

May 8, 2012

## ***Executive Summary***

### **H.R. 4624**

### **“Investment Adviser Oversight Act of 2012”<sup>1</sup>**

#### **I. Background**

- a. Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), passed by Congress in July 2010, required the Securities and Exchange Commission (“SEC” or “Commission”) to review and report back to Congress on the frequency of its exam cycle for federally registered investment advisers (“RIAs”). The report was issued in January 2011 and reviewed the SEC’s oversight program over the previous five years and whether one or more self-regulatory organizations (“SROs”) should be created to improve the frequency of exams.<sup>2</sup>
- b. A draft bill by Rep. Spencer Bachus, R-Ala., chairman of the House Committee on Financial Services, to provide for SRO oversight of investment advisers was reviewed by the House Subcommittee on Capital Markets and Government Sponsored Enterprises in a September 2011 hearing. A witness panel of financial and consumer trade groups, state securities regulators, and the presumed SRO for investment advisers, the Financial Services Industry Regulatory Authority (“FINRA”), testified before the subcommittee on the draft bill’s provisions.

#### **II. Short Title and Bill Status.**

- a. Title: “Investment Adviser Oversight Act of 2012.”
- b. Bill status: Introduced on April 25, 2012 by Reps. Bachus and McCarthy, D-N.Y., with two additional Republican co-sponsors. A markup of the bill in committee may be scheduled in May 2012.

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<sup>1</sup> See The Library of Congress, *Bill Summary and Status*, <http://financialservices.house.gov/UploadedFiles/l2458.pdf> (May 2012).

<sup>2</sup> See *Study on Enhancing Investment Adviser Examinations* (January 2011), available at <http://www.sec.gov/news/studies/2011/914studyfinal.pdf>.

### III. Scope of RIA Registration.

State and federal RIAs would be required to maintain membership with a registered national investment adviser association (SRO) unless otherwise exempt. Dually registered broker-dealer/RIAs would not be exempt from registration.

- a. Exemptions. Any investment adviser with 90 percent or more of the firm's total assets under management attributable individually or in aggregate to one or more of the following types of clients would not be subject to SRO membership:
  - i. Investment advisers to investment companies<sup>3</sup>
  - ii. Non-U.S. clients
  - iii. Private equity funds
  - iv. An RIA that is controlled by another RIA registered with the SRO with similar client attributes, unless the Commission determines the RIA to be an independent affiliate
  - v. An RIA that is a member of another adviser SRO registered with the Commission
  - vi. Any other adviser or class of adviser that the Commission may exempt by rule or regulation

*Note:* Religious, education and charitable entities, stock pension plans, collective trusts, as well as advisers to venture capital funds, were removed from the list of exemptions contained in the discussion draft.

- b. Definition of an 'independent affiliate.' Any affiliated investment adviser with compliance programs, operations and businesses "sufficiently independent" of the affiliated RIA such that SRO membership would be "in the public interest and for the protection of investors."
  - i. The SEC must determine whether an affiliate is independent by order 180 days from a request by an SRO for such a determination, or from the date of the first on-site examination.

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<sup>3</sup> Other exempt advisers to investment companies would include qualified purchasers under sec. 2(a)(51) of the Investment Company Act of 1940 ("ICA"); issuers under sec. 3(c)(10), 3(c)(11), 3(c)(5)(C), and Rule 3a-7 of the ICA; and a business development company under sec. 54 of the ICA.

#### **IV. Requirements for SRO Registration.**

- a. An association of investment advisers (“Adviser SRO”) may be registered with the Commission by filing an application. However, the SEC must first determine that each applicant:
  - i. is organized so that it has the “capacity” to enforce compliance with its rules and regulations under the Advisers Act; and
  - ii. has rules that meet the following criteria:
    - 1. assure that a majority of its board of directors shall not be associated with any member of the Adviser SRO or a broker-dealer or stock exchange SRO, or any advisory or brokerage firm;
    - 2. are designed to prevent fraudulent acts, promote business conduct standards “consistent with their obligations to investors” under the Advisers Act, and to protect investors;
    - 3. are necessary and consistent with the Act and the fiduciary standards applicable to investment advisers under the Advisers Act or similar state law, and do not duplicate, overlap or conflict with those laws;
    - 4. do not pose “any burden” on the business of investment advisers or their ability to compete in the marketplace;
    - 5. and provide for periodic exams of its members (RIAs) to determine compliance with the Advisers Act and the rules of the Adviser SRO.

#### **V. State Securities Commissioner Examination and Enforcement Programs.**

- a. The Adviser SRO shall not conduct periodic exams of investment advisers in states that have adopted a plan to conduct on-site examinations of all RIAs with a principal office and place of business in that state at least once every four years.
- b. An annual conference will be held with the North American Securities Administrators Association (“NASAA”), SEC and Adviser SRO to review, among other things, the state examination programs.
- c. States retain the authority to adopt rules for, investigate violations by, and initiate enforcement proceedings against state-registered investment advisers.

- d. Adviser and broker-dealer SROs may share information with the SEC and state regulators, presumably regarding investigations and enforcement actions.

#### **VI. Adviser SRO inspections of State RIAs.**

- a. For 'cause' inspections are permitted of Adviser SRO members, including state RIAs with a principal office and place of business in states that have adopted an examination program; and
- b. Periodic examinations are permitted of Adviser SRO members that are dually registered as broker-dealers, including such state RIAs with a principal office and place of business in states that have adopted an examination program.

#### **VII. Adviser SRO Administrative Requirements.**

The Adviser SRO shall:

- a. Provide for 'equitable allocation of reasonable dues, fees and other charges' among SRO members.
- b. Provide for the issuance of an annual report to the SEC.
- c. Establish criteria and procedures for registration of investment advisers, to require supervisory systems, and to discipline members for violations of rules and regulations.
- d. Require the association to implement and maintain a comprehensive information security program and obtain an independent review of the program every three years.
- e. Following each annual conference with NASAA and the SEC, submit a report to Congress describing the state-adopted examination programs, their proposed methodology, and the extent to which the states have adhered to those programs.

#### **VIII. Consistency between Adviser SROs.**

Each Adviser SRO shall provide for "substantively equivalent regulation and oversight" of advisory firms, including their business conduct requirements and examinations.

**IX. Time Period for Establishing an Adviser SRO.**

The SEC, upon approval of an Adviser SRO, shall permit a “reasonable period of time” following the effective date of registration for advisory firms to apply for membership.

**X. Procedures for SEC Approval of an Adviser SRO.**

- a. Upon receiving an application from a prospective Adviser SRO, the SEC shall publish notice and “afford interested persons an opportunity to submit written data, views and arguments.”
- b. Within 90 days of the application, the SEC shall either grant registration or initiate proceedings to determine whether registration should be denied.
- c. Proceedings for denial shall include
  - i. Notice of the grounds for denial and opportunity for hearing and a final decision within 180 days.
  - ii. The SEC may extend the proceedings for up to 90 days if it finds good cause.
- d. Approval of an Adviser SRO shall be based on whether the Commission finds that the requirements of the Advisers Act with respect to the applicant are satisfied.

**XI. Procedure for Rule Approvals or Changes by the SEC.**

- a. Each Adviser SRO shall file rules of the association with the Commission, and explain the nature of comments received, including those on cost-benefits analyses, and its response to those comments.
- b. Generally within 35 days of publication of notice by the Commission, the SEC shall approve the proposed rule or institute proceedings for disapproval.
- c. If a rule is not approved, a notice and proceedings shall be concluded within 180 days, with an extension of another 60 days if the Commission finds good cause for the delay.
- d. The Commission must consider in its review of the proposed rule consistency with the requirements of the Advisers Act and the regulations applicable to Adviser SROs registered thereunder.

- e. No proposed Adviser SRO rule shall take effect unless approved by the Commission after public notice and opportunity for comment.
- f. Approved rules shall take effect after one year unless the Commission determines an earlier effective date is “appropriate.”
- g. The SEC may also summarily approve a rule change without delay if “such action is necessary for the protection of investors or the safeguarding of securities or funds.”
- h. Proposed changes to Adviser SRO rules shall be published for public comment by the SEC, along with a statement by the Commission citing the basis for amending the rules.

**XII. Adviser SRO Disciplinary Procedures.**

- a. In any proceeding to discipline an RIA or associated person, the Adviser SRO shall include a statement citing the activity and rule violation, including the sanction and reason for it, notify the party, and give that person an opportunity to defend against such charges.
- b. The Adviser SRO may summarily
  - i. suspend a member or associated person that has been expelled or suspended by another SRO,
  - ii. suspend a member in serious financial or operational difficulty, or
  - iii. limit or prohibit access to the Adviser SRO’s services by any person, including non-members, if the SRO determines such person does not meet its qualifications.
- c. The Commission may stay a summary action on its own or upon application by an aggrieved person.
- d. The Adviser SRO shall promptly file notice with the SEC of all final disciplinary sanctions. A person may file for review with the Commission within 30 days of such notice. The Commission has the authority to cancel, reduce or revoke the sanction upon review.

**XIII. Denial of Adviser SRO Membership.**

- a. The Commission shall follow certain procedures for reviewing a denial of membership in the Adviser SRO, or the barring of any person from becoming associated with a member.

**XIV. Adviser SRO Compliance.**

- a. Each Adviser SRO shall comply with the provisions of the Advisers Act, the rules of the SEC, and its own rules. The Commission shall conduct a regular inspection of the SRO at least annually to ensure compliance.
- b. The SEC may suspend the registration of an Adviser SRO or its members for up to 12 months, revoke the Adviser SRO's registration or expel one of its members, or place limitations on the Adviser SRO's activities upon a finding that the Adviser SRO or member has violated or is unable to comply with the Advisers Act or related rules.
- c. Officers and Directors of the Adviser SRO may also be removed or censured by the Commission after notice and opportunity for hearing regarding willful violations of the Advisers Act or any related rules.