GAO

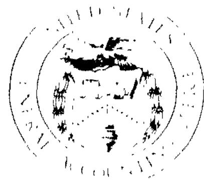
United States General Accounting Office

Report to Congressional Requesters

June 1990

# INVESTMENT ADVISERS

# Current Level of Oversight Puts Investors at Risk



GAO/GGD-90-83

**United States**
**General Accounting Office**
**Washington, D.C. 20548**

**General Government Division**

B-236244

June 26, 1990

The Honorable Edward J. Markey
Chairman, Subcommittee on
Telecommunications and Finance
Committee on Energy and Commerce

The Honorable Dennis E. Eckart
Chairman, Subcommittee on Antitrust,
Impact of Deregulation and
Privatization
Committee on Small Business

The Honorable Rick Boucher
Subcommittee on Telecommunications
and Finance
Committee on Energy and Commerce
House of Representatives

This report responds to your June 13, 1989, request to evaluate the Securities and Exchange Commission's (SEC) regulation of investment advisers. The report offers recommendations to SEC as well as some matters for congressional consideration.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to SEC, the Director of the Office of Management and Budget, appropriate congressional committees, and other interested parties.

Major contributors to the report are listed in appendix II. If you have any questions on this report, please call me on 275-8678.

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

# Executive Summary

## Purpose

In these complex economic times, more and more people seek advice from investment advisers and financial planners on how to invest their money for such purposes as generating retirement income or financing their children's education. Investment advisers are regulated by the Securities and Exchange Commission (SEC). Since 1980, the number of advisers has tripled from about 4,600 to about 14,000, and the assets they manage have increased 10-fold from about $440 billion to about $4.6 trillion. During the same period, SEC resources available to regulate the industry have increased much less, and SEC officials have expressed concern about their continued ability to regulate the industry. Few reliable studies have been done to determine the amount of fraud and abuse in the industry. Although estimated losses ranging from about $90 million to $200 million a year are low compared to the amount of assets managed, observers point out that many cases of fraud and abuse go unreported because, among other reasons, people are embarrassed when they lose their money.

GAO was asked to evaluate the regulation of investment advisers. As agreed with the requesting subcommittees, GAO examined (1) the adequacy of SEC requirements and procedures for registering investment advisers, (2) the capability of SEC inspections of investment advisers to ensure compliance with statutory and regulatory requirements, and (3) the feasibility of establishing a self-regulatory organization, as SEC has proposed, to monitor activities performed by investment advisers.

## Background

The Investment Advisers Act of 1940 defines an investment adviser as any firm or individual who, for compensation, is engaged in the business of providing advice to others regarding securities or who issues reports or analyses regarding securities. Investment advisers are required to register with SEC. The term "financial planner" is also used in practice to describe an individual who provides investment advice. Although financial planners may not necessarily provide securities advice and thus may not be subject to SEC regulation, both SEC and representatives of the financial planning industry said that in practice most financial planners do provide securities advice and, therefore, are subject to SEC regulation. Thus, GAO did not differentiate between investment advisers and financial planners covered by the act for purposes of this report.

SEC's regulatory program includes a registration process and periodic inspections of advisers. SEC regulates investment advisers to assure that they provide potential investors accurate and complete information about their background, experience, and business practices and that

they comply with the act and related rules. GAO analyzed a random sample of investment adviser registration and inspection records in four SEC regions.

## Results in Brief

SEC's oversight of investment advisers provides investors little assurance that the information they receive from advisers is accurate or that advisers operate in accordance with the requirements of the 1940 act and SEC regulations. So far, the effects of the current regulation, as measured by the amount of fraud and abuse detected and reported, have not been very evident. However, the 3-fold increase to about 14,000 in the number of people providing advice and the 10-fold increase to about $4.6 trillion in the amount of assets they manage raises both the risk that fraud and abuse will occur and the potential that any amounts lost could be large. If the oversight program is not improved, the 1940 act may be doing more harm than good by giving investors the illusion that SEC-registered advisers have a "seal of approval."

Whether the federal government continues to regulate investment advisers either directly through SEC or indirectly through a self-regulatory organization, registration and inspection program enhancements are needed to protect the investing public.

## Principal Findings

### Regulation of Investment Advisers Could Be Improved

Abuses by investment advisers can have devastating effects. One investor lost her life savings of $60,000 despite determining from SEC that her adviser was registered. (See p. 19.)

To register as investment advisers, individuals or firms must pay a one-time $150 fee and submit applications that include the specific information they plan to disclose to the customer. SEC reviews the applications only to assure that advisers provide all requested information. SEC does not evaluate adviser competence. None of the information submitted is verified as correct during registration except information concerning SEC disciplinary history. (See pp. 17-18.)

SEC inspects advisers to assure that advisers (1) operate according to the business practices they espouse, such as how fees are charged; (2) disclose these business practices and their background to prospective

investors; and (3) comply with applicable laws and regulations. SEC inspections of advisers usually first occur an average of about 3 years after registration, if at all. However, almost 60 percent of the advisers who had been registered for more than 1 year that GAO reviewed had never been inspected. (See pp. 19-22.)

When advisers are inspected, SEC usually finds such problems as inadequate disclosure or recordkeeping deficiencies. However, SEC officials said that it does little follow-up to ensure that the deficiencies are corrected. Also, SEC has no comprehensive information system to provide summary information on inspection results. Such a system could help develop a cycle for periodic reinspection that is based on the risks advisers pose to investors. (See pp. 22-24.)

SEC officials said that they do not have the resources necessary to adequately regulate the advisory industry. However, SEC has not determined the amount of resources needed primarily because it has no way to determine how often advisers should be inspected. The frequency of inspection could be related to the risk to clients posed by individuals or groups of advisers based on factors such as previous inspection results. (See pp. 23-26.)

## Self-Regulation of Investment Advisers Proposed

SEC submitted a legislative proposal to Congress in June 1989 calling for a self-regulatory organization for investment advisers. A 1987 study showed that a self-regulatory organization would have the capability to regulate investment advisers. Some industry officials said that if SEC had adequate resources, SEC could regulate the industry more effectively than a self-regulatory organization.

However, for a self-regulatory organization to be effective, several issues must be resolved, such as the potential additional administrative costs that advisers and their clients would have to pay and the effect of self-regulation on small advisers. Whatever the method of regulation, SEC should ensure the enhancements GAO recommends to the registration and inspection programs are included as part of the oversight program. (See pp. 28-37.)

## Congressional Proposal Would Supplement Federal Regulation of Advisers

Given the potential for fraud and abuse in the advisory industry, some Members of Congress have proposed an amendment to the 1940 act (H.R. 4441) to provide better investor protection. This amendment would require anyone providing investment advice to register with SEC

and makes specific advisers' requirements to provide clients accurate information. It would also create a private right of action to enable customers to sue for damages when they sustain losses because of violations of the act. This proposal, if adopted, would represent another way to police compliance with the act. (See pp. 33-34.)

## Matters for Congressional Consideration

Congress is already considering amendments to the 1940 act which would improve investor protection by requiring investment advisers to disclose accurate and complete information and by giving investors a private right of action against advisers who violate the act's requirements. In addition, given the limited protection provided by the existing federal oversight program, Congress should either take action to strengthen the program or consider repealing the requirements for federal regulation of investment advisers. If Congress decides to strengthen the regulatory program it can do so by establishing one or more self-regulatory organizations or by providing SEC additional resources. Regardless of which approach is adopted, the enhancements to the registration and inspection programs GAO recommends should be included. (See p. 36.)

## Recommendations

To improve oversight of investment advisers and provide investors at least minimum assurance that their decisions about advisers are based on accurate information, GAO recommends specific enhancements to the registration and inspection programs. These include verifying information before registering advisers; warning investors that registration is limited to disclosing information and business practices and not to evaluating adviser competence; and inspecting each new adviser within a reasonable time, such as within 1 year after registration, and periodically thereafter based on risk.

Whether the federal government continues to regulate investment advisers either directly by SEC or indirectly through a self-regulatory organization, GAO recommends that the Chairman, SEC, ensure that these enhancements are included as part of the oversight program. (See pp. 36-37.)

## Agency Comments

GAO provided copies of a draft of this report to SEC for written comment (see app. I). In general, SEC supports the recommendations because they would improve SEC's oversight of investment advisers. However, SEC said

implementing the recommendations would require more than triple the staff now assigned to regulate investment advisers.

GAO agrees that the enhanced oversight program recommended may increase some costs under the current structure. However, the recommended enhancements are the minimum necessary to meet the legislative requirement for investor protection. Total program cost cannot be accurately estimated until Congress and SEC make policy decisions on which method of industry oversight should be used and what level of resources is appropriate for the chosen approach. (See p. 37.)

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### Abbreviations

| | |
|---|---|
| FBI | Federal Bureau of Investigation |
| NASD | National Association of Securities Dealers |
| SEC | Securities and Exchange Commission |
| SRO | Self-regulatory organization |

# Introduction

Because the numbers and types of investment instruments available have increased, more and more individuals are choosing to seek investment advice. Many of these individuals are parents saving for their children's college education, couples planning for retirement, and widows with inheritances. Since 1980, the number of registered investment advisers has more than tripled from about 4,600 to about 14,000 and the assets they manage have increased 10-fold to about $4.6 trillion. These assets amount to nearly 25 percent of all financial assets owned by Americans. Few reliable studies have been done to determine the amount of fraud and abuse in the industry. Although estimated losses ranging from about $90 million to $200 million a year are low compared to the amount of assets managed, observers point out that many cases of fraud and abuse go unreported because, among other things, people are embarrassed when they lose their money.

The growth in the investment advisory industry, the amount of funds involved, and the increasing complexity of financial products have caused increasing concern about the Securities and Exchange Commission's (SEC) ability to regulate the advisory industry without a corresponding growth in resources. The number of field inspectors at SEC responsible for doing investment adviser inspections has remained constant at about 41 positions since 1980.

The definition of an investment adviser in the Investment Advisers Act of 1940 as amended is lengthy and complex and contains a number of exceptions. However, the act generally defines an adviser as any individual or firm who receives compensation for giving advice, making recommendations, issuing reports, or furnishing analyses on securities either directly or through publications. Individuals or firms meeting this definition must register with SEC and are subject to SEC regulation. Some investment advisers also call themselves financial planners. Although there is no statutory definition of a financial planner, an SEC official said that most persons engaged in financial planning give advice to their clients about securities and, therefore, are subject to SEC regulation. In addition, SEC and industry officials said that the investing public does not make any distinction between an investment adviser and a financial planner. Thus, we did not differentiate between investment advisers and financial planners covered by the act for purposes of this report.

## Background

The act requires investment advisers to disclose their background and business practices and to adhere to the high standards of honesty and loyalty expected of a fiduciary. In passing the act, Congress recognized

the fiduciary nature of the advisory relationship and the need to eliminate or disclose all conflicts of interest that could cause advisers to render less than impartial advice. The act was also influenced by an SEC study that concluded that investment advisers could not perform their function unless conflicts of interest between them and their clients were removed. The study emphasized that a significant problem in the industry was the existence of prejudice by advisers in favor of their own financial interest. For example, an adviser could encourage a client to purchase a product that would not be the best option for the client but would generate the greatest profits for the adviser.

Investment advisers offer a variety of services. These services include supervising individual clients' portfolios, publishing periodic market reports for subscribers, and selling financial products. Investment advisers give advice concerning insurance, taxes, real estate, and other financial matters. Advisers also develop plans for their clients to achieve such goals as saving for retirement, reducing taxes, and providing for their children's education. The plans may include recommendations about budgeting, appropriate levels and types of insurance coverage, the need for tax and estate planning, as well as recommendations for suitable types of investments. Advisers' clients include pension/profit sharing plans, banks, and investment companies, but the most common client is an individual seeking investment advice.

The size of investment adviser firms and their affiliations can range from single advisers operating as sole proprietors to large multi-office firms with thousands of employees. According to SEC, approximately 95 percent of registered advisers are firms with fewer than 10 employees.

The amount of money investors lose each year due to improprieties by investment advisers and financial planners is difficult to determine, but abuse appears to be on the rise. Although precise figures are unavailable for the investment advisory industry as a whole, estimates are available for abuse by financial planners. The North American Securities Administrators Association reported in 1985 that annual losses were $91 million. In a July 1988 study, the Association reported losses of about $200 million a year as a result of fraud and abuse in the financial planning industry between mid-1986 and mid-1988.

Fraud and abuse by investment advisers can occur in different ways. For example, in May 1989, an adviser pleaded guilty to charges of mail, wire, and securities fraud arising from a scheme to defraud clients out of $3 million. From early 1986 through 1988, the adviser encouraged

clients to invest money by promising to purchase stocks on their behalf and manage their investments. Instead, the adviser did not invest the clients' money as promised and made up excuses for not providing clients any returns on their investments. In another case, an investment advisory firm misled investors about investments and misappropriated client funds. According to the SEC, the firm falsely told investors that proceeds from bond sales would be used for commercial lending. In fact, the funds were used to retire the pre-existing debt of one company and to fund other companies owned by the owner of the advisory firm. The advisory firm also misappropriated at least $22,500 of clients' funds to pay its own operating expenses.

## Regulation of Investment Advisers

The act requires investment advisers to register with SEC and conform their activities to statutory standards designed to protect investors' interest. SEC regulates investment advisers through its registration and inspection processes. The purpose of SEC's program is to assure that advisers provide potential investors accurate and complete information about their background and business practices and conform to applicable laws and regulations.

SEC regulates investment advisers through its headquarters and its regional offices. The Division of Investment Management in Washington, D.C., is primarily responsible for the overall regulation of investment advisers. The Office of Applications and Reports Services is responsible for processing investment adviser registration applications, as well as reviewing any amendments and required annual reports submitted by advisers. SEC's regional offices are responsible for inspecting investment advisers. Although headquarters provides general guidance on selecting advisers for inspection, the regional offices have primary responsibility for selecting which advisers to inspect.

In addition to SEC regulation, most states regulate investment advisers' securities activities under state securities laws. Our survey of state regulators showed that 39 out of the 47 respondents had some form of regulation.

## Objectives, Scope, and Methodology

In their June 13, 1989, letter the Chairman and one member of the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, and the Chairman of the Subcommittee on Antitrust, Impact of Deregulation and Privatization, House Committee on

Small Business, requested that we evaluate SEC's regulation of investment advisers and the enforcement of advisers' responsibilities to protect investors. Specifically, as agreed with the Subcommittees, we examined

- the adequacy of the requirements and procedures for registering investment advisers,
- the capability of SEC inspections of investment advisers to ensure compliance with statutory and regulatory requirements, and
- the feasibility of establishing a self-regulatory organization to monitor activities performed by investment advisers.

We also agreed to do our field work at four SEC regions. We selected the Chicago, Los Angeles, and New York regions because they have the highest number of registered advisers. Collectively, these three regions account for 55 percent of the total advisers registered with SEC. We also selected the Denver region because the Director of SEC's Division of Investment Management said that this region has not experienced the staffing problems that other regions have. We sent a questionnaire to the securities administrators of all 50 states and the District of Columbia to obtain information about their regulatory programs and their views on SEC proposals relating to state regulation of investment advisers. We received 47 responses from 46 states and the District of Columbia. We provided copies of a draft of this report to SEC for formal review and comment. SEC's comments and our evaluation are summarized at the end of chapter 4; SEC's comment letter and our more detailed analysis are contained in appendix I. We did our work between June 1989 and October 1989, using generally accepted government auditing standards.

## Assessing Registration Requirements

To determine the adequacy of current requirements for registering investment advisers, we reviewed the act's provisions relating to registration and interviewed SEC officials on the current requirements. We also interviewed officials from selected organizations representing investment advisers and financial planners, to determine their membership requirements and views on the federal registration requirements for investment advisers.

## Assessing Inspections of Advisers

To assess whether SEC inspections of investment advisers ensure advisers' compliance with statutory and regulatory requirements, we reviewed SEC's criteria for selecting advisers for inspection, the frequency of inspections, and the procedures for monitoring deficiencies

identified during the inspections. We interviewed SEC headquarters and regional officials responsible for the investment adviser program and officials from selected investment adviser and financial planning organizations. We also asked the state securities administrators, in a questionnaire, about their inspection requirements, including the frequency of their inspections and the criteria used for selecting which advisers to inspect.

To determine how often advisers are inspected, we used a systematic random sampling technique to select a sample of investment advisers registered in each of the four regions we reviewed. We compared the date they registered with the dates SEC inspected them. We selected a total of 1,713 out of 9,023 registered investment advisers—381 in Chicago, 232 in Los Angeles, 447 in New York, and 653 in Denver. Sample sizes represented 12 percent of the total population in Chicago, 9 percent in Los Angeles, and 18 percent in New York. Because of the small population in Denver, we reviewed all registered advisers in that region. Our sampling methodology allows us to project our results to the universe of investment advisers in these four regions with a 95-percent level of confidence. Our overall sampling error rate is plus or minus 5 percent except where the rate differs as shown in figure 2.1.

We also analyzed SEC reports and documents pertaining to the manner in which advisers are selected for inspection and the process for monitoring deficiencies identified during inspections. Our intent was to determine the evidence SEC uses to develop criteria for inspection and to evaluate the effectiveness of the follow-up procedures that SEC uses to ensure that advisers correct deficiencies identified during the inspections.

## Assessing SEC's Proposals to Regulate Investment Advisers

SEC has proposed several alternatives that would change how investment advisers are regulated. We assessed the extent to which SEC has considered the advantages and disadvantages —including costs—of each alternative. We also identified concerns of the industry and state regulators about the various proposals and alternatives to the regulation of investment advisers through discussions with selected organizations within the investment advisory and financial planning industry and through the responses to our questionnaire.

## Sources of Information

To do our analyses, we reviewed relevant provisions of the Investment Advisers Act of 1940. We obtained and analyzed information from professional literature and reports on the regulation of investment advisers, statistics prepared by SEC and other regulatory agencies, discussions with SEC officials, and results of the responses we received from our questionnaire. We also obtained the views of other interested groups. The listing of sources follows:

- American Institute of Certified Public Accountants
- Consumer Federation of America
- Financial Analysts Federation
- Institute of Certified Financial Planners
- International Association of Financial Planning
- International Board of Standards and Practices for Certified Financial Planners, Inc.
- Investment Counsel Association of America
- National Association of Personal Financial Advisors
- National Association of Securities Dealers
- National Futures Association
- North American Securities Administrators Association, Inc.
- Securities Industry Association

# Regulation of Investment Advisers Needs Improvement

SEC is responsible for regulating investment advisers to assure that information provided to investors is accurate and complete and that the advisers adhere to business practices described in the material they submit to SEC and investors.[1] SEC's regulatory program consists primarily of registering advisers and inspecting their business operations. When a potential adviser applies for registration, SEC checks the application to see if all the information requested has been provided and checks its own records for information about previous securities regulatory violations. However, SEC does not attempt to verify any other information submitted and does not check for regulatory or criminal violations with other federal agencies, such as the Federal Bureau of Investigation (FBI) or the Commodity Futures Trading Commission. Also, SEC has no program to identify individuals and firms who have failed to register.

SEC inspections of investment advisers' operations are usually done an average of about 3 years after SEC grants registration, if at all. In addition, although SEC inspections usually find problems with advisers' business practices, SEC does almost no follow-up inspections to assure that deficiencies are corrected. SEC officials have reported that the increase in the number of investment advisers without a similar increase in the number of SEC inspector positions has made it difficult to regulate investment advisers. As a result, SEC and the public have little assurance that the information that investors receive from advisers is accurate or that advisers operate in accordance with the requirements of the law and regulations.

## SEC's Registration Program Needs Improvement

The primary purpose of SEC's registration program is to ensure that registered investment advisers have prepared accurate and complete information about their background and business practices to disclose to their potential clients. Regulations under the act require that investment advisers give potential clients disclosure statements concerning their business practices and offer to update this information for clients annually. However, SEC's registration program provides little protection for investors because (1) SEC does not verify the information to be provided to clients until long after advisers are registered and (2) SEC has no program to identify people who provide advice but never register. In addition, some clients may assume that registered advisers meet certain standards of competency.

[1] Business practices include how fees are charged and the types of investment advice advisers offer.

## Information Provided to Investors Should Be Verified

With the exception of disciplinary history from its own records, SEC verifies none of the information submitted by potential advisers on initial applications or amendments to the applications. Thus, investors have little assurance that the information advisers provide is accurate.

The Investment Advisers Act requires that individuals or firms who wish to practice as investment advisers register with SEC. Registration is designed to assure that advisers have prepared information about their educational and business background, business practices, and any potential conflicts of interest. The intent of the act was for investors to receive accurate information with which to make informed decisions when securing the services of advisers.

To register, individuals or firms must submit a $150 registration fee and an application containing basic information about themselves, as well as the package of information they plan to disclose to their clients. Any changes to this information or to an adviser's business plans must be submitted as amendments to the original registration information.

SEC's Office of Applications and Reports Services is responsible for reviewing investment adviser registration forms, annual reports, and amendments. The act requires SEC to grant registration within 45 days after the filing of the application or begin proceedings to deny it. SEC is to deny registration as an investment adviser if the applicant has been convicted of certain crimes involving securities or if the applicant has made false statements or material omissions in any application or report to SEC.

SEC examiners review registration forms to ascertain whether they are complete. Examiners verify the applicants' disciplinary history by checking SEC files to determine if the applicants have committed any securities-related violations. However, examiners do not have access to FBI files to check for felonies nor do they check with other federal agencies for possible related misconduct. Also, examiners do not verify the applicants' education and business background. A statement about the lack of verification appears in small print at the top of an information disclosure form that advisers must give to their potential clients. SEC officials said that the information is verified during inspection. However, the initial inspection may not occur for a number of years, if at all, as discussed later in this chapter.

SEC gives amendments to the original registration form only a cursory review. For example, examiners do not check SEC files for the disciplinary history of new individuals named in amendments. An official from the Office of Applications and Reports Services said the office has insufficient staff to review the large number of amendments filed each year. Advisers filed over 10,000 amendments in fiscal year 1988 alone.

## SEC Could Better Identify Unregistered Advisers

In addition to the improvements needed for registered advisers, SEC also needs to do more to identify firms and individuals who provide investment advice but who may not be registered at all. Certain financial planners and individuals in large firms are not required to register. With the exception of a limited Denver region survey, SEC headquarters and regional officials said they do not investigate the financial planning and advisory industry to determine whether unregistered individuals are providing investment advice.

Financial planners who do not provide advice on securities investments are not required by the Investment Advisers Act to register with SEC. However, SEC and financial planning organizations said that most financial planners could not perform their responsibilities unless they act as investment advisers as defined by the act. In July 1988, the Senate Committee on Banking, Housing, and Urban Affairs held hearings concerning financial planners. At the hearings, the Director of SEC's Division of Investment Management testified that most financial planners advise their clients on securities investments and, therefore, are required to register with SEC as investment advisers.

The International Association of Financial Planning estimated that between 100,000 and 300,000 financial planners operate in the United States. SEC officials said that they do not know how many of these financial planners are registered. In a limited check in Denver, SEC found 299 financial planners listed in the telephone book. Matching these names against those of registered advisers in Denver showed that about 150 of the 299 were not registered. Denver officials said they did not investigate further to determine how many of the 150 should have been registered. They said that the high cost involved in investigating the operations of each financial planner prohibited further investigation.

In addition to these financial planners, SEC also may not be aware of all employees giving investment advice in large advisory firms. The investment adviser registration application states that if more than five individuals in a firm give investment advice, only their supervisors are

required to be listed on the application. Therefore, SEC may not know, and thus would not be able to verify, the background of all the individuals in a firm who may give investment advice. Furthermore, a client may not receive any background information on the actual person providing the advice if the adviser is not one of the individuals included on the registration form.

### Investors Should Be Warned That Registration Does Not Assure Competence

The Investment Advisers Act does not require that advisers be qualified by education or experience, or meet any minimum financial requirements. An industry official said that it is easier to become a registered investment adviser than to become a licensed driver. Besides not having to meet any educational requirements, advisers do not need to meet any experience requirements or pass any tests of their knowledge of the financial services industry. Thus, the act leaves the advisers' clients with the responsibility to evaluate the capabilities of the individuals or firms.

SEC and advisory industry officials said that investors may believe that SEC registration implies a "seal of approval." These officials said that clients may assume that investment advisers are qualified to give investment advice because they are SEC-registered. For example, one investor lost her life savings of $60,000 despite determining from SEC that her adviser was registered. She reported being "impressed" that the adviser was registered with SEC. Just as the public assumes that others who offer professional services, such as lawyers and accountants, possess certain qualifications because of their certification, the public may also assume that investment advisers are similarly qualified. Such an assumption is unfounded. The SEC registration program is intended to disclose education and experience information on advisers and not to evaluate adviser competence.

## SEC Can Improve its Inspection Program

SEC inspects individual advisers and advisory firms to assure that they (1) operate according to the business practices they describe in their registration applications and to applicable laws and regulations and (2) provide information on these business practices to prospective investors. However, SEC usually inspects advisers for the first time an average of 3 years after they are registered, but many have never been inspected. When deficiencies are identified by these inspections, SEC does almost no follow-up to assure that the deficiencies are corrected. In addition, SEC could better collect and use information from inspection results to help identify for more frequent inspection those advisers posing the greatest

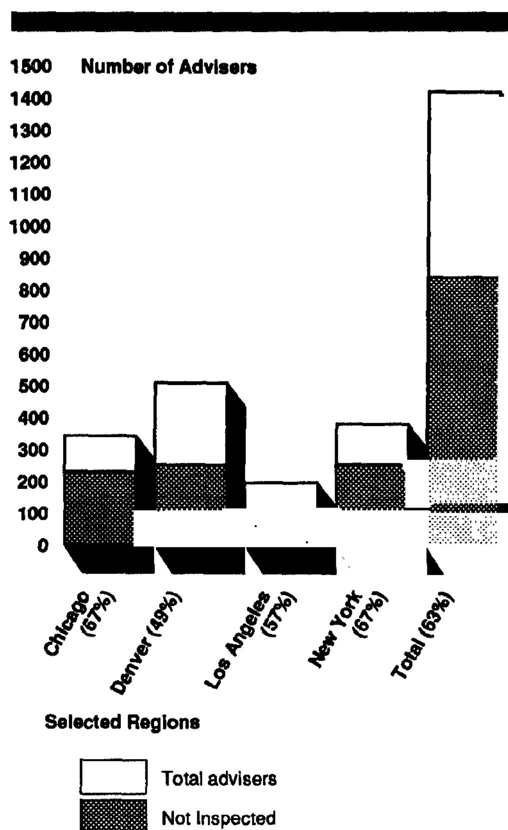
risks to potential investors. SEC officials said that they have too few staff to adequately inspect advisers. As a result, investors have little assurance that their advisers operate as they say they do and have little protection from unscrupulous advisers.

## More Inspections of Advisers Are Needed

Inspecting advisers' operations is the primary way SEC can evaluate whether advisers conform to the business plans they disclose to potential clients. Because these inspections can occur long after the adviser has been in business, or not at all, the opportunity for advisers to defraud their clients without detection or punishment is great. More frequent inspections could reduce this opportunity.

On average, about 60 percent of the advisers registered for more than 1 year in SEC's Chicago, Denver, Los Angeles, and New York regions have never been inspected. These regions are responsible for inspecting approximately 59 percent of the total registered investment adviser population. As shown in figure 2.1, the Chicago and New York regions have the largest percentage of advisers that have never been inspected—67 percent—followed by Los Angeles with 57 percent and Denver with 49 percent.

**Figure 2.1: Comparison of Those Advisers Not Inspected to Total Investment Advisers** (Registered for More Than 1 Year) **As of June 1, 1989**




Note: For a 95-percent level of confidence, the sampling error rates are less than 5 percent for the Chicago, Denver, and New York regional offices, and less than 7 percent for Los Angeles. Total weighted sampling error rate is less than 3 percent.

For the advisers' registration and inspection records we examined, the time between registration and inspection most frequently ranged from 2 to almost 5 years—an average of about 3 years. Some advisers had never been inspected even though they had been registered for more than 20 years. For example, one adviser in the Chicago region, registered since 1940, was not inspected until 1982—42 years after registration, and has not been inspected since that time. In Los Angeles, one adviser registered in 1967 has yet to be inspected. Of the 683 investment advisers in our sample that were inspected, only 15 percent, or 104 inspections, occurred within the first year of operations. The times between registration and inspection for the advisers we reviewed are shown in table 2.1.

**Table 2.1: Time Period Between Advisers' Registration and Inspection for Cases Reviewed in Selected Regions as of June 1, 1989**

| | Less than 1 year | 1 to less than 2 years | 2 to less than 5 years | 5 to less than 10 years | 10 or more years | Total inspections |
|---|---|---|---|---|---|---|
| Chicago | 17 | 40 | 55 | 10 | 7 | **129** |
| Denver | 48 | 93 | 126 | 35 | 3 | **305** |
| Los Angeles | 11 | 29 | 39 | 12 | 4 | **95** |
| New York | 28 | 29 | 73 | 20 | 4 | **154** |
| **Total** | **104** | **191** | **293** | **77** | **18** | **683** |
| **Percent** | 15 | 28 | 43 | 11 | 3 | **100** |

## SEC Needs Follow-Up Inspections to Assure That Advisers' Deficiencies Are Corrected

The SEC Investment Advisers Examination Manual recommends that SEC regional offices follow up on advisers' activities to ensure that deficiencies found during inspections are corrected. However, SEC's follow-up procedure relies primarily on the word of the advisers themselves that deficiencies have been corrected. Although regional officials said that follow-up inspections may be done for serious deficiencies, such as a loss of investor funds, follow-up inspections are rare. As a result, the adviser would not be reinspected until SEC targets the adviser for inspection in its process of deciding which advisers should be inspected. This decision may take a number of years, if it takes place at all.

When SEC inspects investment advisers, it usually finds deficiencies in the advisers' operations. For example, SEC found deficiencies in 80 percent, or 1,102 of the 1,376 inspections done in fiscal year 1988. Frequently cited deficiencies include failure to disclose business relationships and fees to clients and inadequate maintenance of books and records. Deficiencies in disclosure practices accounted for approximately 34 percent of all deficiencies found in fiscal year 1988, while books and records problems accounted for about 26 percent. Inspectors said that such deficiencies may indicate inaccurate records; inadequate disclosures made to clients; or other more serious violations, such as breach of fiduciary obligations and conflicts of interest.

SEC usually relies on investment advisers rather than follow-up exams to certify that deficiencies have been corrected. According to SEC officials, letters are sent to investment advisers, and the advisers are required to respond in writing within a specified timeframe indicating their plan to correct the deficiencies cited. If the adviser does not respond within the specified time, SEC may take enforcement action. Inspectors in two of the

regions we reviewed said that the next time the adviser is inspected, the inspector would determine whether previous violations have been corrected. However, SEC does not promptly reinspect advisers whose operations are deficient.

Even when advisers respond, SEC has no standardized system for monitoring the responses. The SEC regional offices we reviewed have different systems for monitoring advisers' responses. For example, the Denver region maintains a log that is centrally located and controlled by an administrative assistant. The Los Angeles and Chicago regions also maintain logs, but the Los Angeles region relies upon each inspector to maintain individual follow-up logs for the advisers they inspect. The New York region has no formal system for determining if the advisers respond appropriately to deficiency letters, and no computer statistics or formal records are kept. Although the region maintains copies of deficiency letters and replies received in adviser files, no one tracks the letters and responses to ensure that advisers indicate that they will take corrective action.

A Los Angeles region official said that advisers often know that they actually do not have to correct deficiencies. Instead, advisers only tell SEC that they will correct the deficiencies because they know SEC will not do any checking.

## SEC Needs an Effective Management Information System to Target Inspections

Even though SEC may be unable to inspect all advisers on a regular basis, its inspections could better protect investors if SEC could identify advisers that pose the highest risk to investors and target them for more frequent inspections. SEC already does this to some degree based on general guidance that headquarters supplies each year to the regions, which is supplemented by the day-to-day knowledge and experience of regional inspectors. However, SEC has no comprehensive system to provide summary information on inspection results by region or in total. Such a system could help SEC identify types and locations of advisers most likely or least likely to violate requirements of the act and plan inspections accordingly. On the basis of how serious deficiencies were, it could also show firms most in need of follow-up inspections. Finally, such a system could also quickly identify the time between inspections for all advisers.

SEC's headquarters recordkeeping system contains information provided by advisers on their registration forms and a list of the advisers inspected within the last year, including any deficiencies noted and

whether the case was referred for enforcement. Annually, SEC headquarters uses this information as general guidance to each regional office in targeting inspections. Headquarters might suggest targeting inspections based on quantitative factors, such as the number of exams expected to be done in each region, and qualitative factors, such as advisers with custody of client funds that have not been inspected in the past 4 years. However, as we have discussed, registration information is not verified until the regions do initial inspections, which are usually about 3 years after registration, if at all. Furthermore, SEC relies on information submitted on registration forms to determine whether to inspect a particular investment adviser. For example, SEC may assume that an investment adviser who reports not having custody of client funds or securities does not present a high risk to clients. As a result, SEC may not inspect the adviser even though it has never verified the adviser's information.

Each regional office also maintains its own information system on investment advisers. These systems range from a computer database to a manual card file system. The Denver region maintains a database of registered investment advisers that includes information provided by the advisers during registration but does not include information on the results of previous inspections. The Los Angeles region uses computer printouts prepared by SEC headquarters and organized by region. About twice a year, an inspector reviews the list and manually indicates the year of the last exam next to the adviser's name. We found inaccuracies in some of the listings when we compared the dates to actual inspection reports. Regional officials cited a lack of staff and resources as a reason for the inaccurate listings.

The New York and Chicago regions maintain manual card catalog systems that include the adviser's name, location, type of organization, date of registration, date of inspection, and comments. According to New York and Chicago region officials, this system is not accurately maintained.

Although SEC headquarters provides the regions with general criteria, the regions decide which advisers to select for inspection. The regions we reviewed use a number of different factors to select advisers for inspection. These include geographical location, time elapsed since registration or last inspection, customer complaints, news articles, availability of travel funds, and information from advisers' registration statements. Generally, regions do not use criteria based on results of previous or initial inspections.

## Staffing Requirements Are Uncertain

SEC officials said that the lack of an appropriate number of staff makes it difficult to have a complete oversight program. SEC's resources have not kept pace with the explosive growth in the advisory industry. For example, although SEC has requested more staff than previously allocated in 9 out of the 10 years since 1980 (see p. 27), the number of field office inspectors has remained relatively constant. Determining the number of inspectors needed depends on the total number of registered advisers, the number of inspections that each inspector can do each year, and the results of previous inspections. As we have shown, SEC does not have the results of previous inspections and, therefore, cannot accurately determine the number of inspectors needed.

According to an SEC report dated October 12, 1989, the number of registered investment advisers increased 208 percent, from 4,580 to 14,120, between 1980 and 1989. During the same period, the dollar amount of assets under management by these advisers increased 10-fold, while the field examination staff responsible for doing investment adviser inspections remained constant at about 41 positions. In the four regions we reviewed, the ratio of investment advisers to SEC inspectors ranged from 250 advisers to 1 inspector in the Denver region to 900 advisers to 1 inspector in the Los Angeles region.

SEC has estimated that, on average, each inspector should complete about 25 inspections a year. Using that figure and given the number of newly registered advisers in each region from June 1988 to June 1989, we estimated the number of inspectors needed to inspect each newly registered adviser within the first year after registration. The number needed would be about 14 in Chicago, 6 in Denver, 17 in Los Angeles, and 15 in New York—a total of about 52. The number of inspector staff years currently available in these regions is six in Chicago, about three in Denver, three in Los Angeles, and four in New York. Thus, the number of additional inspectors needed is about 36 more than the number available in those regions, and the total number needed is more than the total number (41) available in all SEC regions.

These figures do not include the number of inspectors needed to do periodic inspections of the advisers. This number will depend primarily on the results of previous inspections, including factors such as (1) the number and significance of the deficiencies found and the types of advisers requiring more frequent inspection because of the risks they pose to their clients, (2) the size of the firms to be inspected, and (3) the

availability of books and records from the advisers. As we have discussed, SEC does not have this information. (See pp. 23-24.) Other factors, such as increased registration fees, as discussed in chapter 3, may reduce the total number of advisers registered. This could reduce the need for additional inspectors.

SEC officials said that staffing shortages have had an adverse impact on its ability to manage the registration and inspection programs for advisers. These officials said that SEC does not have the staff to (1) ensure that registered investment advisers have submitted accurate and complete information about their background and business practices to disclose to their clients or (2) do investigations to determine whether unregistered individuals are providing investment advice. In addition, SEC officials said that staffing shortages have prevented SEC from doing more inspections of investment advisers and following up on inspections to assure that advisers' deficiencies are corrected.

As a result of these staffing shortages, SEC officials have proposed legislation that would shift primary responsibility for regulating investment advisers to one or more self-regulatory organizations. We discuss this proposal and others in chapter 3.

# Proposals for Improving the Regulation of Investment Advisers

The numbers of SEC-registered investment advisers are growing faster than the resources available to regulate them. This problem is compounded by the unknown numbers of people providing investment advice who are not SEC-registered. Unable to obtain the oversight resources necessary, SEC has proposed an amendment to the Investment Advisers Act authorizing the creation of one or more self-regulatory organizations (SRO) to oversee investment advisers. Its limited test of this approach, although successful, raised concerns about how to regulate widely differing business practices and services, as well as the increased costs to advisers of self-regulation. Addressing the cost issue, SEC also proposed exempting from federal regulation advisers with small operations which would be regulated by the states. Also reacting to the lack of adviser oversight resources, members of Congress proposed amending the 1940 legislation to provide the public better information about financial advisers and, more importantly, a private right of action to sue for damages when individuals sustain losses because of violations of the act.

## SEC Efforts to Increase Staff Have Been Unsuccessful

Between 1980 and 1989, the size of the field examination staff responsible for investment adviser inspections remained constant at 41 positions. During the same period, the number of investment advisers more than tripled. These disproportionate increases have made it difficult for SEC to regulate effectively, as discussed in chapter 2.

With one exception, SEC has annually requested additional staff for the Investment Management Program since 1980. Each year, the Office of Management and Budget has reduced the size of the requested increases, as indicated in table 3.1. In most years since 1983, Congress has restored some of the Office of Management and Budget's cuts.

**Table 3.1 Investment Management Program Staffing Requests and Adjustments, Fiscal Years 1980-1989**

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|---|---|---|
| SEC program request to OMB | 230 | 249 | 231 | 202 | 200 | 231 | 220 | 219 | 246 | 323 |
| OMB adjustments | (22) | (46) | (16) | (10) | (12) | (31) | (20) | (4) | (12) | (30) |
| Estimate submitted to Congress | 208 | 203 | 215 | 192 | 188 | 200 | 200 | 215 | 234 | 293 |
| Adjustments after congressional review | (7) | (2) | (15) | 8 | 12 | 0 | 15 | 2 | 7 | (50) |
| **Total positions allocated** | **201** | **201** | **200** | **200** | **200** | **200** | **215** | **217** | **241** | **243** |
| Net change | (29) | (48) | (31) | (2) | 0 | (31) | (5) | (2) | (5) | (80) |

Note: SEC does not separate investment adviser regulation from the other activities in the program. As a result, these numbers include positions for investment adviser registration, investment company regulation, clerical and support staff, and investment adviser inspections.

In its fiscal year 1990 budget estimates, SEC reported that the relatively small increases in inspection staff compared to the dramatic growth in both the number of advisers and assets managed during the last several years have resulted in a persistent annual decline in the percentage of advisers inspected. SEC reported in its 1990 budget submission that because inspections occur so infrequently, the Investment Management Program is currently "at a point where inspections may have lost much of their deterrent effect."

## Self-Regulation Is Possible but Industry Concerns Exist

Lacking adequate staff to effectively regulate the industry, SEC submitted draft legislation to Congress on June 19, 1989, authorizing the establishment of one or more SROs for investment advisers with SEC maintaining regulatory oversight of the SROs and the industry. The SEC Chairman indicated that the proposed SRO(s) would establish qualification and business practice standards, register and inspect advisers, and enforce compliance with the law. Membership in the SRO(s) would be mandatory for all registered advisers. Although SEC has concluded, in a limited test, that an SRO can do the oversight necessary, the costs of such a program will be higher than the current registration fee, and industry officials are concerned about other issues that may undermine the concept.

### Self-Regulation Is Not a New Concept

SEC's proposed SRO structure for the investment advisory industry is patterned after the self-regulatory structure for broker/dealers established by the Securities Exchange Act of 1934. Under this act, SROs are delegated governmental power to enforce compliance with legal and ethical standards in the securities industry. The SROs—primarily the securities exchanges and National Association of Securities Dealers (NASD)—operate and regulate market facilities, write rules governing members' conduct, examine members for violation of law or SEC and SRO rules, and discipline members.

SEC has considered the self-regulatory concept of regulation of investment advisers for a number of years. SEC's Report of Special Study of Securities Markets issued in 1963 concluded that an SRO should be required for all registered investment advisers. Such an SRO would have the same authority as the SROs that oversee broker/dealers, for such functions as establishing minimal registration standards.

In 1976, SEC requested authority from the Senate Committee on Banking, Housing, and Urban Affairs to do a study on the feasibility of self-regulation for investment advisers. Although the committee agreed that the concept should be studied, it expressed concern as to whether self-regulation was feasible because of the diversity of individuals and organizations within the industry and the differences in the mix of advisory services. The authority for the study was included as part of the committee bill, which called for minimum standards for advisers. The bill did not pass. Opponents said SEC lacked evidence on the need for adviser examination and licensing.

## SEC Proposal Based on NASD Study Results

The June 19, 1989, SEC proposal to establish one or more SROs is based on the results of two NASD studies on the regulation of investment advisers. The first study, done between June 1986 and March 1987, examined the feasibility of NASD inspecting the investment adviser activities of its own members. The study consisted of NASD inspections of 45 volunteer members who were registered investment advisers. On the basis of these inspections, SEC concluded that NASD examiners had a working understanding of the Investment Advisers Act and were able to identify the same basic or technical deficiencies as would be found by SEC inspectors. NASD estimated that it would need 41 additional examiners and 6 supervisors to examine its member advisers every 2 to 4 years. NASD estimated the annual cost of the program to be approximately $2.5 million, or $426 for each adviser. This cost included only salaries and travel expenses of NASD examiners.

In 1988, NASD did another study to estimate the cost of regulating all investment advisers, including the advisers who were not NASD members. This study used criteria similar to that used in the 1986 study but included such other expenses as the costs of benefits and office space. NASD concluded that it would need 138 additional examiners to regulate approximately 14,000 advisers at an annual cost of about $21 million, or $1,569 per adviser. The study established an inspection cycle for advisers from 2 to 4 years depending on the adviser's risk factor, which refers to whether the adviser has custody of, or discretion over, customer funds and securities.

NASD officials said that the cost could be much lower were the securities laws amended to enable NASD to establish standards and requirements for advisers and set fees to cover the cost of the program. NASD reported that such regulation, based on many advisers' comments during the study and not on any kind of analysis, could cause a substantial number

of advisers to terminate their registration and reduce the overall annual program cost to about $14.5 million. For example, NASD indicated that about 50 percent of the advisers who are financial planners would terminate their registration. SEC officials said that most planners terminating their registration would likely be small or inactive investment adviser companies.

Investment advisers are required to pay a one-time fee of $150. Although SEC officials have not determined the cost of processing investment adviser applications, they did tell us that the $150 registration fee does not cover that cost, much less the cost of inspecting advisers. Furthermore, the same registration fee is charged for each application regardless of the number of individuals covered. For example, a sole proprietor and a large advisory firm employing 5,000 people both pay $150. In the large firm, although SEC is responsible for regulating 5,000 times more people, it receives no more money than it does for regulating the sole proprietor.

As a result of the NASD studies, its Board of Governors authorized NASD staff to proceed with action necessary to establish the NASD as the SRO for registered advisers if it is selected to be an SRO. However, the Board also stated that the securities laws would have to be amended to give NASD, among other things, the authority to

- establish financial responsibility standards for registered investment advisers;
- establish fees, payable by registered investment advisers, to defray the costs associated with regulation;
- establish minimum experience, training, educational, or other qualification standards for registered investment advisers; and
- use the NASD's registration facilities for capturing and maintaining the registration records of registered investment advisers.

NASD officials said that they had not made a decision on how the program would be funded or managed if SEC's proposed legislation is passed and NASD is given the authority to regulate the industry. One official added that the program would have to support itself and would most likely be financed through fees paid by investment advisers.

## Industry Views Vary

A number of organizations said that SEC should continue to be the regulator but should be given additional staff and funding. Others suggested

that SEC could increase its fee schedule to offset the overall cost to continue government regulation of advisers. For example, the Financial Analysts Federation reported to SEC that increasing SEC's budget appears to be more reasonable than adding another layer of regulation and additional staff and fee structures that any new SRO would require. Officials from the Securities Industry Association, which represents 550 securities firms, also reported that the existing federal regulation governing investment advisers would be adequate to protect investors if SEC had sufficient resources to enforce the regulations. A representative from the National Association of Personal Financial Advisers indicated that it would support SEC increasing its registration fee to fund the program.

Other interested groups expressed concern with giving NASD the responsibility to self-regulate the entire investment advisory industry. They said NASD has an interest in the sale of securities and, as a result, would have a conflict of interest in regulating investment advisers. In its comments to SEC on the SRO proposal, the International Association of Financial Planning reported that the background, interest, philosophy, and training of NASD in product delivery of the securities industry makes NASD inappropriate for regulating investment advisers. The Investment Council Association of America also reported that investment advisers are the representatives of customers of broker/dealers and, in representing the interests of their clients, investment advisers must often deal with broker/dealers as adversaries. The Association stated that if investment advisers were forced into NASD membership, it would be difficult or impossible for advisers to adequately represent their clients' interests in any dispute resolution procedures because of advisers' affiliations with NASD member broker/dealers.

Two organizations proposed that in addition to NASD, a second SRO be established to regulate advisers who are opposed to being a member of NASD. Although SEC's proposal does not limit the number of SROs, the industry's ability to financially support more than one SRO is questionable. The Investment Counsel Association of America reported to SEC on June 8, 1988, that multiple standard-setting SROs are impractical for economic reasons. The Association indicated that, although no data on which to base a firm conclusion exist, segmenting the industry on a basis such as the diverse business practices of advisers would result in segments that would be too small and not sufficiently profitable to support an SRO.

The Policy Coordinator of the Financial Analysts Federation said that the organization was generally opposed to an SRO for investment

advisers. However, she said that if an SRO concept were adopted, the Federation would support NASD as opposed to a new organization because NASD already has staff and a central computer system for registering broker/dealers—all of which could reduce start-up costs.

## State Regulation of Advisers With Small Operations Is Questionable

In addition to proposing self-regulation in the investment advisory industry, SEC also proposed two rules that would exempt advisers with small operations from existing federal regulation. An SEC official said that these proposals are intended to reduce SEC's workload if the self-regulatory approach is not accepted. The proposals are intended to decrease the costs and paperwork associated with dual federal and state regulation of small adviser businesses.

Under the proposed rules, which SEC officials said were still under review as of March 6, 1990, advisers with small operations would be regulated by the states. The first rule would exempt advisers who recommend exchange-traded securities when they operated solely in one state, had no more than 50 clients during the course of the preceding 12 months, and managed securities portfolios with an aggregate fair market value of not more than $10 million at the end of the adviser's last fiscal year. The second rule would exempt, regardless of their location, advisers who had no more than a total of 25 clients during the course of the preceding 12 months and managed securities portfolios with an aggregate fair market value of not more than $1 million at the end of the adviser's last fiscal year. SEC estimated that one-half of all federally registered advisers would be eligible for these exemptions.

Many states are opposed to accepting the responsibility for regulating small advisers. As mentioned in chapter 1, we sent out a questionnaire about regulation of investment advisers and received 47 responses from 46 states and the District of Columbia. Twenty-three of the 47 respondents to our questionnaire opposed the SEC proposal; 15 respondents supported the proposal. The remaining nine respondents neither opposed nor supported the proposal or had no basis to judge. Twenty-seven of the 43 respondents that had an opinion indicated that at that time they did not have the resources to regulate the advisers, while 16 respondents indicated that they did have adequate resources to regulate the advisers identified in the SEC proposal.

Eight respondents to our questionnaire indicated that they do not regulate investment advisers at all, and two respondents do not require advisers to register. Twenty-one respondents indicated that they do not

routinely inspect investment advisers, and inspections that are done result from a customer complaint, a news article, an informant, or a referral from another government agency. Most of these respondents reported that they inspected fewer than 10 advisers in the previous year.

Most of the industry officials who commented on the proposed rule changes were opposed to the exemptions. Some of the reasons for opposition included that state regulation of investment advisers is less protective of advisory clients than federal regulation, states lack the resources to devote to enforcement, and the cost savings at the federal level would be more than offset by increased cost at the state level. Groups we met with also opposed the proposals. For example, officials of the Financial Analysts Federation reported that they were opposed to exempting specific groups from the 1940 act requirements. They indicated that more emphasis should be placed on uniformity of state and federal regulations rather than on the elimination of federal regulations for small advisers.

## Congressional Proposal Would Supplement Federal Regulation of Advisers

Given the potential for fraud and abuse in the investment advisory industry, some members of Congress proposed the Investment Advisors Disclosure and Enforcement Act of 1990 (H.R. 4441). This legislation would amend the 1940 Investment Advisers Act to provide better investor information and protection. The proposal would require anyone providing investment advice to register with SEC and, makes specific advisers' requirements to provide clients accurate information. It would also create a private right of action to enable customers to sue for damages when they sustain losses because of violations of the act.

The legislative proposal creating a private right of action against investment advisers for damages arising from fraudulent, manipulative, or other prohibited forms of conduct such as failing to disclose a material conflict of interest, represents another way to police compliance with the act. Currently, a defrauded or abused customer's remedies under the act are limited. In Transamerica Mortgage Advisors, Inc., v. Lewis, 444 U.S. 11 (1979), the Supreme Court held that section 215 of the act provides for a private right of action to rescind an investment adviser contract and obtain restitution of any fees paid to the investment adviser under it. But the Supreme Court held that section 206 of the act, which prohibits an investment adviser from engaging in any fraudulent or manipulative conduct, does not provide for a private right of action for

damages compensating the investor for losses resulting from such conduct.

The absence of a private right of action for damages under the Investment Advisers Act may leave a gap in the remedies available under Federal securities laws to some defrauded or misled investors. If an investment adviser's fraud involves the purchase or sale of a security, the investor may sue for damages under section 10(b) of the Securities Exchange Act and SEC rule 10b-5, which prohibit manipulative conduct in the securities markets. But the remedy under the Securities Exchange Act is not available where fraud involves a transaction other than the purchase or sale of a security. For instance, it was not available to an investor whom an investment adviser had admittedly misled into guaranteeing a risky bank loan. Furthermore, remedies are not available to investors for violations of the 1940 act not necessarily involving fraudulent transactions. Therefore, amending the Investment Advisers Act to establish explicitly a private right of action for damages arising from violations of the act would broaden the remedies available to defrauded or abused investors as well as complement regulatory efforts to enforce provisions of the act.

# Conclusions and Recommendations

## Conclusions

SEC's oversight of investment advisers provides investors little assurance that the information they receive from advisers is accurate or that advisers operate in accordance with the requirements of the Investment Advisers Act of 1940 and SEC regulations. So far, the effects of the current regulation, as measured by the amount of fraud and abuse detected and reported, have not been very evident. However, the 3-fold increase to about 14,000 in the number of people providing advice, and the 10-fold increase to about $4.6 trillion in the amount of assets they manage raises both the risk that fraud and abuse will occur and the potential that any amounts lost could be large. If the oversight program is not improved, the 1940 act may be doing more harm than good by giving investors the illusion that SEC-registered advisers have a "seal of approval."

Enhancements are needed in the current oversight program to provide people who might use an adviser a minimum level of assurance that their decisions are based on accurate information and that their adviser operates within the law. In this regard, as a minimum, the registration program should require that applicants' education and experience be verified before registration is granted, possibly by contacting applicants' former employers. The program should also warn clients of their own responsibility to evaluate an adviser's competence if the registration process does not include an assessment of advisers' competency. Also, some effort should be made to identify unregistered advisers and to register all individuals at advisory firms who give advice.

The inspection program should, at a minimum, inspect all newly registered advisers within a reasonable time period, such as within 1 year of registration, and periodically thereafter based on risk to investors, to assure that advisers operate according to their business plans and securities laws. Also, advisers found to have deficiencies that present high risks to their clients should be reinspected within a reasonable time, such as 6 months. SEC also needs a comprehensive system that would provide information on inspection results. The system could help SEC identify which advisers present the highest risks to investors and plan inspections accordingly. It could also assist SEC in determining its staffing requirements for inspecting the industry.

SEC's proposal to pass the primary responsibility for regulating advisers from SEC to one or more SROs is consistent with SEC's general approach to regulating securities markets. For an SRO to be effective, however, several problems must be resolved. These problems include the potential additional administrative costs that advisers and their clients would

have to pay, the effect of self-regulation on small advisers, and which organization or organizations is best suited to be designated SRO for investment advisers.

SEC's inability to get the resources it needs to administer an effective regulatory program mitigates against it being the sole regulator for investment advisers. However, the costs of the additional resources necessary could possibly be borne by advisers and their clients based on such factors as the volume of business. For most advisers costs would increase under this plan because the $150 existing lifetime registration fee is not adequate to fund an expanded program.

The large number of clients and the large amount of money that investment advisers already handle, as well as the growing size of the industry, probably indicate a need for responsible federal oversight. An additional issue that needs to be considered is whether the information disclosure required by the act is sufficient to protect investors or whether new standards for proof of adviser competency, as required in many other professions, should be added. The proposed amendments to the 1940 act address the need for investors to receive accurate information from their advisers and provide investors a direct means of recourse in cases of fraud and abuse. Whether or not resources can be found for an effective federal oversight program, these amendments may help deter abusive investment adviser practices.

## Matters for Congressional Consideration

Congress is already considering amendments to the 1940 act which would improve investor protection by requiring investment advisers to disclose accurate and complete information and by giving investors a private right of action against advisers who violate the act's requirements. In addition, given the limited protection provided by the existing federal oversight program, Congress should either take action to strengthen the program or consider repealing the requirements for federal regulation of investment advisers. If Congress decides to strengthen the regulatory program it can do so by establishing one or more SROs or by providing SEC additional resources. Regardless of which approach is adopted, the enhancements to the registration and inspection programs we recommend should be included.

## Recommendations to SEC

Whatever the method of regulatory oversight, SEC needs to provide investors at least minimum assurance that their decisions about advisers are based on accurate information. Accordingly, we recommend that, at

a minimum, SEC require that the oversight program for investment advisers

- verify education and experience information that advisers submit on their applications and check their criminal history through all available federal sources before allowing them to be registered;
- take action, such as comparing advisers who advertise as such to the list of registered advisers, to identify advisers who should be registered but are not and require them to register or stop providing paid advice;
- register all individuals at advisory firms who give advice;
- inspect the business operations of each newly registered adviser within a reasonable time, such as within 1 year of registration, and periodically thereafter according to risk;
- reinspect within a reasonable time, such as 6 months, advisers found to have deficiencies that present high risks to their clients; and
- develop summary information on inspection results to help target for reinspection those advisers found to present the highest risks to investors.

In addition, if oversight continues to focus on the present statutory and regulatory requirements for information disclosure, SEC should require investment advisers to notify potential clients that although the registration program is intended to disclose information accuracy and business practices, it does not pass judgment on adviser competence.

## Agency Comments and Our Evaluation

SEC generally agreed that our recommendations would improve its oversight of investment advisers. However, SEC said that to implement these recommendations would require more than triple the resources now devoted to the regulation of advisers.

We agree that, given SEC's present approach, the enhanced oversight program we recommend may increase costs in specific program areas. However, we view the recommended enhancements as the minimum necessary to meet the legislative requirement for investor protection. Given the potential for fraud and abuse in the investment advisory industry, these enhancements are needed to provide people who might use an investment adviser a minimum level of assurance that their decisions are based on accurate information and that their adviser operates within the law. The program cost cannot be accurately estimated until Congress and SEC make policy decisions on which method of industry oversight should be used and what level of resources is appropriate for the chosen approach.

# Comments From the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

April 23, 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

I am responding to your letter of March 19, 1990, to Chairman Richard C. Breeden transmitting copies of the General Accounting Office's draft report entitled Investment Advisers: Lax Regulation Puts Investors at Risk ("Report") for our review and comment. The staff of the Commission's Division of Investment Management has reviewed the report and has the following comments.

Our response is in two parts. The first addresses GAO's major recommendations to the Commission that are summarized in Chapter 4 of the Report. The second replies to statements, findings and conclusions in other sections of the Report.

The Report makes a number of recommendations to the Commission, all of which reflect laudable goals that the staff would support in a cost-free environment. Unfortunately, most of these recommendations, if implemented, would require significant additional resources.

See chapter 4, p. 37

GAO asserts that the Commission's oversight of investment advisers provides investors with little assurance that the information they receive is accurate, or that a given adviser is operating in accordance with regulatory requirements. The Report also states that the effects of this ". . . lax regulation, as measured by the amount of fraud and abuse detected and reported, have not been very evident." (Report, page 51). To correct these perceived deficiencies, GAO recommends changes that would require more than triple the staff and other resources now devoted to regulation of advisers. We believe that the final GAO report should state clearly the cost to the federal government of implementing these recommendations, so that the Congress and the Commission can weigh those costs against the likely benefits to be derived.

See comment 1.

- 2 -

**GAO's RECOMMENDATIONS TO THE COMMISSION**

**Verification of application information - page 54** The Report recommends that the staff verify education and experience information advisers submit on their applications, and check criminal histories through all available federal sources before allowing advisers to be registered.

Except for disciplinary data, information contained in advisers' initial applications for registration and in periodic amendments to such applications generally is not verified by the staff before the application becomes effective. There are two reasons verification is not made. First, with 100 to 200 new applications and, on average, 900 amendments received each month, the ten staff members assigned to process these filings could not do the work on a timely basis, if at all. 1/ Second, items on the application relating to business practices are not verifiable short of an on-site visit by a Commission examiner; to verify education and experience information, staff would have to write or call academic institutions or former employers. For these reasons, the applications review staff simply determines that the answers to items in the application appear to be complete.

The staff does, however, check the applicant's disciplinary history using a database containing information from a large number of sources. These sources are: matters under inquiry by SEC staff; state administrative and court actions involving securities related matters; federal court cases involving securities related matters; 2/ CFTC administrative actions; self-regulatory organization administrative actions; SEC investor complaints; applications and periodic reports filed with the SEC; general correspondence received by the SEC; reports filed with the SEC by officers, directors and security holders reporting beneficial ownership of securities; SEC investigation, litigation and enforcement actions and registration statements filed with the SEC. This database contains all relevant violations necessary to determine statutory disqualifications under the Act.

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1/ The Investment Advisers Act of 1940 ("Act") states that an application will become effective automatically 45 days after it is filed unless the Commission begins a formal administrative proceeding to deny the application.

2/ Information on state administrative and court actions is sent to the SEC by state securities commissions. Information on federal court actions is sent by the court to the SEC. While the staff believes it receives information on all such actions, it is not certain that is the case.

There are certain criminal violations that we would learn of by contacting the FBI, such as murder or drug dealing. However, such violations are not statutory disqualifications under the Act.

During on-site inspections of advisers, much of the information in the applications is checked. The staff has not found many situations in which education and experience information was misstated or where convicted criminals were acting as investment advisers.

See comment 2.

**Unregistered advisers - page 54** The report recommends that the staff better police the unregistered adviser population by comparing names of advisers who advertise to lists of registered advisers, and then requiring those who are unregistered to register or stop providing advice.

In the past, the staff has tried to identify unregistered advisers by comparing yellow page listings of advisers in selected cities to lists of registrants. Few unregistered advisers were actually identified and the staff found this approach to be unproductive for several reasons. First, an adviser may register under one name and do business under another. 3/ Second, matching names is an inexact science because of letters that may be included or excluded from a name in one list or the another. Third, a person may be registered through a large firm but may advertise using a personal or business name. Fourth, a person may advertise as an investment adviser but do nothing but sell insurance or real estate and not be required to register. Thus, using yellow page listings to find persons who should be registered as advisers produces many false leads.

Nonetheless, the staff is interested in finding unregistered advisers. The staff actively follows up on complaints and leads that come to its attention about unregistered entities that appear to be providing advice about securities for compensation. The staff reviews advertisements in various newspapers and other publications for indications of misleading advertising or the existence of an unregistered entity. When an entity is identified, the staff will ask the adviser to come to the

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3/ An adviser's application for registration must contain all names an adviser will use in its business. A sole proprietor adviser will usually register using his/her name and then show another name in the application under which it will do business - its "dba name". The Commission's computerized database for filings lists only the name of a registrant and not its dba name.

appropriate SEC office and explain what it does, and why it believes that it does not need to be registered.

See comment 3.

**Register all advisory representatives - page 55** The Report recommends that the Commission register all persons at advisory firms who give investment advice. It appears that this recommendation was intended to assure that the Commission would have some background information on all advisory representatives. The Act requires the registration of the advisory entity or business; it does not require the registration of all individuals at advisory firms who give advice (also called advisory representatives). Thus, the Commission does not have the authority to register such representatives. Congressional action would be needed to change the law.

The Commission does, however, obtain significant information about advisory representatives in Form ADV. An adviser's application must include the name, education and business background (Schedule D information) for the adviser; 10% owners; control persons; officers, directors and partners; members of the investment committee and any non-clerical employee that has been the subject of a disciplinary action. In addition, most states receive Schedule D of Form ADV for all advisory representatives acting on the adviser's behalf in the state. Thus, state government employees are able to review, in the process of registering advisers in the state, relevant background data for advisory representatives operating in that state.

If advisory representatives were to register with the Commission, a significantly larger staff would be needed to review these registrations.

See comment 4.

**Inspections of newly registered advisers - page 55** The Report recommends that each newly registered adviser be inspected within one year of registration. The staff believes this is a good idea because deficiencies would be detected early, thereby allowing the adviser to correct problems before significant harm to investors develops. The practice followed by SEC staff in several regions of sending a "Welcome to the Region" letter to new registrants fulfills some of the goals of an inspection. These letters typically discuss in some detail the responsibilities the adviser has undertaken by registering.

Recently, between 2,000 and 3,000 new advisers have registered annually. To inspect all new registrants within one year of registration would require a very large increase in staff resources. Currently, the average examiner is able to complete about 25 inspections per year. During 1990, the staff expects to complete about 1,330 examinations with a staff of 53 examiners (excluding supervisors and secretaries). To examine, on average, 2,500 new advisers each year would require at least 100

additional examiners and additional supervisory and clerical staff. While an inspection of a new adviser probably would not take as long as an inspection of an established adviser, travel time likely would increase because it might become more difficult to perform a number of inspections in the same geographic area.

See comment 5.

**Inspect advisers periodically according to risk - page 55** The Report recommends that after the initial inspection, all advisers should be inspected periodically according to the risk they present. The staff agrees that all advisers should be inspected periodically, and that the risk the adviser's operating methods present to clients should be a factor in deciding how often an adviser is inspected. However, as explained more fully below, an inspection program based primarily on risk would be difficult to administer efficiently. Nonetheless, once the geographical dispersion of advisers is considered, risk should then be one of the major factors used.

You should be aware that the perceived risk in advisers' activities already is considered in selecting inspection candidates. However, because of insufficient staff resources, it is not possible to inspect the riskiest advisers more frequently than every four to five years; inspections more often than that would mean the lowest risk advisers might never be inspected. With the staff available in 1990, the Division expects a 12.5 year inspection cycle. This is clearly inadequate. Based on relative risk, all advisers should be inspected once every three to six years with the most risky inspected every third year and the least risky every sixth year. Because most advisers have a rather low risk profile, an average inspection cycle would be 5 to 5.5 years. In order to reduce the inspection cycle for existing advisers from 12.5 to 5.5 years, 65 additional examiners would be needed, assuming current productivity remains unchanged.

See comment 6.

**Reinspection of advisers found to be deficient - page 55** The Report recommends that advisers whose operations are found to be deficient should be reinspected within a reasonable time, such as six months.

The staff currently deals with most deficiencies found during inspections (except those referred to enforcement) by sending a letter to the registrant which lists each deficiency, and asks the adviser to take appropriate corrective action and inform the staff of the corrective actions taken. During 1989, approximately 85% of the 1,150 inspections completed resulted in deficiency letters. Except in those situations where the staff has reason to distrust the adviser, follow-up inspections are not conducted due to resource constraints and the belief that most advisers in fact take the promised corrective actions. Of course, in the next regularly scheduled inspection, the results

of the previous examination are reviewed and the actual corrective actions taken by the adviser are evaluated.

Occasionally, the staff finds that an adviser appears to have misrepresented corrective actions taken. However, we do not believe this occurs with sufficient frequency to justify reinspecting all advisers with deficiencies within six months. We assume that follow-up inspections would focus only on those areas found deficient, and that an examiner could do at least 50 such examinations annually. Using 1989 as an example, almost 1,000 of the inspections done required a deficiency letter. To do 1,000 follow-up inspections within six months would have required at least 20 to 25 additional staff. Accordingly, given present budgetary constraints, the staff does not believe a program of doing follow-up inspections to be feasible.

See comment 7.

**Analysis of inspection results - pages 26 and 55** The Report recommends that the staff develop summary information on inspection results to help target for reinspection those advisers found to present the highest risks to investors.

Starting in fiscal 1988, the staff implemented a computer based Examination Activity Tracking System ("EATS"). This system collects information about the registrant and deficiencies found during each examination. The staff now has merged this examination data with information taken from the adviser database containing information filed by registered advisers in their applications and amendments. When three to four years of EATS data has been collected, the combination of these two databases will provide an excellent means to study the risk characteristics of the adviser population and target for more frequent inspection those advisers with the highest risks.

Managing the adviser inspection program on a "risk presented" basis has been a key objective of the staff for the past eight years. In 1982 the staff developed a risk profile for advisers using information contained in registration applications and amendments. We assigned a risk measure to each adviser and developed an inspection schedule based on the relative risk inherent in adviser operations. After some experimentation, we found that relying on the Form ADV database to assign risk was not sufficiently reliable. 4/ As a result, we developed the EATS

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4/ For example, in responding to questions on Form ADV an adviser may cite business practices it might engage in at some future time (e.g., take custody of client funds or securities), not just practices in which the adviser actually is engaged. Risk-based targeting should focus only on the actual practices of advisers. Combining EATS and adviser databases to target (continued...)

system to provide a more reliable tool to target advisers for inspection based on risk.

Developing a risk-based targeting system has been hindered by the lack of resources to convert data collected on paper into a computerized database and to pay competitive salaries to computer programers.

See comment 8.

**Resource requirements** During 1990, the adviser inspection program will have 53 field examiners (not counting supervisory and clerical staff). If the Commission were to follow the Report's recommendations to both examine all new advisers within one year of their registration and reduce the inspection cycle for existing advisers to an average of 5.5 years, the Commission would need to have an additional 165 examiners (a 211% increase in staff). Additional supervisory and clerical staff also would be needed. Finally, a large increase in travel money would be needed to support the expanded examination effort.

See comment 9.

**Notification to potential clients - pages 6 and 55** The Report recommends that if oversight continues to focus on the present statutory and regulatory requirements for information disclosure, the Commission should require advisers to notify potential clients that although the registration program is intended to disclose information accurately, it does not pass judgment on adviser competence.

The Commission does not have statutory authority to establish qualification standards for advisers' competence. Congressional action would be needed to change the law. Part II of the application form contains the following prominent language:

> **This part of Form ADV gives information about the investment adviser and its business for the use of clients. The information has not been approved or verified by any governmental authority.**

Advisers are required to give a copy of Part II, or a brochure containing the substance of Part II to all new clients, and to annually offer to provide, free of charge, a copy of its current Part II or its brochure to all existing clients.

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4/(...continued)
inspections should reflect actual practices more accurately, and make the use of risk criteria more reliable.

OTHER COMMENTS ON THE REPORT

See comment 10.

**Number of advisers - pages 2 and 9** The Report states that the number of advisers has tripled from about 4,600 to about 14,000. There are currently about 16,200 advisers.

See comment 11.

**Purpose of regulation - page 3** The statement on page 3 of the Report that the "SEC regulates investment advisers to assure that they provide potential investors accurate and complete information about their background, experience, and business practices" is incomplete. In addition to reviewing disclosures made by advisers for accuracy and completeness, the staff also reviews advisers' compliance with the Act and related rules and recommends appropriate actions to effect compliance with the antifraud provisions of the Act.

See comment 12.

**Services provided by advisers - page 11** On page 11 of the Report, there is a description of the services provided by advisers. Among those listed is "selling financial products." If an entity is registered only as an adviser, it is not legal for it to sell financial products to clients. Thus, any adviser that sells financial products also must be registered either as a broker/dealer or as a registered representative of a broker/dealer. Advisers that are financial planners often wear these two hats: adviser and registered representative.

See comment 13.

**Checking violations with other federal agencies - page 19** The Report states that the staff does not check with other federal agencies such as the FBI and CFTC for information about criminal violations involving applicants. We do not believe this is necessary because the database used by the staff to check the disciplinary history of applicants and advisory representatives contains all of the relevant violations necessary to determine statutory disqualifications under the Act. There are certain criminal violations that we would learn of by contacting the FBI, such as murder or drug dealing, that are not statutory disqualifications under the Act.

See comment 14.

**Targeting inspection candidates - pages 32 to 34** The Report contains a description of the staff's process for selecting inspection candidates. While substantially accurate, this description does not provide a complete picture of what happens and why it happens.

The staff identifies advisers to be inspected based on a number of factors. Specifically, the staff believes that: (1) routine inspections of all advisers should be conducted on a periodic basis, (2) advisers perceived to present higher risks to clients should be inspected more frequently than lower risk advisers, (3) examinations for cause should be done whenever

suggested by events, and (4) segments of the industry should be targeted for inspection to respond to industry developments.

Routine inspections Over time, as staff resources permit, all advisers will be inspected in what are considered to be routine, periodic examinations. The staff attempts to perform routine inspections as efficiently as possible. Because advisers are dispersed throughout the United States, the regional offices often will conduct geographical sweeps during which a group of examiners will travel to an area, e.g. Kalamazoo, Michigan, for a one to two week period to conduct examinations of all advisers in the area. Once the sweep is completed, the staff may not return to the Kalamazoo area for several years because of the need to conduct exams in hundreds of other cities in the region. Conducting examinations by geographic area within a region saves travel time and costs.

Each region selects advisers for routine examination based upon information maintained by the region. The regions have used different systems to maintain records of when each adviser was inspected. With the development of the EATS system all regional offices will, in time, use one system to maintain a record of when each adviser was last inspected and the results of that inspection. The Division also will use this database to review each region's examination scheduling activities to ensure that regions are performing their targeting functions appropriately.

High risk inspections The staff attempts to identify and inspect more frequently those advisers with high risk characteristics, such as those having custody of client securities, discretionary authority to undertake transactions in client accounts or the authority to choose executing broker/dealers. However, in determining how many high risk inspections can be performed each year, the staff must take into account travel time and costs.

Cause inspections Examinations for cause resulting from events such as a client complaint, press report or egregious advertisement take precedence over routine inspections. Where necessary, a cause examination can be started the same day or the day after a situation comes to the staff's attention.

Event-driven inspections At times, because of policy concerns or concerns about developments in certain segments of the advisory industry, the Division of Investment Management asks the regional offices to target certain kinds of advisers for inspection. These types of inspections are discussed with the regional inspection staff. Often an inspection outline addendum is prepared for use during the inspections to ensure that all examiners focus on the same areas of interest.

Annually, the Division provides the regional offices with policy guidance concerning the upcoming year's inspection program. This guidance is both quantitative and qualitative. As the year progresses, the Division monitors each region's performance and discusses shortcomings and deviations from the plan.

See comment 15.

**Attempts to increase resources** Since the early 1980's, the Commission annually has tried to obtain increased staff resources for the adviser inspection program in order to keep some degree of parity between growth in the advisory industry and the number of staff available to review adviser disclosures and perform inspections. However, as shown in Table 3.1 in the Report, 5/ the Commission was largely unsuccessful in obtaining additional resources. Even though the inspection staff increased its productivity by over 100% between 1981 and 1985 in terms of the number of inspections done annually per examiner, growth in the advisory industry has far exceeded the ability of the staff to keep up. As a result, the frequency with which advisers are inspected declined steadily from about once every 7.5 years in 1983 to once every 12.5 years in 1990 (even with some increased staff in 1990).

See comment 16.

**Funding and fees** As stated in the Report, an adviser pays a $150 fee when filing its initial application. The fee is the same for all advisers. No other fees are payable at the federal level during the time an adviser remains registered. A one-time fee of $150 does not cover the costs incurred in regulating an adviser. The staff has estimated that an annual fee of between $800 and $850 would be required to cover the full cost of Commission regulation (including inspections on a 5.5 year cycle.) It appears that the advisory industry generally would support an increase in fees of this magnitude if it would result in the Commission continuing as the primary regulator of the industry. Obviously, either the increased fees would have to be paid to the Commission under some kind of self-funding arrangement or the Commission's budget would have to increase along with the increased fees. However, the negative impact of significant fee increases on advisers that are small businesses or sole proprietorships would have to be considered.

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5/ In Table 3.1, the total positions allocated line shows an increase from 200 to 215 from 1985 to 1986. This increase was due to the addition of the staff responsible for regulating public utility holding companies to the Division. None of the additional 15 positions in 1986 was devoted to regulation of investment advisers.

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The Commission has imposed the $150 fee under the Independent Offices Appropriations Act. Because of the findings the Commission would have to make under the Act to increase the fees advisers pay, raising fees administratively to the $800 level involves the possibility of litigation. This problem would be avoided if the Act were amended to provide for annual fees of this magnitude.

If you have any questions about our comments, please contact Gene Gohlke, Associate Director, of the Commission's Division of Investment Management at 272-2043.

Sincerely,

Kathryn B. McGrath

Kathryn B. McGrath

The following are GAO's comments on the Securities and Exchange Commission's letter dated April 23, 1990.

## GAO Comments

1. We agree that the 10 staff members currently assigned to review investment adviser applications are insufficient to completely verify information contained in the applications. However, the Investment Advisers Act of 1940 requires that investors receive accurate information with which to make informed decisions when securing the services of advisers. We believe that SEC cannot have reasonable assurance that application information is accurate without some degree of verification.

FBI criminal history records contain information on securities fraud and other white collar crimes in addition to murder or drug dealing. These crimes may be statutory disqualifications for potential investment advisers. As SEC states in its comments on this report, it is not certain it obtains the records on all federal court actions from the courts. The FBI's records could supplement those obtained from the courts.

2. We agree that SEC needs to take a proactive approach to identify unregistered advisers. We found efforts to identify unregistered advisers in only one of the regions we visited. Implementing nationwide the approach SEC describes in its comments would meet the intent of our recommendation.

3. Our recommendation on the registration of all advisory representatives is intended to provide SEC and investors with information on the background of all individuals who may give investment advice. The registration application (Form ADV) requires background information (Schedule D data) only for supervisors in advisory firms with more than five individuals providing investment advice. We point this out on pp. 18-19. Although some states register advisory representatives as well as advisory firms, as we point out on p. 32, not all states regulate investment advisers. Thus, investors may still be at risk if the background of those advisory representatives actually providing investment advice is not reviewed at either the federal or state level.

SEC argues that it requires additional authority to compel all advisers in advisory firms to register. We disagree. The act requires all investment advisers, unless they meet one of several statutory exceptions or have been exempted from registration by SEC, to register with SEC. The act defines an investment adviser as a person (either a natural person or a firm) who receives compensation for advising another person about the

value of or the advisability of investing in securities or who distributes reports concerning securities. Because the definition of an investment adviser is not limited to firms but also includes natural persons, the existing terms of the act would permit SEC to compel the registration of all individual advisers.

4. We agree with SEC that more inspectors are needed to inspect newly registered advisers within a year of registration. As we discussed on p. 37 the amount of resources needed may change depending upon how the program is restructured.

5. We agree that efficiently administering an inspection program calls for consideration of geographical dispersion of advisers as well as the risk they present. However, geographical location should not be the primary consideration. Advisers that pose great risk to their clients should be inspected regardless of where they are located.

The 3 to 6 year general guidelines for inspections based on risk that SEC includes in its comments are useful to indicate resource needs and to provide inspection goals. However, the need for inspection of advisers should be based on quantitative data obtained from previous inspections as well as the time elapsed since the last inspection.

6. SEC's reliance on investment advisers' self-certification rather than its reliance on follow-up exams to determine whether deficiencies identified during inspections have been corrected does not assure that advisers comply with the act. SEC officials commented that although they occasionally find advisers who misrepresent corrective actions taken, they do not believe this happens with sufficient frequency to justify reinspecting all advisers with deficiencies within 6 months. Without an active reinspection program or the results of a statistically valid sample of reinspections, we are uncertain how this judgment could be made. Moreover, our recommendation did not suggest reinspecting all advisers found to have deficiencies within 6 months. Given resource constraints, the intent of our recommendation could be met by targeting only those advisers whose deficiencies have been found to present the most risk to their clients. We have changed the recommendation language to clarify this intent.

7. We encourage SEC to continue to develop a comprehensive system to target advisers for inspection based on their risk to investors as recommended on p. 37.

8. The resources SEC needs for its investment adviser oversight program will depend on the type of program it chooses to administer as discussed on p. 37.

9. Our recommendation that investors should be informed that the registration program does not pass judgment on adviser competence is based on SEC officials' statements that the 1940 act may be giving investors the illusion that SEC-registered advisers have a "seal of approval." We agree that SEC does not have statutory authority to establish qualification standards for advisers' competence. However, we believe the language contained in Part II of the Form ADV needs to be expanded to inform investors that it is their responsibility rather than SEC's to evaluate an adviser's competence.

10. Numbers used in this report reflect advisers registered in fiscal year 1989, which was the latest available data at the time of our field work. Adding unaudited, selected 1990 data would not affect positions taken in the report.

11. We agree that SEC regulates investment advisers to assure that they provide potential investors accurate and complete information about their background and conform to applicable laws and regulations as discussed on p. 12. We modified the text on p. 3 to indicate that SEC staff also review advisers' compliance with the act and related rules.

12. The description given on p. 11 is intended to provide a broad description of services advisers may possibly provide, not a specific discussion of the limitations on these services. Therefore, no change has been made to the report.

13. See comment 1.

14. We agree that SEC targets advisers for inspection based on a number of factors, including general policy guidance from headquarters supplemented by specific information within each region. Our discussion on pp. 23-24 is meant to show that in addition to these factors, results of previous inspections should be used for targeting advisers for inspection.

15. We agree that SEC has been largely unsuccessful in obtaining additional resources while the industry has been experiencing growth as discussed on pp. 27-28.

16. We agree with SEC about fee increases, however, we state on p. 36 that costs could possibly be borne by advisers and their clients based on such factors as the volume of business. Setting fees based on business volume would be one way in which consideration could be given to the interests of small businesses and sole proprietorships.

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