



Speech by SEC Commissioner: SEC's Oversight of the Adviser Industry Bolsters Investor Protection

by

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Thank you for that generous introduction. I'm very pleased to be here at the Investment Advisers Association's 2009 Annual Conference. At the outset, I want to make clear that the views I express today are my own, and do not necessarily reflect the views of the Commission, other Commissioners, or the staff.

I was sworn in as a Commissioner at the end of last July, and have been in office for nine months. I've been a practitioner in the securities industry for 30 years, and during that time I've served as the general counsel of a large global asset manager, as well as a President of a broker-dealer. Over the years, I have worked on the buy and sell side of the industry and understand how they contrast. I fully understand that broker-dealers and investment advisers differ significantly and I can appreciate that we should be careful to discuss them as such.

Still, when particular services provided by these two different entities begin to look the same, it is time to ask why their clients don't receive similar protections. Most importantly to me, in determining what that protection should be, it is crucial that investor protections not be undercut by any potential changes to the regulation of broker-dealers and investment advisers.

There are many more complex and intricate issues involved in this topic than I can cover today. As a result, I will concentrate my remarks today on the following:

Defining the Scope of the Issue

Outlining why the Fiduciary Standard is an important investor protection
Describing how the SEC can strengthen oversight of the investment adviser industry with dedicated resources
Discussing Possible Investment Adviser Reforms

Scope of the Issue

Historically, broker-dealers that simply effected transactions as directed by their clients did not provide investment advice and would not have been considered investment advisers. It was in this context that broker-dealers were excluded from the definition of "investment adviser" in the Investment Advisers Act of 1940 when their performance of advisory services were "solely incidental" to their broker-dealer activities and where they did not receive any "special compensation."

With the advent of fee-based brokerage accounts in the 1990s, broker-dealers have been increasingly selling programs that regularly provide "investment advice" in exchange for "special compensation" in the form of an asset-based fee. As a consequence, it is hard to say that broker-dealers are not acting as investment advisers in this context. More importantly, as they increasingly providing investment advice, broker-dealers are doing so outside of the regulatory framework established for investment advisers.

Before the advent of these fee-based accounts, broker-dealers received transaction-based compensation for executing a transaction — for example, when one of their clients wanted to buy shares in a particular company. In comparison, an investment adviser receives an asset-based advisory fee for providing investment advice on an on-going basis, most often by having discretion over a clients' assets and making the decisions as to what to buy and sell. Thus, the different compensation structures reflected fundamental differences in the services provided, which led to different protections available to investors.

Functional regulation is an easy concept to understand — entities that do the same thing should be regulated the same. However, the concept cannot easily be applied to the distinct worlds of broker-dealers and investment advisers without masking the very real and complicated differences in how the two types of entities operate. For example, the primary purpose of many broker-dealers is to distribute and sell securities, as compared to investment advisers whose primary purpose is to provide on-going advice to their clients. Because these are fundamentally different client interactions, they have always been governed by different regulatory regimes.

To the extent that securities firms that were predominantly broker-dealers are now entering into on-going relationships with clients by emphasizing the offer of investment advice in exchange for a fee based on assets under management, the brokerage industry is moving closer to the investment adviser industry. There is a significant conflict of interest that results when the same entity serves both as an agent selling a security and as one

providing investment advice.

As a result of this movement by broker-dealers, there has been a great deal of discourse about "harmonizing" the regulations of broker-dealer versus investment advisers. I think the better way to frame the issue is to ask how broker-dealers who provide investment advice should be regulated. There is a reason that investment adviser services are regulated differently than broker-dealer services. As broker-dealers increasingly provide advisory services to their clients, we should consider whether the higher standards and fiduciary duties of advisers should also be applied to these broker-dealers.

It is important to note that the investment adviser industry has not materially changed the services it has offered for the past 15–20 years. I would not want the movement in the brokerage industry toward providing investment advice to serve as a catalyst to undercut fundamental investor protections in the investment advisory regulatory framework.

Fiduciary Standard — Fundamental Investor Protection

For those of us who have been in the industry, we know that the fiduciary relationship between an investment adviser and its client is a bedrock principle that underpins the Advisers Act. As described by the Supreme Court in 1963, it is a fundamental investor protection.

The Supreme Court stated "The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested."¹

The fiduciary standard is a dynamic, living principle that provides investors with true protection.

I have been listening to the current debate about what the standard should be for those that provide investment advice. I have heard a lot of "standards" offered including the following:

- A Professional Standard for All Financial Intermediaries
- A Universal Standard of Care
- A Fiduciary-like Standard

It is not clear to me that any of these standards measures up to the fiduciary standard that currently exists, and there is great concern that these proposed standards may have the effect of diluting the existing high fiduciary standard that serves as an important investor protection.

We need to be very careful about adopting any new standard simply because it's called a "fiduciary" standard. Many of the standards I have heard proposed are referred to as "fiduciary" standards but seem to be

defining standards of suitability. There is only one fiduciary standard and it means that a fiduciary has an affirmative obligation to put a client's interests above his or her own. As a result, a fiduciary acts in the best interests of the client, even if it means putting a client's interest above his own.

For example, in making an investment decision for a client, an investment adviser subject to a fiduciary duty would be required to make investment decisions that are in the best interest of the client. Additionally, if the investment decision poses any conflict of interest such as where a financial benefit accrues to the adviser in recommending a particular investment, the adviser (as a fiduciary), must fully disclose the conflict to the client. By comparison, a broker-dealer under a suitability duty can sell securities to a client as long as they are "suitable" for that client, even if they may not be in the best interests of the client.

A fiduciary standard has real teeth because it is an affirmative obligation of loyalty and care that continues through the life of the relationship between the adviser and the client, and it controls all aspects of their relationship. It is not a check-the-box standard that only periodically applies.

The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate abuses in the securities industry. The Commission and the investment adviser community have historically stood for the principle that investment advisers could not "completely perform their basic function — furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments — unless all conflicts of interest between the investment counsel and the client were removed."²

What does this mean for investors?

It means that the SEC has been bringing cases on behalf of investors for the last 70 years prosecuting fiduciaries for breaching their duties and for failing to mitigate or disclose conflicts to their clients. These cases include actions against:

- Those who purchased stock for their own accounts prior to recommending it to their clients and then selling it from their own accounts for a profit;
- Those who were dually registered as broker-dealers and investment advisers and failed to disclose they were selling securities as a principal to their advisory clients;
- Those who entered into undisclosed arrangements to direct brokerage and/or soft dollars in exchange for the referral and retention of a client; and
- Those who were representatives for both an investment adviser and a broker-dealer and failed to disclose they received brokerage commissions and 12b-1 fees on trades recommended to pension clients.

These are just a few examples of the types of egregious conduct prosecuted

by the Commission based on the protection that the fiduciary principle affords investors.

In his speech entitled, "*Building a Fiduciary Society*," John Bogle provided a nice summary when he stated ". . .the fiduciary standard must be extended to other financial advisors, including broker-dealers who elect to act as advisors." He went on to remark that

"it should be made clear to clients whether they are relying on (1) trained investment professionals, paid solely through fully-disclosed fees to oversee their investments; or (2) sales representatives who sell the products and services of the companies that they represent, whether life insurance, annuities, mutual funds, or anything else. Simply put, the first group is representing its clients; the second group is representing its employers. And each firm's advertising and promotion should make this distinction clear."³

I couldn't agree more.

As the Supreme Court recognized, it was clear from the abuses that gave rise to the Advisers Act that there was a real necessity for investors to be protected by a fiduciary standard. For those of us who have spent time in the investment adviser industry, it is clear that the fiduciary relationship is the foundation of the adviser-client relationship. We need to ensure that advocates who seek to strengthen investment adviser regulation also appreciate the tough lessons learned in the past, and keep sacrosanct a real fiduciary standard.

SEC is the Regulator of the Investment Adviser Industry

As you can see, I do not think the question of what standard should govern broker-dealers that deliver investment advice is a real question. There is a real question, however, about how to strengthen inspection oversight over the investment adviser industry as a whole.

This is a question that the SEC and the investment adviser industry have been wrestling with for decades. From 1981 to 1990, the number of investment advisers registered with the Commission increased from roughly 4,500 to 16,500. The amount of registered investment advisers reached its highest point in 1996 at 22,400. After Congress passed The National Securities Markets Improvement Act of 1996, the number of registered advisers fell to a low point of 6,650 in 1999, in part, because the statute divided licensing authority between the SEC and states. From 1999 to now, there has again been a significant growth in the number of registered advisers and as of 2008, the number stands at about 11,300 advisers. Yet again, the growth in adviser registrants has outstripped the SEC's ability to examine every firm on a regular basis. Currently, about 425 staff conduct examination oversight of investment advisers and mutual funds, that's down from 489 in 2005. Simply stated, too few are being asked to do too much.

In addition to the number of advisers, the other number that is informative

is the assets under management. In 1990, these registered investment advisers as a whole had approximately \$4.9 trillion in assets and as of September 2008, registered investment advisers were managing approximately \$43 trillion in assets.

The question then is how to provide effective oversight without either compromising investor protections or fragmenting the regulatory landscape to the detriment of investors and the industry.

To address this resource issue some are calling for:

Reducing the Number of SEC Registered Advisers by Raising the Assets Under Management Required For Adviser Registration. Under the Advisers Act, advisers are not permitted to register with the SEC unless they have at least \$25 million of assets under management, advise a registered investment company, or are co-located with a SEC-registered adviser. Advisers below the threshold are regulated by state securities authorities. The Advisers Act provides the SEC with authority to increase the dollar threshold and thereby decrease the number of registered advisers to a number that can be effectively examined by the SEC. For example, if raised to \$50 million, the SEC-registered advisers would be reduced by approximately 3,000 (about 26%); if raised to \$100 million, they would be reduced by as many as 5,000 (about 44%). The corollary, of course, is that the states would assume responsibility for a larger population of advisory firms. Under this scenario, the states already stretched resources would face significant hurdles. The outcome would be merely to move the problem from the SEC to the states — but the problem would remain.

Creating an SRO for Advisers. Others propose creating an SRO for investment advisers as a solution to the resource issue. This is an idea that has been proposed for decades and every time it has come up in the past — it has been defeated. This proposal raises some serious concerns.

First, it is an illusory way of dealing with the problem of resources. The issue is really one of hiring, training, and overseeing an adequate program to examine advisers. Unfortunately, the SEC hasn't received adequate resources to do this job. A new SRO would need at least as many resources as a properly staffed and funded SEC, and would, of course, need to incur significant start-up expenses and would most likely pay higher private sector salaries. It would end up being a more costly alternative than if you simply provided the SEC with adequate resources.

Second, there is a significant accountability concern. The SEC is accountable to Congress and the public. Other SROs like the PCAOB arose from pre-existing private membership organizations, such as the AICPA. By adjusting structural defects, such as independence, in these organizations and providing SEC oversight, there was an attempt to strike a balance between building on an existing structure and public accountability. FINRA emerged somewhat similarly; it, too, is a legacy institution that can trace its roots back to 1939, when the National Association of Securities Dealers (NASD) was formed. Building on legacy organizations like the AICPA and

NASD may have seemed to make sense at the time because they had existing expertise and personnel.

Moving to an SRO in the investment adviser space, however, would be different. It would take existing SEC responsibility and hand it to some as-yet uncertain private organization. There is no existing adviser membership organization that polices conduct. In short, it would be outsourcing a regulatory obligation rather than building on an existing structure. I personally believe that the SEC should not outsource its mission. It is the only entity with experience overseeing investment advisers, an industry governed by the Advisers Act, which is based on a principles-based regime. By contrast, broker-dealer SROs primarily regulate through the use of very detailed, specific sets of rules and are not well versed in the oversight of principles-based regulation.

The SEC is the only securities regulator with the necessary experience in dealing with a principles-based regime. In fact, the SEC has administered this regime for over 70 years. No other regulator or SRO has this experience — nor is any other entity directly accountable to the public.

Direct regulation by the SEC is Smart, Efficient Regulation.

Investment advisers are going to have to pay a fee to an oversight entity. Why not pay it to the SEC? The SEC already has the infrastructure and the expertise in place. It will be the most cost-effective solution for the industry as well as the best solution for investors. There doesn't seem to be any logical reason for reinventing the wheel. All that the SEC needs is the funding.

I have previously called for Congress to pass legislation establishing the SEC as a self-funded agency, similar to the way other financial regulators are funded — such as the Federal Reserve Bank, the FDIC, OTS and OCC. This would solve the problem.

If Congress doesn't establish the SEC as a self-funded agency, however, then it may be necessary for the industry and the SEC to unite as they did in the early nineties to try to persuade Congress to pass legislation to set up a dedicated investment adviser oversight program funded by investment advisers paying a fee to the SEC.

In 1990, Congressmen Boucher, Dingell and Markey sponsored a bill, called "The Investment Advisors Disclosure and Enforcement Act of 1990" which, among other things, would have provided that advisers pay an annual fee to the SEC to finance this type of oversight.⁴ The SEC's current chairman, Mary Shapiro was an SEC Commissioner at the time and she gave testimony on the bill. I agree with then-Commissioner Shapiro's testimony where she contrasted direct oversight by the SEC with a system of self-regulation and stated "We [the Commission] recognized then and we recognize now that direct regulation of advisers by the Commission is in many respects preferable to creating another regulatory system. However, the Commission cannot provide meaningful direct regulation of advisers without significant additional resources."⁵

We find ourselves in that same position today. There is only one capital markets regulator charged with protecting investors, promoting capital formation, and maintaining fair and orderly markets — and that is the SEC.

I do not believe that the answer is to create another SRO — particularly when it would be one without any experience in dealing with the investment advisory industry and the Advisers Act regulatory tradition. Moreover, this current crisis has illustrated the dangers of regulatory fragmentation where the primary regulator is not able to quickly obtain, assess, and analyze information. Now is not the time to fragment even more, but to consolidate and employ smart regulation.

The SEC is the only public agency charged with regulating our capital markets and maintaining a keen sense of the entire market on behalf of investors. To create another regulator at this time without the experience in regulating a principle-based system of regulation would be too costly for the industry and the public in terms of both dollars and investor protection.

In addition, there are currently several bills pending in Congress to require that hedge fund advisers register with the SEC which would significantly increase the registered advisers under the SEC's oversight. Members of Congress are right to indicate that the SEC would be the appropriate overseer for these newly registered advisers. Instituting a clear system where registered advisers pay an annual fee for the cost of their oversight would create a flexible system that could accommodate any future increase or decrease in the number of registrants.

Possible Reforms for Investment Advisers

I would also like to discuss briefly a few proposed ideas that have been suggested for the SEC act upon in the near term:

Custody Rule

Any time there is a shocking Ponzi scheme fraud, a natural reaction is for regulators to evaluate the custody rules that contain the requirements to safeguard investor assets. The truth of the matter is that unlike banks and broker-dealers, few investment advisers maintain physical custody of client assets. In fact, Rule 206(4)-2 under the Advisers Act that regulates the custody practices of advisers requires investment advisers with legal custody of client assets to maintain those assets with one or more qualified custodians. Qualified custodians are usually the financial institutions that customarily provide custodial services, like banks and registered broker-dealers.

In the past few months, the Commission has brought numerous cases against investment advisers and broker-dealers alleging fraudulent conduct for misusing client assets. We will be aggressively prosecuting these cases against any advisers and broker-dealers who may have stolen client assets. In addition, our staff is undertaking a comprehensive review of the custody rules to ascertain whether any reforms are needed to ensure the highest

standard for the safekeeping of client assets.

Some areas the staff is looking into include:

reinstating the annual surprise examination requirement for registered investment advisers that have custody of client funds or securities; and
requiring the "qualified custodians" that hold advisory client assets to provide account statements directly to the clients or their representatives.

After its review, the staff will recommend action to the Commission. Assuming we move forward with a proposal, I welcome the public comment that we will receive to flesh out these ideas as well as others and improve our custody rules.

Third Party Compliance Audit

There has also been some talk of investment advisers being required to undergo a third party compliance audit or examination. I have some concerns about this idea. There are real questions about who would do this audit or examination — for example, what qualifications should they have? It really can't be by just anyone that hangs a "shingle" that says they do compliance audits. What sort of training and/or experience should be required? How do you verify they have the requisite industry knowledge to be effective?

More importantly, what will be the auditing standards? Even if you resolve the qualification issue, how do we ensure that the audit is a rigorous test resulting in real information? There are significant questions as to both the cost as well as the benefits of this type of idea. We would need to carefully consider the type of auditing standards we need in this area and in particular, the balance we strike in each auditing standard between the clarity and prescriptiveness of a rules-based standard versus the flexibility of an objectives-based standard.

I worry that this potential requirement has the potential to be quite costly with little real benefit if not properly thought out. Moreover, the "cold comfort" that a defective compliance audit provides to an unsuspecting investor may prove more harmful than not having one at all.

21(a) certification

There has also been discussion of a requirement that senior officers from broker-dealers and investment advisers who legally have custody over investor assets certify that controls are in place to protect investor assets. While this may be a useful exercise to focus attention on existing controls, it could also provide inappropriate "cold comfort" if not handled correctly. Undoubtedly, there is a benefit in focusing the attention on existing controls and creating clear accountability in senior management for compliance. However, there is always a danger that fraudsters will be only too happy to

submit a certification. Where senior management is involved in fraud, the certification loses value, and could even be harmful by providing the client with a false sense of security. I have raised these issues with staff and we are thinking through how to get the benefits while minimizing any false expectations.

Conclusion

In discussion of any potential changes to investment adviser regulation, it is crucial that the scope of the issues to be solved is well-defined. The regulatory regimes of investment advisers and broker-dealers were purposely constructed differently because of the different nature of their services. Now that broker-dealers are increasingly holding themselves out as giving investment advice, any potential reform must take into account these similarities and the need to uphold fundamental investor protections.

Moreover, just as there was in the early nineties, there remains a concern about how to strengthen the investment adviser oversight program. Congress and the Commission should seriously explore instituting a system whereby the adviser industry pays an annual fee to the SEC to offset the cost of this oversight. It seems to be the better, more cost-effective solution as compared to other alternatives because it would leverage expertise and maximize public accountability, which is good for the industry, and more importantly, good for investors.

I support strengthening the regulatory framework governing investment advisers, as long as the proposals provide smart, effective regulation without diminishing investor protections.

As investment advisers, you have a critical role to play in any regulatory improvements for advisers. Investors place their trust in you to act as their fiduciaries in managing their investments, but they also need you to bring your experience and expertise to the discussion of strengthening advisor regulation. As I said earlier, the fiduciary standard arising from the Investment Advisers Act was a victory for investors. That vital protection for investors cannot be ignored in any current discussions.

Thank you for the opportunity to speak with you today.

Endnotes

¹ Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., et al., 375 U.S. 180, 191-192 (1963) (quoting 2 Loss, Securities Regulation (2d ed. 1961), 1412).

² Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility

Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H. R. Doc. No. 477, 76th Cong., 2d. Sess., 1, (1939) at 28.

³ John Bogle, "Building a Fiduciary Society," IA Compliance Summit (March 13, 2009) at 10.

⁴ H.R. 4441, 101st Cong., 2d Sess. (1990).

⁵ Testimony of Mary Shapiro, Commissioner, U.S. Securities and Exchange Commission, concerning H.R. 4441, the "Investment Advisors Disclosure and Enforcement Act of 1990," before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, United States House of Representatives, July 18, 1990.

<http://www.sec.gov/news/speech/2009/spch050709laa.htm>