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Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act)

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Introduction

Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires that the Commission review and analyze the need for enhanced examination and enforcement resources for investment advisers. It expressly requires that the Commission examine three specific areas:

- The number and frequency of examinations of investment advisers by the Commission over the five years preceding the date of the legislation;

- The extent to which having Congress authorize the Commission to designate one or more self-regulatory organizations ("SROs") to augment the Commission'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 and registered investment advisers that are affiliated with a broker-dealers.

Section 914 also specifies that the Commission report its findings to Congress and use such findings to revise its rules and regulations, as necessary. The legislation specifies that the report include a discussion of regulatory or legislative steps that are recommended or that may be necessary to address concerns identified in the study.

I appreciate the mandate and opportunity that Congress has provided for us to evaluate thoroughly the Commission's examination and enforcement resources allocated to investment advisers, especially given the inadequate resources, troubling trends, and obvious need for improvement in this area. I also appreciate the efforts that the staff has put into the study, given the difficult time and other constraints under which we are currently operating.

That said, I am quite disappointed with the result. Although I voted to release the study, for the first time in my tenure as a Commissioner, I feel that it is necessary for me to write separately in order to clarify and emphasize certain facts, and ensure that Congress knows that the current resource problem is severe, that the problem will only be worse in the future, and that a solution is needed now. I have spent many years considering these issues, and have definite and clear views on them.

Statutory Mandate

I would like to begin with straightforward responses to the first two areas Congress mandated that the Commission address. The response to the first inquiry required under Section 914 is that the number and frequency of examinations of investment advisers has gone down decidedly in the past five years. Specifically, the number of examinations has decreased since 2004 by nearly 30%, and the frequency by 50%. That means that, as things currently stand, the average investment adviser can expect to be examined only once every 11 years, and OCIE's examination coverage of this population is only 9% annually. These decreases appear to be attributable in part to the consistent growth in the investment advisory industry, in terms of both an increase in number of investment advisers (38.5%) and an even greater increase in assets under management (58.9%)—with the latter also indicating that advisers likely are growing larger and more complex.

To me, there is an inevitable conclusion to be drawn from these decreases in adviser examination number and frequency. In simple terms, I believe that the Commission is not, and, unless significant changes are made, cannot fulfill its examination mandate with respect to investment advisers. That is the case even though the Dodd-Frank Act decreased substantially the number of investment advisers subject to the agency's jurisdiction. And, that would be the case even if the Commission had the resources to double its examination frequency percentage, returning to the 2004 frequency level of 18%. Eighteen percent coverage annually is better than 9%, but still insufficient.

The response to the second area of inquiry under Section 914 is that one or more SROs would dramatically improve the frequency of investment adviser examinations. Although the study focuses primarily on an alternative to SROs—user fees, it eventually does answer the basic question, stating: "The Commission's and Commodity Futures Trading Commission's experiences with SROs support the view that an SRO can augment government oversight programs through more frequent examinations." It then provides some statistical information concerning SRO examinations, reporting that FINRA examined 57% of its members in 2008, and 54% of them in 2009. The National Futures Association, for its part, examined 33% and 30% of its members in 2008 and 2009, respectively.

Thus, OCIE's current examination rate for investment advisers (9%)[1]—which it estimates could drop as low as 7% in 2011 if additional examiners are not added—would have to

[1] As the study notes, OCIE does not track separately resources used for examinations of investment advisers and registered investment companies. The examination frequency data treats all those resources as devoted

increase by nearly five times to reach the average SRO examination rate for these years (43.5%), and more than six times to reach the average rate at FINRA (55.5%).

OCIE has estimated that, in addition to its current enhancement efforts, it would need to double the current number of its investment adviser examiners (460) to increase the frequency of examinations to even 20%.[2] That roughly equates to 46 examiners per 1% increase, and thus the number of examiners needed to increase examination frequency to the average SRO examination rate of 43.5% would be 1,540, increasing the total to about 2,000. To increase the frequency to FINRA's average, OCIE would need to add more than 2,000 examiners to its advisory program, bringing the total to about 2,500. To provide context for those numbers, OCIE currently has about 850 full-time employees covering all of its programs, and the Commission overall has about 4,000 full-time employees.

It is an understatement to say that these increases would be difficult to achieve, even if the funding authorized under the Dodd-Frank Act were ultimately appropriated. This would be the case despite the noteworthy efforts of OCIE's current leadership, which has spent a considerable amount of time and thought in making important changes to OCIE's programs. Their outstanding efforts cannot overcome their completely inadequate resources. I believe that this must change.

Factual Predicate

There are additional facts that I think need to be aired. As the few facts set out above suggest, the study is not sufficiently clear about the challenges that the Commission is facing today in examining investment advisers.

As indicated above, Section 914 requires the Commission to examine the changes in frequency of examinations over the past five years. It is important to emphasize that the frequency has decreased since 2004 (remaining flat from 2007-08), for a total drop in frequency of 50% during the time period. In addition, the frequency of examinations continued to drop despite increases in the number of examiners in 2009-10 (a trend also present in the number of advisory examinations).

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to advisers and thus unfortunately overstates adviser examination coverage. Although not directly covered by Section 914, resources to examine funds are at risk as well. Examinations of investment companies, in which it is estimated that 45% of U.S. households hold $11.5 trillion, are expected to decrease in FY2011. The need to cover the fund industry will place additional strains on the examination resources they share with advisers.

2 OCIE also estimates, however, that the time required to complete various types of examinations, such as cause and sweep examinations, may mean that even greater numbers of additional examination staff may be required to meet these frequency levels.

Other information deserves emphasis. For example, the ratio of assets under management to the number of OCIE staff provides another proxy for the relative changes in the resources available at the Commission to examine investment advisers. That ratio nearly doubled from 2004 to 2010, from $42 billion to $83 billion per examiner.

In addition, it is critical to understand that the current challenges are likely to become exacerbated in the immediate and foreseeable future. Importantly, as a result of the Dodd-Frank Act, while there will be a near-term decrease in the number of registered investment advisers under the Commission's jurisdiction, the staff estimates that net assets under management will increase immediately as larger and more complex entities enter the Commission's oversight.

Consequently, the nature of the advisers coming under the Commission's jurisdiction is changing. The advisers that will shift to state jurisdiction are generally smaller ones, while the private fund advisers, such as those advising hedge funds and private equity funds that are now required to register with the Commission, are generally larger and more complex and thus require more resources to examine. The staff estimates that, due to the Dodd-Frank Act, the number of large and complex entities registered with the Commission will increase from 38% of all advisers to 58%.

These advisers are also more likely to be assessed as higher-risk advisers, requiring more resources. In fact, the staff estimates that hedge funds are nearly three times more likely to carry a high-risk assessment than are smaller advisers. Hedge funds also have greater assets, and more employees, locations, affiliates, and disciplinary disclosures than smaller advisers. The staff estimates that the amount of time it takes to conduct risk-based examinations of investment advisers with higher-risk profiles has increased by 12% compared to 2005.

In addition to these strains in the advisory examination program, as noted in the study, other new areas required to be regulated by the Dodd-Frank Act will compete for resources and will continue to divert resources from the advisory area. Whether OCIE is able to increase the number of examiners or not, it estimates that it will need to divert resources from dedicated advisory examination staff to these new areas.

For instance, Title IX of the Dodd-Frank Act requires that municipal advisors register with the Commission. The staff expects that this requirement will result in thousands of new entities and individuals registering with the Commission. More than 800 entities have already registered, and at least 200 more are expected to do so. Regarding individuals, the process has not yet begun, but the staff estimates that the number of individuals could be more than 20,000. OCIE staff estimates that nearly half of the examinations of municipal advisors will divert resources directly from the investment advisory area. In addition, OCIE will be responsible for the review and approval of new registrations. OCIE estimates that it will need to divert approximately 2% of advisory resources to this area.

Title IX also requires that OCIE conduct annual examinations of credit rating agencies, and OCIE has already begun diverting resources from the advisory area for these examinations. In fact, during this fiscal year, OCIE is required to examine all 10 credit rating agencies and release a public report. OCIE has initially diverted approximately 1.5% of its advisory resources to this area.

Further, under Title VII of the Act, security-based swap dealers, major security-based swap participants, and security-based swap data repositories all must register with the Commission and be subject to examination. OCIE's preliminary estimate is that it will need to divert approximately 2% of advisory resources to this area.   To the extent that investment advisers register as security-based swap entities, the scope of examination of these entities may need to be expanded as well.

Other new areas under the Dodd-Frank Act will result in increased demands on examination resources. For example, OCIE expects that the new Whistleblower program established under Title IX of the Dodd-Frank Act could increase the percentage of examinations initiated pursuant to a tip, complaint, or referral to as much as 50% (from 30-40% currently).

Also, Title VIII of the Dodd-Frank Act requires the Commission to conduct annual examinations of all clearing agencies designated as systemically important and to consult with the Federal Reserve Board regarding the scope and methodology of such examinations. Further, the Commission has enhanced SRO oversight responsibilities under the Dodd-Frank Act, and OCIE believes that this will also require additional examination resources.

The study relies substantially on an analysis of the changes in the adviser population and examinations that followed NSMIA, although with some caution. I believe that greater caution is warranted. Although the experience with NSMIA may help to inform the possible trends and demonstrates the inability of periodic reallocation of responsibilities for the regulation of investment advisers to the states to provide a long-term solution, it may in fact underestimate the extent of the strains on the Commission's examination resources. For one, the magnitude of the decrease in investment advisers was significantly larger due to NSMIA than the Dodd-Frank Act, both in terms of numbers (15,740 advisers versus 4,100) and percent (70% versus 28%). In addition, NSMIA did not require new complex investment advisers to come under the Commission's jurisdiction or introduce a significant number of new areas for examination. Also, the study may underestimate the rate of growth in the investment advisory industry.

Also, quite importantly, simultaneous with the developments above, the Commission's budget situation is in a critical state. The Continuing Resolution that is funding the Commission's budget through March 4, 2011, at 2010 fiscal-year levels, has led to resource problems across the Commission, and OCIE has been no exception. Simply put, the fact that the Commission is not currently receiving the funding previously authorized in the budget is having very significant consequences for the Commission overall and for OCIE.

Significantly, OCIE is not able to add any new staff to conduct examinations of investment advisers or any other entities under the Commission's jurisdiction, and in fact will continue to divert resources from the advisory area in order to address other examination priorities. It also is hindered in its ability to do its job effectively—as it estimates that there will be significant and ongoing limitations on assessing and addressing non-mandated risk areas, reviewing tips, complaints, and referrals, conducting cause and special examinations, and even the basic ability to conduct sufficient field work due to travel restrictions.

Aside from the serious and systemic problems the series of unfunded mandates creates for the Commission as the investor's advocate, it may exacerbate the trend of consistent growth in the advisory industry outstripping the Commission's resources.

Options and Recommendations

I would have strongly preferred that the study make more precise and objective recommendations. An option relying on industry funding seems the most likely to provide a solution, and the options set forth in the study support this. The Commission requested self-funding from Congress last year, but it was not granted. The appropriations process currently in place, even with the periodic reallocation of responsibilities for the regulation of investment advisers to the states, poses significant challenges.

The study discusses three options to address the significant need to improve in this area. I believe that all three hold some promise, and each has advantages and disadvantages that warrant discussion. Unfortunately, the study's description and weighing of the alternatives is far from balanced or objective.

For example, the study does not make clear that many of the benefits of the user fee option are shared by the SRO option. In addition to providing OCIE with the resources to perform more frequent examinations of investment advisers, they would both enable it to improve and modernize its investment adviser examination program. They would also provide the adviser examination program increased flexibility to reach developing and emerging risks associated with advisers and to direct staffing and strategic resources. Significantly, they both would provide a more facile capability to develop and employ needed technology to strengthen the examination program. The result of these improvements would be a greater level of deterrence of wrongdoing. In addition, under the SRO option as well as user fees, the cost of regulation would be shifted to the advisers themselves.

Also, the study attributes virtually no disadvantages to the user fee option, but many disadvantages to the SRO and FINRA dual registrant options. The study does not lay out the variety of viewpoints regarding the SRO option, instead emphasizing those of the investment management industry and others who have concerns about the SRO option.

Thus, let me undertake to balance the discussion in the study by providing some clarification. Despite implications in the study that the establishment of an SRO would not enhance the Commission's own oversight resources, I believe that the SRO model has, in fact, benefitted regulation of the securities industry for more than seven decades. I also believe that the SRO option has significant and long-term benefits to investors and the Commission, and I am on record as supporting it—although I do not believe that there has to be a single SRO or that it has to be FINRA.

First, the SRO model should increase the frequency of examinations of investment advisers—thus directly answering the question that Congress posed to us. Moreover, an SRO has other important benefits, including (1) permitting the Commission to transfer more of its resources in this area to complex and emerging issues, at a time when they are most needed, (2) permitting the Commission to do its job with fewer but more expert resources, (3) adding significant resources outside the Commission to support the agency's mission, (4) increasing speed and efficiency through SRO processes that are more expedited than those used by the government, and (5) although not directly related to examinations, adding to the Commission's set of tools an ability to promulgate ethical and business conduct standards that would further protect investors. Significantly, the user fee option does not necessarily provide any of these benefits.

The study also raises the specter that the use of the SRO model will undermine the expertise of the Commission's staff, particularly its examination staff. That certainly does not have to be the case. Indeed, while use of an SRO would mean that the Commission could do its job with a smaller examination workforce, by eliminating the need to perform a large number of routine examinations, it actually provides the opportunity for that smaller group to be more expert and experienced.

There will be oversight and costs associated with the SRO option, as there will be with any option. And, although the staff has not fully analyzed them, in the short-run they are likely to be significant. The user fee option, however, also brings with it significant costs. We do not yet know which alternative will be more costly because the comparative costs and savings have yet to be closely evaluated for any of the options. And, we need to distinguish between costs over the short and long term. Over the long-run, in my view, the benefits of the SRO option will outweigh its costs.

Through NSMIA we have precedent, albeit limited, indicating that periodic reallocation of responsibilities for the regulation of investment advisers from the Commission to the states is not a long-term solution to enhancing the Commission's examination and enforcement resources. We also have precedent, spanning more than seven decades, that SROs can significantly enhance the Commission's examination and enforcement resources relating to its regulated entities. And this can and has been done through a structure in which the Commission retains and exercises comprehensive oversight and supervision of SROs. The SRO model can also be used to buttress scarce resources at the state level.

We need to address this issue now. It must not be relegated to another day—as has happened in the past. For far too long, in the investment advisory area, the Commission has been unable to perform its responsibilities adequately to fulfill its mission as the investor's advocate, and investment advisory clients have not been adequately protected. This must change.