CARLTON FIELDS

Controversial Investment Adviser SRO Legislation Introduced

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May 4, 2012 – As has long been expected, Congressman Spencer Bachus (R-AL) last week introduced legislation (H.R. 4624) to require most investment advisers to become members of an investment adviser self regulatory organization ("SRO"). If enacted in its current form, this legislation, over time, would have immense consequences for the industry. ***Which Investment Advisers Would Be Affected?*** With a few important exceptions, all investment advisers that are registered with the SEC or with a state would be required to be members of an SRO. The main *exceptions* are investment advisers that: 1. Have at least one client that is a registered investment company. Such an adviser would not be required to be an SRO member, even if its investment company business represented a very small proportion of its overall advisory business. *or*
2. Have certain enumerated types of clients that, in the aggregate, account for at least 90% of the adviser's assets under management. The types of clients that count toward this exception include: individuals with at least $5 million of investments; companies with at least $25 million of investments; non-U.S. investors; other investment advisers and broker-dealers; private investment companies; and certain other types of institutional investors. In addition, no SRO membership would be required for an investment adviser that is an affiliate of one or more advisers referred to in 1. and 2. above, provided that (a) at least 90% of all of such firms' aggregate assets under management are attributable to the types of clients referred to in 1. and 2. above and (b) the SEC does not determine that such affiliate should be an SRO member. (The SEC would make any such determinations based on how independent the affiliate's compliance program, operations, and business are from those of its affiliated firms referred to in 1. and 2. above.) ***What Would an Investment Adviser SRO Do?*** Although much of the public discussion to date has focused on an SRO's taking on the role of performing examinations of its investment adviser members, H.R. 4624 contemplates that an SRO would perform much more comprehensive regulatory functions. Thus, in order for the SEC to approve any entity's application to register as an SRO, the SEC would have to find that the entity is "so organized and has the capacity to be able to carry out the purposes of [the Investment Advisers

Act] and to enforce compliance by its members and persons associated with its members with the provisions of [the Investment Advisers Act], the rules and regulations thereunder, and the rules of the [SRO]." Moreover, the SEC would have to find that the entity's rules:

- "are designed to prevent fraudulent and manipulative acts and practices, to protect investors and the public interest, and to promote business conduct standards for its members consistent with their obligations to investors under [the Investment Advisers Act] and the rules thereunder" and

- "establish appropriate procedures to register persons associated with members, to require supervisory systems for members and persons associated with members, and to discipline its members and persons associated with its members for violations of provisions of the [Investment Advisers Act] or the rules and regulations thereunder, and the rules of the [SRO]."

The SRO would have broad authority to set the fees its members would have to pay to finance the SRO's operations. ***Who Could Be an SRO?*** FINRA continues to propose that the investment adviser SRO would be a FINRA affiliate. While permitting this, H.R. 4624 would require that the SRO's rules (a) "assure a fair representation of the public interest and the [SRO's] members in the selection of the [SRO's] board of directors and the administration of its affairs" and (b) provide that a majority of the SRO's directors shall not be associated with FINRA or any investment adviser, broker, or dealer. Many investment advisers continue to prefer that, if they must be members of an SRO, the SRO not be affiliated with FINRA. This includes, particularly, many "independent" advisers that are not already associated with FINRA-regulated broker-dealer firms and that do not qualify for any of H.R. 4624's exceptions from the investment adviser SRO membership requirement. While there has been some discussion of establishing an investment adviser SRO unrelated to FINRA (and some steps in that direction have been taken), it is unclear whether any such efforts will have the resources to succeed. In theory, H.R. 4624 would permit more than one SRO to register with the SEC, and those investment advisers that are required to become SRO members could choose from the ones that have so qualified. As a practical matter, however, the broad functions (discussed above) that this bill envisions for an SRO will probably increase the resources required and discourage non-FINRA-related applicants for SRO status. In this regard, H.R. 4624 requires that the rules of an investment adviser SRO "provide for substantively equivalent regulation and oversight of members and associated persons of members, including with respect to business conduct requirements and examinations, as provided under the rules of any other investment adviser SRO" registered with the SEC. This could make it difficult, for example, for any segment of the investment adviser industry to efficiently develop a separate SRO tailored to its own characteristics. ***Would the SRO Requirement Result in Disparate Treatment of Investment Advisers?*** As discussed above, H.R. 4624 aims for uniform treatment as among those investment advisers that it would require to become SRO members -- perhaps even to the exclusion of giving appropriate consideration to relevant differences in the businesses of different types of advisers. The bill does not, however, prescribe any uniformity of treatment as between those advisers that will be regulated by SROs and those that will continue to be regulated solely by the SEC. This would result in issues of disparate regulation among investment advisers similar to issues that existed among broker-dealers in the days when some

firms (so-called "SECO" firms) were regulated only by the SEC and not by any self-regulatory organization. ***What Comes Next for H.R. 4624?*** The bill is currently under consideration in the House Financial Services Committee chaired by Mr. Bachus, and no companion legislation has yet been introduced in the Senate. The concept of requiring SRO membership for investment advisers remains contentious, with differing factions lined up in the investment services industry and within the Congress. Early indications are that the prospects for passage this year of legislation of this type are better in the House than in the Senate.

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