Written Testimony of John Morgan

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On behalf of

The North American Securities Administrators Association, Inc.

Before the

House Committee on Financial Services

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

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Good morning Chairman Bachus, Ranking Member Frank, and members of the Committee, I'm John Morgan, Securities Commissioner of Texas and a member of the North American Securities Administrators Association, Inc. ("NASAA"), the association of state and provincial securities regulators. I am honored to be here today on behalf of NASAA to discuss H.R. 4624, the Investment Adviser Oversight Act of 2012.

State securities regulators have protected Main Street investors from fraud for the past 100 years, longer than any other securities regulator. I have been a regulator in Texas for 28 years and, along with my state colleagues, am understandably proud of our commitment to investor protection. State securities regulators have continued, more than any other regulator, to focus on protecting retail investors. Our primary goal is to act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

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

The securities administrators in your states are responsible for enforcing state securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents. Ten of my colleagues are appointed by state Secretaries of State, five fall under the jurisdiction of their states' Attorneys General, some are appointed by their Governors and Cabinet officials, and others, like me, work for independent commissions or boards.

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 Moreover, in 2010, more than 3,200 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action.

Oversight of Investment Advisers

On September 13, 2011, my colleague Steve Irwin, a securities commissioner for the State of Pennsylvania, testified before the Subcommittee on Capital Markets and Government Sponsored Enterprises on what was then a draft bill on investment adviser oversight. At the outset of his testimony he noted NASAA's vigorous opposition to the creation of a self regulatory organization ("SRO") for state regulated investment advisers and their associated persons. NASAA's position then, and now, is that the regulation of investment advisers should continue to be the responsibility of state and federal governments and that these regulators must be given sufficient resources to carry out this mission.

Federal vs. State Responsibilities in Investment Adviser Oversight

Since the passage of the National Securities Markets Improvement Act in 1996 and the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (the "Dodd-Frank Act"), the division of federal and state regulatory responsibility over investment advisers has been delineated according to the amount of investors' assets under management. Certainly, from the perspective of Texas, and to the best of my knowledge, for most states, this division has worked very well.

However, according to the U.S. Securities and Exchange Commission ("SEC"), in 2011 it examined only 8 percent of the investment advisers under its jurisdiction and it has never examined approximately 40 percent of federally registered investment advisers.[1]

The problems that exist with the SEC's oversight of federally registered investment advisers have been characterized as a "regulatory gap." NASAA recognizes these problems place investors at risk, and agrees that Congress should act to address them.

Crucially, however, no similar gap exists with respect to investment adviser regulation in Texas, nor in the overwhelming majority of states.[2] To the contrary: the Dodd-Frank Act placed great confidence in state investment adviser examination programs by increasing state oversight to those advisers with $100 million in assets under management, up from $25 million. This means that a significant number of investment advisers are switching from federal to state regulation.

This switch, targeted for completion on June 28th of this year, is one of the largest regulatory events involving a coordinated effort by the states and the SEC. When the dust settles, approximately 2,500 investment advisers will have transferred their registrations from the SEC to one or more states. This means that the states will be responsible for the oversight of approximately 17,000 investment adviser firms and the SEC will regulate roughly 10,000 investment adviser firms.

States have been preparing for this switch for two years and look forward to accepting the increased regulatory oversight of mid-sized investment advisers. This is our main focus. NASAA believes that Congress should focus its attention on improving deficiencies in the oversight of federally registered investment advisers, while allowing

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[1] Testimony on "SEC Oversight" by Chairman Mary L. Shapiro: Hearing before the Capital Markets and Government Sponsored Enterprises Subcommittee and Financial Institution and Consumer Credit Subcommittee of the House of Committee on Financial Services (Apr. 25, 2012), available at http://www.sec.gov/news/testimony/2012/ts042512mls.htm; *see also* Study on Enhancing Investment Adviser Examinations, As Required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011), available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

[2] NASAA Report to SEC, State Securities Regulators Report on Regulatory Effectiveness and Resources with Respect to Broker-Dealers and Investment Advisers (Sept. 24, 2010), available at http://sec.gov/comments/4-606/4606-2789.pdf.

the states to continue to focus on our distinct responsibility for the oversight of state registered investment advisers.

H.R. 4624 and State-Registered Investment Advisers

Mr. Chairman, NASAA genuinely appreciates your efforts to improve the oversight of investment advisers. We share the same mission of investor protection. As we outline our concerns, please consider them in the context that we have shared goals in this effort, but different approaches to solving the regulatory gaps.

Unfortunately, H.R. 4624 embraces a "one size fits all" approach to regulation. It will require some federally registered investment advisers and most state registered investment advisers to become members of an SRO, pay membership fees to the SRO, comply with its rules, and be subject to inspection by the SRO—regardless of whether the firm has clients in more than one state or conducts business in a way that has any demonstrable effect on national markets.

From a state regulatory perspective, H.R. 4624 is unnecessary in Texas as Texas-registered investment adviser firms are currently subject to strong state oversight and inspection. The same holds true for the overwhelming majority of states.

The regulatory process at the state level typically begins before an entity ever becomes a registrant. State securities regulators review information submitted by applicants to determine whether the applicant satisfies the standards necessary to achieve registration as an investment adviser or investment adviser representative. States monitor ongoing compliance of investment advisers and their representatives in a variety of ways including, but not limited to, post-registration reviews, annual questionnaires, and both on-and off-site examinations. Thousands of on-site examinations employing sophisticated examination modules are performed on a routine and for-cause basis every year in virtually every state. In fact, according to NASAA's most recent nationwide survey which was conducted in 2010, the vast majority (89%) of states that conduct routine examinations complete these examinations on a formal cyclical basis of six years or less. Moreover, a majority of those states examine investment advisers at a rate that is on average at least once every four years.[3] In sum, states use a variety of regulatory tools in carrying out the oversight of investment advisers.

Leaving the structural issues of the legislation aside for the moment, we are extremely concerned about the very real impact this legislation will have on state registered investment advisers and the clients they serve. In short, the most urgent problem with this legislation is that it has the very real potential to be a job killer.

Most state registered investment advisers are small businesses employing only a few people. The majority of their clients are not wealthy individuals or institutions but hard working Americans trying to plan for retirement or their child's education. As

[3] NASAA expects to update information on state oversight of investment advisers when the investment adviser "switch" mandated by the Dodd-Frank Act has been completed.

introduced, H.R. 4624 would threaten the financial viability of these small businesses in Texas and across the country by creating an unnecessary, expensive, and duplicative layer of regulation.

Much has been said in recent weeks regarding the potential cost burden on investment advisers generally, although a clear picture of the size of the burden on state registered investment advisers has yet to emerge. One thing is known: the economics for many state registered investment advisers indicate that it is perilous for these firms to bear the weight of another layer of costs, particularly when it is unnecessary to impose such costs.

I have heard from an association that represents investment adviser firms in Texas that are worried about these costs and I have also spoken to individuals who help state registered investment advisers maintain compliance. The chorus is the same. Texas investment advisers suffer from regulatory fatigue, having already undergone significant regulatory changes, and they want to focus on the markets they serve and their clients. In fact, they have told me, based on the comments from their clients and others, that small investment advisers will see the advent of a new regulatory body as a final straw and will simply close their doors.

Texas' investment advisers are not alone in their concern about the devastating consequences H.R. 4624 may bring to small and mid-sized investment adviser businesses if enacted. A survey of investment advisers registered in the State of Massachusetts, released last week by Secretary of the Commonwealth William Galvin, indicated that investment advisers in that state are "adamantly opposed" to a bill such as H.R. 4624 that would require them be members of an SRO.[4] According to Secretary Galvin, over half of the 649 investment advisers registered in Massachusetts responded to the survey, and of those who did, 41 percent volunteered comments suggesting that they would be forced out of business if the bill passes in its current form.[5]

Let me reiterate: *41 percent of investment advisers surveyed in the State of Massachusetts feel that H.R. 4624 – if enacted – may force them out of business.*

Mr. Chairman, the message I am hearing from investment advisers in Texas is the same message Secretary Galvin is hearing in Massachusetts: H.R. 4624, in its present form, has the very real potential of being a job killing bill for these small and mid-sized firms. The legislation would create redundant and unnecessary layers of new regulation and cost, and this cost may force many small investment adviser firms to close their doors.

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[4] News Release, Investment Advisers in Massachusetts Strongly Oppose Pending Federal Oversight Bill, (May 31, 2012), by William Francis Galvin, Secretary of the Commonwealth of Massachusetts.
[5] Id. at 1.

NASAA Urges the Committee to Address the Following Critical Flaws with H.R. 4624

1. State registered investment advisers should not be required to become members of an SRO.

As discussed above, requiring state registered investment advisers to become members of an SRO in states where these firms are already adequately regulated is unnecessary and will harm small businesses. This mandate will have the effect of placing a costly new burden on thousands of small and mid-sized investment advisers (the majority of whom are one and two person shops). Under the bill, most of these firms will receive no benefit from their membership in the SRO as they will continue to be primarily regulated and examined by the states.

Imposing an additional layer of bureaucracy runs contrary to the many recent attempts by Congress and by the Financial Services Committee to support small business and reduce regulatory hurdles. Simply stated, many small businesses are likely to be harmed or even put out of business by the costs associated with joining an SRO. To make matters worse, as the bill's expressed aim is to "preserve state authority over investment advisers with fewer than $100 million in assets under management,"[6] it is difficult to conceive of a valid reason for requiring state registered investment advisers to join and pay membership fees to an SRO. Essentially, these small businesses would be forced to subsidize costs of the SRO's examination program related to larger firms.

States' track record in examining small and mid-sized investment advisers with less than $25 million in assets under management is exemplary and that performance was recognized and validated by Congress when the Dodd-Frank Act expanded the states' oversight role. State securities regulators are prepared to take on this additional oversight, and have already put into place new resources to meet this responsibility in anticipation of the SEC's June 28th deadline.[7] These resources include additional personnel, training programs, and a protocol for the sharing of resources among state regulators. It is premature to assume that states are not able to uphold this increased regulatory authority.

Finally, even as NASAA ardently opposes the bill's requirement that all state registered investment advisers be members of an SRO, and although we consider it essential that state registered investment advisers be expressly exempted from such a membership requirement, NASAA does recognize that a very small number of states may want the option to augment their current examination programby enlisting the resources

[6] Press Release, House Financial Services Committee (Majority), Chairman Bachus and Rep. McCarthy Propose Bipartisan Bill for More Effective Oversight of Investment Advisers (April 25, 2012), available at http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=292499.

[7] Testimony on "Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight" by Steve Irwin, Pennsylvania Commissioner of Securities: Hearing before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House of Committee on Financial Services (Sept. 13, 2011), available at http://financialservices.house.gov/UploadedFiles/091311irwin.pdf.

of an SRO. In the event Congress chooses to establish an SRO for federally registered investment advisers only, NASAA would be prepared to work with the Committee to explore options that would allow individual states , acting on their own accord, to enlist the assistance of an SRO for purposes of examining investment advisers under their direct jurisdiction for compliance with state laws and regulations.

2. States should be able to adopt examination practices that are best suited to their pool of investment advisers.

The four year on-site examination requirement ignores the reality that investment advisers vary significantly in the size and types of businesses they conduct. Some manage and maintain custody of sizable client assets while others don't actively manage any assets, but instead develop sophisticated financial plans for their clients. These differences play a key role in determining the amount of risk posed by an investment adviser's business. States have extensive experience designing examination programs to account for these variables and differences in risk profiles. To this end, states utilize examination methods and review cycles that maximize investor protection through a focused use of resources. Of course, the period between examinations should not be ignored, and does serve as an important factor in determining the need to conduct an examination. However, requiring regulators to visit every investment adviser on a four year cycle may actually undermine investor protection by forcing regulators to overemphasize one component of risk instead of effectively accounting for all components of an investment adviser's business.

The regulatory flexibility of the states to do what is in the best interest of investor protection within their own borders should not be supplanted by afederally-mandated "one size fits all" standard.

3. State securities regulators should not be required to report to an SRO.

H.R. 4624 would require state securities regulators to report to an industry-funded SRO overseen by the SEC. States are sovereign, independent entities, and should not be subordinated to a private, industry-funded corporation. Such a regulatory structure would compromise the independence and flexibility that are essential to effective state regulation. It would also ignore fundamental democratic principles from which regulation derives legitimacy.

Further, even though the majority of the SRO's membership would likely be state registered investment advisers prohibited from registering with the SEC under section 203A of the Investment Advisers Act of 1940, H.R. 4624 gives the SEC exclusive oversight of the SRO for purposes of approving its rules and hearing appeals involving the discipline of its members. State regulators are given no role in overseeing the SRO. Moreover, because decisions of the SRO would be appealable to the SEC rather than a state securities regulator, the SEC becomes the final arbiter of actions against persons (state regulated investment advisers) that it does not regulate.

Perhaps most troubling is the bill's burdensome and highly unwarranted requirement that the SRO hold an "Annual Conference" with NASAA for the purpose of determining which states are meeting the examination standards prescribed in the bill, and then submit a report to Congress identifying: "[s]tates that have adopted a State examination plan" in conformity with the bill, and "providing any information available to the [SRO] concerning the States' proposed methodology of their examinations and the extent to which those States have been able to meet their previously-submitted examination plans."

Taken collectively, these requirements diminish state independence by effectively compelling sovereign states to report to an industry-run SRO, which may then critique the states in its annual report to Congress. This creates a reporting structure that is antithetical to securities regulation and state sovereignty.

We believe that such a delegation of authority to a private agency is constitutionally problematic as was pointed out by Professor Ernest A. Young of Duke University School of Law in a recent letter to the Chairman and Ranking Member of this Committee. Further, the regulatory scheme proposed in this bill whereby the principal regulator—in this case state regulators—is subordinated to a private organization is an attack on the principles of federalism and state sovereignty established in the Constitution. States, like the federal government, are statutory regulators and accordingly should not be subordinated to an industry self-regulator.

4. <u>The exemptions in H.R. 4624 undermine the legislation's goal and purpose</u>.

H.R. 4624 is a misapplication of the 914 Study. H.R. 4624 in many ways fails to address or remedy the problems that were the study's core focus. If the rationale for the legislation is to "augment and supplement the SEC's oversight to dramatically increase" its examination rate for investment advisers with retail customers, the numerous exemptions set forth in Section 203(B)(b) need substantial narrowing. This subsection exempts major categories of SEC registered advisers from SRO membership including advisory firms with at least one mutual fund client, regardless of the amount of assets the adviser has under management, and advisory firms with at least 90% of its assets attributable to institutional and high net worth clients or private funds.

Congress Should Consider All Options Available to Enhance Federal Oversight of Investment Advisers

As part of the 914 Study, the SEC examined various alternatives designed to increase the frequency of examinations of federally registered investment advisers. The alternative preferred by the SEC staff was the imposition of user fees that would be charged to investment advisers. H.R. 4624 makes no mention of this option and disregards the findings of the SEC—the individuals most familiar with the challenges that come with examining federal registered investment advisers.

The best way to improve IA oversight at the federal level is through SEC user fees.

Regulation of the financial services industry is the responsibility of the government agencies answerable to the investing public and not private organizations that report to a board of directors. These agencies should be adequately funded to carry out the responsibilities entrusted to them by the government. Therefore, as a matter of policy, the most appropriate way to improve the oversight of federally registered investment advisers is to provide the SEC with the resources needed to do the job, either through increased appropriations or by authorizing the SEC's Office of Compliance Inspections and Examinations to collect user fees from the investment advisers it examines.

As a matter of efficiency and cost, authorizing the SEC to fund enhanced oversight of federally registered investment advisers through the imposition of user fees also makes more sense than establishing a new SRO for investment advisers. Further, imposing user fees would be a less expensive option because the SEC would not have to spend significant resources in overseeing an SRO. The 914 Study acknowledged the high costs of coordination between the SEC staff and an SRO "which might include, for example, not only direct costs like additional management costs required to oversee the SRO's effectiveness, but also other costs that are even more difficult to quantify." In the 914 Study, the SEC staff went on to state as follows:

> There is no certainty that the level of resources available to the Commission over time would be adequate to enable staff to effectively oversee the activities of the SRO. Therefore, a user fee approach, which would contribute directly to the Commission's investment adviser examination program, would avoid the risk of underfunded oversight of an SRO.[8]

According to the BCG analysis, the start-up costs alone of an SRO could fund an enhanced SEC examination program for an entire year.

Before Creating a New SRO Congress Should Fix Flaws in the Current SRO Model

NASAA's primary position regarding investment adviser regulation is that it should continue to be the responsibility of state and federal governments that bring experience unmatched by any entity in existence. NASAA therefore urges Congress not to enact an SRO model for investment advisers.

[8] Study on Enhancing Investment Adviser Examinations, As Required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011), available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

However, in the event that Congress determines to establish an SRO for federally registered investment advisers, NASAA believes it is essential that this bill be improved to address the following concerns that are inherent in an SRO model.

1. Accountability of SROs.

Time and experience have demonstrated that SROs simply cannot match the accountability of government regulators, nor the proximity to and familiarity of state regulators with investment advisers when considering investor protection and regulatory thoroughness. The challenge of ensuring accountability of an SRO is linked to the question of whether an SRO is a "state actor." If an SRO's rules are viewed as equivalent to federal securities regulations by not being subject to oversight from state securities regulators, they will displace state laws and rules.

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

In a separate report prepared by the Boston Consulting Group examining the SEC's management structure including the oversight the SEC currently conducts of SROs, the BCG was forceful and direct in its call for improving SRO accountability, stating that, in view of "the important role SROs play in the governance of securities markets today, it is critical that the SEC maintain a robust level of oversight over their regulatory operations."[9] Their analysis went on to state that "the SEC should develop careful guidelines to SROs for overseeing investment advisers and ensure that those guidelines are followed meticulously."[10]

Notably, the BCG analysis placed particular emphasis on the need for more accountability in the relationship between the government and the largest SRO – FINRA. Citing FINRA's ongoing efforts "to further expand the scope of its regulatory activities," the BCG analysis stated that "the current level of oversight over FINRA should be enhanced."[11] A similar conclusion was reached very recently by the Government Accountability Office. (insert FN citing recent GAO report). Before efforts to expand the authority of SROs are undertaken these issues regarding oversight should first be addressed.

NASAA appreciates that H.R. 4624 includes a provision apparently intended to ensure that the legislation will not preempt the authority of the states to regulate investment advisers under their jurisdictions. Should the Committee consider H.R. 4624 this session, NASAA hopes to work with the Chairman and the Committee to refine and strengthen this provision.

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[9] The Boston Consulting Group, U.S. Securities and Exchange Commission, Organizational Study and Reform, pg. 237 (March 10, 2010), available at http://www/sec/gov/news/studies/2011/967study.pdf.
[10] Id. at151.
[11] Id. at 135.

2. <u>Conflicts of interest and susceptibility to industry capture</u>.

The existing securities industry SRO model, as typified by FINRA, is replete with conflicts of interest. Members of the industry serve on the SRO's board and occupy other positions of prominence such as serving on various advisory committees. Even where there is an independent Board of Directors, SROs remain organizations built on the premise of self-rule and are, as a matter of first principle, accountable to their members and not the investing public. NASAA appreciates that H.R. 4624 takes some steps to limit conflicts of interests in an investment adviser SRO. Notably, the bill provides that a majority of the new SRO's board of directors shall not be associated with any member of the SRO, and shall not be investment advisers or broker dealers. Nevertheless, by its very nature, there is some conflict of interest inherent to the SRO model. Further, any SRO that depends on its members as its primary funding source faces a heightened susceptibility to industry capture.

3. <u>Barriers to collaboration between SROs and government regulators</u>.

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

NASAA appreciates that H.R. 4624 attempts to mitigate obstacles to information sharing between SROs and government agencies. Specifically, the bill includes a provision that provides, in pertinent part, that "Nothing in this Act shall be construed to limit the authority of any national investment adviser association, whether or not it is also a self-regulatory organization registered under the Securities Exchange Act of 1934, to share any information in its possession with a Federal, State, or local governmental agency, nor shall the sharing of information be construed to be the action of such an agency."

NASAA is gratified to see that the legislation takes into account barriers to information sharing between regulators and SROs. Nevertheless, based on experience in working with various SROs over decades, state securities regulators remain concerned that the "State-Actor Doctrine" could persist as an obstacle to collaboration. As this doctrine arises from the Constitution, its breadth will be established not by Congress but by the courts, and, at present, the case law in this area is unsettled and contradictory.

4. <u>Transparency of SROs</u>.

Collaboration issues aside, the regulatory work performed by SROs lacks transparency. SROs are not subject to the Freedom of Information Act (FOIA) or other similar public records requirements, as are state securities regulators and the SEC. Even where there is public disclosure by SROs regarding members, as in the case of *BrokerCheck*, the SRO has placed limitations and filters on regulatory records that exceed FOIA provisions, resulting in less public disclosure of information than state

securities regulators routinely make publicly available. The end result is that important information is withheld by the SRO from the investing public.

Conclusion

In summary, state securities regulators share the Committee's concern regarding the oversight and examination of federally registered investment advisers. Further, we appreciate the improvements that the Chairman and Congresswoman McCarthy (NY) have made to the bill since a discussion draft was made public last fall—notably, in the independence of the SRO's governance structure, the sharing of information between the SROs and government regulators and the non-preemption language. Nevertheless, NASAA remains strongly opposed to H.R. 4624 in its present form, without significant changes.

As a matter of policy, investment adviser regulation is a governmental function that should not be delegated to an SRO. If Congress adopts an SRO model its scope and authority must be limited to specific regulatory need, and state securities regulators and the SEC must be maintained as the primary regulators of investment advisers. Moreover, any such SRO must be answerable to the appropriate government regulators, not the other way around, as both a legal matter and as a matter of fact.

Above and beyond NASAA's concerns with the SRO model and its application to investment adviser regulation, however, state securities regulators are adamantly opposed to H.R. 4624 because we believe it would subordinate state regulators to an SRO, impose redundant regulation and new costs on small and mid-size investment advisers that are impossible to justify, and very likely put many of the small firms that we regulate out of business.

We look forward to working with Congress to arrive at a legislative solution that maintains appropriate oversight of investment advisers.

Thank you, Mr. Chairman, for the opportunity to testify at today's hearing. I will be pleased to answer any questions that you or other members of the Committee may have.