FIRMA Regulatory Update
Summer 2009
Prepared by: Donald F. Moore, Jr.

Editor's Note: In this edition of the Regulatory Update I outline the proposed amendments to the custody rule under the Investment Advisers Act of 1940 and the related forms. I also outline some of the items being discussed in H.R. 1984 (401(k) Fair Disclosure for Retirement Security Act of 2009) – it appears as 401(k) fee disclosure is taking center stage. Also, I have included a couple of recent speeches; one from the Federal reserve and one from the SEC – both of them will provide insight into the increased regulation and oversight that is forthcoming. Finally, I bring your attention to the new notice for sweep accounts in the event of a bank failure. This is an exciting time in our industry and there is s tremendous amount of information to review and/or understand. Should you have specific items you would like to be presented/discussed in the Regulatory Update, please send your requests to the attention of the FIRMA Forum Editor, or myself.

SEC: Proposed Rule – Custody of Funds or Securities of Clients by Investment Advisers

Background

The Securities and Exchange Commission is proposing amendments to the custody rule under the Investment Advisers Act of 1940 and related forms. The amendments, among other things, would require registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. In addition, unless client accounts are maintained by an independent qualified custodian (*i.e.*, a custodian other than the adviser or a related person), the adviser or related person must obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets. Finally, the amendments would provide the Commission with better information about the custodial practices of registered investment advisers. The amendments are designed to provide additional safeguards under the Advisers Act when an adviser has custody of client funds or securities.

Rule 206(4)–2 regulates the custody practices of investment advisers registered under the Advisers Act. Unlike banks and broker-dealers, investment advisers typically do not maintain physical custody of client funds or securities but rather may have custody because they have the authority to obtain client assets, such as by deducting advisory fees from a client account, writing checks or withdrawing funds on behalf of a client, or by acting in a capacity, such as general partner of a limited partnership, that gives an adviser or its supervised person the authority to withdraw funds or securities from the limited partnership's account. Rule 206(4)–2 requires advisers that have custody of client funds or securities to implement controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses, such as insolvency. The rule contains two primary protections.

First, the rule requires advisers that have custody, with certain limited exceptions, to maintain client funds or securities with a ''qualified custodian.'' Qualified custodians under the rule include the types of financial institutions to which clients and advisers customarily turn for custodial services, including banks, registered broker-dealers, and registered futures commission merchants. These institutions' custodial activities are subject to extensive regulation and oversight.

Second, the rule requires that an adviser with custody of client assets have a reasonable belief that the qualified custodian holding the assets provides account statements directly to clients, or investors in pooled investment vehicles, at least quarterly.

Clients can use the statements they receive from the qualified custodians to compare them with the statements (or other information) they receive from their advisers to determine whether account transactions, including deductions to pay advisory fees, are proper. An adviser to a pooled investment vehicle is not required to comply with the rule's account statement delivery requirement if the pooled investment vehicle is audited at least annually and distributes its audited financial statements to investors in the pool within 120 days of the end of its fiscal year.

If, however, clients do not receive account statements directly from their qualified custodians, the adviser must itself deliver quarterly account statements to clients and engage an independent public accountant to verify the client assets in a surprise examination that must occur at least once during each calendar year. During a surprise examination, an independent public accountant generally must (i) confirm with the custodian *all* cash and securities held by the custodian, including physical examination of securities if applicable, and will reconcile all such cash and securities to the books and records of client accounts maintained by the adviser, (ii) verify the books and records of client accounts maintained by the adviser by examining the security records and transactions since the last examination and by confirming with clients *all* funds and securities in client accounts, and (iii) confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination. The results of the examination must be reported by the accountant to the Commission. The surprise examination may uncover problems indicating that client assets may be at risk. Accordingly, the Commission has have designed the surprise examination requirement to provide timely information to the Commission staff in the event that the accountant uncovers a problem during the examination. Under the existing rule, the accountant must notify our Office of Compliance Inspections and Examinations within one business day of finding any material discrepancies during an examination.

Information

In recent months, the Commission has brought several enforcement actions against investment advisers and broker dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets. The Commission is intensively investigating this conduct, including the role of the investment advisers, broker-dealers, and individuals that may have participated in the conduct. The Commission will continue to work with criminal authorities and other Federal and State regulators to see that the full weight of the law is brought to bear on any advisers and broker-dealers that are found to have betrayed investor trust and confidence. In addition, our staff is conducting examinations of broker-dealer and adviser custodial practices designed to evaluate whether the assets entrusted to these firms are appropriately accounted for and that the firms have in place controls reasonably designed to prevent the theft, misappropriation or other misuse of investor assets.

The Commission also is undertaking a comprehensive review of the rules regarding the safekeeping of investor assets in order to determine changes that might make that would decrease the likelihood that client assets are misused, or would increase the likelihood that fraudulent activities are discovered earlier and client losses are thereby reduced. The Commission is proposing for comment several revisions to rule 206(4)–2 under the Advisers Act that are designed to improve the safekeeping of client assets.

A. Annual Surprise Examination of Client Assets

1. Application to All Advisers With Custody

The Commission proposes to require that all registered investment advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets. When the Commission adopted the custody rule in 1962, each adviser with custody of client securities or funds was required by rule 206(4)–2 to engage an independent public accountant to conduct an annual surprise examination. In 2003, The Commission amended the rule to eliminate the annual surprise examination with respect to client accounts for which the adviser has a reasonable belief that ‘‘qualified custodians’’ provide account statements directly to clients. The Commission believed that direct delivery of account statements by qualified custodians would provide clients confidence that any erroneous or unauthorized transactions would be reflected and, as a result, would be sufficient to deter advisers from fraudulent activities. The Commission has have decided to revisit the 2003 rulemaking in light of the significant enforcement actions that have recently brought alleging misappropriation of client assets. The Commission believes that a surprise examination by an independent public accountant would provide ‘‘another set of eyes’’ on client assets, and thus additional protection against their misuse. Moreover, an independent public accountant may identify misuse that clients have not, which would result in the earlier detection of fraudulent activities and reduce resulting client losses. Therefore, the Commission proposes to require all registered investment advisers with custody of client assets to obtain an annual surprise examination regardless of whether a qualified custodian directly provides statements to clients or, in the case of a pooled investment vehicle, the pool is audited at least annually and distributes its audited financial statements to its limited partners (or other investors) within 120 days of the end of its fiscal year. The Commission is proposing a number of additional enhancements to the rule, discussed below, including additional adviser and accountant reporting requirements and independent review of custody controls in certain circumstances, that the Commission believes would improve the utility of the surprise examination requirement and address some of the concerns had in 2003.

2. Commission Reporting

The Commission proposes to amend rule 206(4)–2 to require investment advisers subject to the rule to enter into a written agreement with an independent public accountant to conduct the surprise examination requiring the accountant, among other things, to notify the Commission within one business day of finding material discrepancies, and to submit Form ADV–E to the Commission accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that it has examined the funds and securities and describing the nature and extent of the examination. The accountant's certificate describing the nature and extent of the examination assists the Commission's examination staff in identifying and assessing risks raised by the investment adviser's custodial practices and in determining the scope of the Commission staff's examination of an investment adviser.

The reporting by the independent public accountant of a material discrepancy provides the Commission's examination staff with notice of a possible problem with the investment adviser's custodial practices. Should the Commission require additional information be included in the accountant's certificate? Although the Commission is not proposing to change the requirement, is the term ''material discrepancy,'' as used in the context of a surprise examination, widely understood by independent public accountants? If not, should the Commission define the term or provide guidance as to the requirement? Should the Commission require the accountant's certificate to be provided to clients or investors in pooled investment vehicles?

Currently, the custody rule requires that the accountant that performs the surprise examination file Form ADV–E with the Commission within 30 days of the completion of the examination stating that it has examined the funds and securities and describing the nature and extent of the examination. Our examination staff has found that an adviser's surprise examination may sometimes continue for an extended period of time. The Commission proposes to amend the rule to require that the accountant instead file Form ADV–E within 120 days of the time chosen by the accountant for the surprise examination. As described above, 120 days is the period of time in which a pooled investment vehicle managed by an adviser relying on the rule's annual audit exception must distribute its audited financial statements to investors in the pool.   Accordingly, the Commission believes 120 days should be sufficient time for an accountant to complete a surprise examination and file Form ADV–E.

In addition, the Commission proposes that the written agreement require the independent public accountant to submit Form ADV–E to the Commission within four business days of its resignation, dismissal from, or other termination, of the engagement, or upon removing itself or being removed from consideration for being reappointed, accompanied by a statement that includes (i) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant, and (ii) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination (‘‘termination statement’’). This information would permit our staff to compare information provided by the adviser with the perspective of the accountant, and to further evaluate the need for an examination of the adviser to determine whether client assets are at risk.

B. Custody by Adviser and Its Related Persons

1. Custody by Related Persons

The Commission proposes to amend rule 206(4)–2 to provide that an adviser has custody of any client securities or funds that are directly or indirectly held by a ‘‘related person’’ in connection with advisory services provided by the adviser to its clients. A ‘‘related person’’ would be a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. For purposes of this definition the Commission would define ‘‘control’’ as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. As a result, the protections of the rule would be afforded to clients when their funds and securities are not held with an independent custodian, but rather with the adviser itself or indirectly through a related person.

Under rule 206(4)–2, an adviser has custody of client assets if it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. In our release adopting the 2003 amendments to rule 206(4)–2, the Commission explained that an adviser *may* have custody of client assets under circumstances in which the adviser or its personnel have access to those client assets through a related person, and cited one of our staff interpretive letters that set forth factors the staff will consider in determining whether an adviser has ‘‘indirect’’ custody of client assets. The proposed amendments would simply deem advisers whose ‘‘related persons’’ hold client assets to have custody under the rule if those assets are held by the related person in connection with the advisory services provided by the adviser. The Commission believes that the risks to advisory clients that arise as a result of a related person’s ability to obtain client assets, regardless of the separation between the adviser and a related person, may be substantial enough to require the adviser to comply with the custody rule. The ‘‘in connection with’’ limitation of the proposed rule is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice.

2. Internal Control Report and PCAOB Registration and Inspection

The Commission also proposes to amend rule 206(4)–2 to require that, if an independent custodian does not maintain client assets but the adviser or a related person instead serves as a qualified custodian for client funds or securities under the rule in connection with advisory services the adviser provides to clients, the adviser must obtain, or receive from the related person, no less frequently than once each calendar year a written report (‘‘internal control report’’), which includes an opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (‘‘PCAOB’’), with respect to the adviser’s or related person’s controls relating to custody of client assets. The adviser would be required to maintain the internal control report in its records and make it available to the Commission or its staff upon request.

The Commission is proposing this addition to the rule because the Commission believes maintaining client assets with the adviser or a related person instead of with an independent custodian can present higher risks to advisory clients. Indeed, several of the recent enforcement actions have brought alleging misappropriation of client assets by investment advisers have involved advisers or related persons that maintained client assets. While advisers that are themselves, or use related persons that are, qualified custodians would be required to obtain a surprise examination, the utility of the surprise examination may be limited because the independent public accountant seeking to verify client assets may have to rely on custodial reports issued by the adviser or its related person. Because of the relationship between the adviser and the custodian, the Commission believes that there is a greater risk that the custodian could be a party to any fraud and therefore the custodian's reports could be compromised. Requiring these advisers to also obtain an internal control report would provide an additional check on the safeguards relating to client assets held by the adviser or the related person qualified custodian.

An internal control report could also significantly strengthen the utility of the surprise examination when the adviser or a related person custodian maintains client assets because the independent public accountant performing the surprise examination could obtain additional comfort that confirmations received from the qualified custodian in the course of the surprise examination are reliable and, where a broker-dealer is the qualified custodian, may be able to leverage existing tests performed in compliance with broker-dealer auditing and internal control requirements. The internal control report may also reveal control problems, which could be significant. Thus, the requirement to obtain an internal control report informs the surprise examination process and may itself act as a deterrent to advisers that may consider misappropriating client assets directly or through a related person in the guise of providing custodial services as a qualified custodian.

The proposed amendments would require that the internal control report include an opinion of an independent public accountant registered with, and subject to regular inspection by, the PCAOB, that is issued in accordance with the standards of the PCAOB, with respect to the description of controls placed in operation relating to custodial services, including the safeguarding of cash and securities held by either the adviser or a related person on behalf of the adviser's clients, and tests of operating effectiveness. In addition, the internal control report would also contain a description of the relevant controls, the control objectives and related controls, and the independent public accountant's tests of operating effectiveness that were performed and the results of those tests. Opinions provided in reports on controls over custodial services conducted in accordance with PCAOB standards address control objectives relevant to the custodial operations, as well as the general control environment and information systems. Control objectives relevant to custodial operations might include:

- Physical securities are safeguarded from loss or misappropriation;

- Cash and security positions are reconciled accurately and on a timely basis between the custodian and depositories, and between the custodian and accounting systems;
- Client-initiated trades are properly authorized and recorded completely and accurately in the client account;
- Securities income and corporate action transactions are processed to client accounts in an accurate and timely manner;
- Net settlement procedures for delivery and receive transactions are performed accurately;
- Documentation for the opening of accounts is received and authenticated, and established completely and accurately on the applicable system; and
- Market values of securities obtained from various outside pricing sources have been recorded accurately in client accounts.

The Commission is proposing that the independent public accountant issuing the internal control report be registered with, and subject to regular inspection by, the PCAOB, in accordance with the rules of the PCAOB. The Commission believes that registration and the periodic inspection of an independent public accountant's overall quality control system by the PCAOB will provide us greater confidence in the quality of the internal control report.

3. Surprise Examination and PCAOB Registration

The Commission also is proposing to require that when an adviser or a related person serves as a qualified custodian for the adviser's clients' funds or securities, the surprise examination discussed above be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, in accordance with the rules of the PCAOB. The Commission is proposing this requirement because, as discussed above, the Commission believes PCAOB registration and inspection will provide us greater confidence in the quality of the examination performed by the independent public accountant, which is even more important when an adviser or its related person, rather than an independent custodian, maintains client funds or securities.

4. Independent Qualified Custodians

The Commission requests comment on whether, as an alternative to our proposal to impose additional conditions on advisers that serve as, or have related persons that serve as, qualified custodians for client assets, the Commission should simply amend rule 206(4)–2 to require that an independent qualified custodian hold client assets. The use of a custodian not affiliated with the adviser would address the conflict, and potentially greater risks to client assets, that may be presented when an adviser or its related person acts as custodian for client assets. When the Commission amended rule 206(4)–2 in 2003 to require that advisers with custody of client funds or securities maintain those assets with a qualified custodian, the Commission acknowledged that the rule would permit advisers that are also qualified custodians to hold their clients' assets or to maintain them with related persons that are qualified custodians. Most qualified custodians are banks and broker-dealers, which are subject to extensive regulation and oversight of their custodial practices, and the Commission did not believe that permitting advisers to maintain securities with them presented additional custodial risk.

C. Delivery of Account Statements and Notice to Clients

The Commission proposes to amend rule 206(4)–2 to require registered advisers with custody of client funds or securities to have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities. The amendment would eliminate the alternative, currently provided in the rule, under which an adviser can send reports to clients if it undergoes a surprise examination by an independent public accountant at least annually. The Commission permitted the latter alternative delivery option because some advisers did not wish to disclose the names of their clients to custodians to prevent a potential competitor from having access to their lists of clients, or to protect the privacy of some well known clients.

The Commission is proposing to eliminate the alternative delivery option and require all advisers with custody of client assets to have a reasonable belief that the qualified custodian delivers account statements to advisory clients or their representatives (and not through the investment adviser). The Commission believes that direct delivery will provide greater assurance of the integrity of those account statements, which the Commission now believes, in light of recent frauds, is of substantially greater value than the concerns that led us in 2003 to accommodate those advisers that wished not to share client names with custodians. The confidentiality concern, the Commission believes, could also be addressed in custodial contracts or agreements outside of the contract that would restrict the custodian's use of the information.

The Commission is also proposing to amend rule 206(4)–2 to state that advisers relying on the qualified custodian to send account statements directly to clients must form their reasonable belief that such account statements are sent after ''due inquiry.'' Because the effectiveness of the rule depends significantly on direct delivery of account statements by the qualified custodian, the Commission is making it explicit that the adviser is obligated under the rule to conduct some inquiry to form a reasonable belief.

D. Liquidation Audit

The Commission is proposing an amendment to clarify the provision of the rule that exempts advisers from the account statement provisions with respect to those limited partnerships or other pooled investment vehicles that are subject to an annual audit and that distribute financial statements to investors. The proposed amendment would clarify the availability of the annual audit exception to pooled investment vehicles that liquidate and make final distributions other than at year end. This amendment is designed to assure that the proceeds of the liquidation are appropriately accounted for so that investors can take timely steps to protect their rights. Do commenters agree with us that this clarification would provide additional protection to the investors in the pool? Are there alternatives to a liquidation audit that the Commission should consider that would also protect pool investors?

E. Amendments to Form ADV

The Commission is proposing several amendments to Part 1A and Schedule D of Form ADV. The amendments are designed to provide more complete information about the custody practices of advisers registered with the Commission, and to provide us with additional data to improve our ability to identify compliance risks.

Item 7. Item 7 of Part 1A requires advisers to report certain financial industry affiliations, including whether the adviser has a related person that is an investment adviser or a broker-dealer. The item *requires* an adviser to identify on Schedule D of Form ADV each related person that is an investment adviser, and *permits* advisers to report the names of related person broker-dealers. The Commission proposes to modify Item 7 to require an adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities.

Item 9. Item 9 of Part 1A requires advisers to report to us whether they or a related person have custody of client funds or securities. The Commission proposes to amend the item to require advisers that have custody (or whose related persons have custody) of client funds or securities to provide additional information about their custodial practices under rule 206(4)–2. Specifically, The Commission proposes to amend Item 9 of Part 1A to require an adviser to report the amount in U.S. dollars of client assets and number of clients of which it or its related person has custody, and whether it or its related person serves as qualified custodian with respect to the adviser's clients' funds or securities. The Commission would also add a new subsection that would require an adviser with custody to report (i) whether a qualified custodian sends quarterly account statements to investors in pooled investment vehicles the adviser manages, (ii) whether the financial statements of the pooled investment vehicles the adviser manages are audited, (iii) whether the adviser's clients' funds or securities are subject to a surprise examination, and (iv) whether an independent public accountant registered with, and subject to regular inspection by, the PCAOB prepares an internal control report with respect to the adviser or its related persons' custodial services when acting as a qualified custodian for advisory client funds or securities. The Commission also proposes to amend Item 9 to require advisers that are subject to the surprise examination to report the month in which the last examination commenced. Last, the Commission proposes to amend Form ADV: General Instruction number 4 to make conforming changes to reflect that certain of the proposed questions are only required to be updated in an adviser's annual amendment. The information the Commission proposes to collect would improve our ability to monitor compliance with the custody rule.

The Commission also proposes to amend Schedule D of Form ADV by adding items to require additional details relevant to an adviser's response to the proposed amendments to Item 9 discussed above. With respect to accountants, these amendments would require advisers to: (i) Identify the accountants that perform audits or surprise examinations and that prepare internal control reports; (ii) provide information about the accountants, including address and PCAOB registration and inspection status; (iii) indicate the type of engagement (audit, surprise examination, internal control report); and (iv) indicate whether the accountant's report was unqualified.

With respect to qualified custodians, these amendments would require advisers to identify any related person that serves as a qualified custodian for its clients by reporting the related person's name and address, and indicate whether the related person qualified custodian is a bank, futures commission merchant or foreign financial institution. This information would allow our staff to better monitor compliance with the requirements of rule 206(4)–2, and, together with other data reported on Form ADV, would allow our staff to better assess the compliance risks of an adviser. The Commission requests comment on the amended items. The Commission understands that the additional information the Commission would require is readily available to investment advisers and should not be burdensome to provide. Is our understanding correct? Are the new questions clear? If not, what changes should the Commission make to make them clearer? The Commission does not believe that the information the Commission proposes to require is proprietary information the disclosure of which would have adverse consequences to the adviser or its clients. Is the Commission correct in this belief?

F. Amendments to Form ADV–E

The Commission is proposing three amendments to the instructions to Form ADV–E. First, the Commission proposes to amend the instructions to require that the form and the accountant's examination certificate that accompanies it be filed electronically with the Commission. Second, the Commission proposes to amend the instructions to reflect the proposed requirement that Form ADV–E and the examination certificate must be filed within 120 days of the time chosen by the accountant for the surprise examination. Third, the Commission proposes to add an instruction that would implement the proposed rule change regarding the accountant's obligation under the written agreement with the adviser to file Form ADV–E accompanied by the termination statement, described above, within four business days of the accountant's resignation, dismissal, or removal. The Commission requests comment on these proposed amendments. Are there additional changes to Form ADV–E that the Commission should consider?

G. Required Records

The Commission also is proposing to amend rule 204–2 to require the adviser to maintain a copy of the internal control report that an adviser would be required to obtain or receive from its related person, pursuant to proposed rule 206(4)–2(a)(6) for five years from the end of the fiscal year in which the internal control report is finalized. Requiring an adviser to retain a copy of the internal control report would provide our examiners with important information about the safeguards in place at an adviser or related person that maintains client assets. Information from these reports would also assist our staff in assessing custody-related risks at a particular adviser. The Commission requests comment on this proposal. Is there any additional documentation relating to the internal control report that should be maintained under rule 204–2?

Conclusion

The Commission requests comment on the rule amendments proposed in this Release, suggestions for additional changes to the existing rules and comment on other matters that might have an effect on the proposals contained in this Release. Commenters should provide empirical data to support their views.

Congress: H.R. 1984; Proposal to Amend Title I of ERISA – "401(k) Fair Disclosure for Retirement Security Act of 2009"

Background
A bill presented in the House of Representatives on April 21, 2009 by Mr. George Miller of California (for himself, Mr. Andrews, Ms. Woolsey, Mr. Sablan, Mr. Grijalva, Ms. Hirono, Ms. Clarke, Mr. Hare, Mrs. Davis of California, and Mr. Kildee) introduced the following a bill to amend title I of the Employee Retirement Income Security Act of 1974 to provide special reporting and disclosure rules for individual account plans and to provide a minimum investment option requirement for such plans. This Act may be cited as the '401(k) Fair Disclosure for Retirement Security Act of 2009'.

Information
Specifically, H.R. 1984 requires that:

- Workers must receive basic investment information, including information on risk, return, complete fees and investment objectives before enrolling in the plan. The bill's language specific to this area states the following.

  The plan administrator of an individual account plan (or any other plan official with contracting authority under the terms of the plan) and any other person may not enter into a contract for services to the plan (including, for purposes of this section, the offering of any investment option to the plan) unless such plan administrator or other official has received, not less than 10 business days in advance of entering into the contract, a single written statement from such person which-- (A) describes such services for the plan that will be provided in connection with the contract, and (B) provides the expected total annual charges for such services for the plan that will be provided in connection with the contract, including a reasonable allocation of such total annual charges among all relevant component charges (regardless of how the charges are actually assessed).

- All fees charged against a workers' account would have to be included in the account holder's quarterly statement. The fee can be expressed as one number, but a plan participant is given the right to request additional details from the plan administrator. 401(k) service firms must disclose the employers the fees that participants are charged on all investment options. Fees will need to be segmented into four categories.

  The allocation required under paragraph (B) in connection with the services provided under each contract shall specify component charges (to the extent such services for the plan are provided under the contract) as follows:
  - *charges for administration and recordkeeping,*
  - *transaction-based charges,*
  - *charges for investment management, and*
  - *all such charges not described or included in the above categories.*

- Service providers must disclose financial relationships so that plan sponsors can make sure there are no conflicts of interest.

    - *any payment provided (or the amount representing the value of any services provided) to the service provider (or any affiliate thereof) pursuant to, or in connection with, the contract described in paragraph (1) and the amount and type of any payment made or credit received for such services (irrespective of whether the service provider (or affiliate thereof) or other person providing such services is affiliated or unaffiliated with the plan, the plan sponsor, the plan administrator, or any other plan official),*
    - *any personal, business, or financial relationship with the plan sponsor, the plan, or the service provider (or any affiliate of the service provider) or any totality of such relationships which is material, if such relationship results in the service provider (or any affiliate thereof) deriving any material benefit, and*
    - *such other similar arrangements benefitting the service provider (or any affiliate thereof) as may be specified by the Secretary.*

- Plan sponsors would have to offer at least one low-cost index fund to plan participants in order to receive protection against liability for participant's investment losses. The criteria for such a fund as outlined in the bill are:

    - *Is an unmanaged or passively managed mutual fund with a portfolio of securities designed to substantially match the performance of the entire U.S. equity market, bond market, or a combination of the two.*
    - *Offers a combination of returns, risks, and charges likely to meet retirement income needs at adequate levels of distribution.*
    - *Is described in terms of the plan as offered without any endorsement of the government or plan sponsor.*

- The DOL must review plan provider and plan sponsor compliance with new disclosures laws and impose penalties for violations.

    The Secretary shall notify the applicable regulatory authority in any case in which the Secretary determines that a service provider is engaged in a pattern or practice that precludes compliance by plan administrators with section 111. The Secretary shall, in consultation with the applicable authority, take such timely enforcement action under this title as is necessary to assure that such pattern or practice ceases and desists and assess any appropriate penalties.

Conclusion

There is much activity taking place around 401(k) reform, including Congressional hearings and DOL initiatives. Plan sponsors and plan providers will be see changes occurring.

FRB: Speech by Governor Daniel K. Tarullo at the North Carolina Bankers Association Annual Convention - Large Banks and Small Banks in an Era of Systemic Risk Regulation

Background
On June 15, 2009 Federal Reserve Board Governor Daniel K. Tarullo spoke at the North Carolina Bankers Association Annual Convention. The topic of his speech was on the risk management environment and how both large and small banks will operate in the era of systemic risk regulation. Governor Tarullo's comments indicate that systemic risk issues and regulation will be the primary focus of public policy agenda. He further indicates that the risk-mitigation practices of all financial institutions will need to adjust. His comments will assist in providing insight to the potential regulatory environment of the future. Below are his comments.

Information
The financial crisis and its aftermath have revealed fundamental problems in both risk management by financial institutions and supervision by government regulators. These shortcomings arose in no small part from a failure by both the private and public sectors to adjust to far-reaching changes in financial markets over recent decades. There is a growing, though certainly not unanimous, view that supervision and regulation must be substantially more oriented toward containing systemic risk and addressing the associated problems posed by institutions considered too-big-to-fail. The public policy agenda will thus rightly be dominated for some time by proposals for legislative and administrative measures directed at systemic risk. In a moment I will offer some of my own views on the subject.

Even as we move into this era of systemic risk regulation, however, it is important to recognize that changes in the financial services industry have affected every bank in America, large and small. While smaller banks will not likely see the extensive supervisory changes that have been proposed for the largest financial institutions, they too must adapt their risk-management practices to new competitive and economic conditions. Only by doing so will they continue to play their distinctive role in providing credit to individuals and small businesses.

The changes in the financial services industry that preceded the crisis, the crisis itself, and the regulatory changes that will follow together carry important consequences for all banks. It seemed to me particularly appropriate to address the implications of these changes here in North Carolina, home to institutions that range from the very large to the very small.

Large Banks: If we have learned anything from the present crisis, it is that systemic risk was very much built into our financial system. This situation was the outcome of a decades-long trend, during which traditional bank lending, trading, and other capital markets activities were increasingly integrated. The most visible manifestations of this trend were the explosive growth of securitization and the increasing involvement of banks and their affiliates in all parts of the securitization process. And, as we learned during the course of the crisis, the universe of institutions whose potential failure was regarded as having systemic consequences extended well beyond banks, or even bank holding companies, to include financial firms not subject to mandatory prudential regulation.

More generally, the emergence of the so-called shadow banking system changed important features of the traditional banking model, particularly at the largest institutions. These banks became increasingly dependent on the wholesale funding provided by securitization, commercial paper issuance, and other sources--funding that was often poorly matched to the maturity of the firm's assets.

The result was the rising vulnerability of these institutions to non-traditional sources of risk. The new market-based liquidity problems arose from sudden, sharp movements in asset prices that led to enormous market uncertainty concerning the values of those assets. As now liquidity-strained institutions made increasingly distressed asset sales, they placed further downward pressure on asset prices, leading to margin calls for leveraged actors and mark-to-market losses for all holders of the assets. Since multiple firms were relying on similar marketable assets as a ready source of liquidity, extreme price declines could ensue, engendering a negative feedback loop that, if unchecked, would threaten the solvency of firms operating on the assumption of liquidity through asset sales or borrowings secured by such assets.

These and other changes in the competitive environment both prompted and advanced the relaxation over the past few decades of many of the restrictions on bank activities and affiliations that had been established in the 1930s. As a result of these changes, which had taken place both through administrative action and by statute, banks could operate nationally, had few practical restrictions on their ability to pay competitive deposit rates, could conduct a much broader range of activities within their own operations, and could affiliate with virtually any kind of financial firm. In response to now-permissible bank involvement in more activities and affiliation with broker-dealers and other financial firms, regulatory agencies imposed more detailed capital requirements and insisted on better risk management. But there was no overhaul of financial regulation to take account of the impact of trading and capital market activities on both traditional banking and systemic risk.

The financial crisis has focused the attention of policymakers on the need for just this kind of regulatory reorientation. I have recently set forth a fairly extensive explanation of the changes I believe should accompany this reorientation. I will not repeat this whole agenda today. Instead, let me simply highlight a few of these items to illustrate concretely what an era of systemic risk regulation would look like.

First, within the Federal Reserve, we are adjusting our consolidated supervision practices to take greater account of the risks faced, and created, by affiliates principally involved in trading and other capital market activities. Recent supervisory practices had not moved quickly enough away from the traditional focus on bank holding company regulation as a way to protect the insured depository institution subsidiaries, and toward more attention to such factors as the common exposures of different affiliates within the consolidated entity.

Second, we must strengthen existing regulations and supervisory guidance, particularly in areas in which bank involvement in trading and markets is most significant. The centrality of liquidity problems to the crisis requires considerable attention to adequate liquidity risk-management practices, particularly at firms substantially reliant on wholesale funding. While the most serious liquidity problems occurred outside traditional commercial bank lending and borrowing activities, the crisis revealed significant fragilities in financial institutions' extensive use of short-term repurchase agreements and reverse repurchase agreements to finance large portions of dealer inventory and trading positions. On the other side of the balance sheet, capital requirements for assets in the trading book were revealed by the crisis to be seriously deficient, based as they were on only a 10-day trading horizon. Along with our colleagues in the other regulatory agencies and, indeed, with our international colleagues in the Basel Committee on Banking Supervision, we are working on proposals to address these problems.

Third, we are augmenting our supervisory approach for bank holding companies to include a more explicitly systemic perspective. "Horizontal reviews" of risks, risk management, and other practices that are conducted across multiple financial firms and grounded in a uniform set of supervisory stress parameters can help identify both common trends and firm-specific weaknesses. We will incorporate into more routine supervisory practice some lessons learned from our recently completed Supervisory Capital Assessment Program of the nation's 19 largest bank holding companies.

Fourth, it is important to solve through legislation the so-called boundary problem in financial regulation. Last year there was a series of runs on nondepository financial institutions that raised systemic concerns. Institutions that may be considered too-big-to-fail, or at least too-interconnected-to-fail, must be subject to regulatory requirements and consolidated supervision.

Of course, these are not the only steps I would recommend, either within the Federal Reserve or for the financial regulatory structure more generally. They should, however, give you an idea of the kinds of changes that will be necessary as we shift to a focus on systemic risk regulation.

Small Banks: Let me turn now to the situation of smaller banks--here in North Carolina and around the nation. The financial crisis did not originate in smaller banks, but they have hardly escaped the fallout from the crisis itself, and from the serious recession that has followed. On average, commercial banks with less than $1 billion in assets reported a modest net profit during the first quarter of 2009, recovering from an average loss position in the fourth quarter of 2008. But this average figure hides the fact that nearly one in five of these banks lost money in the first quarter. As of March 31, nonperforming assets were twice the level of one year ago, and when measured against total loans and the category of Other Real Estate Owned, stood at an historic peak. Furthermore, capital ratios, although still strong for these banks as a group, have fallen since early 2008.

At the same time, the importance of traditional financial intermediation services, and hence of the smaller banks that typically specialize in providing those services, tends to increase during times of financial stress. Indeed, the crisis has highlighted the important continuing role of community banks. This seems an opportune moment both to review the virtues of community banking and to identify some of the difficulties faced by community bankers during this recession and beyond.

The dramatic changes in the U.S. financial services industry that I described earlier have also produced a new competitive environment for community banks. Consolidation has reduced the number of banking institutions (that is, commercial banks and thrifts) in the United States by nearly 50 percent since 1989. The number of community banks has declined by a similar percentage, leaving the share of all banking institutions that are community banks virtually unchanged.

Even as the number of banking institutions has been declining, the number of banking offices (branches plus headquarters) has been growing. Not surprisingly, big banks have been the drivers of the increase in banking offices. Since 1989, the number of community bank offices has declined by about 14 percent. The number of offices per community bank did increase from 2.4 to 3.9, but even this 60% growth must be understood in the context of the changes in larger banks. In this same 20-year period, the number of big bank offices increased by about 42 percent, and the number of offices per big bank more than tripled, from just under 17 to nearly 55. The net effect was a decline of more than 25 percent in the share of banking offices operated by community banks. The shares of deposits, banking assets, and small business loans held by community banks have declined substantially as well.

These declines can be explained by a number of factors, including legal developments, technological advances, and changes in the business strategies of larger banks and non-bank financial service providers. For example, deregulation has allowed banks to expand their geographic reach, facilitating the formation of a number of large, geographically diversified banking organizations. These large banking organizations can now be found in many local markets, competing for business with the community banks that call those markets home. Here in North Carolina, the number of large banks with a branch presence in the state has more than doubled over the past twenty years, from 18 to 39.

At the same time, technological advances have made information about households and small businesses more readily available, allowing some (typically large) institutions to substitute credit scoring for more costly traditional techniques in the underwriting of some types of consumer and small business loans. This development has allowed larger banks to compete more effectively with community banks in providing these types of loans.

Another salient change in the competitive environment is that non-bank financial service providers have become increasingly important participants in the financial services sector, capturing a large and growing share of the retail financial services business. For example, while the number of credit unions has declined by 42 percent since 1989, credit union deposits have more than quadrupled, and credit unions have increased their share of national deposits from 4.7 percent to 8.5 percent. In addition, some credit unions have shifted from the traditional membership based on a common interest to membership that encompasses anyone who lives or works within one or more local banking markets. In the last few years, some credit unions have also moved beyond their traditional focus on consumer services to provide services to small businesses, increasing the extent to which they compete with community banks.

These changes have posed significant challenges for community banks. Even so, many community banks have thrived, in large part because their local presence and personal interactions give them an advantage in meeting the financial needs of many households, small businesses, and agricultural firms. Their business model is based on an important economic explanation of the role of financial intermediaries--to develop and apply expertise that allows a lender to make better judgments about the creditworthiness of potential borrowers than could be made by a potential lender with less information about the borrowers.

A small, but growing, body of research suggests that the financial services provided by large banks are less-than-perfect substitutes for those provided by community banks. Consistent with this view, one study finds that the increase in competition from large, geographically diversified banking organizations has not affected the profitability of community banks in urban areas. There is some evidence of a profitability effect in rural areas, but it is actually more likely to be positive than negative. Thus, for most community bankers, the increased presence in their local markets of large, geographically diversified banking organizations appears not to adversely affect profitability. This circumstance may be due to the fact that a branch manager at a large depository institution typically does not have the same local connections and relationships as a community bank president.

Furthermore, although survey data indicate that small businesses have increased their reliance on large banks and non-bank financial service providers in recent years, the data show that these same firms have not reduced the average number of financial services they obtain from community banks. Rather, small businesses are, on average, using more financial services and types of services than they have in the past, and are obtaining these services from a greater number and wider variety of financial institutions, often including community banks.

To remain successful, any business must adapt to a changing competitive environment. The adaptation of community banks over the past two decades is evidenced by the substantial changes in their balance sheets, on both the asset and liability sides. On the asset side, both the average ratio of total loans to total assets and the average share of lending comprised by commercial real estate loans have increased markedly. On the liability side, reliance on deposits of individuals, partnerships, and corporations has declined somewhat, and there has been a dramatic increase in the share of community banks that hold brokered deposits. In addition, community banks have become more reliant on non-interest sources of revenue.

These changes in business strategy, which undoubtedly helped to maintain community bank profitability over much of the past two decades, may in the current financial environment exacerbate the risks faced by community banks. In this difficult operating environment, Federal Reserve examiners are encouraging community banks to focus on maintaining sound loan quality and strong credit administration practices. In addition, they are working with community banks to ensure that they maintain appropriate capital planning, credit administration, and liquidity management policies.

For example, earlier this year, the Federal Reserve issued supervisory guidance (SR letter 09-4) that reemphasized the importance of capital planning and prudent dividend policies for bank holding companies (BHCs) and their bank subsidiaries. This guidance--which was directed at all BHCs, both large and small--reminded them to ensure that they remain sources of strength to their bank subsidiaries and to curtail dividends when their financial condition is under stress.

A key part of any effective capital planning process is an evaluation of the risk posed by concentrations in specific portfolios of loans or other assets, and of the buffers necessary to offset potential losses on these holdings. In late 2006, the banking agencies issued guidance addressing concentrations in commercial real estate lending. This guidance set forth supervisory expectations for the management of risks stemming from these and other concentrations, including consideration of the effects of stressed market conditions on a bank's assets and capital. In the time since this guidance was issued, examiners report that many community banks have conducted rigorous and effective stress tests. But examiners have also visited many institutions that have only recently begun the essential step of ensuring that their management information systems are sufficiently detailed to support a robust analysis of bank concentration, and identifying where more work on stress testing is needed.

Funds management has also been an area that has received a renewed supervisory focus at banks of all sizes. As depositors and other funds providers have become more sensitive to bank risk, many banks have reinforced their contingency funding plans and developed sophisticated systems to more closely track their sources and uses of funds. These steps are particularly important for banks facing weaker asset quality.

Conclusion

The differences in the business models of systemically important financial firms and community banks are obvious. Yet the financial crisis and ensuing recession have revealed deficiencies in risk management in institutions of both types. Changes in competitive environments require banks to respond with changes in their business strategies. But the financial crisis has also revealed the importance of banks adopting risk-management strategies appropriate to these strategic changes, and of bank regulatory agencies adapting their supervisory models to both these kinds of changes in financial institutions.

The characteristics of the financial services industry have changed enormously in the last 30 years. Along with the nature of the regulatory regime that will be effective, the key aim of prudential regulation remains what it has always been--to encourage the efficient allocation of capital to productive uses while protecting the system from the defects and excesses that are inherent in financial markets. As we recover from the crisis and the recession, we will likely be entering a new era in which systemic risk regulation assumes much greater importance for supervisors. But the role of bank management, and of risk management at banks, will also remain what it has always been--to allow these institutions to play an effective intermediating role in a safe and sound fashion.

SEC: Speech by Commissioner Luis A. Aguilar - SEC's Oversight of the Adviser Industry Bolsters Investor Protection

Background

On May 7, 2009 SEC Commissioner Luis A. Aguilar presented a speech at the Investment Advisors Association Annual Conference in San Diego, CA. Commissioner Aguilar's speech discussed the protections provided to clients and the need to not undercut such protections by any potential changes to the regulation of broker-dealers and investment advisers. His comments focused on the following areas:

- 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

Information

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 are 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."

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."

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 Advisors 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. 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."

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:

<u>Custody Rule:</u> 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.

<u>Third Party Compliance Audit :</u> 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.

<u>21(a) certification :</u> 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.

OCC: Bulletin 2009-19 - New Notice For Sweep Accounts

On June 17, 2009 the OCC issued Bulletin 2009-19, New Notice For Sweep Accounts. This bulletin reminds national banks of a new Federal Deposit Insurance Corporation (FDIC) rule that requires banks to provide notices to sweep account customers. Specifically, the rule requires that, beginning July 1, 2009, each depository institution prominently disclose, in writing to its sweep account customers, whether the customers' swept funds are "deposits" within the meaning of 12 USC 1813(l), and, if not, the status of such funds in the event of the institution's failure. Such notices must be included in all new sweep account contracts and in all sweep account contract renewals, effective July 1, 2009. For existing sweep accounts, these disclosures must be made within 60 days after July 1, 2009, and at least annually thereafter. In cases when, based on the rules for determining end-of-day balances, it is possible that an account's sweep transaction may not be completed on the day of a bank's failure, the bank must disclose this possibility along with the resulting status of such unswept funds. The disclosure requirements do not apply to sweep accounts in which the transfers are within a single account or sub-account, or to sweep arrangements involving a deposit account-to-deposit account sweep in which the sweep does not affect the customer's insurance coverage.

On February 2, 2009, the FDIC published in the *Federal Register* the attached final rule "Method for Determining Deposit and other Liability Account Balances at a Failed Insured Depository Institution" (12 CFR 360.8) as an addition to the FDIC's resolution and receivership rules. The effective date of the final rule was March 4, 2009, with the sweep notice requirements effective beginning July 1, 2009. This rule articulates general principles underlying the FDIC's practices and procedures for establishing the final deposit account balances of each customer upon the failure of an insured depository institution for insurance coverage and receivership purposes. This "end-of-day ledger balance" will, with certain exceptions, be based on the cutoff times normally applied by the failed insured depository institution. In certain circumstances, the FDIC may impose an end-of-day cutoff point that is different from the bank's normal end-of-day cutoff point. The rule specifically addresses how the end-of-day ledger balance is determined for sweep accounts and imposes related ongoing notice requirements for sweep accounts.

Sweep accounts involve the pre-arranged transfer of funds from a deposit account to either an investment vehicle located outside the depository institution or another account or investment vehicle located within the institution. Depending upon a number of factors, an automated sweep transaction may or may not be deemed by the FDIC to have been completed when determining the end-of-day ledger balance used by the FDIC for insurance and receivership purposes. Recognizing that there are various types of sweep arrangements in place at insured depository institutions, the FDIC provides numerous examples in the preamble to their final rule. Banks will need to analyze their various sweep arrangements in light of this rule to determine the appropriate information that must be disclosed to their sweep account customers. Further guidance may be forthcoming on the FDIC's Web site.