Regaining Clarity During Regulatory Instability

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Overview

- Dodd–Frank Wall Street Reform and Consumer Protection Act
  - Study on Investment Advisers and Broker-Dealers
  - Study on Enhancing Investment Adviser Examinations
  - The “Switch”
- Form ADV Part 2
- Other changes percolating

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Study on Investment Advisers and Broker-Dealers

More Than Just Fiduciary Duty

- Dodd-Frank required the SEC to conduct a study to evaluate:
  - Effectiveness of existing standards of care for providing personalized investment advice to retail customers.
  - Whether there are gaps, shortcomings or overlaps in legal or regulatory standards in the protection of retail customers that should be addressed.
- The SEC was to consider 14 items in the report including:
  - Retail customers understanding of differing standards of care.
  - Regulatory, examination and enforcement resources available to enforce standards of care.
  - Potential impact on retail customers if regulatory requirements change.
  - Potential impact of eliminating the broker-dealer exclusion from the Advisers Act.
  - Potential additional costs to retail customers.
  - Specific instances where regulation of one industry provides greater protection to retail customers than another.
- The report was delivered to Congress on January 21st.

Standard of Care Analysis

- Investment Advisers:
  - Principles-based.
  - Fiduciary whose duty is to serve the best interests of clients, including an obligation not to subordinate clients' interests to its own.
  - Includes duties of loyalty and care.
  - Material conflicts of interest must be either eliminated or fully-disclosed.

- Broker-Dealers:
  - Rules based.
  - Required to deal fairly with customers.
    - Basis for the "suitability" requirement.
    - Only required where the broker-dealer has made a "recommendation."
  - Some courts have fund them to be subject to fiduciary duty under certain circumstances.
  - Subject to SEC and FINRA rules designed to promote fair business conduct.
  - Important aspect of duty of fair dealing is "suitability obligation."

Retail Investor Perceptions

- Public comment process:
  - Many do not understand the standard of care differences.
  - Particular concern over the use of multiple titles used by financial advisers.

- SEC studies:
  - SEC sponsored two studies regarding investor understanding.
  - Retail customers are confused by the roles played by investment advisers and broker-dealers.
  - Retail customers do not understand the differing standards of care applicable.

Standard of Care Recommendations

- Staff rejected the notion of repealing the broker-dealer exclusion.

- SEC should specify a uniform fiduciary standard of conduct.
  - Standard should be no less stringent than currently applied to advisers.
  - Would apply to broker-dealers when they provide personalized investment advise to retail customers.
  - The standard would be an overlay on top of existing regimes (supplement, not supplant).
  - SEC should engage in rulemaking and issue interpretive guidance on the standard.
  - SEC should facilitate uniform, simple and clear disclosures to retail customers.
  - SEC should consider uniform standards for duty of care which would set a baseline regarding the basis advisers and broker-dealers have in making a recommendation.

Other Harmonization Recommendations

- Regulatory protections should be harmonized to provide meaningful investor protection.
  - Advertising.
  - Use of finders or solicitors.
  - Rights of customers.
  - Supervision.
  - Firm licensing and registration.
  - Individual licensing and continuing education.
  - Books and records.

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Study on Enhancing Adviser Examinations

Study On Adviser Examinations

- Dodd-Frank required the SEC to conduct a study to review and analyze the need for enhanced examination and enforcement resources for investment advisers.

- The study had to include an examination of:
  - The number and frequency of examinations of advisers by the SEC;
  - The extent to which one or more self-regulatory organizations ("SRO") would improve the frequency of examinations;
  - Potential approaches to examining the advisory activities of dually-registered broker-dealer / investment advisers.

Impact of Dodd-Frank

- The staff estimates that the increased threshold for SEC registration will result in 3,350 fewer SEC advisers.
- Similar to the effect of NSMIA in 1996.
- The staff expects the purge to be short-lived.
- The number of OCIE staff could increase significantly if approved by Congress.
- The drop in the number of SEC registered advisers will bring the OCIE ratio back to 2004 levels.
- Frequency of examinations should rebound temporarily.
- Staff does not believe that reallocation to states is a stable solution.

Option 1: User Fees

- Fees collected from advisers would be available to the SEC solely to fund the adviser examination program.
- SEC already utilizes user fees for the IARD system.
- Direct funding through user fees would allow more frequent examinations and better staff training.
- Less expensive option than an SRO.
- More efficient than having multiple SROs that may differ in approach.
- Would avoid resulting in underfunding of an SRO.

Option 2: Self Regulatory Organization(s)

- Proposals to create one or more SROs have been considered for 45 years.
- SEC would still be required to oversee the SRO.
- In 2009 FINRA examined 54% of its broker-dealer firms.
- More difficult proposition in adviser industry due to:
  - Diversity of the industry.
  - Strong opposition among advisers and their associations, state regulators and investor advocates.
  - Tension about the prospect of FINRA becoming the SRO.
  - SROs for advisers do not exist in any other major financial jurisdiction around the world.

Option 2: Self Regulatory Organization(s)

- Number of SROs
  - Diversity of advisory industry suggests the potential for multiple SROs.
  - Could lead to regulatory arbitrage.
  - Multiple SROs are more costly to members and the SEC.
  - Any SRO, other than FINRA, could require broker-dealers to submit to multiple SROs.
- Membership
  - Mandatory for all SEC advisers.
  - Differing state rules would be problematic if state advisers included.
- Governance must not favor a line of business.
- Costs would be substantial and funded by member fees.

Option 3: FINRA for Dual Registrants

- Allow FINRA to examine its members for compliance with the Advisers Act.
- Would only impact about 5% of advisers, but they are typically the largest institutions that use the most OCIE resources.
- Would allow FINRA to have a more holistic view of its members.
- Cost efficient.
- Drawbacks:
  - SEC staff would lose experience examining large advisers.
  - SEC would lose information about their activities.
  - Result in inconsistent approaches to enforcing Advisers Act.

Recommendations

- The SEC recommended that Congress:
  - Authorize the SEC to impose user fees on advisers to bolster its examination and enforcement resources;
  - Allow the SEC to designate one or more adviser SROs; or
  - Grant FINRA the power to examine broker-dealers who are dually registered as investment advisers.

- Commissioner Elisse Walter

  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. … 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.

The “Switch”

The “Switch”

“States have both the will and the ability to regulate. The state system of investment adviser regulation has worked well with the $25 million threshold since it was mandated in 1996. The states have developed an effective regulatory structure and enhanced technology to oversee investment advisers. Increasing the threshold to $100 million would reduce the SEC’s examination burden and allow the agency to focus on larger firms and other market issues.”

“Government never has enough resources to do everything, but it’s clear that states have done a much better job at deploying their limited resources. States are ready to accept this increased responsibility.”

NASAA Statement on Investment Adviser Regulation
by Denise Voigt Crawford, then-NASAA President
October 28, 2009

The “Switch”

- SEC Registration:
  - Greater than $100 million in assets under management (“AUM”);
  - General exemptions from asset based qualification that currently exist;
  - If between $25 million and $100 million in AUM:
    - If the firm is in a state that does not have an examination program.
    - If the firm would have to register in 15 states or more.

- State Registration:
  - Everyone not mentioned above.

The “Switch”

- Timing
  - The $100 million AUM qualification is applicable to new firms as of July 21, 2011.
  - The SEC has a **proposed rule** that would require advisers to certify that they have at least $100 million in AUM in August 2011; those who fall below must withdraw from SEC registration by October 2011.
    - In April 2011, the SEC sent a letter to NASAA asking NASAA’s opinion about delaying the deadline to withdraw from SEC registration from October 2011 to the 1st quarter of 2012.
  - States have to certify that they have an examination program by May 2.

The “Switch”

- Calculating "Assets Under Management“
  - Include the entire value of each securities portfolio for which you provide *continuous and regular supervisory or management services*.
  - If you provide continuous and regular supervisory or management services for only a portion of a securities portfolio, include as assets under management only that portion of the securities portfolio for which you provide such services.
- Continuous and regular supervisory or management services are provided with respect to an account if:
  - You have discretionary authority over and provide ongoing supervisory or management services with respect to the account; or
  - You do not have discretionary authority over the account, but you have ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, you are responsible for arranging or effecting the purchase or sale.

Form ADV Part 2

Form ADV Part 2

- Part 2A (the Disclosure Brochure):
  - Must be completed and filed within 90 days of the firm's fiscal year end beginning December 2010.
  - Many states have extended the deadline.
- Part 2B (Brochure Supplement for Supervised Persons):
  - For existing firms with a fiscal year end before April 1.
    - July 31, 2011 delivery to new and prospective clients.
    - September 30, 2011 delivery to existing clients.
  - For existing firms with fiscal year end after April 1.
    - Deliver to new, prospective and existing clients within 60 days of annual amendment
  - New firms registered from January 1, 2011 to April 30, 2011
    - May 1, 2011 delivery to new and prospective clients.
    - July 1, 2011 delivery to existing clients
  - New firms registered after April 30, 2011
    - Deliver when the Supervised Person begins providing advice to the client

Form ADV Part 2

The Brochure Supplement

- Who:
  - Any supervised person who formulates investment advice for a client and has direct client contact; or
  - Any supervised person who has discretionary authority over a client's assets, even if the supervised person has no direct client contact.
  - Must deliver a brochure supplements for each supervised person who provides advisory services to that client.
- What:
  - Description of education and employment history
  - Disclosure of outside business activities
  - Disclosure of certain compensation structures (i.e. bonuses based on referrals)
  - Disclosure of disciplinary events

Form ADV Part 2

Delivery Requirements: Part 2A

- Same delivery requirements to new/prospective clients
- Annual delivery to clients within 120 days after your fiscal year end
  - Summary of material changes and offer to deliver entire Part 2 or
  - A copy of the entire Part 2
- For 2011 only, the deadline to make the delivery to clients is 60 days from the filing deadline, or 180 days from your fiscal year end
- How to deliver:
  - Paper
  - Electronic deliver can be done:
    - If a client has consented to receiving required communications electronically; or
    - You can show actual receipt.

Form ADV Part 2

Delivery Requirements: Part 2B

- If your fiscal year end is before April 1, 2011
  - July 31, 2011: delivery to new and prospective clients.
  - September 30, 2011: delivery to existing clients.
- If your fiscal year end is on or after April 1, 2011
  - Delivery of brochure supplements within 60 days of annual amendment

Regulatory Reform

Other Reform Percolating

PROPOSED RULE	AGENCY	STATUS
Red Flags Rule	FTC	Effective January 1, 2011
Revisions to Custody Rule	SEC	Effective March 12, 2010
Revisions to Pay to Play Rules	SEC	Effective March 14, 2011 (small portion effective September 2011)
Revisions to Regulation S-P	SEC	Comment period closed May 12, 2008
Proxy Disclosure and Solicitation Enhancements	SEC	Effective February 28, 2010
Revisions to Advertising Rules	SEC	Pending rule proposal
Revisions to Books & Records	SEC	Pending rule proposal

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