that broker-dealers and their representatives are regularly inspected for compliance with the law, and that those laws are enforced. FINRA conducts regular examinations and investigations of firms to ensure that they are complying with applicable laws and rules. We undertake enforcement and disciplinary proceedings when violations have been uncovered, and penalties include barring firms and individuals from the industry. FINRA also administers registration and disciplinary databases to provide critical information to regulators and the public, and implements continuing education and training programs.

Self-regulatory organizations like FINRA provide these benefits without significant additional cost to taxpayers, since they are typically funded by fees assessed on regulated entities. Self-regulatory organizations also have more flexibility than their government counterparts to devote and direct resources to large, multi-year technology development efforts that can support a variety of regulatory programs, including those focused on examinations, enforcement, market transparency and licensing qualifications.

Under federal law, the SEC must oversee all aspects of FINRA's programs. For example, the SEC:

- approves all FINRA rulemaking and seeks public comment on FINRA proposals through notice in the *Federal Register*;
- can add, delete or amend FINRA rules as it deems necessary or appropriate;
- hears appeals of FINRA disciplinary actions, which also may be appealed to the federal courts;
- requires FINRA to keep records and file reports with the Commission, and records are subject at any time to Commission inspection;
- inspects FINRA regulatory programs to ensure that it is fulfilling its regulatory responsibilities and to mandate corrective action as needed;

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[1] S. Rep. No. 1455, 75th Cong., 3d Sess. I.B.4. (1938).; H.R. Rep. No. 2307, 75th Cong., 3d Sess. I.B.4. (1938) (duplicate text quoted in both reports).
[2] S. Rep. No. 94-75, 94th Cong., 1st Sess. 7, II (1975).

- may conduct special inspections at any time for any reason;
- can impose limitations on FINRA's operations if it finds deficiencies justifying such action;
- may compel FINRA to act if it determines that FINRA is failing to provide adequate protection to investors; and,
- may suspend or revoke FINRA's registration under the Exchange Act and remove from office or censure any FINRA officer or director.

The United States has a long and successful experience with the SRO model, and H.R. 4624 would represent a tailored extension of the SRO model to the investment adviser industry.

The concept of an SRO for investment advisers is not a new one. The SEC first recommended establishing an SRO for investment advisers in its 1963 Special Study of the Securities Markets. And in 1989, the Commission submitted legislation to Congress that would have authorized an SRO for investment advisers. Over the nearly five decades since that time, the gap in oversight has continued to increase and governmental regulatory resources have continued to fall short of supporting needed oversight for advisers and the customers they serve.

The legislation would help ensure that investment advisers are examined regularly by an SRO, while requiring that the SRO conduct its examinations in a manner consistent with the investment adviser business and the principles of the Investment Advisers Act. H.R. 4624 would ensure that a registered representative who “wears two hats” could not escape inspection as an investment adviser representative, even while being subject to SRO oversight as a broker-dealer representative. The legislation would ensure that the Investment Advisers Act is enforced, and that those advisers who commit serious offenses will be disciplined and, if necessary, removed from the industry.

Cost Estimate for FINRA IA SRO

Much has been said by opponents of increased oversight for investment advisers about the potential costs of an IA SRO. The cost projections in the Boston Consulting Group (BCG) study—which was funded by trade groups for investment advisers and the advisory industry—of FINRA becoming the SRO for investment advisers are inaccurate and based on flawed methodology. By its own admission, BCG never consulted with FINRA or the SEC to discuss projected costs of IA oversight. As such, it is evident that their analysis was meant to be a political document rather than a serious attempt to explore costs.

We at FINRA thought it was important to take an accurate and realistic look at what the numbers would actually look like for our organization. To calculate an estimated investment level for the establishment and ongoing work of an investment adviser SRO, FINRA assumed a universe of approximately 14,500 firms out of the total population of over 26,000 current IA firms. This assumption is an attempt to reflect an approximate number of firms that could be subject to SRO examinations, given that the pending legislation provides exemptions for IAs with institutional customer bases as well as for state-regulated IAs for which examinations are conducted by state regulators an average of once every four years. We assumed a risk-based examination program across all firms, and assumed that all firms would be examined at least once every four years. The examination program would assess risk based on factors such as custody arrangements, business lines, personnel, customer complaints and assets under management.

Based on that analysis, we determined that FINRA's one-time start up cost would be approximately $12 - $15 million. This reflects an investment in technology solutions to support an investment adviser examination program, as well as initial organization, training and governance costs. Ongoing technology maintenance is reflected in the ongoing investment numbers, as are staffing costs.

This investment builds upon FINRA's established, nationwide program for examinations currently in place, district offices across the country and ability to leverage existing infrastructure, technology and staff.

Again, based on the assumed universe of approximately 14,500 firms, we determined that ongoing costs would total approximately $150 – $155 million annually. We anticipate a staff increase of approximately 900 employees, the vast majority of whom would be examinations staff. Because staffing is unlikely to be complete in the first year, the staffing estimate is reflected in the annual ongoing cost.

This estimate also includes overhead and support costs for examinations and enforcement. It does not include costs for testing, advertising review or dispute resolution. If either Congress or the Commission determines that those functions should be included, then the annual ongoing investment would increase by approximately $10 million.

Our numbers reflect a realistic estimate for extending FINRA's examination program to covered investment advisers. By contrast, in determining its estimated costs for a FINRA IA SRO, BCG used as its base the costs for establishing the Public Company Accounting Oversight Board and the Consumer Financial Protection Bureau from scratch. BCG used these figures—set up costs for organizations that did not have one desk or employee—and provided for only a 20 percent discount off the from-scratch start-up costs to allow for efficiencies in FINRA's existing infrastructure. While FINRA would need to hire additional staff to serve as an SRO for investment advisers, we believe BCG vastly underestimated our ability to leverage existing staff, district offices and the technology underlying our existing nationwide examination program.

In addition, BCG misconstrued data concerning FINRA regulatory and user fees. BCG relied on this data to estimate examination program costs, even though the fees support a wide variety of programs beyond just examinations, including testing, advertising review and dispute resolution. BCG also relied upon SEC data to estimate the number of annual examinations per examiner, but the SEC ratio of annual examinations per examiner is less than FINRA's ratios.

The study demonstrates a bias in several respects. For example, it added on the costs to the SEC of overseeing an investment adviser SRO program, but didn't include a reduction in the SEC's costs if FINRA were to conduct examinations of investment advisers. It also assumes that it costs the SEC about half as much to examine an investment adviser as the costs that FINRA would incur—even for dually registered investment advisers who are already examined by FINRA.

The BCG study is flawed in a number of ways, but even more important, it is tangential to the principal reason why enactment of IA SRO legislation is necessary. The primary purpose of the pending legislation is to ensure that the investment adviser industry is, at last, subject to regular inspections, oversight and enforcement of the Investment Advisers Act. Our experience with the SRO model demonstrates that extension of the model to the investment adviser industry would ensure that these objectives are achieved in the most efficient manner available.

Structuring an SRO Approach to Enhancing Investment Adviser Oversight

H.R. 4624 is crafted to ensure that the SRO's governance structure provides the independence and objectivity necessary for the SRO to perform its responsibilities, that its jurisdiction is appropriately focused, and that the SRO's regulatory programs reflect the nature of the investment adviser business and the principles of the Investment Advisers Act.

Governance

H.R. 4624 would require that the SEC approve applications of any organization that seeks to become an SRO, subject to standards set out in the legislation. The SEC would be required to determine that an applicant will provide fair representation of the public interest and the adviser industry in the selection of its governing body; adopt rules designed to prevent fraud and protect investors, consistent with existing law, and not impose burdens on advisers that are not necessary or appropriate; conduct periodic examinations of members and their associated persons; and allocate reasonable fees in an equitable manner. The legislation's approach is based upon the application process for national securities associations in the Exchange Act, modified to reflect the investment adviser industry. FINRA supports the proposed requirement in H.R. 4624 that public representatives should form a majority of any governing body. We also support the proposed requirement that participants in the investment advisory industry should be allocated a number of the remaining seats, to ensure that the industry is adequately represented.

Focus on Retail Investors

The focus of any adviser SRO should be on retail-facing business. FINRA supports the approach taken by the legislation that would exempt certain advisers from SRO regulation, such as advisers that primarily serve mutual funds and other qualified institutional buyers. By focusing on SRO oversight of retail advisers, the legislation would free-up SEC resources to examine institutional advisers.

The SEC study similarly recognized that some exclusions from membership may be appropriate. As the study states: "For example, advisers to registered investment companies that are subject to examination under the 1940 Act could be excluded. Or specific exclusions could be provided for investment advisers to private funds (such as hedge funds) or advisers that do not have retail clients."

Reflecting the Nature of the Advisory Business and the Investment Advisers Act

FINRA supports the various provisions of H.R. 4624 that would ensure that the regulatory programs of an SRO reflect the nature of the investment adviser industry. The investment adviser industry provides a diverse array of services to the investing public. We strongly believe that any SRO must conduct its regulatory programs in a manner that reflects the nature of those services and the principles of the Investment Advisers Act.

H.R. 4624 would, for example, require that the rules of the SRO are consistent with the purposes of the Investment Advisers Act and the fiduciary standards applicable to investment advisers under the Act and state law. The legislation would require that those rules are necessary or appropriate "in light of the business of registered investment advisers." These

provisions would help to ensure that the SRO administers its programs in a manner that is appropriate to the investment adviser business.

Before concluding, I want to be very clear—if FINRA becomes an SRO for investment advisers, we would implement regulatory oversight that is tailored to the particular characteristics of the investment adviser business. FINRA would establish a separate entity with separate board and committee governance to oversee any adviser work, and would plan to hire additional staff with expertise and leadership in the adviser area. That said, given our experience operating a nationwide program for examinations and our ability to leverage existing technology and staff resources to support a similar program for investment advisers, we believe we are uniquely positioned to serve as at least part of the solution to this pressing problem. In addition, FINRA's current programs would be enhanced and investors would be better protected if we had the authority to examine the full operations of dually registered firms, where currently we can only see the broker-dealer side of what is typically a fully integrated business.

Conclusion

The SEC and state securities regulators play vital roles in overseeing both broker-dealers and investment advisers, and they should continue to do so. Investor protection demands, however, that more resources be dedicated to regular and vigorous examination and day-to-day oversight of investment advisers. While the regulatory status quo may be appealing to some in the investment advisory industry, the current level of adviser exams is unacceptable, and authorizing the SEC to designate one or more SROs to assist it with overseeing investment advisers is the most efficient solution to addressing this critical investor protection issue.

FINRA is committed to working closely with other regulators and this Committee as you work to address the lack of examination resources for investment advisers.