FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT BROKER-DEALERS AND INDEPENDENT FINANCIAL ADVISORS
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VIA ELECTRONIC MAIL

December 20, 2010

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

RE: Title IX - Enhancing Investment Adviser Examinations

Dear Ms. Murphy:

On July 27, the Securities and Exchange Commission (SEC) published a request for public comment related to its study on enhancing investment adviser examinations (Study). The Study is required under Title IX, Section 914 the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),[1] which President Obama signed into law on July 21, 2010. Section 914 requires the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers.[2] More specifically, the Study must examine:

- The number and frequency of examinations of investment advisers by the SEC over the past five years;
- The extent to which having Congress authorize the SEC to designate one or more self-regulatory organizations (SRO) to augment the SEC's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers; and
- Current and potential approaches to examining the investment advisory activities of dually registered broker-dealers and investment advisers.[3]

The Financial Services Institute (FSI)[4] welcomes this opportunity to offer input into this very important Study. We commend the SEC for its efforts to encourage public input and comment to inform this Study and their efforts to enhance investor protection for clients of investment advisers. FSI urges the SEC to use the Section 914 study to call for legislation providing it with the authority to establish FINRA as the self-regulatory organization (SRO) for all entities regulated under the Investment Adviser Act of 1940 ('40 Act). In addition, FSI calls on Congress to create an SRO governance structure that is transparent, publicly accountable, operated in the public interest and subject to continuous oversight by the SEC. We hope to further the SEC's efforts to improve investor protection through the submission of this comment letter.

Background on FSI Members

FSI represents independent broker-dealers (IBD) and the independent financial advisors affiliated

[1] Public Law No: 111-20, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.
[2] *Id* at 914(a)(1).
[3] *Id* at 914(a)(2).
[4] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 126 Broker-Dealer member firms that have more than 188,000 affiliated registered representatives serving more than 15 million American households. FSI also has more than 14,500 Financial Advisor members.

with them. The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees of their affiliated broker-dealer firm.[5] These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market for advisors affiliated with IBDs is clients who have tens and hundreds of thousands, as opposed to millions, of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[6] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. Our mission is to insure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. We also provide our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Introduction to FSI's Detailed Comments

FSI has long supported the thoughtful harmonization of regulatory oversight and the creation of a uniform fiduciary standard of care owed by broker-dealers and investment advisers to retail investors. We have consistently stated that true harmonization requires this heightened standard of care be paired with meaningful efforts to close the substantial gap in resources dedicated to the examination and supervision of broker-dealers and investment advisers.[7] The studies required by Sections 913 and 914 of the Dodd-Frank Act set the stage for the SEC and Congress

[5] Cerulli Associates at http://www.cerulli.com/.

[6] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

[7] See FSI's comment letter on the SEC's Study Regarding Obligations of Brokers, Dealers, and Investment Advisers (File Number 4-606) at http://sec.gov/comments/4-606/4606-2687.pdf.

to vastly improve investor protection by addressing these glaring weaknesses in the current financial regulatory system.

FSI urges the SEC to take advantage of this unique opportunity to protect investors and balance the playing field for all financial advisors by using the Study to call for legislation providing it with the authority to establish FINRA as the SRO for all entities regulated under the '40 Act. Further, FSI calls on Congress to create an SRO governance structure that is transparent, publicly accountable, operated in the public interest and subject to continuous oversight by the SEC.

FSI believes FINRA is particularly well suited for the role of investment adviser SRO because it has:

- Experience operating an SRO whose structure is designed to ensure its governing body, committees, and staff act independently in the public interest.
- Experience with a private funding model capable of equitably allocating the cost of the examination, enforcement, surveillance, and technology resources needed to do the job among regulated entities at no cost to the taxpayer.
- Knowledge of the overlapping nature of the financial products and services offered by broker-dealers and investment advisers.
- Experience in performing regulatory examinations of a wide variety of financial service providers.
- Demonstrated the ability to handle a complex expansion of their regulatory responsibilities through the NASD/NYSE merger.
- Successfully developed and operated the Investment Adviser Registration Depository (IARD), a key resource for any investment adviser regulator.

The new regulatory configuration would result in a layering of effective specialized regulatory entities that mirrors the structure utilized to supervise broker-dealer firms. Under the supervision of the SEC, FINRA would focus on the routine examination and supervision of all investment advisers. The SEC would thus be free to focus on capital markets concerns, the development of appropriate regulations for all regulated entities, the supervision of the new investment adviser regulatory authority, and the fulfillment of other appropriate regulatory goals. This structure will also eliminate the current practice of "regulator shopping" that allows advisors to seek the least regulated arena in which to operate their practice.

A regulatory structure that places the same emphasis on the examination of investment advisers, broker-dealers and their affiliated financial advisors will benefit investors by closing the existing gap in dedicated regulatory examination and enforcement resources between broker-dealers and investment advisers. Investors will not only better understand that their financial advisor is working in their best interests, but will be comforted by the fact that a knowledgeable and specialized regulatory authority is working to ensure compliance. The layered regulatory framework will allow the SEC to review the quality of the supervisory work of FINRA resulting in a more effective system of supervision. Industry input into FINRA's investment adviser rulemaking process will ensure that regulators protect the investing public while also considering potential unintended negative consequences. Consolidated exam programs for dual registrant firms will limit business disruptions thereby reducing the related costs that are passed on to investors. Therefore, FSI believes FINRA serving as the SRO for registered investment advisers is an essential part of any serious effort to enhance investor protection.

The Number and Frequency of Investment Adviser Examinations

Investment advisers and broker-dealers are subject to very different levels of regulatory supervision. While broker-dealers can expect routine regulatory examinations on a regular schedule, investment advisers operate their businesses without the expectation of being subject to routine regulatory scrutiny. The lack of SEC and state regulatory resources is the cause of this unjustifiable supervisory gap. Federal and state budgetary challenges make it highly unlikely that the necessary resources will be made available securities regulators in the near future. This unbalanced playing field has significant negative consequences for investors. These issues are discussed more fully below.

The Supervision Gap

The current regulatory framework for broker-dealers is multilayered. The nearly 4,700 brokerage firms,[8] 167,000 branch offices,[9] and approximately 635,000 registered securities representatives[10] are subject to supervision by:

- The professional broker-dealer compliance staff of their broker-dealer firm,
- FINRA,
- SEC, and
- State securities regulators.

Broker-dealers are subject to primary oversight by FINRA, an SRO that conducts periodic routine examinations of its broker-dealer members. These examination efforts supplement the SEC's own examinations of broker-dealer firms. FINRA has approximately 3,000 employees.[11] It operates from Washington, DC, and New York, NY, with 20 regional offices around the country.[12]

The SEC and FINRA examine more than half of these registered broker-dealer firms each year.[13] While improvements can certainly be made, and are being made, to the effectiveness of these examinations, it is hard to sustain an argument that they do not occur with sufficient frequency.[14]

This layered and frequent broker-dealer supervision and examination program is unparalleled in the investment adviser world. The 14,500 state registered investment advisers[15] and 11,300 federally registered investment advisers[16] are subject to supervision by:

- A compliance officer, who may be the investment adviser himself, and
- Either the SEC or a state securities regulator.

[8] About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited August 30, 2010).
[9] *Id.*
[10] *Id.*
[11] About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited August 30, 2010).
[12] *Id.*
[13] Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/speeches/Ketchum/P118889.
[14] See generally Bowsher, *surpa* note 7.
[15] David G. Tittsworth et al., *Evolution Revolution – A Profile of the Investment Advisor Profession*, 2009 INVESTMENT ADVISOR ASSOCIATION 8, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PN_RB (follow "2009 Evolution Revolution Report").
[16] David G. Tittsworth et al., *Evolution Revolution – A Profile of the Investment Advisor Profession*, 2009 INVESTMENT ADVISOR ASSOCIATION 4 n.1, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PN_RB (follow "2009 Evolution Revolution Report").

The SEC projects that fewer than 10 percent of the registered investment adviser firms subject to their supervision will be examined during the fiscal years 2009 and 2010.[17] State examination programs vary widely, but are also overwhelmed by the volume of registered investment advisers requiring supervision. Even a strong state registered investment adviser examination program cannot match the regularity of broker-dealer exams. For example, the State of Texas indicates that they "try to get to every adviser once every five years."[18] Simply put, registered investment adviser firms go unsupervised by their regulators for long periods.

Lack of Resources Is the Cause

As of January 2009, the SEC had 425 staff dedicated to examinations of registered investment advisers and mutual funds, and approximately 315 staff dedicated to examinations of registered broker-dealers.[19] These examiners are located in Washington, DC and the SEC's eleven regional offices located in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Denver, Salt Lake City, Fort Worth, San Francisco, and Los Angeles.[20]

The SEC has large and diverse examination responsibilities. The registered population consists of approximately: 11,300 investment advisers (a population that has grown rapidly in recent years, as discussed further below); 950 fund complexes (representing over 4,600 registered funds); 5,500 broker-dealers; and 600 transfer agents.[21] The SEC also examines eleven exchanges, five clearing agencies, ten nationally recognized statistical rating organizations, SROs such as FINRA and the Municipal Securities Rulemaking Board (MSRB), and the Public Company Accounting Oversight Board (PCAOB).[22]

From 1998 through 2002, the SEC staff examined every RIA subject to their jurisdiction using a periodic exam frequency of once every five years, and sought to examine newly registered advisers early in their operations.[23] The staff was able to do this because the population of RIAs was much smaller at that time.[24] However, the SEC reports that the number of RIAs has increased dramatically in recent years. After 2002, the number of RIAs increased by 50% (in 2002, there were 7,547 advisers, and as of January 2009 there were nearly 11,300).[25] This growth has negatively affected the SEC's examination program. The SEC is now only able to examine a small fraction of RIAs each year. For example, in 2008 the SEC's staff conducted 1,521 investment adviser examinations (approximately 14% of the registered community).[26] These examinations included routine examinations of certain investment advisers, examinations "for cause" based on an indication of a compliance problem, and "sweep" examinations focused on a particular risk area. Because only a small portion of RIAs can be examined each year, the process of selecting firms and business areas is of crucial importance to investor protection. Given the number of firms subject to examination oversight and the breadth of their operations,

[17] Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/speeches/Ketchum/P118889.
[18] Scannell, *supra* note 58. It is important to note that Section 410 of the Dodd-Frank Act will further stress state securities regulators by shifting oversight responsibility for some 4,000 registered investment advisers to the states.
[19] Lori A. Richards, Testimony Concerning Examinations by the SEC and Issues Raised by the Bernard L. Madoff Investment Securities Matter (January 27, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts112709lar.htm.
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] Lori A. Richards, Testimony Concerning Examinations by the SEC and Issues Raised by the Bernard L. Madoff Investment Securities Matter (January 27, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts112709lar.htm.
[24] *Id.*
[25] *Id.*
[26] *Id.*

examinations are no longer comprehensive audits of a firm's activities, but are instead more limited in scope.[27]

Prior to 2010, the SEC's Office of Compliance Inspection and Examination (OCIE) developed and implemented a risk-based program for selecting RIAs and activities for examination. During these inspections and examinations, examiners interviewed firm personnel, reviewed the books and records of regulated entities, and analyzed the entity's operations.[28] The goal of the examinations was to test the registrant's compliance with the federal securities laws and regulations. OCIE used risk-based methodologies to focus resources on RIAs and activities that could pose the greatest risk to investors and the integrity of the markets.[29] Higher-risk RIAs were those that appeared to engage in activities associated with emerging or resurgent risks or that simply managed or handled such large amounts of investor assets that if something were to go wrong there could be significant harm to both investors and investor confidence.[30] Because of these examinations, RIAs often corrected the deficiencies identified and improved compliance controls to prevent them from reoccurring.[31]

However, in early 2010, due to lack of resources and investor confidence in the markets, the SEC changed its risk-based methodology for selecting RIAs for examination. The SEC unofficially announced that it had indefinitely suspended its goal of inspecting some 11,000 RIAs on a regular schedule, and instead was focusing its examination resources on investment advisers who were the subject of tips and complaints.[32]

State Securities Divisions Also Lack the Resources

The inspection, examination, and enforcement capabilities of state securities regulators vary significantly from state-to-state. Approximately 8 state securities regulators do not currently conduct routine examinations of the brokers-dealers or investment advisers under their jurisdiction.[33] The remaining 42 states that do conduct routine examinations have significant resource constraints that prevent them from completing robust and comprehensive examinations. For the purposes of this comment letter, we will not review each state's examination program; however, we will provide a few examples.[34]

The state of New York does not routinely examine broker-dealers or investment advisers registered in the state. The Investor Protection Bureau of the state of New York is charged with enforcing the Martin Act, which is the New York State blue-sky law. Article 23-A,[35] sections 352 and 353 of the Martin Act give the Attorney General broad law-enforcement powers to conduct public and private investigations of suspected fraud in the offer, sale, or purchase of securities. Where appropriate, the Attorney General may commence civil and/or criminal prosecutions

[27] *Id.*
[28] Office of Compliance Inspections and Examinations: Highlights, http://www.sec.gov/about/offices/ocie/ocie_highlights.shtml.
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] Jed Horowitz, *SEC's new adviser exam schedule: 'We simply show up,'* INVESTMENT NEWS, April 9, 2010, *available at* http://www.investmentnews.com/article/20100409/FREE/100409833.
[33] Elizabeth MacBride, *It's looking official: Advisors switching to state oversight to face many more audits*, RIABIZ.COM, September 28, 2010, *available at* http://www.riabiz.com/a/2323150.
[34] *See* NATL. CONF. ST. LEGISLATORS, STATE BUDGET UPDATE: JULY 2009 14 (2009), *available at* http://www.ncsl.org/documents/fiscal/statebudgetupdatejulyfinal.pdf. *See also* SUNSHINE REVIEW, STATE BUDGET ISSUES, 2009 – 2010, http://sunshinereview.org/index.php/State_budget_issues,_2009-2010#cite_note-NCSL_July-1.
[35] N.Y. Gen. Bus. § 23-A (McKinney 2009), *available at* http://law.justia.com/newyork/codes/general-business/idx_gbs0a23-a.html.

under the Martin Act to protect investors. The Bureau also protects the public from fraud by requiring broker-dealers and investment advisers to register with the Attorney General's Office. However, the Bureau does not have the authority to conduct routine examinations of the broker-dealers or investment advisers registered in the state.

The lack of a routine examination program in New York has had consequences for investors. Bernard Madoff operated his massive Ponzi scheme from his firm's office on Third Avenue in New York City.[36] In addition, Cohmad Securities Corporation brought investors into the Ponzi scheme from offices located within the Madoff firm.[37] There is no indication that the New York Investor Protection Bureau ever conducted an examination of the offices or activities of Bernard L Madoff Investment Securities or Cohmad Securities Corp. As a result, valuable opportunities to uncover the ongoing frauds were lost.[38]

In contrast to the state of New York, the Texas State Securities Board does conduct examinations of broker-dealers and investment advisers. According to the Texas State Securities Board Strategic Plan for Fiscal Years 2009 – 2013,[39] Texas has 19 full time employees who conduct examinations for the Agency.[40] As of August 31, 2009, Texas had approximately 2,700 registered broker-dealers (both FINRA and non-FINRA member firms), 1,200 state registered investment advisers, and 3,500 SEC-registered Notice filers subject to their jurisdiction.[41] As previously mentioned, the number of RIAs regulated by the states, including Texas, will likely rise given that investment advisers who manage $100 million or less will soon be regulated by the states.[42] Texas appears to be a well-funded state,[43] however, they cannot match the frequency of broker-dealer examinations conducted by FINRA. In fact, Texas states that their current examination program amounts to trying "to get to every adviser once every five years."[44] It remains to be seen what impact the jurisdictional change will have on Texas' examination program.

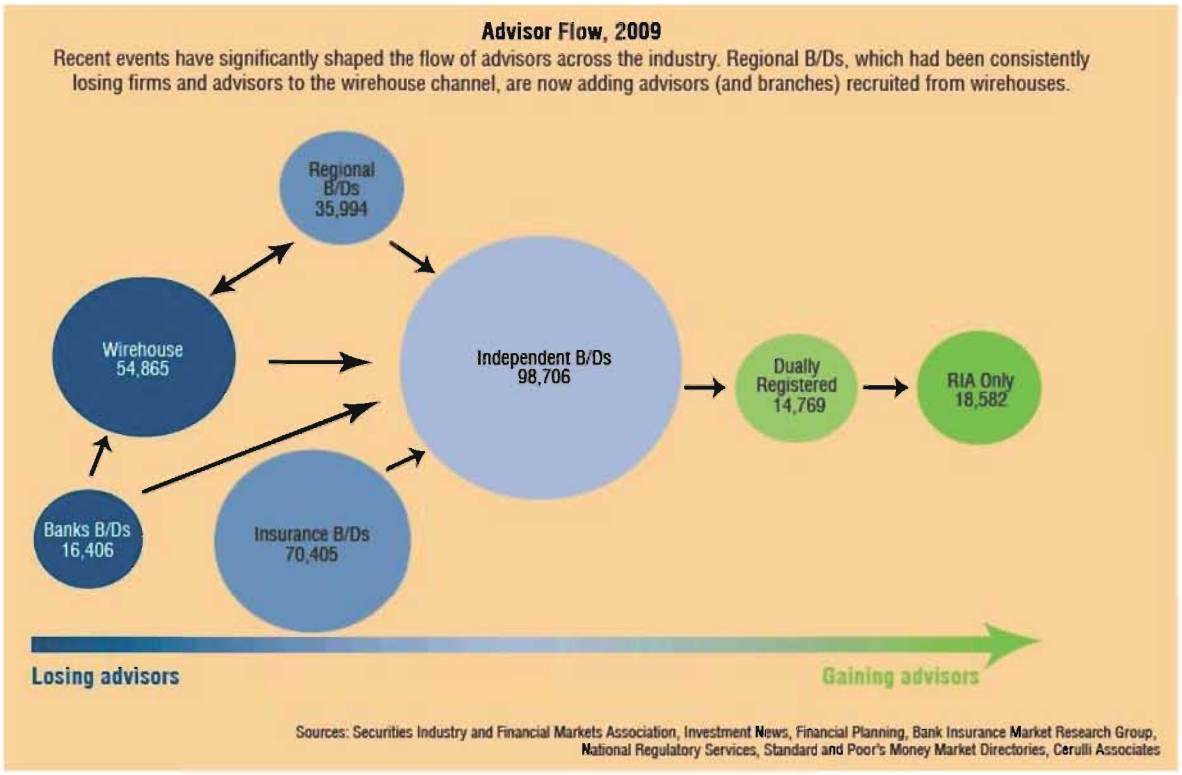
Based on the lack of routine examination programs in every state and the budget problems being experienced by most state governments,[45] we believe that the states are not adequately prepared to take on the inspection, examination, and enforcement role assigned to them under the Dodd-

[36] *See* BrokerCheck report of Bernard L. Madoff Investment Securities LLC at http://brokercheck.finra.org/.
[37] *See* Bowsher, *supra* note 7, at 5 n.6.
[38] The SEC and FINRA also failed to uncover the Madoff Ponzi scheme and Cohmad's involvement in it despite examining each firm's activities. However, each of these regulators engaged in a thorough public review of the failures of their exam programs and has made specific commitments to improve them based upon the lessons learned. The New York Investor Protection Bureau has not.
[39] TEXAS SECURITIES BOARD, AGENCY STRATEGIC PLAN FOR THE FISCAL YEARS 2009 – 2013 PERIOD, (2008), *available at* http://www.ssb.state.tx.us/About_Us/StratPlan2008.pdf.
[40] *Id.* It should be noted that in 2007, the Texas State Securities Board experienced an employee turnover rate of approximately 20%. The Texas Securities Commissioner has indicated that they plan to add 10 additional staff positions in the near future to accommodate the investment advisers that will now fall under state jurisdiction because of the Dodd-Frank Act. In addition, it should be noted that the headquarters of Stanford Financial Group was located in Houston, TX. On February 17, 2009, the SEC put the company under management of a receiver alleging it operated a massive Ponzi scheme. There has been no public indication that Stanford Financial Group was ever the subject to a Texas State Securities Board examination. The SEC and FINRA also failed to uncover Stanford's Ponzi scheme despite examining the firm's activities. However, each of these regulators engaged in a thorough public review of the failures of their exam programs. The Texas State Securities Board has not.
[41] *Id.*
[42] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.
[43] Texas State Securities Board was appropriated funding of $5,712,676 for Fiscal Year 2008 and again for Fiscal Year 2009. *See* TEXAS SECURITIES BOARD, *supra* note 124, at 7.
[44] Scannell, *supra* note 58.It is important to note that Section 410 of the Dodd-Frank Act will further stress state securities regulators by shifting oversight responsibility for some 4,000 registered investment advisers to the states.
[45] *See* NATL. CONF. ST. LEGISLATORS, *supra* note 119; *see also* SUNSHINE REVIEW, *supra* note 119.

Frank Act.[46] Ultimately, investor protection will be diminished if regulators are unable to increase substantially the quality and frequency of RIA examinations.

Unbalanced Playing Field Has Consequences for Investors

In recent years, financial advisors have been fleeing broker-dealer and FINRA supervision to become registered investment advisers. The chart below graphically depicts this growing phenomenon:[47]



While there are many reasons for the movement of financial advisors from wirehouse, regional, insurance, bank, and independent broker-dealers to investment advisers, avoidance of regulatory oversight is clearly one significant factor.[48] Under the current regulatory system, financial advisors who wish to operate their business free from vigorous regulatory scrutiny have a viable option – investment adviser registration.

The flight of financial advisors from the heavily regulated broker-dealer channel to the under-regulated investment adviser channel is projected to continue in the near future. The chart below represents projections provided to FSI by Cerulli Associates:

[46] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.
[47] See at http://retirementincomejournal.com/upload/567/advisor-flow-2009.jpg.
[48] For example, Mike Byrnes and Brooke Southall ADVISOR SPOTLIGHT: HOW A BIG-TIME IBD REP ENDED UP AS A SCHWAB RIA, RIABIZ.COM, October 25, 2010, *available at* http://www.riabiz.com/a/2885078.

Projected Advisor Headcount Market Share by Channel, 2009-2014

Channel	2009	2010	2011	2012	2013	2014	2009-2014 Market Share Change
Bank	4.8%	4.6%	4.5%	4.3%	4.2%	4.0%	-0.7%
Wirehouse	15.0%	15.2%	15.0%	14.8%	14.4%	14.1%	-1.0%
Regional	11.5%	11.2%	10.9%	10.7%	10.4%	10.1%	-1.4%
Insurance broker/dealer	29.0%	28.1%	27.2%	26.3%	25.4%	24.5%	-4.5%
IBD	29.6%	29.6%	29.6%	29.6%	29.6%	29.5%	-0.1%
Dually registered	4.2%	4.8%	5.4%	6.1%	6.9%	7.7%	3.5%
RIA	5.9%	6.6%	7.3%	8.2%	9.1%	10.1%	4.2%

The flow of financial advisors from to the investment adviser channel has significant consequences for investors. Chief among these is the lack of routine regulatory examinations of the entities responsible for managing the investors' portfolios. The problem of unsupervised investment advisors must be addressed or the number of unprotected investors will continue to grow.

Augmenting SEC Oversight Efforts: The SRO Model Provides the Answer

Notwithstanding the differences in the current legal standards of care offered to investors by broker-dealers and investment advisers, FSI believes that the existing regulatory system in place for investment advisers is inferior to that for broker-dealers in providing effective supervision. The SEC and states simply lack the resources necessary to do the job. However, the existence of a well-funded, experienced, self-regulatory authority dedicated to the supervision of investment advisers would allow for more frequent examinations of these regulated entities. As a result, it is clear to us that investment advisers' compliance with the existing legal and regulatory standards should be subject to routine testing by FINRA as the SRO for entities regulated under the '40 Act.

The benefits of the SRO regulatory model are best demonstrated through a review of FINRA's supervision efforts over broker-dealers. Broker-dealers are subject to primary oversight by a FINRA. FINRA is the largest non-governmental regulator for securities brokerage firms doing business in the United States.[49] Congress mandated the creation of FINRA's predecessor, the National Association of Securities Dealers (NASD), in 1938.[50] In 2007, FINRA was created through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. FINRA has approximately 3,000 employees and operates from Washington, DC, and New York, NY, with 20 additional District Offices around the country.[51] FINRA oversees nearly 4,700 brokerage firms, about 167,000 branch offices and approximately 635,000 registered securities representatives.[52] Federal law charges FINRA with the responsibility to examine each broker-dealer for compliance with the Exchange Act, MSRB rules, and NASD/FINRA Conduct Rules.[53]

[49] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.
[50] *Id.*
[51] About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited August 30, 2010).
[52] *Id.*
[53] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.

FINRA has a comprehensive examination program with dedicated resources of more than 1,000 employees.[54] Routine examinations are conducted on a regular schedule that is established based on a risk-profile model.[55] This risk-profile model permits FINRA to focus resources on the items most likely harm to investors.[56] FINRA applies the risk-profile model to each broker-dealer firm, and its exams are tailored accordingly. [57] In performing its risk assessment, FINRA considers a broker-dealer's business activities, methods of operation, types of products offered, compliance profile, and financial condition, among other things.[58] In addition, FINRA conducts more narrow examinations based on information received, including investor complaints, referrals generated by FINRA market surveillance systems, terminations of brokerage employees for cause, arbitrations, and referrals from other regulators.[59] In 2009, FINRA conducted approximately 2,500 routine examinations and approximately 6,500 cause examinations in response to events such as customer complaints, terminations for cause, and regulatory tips.[60]

FINRA's Enforcement Department is dedicated to vigorous enforcement of the Exchange Act, MSRB rules, and NASD/FINRA Conduct Rules.[61] FINRA brings disciplinary actions against broker-dealer firms and their associated persons that may result in sanctions ranging from cautionary actions for minor offenses to fines, suspensions from the business and, in egregious cases, expulsion from the industry.[62] In 2009, FINRA took 993 disciplinary actions, barring 383 individuals, suspending 363 others, and expelling 20 broker-dealer firms[63]. FINRA levied fines against firms and individuals totaling nearly $50 million, and ordered broker-dealers and individuals to return more than $8.2 million in restitution to investors.[64] Over the past decade, FINRA issued 12,158 decisions in formal disciplinary cases, expelled or suspended 208 firms, and barred or suspended 7,496 individuals.[65]

Investment advisers should be subject to the same level of regulatory examination, supervision and enforcement as broker-dealers. Absent frequent examinations to insure compliance with the fiduciary duty, investors are likely to be mislead by the rhetoric of the standard of care. However, unless compliance with regulatory standards is tested periodically by a trained regulatory entity, they have the potential to become a hallow promise used by unscrupulous investment advisers to take advantage of unwitting investors.

[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf. Through November 30, 2010, FINRA had conducted 2,600 routine cycle examinations and 6,600 cause examinations during the current calendar year (see at http://www.finra.org/Newsroom/NewsReleases/2010/P122662).
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] FINRA: 2009 A Year In Review 2, http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p121646.pdf (last visited August 30, 2010).
[64] *Id.*
[65] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (March 26, 2009), *available at* http://www.finra.org/Newsroom/Speeches/Ketchum/P118298.

Potential Approaches to Dual Registrant Supervision

During the legislative process that concluded with the adoption of the Dodd-Frank Act, Ranking Member Spencer Bachus (R-AL) offered an amendment to the Discussion Draft of the Investor Protection Act (later reported as H.R. 3817). The amendment would have permitted the SEC to delegate responsibility to FINRA to enforce compliance by its members and associated persons with the legislation's requirements. More specifically, the amendment would have provided the SEC with the authority to empower FINRA to enforce the fiduciary duty provisions of the Dodd-Frank Act against its broker-dealer members, their financial advisors, and any affiliated investment advisory firm. On first blush, this amendment would appear to be a helpful improvement to the current lack of investment advisor regulation and supervision. However, a careful analysis indicates that the amendment would only accelerate the flow of financial advisors from the broker-dealer channel to the under-regulated investment advisor world.

It is estimated that approximately 4,500 firms are dually registered as broker-dealers and investment advisers or have affiliated broker-dealers and investment advisers.[66] Moreover, approximately 88 percent of all investment advisor representatives are also registered representatives of a broker-dealer.[67] Most of these representatives are employed by a firm that is dually registered, and is subject to both the broker-dealer and investment advisor regulatory regime. Therefore, the amendment would have subjected the vast majority of investment advisers to FINRA supervision.

Unfortunately, any solution that fails to subject all investment advisers to close examination and supervision by an SRO leaves an escape hatch open to those who wish to avoid this regulatory scrutiny. For example, the proposed expansion of FINRA's responsibilities to all dual registrants would have allowed financial advisors the option to drop their securities licenses and continue their business operations while avoiding FINRA supervision. As a result, FSI concludes that all investment advisers must be subject to the same regulatory examination and supervision in order to eliminate the regulatory gaps. Failure to do so will allow the flow of financial advisors from the heavily regulated broker-dealer channel to the under-regulated investment adviser channel to continue unabated. This trend deprives investors of the protections they expect and deserve. Therefore, it is essential that Congress and the SEC staunch the tide by subjecting all '40 Act regulated entities to FINRA supervision.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to harmonize the supervision of brokers, dealers and investment advisers through the establishment of FINRA as the SRO for all entitities regulated under the '40 Act.

Respectfully submitted,

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President & CEO

[66] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.
[67] *Id.*