Consumer Federation of America

June 4, 2012

The Honorable Spencer Bachus
Chairman
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Barney Frank
Ranking Member
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Bachus, Ranking Member Frank and Members of the Committee:

I am writing in advance of this week's scheduled hearing on H.R. 4624, "The Investment Adviser Oversight Act of 2012," to share CFA's views on the problem of inadequate investment adviser oversight and potential solutions to that problem. CFA has long been concerned with the lack of adequate funding for investment adviser oversight, a problem that stretches back at least two decades and that we believe poses a significant risk to investors. We are therefore gratified that the Committee has chosen to focus on this long-festering problem, but disappointed that it has chosen to devote this hearing to just one of the several options available to Congress to address the issue.

CFA shares the view expressed by SEC Commissioner Elisse Walter that "the current resource problem is severe, that the problem will only be worse in the future, and that a solution is needed now."[1] For this reason, we are open to considering a variety of approaches, including designation of an investment adviser SRO, to improve regulatory oversight of investment advisers. Because of its serious short-comings, however, we cannot support H.R. 4624 as currently drafted. Moreover, we believe investors will be best served if Congress carefully considers all the available options before jumping to the conclusion that an SRO is the best approach. The goal should be to determine which approach has the potential to deliver the highest quality of oversight at a reasonable cost to the investment adviser community and the investors who will ultimately bear those costs. It does not appear that any such analysis has yet been conducted by this Committee, nor does it appear that this hearing, with its preponderance of broker-dealer industry witnesses, will significantly expand our understanding of the potential impact of this legislation on the investment adviser community it will most directly affect.

As a matter of principle, CFA believes in funding government adequately to fulfill the functions it is mandated to perform. We see no reason why Congress should not adopt that approach in this case, since adequate funding for investment adviser oversight could be provided

[1] Commissioner Elisse B. Walter, "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)," January 2011.

either through the normal appropriations process or through special user fees at no additional cost to taxpayers and without adding to the deficit. Moreover, representatives of the investment adviser community have indicated their willingness to pay user fees to fund more robust SEC oversight. Nonetheless, we are realists. Having advocated both of these funding approaches for over two decades without results, we are prepared to consider an SRO as a meaningful improvement over the status quo if that SRO is appropriately designed. After all, one of the advantages of an SRO is that it is not subject to the vagaries of the congressional appropriations process.

Unfortunately, as currently drafted, H.R. 4624 does not meet the standard of an appropriately designed SRO. Its central problem is the numerous exemptions it provides for various groups of investment advisers. As you are doubtless aware, essentially all broker-dealers who deal with the public are required to be members of the Financial Industry Regulatory Authority (FINRA). As a result, the costs of that regulatory oversight can be spread equitably across firms both large and small. In contrast, H.R. 4624 provides an exemption from SRO membership for any investment adviser that manages a mutual fund, even if the adviser also has an extensive retail client base, as well as any adviser for whom 90 percent of their assets under management are attributable to charitable funds, hedge funds, retirement plans, mortgage pools, investment advisers and broker-dealers, and individuals with at least $5 million in investments.[2] One result is that the largest advisers, and those with the wealthiest client base, will continue to receive direct SEC oversight at no additional cost, while the smaller advisers with less wealthy clients will be subject to a new added expense for regulatory oversight. Without the ability to spread a portion of those costs to larger, wealthier firms, the costs for small firms could be considerable.

Because so many advisers would continue to be subject to direct SEC oversight under this bill – including those advisers with the large, complex, high-risk operations that are most difficult to oversee and who manage the vast majority of assets – it is not even clear whether this legislation would solve the basic SEC resource problem it is intended to address. Before we can answer that question with any degree of confidence, we would need to know how many advisory firms would remain under direct SEC jurisdiction and understand the characteristics of those firms in order to be able to determine what inspection frequency the agency would likely be able to maintain at its expected funding level. It is not at all clear that, without a funding increase, the Commission would be able to achieve the once-every-four-years inspection schedule that the bill authors appear to view as minimally acceptable.[3] Moreover, both the Boston Consulting Group study commissioned to examine SEC operations[4] and a recent GAO study examining SEC's oversight of FINRA[5] have concluded that the SEC needs to do a better job of overseeing the

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[2] Ironically, had it been in place, this latter provision almost certainly would have exempted Madoff from registration in an SRO that is being promoted as a solution to the regulatory failure that allowed his fraud to go undetected for so long.

[3] Advisers registered in states that maintain a plan for routine inspections once every four years would be exempt from routine SRO inspections under the bill, though not from SRO membership. (It is not clear what the result would be under this bill if a state maintained a plan for a four-year inspection cycle but did not achieve that goal.)

[4] Boston Consulting Group, "U.S. Securities and Exchange Commission Organizational Study and Reform," March 10, 2011.

[5] U.S. Government Accountability Office, "Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority," (GAO-12-625), May 2012.

SROs that operate under its supervision. Designating an SRO for investment advisers could be expected to increase the challenges the Commission faces in this area and could require that additional agency resources be devoted to this task. The legislation does nothing to address this issue.

Another argument that has been made in favor of designating an SRO for investment advisers is that it would harmonize regulatory oversight for brokers and advisers. The argument goes that investors who cannot distinguish between brokers and investment advisers are no more likely to understand the differences in regulatory oversight that apply to these two classes of financial professional than they are to understand that different legal standards apply to the advice they offer. But this legislation does even less to achieve that goal of harmonization than it does to solve the resource problem. Because of the bill's expansive exemptions, many advisers with an extensive retail client base would likely escape regulation by the SRO. Thus, the same disparity that currently exists with regard to oversight of brokers and investment advisers would be perpetuated between one class of retail advisers and another under this bill. This would likely be even more confusing for investors than the current system. The only way to truly harmonize regulatory oversight, if that is your goal, is to ensure at a minimum that any investment adviser with more than a de minimis number of retail clients be subject to oversight by the SRO.

While we applaud the Committee for focusing on the issue of investment adviser oversight, this legislation is not the answer. Rather than moving forward with a bill that clearly fails to solve the issues it is intended to address, we urge the Committee to conduct an objective review of the available alternatives in order to arrive at an approach that increases the quality of oversight at a reasonable, and equitably shared, cost to the investment adviser community and their clients. We look forward to working with the Committee to achieve that goal.

Respectfully submitted,

Barbara Roper
Director of Investor Protection