

May 29, 2012

House Committee on Financial Services  
2129 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Bachus and Ranking Member Frank:

We appreciate your consideration of possible reforms to the existing regulatory structure for investment advisers in the aftermath of the financial crisis that continues to cause uncertainty about the investing environment in America. However, we write to raise concerns about the Investment Adviser Oversight Act of 2012 (H.R. 4624), co-sponsored by Chairman Bachus and Representative McCarthy, which would delegate governmental authority for the oversight of investment advisers to one or more industry-funded self-regulatory organizations (SROs).

The Project On Government Oversight (POGO) is a nonpartisan independent watchdog that champions good government reforms. POGO's investigations into corruption, misconduct, and conflicts of interest achieve a more effective, accountable, open, and ethical federal government. As such, POGO believes that industry regulation is most effective when carried out by a governmental agency that is transparent, independent, ethical, and accountable.

POGO has joined others in raising serious concerns about the Financial Industry Regulatory Authority (FINRA), the largest SRO for the securities industry. FINRA's regulatory effectiveness is undermined by its inherent conflicts of interest, its lack of transparency and accountability, its lobbying expenditures, and its executive compensation packages, among other issues. A recent analysis by the Boston Consulting Group underscored the costs associated with authorizing FINRA or a new SRO to regulate investment advisers.<sup>1</sup>

For these reasons, we oppose H.R. 4624, which would authorize one or more SROs to oversee the investment adviser industry.

**Conflicted mission leads to cozy ties with industry**

FINRA collects fees from its member firms and invests in the securities industry, while also assuming responsibility for regulating and disciplining these firms, raising concerns about an inherent conflict of mission.

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<sup>1</sup> Boston Consulting Group, *Investment Adviser Oversight: Economic Analysis of Options*, December 2011, p. 5. <http://pogoarchives.org/m/fo/bcg-ia-report-20111201.pdf> (Hereinafter "BCG Analysis")

If H.R. 4624 is enacted into law, it remains to be seen whether the task of regulating investment advisers would be assigned to FINRA or to other SROs. But there could be serious conflicts of interest in either case, as highlighted in a recent study by the Securities and Exchange Commission's (SEC) Division of Investment Management:

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.<sup>2</sup>

Along these lines, a recent report by the Government Accountability Office (GAO) noted that when "the system of self-regulation was created, Congress, regulators, and market participants recognized that this structure possessed inherent conflicts of interest because of the dual role of SROs as both market operators and regulators."<sup>3</sup>

In the case of FINRA, POGO believes that the organization's inherently conflicted self-funding model has contributed to an incestuous relationship between FINRA and the industry it is tasked with regulating. There has been abundant evidence of this relationship in recent years, including the ties between current and former FINRA officials and firms that were later investigated or charged with fraud involving major investor losses:

- Several members of Bernard Madoff's family held leadership roles at FINRA and its predecessor, the National Association of Securities Dealers (NASD), as acknowledged in an internal study conducted by FINRA's board after Madoff's Ponzi scheme was exposed.<sup>4</sup>
- Bernerd Young, a former director of NASD's Dallas office, became a compliance officer at a bank run by convicted Ponzi schemer R. Allen Stanford. Young may soon face civil charges from the SEC, including a lifetime ban on working in the securities industry, according to *Reuters*.<sup>5</sup> At least two other Stanford executives also had previous

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<sup>2</sup> Securities and Exchange Commission, Division of Investment Management, *Study on Enhancing Investment Adviser Examinations*, January 2011, p. 33. <http://www.sec.gov/news/studies/2011/914studyfinal.pdf> (Downloaded May 23, 2012) (Hereinafter "SEC Study")

<sup>3</sup> Government Accountability Office, *Private Fund Advisers: Although a Self-Regulatory Organization Could Supplement SEC Oversight, It Would Present Challenges and Trade-offs* (GAO-11-623), July 2011, p. 10. <http://www.gao.gov/new.items/d11623.pdf> (Downloaded May 23, 2012) (Hereinafter "GAO Report")

<sup>4</sup> Despite these ties, the internal report found "no information to suggest that the Madoff firm received preferential or lenient treatment because of Madoff's prominence or his family's history of service to NASD and FINRA." Financial Industry Regulatory Authority, *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes*, September 2009, p. 46. <http://www.finra.org/AboutFINRA/Leadership/Committees/P120076> (Downloaded May 23, 2012)

<sup>5</sup> Murray Waas, "How Allen Stanford kept the SEC at bay," *Reuters*, January 26, 2012. <http://www.reuters.com/article/2012/01/26/us-sec-stanford-idUSTRE80P22R20120126> (Downloaded May 23, 2012)

experience at FINRA.<sup>6</sup>

- Jon Corzine, the former CEO and Chairman of MF Global, used to be a member of NASD's board.<sup>7</sup> A recent article in *Forbes* suggested that FINRA might have waived some of Corzine's registration requirements when he joined MF Global,<sup>8</sup> which filed for bankruptcy after losing up to \$1.6 billion in customer funds.<sup>9</sup> More recently, Suzanne Elovic, former chief counsel in FINRA's Department of Enforcement,<sup>10</sup> became MF Global's head of U.S. regulatory inquiries shortly after leaving FINRA.<sup>11</sup>
- Susan Merrill, FINRA's former head of enforcement, left the organization and went on to represent JPMorgan<sup>12</sup> in its widely criticized settlement with the SEC 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.<sup>13</sup>

To be sure, there are conflict-of-interest problems in government regulatory agencies as well as SROs.<sup>14</sup> As described below, however, government employees are at least required to comply with federal ethics laws and agency regulations designed to mitigate potential conflicts of interest. FINRA and other SRO employees, on the other hand, are only required to follow their organization's decidedly anemic ethics policies.

POGO is concerned that the inevitable conflicts of interest between an investment adviser SRO and its members will not only limit the SRO's actual effectiveness, but also damage the public's confidence in the organization's enforcement activities, thereby further limiting its regulatory impact.

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<sup>6</sup> 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 May 23, 2012)

<sup>7</sup> National Association of Securities Dealers, "Jon S. Corzine Elected to NASD Board of Governors," June 26, 1997. <http://www.finra.org/Newsroom/NewsReleases/1997/P010484> (Downloaded May 23, 2012)

<sup>8</sup> Bill Singer, "Did Someone at FINRA Do Corzine A Favor And Waiver His Registration Requirements?" *Forbes*, November 4, 2011. <http://www.forbes.com/sites/billsinger/2011/11/04/did-someone-at-finra-do-corzine-a-favor-and-waive-his-registration-requirements> (Downloaded May 23, 2012)

<sup>9</sup> House Committee on Financial Services, "Subcommittee Investigates MF Global's Final Days," March 23, 2012. <http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=286900> (Downloaded May 25, 2012)

<sup>10</sup> Financial Industry Regulatory Authority, "Letter of Acceptance, Waiver and Consent, No. 20080144507," February 16, 2010, p. 11. <http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p121484.pdf> (Downloaded May 23, 2012)

<sup>11</sup> "Suzanne Elovic," LinkedIn. <http://www.linkedin.com/pub/suzanne-elovic/21/726/a8a> (Downloaded May 23, 2012)

<sup>12</sup> 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>

<sup>13</sup> 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 May 23, 2012)

<sup>14</sup> Project On Government Oversight, *Revolving Regulators: SEC Faces Ethics Challenges with Revolving Door*, May 13, 2011. <http://www.pogo.org/pogo-files/reports/financial-oversight/revolving-regulators/fo-fra-20110513.html>

### **Lack of transparency and accountability**

POGO and other groups from across the political and ideological spectrum have raised concerns about the lack of transparency and accountability at FINRA. We strongly urge the Committee to probe these issues before delegating any additional governmental authority to FINRA or another SRO.

The GAO recently noted that one of the potential drawbacks of creating an SRO for private funds is that it would “limit transparency and accountability, as the SRO would be accountable primarily to its members rather than to Congress or the public.”<sup>15</sup> In the case of FINRA, even industry groups have expressed frustration with the organization’s lack of transparency and accountability. The Chamber of Commerce, for instance, has noted that FINRA is not bound by the system of checks and balances that applies to government agencies:

Transparency into FINRA’s governance, compensation, and budgeting practices is extremely limited and superficial. Furthermore, FINRA is not subject to the Freedom of Information Act or the [Administrative Procedure Act], nor is it required to conduct a cost-benefit analysis when it engages in rulemaking or exercises its policy-making functions.<sup>16</sup>

Several recent episodes have illustrated the vast differences between FINRA and government agencies with respect to transparency and accountability.

FINRA’s board has consistently rejected calls for more transparency and accountability, even when the proposals come from the organization’s own member firms. In 2010, for instance, FINRA’s board rejected a series of proposals approved by FINRA’s member firms that would have required the organization to provide transcripts of board meetings, employ an independent private sector inspector general to oversee the organization, and give FINRA members a non-binding “say on pay” for the most highly compensated FINRA employees, among other things.<sup>17</sup> In addition, POGO has argued that FINRA’s recently introduced revolving door rule is woefully inadequate to protect against conflicts of interest.<sup>18</sup>

Even though FINRA is not subject to many basic oversight measures, the organization is still protected by a special type of legal immunity that normally applies to governmental entities. Last year, POGO joined with several public interest groups in an amicus brief asking the Supreme Court to consider whether FINRA and other groups acting with quasi-governmental authority

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<sup>15</sup> “GAO Report,” p. 20

<sup>16</sup> Chamber of Commerce, Center for Capital Markets Competitiveness, *U.S. Capital Markets Competitiveness: The Unfinished Agenda*, Summer 2011, p. 23. [http://www.uschamber.com/sites/default/files/reports/1107\\_UnfinishedAgenda\\_WEB.pdf](http://www.uschamber.com/sites/default/files/reports/1107_UnfinishedAgenda_WEB.pdf) (Downloaded May 23, 2012)

<sup>17</sup> Project On Government Oversight, “POGO letter to FINRA calling for open Board meetings,” December 8, 2010. <http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20101208.html>

<sup>18</sup> 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>

should enjoy the same kind of sovereign immunity that applies to government agencies, even when the SRO is sued for misconduct related to its private business. The brief stated that:

The extension of sovereign immunity to SROs... produces the bizarre result that a corporate entity—which lacks the democratic accountability that legitimizes our federal and state governments—can avail itself of the same protections as actual governments subject to oversight via the democratic process.<sup>19</sup>

The Supreme Court declined to consider this matter,<sup>20</sup> but we urge the Committee to examine the potential legal ramifications of granting new powers to FINRA or another SRO.

POGO has also heard from many investors and current and former employees of broker-dealers about the lack of transparency and accountability in FINRA's mandatory arbitration system. In one recent case, Mark Mensack, a former financial adviser at Morgan Stanley, filed a suit in the New Jersey Superior Court alleging that Morgan Stanley retaliated against him after he raised concerns internally about a "pay-to-play" scheme involving 401(k) assets administered by the firm. Morgan Stanley was able to get the case moved to a FINRA arbitration proceeding, where it also filed a claim against Mensack seeking return of his signing bonus. The arbitrators ruled in Morgan Stanley's favor, ordering Mensack to pay \$1.2 million and forcing him into bankruptcy.

But when Mensack and his attorney requested an audio copy of the arbitration hearing, they discovered that eight hours' worth of testimony had mysteriously gone missing. Earlier this year, a FINRA regional director apologized for the fact that "portions of testimony returned to us by the panel are missing from the records," but informed Mensack and his attorney that "FINRA has no authority to reverse the award."<sup>21</sup> Mensack has indicated that the missing recordings would have provided evidence of additional misconduct in the arbitration hearing. Several commentators have pointed to Mensack's case as an example of "sham justice" before a "kangaroo court."<sup>22</sup>

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<sup>19</sup> "Brief of Amici Curiae Public Citizen, Consumer Action, Project On Government Oversight, and U.S. PIRG in Support of Petition for a Writ of Certiorari," *Standard Investment Chartered, Inc. v. National Association of Securities Dealers, et al.*, October 2011, p. 15. <http://pogoarchives.org/m/fo/standard-amicus-20111025.pdf>

<sup>20</sup> James Vicini, "Supreme Court won't hear FINRA immunity case," *Reuters*, January 17, 2012. [http://newsandinsight.thomsonreuters.com/Legal/News/2012/01\\_-\\_January/Supreme\\_Court\\_won\\_t\\_hear\\_FINRA\\_immunity\\_case](http://newsandinsight.thomsonreuters.com/Legal/News/2012/01_-_January/Supreme_Court_won_t_hear_FINRA_immunity_case) (Downloaded May 23, 2012)

<sup>21</sup> Letter from Katherine M. Bayer, Regional Director, Financial Industry Regulatory Authority, to Robert Lakind, Szaferman, Lakind, Blumstein & Blader, P.C., regarding FINRA Dispute Resolution Arbitration Case Number 10-01687, *Morgan Stanley Smith Barney LLC, vs. Mark D. Mensack vs. Morgan Stanley & Co., Inc., Peter Prunty and Rich Maratea*, January 13, 2012. <http://pogoarchives.org/m/fo/finra-response-20120113.pdf>

<sup>22</sup> Al Lewis, "Broker bankrupted in kangaroo court," *MarketWatch*, March 14, 2012. [http://articles.marketwatch.com/2012-03-14/commentary/31163067\\_1\\_finra-financial-industry-regulatory-authority-morgan-stanley](http://articles.marketwatch.com/2012-03-14/commentary/31163067_1_finra-financial-industry-regulatory-authority-morgan-stanley) (Downloaded May 23, 2012); William D. Cohan, "Whistleblower Gets Sham Justice From Wall Street Court," *Bloomberg*, March 18, 2012. <http://www.bloomberg.com/news/2012-03-18/whistleblower-gets-sham-justice-from-wall-street-court.html> (Downloaded May 23, 2012)

Mensack's case is also troubling in light of another recent episode in which the SEC alleged that a FINRA regional director "caused the alteration of three records of staff meeting minutes just hours before producing them to the SEC inspection staff, making the documents inaccurate and incomplete."<sup>23</sup>

### **Excessive spending on lobbying and executive compensation**

FINRA has also distinguished itself from governmental regulatory agencies through its excessive spending on lobbying and executive compensation. The organization spent nearly \$4 million on lobbying between 2008 and 2011, according to the Center for Responsive Politics,<sup>24</sup> not to mention its significant expenditures on advertising and "public interest" spots in national media outlets.<sup>25</sup> These figures do not include the significant lobbying expenditures and campaign contributions made by FINRA's member firms.

In addition, FINRA provides lucrative compensation packages for its top executives and board members. In 2010, FINRA's top 10 executives received nearly \$13 million in pay and benefits, according to FINRA's annual report.<sup>26</sup> POGO believes these compensation packages are excessive for a non-profit regulatory organization, especially one that failed to crack down on the abusive market activities that fueled the financial crisis. POGO is also concerned that these lavish pay packages may have exacerbated the organization's inherent conflicts of interest, as top officials become even more indebted to the industry they are supposed to oversee.

POGO believes that FINRA should be benchmarking its compensation packages against those provided by federal agencies such as the SEC, which already has the authority to pay its top employees at rates beyond the normal governmental pay scale.<sup>27</sup>

Furthermore, POGO is concerned that some SEC officials may generally be biased in favor of the SRO model due to the extravagant pay packages they received while working at FINRA. In its press release announcing the introduction of H.R. 4624, the Committee cited several key leaders who have supported creating an SRO for investment advisers.<sup>28</sup> It is worth noting that many of these leaders used to work for FINRA and recently received generous pay packages from the organization. For instance, SEC Chairman Mary Schapiro received a final distribution of nearly \$9 million when she stepped down as the head of FINRA.<sup>29</sup> SEC Commissioner Elisse

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<sup>23</sup> Securities and Exchange Commission, "SEC Orders FINRA to Improve Internal Compliance Policies and Procedures," October 27, 2011. <http://sec.gov/news/press/2011/2011-227.htm> (Downloaded May 23, 2012)

<sup>24</sup> Center for Responsive Politics, "Lobbying: Financial Industry Regulatory Authority." <http://www.opensecrets.org/lobby/clientsum.php?id=D000021564&year=2011> (Downloaded May 23, 2012)

<sup>25</sup> Sarah Lynch, "New Finra Ad Campaign Talks Tough On Fraud," *Dow Jones Newswires*, June 15, 2009.

<sup>26</sup> Financial Industry Regulatory Authority, *FINRA 2010 Year in Review and Annual Financial Report*, p. 18. <http://www.finra.org/AboutFINRA/AnnualReports> (Downloaded May 23, 2012)

<sup>27</sup> Securities and Exchange Commission, *Pay Parity Implementation Plan and Report*, March 6, 2002. <http://www.sec.gov/news/studies/payparity.htm> (Downloaded May 23, 2012)

<sup>28</sup> House Committee on Financial Services, "Chairman Bachus and Rep. McCarthy Propose Bipartisan Bill for More Effective Oversight of Investment Advisers," April 25, 2012.

<http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=292499> (Downloaded May 23, 2012)

<sup>29</sup> Financial Industry Regulatory Authority, *Report of the Amerivet Demand Committee of the Financial Industry Regulatory Authority, Inc.*, September 13, 2010, p. 92.

<http://www.finra.org/AboutFINRA/Leadership/Committees/P122215> (Downloaded May 23, 2012)

Walter, another former FINRA executive, received more than \$3.7 million in salary and bonuses when she left the organization.<sup>30</sup>

It is hard to see how these officials could provide truly objective advice about SROs given their recent professional and financial ties to FINRA.

### **Costs of creating and overseeing an investment adviser SRO**

The SEC staff study on investment adviser oversight 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.”<sup>31</sup> 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,” according to the study.<sup>32</sup>

A recent analysis by the Boston Consulting Group found that the annual costs of authorizing FINRA or a new SRO to oversee investment advisers would be anywhere from \$550 million to \$670 million, compared to an annual cost of \$100 million to \$270 million to enhance the SEC’s capacity to examine investment advisers.<sup>33</sup>

There is no question that the SEC—which is already working with limited resources to implement a wide range of requirements under the Dodd-Frank Act—would have to set aside significant budgetary and staffing resources to oversee an investment adviser SRO. In some cases, these oversight duties may even result in a duplication of efforts between the SEC and the SRO. 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.”<sup>34</sup>

One possible reform outlined in the SEC staff study would authorize the agency to collect user fees from registered investment advisers to support the SEC’s examination program.<sup>35</sup> If Congress decides that user fees are an appropriate measure to enhance investment adviser oversight, it should take steps to ensure that the fees are collected and managed by the SEC, not

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<sup>30</sup> Financial Industry Regulatory Authority, Form 990, 2008, p. 32. <http://pogoarchives.org/m/er/merrill-2008-compensation.pdf>. But unlike Chairman Schapiro, who recused herself from voting on the SEC staff study regarding investment adviser oversight, Commissioner Walter issued an unusual statement criticizing the study and calling on Congress to authorize an investment adviser SRO. 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 May 23, 2012); Securities and Exchange Commission, “Commissioner Elisse B. Walter: Statement on Study Enhancing Investment Adviser Examinations,” January 2011.

<http://sec.gov/news/speech/2011/spch011911ebw.pdf> (Downloaded May 23, 2012)

<sup>31</sup> “SEC Study,” p. 28

<sup>32</sup> “SEC Study,” p. 30

<sup>33</sup> “BCG Analysis,” p. 5

<sup>34</sup> Securities and Exchange Commission, “Speech by SEC Commissioner: SEC’s Oversight of Adviser Industry Bolsters Investor Protection,” May 7, 2009. <http://www.sec.gov/news/speech/2009/spch0507091aa.htm> (Downloaded May 23, 2012)

<sup>35</sup> “SEC Study,” p. 39

an SRO, prevent investment advisers from negotiating the fees, and mitigate other potential conflicts of interest.<sup>36</sup>

Regardless of how the funding is provided to enhance the SEC's oversight of investment advisers, it is ultimately Congress's responsibility to ensure that the SEC and other financial regulatory agencies have the resources they need to effectively carry out their mission, including their expanded responsibilities under Dodd-Frank.

### **Recommendations**

POGO believes there is no substitute for governmental regulation of the investment adviser industry. Therefore, we urge the Committee to reject H.R. 4624.

FINRA's inherent conflict of mission, its lack of transparency and accountability, and its excessive expenditures on executive compensation and lobbying illustrate why creating an SRO for investment advisers will not serve the interests of investors, shareholders, consumers, or other stakeholders. In addition, creating a private self-regulatory group for investment advisers would create significant costs and oversight challenges for the SEC.

Instead of delegating additional authority to private self-regulatory groups, Congress should reduce the SEC's current reliance on FINRA and other SROs, work to improve FINRA's transparency and accountability policies, 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.

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<sup>36</sup> POGO and its allies have also urged Congress to consider authorizing user fees as a way to increase funding for the Commodity Futures Trading Commission (CFTC). These fees would be set across the board at a level needed to offset the agency's budget, mitigating the potential conflicts of interest that might arise if the CFTC was able to independently assess fees on individual firms. Project On Government Oversight, "POGO and Allies Urge Congress to Provide Full Funding to CFTC," May 4, 2012. <http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20120504-congress-funding-cftc.html>



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](mailto:acanterbury@pogo.org) or [msmallberg@pogo.org](mailto:msmallberg@pogo.org).

Sincerely,

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Director of Public Policy

Michael Smallberg  
Investigator

cc: Members of the House Committee on Financial Services  
Senate Committee on Banking, Housing and Urban Affairs