

FSI BRIEFING – April 5, 2010

Harmonizing the Regulation & Supervision of Broker-Dealers and Investment Advisers

Introduction

On June 17, 2009, the Obama Administration released its plan for reforming the financial services industry's regulatory structure in the form of a white paper entitled "Financial Regulatory Reform - A New Foundation: Building Financial Supervision and Regulation" (White Paper).¹ Among the reforms offered in the White Paper is the establishment of "a fiduciary duty for broker-dealers offering investment advice and harmoniz[ation] of regulation of investment advisers and broker-dealers."²

Legislative Background

Shortly after the release of the White Paper, the Treasury Department proposed legislation entitled the "Investor Protection Act of 2009" (IPA).³ The bill was designed to achieve the goals of the White Paper by giving the Securities and Exchange Commission (SEC) explicit authority to promulgate rules requiring broker-dealers and investment advisers "to act solely in the interest of the customer...without regard to" their own financial or other interests.⁴ The investor protection components of the *Wall Street Reform and Consumer Protection Act of 2009* (H.R. 4173), passed by the House of Representatives on December 11, 2009, are largely based upon the Treasury Department's IPA.⁵

On November 10, 2009, Senator Christopher Dodd (D-CT), Chair of the Senate Banking, Housing and Urban Affairs Committee, released a discussion draft of the *Restoring American Financial Stability Act of 2009*.⁶ On March 15, 2010, Senator Dodd released a revised version of the discussion draft titled *Restoring American Financial Stability Act of 2010* (RAFSA).⁷ On March 22, 2010, the Senate Banking Committee approved by a party-line vote of 13 to 10 a version of RAFSA substantially similar to the March 15 discussion draft.⁸

¹ Financial Regulatory Reform - A New Foundation: Building Financial Supervision and Regulation, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

² *Id.* at 16.

³ Investor Protection Act of 2009 – Treasury Proposal, available at <http://www.treas.gov/press/releases/docs/tg205071009.pdf>.

⁴ *Id.* at 5.

⁵ The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009), available at

http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/111_hr_finsrv_4173_full.pdf.

⁶ Discussion Draft, Restoring American Financial Stability Act of 2009, November 10, 2009, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=943242e1-ca66-411c-89e2-8954eb3fc085.

⁷ Discussion Draft, Restoring American Financial Stability Act of 2010, March 15, 2010, available at http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf

⁸ Managers Amendment, RAFSA, March 22, 2010, available at

http://banking.senate.gov/public/_files/032310MangersAmendmentAYO10627.pdf.

RAFSA recognizes the current ineffective and inefficient allocation of regulatory resources. The bill attempts to address this concern by creating a self-funding mechanism for the SEC and increasing the jurisdiction of state securities administrators over investment adviser firms to all those with less than \$100 million in assets under management.⁹

Section 913 of the RAFSA calls for the SEC to study all the issues surrounding harmonization of broker-dealer and investment adviser oversight. The purpose of the SEC study is to determine the appropriate obligations of brokers, dealers, investment advisers, and their associated persons in offering personalized investment advice about securities to retail customers. The SEC would be required to report the results of the study to Congress within 12 months of the passage of RAFSA. If the study revealed there are regulatory gaps or overlaps in regulation that may harm or reduce protections to retail customers, the SEC would be required to draft rules to address these issues.

The Financial Services Institute¹⁰ (FSI) believes that enhanced investor protection will be best achieved via a transparent universal standard of care supported by effective and efficient regulatory supervision and enforcement by an industry-funded regulatory authority for investment advisors. We believe that this is best achieved through the provisions of Title IX, Section 913 of RAFSA.

Development of a New Universal Standard of Care

FSI supports a universal standard of care applicable to all financial advisors who provide investment advice to clients. The universal standard of care should be designed to ensure transparent business relationships, effective client disclosures, and efficient low-cost investment solutions and operations. Development of a single standard of care will promote and enhance investor protection while reducing inefficiencies inherent in the current regulatory system.

FSI believes the RAFSA's proposed SEC study is the most effective option available to ensure universal access to advice and service while also enhancing investor protection. We believe the study will conclude that a fully transparent universal standard of investor care should be applied to the relationships between retail customers and their financial advisors. This universal standard of care should be based upon the following principles:

1. A financial advisor shall place the interests of their client before their own;
2. A financial advisor shall avoid material conflicts of interest when possible, and obtain informed client consent to act when such conflicts cannot be reasonably avoided; and
3. A financial advisor shall provide advice and service with skill, care, and diligence based upon information known about their client's investment objectives, risk tolerance, financial situation, and needs.

¹⁰ The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 120 Broker-Dealer member firms that have more than 188,000 affiliated registered representatives serving more than 15 million American households. FSI also has more than 13,700 Financial Advisor members.

Under this standard, financial advisors of all types would be required to disclose the standard of care to their clients via a simple and effective disclosure statement. The SEC would develop regulations necessary to apply these principles to the activities of broker-dealers and registered investment advisers within the context of their unique business relationships with retail investors. In this way, investor protection would be enhanced, understanding of the duty of care improved, and the cost of investing minimized.

Effective Regulatory Supervision and Oversight of Broker-Dealers and Investment Advisers

Currently, a significant regulatory gap exists between the resources dedicated to the examination of broker-dealers and those committed to the examination of registered investment advisers. The SEC and industry regulatory organizations examine more than half of the approximately 4,900 registered broker-dealer firms each year.¹¹ Every broker-dealer is examined at least once every three years.¹² By contrast, the SEC projects that fewer than 10 percent of the more than 11,000 registered investment adviser firms will be examined during fiscal years 2009 and 2010.¹³ RAFSA attempts to address this inefficient allocation of regulatory resources by creating a self-funding mechanism for the SEC. Under the bill, the SEC would retain fees and assessments it collects from financial institutions for transactions, mergers, registrations, and other revenue generating activities.¹⁴ RAFSA would thus free SEC funding from the annual appropriations process.

The bill would also increase state securities administrators' jurisdiction over registered investment advisers to include firms with less than \$100 million in assets under management.¹⁵ It is estimated that this change would shift 4,200 investment advisers from SEC to state supervision.¹⁶

FSI believes that in order to effect meaningful regulatory reform, any change in the standard of investor care must be supported by effective regulatory supervision designed to end the current ineffective and inefficient allocation of regulatory resources. We believe that the SEC study will reveal the correct path to harmonization of broker-dealers and registered investment advisers.

Unfortunately, RAFSA would require the SEC and states to engage in a disruptive and sudden reallocation of their regulatory resources from the supervision of broker-dealers to the supervision of investment advisers. States would be required to take on the additional burden of supervising and examining thousands of additional investment advisers at a time when many state budgets are in crisis. While we do not question the states' desire to effect meaningful supervision, we have concerns about their ability to marshal sufficient resources to do the job.

¹¹ See Richard G. Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at <http://www.finra.org/Newsroom/speeches/Ketchum/P118889>.

¹² *Id.*

¹³ *Id.*

¹⁴ RAFSA, *supra note 8*, Title IX, Subtitle J, Section 991.

¹⁵ RAFSA, *supra note 8*, Title IV, Section 410.

¹⁶ SARA HANSARD, SEC MAY RAISE RIA THRESHOLD TO \$100M (November 1, 2009), available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20091101/REG/311019959&ht=crawford>.

This will result in the unintended consequence of weakened investor protection due to the lack of uniform regulation of smaller investment advisers. The regulatory gap will be widened rather than narrowed. For these reasons, FSI believes there is a better way to enhance the supervision of broker-dealers and investment advisers.

FSI supports the creation of an industry-informed, self-funded regulatory authority dedicated to effective supervision, timely examination, and vigorous enforcement of registered investment advisers. The creation of such an entity would result in a layering of effective specialized regulatory entities that mirrors the structure utilized to supervise broker-dealer firms. Under the supervision of the SEC, the new regulatory authority would focus on the routine examination and supervision of all investment advisers. The SEC would thus be free to focus on capital markets concerns, the development of appropriate regulations for all regulated entities, the supervision of the new investment adviser regulatory authority, and the fulfillment of other appropriate regulatory goals. The creation of an industry informed, self-funded investment adviser regulatory authority will insure a balanced and efficient allocation of regulatory resources and result in significant improvements to investor protection. We believe that the conclusions reached by the study contemplated in Title IX, Section 913 of RAFSA will highlight the need for a self-funded regulatory authority dedicated to registered investment advisers

Other RAFSA Provisions of Concern to FSI Members

In addition to the above-discussed issues, FSI members raise the following concerns with RAFSA:

- **PCAOB Audits for Introducing Broker-Dealer Firms** – RAFSA would require all financial auditors of broker-dealers to be registered with the Public Company Accounting Oversight Board (PCAOB).¹⁷ If this provision is passed in its current form, it will result in significant additional expenses for introducing broker-dealer firms without providing corresponding investor protections. Introducing broker-dealers are prohibited by SEC and FINRA rules from holding customer funds and securities. As a result, they do not represent a significant threat to convert client funds to their own use. We, therefore, urge the Senate to support an amendment to the RAFSA that would exclude auditors of introducing broker-dealers from PCAOB registration.
- **Compliance Examiners** – RAFSA would require the SEC's Division of Trading and Markets and Division of Investment Management to have a staff of examiners who perform compliance inspections and examinations of entities under their jurisdiction.¹⁸ FSI supports this proposal and urges the Senate to abolish the SEC's Office of Compliance Inspections and Examinations (OCIE) and redistribute the duties formerly handled by OCIE to the new Division examination staff. We believe consolidating the inspection, examination, and rulemaking functions within the Divisions will insure the rule-writers are in close contact with the examiners who are in the field visiting registrants. In addition, the examiners will have frequent contact with the rule-writers to make sure that their messages are consistent with the purposes of the rules. We believe the result would be a more effective and efficient SEC. As a result, we urge the adoption of this change to RAFSA.

¹⁷ RAFSA, *supra note 8*, Title IX, Subtitle I, Section 982.

¹⁸ RAFSA, *supra note 8*, Title IX, Subtitle F, Section 965.

- **Senior Investor Protections** – RAFSA would provide grants to states who adopt the NASAA Model Rule or the NAIC Model Regulation on the use of senior specific certifications and professional designations in the sale of life insurance and annuities.¹⁹ FSI supports state adoption of the NASAA Model Rule and/or the NAIC Model Regulation because it directly addresses independent broker-dealers' desire for uniformity among state regulators and provides an enforcement mechanism that will level the playing field for all financial industry participants.
- **Study of Financial Planners** – RAFSA would require the Comptroller General to conduct a study to evaluate: the effectiveness of State and Federal regulations to protect consumers from misleading financial advisor designations; the current State and Federal oversight structure for financial planners; and the legal and regulatory gaps in the regulation of financial planners and other individuals who provide or offer to provide financial planning services to consumers.²⁰ The term “financial planning” is descriptive of a process common to a wide range of financial services. Planning is simply a prelude to the offering of specific investment advice and/or the implementation of solutions to financial problems through the execution of insurance or securities transactions. Financial planning activity is already regulated activity under the Investment Advisers Act of 1940 through SEC Release IA-1092. As a result, FSI believes that financial planning should not be regulated as a distinct profession.
- **Additional Disclosures Due at Purchase** – RAFSA would allow the SEC to circumvent the traditional rule making process and procedure and issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor.²¹ Any documents that are required pursuant to this section of RAFSA will be in a summary format containing clear and concise information about investment objectives, strategies, costs, risks and any compensation or other financial incentive received by a broker, dealer, or other intermediary in connection with the purchase of retail investment products.²² FSI opposes this point-of-sale disclosure proposal because we believe the cost of implementation and continuous update of the point of sale disclosures contemplated in RAFSA will be substantially greater than the benefit given to investors. FSI supports effective disclosure to investors, like that provided by the recently approved summary prospectus for mutual funds. However, the point-of-sale disclosure contemplated by RAFSA would duplicate efforts, add cost, and over emphasize the cost of investing at the expense of other relevant factors in the analysis of investment decisions. As a result, we ask the Senate not to adopt Section 918 of the RAFSA.

Conclusion

FSI stands ready to participate in a constructive dialogue with policymakers on the most effective means of improving investor protection while encouraging universal access to financial products, services, and advice. We urge the Senate to pursue proposals that will create a financial services regulatory system that adopts a transparent universal standard of investor care and supports it through the creation of an industry-informed, self-funded regulatory authority.

¹⁹ RAFSA, *supra note 8*, Title IX, Subtitle I, Section 989A.

²⁰ RAFSA, *supra note 8*, Title IX, Subtitle I, Section 921.

²¹ RAFSA, *supra note 8*, Title IX, Subtitle I, Section 918.

²² *Id. at (3)(A) and (B)*.