



Financial Industry Regulatory Authority

Richard G. Ketchum
Chairman and
Chief Executive Officer

November 2, 2010

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549 -1090

Re: Commission Study on Enhancing Investment Adviser Examinations
Mandated by Section 914 of the Dodd-Frank Wall Street Reform and
Consumer Protection Act of 2010 ("Dodd-Frank")

Dear Ms. Murphy:

My colleagues and I appreciated the opportunity to meet with Commission staff on October 6th to discuss the SEC's study of the need for enhanced examinations of investment advisers. At our meeting, we urged that investor protection requires that increased resources are available to examine investment advisers. Given the SEC's funding limits, it is unlikely that the Commission, despite its best efforts, will be able to accomplish this on its own.¹

To deal with this intractable resource problem, we recommended that the Commission seek authority to establish one or more self-regulatory organizations (SROs) for investment advisers. Adding an independent regulatory layer to augment the government's efforts in overseeing

¹ Speaking before the National Association of Corporate Directors on October 19th, Chairman Mary Schapiro noted "We are really resource constrained at the SEC" and "While we will meet our deadlines ... we will be shifting resources from other areas that I think are equally deserving of our time and attention right now." The Commission has over 105 rules to write, 20 studies to conduct and five offices to staff based on Dodd-Frank. Chairman Schapiro noted that the new rulemaking responsibilities are an "enormous burden," adding that the agency has an agenda of issues unrelated to Dodd-Frank that the agency was already engaged in. Chairman Schapiro added that the most enormous challenges are in areas where the SEC has never regulated before, such as over-the-counter derivatives and the registration of hedge and private equity fund advisers. *See BNA, Schapiro: SEC to Meet Reform Act Deadlines But Will Be 'Stretched Too Thin Over Time'* October 20, 2010.

Chairman Schapiro has testified that even if the Commission receives the full amount of the Administration's FY 2011 budget request (a twelve percent increase over the FY 2010 funding), "[w]e anticipate examining only nine percent of SEC registered investment advisers ... in FY2011." *See* March 17, 2010 Testimony of Chairman Mary Schapiro before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives. House and Senate Appropriations Subcommittees have approved larger FY2011 budget increases for the SEC, but the funding bills have not been passed by the full House or Senate. Dodd-Frank also authorizes a series of increases in SEC funding over the next five years. Given the Commission's expanded responsibilities under Dodd-Frank, however, this would appear unlikely to ensure adequate resources for Commission examinations of investment advisers.

advisers would help ensure a dramatic increase in the frequency of examinations and resources devoted to enforcement. Investment advisory clients deserve no less.

At our meeting, we discussed our view that to ensure that an SRO structure for investment advisers achieves appropriate investor protection, each SRO applicant should be subject to exacting requirements, similar to those set forth in Sections 15A and 19 of the Securities Exchange Act of 1934 (“Exchange Act”) for registered securities associations.² These standards would ensure that an investment adviser SRO is publicly accountable, its rulemaking and other regulatory activities are transparent, and its governance and regulatory programs are free of undue industry influence. Importantly, these standards require continuous, stringent Commission oversight, which has been a major factor in the long and successful history of self-regulation as an adjunct to the Commission’s regulation of broker-dealers.³

FINRA believes that:

- For years, the Commission has had insufficient resources to devote to investment adviser examinations.⁴ Given the Commission’s new responsibilities under Dodd-Frank and its many other programs, Commission resources alone are unlikely to be sufficient to improve the frequency of these examinations;

² Modified, as appropriate, to meet the unique circumstances of the investment adviser industry.

³ Given the urgent need to improve investment adviser examinations, recent statements by the Investment Advisers Association (“IAA”), a trade association for the investment adviser industry, are troubling. See, e.g., October 19, 2010 letter from David G. Tittsworth, Executive Director, Investment Adviser Association, on *SEC Study on Enhancing Investment Adviser Examinations under Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (“IAA letter”). In our view, preservation of the *status quo*, under which an investment adviser may be examined only once every decade, would be a disservice to advisory clients. As the IAA surely is aware, it is highly impractical to suggest that Commission resources will be able to address the problem satisfactorily, particularly in light of the Commission’s own statements regarding its resource constraints.

Moreover, disingenuous mischaracterization of how SROs operate under the federal securities laws is a disservice to the investing public and the Commission staff undertaking this important study. We note that the IAA letter urges the Commission “[t]o resist the illusory solution of recommending an SRO for investment advisers simply to increase the number of exams ...” It is not clear what this statement means. If it is intended to suggest that an examination program must evolve to remain effective, we agree. FINRA refines its programs in light of changing markets and investor needs, and recently has taken substantial steps to enhance its examination program. For example, using risk-based analysis, our exams are more focused on understanding the composition of each firm’s business, so that our examiners can concentrate on areas at firms that pose the most risk to investors. For further information about changes that FINRA has implemented to better protect investors, see 2009 Year in Review, at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p121646.pdf>.

If the IAA letter intends to suggest that an SRO is incapable of effectively enforcing statutory and SEC rule requirements for investment advisers, we beg to disagree. FINRA has a long history of tough, effective enforcement of the regulatory requirements applicable to broker-dealers. In 2009, FINRA conducted approximately 2,500 routine examinations, approximately 7,900 cause examinations and brought 993 disciplinary actions. Clearly, these activities offer more than “illusory” benefits to investors. To suggest otherwise is irresponsible. If a FINRA affiliate were to seek authorization as an investment adviser SRO, it would establish equally effective examination and enforcement of SEC requirements for investment advisers.

⁴ As Commissioner Elisse Walter noted in a May 5, 2009 speech before the Mutual Fund Directors Forum, “Given the Commission’s limited resources, it is simply not possible for the agency to examine all of these entities [broker-dealers and investment adviser] regularly. Requiring all financial professionals to be SRO members could help considerably to fill this oversight gap.”

- A practical solution to the resource problem is for the Commission to have the authority to approve one or more SROs for the investment adviser industry;
- The standards set forth in Sections 15A and 19 of the Exchange Act establish an SRO regime that is transparent, publicly accountable, and operated in the public interest. We recommend a similar approach for an investment adviser SRO. Ongoing and comprehensive Commission oversight will be a critical component;
- The governance structure of every investment adviser SRO should be designed to prevent undue industry influence and ensure appropriate staff independence. Public representatives should form a majority of any governing body. Members of the investment adviser industry should be allocated a number of the remaining seats, to ensure adequate industry representation. If FINRA were to seek authorization as an investment adviser SRO, we would create a separate affiliate, with its own Board of Governors, to ensure that the SRO establishes programs appropriate to the adviser industry; and
- An investment adviser SRO should implement regulatory oversight that is tailored to the particular characteristics of the investment adviser business.

One or More SROs is the Most Practical Option

The Commission's limited resources have led to a great disparity in the exam frequency of broker-dealers and investment advisers. For example, 55% of broker-dealers are examined each year by the Commission and FINRA, while only 9% of investment advisers are examined by the Commission.⁵

The overlap in many of the services offered by broker-dealers and investment advisers, and resulting investor confusion,⁶ makes the disparity in exam frequency especially troubling. Many individuals and firms offer both brokerage and advisory services -- approximately 88 percent of all registered advisory representatives are also registered representatives of a broker-dealer.

The Commission is not self-funded, and its numerous responsibilities, including many new ones added by Dodd-Frank, strain its already limited resources.⁷ It is, therefore, difficult to expect

⁵ See FY 2011 SEC Congressional Budget Justification in Brief ("2011 Budget Justification") at 20. <http://www.sec.gov/about/secfy11congbudjust.pdf>.

⁶ See *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, a study produced by the RAND Corporation under contract with the Commission, January 2008.

⁷ For example, although Dodd-Frank generally raises the asset threshold for SEC-registered investment advisers, it imposes significant new Commission responsibilities for adviser oversight. In particular, Dodd-Frank requires the Commission to regulate advisers to hedge funds with assets under management of more than \$150 million. The legislation also requires Commission regulation of municipal advisers, which will strain the agency's resources even further. As the 2011 Budget Justification states: "[t]he number of registered entities will grow by thousands more if the Administration's legislation is enacted to require oversight of advisers to hedge funds and other private pools of capital." See 2011 Budget Justification at 4.

the Commission to improve the frequency or scope of its investment adviser examinations, particularly in light of its new responsibilities.

Authorization of one or more SROs for investment advisers, subject to Commission oversight, is the most practical way to address this resource problem. Such an SRO should have authority to examine for, and enforce compliance with, its own rules, the Investment Advisers Act and the rules under that Act. While we believe an adviser SRO should have some rulemaking authority, the extent of that authority should be a matter for the SEC to determine. Of course, Commission approval and oversight of any rule proposals would ensure that any such SRO rules are appropriate for the adviser industry. FINRA does not believe that it would be appropriate or in the public interest to impose a broker-dealer-like regulatory regime on investment advisers. The concerns regarding investment advisers primarily relate to the lack of examination resources, which places advisory clients at unacceptable risk. No matter how rigorous their regulatory requirements, an adviser's obligations may provide only hollow protection to investors absent rigorous examination and enforcement.

The SRO Model has a Long and Successful History in the U.S. Securities Markets

Over seventy years ago, Congress decided to supplement direct Commission regulation of broker-dealers and the U.S. securities markets with comprehensive independent regulation under Commission oversight.⁸ The wisdom of establishing a system of SRO regulation for broker-dealers has been reaffirmed by Congress and the Commission on several occasions. For example, in enacting the Maloney Act of 1938, Congress stated that direct Commission regulation alone "would involve a pronounced expansion of the organization of the Securities and Exchange Commissiona large increase in the expenditure of public funds ... and a minute, detailed, and rigid regulation of business conduct by law." The legislative history of the 1975 amendments to the Exchange Act likewise reflects Congress's continued determination that it was "distinctly preferable" to continue to rely on independent regulation.⁹ A principal reason cited was the "sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale."¹⁰ The Commission also has reaffirmed the SRO model in certain major studies.¹¹

Private funding is a critical advantage of the SRO model. Millions of dollars can be spent on examination, enforcement, surveillance and technology at no cost to the taxpayer. SROs also are better positioned to move quickly to address regulatory issues because, among other things, they are not subject to many of the spending restrictions of the federal government, and are better able to develop large-scale systems for important regulatory matters such as (in the case of FINRA) market surveillance, broker-dealer registration and trade reporting.

⁸ For a comprehensive discussion of the history of independent regulation in the US securities markets, see *Concept Release Concerning Self-Regulation*, Exchange Act Release No. 50700 (Nov. 18, 2004).

⁹ S. Rep. No. 94-75, 94th Cong., 1st Sess. 7, II (1975).

¹⁰ Id.

¹¹ See e.g., 1961-1963 Special Study of Securities Markets. Securities and Exchange Commission, Report of Special Study of Securities Markets, ("Special Study"), H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) and *Market 2000: An Examination of Current Equity Market Developments*, Division of Market Regulation, U.S. Securities and Exchange Commission (January 1994) ("Market 2000 Report").

Components of Effective Self-Regulation

One reason the SRO model has been so effective is that it is governed by extensive statutory requirements that ensure comprehensive Commission oversight, complete accountability, and transparency of rulemaking, enforcement and other regulatory activities. Section 15A of the Exchange Act authorizes the Commission to register one or more national securities associations, subject to stringent requirements and findings. For example, registration is contingent on Commission findings that the association's rules are designed to prevent fraud and manipulative acts and to protect investors and the public interest. The association must demonstrate the capacity to enforce compliance with its rules, the federal securities laws and the MSRB rules of the Municipal Securities Rulemaking Board (MSRB). Section 15A also requires a fair procedure for denying membership and for disciplining members and their employees. Section 19 of the Exchange Act governs matters such as the procedural and other requirements for SRO registration, rulemaking and disciplinary proceedings.

A. SEC Oversight

One of the most important factors in the success of self-regulation in the U.S. securities markets is that Congress mandated that the Commission conduct ongoing oversight. For example, the Commission:

- Approves all FINRA rulemaking. As part of that approval process, the Commission seeks public comment on FINRA proposals through notice in the Federal Register. Thus, FINRA rulemaking is fully transparent;
- Can add, delete or amend FINRA rules on the Commission's own volition as it deems necessary or appropriate;
- Reviews all FINRA disciplinary actions, which also may be appealed to the Commission and the federal courts;
- Requires FINRA to keep records and file reports with the Commission. These records are subject at any time to Commission inspection;
- Inspects FINRA regularly to ensure that it is fulfilling its regulatory responsibilities and to mandate corrective action as needed. Routine inspections assess FINRA enforcement, arbitration, and member examination programs at regular intervals. These inspections assess FINRA's surveillance systems and the adequacy of FINRA's policies and procedures. The Commission also reviews case files to determine whether FINRA staff is handling cases and investigations in compliance with its policies and procedures. The Commission also may conduct special inspections at any time for any reason;
- Can impose limitations on FINRA's operations if it finds deficiencies justifying such action;
- Can compel FINRA to act if it determines that FINRA is failing to provide adequate protection to investors; and

- Has the authority to suspend or revoke FINRA's registration under the Exchange Act and remove from office or censure any FINRA officer or director.

Well-established regulatory history argues that any contemplated SRO for investment advisers should be subject to similar stringent Commission oversight.

B. Governance

Governance is a key aspect of a successful SRO. We urge that any SRO for investment advisers have a governance structure that ensures that its governing body, committees and staff act independently and in the public interest.¹² In particular, its governing body should have a majority of its seats allocated to public representatives; representatives of the investment adviser industry should hold a substantial portion of the remaining seats, to ensure appropriate industry representation.

The following aspects of FINRA governance may serve as a model of effective SRO governance:

- FINRA's governance is designed to ensure that its Board of Governors, key committees, and staff act independently and in the public interest;
- FINRA's Board of Governors must at all times have more public governors than industry governors;
- Only those seven Board seats allocated to small, mid-sized and large firms are elected by FINRA firms. All other governors are appointed by the Board based on recommendations from the Board's nominating committee;
- The number of public governors on the nominating committee must at all times equal or exceed the number of industry governors. FINRA's CEO may not serve on the nominating committee;
- Board committees having the authority to exercise the powers and authority of the Board must have more public governors than industry governors. No member of the brokerage industry may serve on the Board's Management Compensation Committee, which sets executive staff salaries;
- FINRA's staff is autonomous, subject to the regular supervision of senior FINRA management and to the Board as it may deem necessary. Firms have no authority to approve or disapprove FINRA rule proposals, interpretations, or enforcement proceedings. FINRA staff can and does present proposed rules and interpretations to the Board that are opposed by firms. In the case of enforcement proceedings, the staff has sole discretion to decide which matters to investigate and prosecute. The initiation of proposed enforcement actions are not subject to Board of Governors approval.

¹² For a more comprehensive discussion of FINRA's governance, see October 14, 2010 letter from Angela Goelzer, FINRA, to Michael Spratt, Division of Investment Management, SEC.

FINRA's Operations Demonstrate that the SRO Model under a Strict Statutory Framework Serves Investor Interests

FINRA's programs provide a significant complement to the Commission's investor protection efforts through a broad array of programs including: the registration and licensing of industry participants; market surveillance; trade reporting facilities that promote market transparency; rulemaking; advertising review; industry training; and, investor education. FINRA does not own or operate any securities markets, but rather is solely dedicated to investor protection and market integrity through its oversight and regulatory activities.

As an SRO, FINRA is able to raise the standard of conduct in the industry by imposing ethical requirements beyond those that the law can establish. In doing so, FINRA can address dishonest and unfair practices that might not be illegal, but nonetheless undermine investor confidence and compromise the efficient operation of free and open markets.

- *Examinations* - FINRA has more than 1,000 employees dedicated to its examination program. Routine examinations are conducted on a one to four year cycle, depending on our assessment of the firm's risks. FINRA also conducts targeted examinations based on investor complaints, referrals generated by our market surveillance systems, terminations of brokerage employees for cause, arbitrations and referrals from other regulators. In 2009, we conducted approximately 2,500 routine examinations and approximately 7,900 cause examinations in response to events such as customer complaints, terminations for cause and regulatory tips;
- *Enforcement* – The effectiveness of our examination program is demonstrated by the fact that in 2009, FINRA took 993 disciplinary actions, barring 383 individuals, suspending 363 others and expelling 20 firms. We levied fines against firms and individuals totaling nearly \$50 million. In addition, we ordered firms and individuals to return more than \$8.2 million in restitution to investors;
- *Registration and Licensing* - FINRA administers qualification examinations that securities professionals must pass to demonstrate competence in the areas in which they will work. FINRA administers 28 different qualifications exams to over 275,000 people every year. FINRA also mandates a continuing education program that every registered representative of a broker-dealer must satisfy. FINRA maintains the Central Registration Depository (CRD), which includes the qualification, employment and disciplinary histories for the nearly 4,700 firms and 637,000 individuals registered;
- *Rulemaking* – Broker-dealers regulated by FINRA are subject to comprehensive, detailed business conduct and ethical rules that address every aspect of a brokerage operation. The SEC has noted that FINRA rules, along with Exchange Act and SEC requirements, provide a level of protection that in many ways exceeds that of the Investment Advisers Act of 1940¹³;
- *Advertising* - In 2009, FINRA reviewed 96,700 pieces of advertising and sales communications from firms to investors;

¹³ See Securities Exchange Act Release No. 50980 (January 6, 2005).

- *Market Surveillance* - FINRA operates automated surveillance programs that analyze over 400 million quotes, trades and orders each day in order to identify matters such as violations of best execution and short sale requirements, manipulation, fraud and insider trading;
- *Transparency* - In 2002, FINRA established a reporting system (the Trade Reporting and Compliance Engine or “TRACE”) that provides secondary market transaction data in corporate bonds. FINRA also maintains the Alternative Display Facility (ADF), which handles quotation and trade collection, trade comparison, and information dissemination. TRACE and ADF exist solely to record data and offer investors access to critical information -- they are not trading markets and do not provide listing or order execution services;
- *Investor Education* - FINRA offers significant investor education opportunities that augment government efforts. Investor Alerts help people avoid abuses and scams. FINRA’s BrokerCheck database allows the public to search a free database of background information on securities firms and brokers, including disciplinary history. Online research tools and calculators help investors understand basic principles of savings and investing, plan for major life events and assess their savings and investment needs. Online information about mutual funds includes a mutual fund expense analyzer that enables investors to compare the costs of different funds. The FINRA Investor Education Foundation, exclusively devoted to financial education, is funded by fines imposed against those who fail to comply with securities laws and regulation; and
- *Industry Training* - FINRA improves compliance and investor protection through the vast array of education services that we provide to securities firms. Unlike a government agency, FINRA is able to devote significant resources to educating and training the industry it regulates. Through conferences, workshops, seminars, on-line and classroom courses and other means, FINRA increases firms’ level of understanding of, and compliance with, regulatory requirements, and encourages the adoption of best industry practices.

The Commission 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 are dedicated to regular and vigorous examination and day-to-day oversight of investment advisers. Under strict Commission oversight and subject to the type of detailed requirements that govern securities associations, investment adviser SROs can help the Commission fill an untenable gap in the protection of investment advisory clients. We strongly urge the Commission to seek the authority to register and oversee such organizations.

My staff and I would be pleased to discuss these issues further or provide any additional information that the Commission may find useful.

Very truly yours,



Richard G. Ketchum

Cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Andrew J. Donohue
Robert W. Cook
Carlo V. di Florio
Robert E. Plaze