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PULLING THE SWITCH

Are state regulators ready to assume oversight of some 4,200 RIAs?

By Andrew Gluck

Between now and July 21, 2011, some 4,200 registered investment advisors regulated by the U.S. Securities and Exchange Commission will switch to oversight by state authorities. This will not be as straightforward as it sounds. In fact, you have to wonder how the states can possibly pull it off.

In the past three years, the credit markets have imploded, the banking system has been effectively nationalized, hundreds of banks became insolvent, thousands of families were financially ruined by a \$50 billion Ponzi scheme, and dozens of brokers and investment advisors were prosecuted for fraud. An unprecedented crisis of confidence threatens America's financial system and institutions—a crisis largely caused by the failure of regulators.

How has our government responded? By passing the 2,319-page Dodd-Frank Wall Street Reform and Consumer Protection Act.

Under this act, the SEC has been saddled with more onerous responsibilities—even though its failures helped cause the financial crisis. The agency must now regulate 10,000 hedge funds and several thousand private equity firms, and it has been charged with conducting more studies about how to regulate the markets. And yet the agency will remain underfunded—it was denied the right to fund itself by charging corporations fees (likely because legislators didn't want to jeopardize the political contributions they need from Wall Street).

In addition to the other massive changes the act has imposed on the financial regulatory system, Dodd-Frank is turning over regulation of registered investment advisors with less than \$100 million to state governments, even though the states themselves are starved for cash, in some cases insolvent, and cutting their budgets as they see revenue from income taxes, sales taxes and other sources decline in the recession.

According to a report released in August by the Center on Budget and Policy Priorities, at least 46 states have imposed cuts, which have hurt both their residents and their economies. "The cuts enacted in at least 46 states plus the District of Columbia since 2008 have occurred in all major areas of state services, including health care (31 states), services to the elderly and disabled (29 states and the District of Columbia), K-12 education (33 states and the District of Columbia), higher education (43 states), and other areas," says the CBPP study. And yet the need for these services did not go away. In fact, it increased with the number of families facing economic difficulties.

Virtually all states are legislatively required to balance their operating budgets annually or every two years. Unlike the federal government, states cannot operate at a deficit.

So handing over the regulatory authority of RIAs to states when they are already starved for cash is like asking a drowning man for a glass of water. It could further erode investor confidence in American markets.

State regulators are not to be blamed for this mess. Perhaps they could be faulted for seizing the opportunity to regulate more investment advisors without also insisting on securing proper funding. But many states zealously protect investors and are known for being more diligent in regulating Wall Street and ferreting out fraud than federal authorities. It was not so long ago that New York Attorney General Eliot Spitzer upstaged the SEC by prosecuting mutual funds for front-running and other illegal activities and cleaned up conflicts of interest posed by Wall Street firms in dishing out biased research about their investment banking clients. (Spitzer rode his reputation as Wall Street's toughest cop to the New York governor's mansion before being forced to resign in disgrace after a 2008 prostitution scandal, and he is now remaking himself as a cable TV commentator.)

Until July 8, 1997, when the National Securities Market Improvement Act of 1996 (NSMIA) went into effect, the SEC shared the regulatory oversight of RIAs with state securities authorities, but the SEC was usually looked upon as the primary regulator and top cop under the Securities and Exchange Act of 1934. It prosecuted the highest profile civil cases. The states could move against an RIA for malfeasance, but most state regulators played a secondary role.

NSMIA amended the Investment Advisers Act of 1940 by mandating that RIAs with less than \$25 million be regulated by state securities departments. RIAs managing more than \$25 million of client assets were to be regulated by the SEC, allowing the federal agency to focus on larger firms. At the time, the main reason was that the SEC was overburdened; the agency was examining about 10% of RIAs annually, which meant on average they were being examined only once every ten years.

While the main goal of NSMIA was to create a clear line divvying up regulatory responsibilities between states and the SEC, the law gave states responsibility for approving IA representatives regardless of how much money was managed by their RIA. This confused the regulatory roles: NSMIA gave states the right to examine all IA reps but not all RIAs. The SEC was responsible for examining IA reps but rarely did so.

NSMIA was a flop. In the years after the \$25 million threshold was created, the SEC lost its ability to credibly regulate RIAs. One regulator estimated that the time between SEC exams of RIAs increased dramatically to an average of 28 years.

Denise Voigt Crawford, president of the North American Securities Administrators Association (NASAA) and Commissioner of the Texas State Securities Board, says that since the 1996 reforms, the SEC has failed to examine thousands of RIAs, dealing only with the largest because of its limited resources.

“As a consequence, over 3,000 RIAs over which the SEC had exclusive jurisdiction

have never been examined,” she says. She calls the 1996 law an “experiment that failed” and says the results to investors have been disastrous.

The Dodd-Frank regulatory reforms are an attempt to address these shortcomings. But you have to wonder if the new law is any better conceived than the one that came out in 1996.

It might not seem like a lot of work to add 4,200 Form ADV reviews, since they will come over a period of months and be distributed throughout the 50 states. But the challenge is greater than you might think. That’s partly because the transition is going to occur in the eight-month period between January 1, 2011 and July 21, 2011, and the way the rules are designed, there could be a registration bottleneck.

Chris Winn of AdvisorAssist, a compliance consulting firm in Boston, says RIAs with less than \$100 million in assets have been free to register with the states since the July 21, 2010 enactment of the new threshold. But few RIAs have moved forward because they would be paying duplicate registration fees, one to the state on top of the one they already paid to the SEC for 2010.

This encourages RIAs to register with their states after January 1, 2011, Winn says. That will force regulators to deal with a torrent of new registrations after that date—and create a bottleneck because the new law requires firms coming under state jurisdiction to file their registration papers by July 21 of next year.

Also, the reality is that a lot more than 4,200 ADV forms are going to be submitted to the states during this eight-month period. That’s because the majority of RIAs transitioning to state regulation must file registration documents in two or more states. So it’s more likely there will be 10,000 or 15,000 new registrations up for state review.

An RIA large enough to be regulated by the SEC is required to file a single Form ADV with federal authorities. If the firm has more than five clients in a single state, most states will require it to submit a relatively simple state notice filing. Such an RIA must also generally submit its Form ADV to state regulators and pay a fee to do business in the state, but the state does not review the ADV.

When RIAs come under state oversight under the new law, however, they must submit their ADV forms to each state and these will be reviewed by each state’s securities regulator.

Bryan Hill, CEO of RIA Compliance Consultants in Omaha, Neb., says state regulators are far more rigorous than the SEC in approving initial applications from RIAs who want to do business in the state. “There’s not a single state that I have seen that does not do more thorough reviews of initial applications than the SEC,” says Hill.

In many instances, he says, the SEC will approve a new RIA registration after a telephone interview with the firm. By contrast, state regulators have a reputation for being far more diligent in performing initial reviews.

According to Winn, state regulators routinely compare Part I of Form ADV to Part II.

State regulators also examine an RIA's client agreement to see if fees are properly disclosed to prospects and clients and to ensure that the explanation of a firm's fees in its agreement is consistent with disclosures in its ADV. An RIA's termination clause, the description of its services and other disclosures in a client agreement are cross-referenced against the firm's ADV Part II.

States regulators commonly find RIAs deficient for inconsistencies in these disclosures, and their penchant for checking all of these details may add to an RIA firm's registration complications.

Also, if one state asks an RIA to amend the ADV, it could trigger a string of revisions when the firm is registered in multiple states. Consider an RIA based in New York that also must register in Arizona, Florida, California and Texas. Let's say the firm submits its ADV to New York and its registration is approved. If one of the other states, meanwhile, requires a change to the firm's fee policy and related disclosures, Winn says the firm will be required to resubmit its ADV to all of the other states, too. "A single state's request for a revision in an RIA's ADV could trigger a cascade of changes in other states and a re-review of a state's approval of an RIA's registration," he says.

A firm with less than \$100 million in assets under management might still have a saving grace—it can register with the SEC instead of the states if it is registered in 15 states or more. The problem is that firms with less than \$100 million are very unlikely to be registered in that many places. There are likely only five or ten states in which such a firm has enough clients to register.

Adding to the challenge state regulators are facing is the fact that RIAs are concentrated in just a handful of states. Texas, for instance, will see the number of RIA registrations double from 1,000 to 2,000. California, New York, Florida and other populous states are going to be disproportionately hit with new registrations, and these are the very states facing the most serious fiscal shortfalls.

In California there are just two full-time registration examiners, and yet the state is expected to see the number of RIAs soar in 2011. Of the 4,200 firms in the U.S. moving to state regulation, 15% are registered in California—some 600 firms. Making matters worse, California recently re-imposed furloughs on state workers because of its budget crisis. Examiners can only work four days a week during the first three weeks of each month.

Meanwhile, as financially stressed states face an avalanche of new registrations, Form ADV itself—the bedrock of RIA regulation in which an advisor discloses all material facts and conflicts of interest—has changed.

RIAs must for the first time submit a new, easy-to-read Part II of Form ADV. Before, they could easily fill in checkboxes, but the form now requires prose. You can expect that these smaller RIAs, not known for their keen writing skills, are going to have difficulty getting the wording just right and in accordance with the wishes of state regulators.

Such a major change to the Form ADV could not have possibly been more poorly timed. It means advisors will have to rewrite key disclosure documents at the same time they are switching to state regulation. It's a glaring example of how government sometimes makes rules without thinking about the consequences.

Keep in mind that the number of sub-\$100 million RIAs is rising. On average, more than 200 new state and federally regulated RIAs have registered every month this year, according to Julie Cooling of RIA Database. The influx of new RIAs has been fueled by Wall Street wirehouse layoffs and broker defections. In addition, some independent advisors affiliated with broker-dealers are leaving corporate RIAs owned by their broker-dealer to start their own RIA shops.

As this regulatory mess unfolds, state securities regulators remain unsung bureaucratic heroes. These regulators are usually part of a state's department of corporations or work under the authority of the state's attorney general. As a young reporter in the 1980s and 1990s, I covered the activities of state securities bureaus for over a decade and found these government employees to be unique in their mission to protect investors. The SEC attracts more headlines, but state prosecutors wield significant power. In many states, securities departments can file criminal charges, unlike the SEC, which is limited to filing civil complaints.

State regulators concede they have a huge challenge ahead of them. The NASAA, the organization for state regulators in all 50 states as well as Canada, Mexico and the U.S. Virgin Islands, is hurriedly planning for the rush of registrations. Denise Voigt Crawford, its president, concedes there will be challenges, specifically because of the differences in rules among the states.

"In almost every aspect of Dodd-Frank, there needs to be rule-making," she says. "We have people in NASAA looking at all of this and devising uniform rules as we speak."

In the long run, she says, investors will be well served by the regulatory switch. "Let's not make perfection the enemy of good," she says.

"The fact that the president just signed the law in July makes it a little unrealistic to expect the states to already have their rules ready to go now. But that doesn't mean state regulators won't be ready to go when the vast majority of RIAs are ready to make the switch."

And there was little choice, she adds, since the law before wasn't working.

"There is no reason to believe that if the Dodd-Frank reforms had not been enacted that the SEC would suddenly have begun examining RIAs," says Crawford. "Would you want your entire nest egg in the hands of an RIA that has never been inspected by a government entity to ensure that your money is actually where you have been told it is? Would you prefer that kind of situation to some confusion while state regulators implement the switch?"

Editor-at-large Andrew Gluck, a veteran financial writer, owns Advisor Products Inc., a marketing technology company serving 1,800 advisory firms.