Exposing Corruption Exploring Solutions
Project On Government Oversight

September 13, 2011

House Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

We appreciate your leadership in considering possible reforms to the existing regulatory regime for investment advisers, especially in the aftermath of a financial crisis that continues to wreak havoc on retail investors across the nation. However, we are writing today to raise concerns about recently proposed reforms that would potentially delegate governmental authority to an industry-funded self-regulatory organization for the investment adviser industry.

We urge the Subcommittee to closely examine recent trends at the Financial Industry Regulatory Authority (FINRA)—the self-regulatory group for the broker-dealer industry—before deciding to give FINRA or a new self-regulatory organization (SRO) any authority to examine investment advisers.

The Project On Government Oversight (POGO) is a nonpartisan independent watchdog that champions good government reforms. As such, POGO believes that industry regulation is most effective when carried out by a governmental agency that is transparent, independent, ethical, and accountable. In addition, POGO's investigations have raised serious concerns about FINRA with respect to its inherent conflicts of interest, its weak enforcement record, the relationship between its senior officials and large broker-dealers, its lack of transparency and accountability, its advertising and lobbying expenditures, and its executive compensation practices, among other issues. For these reasons, we oppose expanding SRO oversight for the investment adviser industry.

Problems with the SRO model

Last week, House Financial Services Committee Chairman Spencer Bachus (R-AL) released a discussion draft of legislation that would require most registered investment advisers to become a member of a self-regulatory national investment adviser association.[1] However, we strongly

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[1] Discussion Draft of the "Investment Adviser Oversight Act of 2011." http://financialservices.house.gov/UploadedFiles/BACHUS_017_xml.pdf (Downloaded September 12, 2011) (hereinafter "Investment Adviser Oversight Act of 2011")

urge you to examine the many potential drawbacks of a self-regulatory framework for investment advisers and other financial firms.

Two recent studies required by the Dodd-Frank Wall Street Reform and Consumer Protection Act—one by the SEC Division of Investment Management, the other by the Boston Consulting Group—identified a number of serious problems with the SRO model. The SEC's study pointed out that "[o]verseeing an SRO requires substantial resources," even though "[t]here is no certainty that the level of resources available to the Commission over time would be adequate to enable staff to effectively oversee the activities of the SRO."[2] Although SROs are typically funded by fees imposed on their members, SEC resources would still be required for "conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee and rule changes."[3] There is also a serious threat of industry capture, under both a single-SRO and multiple-SRO framework:

> Multiple SROs could focus expertise and better accommodate industry diversity, but also could more likely lead to SRO "capture" by the discrete industry group from which SRO staff are drawn and to which they may return after their service. Even a single SRO, because it is not only funded by the industry it oversees, but also may include industry representatives in its governance structure or otherwise have a different relationship with industry than an independent government regulatory agency, could possibly have enhanced susceptibility to industry capture.[4]

The Boston Consulting Group's study also identified many common critiques of the SRO model, all of which could potentially apply to an investment adviser SRO. "The most fundamental critique," according to the study, "is that self-regulation is not real regulation at all: at best, self-regulation is less effective than government regulation, and at worst, is merely an 'illusion' meant to deflect calls for government oversight."[5] Another criticism is that "SROs govern with only limited democratic accountability: besides their respective boards of directors, SRO leadership answers only to the SEC, meaning that investors and other market participants have, at best, indirect democratic means for effecting regulatory change."[6]

Problems with FINRA

In addition to the numerous theoretical problems with the SRO model, POGO has raised the following specific concerns with respect to FINRA.[7]

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[2] Securities and Exchange Commission, Staff of the Division of Investment Management, *Study on Enhancing Investment Adviser Examinations*, January 2011, p. 28. http://www.sec.gov/news/studies/2011/914studyfinal.pdf (Downloaded September 12, 2011) (hereinafter "SEC Study")
[3] SEC Study, p. 30
[4] SEC Study, p. 33
[5] Boston Consulting Group, *U.S. Securities and Exchange Commission: Organizational Study and Reform*, March 10, 2011, p. 25. http://www.sec.gov/news/studies/2011/967study.pdf (Downloaded September 12, 2011) (hereinafter "BCG Study")
[6] BCG Study, p. 25
[7] Letter from Danielle Brian, Executive Director, Project On Government Oversight, to various Congressional Committees calling for increased oversight of financial self-regulators, February 23, 2010. http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html

Inherent conflict of mission

FINRA's practice of collecting fees from its member firms and investing in the securities industry raises concerns about an inherent conflict of mission. It is hard to imagine FINRA ever taking an enforcement action that would jeopardize the financial well-being of a firm that FINRA relies on for its funding and investments. POGO believes that FINRA's inherently conflicted self-funding model has contributed to many of the problems described below.

Weak enforcement record

A lawsuit recently filed by one of FINRA's smaller member firms alleged that the self-regulatory group failed to adequately oversee and regulate many of the larger member firms such as Bear Stearns, Lehman Brothers, Merrill Lynch, Madoff Investment Securities, and Stanford Financial Group. The complaint stated that "FINRA knew or should have known about the fraud being perpetrated by several of its most influential members, but there is nothing in the public record to indicate that FINRA conducted any oversight of these now-failed malefactors or their senior executives."[8]

Even an internal review conducted by FINRA found that the organization missed several key opportunities to detect and crack down on Allen Stanford's $7.2 billion Ponzi scheme.[9] And while FINRA officials have denied any wrongdoing in the failure to detect Bernard Madoff's Ponzi scheme, securities law scholar John Coffee has testified before Congress that "Madoff's brokerage business was by definition within...FINRA's jurisdiction."[10]

Furthermore, an investigation by *The Wall Street Journal* demonstrated that FINRA and its predecessor NASD (the National Association of Securities Dealers), under the leadership of current SEC Chairman Mary Schapiro, had a decidedly light touch when it came to regulation and enforcement, with significant declines in disciplinary fines assessed, individuals barred, and firms expelled during her time at the organization.[11] Although some enforcement trends have picked up over the past two years,[12] FINRA's track record leading up to the 2008 financial crisis should raise serious concerns about the ability of any SRO to protect U.S. financial markets from the next crisis.

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[8] *Amerivet Securities, Incorporated v. FINRA*, No. 09-cv-1715 (D.D.C.). August 10, 2009.

[9] *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes*, September 2009. http://www.finra.org/AboutFINRA/Leadership/Committees/P120076 (Downloaded September 10, 2011)

[10] Testimony of John C. Coffee, Jr., before the Senate Committee on Banking, Housing, and Urban Affairs, January 27, 2009. http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d3f6706f-2d65-4fad-a349-d839e04149e9 (Downloaded September 10, 2011)

[11] Randall Smith, Tom McGinty, and Kara Scannell, "Obama's Pick to Head SEC Has Record Of Being a Regulator With a Light Touch," *The Wall Street Journal*, January 15, 2009. http://online.wsj.com/article/SB123194123553080959.html (Downloaded September 10, 2011)

[12] Financial Industry Regulatory Authority, "FINRA Statistics," September 1, 2011. http://www.finra.org/Newsroom/Statistics (Downloaded September 12, 2011); and Letter from Richard Ketchum, Chairman and CEO, Financial Industry Regulatory Authority, to Danielle Brian, Executive Director, Project On Government Oversight, regarding transparency and accountability reforms, February 16, 2011. http://pogoarchives.org/m/fo/finra-response-20110216.pdf (hereinafter "Ketchum Letter")

To be sure, the SEC also failed to crack down on the widespread trading abuses in the brokerage industry leading up to the financial crisis, and missed several key opportunities to pursue enforcement action against Madoff and Stanford. However, the SEC's failures have been extensively documented through independent reviews by Congress and the SEC Office of Inspector General,[13] and the SEC has responded by initiating several key reforms to improve its operations, such as revamping its handling of tips and complaints, recruiting more staff with specialized expertise, implementing an improved whistleblower award program, and making widespread reforms to its enforcement and examination practices.[14] Meanwhile, FINRA has not been held accountable for its examination and enforcement failures, and there is no indication that the organization has implemented any comparable reforms to improve its operations.

Lack of transparency and accountability

Earlier this year, POGO sent a letter to FINRA criticizing the decision by the organization's Board of Governors to reject a proposal seeking transcripts from Board meetings.[15]

In a notice sent to FINRA's members, the Board explained that it objects to providing transcripts of its meetings because:

- The Board already communicates to FINRA's members through notices, an Annual Financial Report, and other means;
- The Board does not currently transcribe its meetings;
- Transcribing meetings could stifle candid deliberations among Board members;
- The proposal makes no exceptions to protect against the release of sensitive or proprietary information; and

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[13] Securities and Exchange Commission, Office of Inspector General, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme* (Report No. OIG-509), August 31, 2009. http://www.sec.gov/news/studies/2009/oig-509.pdf (Downloaded September 12, 2011); and Securities and Exchange Commission, Office of Inspector General, *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* (Report No. OIG-526), March 31, 2010. http://www.sec.gov/news/studies/2010/oig-526.pdf (Downloaded September 9, 2010)

[14] Securities and Exchange Commission, "The Securities and Exchange Commission Post-Madoff Reforms," http://www.sec.gov/spotlight/secpostmadoffreforms.htm. (Downloaded September 12, 2011); and Testimony of SEC Chairman Mary Schapiro before the Senate Subcommittee on Financial Services and General Government, Committee on Appropriations regarding the President's FY 2012 Budget Request for the SEC, May 4, 2011. http://www.sec.gov/news/testimony/2011/ts050411mls.htm (Downloaded September 12, 2011)

[15] In fact, there were seven transparency and accountability proposals approved by FINRA's members, most of which were rejected by FINRA's Board. The proposals called on FINRA to: 1) disclose in each annual report the compensation approved for the most highly paid FINRA employees and the amount paid to compensation consultants; 2) provide an independent study on the ties between FINRA and Bernie Madoff; 3) disclose more information on FINRA's investment transactions, policies and practices; 4) provide transcripts of FINRA's Board meetings; 5) give FINRA members a non-binding "say on pay" for the five most highly compensated FINRA employees; 6) employ an independent private-sector inspector general to oversee FINRA's performance; and 7) disclose FINRA's correspondence with the IRS concerning the regulatory merger that led to FINRA's creation. Letter from Danielle Brian, Executive Director, Project On Government Oversight, to Richard Ketchum, Chairman and CEO, Financial Industry Regulatory Authority, December 8, 2010. http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20101208.html

- The Board is not aware of any corporation that transcribes and publishes transcripts of board meetings.[16]

Many of these objections simply do not hold up to scrutiny. Annual financial reports, notices, and other means of limited communication are no substitute for full transcripts of Board meetings. And the fact that FINRA's Board does not transcribe its meetings is itself troubling. Many federal advisory committees with far less responsibility post transcripts from their open meetings, in addition to briefing materials, slides, agendas, conflict-of-interest waivers, recusal statements, and more.[17] We see no reason FINRA's Board could not do the same. In addition, a rule could easily be proposed allowing FINRA to close any portion of a Board meeting that would reveal preliminary deliberations or confidential information. Such provisions are a common feature in the rules governing open meetings at government agencies.[18]

In a response letter, FINRA Chairman and CEO Richard Ketchum identified numerous measures FINRA has taken to make its operations transparent, including publishing rulemaking items and Board decisions on its website, disclosing compensation details for its 10 most highly compensated employees, publishing the names of the money management firms it hires to manage its portfolio, and publishing an annual financial statement on its website.[19]

Nonetheless, we believe these measures do not provide sufficient transparency or accountability for an organization with such significant oversight authority. In fact, POGO believes there should be not only transcripts, but also open public access to board meetings at FINRA or any other self-regulatory group. Making SRO board meetings open to the public would give members, investors, taxpayers, and other stakeholders a much-needed glimpse into the organization's affairs.

In addition, POGO has concerns about the public's ability to obtain records pertaining to the SEC's oversight of FINRA, especially in light of the SEC's FOIA practices. In September 2010, POGO's Angela Canterbury testified before the House Financial Services Committee about a Dodd-Frank provision supported by the SEC that would have greatly expanded the agency's authority to withhold key records from the public. Among other things, POGO raised concerns that the SEC has been abusing FOIA Exemption 8, an exemption that is widely considered to be overly broad.[20]

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[16] Financial Industry Regulatory Authority, "Election Notice: Notice of Annual Meeting of FINRA Firms and Proxy," July 12, 2010. http://www.finra.org/Industry/Regulation/Notices/2010/P121716 (Downloaded September 12, 2011)

[17] Food and Drug Administration, Advisory Committees, "Committees & Meeting Materials." http://www.fda.gov/AdvisoryCommittees/CommitteesMeetingMaterials/default.htm (Downloaded September 12, 2011); and Securities and Exchange Commission, "SEC Investor Advisory Committee." http://www.sec.gov/spotlight/investoradvisorycommittee.shtml (Downloaded September 12, 2011)

[18] 94th Congress, "Government in the Sunshine Act" (5 U.S.C. § 552b(c)). http://frwebgate.access.gpo.gov/cgi-bin/usc.cgi?ACTION=RETRIEVE&FILE=$$xa$$busc5.wais&start=390059&SIZE=22647&TYPE=PDF (Downloaded September 12, 2011); and Securities and Exchange Commission, "Closed Meetings," 17 CFR Part 200.402. http://edocket.access.gpo.gov/cfr_2010/aprqtr/pdf/17cfr200.402.pdf (Downloaded September 12, 2011)

[19] Ketchum Letter

[20] Testimony of Angela Canterbury, Director of Public Policy, Project On Government Oversight, before the House Committee on Financial Services regarding "Legislative Proposals to Address Concerns Over the SEC's New

It was recently revealed that the SEC is now using Exemption 8—which is supposed to protect against the release of matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions"[21]—to withhold records concerning the SEC's oversight of FINRA's forced arbitration process.

The Public Investors Arbitration Bar Association (PIABA), which filed the request seeking records related to the SEC's oversight of FINRA's process for selecting arbitrators, appealed the SEC's denial, arguing that the release of the requested records would not endanger FINRA's stability as a "financial institution," nor would it undermine the SEC's ability to oversee FINRA. However, the SEC maintained that the records were "obtained or created during the course of an inspection conducted by Commission staff," and that the information "facilitates the staff's oversight and supervision of this self-regulatory organization's activities."[22]

POGO is concerned that the SEC has adopted an overly broad definition of "financial institution" with regards to FINRA. Exemption 8 is normally used to protect the records of banks and other financial firms examined by federal regulators, but in this case it is being used to protect a self-regulatory group that conducts its own examinations. Since FINRA itself is not subject to any open records laws, the SEC's decision to withhold these records further shields FINRA from any public scrutiny or oversight, and raises concerns about the potential lack of transparency and accountability for an investment adviser SRO.

Revolving door and excessive executive compensation practices

In 2009, FINRA's top 18 executives and board members received nearly $23 million in base compensation, bonus and incentive compensation, deferred compensation, and other benefits, according to FINRA's 990 statement.[23] POGO believes these executive compensation packages are excessive for a non-profit regulatory organization, especially one that failed to crack down on the widespread abusive trading practices leading up to the financial crisis. POGO is also concerned that these executive compensation practices have served to exacerbate FINRA's inherent conflicts of interest, as FINRA's top officials become even more indebted to the industry they are supposed to oversee.

In September 2010, FINRA issued a report that attempted to justify the organization's executive compensation practices. The report emphasized the importance of benchmarking FINRA's compensation with the compensation approved at comparable organizations. A consulting firm retained by FINRA found that "most of FINRA's employees and management had come from and were leaving to the financial services industry," and that "FINRA's role as a complex private sector regulator required a pool of executive talent with the knowledge and skills similar to those

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Confidentiality Provision," September 16, 2010. http://www.pogo.org/pogo-files/testimony/financial-oversight/fo-fra-20100916.html

[21] Department of Justice, *Department of Justice Guide to the Freedom of Information Act: Exemption 8*. http://www.justice.gov/oip/foia_guide09/exemption8.pdf (Downloaded September 12, 2011)

[22] Project On Government Oversight, "SEC Withholds Records on Oversight of Self-Regulatory Group," June 16, 2011. http://pogoblog.typepad.com/pogo/2011/06/sec-withholds-records-on-oversight-of-self-regulatory-group.html

[23] Financial Industry Regulatory Authority, Form 990, 2009. http://pogoarchives.org/m/fo/finra-2009-990.pdf

in the financial industry."[24] The consulting firm, along with FINRA's Compensation Committee, concluded that:

> "[B]ecause FINRA competed primarily with the financial services industry for talent, the financial services industry, including broker-dealers, global investment banks, Federal Reserve banks, commercial banks and insurance companies, would provide the best benchmarks for senior management compensation. They also concluded that non-profit organizations and governmental agencies were inadequate comparables for compensation purposes because FINRA required of its executives a different skill set and knowledge base than many such organizations."[25]

POGO understands the need to offer competitive pay so that FINRA can attract and retain highly qualified senior management. However, POGO does not agree that governmental agencies are "inadequate comparables for compensation purposes." In fact, the SEC and other governmental regulatory agencies are authorized to pay their employees at rates beyond the normal governmental pay scale in order to compete with private sector compensation.[26] POGO believes that any difference in the skill sets required of FINRA executives and senior SEC officials would not be enough to justify the vast disparity in compensation at the two entities.

This disparity has created a unique challenge in the case of SEC Chairman Mary Schapiro, who received a final distribution of nearly $9 million when she stepped down as the head of FINRA.[27] She is now in the potentially conflicted position of having to oversee an organization that approved her generous pay package just a few years ago. It is worth noting that Chairman Schapiro signed an ethics agreement recusing herself from participating in certain matters related to FINRA,[28] and she was recused from voting on the SEC staff study regarding investment adviser oversight.[29] Meanwhile, another SEC Commissioner, Elisse Walter, is also a former senior executive at FINRA, which paid her more than $3.7 million in salary and bonuses in 2008.[30] However, Commissioner Walter did not recuse herself from voting on the SEC study; in fact, she issued an unusual statement criticizing the study and calling on Congress to delegate significant authority to an investment adviser SRO.[31]

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[24] Financial Industry Regulatory Authority, *Report of the Amerivet Demand Committee*, September 13, 2010, p. 86. http://www.finra.org/AboutFINRA/Leadership/Committees/P122215 (Downloaded September 12, 2011) (hereinafter "FINRA Compensation Report")
[25] FINRA Compensation Report, p. 86
[26] Securities and Exchange Commission, "Pay Parity Implementation: Plan and Report," March 6, 2002. http://www.sec.gov/news/studies/payparity.htm (Downloaded September 12, 2011)
[27] FINRA Compensation Report, p. 92
[28] Letter from Mary Schapiro, Chairman, Securities and Exchange Commission, to William Lenox, Ethics Counsel and Designated Agency Ethics Official, Securities and Exchange Commission, January 11, 2009. http://www.propublica.org/documents/item/obama-administration-ethics-agreements#document/p28 (Downloaded September 12, 2011)
[29] Sarah N. Lynch, "SEC to unveil studies on brokers, advisers," *Reuters*, January 12, 2011. http://www.reuters.com/article/2011/01/12/us-sec-fiduciary-idUSTRE70B60W20110112 (Downloaded September 12, 2011)
[30] Financial Industry Regulatory Authority, Form 990, 2008. http://pogoarchives.org/m/er/merrill-2008-compensation.pdf
[31] Statement by Elisse B. Walter, Commissioner, Securities and Exchange Commission, regarding SEC study on enhancing investment adviser examinations, January 2011. http://sec.gov/news/speech/2011/spch011911ebw.pdf (Downloaded September 12, 2011)

In addition, there are many examples of FINRA executives and board members leaving the organization to go work for FINRA's member firms. Several former FINRA employees went to work for Allen Stanford: Lena Stinson, director of global compliance at Stanford, served on FINRA's membership committee, while Frederick Fram, chief operating officer of Stanford Group Holdings, served on FINRA's continuing education committee.[32] Bernerd Young, a former NASD official, is reportedly under investigation for his subsequent role as chief compliance officer of Stanford Financial Group.[33] And Susan Merrill, FINRA's former head of enforcement, recently returned to private practice in the New York office of Bingham McCutchen, where she will "lead Bingham's enforcement practice and advise clients on regulatory and securities enforcement matters."[34] She recently joined with several former SEC officials in representing JPMorgan in its widely criticized settlement with the SEC[35] for allegedly structuring and marketing a complex mortgage securities deal just as the housing market was starting to plummet, without informing investors that the hedge fund Magnetar had essentially created the deal and bet against it.[36]

FINRA recently introduced a revolving door rule that would impose a one-year cooling off period on certain senior officials during which they cannot represent or testify as an expert witness on behalf of a FINRA-regulated entity in disciplinary and other proceedings that take place before FINRA adjudicators.[37] However, POGO believes the rule is woefully inadequate—for instance, it does not address the revolving door between FINRA and the SEC—and serves as an important reminder that employees at FINRA and other SROs are not bound by the same post-employment regulations that were put in place to protect the public's interest at government agencies.[38]

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[32] Anna Driver, "Stanford workers had ties to regulator FINRA," *Reuters*, February 24, 2009. http://www.reuters.com/article/2009/02/24/us-stanford-finra-idUSTRE51N5RO20090224 (Downloaded September 12, 2011)

[33] Kara Scannell, "Ex-NASD Official Under Scrutiny for Work at Stanford Group," *The Wall Street Journal*, July 22, 2010. http://compliancesearch.com/compliancex/current-affairs/exnasd-official-under-scrutiny-for-work-at-stanford-group/ (Downloaded September 12, 2011)

[34] Project On Government Oversight, "Departing FINRA Executive to Join Other Former Enforcement Officials at Bingham McCutchen," April 12, 2010. http://pogoblog.typepad.com/pogo/2010/04/departing-finra-executive-to-join-other-former-enforcement-officials-at-bingham-mccutchen.html

[35] Jonathan Weil, "JPMorgan Gets a Break Where Goldman Got Nailed," *Bloomberg*, June 23, 2011. http://www.bloomberg.com/news/2011-06-23/jpmorgan-gets-a-break-where-goldman-got-nailed-jonathan-weil.html (Downloaded September 12, 2011)

[36] Project On Government Oversight, "JPMorgan Represented by Former Senior SEC Officials in SEC Settlement," June 28, 2011. http://pogoblog.typepad.com/pogo/2011/06/jpmorgan-represented-by-former-senior-sec-officials-in-sec-settlement.html

[37] Securities and Exchange Commission, "Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Implement Revolving Door Restrictions on Former Officers of FINRA," (Release No. 34-64841; File No. SR-FINRA-2011-032), July 8, 2011. http://sec.gov/rules/sro/finra/2011/34-64841.pdf (Downloaded September 12, 2011)

[38] Project On Government Oversight, "Self-Regulatory Group Introduces Revolving Door Rule -- But Does It Go Far Enough?" July 14, 2011. http://pogoblog.typepad.com/pogo/2011/07/self-regulatory-group-introduces-revolving-door-rule-but-does-it-go-far-enough.html

Board stacked with industry representatives

FINRA's Board of Governors is supposed to include a certain number of public representatives, and Representative Bachus's proposed legislation would similarly require an investment adviser SRO to "assure a fair representation of the public interest…in the selection of its directors and the administration of its affairs."[39]

On FINRA's Board, however, many of the members who are supposed to represent the public's interest[40] appear to have close ties to the securities industry. For instance, William Heyman is a former Vice Chairman and CIO of St. Paul Travelers;[41] Richard Pechter is a former Chairman of the Financial Services Group at Donaldson, Lufkin & Jenrette;[42] and John Schmidlin is a former CIO of JPMorgan Chase.[43]

Significant expenditures on advertising and lobbying

In addition to its excessive executive compensation practices, FINRA has recently invested significant resources defending its record through advertisements in *The Washington Post*, commercials on CNN, and "public interest" spots on National Public Radio.[44] In addition, between 2008 and 2010, FINRA spent nearly $2.7 million on lobbying, according to data from the Center for Responsive Politics.[45] POGO believes these spending practices should raise questions about FINRA's allocation of resources. In addition, it is worth noting that federally registered lobbyists retained by FINRA have also lobbied on behalf of Goldman Sachs & Co., BlackRock Capital Management, Inc., and other FINRA member firms,[46] which raises additional concerns about the organization's cozy relationship with the securities industry.

Mandatory binding arbitration

Many consumer groups have raised concerns that forced arbitration denies investors and consumers their constitutional right to sue in court when they have been harmed by a company, and that it is an inherently biased system in favor of companies and organizations that are repeat customers.[47] Likewise, POGO is concerned that FINRA's forced arbitration process deprives investors and consumers of their access to court, their due process rights, and their choice of

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[39] "Investment Adviser Oversight Act of 2011"
[40] Financial Industry Regulatory Authority, "FINRA Board of Governors," August 3, 2011. http://www.finra.org/AboutFINRA/Leadership/P009756 (Downloaded September 12, 2011)
[41] St. Paul Travelers, "St. Paul Travelers Announces William Heyman Named Vice Chairman and Chief Investment Officer," May 5, 2005. http://investor.travelers.com/phoenix.zhtml?c=177842&p=irol-newsArticle&ID=706391&highlight= (Downloaded September 12, 2011)
[42] Donaldson, Lufkin & Jenrette, Inc. , Press Release, "Richard S. Pechter to Retire From DLJ," November 1, 1999. http://findarticles.com/p/articles/mi_m0EIN/is_1999_Nov_1/ai_57051011/ (Downloaded September 12, 2011)
[43] New York Stock Exchange, "John W. Schmidlin Joins NYSE Regulation Board of Directors," August 2, 2007. http://www.nyse.com/press/1186398060067.html (Downloaded September 12, 2011)
[44] Sarah Lynch. "New Finra Ad Campaign Talks Tough On Fraud." *Dow Jones Newswires*. June 15, 2009.
[45] Center for Responsive Politics, "Lobbying Spending Database – Financial Industry Regulatory Authority." http://www.opensecrets.org/lobby/clientsum.php?id=D000043164&year=2011 (Downloaded September 12, 2011)
[46] Center for Responsive Politics, "Lobbyist Profile: Mitchell L. Feuer." http://www.opensecrets.org/lobby/lobbyist.php?id=Y0000041101L&year=2011 (Downloaded September 12, 2011)
[47] "Fair Arbitration Now." http://fairarbitrationnow.org/ (Downloaded September 12, 2011)

venue and arbitrator, and that it does not allow for a proceeding that meets the standards of the civil justice system or even those mandated by the Administrative Procedure Act.

Hidden costs

In previous testimony before Congress, FINRA Chairman and CEO Richard Ketchum argued that "the increased manpower and enhanced investor protection" that would result from authorizing FINRA or another SRO to regulate investment advisers "would come at no cost to the taxpayer" because SROs are funded exclusively by the entities they regulate.[48] Unfortunately, this funding system amounts to a user tax on investors in the form of transaction costs. Furthermore, as mentioned above, taxpayers must foot the bill for the SEC's oversight of FINRA and other self-regulators, which entails approving SRO rules, monitoring their activities, hearing internal appeals, and overseeing board activities. Many of these same responsibilities are included in Chairman Bachus's proposed legislation.

In some cases, these oversight requirements may even result in a duplication of efforts between the SEC and FINRA, an unacceptable state of affairs given the SEC's severely limited resources. For these reasons, POGO agrees with SEC Commissioner Luis Aguilar's statement that creating an investment adviser SRO would be an "illusory way of dealing with the problem of resources."[49]

Funding effective oversight

The SEC's study urged Congress to consider other avenues for increasing funding and resources for investment adviser oversight. One possible reform would be to give the SEC the authority to collect user fees from registered investment advisers to support the SEC's examination program. The SEC's study identified several possible advantages to this approach: for instance, it could "provide OCIE with the resources to perform earlier examinations of newly-registered investment advisers and more frequent examinations of other registered investment advisers... provide resources that would permit OCIE to improve the effectiveness of its examinations through long-term strategic planning...[and] provide the adviser examination program increased flexibility to react to developing and emerging risks associated with investment advisers."[50] In addition, it would avoid many of the problems mentioned above that are likely to result from establishing an investment adviser SRO.

However, POGO believes that imposing user fees on investment advisers is not an ideal solution since it could lead to many of the same inherent conflict-of-interest issues related to self-funding that have limited FINRA's effectiveness. It is ultimately Congress's responsibility to ensure that the SEC and other financial regulatory agencies have the funding they need to effectively carry out their mission, including their expanded responsibilities under Dodd-Frank.

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[48] Testimony of Richard G. Ketchum before the House Financial Services Committee. October 6, 2009. http://www.finra.org/Newsroom/Speeches/Ketchum/P120108 (Downloaded September 12, 2011)
[49] Speech by Luis Aguilar, Commissioner, Securities and Exchange Commission, regarding SEC's oversight of the adviser industry, May 7, 2009. http://www.sec.gov/news/speech/2009/spch050709laa.htm (Downloaded September 12, 2011)
[50] SEC Study, p. 26.

Recommendations

POGO believes there is no substitute for governmental regulation of the investment adviser industry. Therefore, we oppose Representative Bachus's draft legislation.

FINRA's inherent conflict of mission, poor enforcement record, and lack of transparency and accountability illustrate why an SRO model for investment advisers will not serve the interests of investors, shareholders, consumers, and other market participants. Instead of delegating additional authority to a private self-regulatory group, Congress should reduce the SEC's current reliance on FINRA, improve FINRA's transparency and accountability, and provide sufficient funding to the SEC to ensure that it is able to carry out its important regulatory duties on its own. If we have learned anything from the financial crisis of the past few years, it is that inadequate federal regulation of the financial industry leads to excessive risk and instability in our economy.

We appreciate your ongoing leadership in establishing an effective oversight regime for registered investment advisers. We would be pleased to discuss this issue in more detail with you or your staff. If you have questions or would like any additional information, please contact us at 202-347-1122 or acanterbury@pogo.org or msmallberg@pogo.org.

Sincerely,

Angela Canterbury
Director of Public Policy

Michael Smallberg
Investigator

cc: Chairman of House Financial Services Committee Bachus, Ranking Member Frank, and Members of the Committee