

January 27, 2011

SEC Studies Recommend Strengthening Investment Adviser Examination Program and Adopting Universal Fiduciary Standard

Within a period of two days, the SEC released two much-awaited staff studies regarding investment adviser issues as required by the Dodd-Frank Act (the "Act"). In the first study, the staff concludes that insufficient resources exist to oversee advisers and sets forth three recommendations to improve oversight of advisers. In the second study, SEC staff recommends adoption of a uniform fiduciary duty standard for broker-dealers and investment advisers.

With respect to the first report regarding IA oversight, issued on January 19, 2011, the SEC staff notes that the number and frequency of examinations of IAs have declined over the past six years. The decline, the staff explains, is attributable to substantial growth in IAs and a corresponding decrease in personnel in the Office of Compliance Inspections and Examinations ("OCIE"). Although the number of IAs is expected to fall following enactment of Title IV of the Act (the Private Fund Investment Advisers Registration Act), the staff expects the number of IAs and the assets managed by them to grow in subsequent years. While the SEC's resources may increase in the next several years, the size of OCIE staff is unlikely to keep pace with the growth in IAs. Based on these uncertainties, the staff believes that the SEC likely will not have sufficient capacity in the near or long term to conduct effective examinations of IAs with adequate frequency. Thus, the staff recommends that Congress consider the following approaches to strengthen the Commission's examination program of IAs registered with SEC: (1) authorize the Commission to impose user fees on IAs to fund their examinations by OCIE; (2) authorize one or more SROs to examine, subject to SEC oversight, all IAs; or (3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.

Commissioner Elisse Walter released a separate statement expressing her disappointment in the report and criticizing Congress' lack of funding for the SEC. Walter felt it was necessary to clarify and emphasize certain facts in the report to "ensure that Congress knows that the current resource problem is severe, that the problem will only be worse in the future, and that a solution is needed now." Walter emphasized the study's lack of precision and objective recommendations, stating "the study's description and weighing of the alternatives is far from balanced or objective." For instance, she noted the study does not make clear that many of the benefits of the user fee option are shared by the SRO option. Additionally, the study cites virtually no disadvantages with the user fee option, but several disadvantages with the SRO and FINRA options. Walter concluded that the SRO option is the preferred method of enhancing the Commission's examination and enforcement resources relating to IAs.

In the second study released on January 21, 2011, SEC staff encourages the SEC commissioners to draft regulations that would impose upon broker-dealers ("BDs") a universal

fiduciary duty that is “no less stringent” than the standard applicable to IAs. Currently, BDs must only meet a suitability standard when providing personalized advice about securities to retail investors; however, the SEC’s study recommends establishment of a fiduciary duty. According to the study, a universal fiduciary duty is needed because investors are unaware that IAs and BDs operate under different standards. While Commissioners Kathleen Casey and Troy Paredes expressed doubts about the study’s conclusion, stating that it lacks support to reasonably conclude that a uniform standard would increase investor protection, further congressional approval is not required for the SEC to promulgate a fiduciary regulation. Not surprisingly, whether the Commission has the resources to enforce the recommended changes is uncertain.

Except for the comments noted above that were released along with the studies, the SEC Commissioners have not yet responded or proposed any rule changes. Copies of the respective studies are available at: <http://www.sec.gov/news/studies/2011/914studyfinal.pdf> and <http://sec.gov/news/studies/2011/913studyfinal.pdf>

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