Part of an ongoing series

SEC Study
Investment Adviser Oversight

March 2011

On January 19, 2011, the Securities and Exchange Commission (SEC) released its study on the need for enhanced examination and enforcement resources for investment advisers (the “Study”), as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or “the Act”).

It concludes that the SEC “likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency. The Commission’s examination program requires a source of funding that is adequate to permit the Commission to meet the new challenges it faces and sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers.”

To address this, the Study recommends three possible solutions: (1) impose “user fees” on SEC-registered investment advisers; (2) authorize one or more self-regulatory organizations (SROs) to examine all SEC-registered investment advisers; or (3) authorize the Financial Industry Regulatory Authority (FINRA) to examine dual registrants for compliance with the Investment Advisers Act of 1940.

This A Closer Look describes the Study and the three options suggested by the Study in more detail.

Background

The Study, mandated by Section 914 of Title IX of the Dodd-Frank Act, examines:

- the number and frequency of examinations of investment advisers by the Commission over the past six years;
- the extent to which having Congress authorize the SEC to designate one or more 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.

Examinations of registered investment advisers over the past six years

The Study provides an analysis of the number and frequency of examinations of registered investment advisers over the past six years, from October 1, 2004, to September 30, 2010. During that period, the number of registered investment advisers increased 38.5%, from 8,581 advisers to 11,888 advisers. As of September 2010, registered investment advisers managed $38.3 trillion in assets, a 58.9% increase from $21.4 trillion in 2004.

At the same time, the Study states that the growth in the investment advisory industry has not been matched by corresponding growth in SEC resources. In fact, during the same time period, the number of staff at the SEC’s Office of Compliance Inspections and Examinations (OCIE) decreased from 477 to 460. This decline resulted in a 43.3% increase in the ratio between the number of registered investment advisers and the number of OCIE staff, from 18.0 to 25.8.

The Study found that as the number of registered investment advisers (and the assets managed by those advisers) increased and the number of OCIE staff declined, the number and frequency of examinations of registered investment advisers also decreased—from 1,543 examinations in 2004 to 1,083 examinations in 2010, a drop of 29.8%. The Study notes that, at the same time, many examinations took longer to complete than in prior years. For example, more resources were devoted to cause examinations and examinations of higher-risk advisers (which take longer to conduct than examinations of lower-risk advisers), and examiners added additional, resource-intensive procedures during examinations, such as enhanced asset verification to detect fraud and misappropriation of investor assets.

As the Study describes, the number of registered investment advisers has increased significantly in recent years, and the number of SEC examination staff has decreased due to variations in the Commission’s overall budget. These factors, coupled with more time-intensive examinations, resulted in decreases in the percentage of registered investment advisers examined each year (from 18% in 2004 to 9% in 2010). At that rate, the average registered investment adviser can expect to be examined once every 11 years today, compared to approximately one every six years in 2004.
Looking ahead, the Study states that there may be a near-term decrease in the number of registered investment advisers as smaller advisers move to state-registration. That said, it also notes the likelihood of significant growth in the overall number of registered investment advisers due to new registration requirements for advisers to hedge funds and other private funds. The Study puts it bluntly: “[T]he number of OCIE staff is unlikely to keep pace with the future growth among advisers.” Additionally, “the Commission’s new examination obligations under the Dodd-Frank Act will further strain resources that are available for examinations of investment advisers.”

Potential approaches to address capacity constraints concerning examinations

To address the challenges faced by the SEC, the Study outlines three possible approaches, as noted earlier:

1. Impose user fees on SEC-registered investment advisers that could be retained by the SEC to fund the investment adviser examination program.
2. Authorize one or more SROs to examine, subject to SEC supervision, all SEC-registered investment advisers.
3. Authorize FINRA to examine dual registrants for compliance with the Advisers Act.

User fees

In the Study, the staff states that user fees imposed upon registered investment advisers would provide scalable resources to support the SEC’s examination of registered investment advisers. Under this approach, the SEC would continue to rely on appropriated funds to support its other programs, including other aspects of the administration of the Advisers Act. The fees collected from investment advisers would be available to the SEC without further appropriation, used solely to fund the SEC’s investment adviser examination program, and set at a level designed to achieve an acceptable frequency of examinations.

The staff believes that user fees could provide the SEC with the resources to perform earlier examinations of newly registered investment advisers and more frequent examinations of other registered investment advisers. More frequent examinations would provide a greater level of deterrence of wrongdoing, and earlier examinations of investment advisers could help to address problems at an earlier stage and, in some cases, limit the amount of client losses.

The Study states that user fees also could provide resources that would permit the SEC to improve the effectiveness of its examination program through long-term strategic planning that could allow OCIE to better utilize both technology and its workforce.

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2 While noting that Congress has twice responded to capacity challenges within the SEC’s investment adviser examination program by reallocating federal and state responsibilities for the regulation of investment advisers (in 1996 with the enactment of the National Securities Markets Improvement Act and in 2011 with the enactment of Dodd-Frank), the Study states that the staff “does not believe that the periodic reallocation of investment adviser regulatory responsibilities is a stable solution to these capacity challenges. State regulators may not have adequate resources to continue to assume increased regulatory responsibilities, and investor protection could be compromised if such resources are lacking. Stable funding that can increase in response to growth in the investment adviser industry . . . could address these examination capacity challenges.”
According to the staff, user fees also would allow the SEC to retain exclusive responsibility for conducting adviser examinations, which could head off certain inefficiencies associated with delegation to one or more SROs, as described below.

**Self-regulatory organizations**

The Study’s second suggested approach involves Congress authorizing one or more SROs to examine registered investment advisers. 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.

The Study states that one or more SROs, funded by membership fees, would provide scalable resources that could supplement the SEC’s oversight program for investment advisers. An SRO could use those resources to conduct earlier examinations of newly registered investment advisers and more frequent examinations of other registered investment advisers.

The Study states, however, that this approach would not free the SEC to use all resources currently dedicated to adviser examinations to pursue other matters, as it would still need to use resources to oversee the operations of any SRO.

The Study states that authorizing an SRO for investment advisers entails some difficulties. For example, the design and implementation of one or more investment adviser SROs would require resolution of a number of important issues regarding the number, scope of authority, membership, governance, and funding of the SRO or SROs. The Study also notes the opposition by some in the industry to authorization of an SRO.

**Number of SROs**

The Securities Exchange Act of 1934 does authorize designation of multiple SROs or a single unified SRO for investment advisers. The staff states that the diversity of the investment advisory industry suggests the potential for multiple SROs, each of which could oversee a different type or types of investment advisers, as long as each adviser is a member of one SRO.

According to the Study, multiple SROs could focus expertise and better accommodate industry diversity. The Study also lists a number of concerns that seem to undercut a multiple-SRO approach and instead favor creation of a single SRO. For example, multiple SROs could seek to attract members by offering a more accommodating regulatory and oversight program or by charging lower fees, leading to inadequate funding for regulatory programs. There’s also the likelihood that, over time, different SROs would develop different approaches to applying the Advisers Act (and their own rules) to similar activities. Thus, the Study states that multiple SROs could be more costly than a single SRO because they would be less likely to achieve economies of scale. In light of these concerns, the staff states that designation of a single SRO for advisers, rather than multiple SROs, could be advantageous. On the other hand, the staff acknowledges that a single SRO other than FINRA would still result in dual registrants being subject to multiple SROs (a broker-dealer SRO and investment adviser SRO), a result that is likely to be resisted by broker-dealers, and could maintain inefficiencies that may currently exist due to separate oversight of broker-dealers and investment advisers.
The staff also states that certain types of advisers could be excluded from those that must join an SRO—e.g., investment advisers to registered investment companies, private funds (such as hedge funds), or advisers that do not have retail clients.

**Authorize FINRA to examine dual registrants for compliance with the Advisers Act**

The Study provides a third approach: permitting FINRA to examine all of its members that are also registered as investment advisers for compliance with the Advisers Act. The Study notes that while only about 5% of registered investment advisers are broker-dealers, almost all of the largest retail broker-dealers are dually registered as investment advisers. These dual registrants have a substantial portion of retail advisory clients and employ a significant number of investment adviser representatives. The Study states that granting FINRA the authority to enforce the Advisers Act would free existing SEC resources currently spent examining dual registrants and allow them to be redirected to other investment advisers. Moreover, it would partially address the inefficiencies that result from subjecting a dual registrant to two separate examinations. Finally, the staff states that this approach would permit a single regulator (FINRA), subject to existing SEC oversight, to conduct a more effective examination of a dual registrant. The Study notes drawbacks to this approach as well—for example, a risk that, over time, different and inconsistent approaches to applying the Advisers Act to dual registrants and other advisers could develop.

*The Study was submitted to Congress for its consideration. The lack of a steady funding source for oversight of the asset management industry has been long discussed and debated, and none of the options presented by the Study are new. Any of the three alternatives would require Congressional action, and each of the three alternatives has benefits and drawbacks, as well as detractors and supporters. It remains to be seen whether the SEC’s blunt assessment that it “likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency” will be heard as a call to action.*
A Closer Look at Dodd-Frank Wall Street Reform and Consumer Protection Act

PwC will continue to monitor developments and provide you with updates, which will be available at www.pwcregulatory.com.

Additional information

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