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July 2011

PRIVATE FUND ADVISERS

Although a Self-Regulatory Organization Could Supplement SEC Oversight, It Would Present Challenges and Trade-offs

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GAO-11-623

July 2011

PRIVATE FUND ADVISERS

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GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-11-623, a report to congressional committees

Why GAO Did This Study

Over the past decade, hedge funds, private equity funds, and other private funds proliferated but were largely unregulated, causing members of Congress and Securities and Exchange Commission (SEC) staff to raise questions about investor protection and systemic risk. To address this potential regulatory gap, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) brought certain advisers to private funds under the federal securities laws, requiring them to register with SEC. The Dodd-Frank Act also requires GAO to examine the feasibility of forming a self-regulatory organization (SRO) to provide primary oversight of private fund advisers. This report discusses (1) the feasibility of forming such an SRO, and (2) the potential advantages and disadvantages of a private fund adviser SRO.

To address the mandate, GAO reviewed federal securities laws, SEC staff's recently completed study on its investment adviser examination program that was mandated by the Dodd-Frank Act, past regulatory and legislative proposals to create an SRO for investment advisers, and associated comment letters. GAO also interviewed SEC and SRO staffs, other regulators, and various market participants and observers.

We provided a draft of this report to SEC for review and comment. SEC staff provided technical comments, which we incorporated, as appropriate.

View GAO-11-623 or key components.
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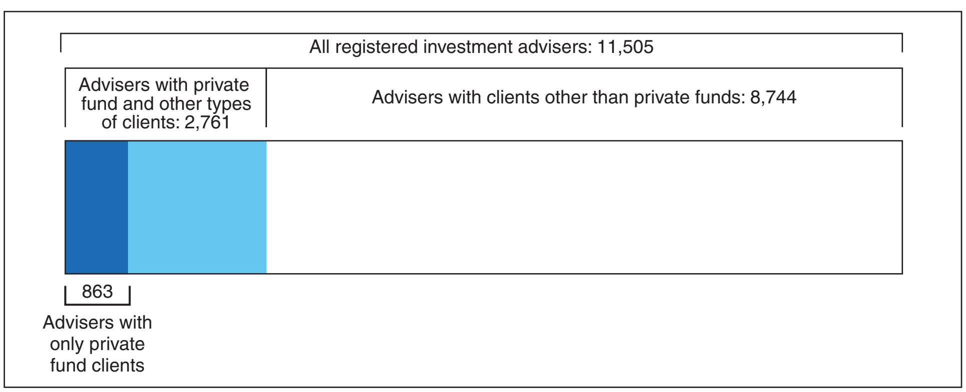
What GAO Found

Regulators, industry representatives, investment advisers, and others told GAO that it was difficult to opine definitively on the feasibility of a private fund adviser SRO, given its unknown form, functions, and membership. Nonetheless, the general consensus was that forming a private fund adviser SRO could be done, as evidenced by the creation and existence of other SROs. At the same time, they said that the formation of a private fund adviser SRO would require legislation and would not be without challenges. SEC staff and securities law experts said that the federal securities laws currently do not allow for the registration of a private fund adviser SRO with SEC. In addition, regulators, industry representatives, and others told GAO that forming such an SRO could face challenges, including raising the necessary start-up capital and reaching agreements on its fee and governance structures. Some of the identified challenges are similar to those that existing securities SROs had to confront during their creation.

Creating a private fund adviser SRO would involve advantages and disadvantages. SEC will assume responsibility for overseeing additional investment advisers to certain private funds on July 21, 2011. It plans to oversee these advisers primarily through its investment adviser examination program. However, SEC likely will not have sufficient capacity to effectively examine registered investment advisers with adequate frequency without additional resources, according to a recent SEC staff report. A private fund adviser SRO could supplement SEC's oversight of investment advisers and help address SEC's capacity challenges. However, such an SRO would oversee only a fraction of all registered investment advisers, as shown in the figure below. Specifically, SEC would need to maintain the staff and resources necessary to examine the majority of investment advisers that do not advise private funds and to oversee the private fund adviser SRO, among other things. Furthermore, by fragmenting regulation between advisers that advise private funds and those that do not, a private fund adviser SRO could lead to regulatory gaps, duplication, and inconsistencies.

Number of Registered Investment Advisers, as of April 1, 2011



Source: GAO analysis of SEC information.

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Abbreviations

CFTC	Commodity Futures Trading Commission
FINRA	Financial Industry Regulatory Authority
NASAA	North American Securities Administrators Association, Inc.
NFA	National Futures Association
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

United States Government Accountability Office
Washington, DC 20548

July 11, 2011

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

Over the past decade, private funds—such as hedge funds and private equity funds—proliferated but generally were not regulated, raising questions about investor protection and systemic risk to financial markets.[1] For example, according to Hedge Fund Research, Inc., in 2000, there were around 3,300 hedge funds with about $490 billion in assets under management, and in 2010, there were around 7,000 funds with $1.6 trillion in assets under management.[2] Institutional investors, such as pension plans, endowments, and foundations, typically invest in private funds to diversify their investment portfolios. Traditionally, private funds have been organized, structured, and operated in a manner that enabled

[1]Section 402(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, to be codified at 15 U.S.C. § 80b-2(a)(29), defines the term "private fund" to mean an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), but for section 3(c)(1) or 3(c)(7) of that act. Although hedge and private equity funds may fall under the definition of private fund, there is no precise legal or universally accepted definition of hedge fund or private equity fund. The term "hedge fund" commonly is used to describe pooled investment vehicles that often engage in active trading of various types of securities and commodity futures and options contracts. The term "private equity fund" can be defined narrowly as pooled investment vehicles that engage in leveraged buyouts of companies or more broadly to include pooled investment vehicles that invest in start-up or early stages of a company (called venture capital).

[2]Hedge Fund Research, Inc., "2010 Q2 Hedge Fund Industry Report," HFR Global Hedge Fund Industry Reports, (Chicago, Ill., 2011), www.hedgefundresearch.com.

the funds to qualify for an exclusion from certain federal securities laws and regulations that apply to other investment pools, namely mutual funds. In addition, many advisers to private funds were able to qualify for an exemption from SEC registration. Concerned that the unregulated status of private funds and their advisers posed a serious regulatory gap, Congress recently brought advisers to certain private funds under the federal securities laws. Specifically, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended the Investment Advisers Act of 1940 (Advisers Act) to generally require advisers only to private funds with assets under management in the United States of $150 million or more to register as investment advisers with the Securities and Exchange Commission (SEC).[3] However, the SEC chairman, SEC staff, and industry associations have questioned the sufficiency of the agency's resources to examine investment advisers, including the private fund advisers soon subject to SEC oversight, with adequate frequency.

Historically, the U.S. securities markets have been subject to a combination of industry self-regulation (with SEC oversight) and direct SEC regulation. This regulatory scheme was intended, in part, to relieve resource burdens on SEC by giving securities self-regulatory organizations (SRO), such as national securities exchanges and associations, responsibility for much of the day-to-day oversight of the securities markets and broker-dealers under their jurisdiction.[4] SEC previously has considered creating an SRO to help it oversee investment advisers and funds, reflecting, among other things, its concern about the adequacy of its resources to address the industry's growth.[5] However, to date, no SRO for investment advisers, which includes private fund advisers, has been created.

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[3]Pub. L. No. 111-203, §§ 403, 408, 124 Stat. 1376, 1571 (2010); 15 U.S.C. § 80b-3.

[4]An SRO can be defined in many ways. It can be broadly defined as a group of persons that establishes and enforces rules or best practices to govern the conduct of its members on a voluntary basis. Under this definition, an industry association could be defined as an SRO. For purposes of this report, we generally are defining the term more narrowly to mean a group of persons that is registered under the federal securities laws and subject to SEC oversight and minimum statutory and regulatory requirements. See, for example, Joel Seligman, *Should Investment Companies Be Subject to a New Statutory Self-Regulatory Organization?,* 83 Wash. U. L. Q. Vol. 83:1115, 1124 (2005).

[5]For example, in 2003, SEC requested comments on whether one or more SROs should be established for funds and/or investment advisers. See SEC, *Compliance Programs of Investment Companies and Investment Advisers,* Release No. IC-25925, IA-2107, 68 Fed Reg. 7038 (Feb. 11, 2003) (proposed rule).

Section 416 of the Dodd-Frank Act requires us to study the feasibility of forming an SRO to oversee private funds. As discussed with your staff, this report discusses

- the feasibility of forming and operating a private fund adviser SRO, including the actions that would need to be taken and challenges that would need to be addressed, and
- the potential advantages and disadvantages of a private fund adviser SRO.[6]

To address these objectives, we analyzed the Securities Exchange Act of 1934, Sarbanes-Oxley Act of 2002, and Commodity Exchange Act to identify the various types of existing SROs, including their registration requirements, regulatory functions, and oversight frameworks.[7] In addition, we reviewed past regulatory and legislative proposals for creating SROs to oversee investment advisers or funds, relevant academic studies, SEC staff's *Study on Enhancing Investment Adviser Examinations* (as mandated under section 914 of the Dodd-Frank Act)—hereafter referred to as the section 914 study—and related material to gain insights on the potential form and functions of a private fund adviser SRO.[8] We also reviewed letters addressing the need for enhanced examination and enforcement resources for investment advisers received by SEC in connection with its section 914 study to review and analyze the need for enhanced examination and enforcement resources for investment advisers, comment letters on past proposals for an investment adviser or fund SRO, and other material to document the potential challenges in, and advantages and disadvantages of, creating a private fund adviser SRO. We also interviewed SEC staff and tested procedures

[6]Our study focuses on an SRO for private fund advisers, not private funds. As discussed with congressional staff, the term "private funds," as used in the Dodd-Frank Act's text for the required GAO study, referred to private fund advisers. The Dodd-Frank Act amended the federal securities laws to require certain advisers to private funds, not the funds themselves, to register with SEC. Securities SROs serve to help enforce the federal securities laws applicable to their members. An SRO for private funds (not advisers) would not serve that purpose, because private funds can continue to qualify for an exclusion from registration with SEC and thus generally are not subject to the federal securities laws.

[7]15 U.S.C. §§ 78a – 78pp; 15 U.S.C. §§ 7201 – 78d-3, 18 U.S.C. §§ 1519, 1520, 1514A, 1348-1350; 7 U.S.C. §§ 1-26.

[8]We did not evaluate the findings of the study or the staff's conclusions regarding the investment adviser examination program.

used to generate estimates of the number of advisers to private funds, as of April 1, 2011, and found the data to be reliable for the purposes of our report. We interviewed staff of regulators, including SEC, the Commodity Futures Trading Commission (CFTC), the North American Securities Administrators Association (NASAA), the Financial Industry Regulatory Authority (FINRA), and the National Futures Association (NFA); representatives of industry associations representing investment advisers and private or other types of funds, including the Alternative Investment Management Association, Coalition of Private Investment Companies, Investment Company Institute, Managed Funds Association, and Private Equity Growth Capital Council; market participants, including 17 advisers and/or investors in private funds who were members of the industry associations with whom we met; and others, including a compliance consultant firm and three law professors, about the potential challenges in, and advantages and disadvantages of, creating a private fund adviser SRO. In our interviews with regulators and others on the feasibility and associated challenges of forming and operating a private fund adviser SRO, we generally predicated our discussion on the assumption that a private fund adviser SRO would be similar in form and function to FINRA, the SRO for the broker-dealer industry.[9]

We conducted this performance audit from August 2010 through July 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The Advisers Act generally defines an investment adviser, with certain exceptions, as any individual or firm that receives compensation for giving advice, making recommendations, issuing reports, or furnishing analyses

[9]FINRA was established in 2007 through the consolidation of NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. FINRA is involved in various aspects of the securities business, including registering and educating industry participants, examining securities firms, writing rules, enforcing those rules and the federal securities laws, informing and educating the investing public, providing trade reporting and other industry utilities, and administering a dispute resolution forum for investors and registered firms.

on securities either directly to investors or through publications.[10] As of July 21, 2011, individuals or firms that meet this definition and that have over $100 million in assets under management generally must register with SEC and are subject to SEC regulation. Advisers with less than $100 million in assets under management may be required to register with and be subject to oversight by one or more state securities regulators. The Advisers Act requires investment advisers to adhere to the high standards of honesty and loyalty expected of a fiduciary and to disclose their background and business practices.[11]

Traditionally, private funds (such as hedge and private equity funds) have been structured and operated in a manner that enabled the funds to qualify for an exclusion from some federal statutory restrictions and most SEC regulations that apply to registered investment pools, such as mutual funds. For example, in 2008, we found that private equity and hedge funds typically claimed an exclusion from registration as an investment company.[12] By relying on one of two exclusions under the Investment Company Act of 1940, such funds are not required to register as an investment company. The first exclusion is available to private funds whose securities are owned by 100 or fewer investors. The second exclusion applies to private funds that sell their securities only to highly sophisticated investors. To rely on either exclusion, the private fund must not offer its securities publicly.[13] Before the passage of the Dodd-Frank

[10]See 15 U.S.C. 80b-2(a)(11).

[11]In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189-192 (1963), the U.S. Supreme Court recognized that the Advisers Act imposes a fiduciary duty on investment advisers. This standard imposes an affirmative duty to act solely in the best interests of the client. The investment adviser also must eliminate or disclose all conflicts of interest.

[12]GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed,* GAO-08-200 (Washington, D.C.: Jan. 24, 2008), and *Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks that Warrant Continued Attention,* GAO-08-885 (Washington, D.C.: Sept. 9, 2008).

[13]Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company any issuer (1) whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and (2) that is not making, and does not presently propose to make, a public offering of its securities. 15 U.S.C. § 80a-3(c)(1). Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company any issuer (1) whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are “qualified purchasers” and (2) that is not making, and does not at that time propose to make, a public offering of its securities. 15 U.S.C. § 80a-3(c)(7). Qualified purchasers include individuals who own at least $5 million in investments or companies that own at least $25 million in investments. 15 U.S.C. § 80a-2(a)(51).

Act, many advisers to private funds were able to qualify for an exemption from SEC registration.[14] Although certain private fund advisers were exempt from registration, they remained subject to antifraud (including insider trading) provisions of the federal securities laws.[15]

The Dodd-Frank Act requires that advisers to certain private funds register with SEC by July 21, 2011.[16] Specifically, Title IV of the Dodd-Frank Act, among other things, amends the Investment Advisers Act by

- eliminating the exemption from SEC registration upon which advisers to private funds have generally relied—thereby generally requiring advisers only to private funds with assets of $150 million or more to register with SEC;[17]
- providing SEC with the authority to require certain advisers to private funds to maintain records and file reports with SEC;
- providing exemptions from registration to advisers solely to venture capital funds, advisers to certain private funds with less than $150 million of assets under management, and certain foreign private advisers;[18]

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[14]Before the passage of the Dodd-Frank Act, private fund advisers typically satisfied the “private adviser” exemption from registration as an investment adviser under section 203(b)(3) of the Advisers Act. This section exempted from SEC registration requirements investment advisers (1) that have had fewer than 15 clients during the preceding 12 months, (2) do not hold themselves out generally to the public as an investment adviser, and (3) are not an investment adviser to a registered investment company. 15 U.S.C. § 80b-3.

[15]See 15 U.S.C. § 80b-6. In 2007, SEC adopted a rule designed to clarify its ability to bring enforcement actions against unregistered advisers that defraud investors or prospective investors in a pooled investment vehicle. See *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Release No. IA-2628, 72 Fed. Reg. 44756 (Aug. 9, 2007)(final rule)(17 C.F.R. § 275.206(4)-8).

[16]On June 22, 2011, SEC adopted final rules extending the date by which advisers relying on the "private adviser" exemption in section 203(b)(3) must register with the commission to March 30, 2012. See *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Release No. IA-3221 (June 22, 2011)(final rule)(17 C.F.R. Parts 275 and 279).

[17]Private fund advisers with more than $100 million in assets under management, if they have other clients along with their private fund clients, must generally register with SEC.

[18]For a discussion of all of the exemptions provided under Title IV of the Dodd-Frank Act, see *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Release No. IA-3222, (June 22, 2011) (Final Rule).

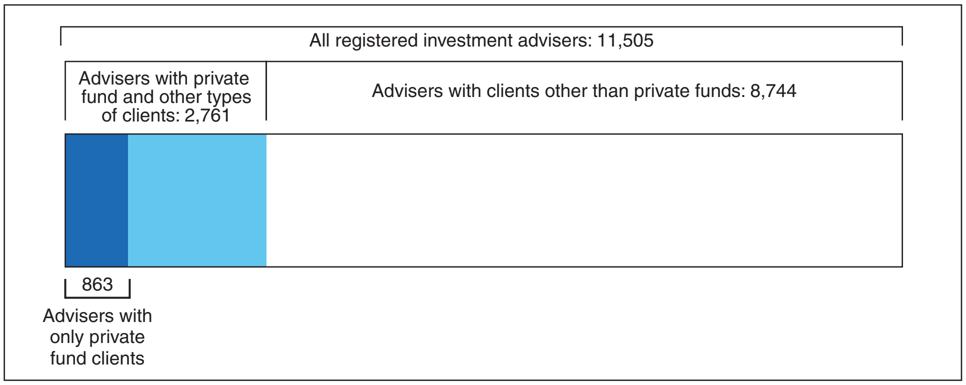
- authorizing SEC to collect certain systemic-risk data and share this information with the Financial Stability Oversight Council; and
- generally requiring that advisers with assets under management of less than $100 million register with the state in which they have their principal office, if required by the laws of that state.

As shown in figure 1, according to SEC staff, 11,505 investment advisers were registered with SEC as of April 1, 2011, of which the staff estimate 2,761 advise private funds.[19] Of these 2,761, approximately 863 registered investment advisers report on their disclosure form that their only clients are private funds, and approximately 1,898 advisers report that they advise private funds and other types of clients, such as mutual funds.[20]

[19]As we previously reported, before the Dodd-Frank Act, SEC's ability to directly oversee private fund advisers was limited to those that were required to register or voluntarily registered with SEC. See GAO-08-200 and GAO-08-885.

[20]SEC staff derived these data based on information from Form ADV—the uniform form that is used by investment advisers to register with SEC, which requires information about, among other things, the investment adviser's business and clients. Form ADV does not currently include a specific question on whether the adviser is an adviser to private funds. To estimate the number of advisers that potentially advise private funds SEC includes the number of advisers whose response to Form ADV's Item 7.B equaled "yes" and Item 5.D(6) is not 0 percent. Item 7.B asks the investment adviser whether it or any related person is a general partner in an investment-related limited partnership or manager of an investment-related limited liability company, or whether it advises any other "private fund," as defined under SEC rule 203(b)(3)-1. Item 5.D(6) asks the adviser to identify whether it has other pooled investment vehicles (e.g., hedge funds) as clients and if so to indicate the approximate percentage that these clients constitute of its total number of clients.

Figure 1: Number of Registered Investment Advisers, as of April 1, 2011



Source: GAO analysis of SEC information.

When the Dodd-Frank Act's new registration provisions take effect, the composition of registered investment advisers will change. SEC staff estimates that approximately 3,200 advisers currently registered with SEC will fall below the required amount of assets under management for registration with SEC (increasing from $25 million under current law to $100 million under the Dodd-Frank Act amendments. As a result, they will be required to register with one or more state securities authorities instead of SEC—leaving 8,300 advisers registered with SEC. In addition to these advisers, SEC staff also estimates that (1) approximately 750 new investment advisers to private funds will have to register with SEC because of the elimination of the registration exemption on which private fund advisers have typically relied and (2) approximately 700 new investment advisers will register with SEC as a result of growth in the number of investment advisers (based on historical growth rates). Therefore, SEC staff estimates that there will be approximately 9,750 registered investment advisers after the implementation of these Dodd-Frank Act amendments. However, an estimate of the total number of registered investment advisers with private fund clients remains uncertain, because some of the 2,761 currently registered advisers with private fund clients may be required to deregister with SEC, depending on the amount of their assets under management, and some of the newly registering advisers may advise one or more private funds.

Although advisers to certain private funds will be required to register with SEC, the private funds themselves may continue to qualify for an exclusion from the definition of an investment company under the Investment Company Act of 1940. Because private funds typically are not required to register as investment companies, SEC exercises limited oversight of these funds.[21] Nonetheless, the Dodd-Frank Act amends the Advisers Act to state that the records and reports of private funds advised by a registered investment adviser are deemed to be the records and reports of the investment adviser.[22] Thus, according to SEC staff, such records and reports are subject to examination by SEC staff.

SEC oversees registered investment advisers primarily through its Office of Compliance Inspections and Examinations, Division of Investment Management, and Division of Enforcement. In general, SEC regulates investment advisers to determine whether they (1) provide potential investors with accurate and complete information about their background, experience, and business practices and (2) comply with the federal securities laws and related regulations. More specifically, the Office of Compliance Inspections and Examinations examines investment advisers to evaluate their compliance with federal securities laws, determine whether these firms are fulfilling their fiduciary duty to clients and operating in accordance with disclosures made to investors, and assess the effectiveness of their compliance-control systems. The Division of Investment Management administers the securities laws affecting investment advisers and engages in rulemaking for SEC consideration and other policy development intended, among other things, to strengthen SEC's oversight of investment advisers.[23] The Division of Enforcement investigates and prosecutes violations of securities laws or regulations.

Securities SROs include national securities exchanges and securities associations registered with SEC, such as the New York Stock Exchange and FINRA. SROs are primarily responsible for establishing the standards under which their members conduct business; monitoring the way that business is conducted; bringing disciplinary actions against their members for violating applicable federal statutes, SEC rules, and their own rules; and referring potential violations of nonmembers to SEC. SEC

[21] See, for example, GAO-08-200 and GAO-08-885.

[22] Pub. Law. No. 111-203, § 404(2), 124 Stat. 1376, 1571 (2010) (to be codified at 15 U.S.C. § 80b-4).

[23] See *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Release No. IA-3221 (June 22, 2011)(final rule)(17 C.F.R. Parts 275 and 279); SEC and CFTC, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF,* Release No. IA-3145, 76 Fed. Reg. 8068 (Feb. 11, 2011) (proposed rule).

oversees SROs, in part by periodically inspecting them and by approving their rule proposals. At the time that the system of self-regulation was created, Congress, regulators, and market participants recognized that this structure possessed inherent conflicts of interest because of the dual role of SROs as both market operators and regulators. Nevertheless, Congress adopted self-regulation of the securities markets to prevent excessive government involvement in market operations, which could hinder competition and market innovation. Congress also concluded that self-regulation with federal oversight would be more efficient and less costly to taxpayers. For similar purposes, Congress created a self-regulatory structure for the futures markets.[24] NFA is a futures SRO registered with CFTC as a national futures association.

Section 914 of Title IX of the Dodd-Frank Act required SEC to study the need for enhanced examination and enforcement resources for investment advisers. Among other things, SEC was required to study the number and frequency of examinations of investment advisers by SEC over the last 5 years and the extent to which having Congress authorize SEC to designate one or more SROs to augment SEC's efforts in overseeing investment advisers would increase the frequency of examinations of investment advisers. In January 2011, SEC staff issued the report. SEC staff concluded that the number and frequency of examinations of registered investment advisers have declined over the past 6 years and that SEC faces significant capacity challenges in examining these advisers, in part because of the substantial growth of the industry and the limited resources and number of SEC staff.[25] As a result, SEC staff recommended three options to Congress to strengthen SEC's investment adviser examination program: (1) imposing user fees on advisers to fund SEC examinations, (2) authorizing an SRO to examine all registered investment advisers, and (3) authorizing FINRA to examine its members that are also registered as investment advisers for compliance with the Advisers Act. In its report, SEC staff discusses the trade-offs of each of these options.

[24]See, for example, GAO, *Securities and Futures: How the Markets Developed and How They Are Regulated*, GAO/GGD-86-26 (Washington, D.C.: May 15, 1986).

[25]SEC, Division of Investment Management, *Study on Enhancing Investment Adviser Examinations* (Washington, D.C. January 2011). We did not evaluate the findings of SEC's study or the staff's conclusions regarding the investment adviser examination program.

Although Forming an SRO to Oversee Private Fund Advisers Appears Feasible, It Would Require Legislative Action and Present Challenges

Regulators, industry representatives, investment advisers, and others we interviewed told us that it was difficult to opine definitively on the feasibility of forming and operating a private fund adviser SRO because of the many unknown factors, such as its specific form, functions, and membership.[26] Nonetheless, the general consensus was that forming a private fund adviser SRO similar to FINRA could be done but not without challenges. Regulators and industry representatives pointed to the creation and existence of other securities SROs as evidence that forming an SRO to oversee private fund advisers is feasible. However, SEC staff and two securities law experts told us that legislation would be needed to allow a private fund adviser SRO to be formed under the federal securities laws. Moreover, regulators, industry representatives, and others identified a number of challenges to forming a private fund adviser SRO, some of which were similar to the challenges involved in creating other SROs, such as FINRA and NFA.

Legislation Would Be Needed to Allow a Private Fund Adviser SRO to Operate under the Federal Securities Laws

According to SEC staff and two securities law experts, legislation would be needed to allow for the formation of a private fund adviser SRO under the federal securities laws. Neither the Advisers Act nor the other federal securities laws expressly authorize the registration of a private fund adviser SRO. As a result, SEC staff and these experts told us that Congress would need to enact legislation to allow for such an SRO to register with SEC and for SEC to delegate any regulatory authority to the SRO. Past proposals to create an SRO to oversee investment advisers

[26]There are multiple types of securities SROs that vary in their forms and functions. These types include (1) national securities exchanges, (2) registered securities associations, (3) registered clearing agencies, and (4) the Municipal Securities Rulemaking Board. As discussed later, some SROs have broad regulatory authorities, including rulemaking, examination, and enforcement authority. Others have more limited authority.

were also predicated on legislation.[27] For example, the House of Representatives passed a bill in 1993 that, among other things, would have amended the Advisers Act to authorize the creation of an "inspection-only" SRO for investment advisers.[28]

Congress has taken different approaches in creating different types of SROs and has granted the SROs different authorities. For example, it passed the Maloney Act in 1938, which amended the Securities Exchange Act of 1934 to provide for the registration of national securities associations as SROs for the over-the-counter securities market.[29] This provision led to the registration of the NASD, which later merged with parts of the New York Stock Exchange to become FINRA. National securities associations have broad regulatory authorities, including rulemaking, examination, and enforcement authority. In contrast, Congress in 1975 provided for SEC to establish the Municipal Securities Rulemaking Board—an SRO charged only with issuing rules for the municipal securities industry.[30] More recently, Congress created the

[27]SEC first considered an investment adviser SRO in 1963 in its report *Special Study of the Securities Markets*. That report recommended that registered investment advisers be required to join an SRO that would assume responsibility for determining and imposing minimum standards for principals and appropriate categories of employees of registered investment adviser firms. The recommendation was not acted upon. In 1983, SEC published a release seeking public comment on whether one or more SROs should be established to prescribe and administer the requirements under the Advisers Act and on whether membership in an SRO should be mandatory. 48 Fed. Reg. 8485 (Mar. 1, 1983). In 1989, legislation was introduced in Congress to provide SEC with authority to designate one or more SROs for investment advisers that would have rulemaking, examination, and enforcement authority (S. 1410, 101st Cong. (1989)). In 1993, the House of Representatives passed a bill that, among other things, would have amended the Advisers Act to authorized designating one or more SROs to conduct periodic examinations of investment advisers (H.R. 578, 103rd Cong. (1993)). Most recently, in 2003 SEC asked for comment on the formation of one or more SROs for registered investment advisers, including whether such an SRO should be limited to conducting examinations. *Compliance Programs of Investment Companies and Investment Advisers,* Release Nos. IC-25925, IA-2107, 68 Fed. Reg. 7038, 7044 (Feb. 11, 2003).

[28]H.R. 578, 103rd Cong. (1993).

[29]Over-the-Counter Market Act, ch. 677, 52 Stat. 1070 (1938), *codified at* 15 U.S.C. § 78o-3.

[30]Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 13, 89 Stat. 97 (1975) (codified at 15 U.S.C. § 78o-4). Section 975(b)(4) of the Dodd-Frank Act provides the Municipal Securities Rulemaking Board with limited enforcement and examination authority to provide guidance and assistance for compliance with its rules to SEC, a registered securities association, or any other appropriate regulatory agency.

Public Company Accounting Oversight Board to oversee the auditors of public companies in the Sarbanes-Oxley Act of 2002.[31] Like FINRA, the Public Company Accounting Oversight Board has broad regulatory authorities, but unlike FINRA, its board is selected by SEC, and its budget, although established by the board, is subject to SEC approval.[32] Previously introduced legislation authorizing the registration of an SRO for investment advisers has ranged from an SRO with potentially broad regulatory authorities similar to those of FINRA to an SRO empowered only to inspect registered investment advisers for compliance with the applicable securities laws.[33]

Representatives from all of the investment funds and adviser associations we spoke with opposed forming a private fund adviser SRO, indicating that their members would not voluntarily form or join one. In addition, officials from NASAA and some industry representatives also told us that no basis exists for forming an SRO to oversee private fund advisers. According to NASAA officials, the requirement under the Dodd-Frank Act for certain private fund advisers to register with SEC obviates the need for an SRO for these advisers because SEC and state securities regulators are in the best position to oversee them. Furthermore, representatives from two industry associations told us that the nature of private equity funds and investors obviates the need for an SRO. For example, representatives from one industry association said that the terms of a private equity fund typically are negotiated between an adviser and institutional investors, providing the investors and their lawyers with the opportunity to include any protections they deem necessary. These views suggest that the feasibility of a private fund adviser SRO may depend, in part, on whether legislation authorizing such an SRO made membership mandatory for registered investment advisers to private funds. Similarly, in its section 914 study, SEC staff noted that for an investment adviser

[31]Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 7211).

[32]Whether the Public Company Accounting Oversight Board is an SRO is an open question. Certain academics have noted that characteristics such as it being a private corporation with regulatory powers similar to other securities SROs and being subject to SEC oversight make it similar to existing securities SROs. They also note differences such as Congress's creation of the Public Company Accounting Oversight Board and SEC's selection of the board members. A Public Company Accounting Oversight Board official noted that although the organization has similar regulatory authorities as securities SROs, it is not an SRO because the accountants it regulates are not its members.

[33]See, for example, S. 1410, 101st Cong. (1989) and H.R. 578, 103rd Cong. (1993).

SRO to be successful, membership would need to be mandatory to ensure that all investment advisers would be subject to SRO examination.[34] For similar purposes, the federal securities and commodities laws require broker-dealers and futures commission merchants dealing with the public to be members of a securities or futures SRO, respectively.[35]

A Number of Challenges Would Have to Be Addressed in Forming a Private Fund Adviser SRO

Regulators, industry associations, and others told us that forming and operating an SRO to oversee private fund advisers would face a number of challenges. One of the principal challenges would be funding the SRO's start-up costs. None of the regulators or associations could provide us with an estimate of the start-up costs in light of the many unknown variables, including the SRO's number of members and regulatory functions. For example, advisers with only private fund clients could be the only advisers required to be members of the SRO. Alternatively, other advisers could also be required to be members, such as advisers with both private fund and other types of clients or advisers managing a certain minimum amount of private fund assets. However, representatives from two industry associations told us that the cost of forming a new SRO would be considerable and that it would exceed the cost of providing resources to SEC to conduct additional examinations of investment advisers to private funds.[36] Data from two of the more recently

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[34]See SEC, Division of Investment Management, *Study on Enhancing Investment Adviser Examinations*.

[35]Neither the Securities Exchange Act nor the Maloney Act compelled broker-dealers to become SRO members. In 1978, Congress amended the Commodity Exchange Act to permit NFA to require mandatory membership. Similarly in 1983, Congress amended the Securities Exchange Act to impose compulsory SRO membership on broker-dealers. According to SEC, before the 1983 change, certain broker-dealers were allowed to choose between direct SEC oversight and NASD oversight. This SEC program, known as SEC Only, was designed to provide participating firms with a regulatory alternative to NASD. When SEC ended the program, also in 1983, the House Committee on Energy and Commerce reported that the program was unnecessarily costly and diverted SEC's limited resources away from areas of major concern, merely to duplicate the functions of NASD. See SEC, *Concept Release Concerning Self-Regulation*, Release No. 34-50700, 69 Fed. Reg. 71256, 71267 (Dec. 8, 2004).

[36]According to FINRA's *2009 Annual Report*, its total operating expenses were nearly $877 million, and it oversaw around 4,700 brokerage firms, 167,000 branch offices, and 633,000 registered securities representatives, and employed about 2,800 persons. In comparison, NFA's *2009 Annual Report* states that its total operating expenses were nearly $40 million, and it oversaw around 4,200 firms and 55,000 associates and employed about 270 persons.

created SROs show that their start-up costs varied considerably. According to the Public Company Accounting Oversight Board's *2003 Annual Report*, the board's start-up costs were about $20 million dollars. In contrast, NFA officials told us they used around $250,000 to fund NFA's start-up in the early 1980s.[37]

Another challenge that a private fund adviser SRO could face is establishing and reaching agreement on matters involving the SRO's organization, including its fee and governance structures. In particular, representatives from industry associations told us that the concentration of assets under management in a small number of large firms may make reaching an agreement on how to assess fees difficult. For example, representatives from one industry association said this condition could present challenges in formulating a fee structure that does not impose too much of a financial burden on smaller advisers or allocate an inequitable share of the fees to the largest advisers. In addition, if the SRO were modeled after FINRA or NFA, it would need to create, among other things, a board of directors to administer its affairs and represent its members. Private funds advisers differ in terms of their business models, investment strategies, and amounts of assets under management. According to several industry associations and firms, such diversity means that each group's interests may differ from each other, making it difficult to reach key agreements. For example, industry associations said that, among other things, the diversity of the industry with respect to investment strategies and assets under management may make reaching agreement on the allocation of board seats a challenge. More specifically, one industry association stated that the larger firms, if required to pay a large portion of the SRO's costs, may also want, or develop greater influence over the SRO's activities.[38] Furthermore, CFTC staff told us that reaching agreements could be complicated by the competitiveness of private fund advisers with each other and their general unwillingness to

[37]We recognize that a private fund adviser SRO could differ considerably from the SROs used in the examples. As a result, these examples may not be illustrative of the range of start-up costs for a private fund adviser SRO.

[38]As private fund advisers have been exempt from registration with SEC, data on the number of these advisers, the size of their funds, or the size of the industry as a whole do not exist. However, hedge fund associations we spoke with noted that parts of the private fund industry are concentrated. For example, as of the second quarter of 2010, approximately 86 percent of hedge fund assets under management were controlled by approximately 16 percent of private fund adviser firms, according to Hedge Fund Research, Inc.

share their data with each other. According to officials from NFA, which today has a membership of about 4,000 firms and six different membership categories, it took nearly 7 years for the various parties to reach all of the necessary agreements.

A private fund adviser SRO may also face challenges in developing, adopting, and enforcing member compliance with its rules, if given rulemaking authority similar to that of FINRA. According to SEC staff and industry representatives, FINRA, like other SROs, traditionally has taken a rules-based approach to regulating its members—adopting prescriptive rules to govern member conduct, particularly interactions between member broker-dealers. Representatives from one industry association told us that SROs traditionally use a rules-based approach, in part, to address the inherent conflicts of interest that exist when an industry regulates itself by minimizing the degree of judgment an SRO needs to use when enforcing its rules, thereby serving to enhance the credibility of self-regulation. In contrast, SEC staff and industry representatives told us that the regulatory regime for investment advisers is primarily principles-based, focusing on the fiduciary duty that advisers owe to their clients.[39] The fiduciary duty has been interpreted through, among other things, case law and enforcement actions (and not defined by rules), and depends on the facts and circumstances of specific situations. According to SEC staff and industry representatives, adopting detailed or prescriptive rules to capture every fact and circumstance possible under the fiduciary duty would be difficult. Further, NASAA officials and industry representatives stated that attempting this approach could result in loopholes that would weaken the broad protections investors are currently afforded. Moreover, SEC staff and some industry representatives told us that the diversity among the different advisers would also make it difficult to adopt a single set of rules for all advisers. For example, SEC staff stated that because of the complex nature of hedge funds (such as their changing investment strategies), regulations will need to be constantly monitored for effectiveness and updated as needed; and as such, it may not be feasible to adopt detailed or prescriptive rules.

Like private fund advisers, SROs, and other financial industry regulators, a private fund adviser SRO could face a challenge in attracting, hiring, and retaining qualified personnel. According to industry representatives,

[39]SEC staff also noted SEC promulgates rules regarding investment advisers under the Advisers Act.

no organization other than SEC has experience and expertise regulating investment advisers. Private fund advisers told us that an SRO would have to compete with private fund advisers and other financial services firms for the limited number of individuals with the skills needed to establish or assess compliance with federal securities laws. For example, as registered investment advisers, private fund advisers may need to hire staff, including a chief compliance officer, to comply with SEC regulations requiring advisers to have effective policies and procedures for complying with the Advisers Act.[40] According to two industry participants, the Dodd-Frank Act will likely further increase the need for individuals with these skills at various types of financial services firms as more entities are brought under regulation and additional requirements are placed on regulated firms. In addition to private entities, an SRO would be competing with SEC for these individuals. For example, SEC has estimated that it will need to hire about 800 staff over the next several years—contingent on its budget requests—to help implement its regulatory responsibilities under the Dodd-Frank Act.

Some of the challenges of forming a private fund adviser SRO may be mitigated if the SRO were formed by an existing SRO, such as FINRA, but other challenges could remain. Representatives from FINRA, NFA, and an industry association told us that an existing SRO may have access to internal funds to help finance the start-up costs of a private fund adviser SRO. An existing SRO also may have in place the necessary offices and other infrastructure. Finally, FINRA officials said that an existing SRO may be able to leverage some of its staff and staff development programs. At the same time, however, a few of the representatives from industry associations we spoke with said that even an existing SRO would face start-up challenges. They told us that an existing SRO would still face the challenges of hiring new staff or training existing staff to examine advisers for compliance with the Advisers Act, given that no SRO currently has such responsibility and skills. Moreover, they said that an existing SRO would also face challenges reaching agreement on, among other things, the SRO's governance structures.

[40]See SEC, *Compliance Programs of Investment Companies and Investment Advisers*, Release Nos. IA-2204, IC-26299, 68 Fed. Reg. 74714 (Dec. 24, 2003).

Although a Private Fund Adviser SRO Could Help Address SEC's Examination Capacity Challenges, It Would Involve Trade-offs

Under Title IV of the Dodd-Frank Act, SEC is required to assume oversight responsibility for certain investment advisers to private funds. According to SEC staff, the agency plans to examine registered private fund advisers through its investment adviser examination program, as it has done in the past, and has taken steps to handle the increased number of examinations of such advisers. These steps include providing training on hedge and private equity funds, identifying staff with private fund experience or knowledge, prioritizing the hiring of candidates with private fund experience, and bringing in outside experts to educate staff about private fund operations. However, SEC staff's section 914 study reported that without a stable and scalable source of funding that could be adjusted to accommodate growth in the industry, SEC likely will not have sufficient capacity in either the near or long term to effectively examine registered investment advisers with adequate frequency.[41] We have also previously found that SEC's examination resources generally have not kept pace with increases in workload, which have resulted in substantial delays in regulatory and oversight processes.[42] In addition, we have previously reported that, in light of limited resources, SEC has shifted resources away from routine examinations to examinations of those advisers deemed to be of higher risk for compliance issues.[43] One trade-off to this approach we identified was that it may limit SEC's capacity to examine funds considered lower risk within a 10-year period.[44]

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[41]SEC, Division of Investment Management, *Study on Enhancing Investment Adviser Examinations*.

[42]GAO, *SEC Operations: Increased Workload Creates Challenges,* GAO-02-302 (Washington, D.C.: Mar. 5, 2002).

[43]GAO, *Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent*, GAO-07-1053 (Washington, D.C.: Aug. 14, 2007).

[44]GAO, *Mutual Fund Industry: SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain,* GAO-05-415 (Washington, D.C.: Aug. 17, 2005).

While a Private Fund Adviser SRO Could Help Address SEC's Examination Capacity Challenges, It Would Involve Trade-offs

According to securities regulators and industry representatives, a private fund adviser SRO could offer a number of advantages and disadvantages. A private fund adviser SRO could offer the advantage of helping augment SEC's oversight of registered private fund advisers and address SEC's examination capacity challenges. Through its membership fees, an SRO could have scalable and stable resources for funding oversight of its member investment advisers. As noted by SEC staff in its section 914 study, an SRO could use those resources to conduct earlier examinations of newly registered investment advisers and more frequent examinations of other registered investment advisers than SEC could do with its current funding levels. As evidence of this possibility, SEC staff cited FINRA's and NFA's abilities to examine a considerably larger percentage of their registrants in the past 2 years compared with those of SEC.[45] In addition, an SEC commissioner stated that an SRO would have the necessary resources to develop and employ technology to strengthen the examination program, provide the examination program with increased flexibility to address emerging risks associated with advisers, and direct staffing and strategic responses that may help address critical areas or issues.[46]

While a private fund adviser SRO could help augment SEC's oversight, its creation would involve trade-offs in comparison to direct SEC oversight. Many of the advantages and disadvantages of a private fund adviser SRO are similar to those of any type of SRO, which have been documented by us, SEC, and others.[47] Advantages of a private fund adviser SRO include its potential to (1) free a portion of SEC's staff and

[45]According to the section 914 study, SEC examined 13 percent of the 11,294 and 11 percent of the 11,452 registered investment advisers in 2008 and 2009, respectively. FINRA examined 57 percent of its 5,564 and 54 percent of its 5,272 member broker-dealers during the same years, respectively. According to NFA officials, NFA examined 28 percent of its 481 and 32 percent of its 460 active commodity trading adviser members in 2008 and 2009, respectively. Similarly, during the same years, NFA examined 33 percent of its 727 and 30 percent of its 656 active commodity pool operator members.

[46]SEC Commissioner Elisse B. Walter, *Statement on Study Enhancing Investment Adviser Examinations*, January 2011.

[47]See, for example, GAO, *Investment Advisers: Current Level of Oversight Puts Investors at Risk*, GAO/GGD-90-83 (Washington, D.C.: June 26, 1990); SEC, Division of Investment Management, *Study on Enhancing Investment Adviser Examinations,* SEC*, Compliance Programs of Investment Companies and Investment Advisers*; and letters to SEC on its section 914 study found at (http://www.sec.gov/comments/df-title-ix/enhancing-ia-examinations/enhancing-ia-examinations.shtml) (accessed May 18, 2011).

resources for other purposes by giving the SRO primary examination and other oversight responsibilities for advisers that manage private funds, (2) impose higher standards of conduct and ethical behavior on its members than are required by law or regulations, and (3) provide greater industry expertise and knowledge than SEC, given the industry's participation in the SRO. For example, according to FINRA officials, the association, as an SRO, is able to raise the standard of conduct in the industry by imposing ethical requirements beyond those that the law has established or can establish. In doing so, FINRA can address dishonest and unfair practices that might not be illegal but, nonetheless, undermine investor confidence and compromise the efficient operation of free and open markets. Some of the disadvantages of a private fund adviser SRO include its potential to (1) increase the overall cost of regulation by adding another layer of oversight; (2) create conflicts of interest, in part because of the possibility for self-regulation to favor the interests of the industry over the interests of investors and the public; and (3) limit transparency and accountability, as the SRO would be accountable primarily to its members rather than to Congress or the public. For example, an SRO would have primary oversight for it members, but SEC currently conducts oversight examinations of a select number of FINRA members each year to assess the quality of FINRA's examinations. Although these examinations serve an oversight function, we previously have found that they expose firms to duplicative examinations and costs.[48]

A Private Fund Adviser SRO Would Fragment Investment Adviser Oversight, Which Could Have Implications for Its Potential Advantages and Disadvantages

SEC staff told us that estimating the extent to which, if any, a private fund adviser SRO would reduce the agency's resources burden is difficult, given the hypothetical nature of such an SRO. Nonetheless, available information suggests that a private fund adviser SRO may free little, if any, SEC staff and resources for other purposes. Although SEC does not collect specific data on the number of investment advisers that have private fund clients, as discussed earlier, its staff estimate that 2,761 of the 11,505 registered investment advisers (as of April 1, 2011) report having private funds as one or more of its types of clients. If, for example, a private fund adviser SRO were limited to those advisers with only private fund clients and were to have primary responsibility for examining its members, it could relieve SEC from having to examine approximately 863 advisers. However, SEC still would have oversight responsibility for

[48]GAO-05-415.

over 10,600 registered investment advisers that do not solely advise private funds.[49] As a result, SEC may need to maintain much, if not most, of the resources it currently uses to oversee investment advisers because it would have oversight responsibility for the majority of the registered investment advisers, as well as the private fund adviser SRO. In contrast to a private fund adviser SRO, a broader investment adviser SRO could have primary responsibility for examining all of the 11,505 registered investment advisers, including private fund advisers, and thus reduce SEC's resource burden by a greater extent.

A private fund adviser SRO could also create regulatory gaps in the oversight of registered investment advisers. Representatives from an investment adviser firm told us that it is common for advisers with a large amount of assets under management to manage portfolios for institutional clients, mutual funds, and private funds. The investment personnel and support functions often overlap, and a single portfolio management team often manages all three types of client portfolios. According to securities regulators, industry representatives, and others, if a private fund adviser SRO's jurisdiction was limited to only an adviser's private fund activities, the SRO would not be able to oversee and understand the full scope of activities of advisers with private fund and other clients. For example, representatives from an industry association told us that advisers typically maintain policies and procedures to allocate grouped trades (such as shares of an initial public offering) fairly among clients and avoid providing preferential treatment to a fund that pays performance fees at the expense of a fund that does not. An SRO with jurisdiction over only an adviser's private fund activities might not be able to detect trade allocation abuses involving an adviser's private fund and other clients. In such a case, SEC would be responsible for detecting such abuse and, therefore, may need to examine an investment adviser's relationship with its private fund clients—which could duplicate the SRO's efforts.

In addition, a private fund adviser SRO could create conflicting or inconsistent interpretations of regulations. The formation of a private fund

[49]These estimates are based on data as of April 1, 2011. When the Dodd-Frank Act's new registration provisions take effect, the composition of investment advisers registered with SEC will change—reducing the number of registered investment advisers and changing the number of registered investment advisers with private fund clients. See the background section of this report for a more detailed discussion of the change in composition.

adviser SRO would result in the SRO overseeing investment advisers to private funds and SEC overseeing all other investment advisers. A securities regulator, industry representatives, and others told us that through examinations or enforcement actions, a private fund adviser SRO could interpret a regulation one way for its members, but SEC could interpret the same regulation another way for advisers that are not members of the SRO. Furthermore, for advisers with both private fund and other clients, if the SRO's jurisdiction were limited to an adviser's private fund activities, the opportunity would exist for the SRO to interpret a regulation one way for the adviser with respect to its private fund clients and for SEC to interpret the regulation a different way for the same adviser with respect to its other clients. Representatives from an industry association commented that SEC would have to spend significant amounts of time ensuring that the SRO and SEC staffs are applying the rules consistently among similar situations and circumstances, which would include writing guidance on interpretations beyond what is normally done.

Finally, a private fund adviser SRO could result in duplicative examinations of investment advisers. As discussed earlier, many advisers with large portfolios manage assets for multiple types of clients, such as private and mutual funds, and have certain functions that serve all of their clients. According to securities regulators and industry representatives, for such advisers, their shared functions could be examined by both SEC and a private fund adviser SRO, if the SRO's jurisdiction was limited to an adviser's private fund activities. For example, the SRO could examine an adviser to ensure that it complied with its trade allocation policies and procedures for trades executed on behalf of its private funds, and SEC could examine the same policies and procedures to ensure that the adviser complied with them for trades executed on behalf of the adviser's other clients. These advisers could then be reexamined through SEC's oversight examinations.

As required by the Dodd-Frank Act, SEC is taking steps to assume responsibility for registering and overseeing certain investment advisers to private funds. However, in its section 914 study, SEC staff concluded that the agency likely will not have sufficient capacity to effectively examine registered investment advisers, including private fund advisers, with adequate frequency. A private fund adviser SRO is one of several options that could be implemented to help address SEC's examination capacity challenges. However, doing so would involve trade-offs, including lessening SEC's capacity challenges versus increasing potential regulatory gaps, inconsistencies, and duplication in the oversight of registered investment advisers. As recommended by SEC staff in its recent study, other options to address SEC's capacity challenges include creating an SRO to examine all registered investment advisers or imposing user fees on advisers to fund SEC examinations. Like the private fund adviser SRO option, these two options would involve trade-offs that would have to be considered.

Agency Comments and Our Evaluation

We provided a draft of this report to SEC. SEC staff provided technical comments, which we incorporated, as appropriate.

We are sending copies of this report to SEC, interested congressional committees and members, and others. The report also is available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact me at (202) 512-8678 or clowersa@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.

A. Nicole Clowers
Director
Financial Markets and
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Appendix I: Scope and Methodology

The objectives of this report were to examine (1) the feasibility of forming and operating a private fund adviser self-regulatory organization (SRO), including the actions that would need to be taken and challenges that would need to be addressed, and (2) the potential advantages and disadvantages of a private fund adviser SRO. Although the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directs us to assess the feasibility of forming an SRO for private funds, our study focuses on an SRO for private fund advisers. As discussed with congressional staff, the term "private funds," as used in section 416 of the Dodd-Frank Act, was intended to refer to private fund advisers. The Dodd-Frank Act amends the federal securities laws to require certain advisers to private funds, not the funds themselves, to register with the Securities and Exchange Commission (SEC). Securities SROs serve to help enforce the federal securities laws applicable to their members. An SRO for private funds (not advisers) would not serve that purpose, because private funds could continue to qualify for exclusions from registering with SEC and thus would not generally be subject to the federal securities laws.

To focus our discussions with regulators, industry associations, and observers on the feasibility, associated challenges, and advantages and disadvantages of a private fund adviser SRO, we generally predicated our discussions on the assumption that such an SRO would be similar in form and function to the Financial Industry Regulatory Authority (FINRA).

To address both objectives, we analyzed the Securities Exchange Act of 1934, Sarbanes-Oxley Act of 2002, and Commodity Exchange Act to identify characteristics of the various types of existing SROs, including their registration requirements, regulatory functions, and oversight framework.[1] In addition, we reviewed past regulatory and legislative proposals for creating an SRO to oversee investment advisers or funds, relevant academic studies, SEC staff's *Study on Enhancing Investment Adviser Examinations* (as mandated under section 914 of the Dodd-Frank Act) (section 914 study), and related material to gain insights on the potential form and functions of a private fund adviser SRO. We did not evaluate the findings of the study or the staff's conclusions regarding the investment advisers examination program. We also reviewed letters

[1] 15 U.S.C. §§ 78a – 78pp; 15 U.S.C. §§ 7201 – 78d-3, 18 U.S.C. §§ 1519, 1520, 1514A, 1348-1350; 7 U.S.C. §§ 1-26.

received by SEC in connection with its section 914 study, comment letters on past proposals for an investment adviser or fund SRO, and other material to document the potential challenges in—and advantages and disadvantages of—creating a private fund adviser SRO.

We obtained information on the number of registered investment advisers from SEC based on information in the Investment Adviser Registration Depository, as of April 1, 2011. Using this database, SEC provided us estimates of the number of advisers with only private fund clients and the number of advisers with private fund and other types of clients. SEC staff derived these estimates based on information from Form ADV—the uniform form that is used by investment advisers to register with SEC, which requires information about, among other things, the investment adviser's business and clients. Form ADV does not currently include a specific question on whether the adviser is an adviser to private funds. To estimate the number of advisers that potentially advise private funds, SEC includes the number of advisers whose response to Form ADV's Item 7.B equaled "yes" and Item 5.D(6) is not 0 percent. Item 7.B asks the investment adviser whether it or any related person is a general partner in an investment-related limited partnership or manager of an investment-related limited liability company, or whether it advises any other "private fund," as defined under SEC rule 203(b)(3)-1. Item 5.D(6) asks the adviser to identify whether it has other pooled investment vehicles (e.g., hedge funds) as clients and if so to indicate the approximate percentage that these clients comprise of its total number of clients. We attribute these estimates to SEC even though we were able to replicate their estimates using these procedures. We found these figures to be sufficiently reliable for the purposes of showing estimated numbers of registered investment advisers serving private clients.

We interviewed regulators, including SEC, the Commodity Futures Trading Commission, FINRA, and the National Futures Association. We also interviewed representatives from the following 10 relevant industry associations representing investment advisers and private or other types of funds. Representatives of 17 advisory firms and/or investors in private funds who were members of some of these associations also participated in the interviews.

- Alternative Investment Management Association
- Association of Institutional Investors
- Coalition of Private Investment Companies

- Financial Services Institute
- Hedge Fund Association
- Investment Adviser Association
- Investment Company Institute
- Managed Funds Association
- North American Securities Administrators Association
- Private Equity Growth Capital Council.

To gather a diverse set of perspectives, we identified industry associations representing various types of investment funds, advisers, and investors in private funds by reviewing letters received by SEC in connection with its section 914 study and previous concept releases about an investment adviser SRO. We also drew upon our institutional knowledge. In addition, we interviewed market observers including a compliance consultant firm that provides these services to the financial services industry, and two law professors who have written papers on the potential use of an SRO to oversee investment companies and one whose paper focused on an SRO for hedge funds.

We conducted this performance audit from August 2010 through July 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the individual named above, Richard Tsuhara, Assistant Director; Rudy Chatlos; Matthew Keeler; Marc Molino; Josephine Perez; Robert Pollard; Linda Rego; and Jennifer Schwartz made major contributions to this report.

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