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Could Dodd Bill Pave the Way for Another Madoff?

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Contrary to its intent, a provision in the financial regulatory bill now before the Senate-known as the Dodd bill-could weaken rather than strengthen oversight of investment advisers. The change could make it more, rather than less, likely that fraudsters similar to Bernard Madoff will escape regulatory scrutiny.

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The provision raises the threshold for investment advisers regulated by the Securities and Exchange Commission (SEC) from a minimum of $25 million in assets under management to $100 million. This means that an estimated 4,200 firms now overseen by the SEC will be regulated by the states instead. A similar provision is in the financial system reform bill that passed the House.

This could mean that more investment advisers could escape the oversight of regulators, as states are charged with examining thousands of additional advisers. Their operations might not, for instance, be equipped with information systems that could prove to the SEC that investments in particular securities actually were made on customers' behalf ("How Bernie Made Basket Cases of Customers' Accounts," Nov.2, 2009, page 16).

And strained state budgets may not be able to afford technology that would enable them to accommodate alternate methods of overseeing advisers.

"I am concerned that some states are not up to it. You are really shifting the burden from one overburdened agency to another," said Chris Winn, managing principal and co-founder of AdvisorAssist, a firm that helps registered investment advisers with business and regulatory issues. "They [states] lack staff and resources to conduct exams."

According to Winn, states could be handed more work than they are equipped to handle. This could cause more investment advisers to fall outside the regulators' radar, as Madoff was able to do for so long. "States are suffering from budget shortfalls, and some of them have already implemented layoffs," he said. "So now you have a huge flow of advisers coming in. I don't see how the states will be able to keep up."

"There really has not been close scrutiny of this idea," said one industry association executive on background. "There really hasn't been much pushback from industry [about this provision], so I think this will become law."

One problem, he explained, is that the actual number of advisers moving from federal to state regulation under the bill is likely to be much larger than the 4,200 estimate. "There will be more incentive for broker-dealers to become advisers, because the bill moves in the direction of imposing a fiduciary duty on broker-dealers," he said.

OPERATIONAL BURDEN

Conducting numerous additional exams would place a considerable operational burden on the states. According to the SEC's description of an adviser exam, this complex and lengthy process normally takes 120 days to complete. Examiners work on site, where they conduct interviews about the firm and its operations, organization, flow of work and risk control environment.

They also prepare an information or document request list, which advisers must complete and return. There may be more meetings and requests for information. On the last day of the onsite visit, there is an "exit interview" to discuss any outstanding information, document requests and issues identified during the exam process.

Examiners then perform additional analysis, consult with SEC staff, and finally, send the firm a written notification, either a "no-further action letter" or a "deficiency letter" asking the firm to take corrective action and possibly request a conference with the SEC.

Serious problems may be referred to the SEC's division of enforcement, a self-regulator or other regulator for possible action.

Investment advisers will face their own issues. "The compliance burden will increase. In the operations area, firms will have to gather more data and monitor more state laws, and possibly have different workflows for different states. All this will increase the operational burden from what it would have been under SEC oversight," Winn said.

REGULATORY GAP

A significant regulatory gap now exists between the operating resources dedicated to the examination of broker-dealers and those committed to the examination of registered investment advisers. The SEC and industry regulatory organizations examine more than half of the approximately 4,900 registered broker-dealer firms each year.

By contrast, the SEC projects that fewer than 10 percent of the more than 11,000 registered investment adviser (RIA) firms will be examined during fiscal years 2009 and 2010.

Instead, the SEC has dropped its goal of inspecting all RIAs on a regular schedule and is instead focusing its resources on advisers who are the subject of tips and complaints. "We simply show up . . . because we don't want to give firms a good deal of lead time to clean up," said Gene Gohlke, associate director of the SEC's Office of Compliance, Inspections and Examinations, at a Practising Law Institute investment management conference on April 9.

The Dodd bill attempts to relieve the commission's ongoing need for greater resources in part via the provision to increase state jurisdiction over advisers. This shifts burden off the SEC and onto the states.

"Unfortunately, the bill would require the SEC and states to engage in a disruptive and sudden reallocation of their regulatory resources from the supervision of broker-dealers to the supervision of investment advisers," says the Financial Services Institute (FSI), a group representing independent broker-dealers, in an April 5 briefing paper. "States would be required to take on the additional burden of supervising and examining thousands of additional investment advisers at a time when many state budgets are in crisis."

The FSI adds: "While we do not question the states' desire to effect meaningful supervision, we have concerns about their ability to marshal sufficient resources to do the job."

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