

Draft as of June 5, 2023
To be discussed at the June 22, 2023 meeting of the Investor Advisory Committee

Recommendation of the SEC Investor Advisory Committee’s Disclosure Subcommittee to
Promote Investor Protection through Oversight of Investment Advisers

The Investor Advisory Committee (IAC) had a panel discussion focused on enhancing oversight of investment advisers on March 2, 2023. The panel included representatives from the SEC’s Division of Examinations, North American Securities Administrators Association (“NASAA”), the Investment Advisers Association (“IAA”) and the Consumer Federation of America (CFA).¹

Investment adviser oversight and regulation is bifurcated between the SEC and State regulatory authorities. Generally, advisers with at least 100 million dollars in assets under management must register with the SEC. Investment advisers that are not eligible to register with the SEC must register in the states where they have their principal places of business and/or have more than a *de minimis* number of clients.

As of 2021, there were over 32,000 investment advisers in the U.S. with over 375,000 associated investment adviser representatives (“IARs”).² These IARs are generally required to register in the states where they work, including those employed by investment advisers registered with the SEC.³ Investment advisory firms manage almost \$129 trillion and serve over 65 million clients.⁴

Since 2016, the number of SEC registered investment advisers has increased 25% to over 15,000. Over the same period, the number of private funds managed by SEC registered advisers has increased 40% to approximately 50,000. This is a growth rate that far outpaces SEC staff increases. Over the same period, the SEC exam staff has increased only 4%.⁵ In 2021 alone, 900 new advisers registered with the SEC.⁶ Indeed, the largest increase in SEC registered

¹ Panelists were Natasha Greiner, Deputy Director of the SEC’s Division of Examinations, Karen Barr, President & CEO of the IAA, Stephen Brey, Staff Attorney with the State of Michigan, Corporations, Securities & Commercial Licensing Bureau and Co-Chair of the Investment Adviser Regulatory Policy & Review Project Group of NASAA and Micah Hauptman, Director of Investor Protection, Consumer Federation of America. See SEC Investor Advisory Committee, *Meeting Agenda*, (Mar. 2, 2023), available at <https://www.sec.gov/spotlight/investor-advisory-committee/iac030223-agenda.htm>.

² Financial Industry Regulatory Authority, *2022 FINRA Industry Snapshot* 5, 15, (May 2, 2022), available at <https://www.finra.org/sites/default/files/2022-03/2022-industry-snapshot.pdf>.

³ All states currently require the IARs be licensed and generally require that individuals pass an exam before they can be licensed.

⁴ Investment Adviser Association, *Investment Adviser Industry Snapshot 2022* 2, (Jun. 23, 2022), available at <https://investmentadviser.org/wp-content/uploads/2022/06/Snapshot2022.pdf>.

⁵ Gary Gensler, Chairman, Testimony of SEC Chair Gary Gensler at Hearing before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee, (May 17, 2022), available at <https://www.sec.gov/news/testimony/gensler-testimony-fsgg-subcommittee>. [hereinafter May 17, 2022 Testimony].

⁶ SEC Division of Examinations, *2022 Examination Priorities Report* 4, (Mar. 30, 2022), available at <https://www.sec.gov/files/2022-exam-priorities.pdf>.

entities has occurred in the investment adviser industry. This growth is due at least in part to many in the broker-dealer industry migrating to the investment advisory industry. Since 2012, the number of broker-dealer firms has declined 18%.⁷ This growth in the number of registered investment advisers does not fully capture the increasing complexity of the investment management industry whose firms are developing more sophisticated trading and investment strategies. This results in increasing complexity of the compliance issues and risks covered by examinations.

Unlike broker-dealers, there is no self-regulatory organization to assist the SEC in overseeing the investment adviser industry. Thus, the SEC and State regulators are the only entities conducting exams of investment advisers. In 2022, the SEC's Examination Division conducted examinations of 15% of registered investment advisers.⁸ This equates to a 7-year exam cycle, assuming the SEC examines every investment adviser - which it may not. Contrast this with the fact that in 2022, the SEC and FINRA together examined nearly half of registered broker-dealers.⁹ SEC Chair Gensler noted in congressional testimony that the Examination Division was able to maintain the level of registered investment adviser examinations by conducting remote examinations during the pandemic. He further noted that the agency would need additional resources to return to on-site examinations, which he viewed as more effective.¹⁰

It should also be noted that in addition to examinations of registered investment advisers, the Division of Examinations, with its staff of just over 1,000, is responsible for examining mutual funds, exchange traded funds, broker-dealers, transfer agents, national securities exchanges, alternative trading systems, credit rating agencies, clearing agencies and self-regulatory organizations. Including registered investment advisers, the SEC oversees the activities of more than 29,000 registered entities.¹¹

Congress has twice responded to capacity challenges facing the SEC's investment adviser examination program by reallocating Federal and State responsibilities for the regulation of registered investment advisers; first in 1996 with the enactment of NSMIA¹² and next in 2010, with enactment of the Dodd-Frank Act.¹³

The Dodd-Frank Act required the SEC to conduct a Study to review and analyze the need for enhanced examination resources for investment advisers. The staff of the SEC's Division of

⁷ *Supra* note 2 at 15.

⁸ SEC Division of Examinations, *2023 Examination Priorities Report 1*, (Feb. 7, 2023), available at <https://www.sec.gov/files/2023-exam-priorities.pdf>.

⁹ *Id.*

¹⁰ *Supra* note 5.

¹¹ SEC, *Fiscal Year 2023 Congressional Budget Justification and Annual Performance Plan 2*, (Mar. 25, 2022), available at https://www.sec.gov/files/fy-2023-congressional-budget-justification-annual-performance-plan_final.pdf.

¹² National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996).

¹³ Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010, Pub. L. 111-203, 124 Stat. 1376 (2010).

Investment Management completed this Study in 2011 (“Dodd-Frank Study”).¹⁴ The SEC staff stated that it did not believe that the periodic reallocation of investment adviser oversight between the SEC and the states was a stable solution to the SEC’s capacity challenges. The staff further predicted that the SEC likely would not have sufficient capacity in the long-term to conduct effective examinations of registered investment advisers with adequate frequency. The staff concluded that the SEC’s examination program required a source of funding that was adequate to permit the Agency to meet the new challenges it faced - and sufficiently stable, to prevent investment adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers.

As predicted by the SEC Staff’s Dodd-Frank Study, examination staffing has not kept pace with the growth in the industry. The current exam cycle of approximately 7 years in the view of the IAC is inadequate to detect or credibly deter fraud in the investment adviser industry. In the Dodd-Frank Study, the SEC Staff recommended that Congress authorize the SEC to assess “user fees” on investment advisers it examines, and that the revenue derived from such fees be used to fund additional adviser examinations.

In its recent release of its 2023 examination priorities, the SEC’s Division of Examinations stated that as the industry continues to grow and change, “increased examinations can only be achieved with significant investment in human capital and technology resources.” Accordingly, there is a question as to whether the current exam cycle can be maintained, as post-pandemic, the SEC returns to on-site examinations.

Clearly, with registered advisers having 65 million investment advisory clients, effective oversight of the investment adviser industry is an important investor protection issue. The IAC believes that the best way to ensure effective oversight of the investment adviser industry is to ensure that the SEC has adequate resources to maintain an effective examination program. However, congressional budget appropriations to the SEC each year are uncertain and never seem to keep pace with industry growth. To effectively detect and deter fraud we believe the SEC work towards examining registered advisers no less frequently than every 4-5 years, with higher risk firms examined more frequently. Growth in the number of SEC registered advisers is likely to continue.¹⁵ User fees would allow the SEC to have a stable source of funding to allow

¹⁴ SEC Division of Investment Management, *Study on Enhancing Investment Adviser Examinations*, (Jan. 12, 2011), available at <https://www.sec.gov/files/914studyfinal.pdf>.

¹⁵ The number of SEC registered advisers has increased in 19 of the past 21 years. *Supra* note 4 at 13. “Employment of personal financial advisers is projected to grow 15% from 2021 to 2031, much faster than the average for all other occupations.” Bureau of Labor Statistics, *Occupational Outlook Handbook*, (last modified Sep. 8, 2022), available at <https://www.bls.gov/ooh/business-and-financial/personal-financial-advisors.htm>. See also McKinsey & Company, *US wealth management: A growth agenda in the coming decade*, (Feb. 16, 2022), available at <https://www.mckinsey.com/industries/financial-services/our-insights/us-wealth-management-a-growth-agenda-for-the-coming-decade>.

for an effective exam cycle and to keep up with growth in the industry. Therefore, the IAC reiterates its recommendation with respect to user fees that it made in 2013.¹⁶

However, given that user fee legislation has not yet been enacted, although it has passed on a bipartisan basis by the House of Representatives several times,¹⁷ the IAC recommends that the SEC consider issuing a Request for Comment on requiring third-party examinations to supplement the SEC's investment adviser examination program. Such a requirement has the potential to enhance oversight of the adviser industry.

Given the current bifurcation of oversight between the SEC and the states, it is important that there be greater consistency in oversight of the investment adviser industry. Therefore, as discussed further below, the IAC also recommends that the SEC join NASAA in encouraging all states to adopt the model IAR Continuing Education Rule and model Policies and Procedures Rule.

RECOMMENDATIONS

User Fee Recommendation: The SEC should request legislation from Congress that would authorize its Division of Examinations to impose “user fees” on SEC-registered investment advisers, the revenue from which could be retained by the SEC to fund and enhance its investment adviser examination program, including more frequent on-site examinations of SEC-registered advisers. The SEC would continue to rely on appropriated funds to support its other programs. As the Dodd-Frank Study observed, user fees imposed upon registered investment advisers would provide scalable resources to support the SEC's examination of registered investment advisers. The fees collected from investment advisers would be available to the SEC without further appropriations, used solely to fund the SEC's investment adviser examination program, and set at a level designed to achieve an acceptable frequency of examinations (a minimum of every 4-5 years). User fees could be assessed based on the complexity of the firms, number of representatives, number of offices, complexity of products and assets under management. Larger and more complex firms could be charged higher user fees.

As noted by the IAA, user fees would better enable the SEC to improve the effectiveness of its examinations through long-term strategic planning and the better use of modern technology. A stable source of funding would permit use of technology-based solutions that could take years to develop and implement. Moreover, stable and scalable resources would also provide the

¹⁶ SEC Investor Advisory Committee, *Recommendation of the Investor Advisory Committee—Legislation to Fund Investment Adviser Examinations*, (Nov. 22, 2013), available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-examinations-recommendation-2013.pdf>.

¹⁷ On September 22, 1992, during the 102nd Congress, the House of Representatives approved H.R. 5726, the Investment Adviser Regulatory Enhancement & Disclosure Act of 1992. H.R. 5726, 102nd Cong. (1992). On May 4, 1993, during the 103rd Congress, the House of Representatives approved H.R. 578, the Investment Adviser Regulatory Enhancement & Disclosure Act of 1993. H.R. 578, 103rd Cong. (1993).

SEC's adviser examination program with increased flexibility to react to emerging risks, and better target staffing and strategic resources as appropriate.¹⁸

User fees are important resources for other federal government agencies, particularly agencies that regulate the financial services sector.¹⁹ Moreover, Congress has already authorized that fees be assessed to investment advisers to cover the costs of the Investment Adviser Registration Depository system ("IARD") to file documents with the SEC and State regulators.²⁰ Accordingly, registered investment advisers bear little of the cost of their regulatory oversight. This is in contrast to broker-dealers who bear substantial cost of their oversight through fees paid to their self-regulatory organization, FINRA.

User fee legislation has at various times been introduced in Congress and has enjoyed support from many investment adviser industry associations and investor advocates. These organizations have acknowledged the public policy imperative of effective adviser oversight and have made clear in testimony and other public statements that they consider authorizing the SEC to collect "user fees" to be an optimal means for effectuating sufficiently frequent on-site examinations of SEC registered advisers.²¹

Third Party Examinations: In addition to user fees, our March panel explored other potential approaches to enhancing oversight of SEC registered advisers, such as:

- (1) Reallocating more adviser oversight responsibilities to State regulators;
- (2) Creating a self-regulatory organization to examine registered advisers;
- (3) Giving FINRA authority to examine firms that are dually registered as broker-dealers and investment advisers; and
- (4) Permitting third-party examinations of registered advisers.

Of the alternatives considered, we believe that the approach that offers the most appeal is third-party compliance examinations of investment advisers.²² The SEC could adopt a rule requiring advisers to undergo a compliance exam conducted by an outside firm and that a copy of the exam results be submitted to the SEC. This approach could be structured to leverage the

¹⁸ See Karen Barr, Chief Executive Officer, Investment Adviser Association, Written Statement at the Meeting of the SEC Investor Advisory Committee, (Mar. 2, 2023), available at <https://www.sec.gov/files/barr-iac-statement-030223.pdf>.

¹⁹ The U.S. Comptroller of the Currency employs user fees to fund examinations of banks and user fees fund examinations of credit unions by the National Credit Union Administration.

²⁰ The IARD is operated by FINRA. Annual fees range from \$40-\$225 depending on the amount of assets under management.

²¹ See *supra* note 18 and Micah Hauptman, Director of Investor Protection, Consumer Federation of America, Written Statement at the Meeting of the SEC Investor Advisory Committee (Mar. 2, 2023), available at <https://www.sec.gov/files/panel-discussion-regarding-oversight-investment-advisers.pdf>.

²² The SEC first raised this idea in a concept release issued in 1983. See Concept of Utilizing Private Entities in Investment Company Examinations and Imposing Examination Fees, Investment Company Act Release No. 13044, 27 SEC Docket 313 (Feb. 23, 1983). The SEC later asked for comment on whether Investment Advisers should undergo third-party compliance reviews. Compliance Policies of Investment Companies and Investment Advisers, Investment Company Act Release No. 25925, 79 SEC Docket 1696 (Feb. 5, 2003).

expertise of the private sector but maintain critical SEC oversight of advisers. Because of the potential benefits, we suggest that the SEC consider issuing a Request for Comment on third-party compliance examinations of registered advisers to support and supplement the SEC's Investment Adviser Examination Program. There are many organizations, including accounting, law and consulting firms that provide compliance reviews or mock audits for investment advisers and they have experience in assessing the effectiveness of compliance programs. The SEC has clear statutory authority to impose such a requirement²³ and has used this authority to require registered advisers that have custody of customer assets to have surprise annual audits to verify assets.

The request for comment would allow the SEC to gather information on the types of voluntary third-party reviews that investment adviser firms currently employ.²⁴ This would inform the SEC on the types of third-party reviews, practices utilized, and the costs involved.

A third-party compliance examination firm could focus on routine examination issues and make factual findings on the accuracy of Form ADV and website disclosures, verify assets, the maintenance of required books and records, and compliance policies and procedures.

The third-party exam requirement could have the following benefits:

- (1) increase frequency of exams beyond what is presently possible under traditional SEC funding levels;
- (2) free-up SEC resources to focus on and perform more in-depth reviews of firms that pose greater risks to advisory clients and to conduct for-cause examinations and address emerging risks;
- (3) allow the SEC to use third-party compliance reports to improve risks assessments and profiles of advisory firms;
- (4) permit initial reviews of newer advisory firms, which could be required to have an initial third-party exam within a reasonable period after commencing operations; and
- (5) allow for competition among service providers could keep the costs of exams at reasonable levels.²⁵

To implement a third-party compliance examination regime, a number of key issues would have to be addressed which could be covered in the Request for Comment. These issues include:

- (1) What qualifications would be necessary for a firm to conduct these compliance reviews? Should qualified examiners be periodically re-certified?;
- (2) What should be the scope of such examinations? Should scope be tied to the size and risks of the firm?;

²³ See. 15 U.S.C. §§ 80b-4, 80b-6, 80b-11 (2023) (commonly known as Sections 204, 206 and 211 of the Investment Advisers Act of 1940).

²⁴ These include financial audits, internal audits, internal control reports, compliance reviews and mock audits.

²⁵ See Angel, James J., *On the Regulation of Investment Advisory Services: Where Do We Go from Here?* (Oct. 31, 2011), available at SSRN: <https://ssrn.com/abstract=1951991> or <http://dx.doi.org/10.2139/ssrn.1951991>.

- (3) What should be the proper frequency of such exams? Should an initial exam be required for newly registered advisers?;
- (4) What type of advisers should be subject to these reviews? Should some types of advisers be exempt from the review requirement, e.g., advisers without discretionary authority over client assets?;
- (5) What independence requirements should be imposed on firms conducting the exams? How should potential conflicts-of-interests of third-party examination firms be addressed?;
- (6) Would the cost be problematic for small firms?;
- (7) What are the incremental resources the SEC would need to oversee the execution of this initiative and to review the results compiled by 3rd party examiners?;
- (8) Should the SEC develop an exam module for such reviews to ensure consistency in exam processes?²⁶;
- (9) Should FINRA be eligible to provide examinations for dual registrants?;
- (10) How should liability exposure of third-party examination firms be handled? Should liability be limited, and if so, what standards should apply?; and
- (11) Should third-party compliance reports be kept confidential?

After considering the comment and input from the Request for Comment, the SEC could consider whether to move forward with a proposal for a third-party exam requirement for SEC registered investment advisers.

Support NASAA Efforts To Promote Investor Protection Through Enhancing Adviser Compliance Programs:

At the March 2023 IAC meeting, a representative of NASAA provided an overview of how State regulators oversee investment advisers. It was noted that States can require Notice filings and retain anti-fraud authority with respect to SEC registered investment advisers. States also have authority to require the registration of most IARs doing business in a State regardless of whether an individual is employed by or associated with a State-registered or SEC-registered investment adviser. NASAA members carry-out examinations of State registered investment advisers to assess adviser compliance with State regulatory requirements. Most NASAA members use the NASAA Examination Module System (“NEMO”) to conduct examinations of investment advisers. Use of NEMO promotes consistency in examination approaches across jurisdictions.²⁷ NASAA has engaged in efforts to enhance oversight of investment advisers through the development of model rules to be considered for adoption by States. Recent examples include the adoption of a model rule requiring written compliance and supervision

²⁶ See North American Securities Administrators Association, *NASAA Upgrades Exam Resource for State Securities Commissions*, (Nov. 13, 2019), available at <https://www.nasaa.org/53161/nasaa-upgrades-exam-resource-for-state-securities-examiners/>

²⁷ *Id.*

policies and procedures²⁸ and a new continuing education requirement for investment adviser representatives.²⁹

The policies and procedures model rule is similar to Rule 206(4)-7 under the Investment Advisers Act which requires SEC-registered advisers to have comprehensive compliance policies and procedures and to designate a chief compliance officer. The policies and procedures model rule lays out specific written policies that investment advisers must adopt, implement and enforce. The IAR Continuing Education Rule requires 12 hours of continuing education credit for IARs who are registered in a State. This requirement applies to all registered IARs, whether they work for a State-registered or SEC-registered firm. The 12 credits are divided into two 6-credit components: the Ethics and Professional Responsibility Requirement and the Products and Practice Requirement. With this Rule, NASAA members seek to ensure that IARs maintain their knowledge of ethics, regulatory requirements, products and practices within the securities industry.³⁰

The NASAA model rule is an effort to address the issue of the need for continuing education and imposes requirements on representatives of SEC-registered advisers. The IAC believes it is reasonable to impose continuing education requirements on investment adviser representatives of firms whose employees interact with retail clients, particularly when there is emphasis on ethical and professional responsibility obligations. Accordingly, the IAC recommends that the SEC join NASAA in encouraging more States to adopt the IAR Continuing Education Rule as well as the model Policy and Procedures Rule. We believe both of these rules have considerable investor protection benefits.

²⁸ North American Securities Administrators Association, *Model Rule for Investment Adviser Written Policy and Procedures under the Uniform Securities Act of 1956 and 2002*, (Nov. 24, 2020), available at <https://www.nasaa.org/wp-content/uploads/2020/07/NASAA-IA-PandP-Model-Rule-and-Sample-Compliance-Grid.pdf>.

²⁹ North American Securities Administrators Association, *Model Rule on Investment Adviser Continuing Education (Model Rule 2002-411(h) or 1956-204(b)(6)-CE)*, (Nov. 24, 2020), available at <https://www.nasaa.org/wp-content/uploads/2020/10/NASAA-IAR-CE-Model-Rule.pdf>.

³⁰ In 2011, the SEC Staff recommended that the SEC consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements. See SEC, *Study on Investment Advisers and Broker-Dealers* ix, (Jan. 11, 2011), available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf> (as required under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act). Additionally, in 2018, the SEC requested comment on whether there should be federal licensing and continuing education requirements for personnel of SEC-registered investment advisers. See Proposed Commission Interpretation Regarding Standards of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. 4889, (Apr. 18, 2018), available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>. The IAC is not making a recommendation on federal licensing and continuing education for IARs.