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**INVESTMENT MANAGEMENT  
UPDATE****SEC Issues Report on Investment Adviser Examinations**

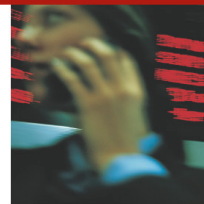
On January 19, 2011, the Securities and Exchange Commission (SEC) issued a report detailing the findings of the study mandated under Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)<sup>1</sup> regarding the need for enhanced examination and enforcement resources for investment advisers. In particular, Section 914 of the Dodd-Frank Act required the SEC to examine three key areas regarding the investment adviser examination process:

- The number and frequency of examinations of investment advisers by the SEC over the five years preceding the date of the enactment of Title IX of the Dodd-Frank Act;
- The extent to which having Congress authorize the SEC to designate one or more self-regulatory organizations (SROs) 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 (“dual registrants”) and registered investment advisers that are affiliated with a broker-dealer.<sup>2</sup>

Over the past six years the number of registered investment advisers has increased by 38.5 percent, from 8,581 investment advisers in 2004 to 11,888 advisers in 2010.<sup>3</sup> The increase in the number of registered investment advisers has presented challenges to the SEC and its staff, particularly the staff of the Office of Compliance Inspections and Examinations (OCIE), which is tasked with conducting examinations of investment advisers that are registered with the SEC. Indeed, as the number of investment advisers has grown over the past few years, the number of OCIE examiners actually decreased by 3.4 percent over the same period.<sup>4</sup>

Not surprisingly, as the number of investment advisers has grown and the number of OCIE staff has decreased, so too has the frequency of investment adviser examinations declined. In 2004, 18 percent of registered investment advisers were examined.<sup>5</sup> In contrast, only 9 percent of registered investment advisers were examined in 2010, which would result in the average registered investment adviser being examined only once every 11 years.<sup>6</sup>

Immediately following the implementation of Title IV of the Dodd-Frank Act, the SEC expects the number of investment advisers to decrease slightly as the minimum asset threshold for registration with the SEC moves from \$25 million to \$100 million.<sup>7</sup> However, within 10 years of the implementation of Title IV, the SEC anticipates that nearly 14,000 investment advisers will be registered with the SEC.<sup>8</sup>



## **SEC RECOMMENDATIONS**

In order to address concerns over the capacity challenges described above, the Study presents three alternatives:

- The imposition of “user fees” on investment advisers registered with the SEC that could be used to fund the investment adviser examination program;
- Authorizing one or more SROs to examine, subject to oversight and supervision by the SEC, all investment advisers registered with the SEC; or
- Authorizing the Financial Industry Regulatory Authority (FINRA) to examine dual registrants for compliance with the Investment Advisers Act of 1940, as amended (“Advisers Act”).<sup>9</sup>

### ***Impose User Fees***

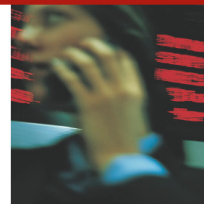
The SEC would propose to impose user fees on registered investment advisers as a means of funding the examination program. As described in the Study, the user fees imposed on advisers would be retained by the SEC and would not be subject to the federal budgetary appropriation process and, in theory, would be set at a level that would support “an acceptable frequency of examinations.”<sup>10</sup> Such an approach would be consistent with the model followed by other federal agencies to fund examinations, including the Office of the Comptroller of the Currency.

The SEC believes that having a consistent amount of funding, in addition to any amounts that are appropriated through the annual budget process, would enable it to strengthen the examination process. Among other benefits, the Study suggests that user fees would support earlier examinations of newly registered investment advisers and more frequent examinations of all advisers. In the view of the SEC, more frequent examinations would have a deterrent effect on potential wrongdoing by altering the perception that it is unlikely that any individual adviser would be examined. Furthermore, earlier examinations of new advisers could help identify problems at an earlier stage and, in some cases, reduce the potential losses by investors in the event of malfeasance on the part of the adviser.

In addition to earlier and more frequent examinations, user fees could further improve the effectiveness of examinations by allowing the SEC and its staff to engage in long-term strategic planning that could enable OCIE to better utilize both technology and its workforce. In doing so, the staff of OCIE would be better equipped to understand and evaluate the increasingly sophisticated investment products and trading strategies being utilized in the marketplace.

### ***Create Self-Regulatory Organizations***

Another proposal offered by the Study is the creation of one or more SROs for investment advisers. As noted in the Study, “SROs are privately funded entities with market specific expertise that, subject to SEC oversight, can have the authority to adopt rules, examine member firms for compliance with those rules and the federal securities laws, and enforce those rules and laws.”<sup>11</sup> It



is worth noting that the idea of creating an SRO for investment advisers is not new and various proposals to create such entities have been considered over the past 45 years.<sup>12</sup>

As presented in the Study, a new SRO would have certain benefits. Since it would be funded by membership fees, the new SRO would have access to more resources as more investment advisers became members. Having access to stable and scalable funding would allow the organization to conduct examinations of newly registered investment advisers and more frequent examinations of other registered investment advisers.

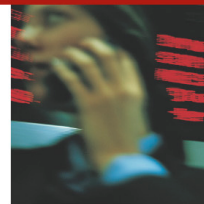
However, the creation of an SRO to oversee investment advisers would not allow the SEC to shift all of the resources currently allocated to investment advisers to other pursuits. As the Study notes, SEC resources “would still be required to oversee the operations of any SRO by, depending upon the scope of the SRO’s authority, conducting examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee and rule changes.”<sup>13</sup> By way of illustration, the Study notes that both OCIE and the SEC’s Division of Trading and Markets devote significant resources to overseeing the operations of FINRA.

In discussing the creation of one or more SROs, the Study points out several important issues that would need to be resolved, including:

*Number of SROs.* Given the diversity of the investment adviser industry, the Study envisions the possibility of multiple SROs, each covering different segments of the industry. Although the Study identifies several advantages to the creation of multiple SROs, it notes that multiple SROs also would create additional complexities and likely would be more costly, as any single SRO would be less likely to achieve sufficient economies of scale. In addition, multiple SROs create the potential for regulatory arbitrage and the potential that, over time, the organizations could develop differing approaches with respect to the application of the Advisers Act and their own rules to similar activities. Thus, the SEC would need to devote additional resources to avoid such less desirable outcomes. In consideration of the foregoing, the Study recommends the creation of a single SRO.

*Scope of authority.* It would be up to Congress to establish the scope of the authority of any SRO intended to oversee investment advisers. On one hand, any such SRO could have broad authority, similar to that of FINRA, to adopt business and conduct rules, as well as to examine and enforce member compliance with such rules. In contrast, the scope of authority could be limited to the examination of investment advisers similar to what the SEC has considered in the past. The determination of the scope of authority clearly has important implications to both industry participants and regulators.

*Membership.* To be effective, membership in at least one SRO would be necessary in order to ensure sufficient oversight of investment advisers. However, the scope of membership would have to be settled. For example, if state-registered investment advisers are eligible for membership in a newly created SRO, it would be difficult for the SEC to oversee an organization that enforced the regulatory requirements of multiple states.



Alternatively, the Study suggests it may be appropriate to exclude certain advisers from membership in an SRO, including advisers to registered investment companies and other advisers that do not have retail clients. However, as the Study notes, crafting such an exclusion would be difficult given that many investment advisers have diverse client bases and business lines. In addition, creating such exclusions, in the view of the SEC, could lead to a degree of regulatory arbitrage.

*Governance.* One of the critical factors that would have to be resolved prior to the implementation of any SRO would be to settle upon a governance structure. As the Study observes, there is an inherent conflict of interest where an organization regulates its own members and those members also compete with each other. As noted previously, the investment adviser industry is quite diverse; therefore, a structure would need to be implemented to ensure that one segment of the industry does not dominate any SRO or otherwise gain a competitive advantage.

To that end, the Study acknowledges that investment advisers have expressed concern at the prospect of FINRA being designated as the investment adviser SRO. In particular, the appointment of FINRA would create at least the appearance of a bias toward the broker-dealer business model and create the potential for a conflict of interest where the “sell side” would be asked to function as an SRO for the “buy side.”

*Funding.* Although any SRO likely would be funded primarily through membership fees, creating a new SRO would involve substantial start-up costs. Subsequently, a mechanism would have to be implemented to ensure the ongoing financial viability of the organization.

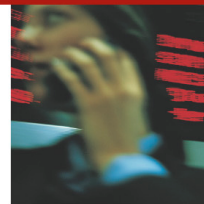
### ***Authorize FINRA to Examine Dual Registrants***

The third proposal set forth in the Study is to amend the Securities Exchange Act of 1934 to expand the authority of FINRA to enforce compliance with the Advisers Act in connection with FINRA members that are dually registered as investment advisers. Expanding FINRA’s authority would capture only 5 percent of registered investment advisers. Nonetheless, as the Study observes, almost all of the largest retail broker-dealers also are registered as investment advisers and account for a large portion of retail advisory clients.<sup>14</sup>

Expanding FINRA’s authority to cover dual registrants would have several advantages. Currently, dual registrants are subject to examination by both the SEC and FINRA. The existing overlap of jurisdiction inherently results in certain inefficiencies, both for the member firm and the regulator. By consolidating regulatory oversight in a single entity, FINRA would gain a more holistic view of the activities and compliance environment, resulting in a more effective examination process. Such a consolidation also would allow the SEC to direct resources currently allocated to examining dual registrants elsewhere.

## **CONCLUSION**

Each proposal presented in the Study has relative advantages and disadvantages. However, in order to fulfill its mandate under the Dodd-Frank Act, the SEC requires a source of funding that is



adequate to meet the challenges faced by the SEC as the number of investment advisers grows and their operations become increasingly complex and diverse and is sufficiently stable to prevent the growth in the number of investment advisers from outstripping SEC resources. Although the Study does not advocate one recommendation over the other, it seems clear that the SEC believes it needs far greater funding than Congress appears willing to allocate. Thus, the outcome of this debate seems likely to involve the imposition of some sort of additional fees on registered investment advisers in order to defray the cost of the adviser examination process and to better allocate the SEC's limited resources among any number of competing priorities.

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> Study on Enhancing Investment Adviser Examinations, U.S. Securities and Exchange Commission (January 19, 2011) (the “Study”).

<sup>3</sup> *Id.* at 8.

<sup>4</sup> *Id.* at 10.

<sup>5</sup> *Id.* at 14.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 17.

<sup>8</sup> *Id.* at 20.

<sup>9</sup> *Id.* at 25.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 29.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 30.

<sup>14</sup> *Id.* at 37.