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Introduction

Thank you very much, David, for that kind introduction. I have very much appreciated the heartfelt response I have received to my speaking out on the challenges I've been forced to confront. I hope that it will help at least one of the many, many people out there who are faced with what may seem like insurmountable obstacles every day.

It is wonderful to be with you this morning and to give the keynote address at such an important conference. I was pleased to learn that over the next two days you will focus in part on the changing regulatory landscape for investment advisers. With regulatory reform being debated at the highest levels, there is certainly potential for significant change in the financial services industry.

Today I would like to give you my thoughts on this changing landscape, mainly from the vantage point of legislative initiatives to address important regulatory gaps and inconsistencies in the advisory area, but also in the context of recent Commission action to address challenges that we have seen. Before I get too far along though, please let me remind you that I speak only for myself and not my colleagues at the Commission.

The most important thing I want to do this morning is to thank each one of you for your partnership with us to foster compliance with the federal securities laws. Your work is very important. At the Commission, we value that relationship, and devote our resources to efforts like CCOutreach to help it succeed. And, I am sure that I will find you in complete agreement when I say that compliance functions are always critical—perhaps even more so in times of market stress and turbulence.

Legislative Initiatives

Now that I have given you a rallying cry of sorts, I would like to walk you through some of my thoughts on important changes under way in the advisory area. Although it can no doubt be painful, change can also be a very good thing. As railroad executive Alfred Perlman said over 50 years ago, "[a]fter you've done a thing the same way for two years, look it over carefully. After five years, look at it with suspicion. And after ten years, throw it away and start all over."

Now, that's an overstatement in the context of these remarks. Although Congress enacted much of the current regulatory framework in the United States decades ago, I'm not ready to just discard it. But, recent market turmoil, changing business practices, and other factors have exposed a number of areas as ripe for reconsideration. Although I am continually amazed at how well our securities statutes have done their job over time, when you look closely at the regulatory fabric for financial services, it is apparent that there are gaps and overlaps. Addressing them is high on the Commission's agenda, both by working with Congress to develop appropriate legislation and also through the exercise of its current authority.

There are a number of important pending legislative initiatives affecting the investment advisory industry. I would like to focus this morning on private fund advisers and the regulation of broker-dealers and investment advisers giving personalized advice. Although divining what will eventually come out of Congress is better left to others, these initiatives are worth discussing at this point. Keep in mind that new Senate proposals reportedly are forthcoming shortly. For today, however, my remarks generally focus on the bill that Chairman Dodd introduced last fall and on the bill that the House has already passed.
As you may know, there have been many voices calling for increased regulation of private funds and their advisers.

That chorus is growing increasingly louder. This is due at least in part to concerns over systemic risk and market integrity, given the potential of these funds to affect the broader securities markets and economy, and particularly given the explosive growth in this sector. Hedge fund advisers alone, for example, now manage over $1.4 trillion. There are also concerns about the use of information in the private fund space, as demonstrated by recent insider trading cases such as

Galleon. The proliferation of private funds also raises other investor protection concerns, by virtue of exposure through direct investment and also through funds of funds and pension funds.

The voices now calling for regulation aren't the first. In 2004, the Commission sought to require hedge fund advisers to register with us, only to have that action overturned by the courts. But, since the financial crisis, there appears to be a growing consensus that more information is needed about these important and influential market participants—especially given the sparse oversight in this area.

Mandated information flow would better enable regulators to make critical decisions, both in times of market turbulence and in times of relative calm. We are in constant need of fulsome information in order to assess systemic risk to the economy, maintain the integrity of markets, and ensure that investors are protected.

The Administration and the Congress understand the importance of this issue. Last year, the Administration introduced its White Paper, and Congress is now considering proposals in both the House and Senate. Although the House bill and the bill that Chairman Dodd introduced last fall have their differences, they take the same basic approach to hedge fund advisers.

In essence, the bills narrow the exemptions from registration that are currently available. Perhaps most importantly, they would eliminate the "de minimis" exemption, which private fund advisers rely on extensively today to avoid registration under the Advisers Act. This would have the effect of requiring many advisers to register with the Commission and thus subject them to the investment adviser regulatory regime beyond our antifraud authority. For a number of reasons, this makes a great deal of sense. For one, although Congress designed the exemption to cover advisers that were too small to warrant federal attention, it now applies to advisers with billions of dollars under management because it permits them to count a fund with many underlying investors as a single "client."

The bills also contain recordkeeping, reporting, and information sharing provisions that I believe are important. For example, the House bill requires explicitly that the records of private funds be considered records of their advisers. I know that this may sound technical, but it is not. In fact, it would ensure that during examinations we have access to the information we need.

Although we have the authority to examine the records of any adviser registered with us, there have been occasions when some registered hedge fund advisers sought to deny our staff access to their hedge fund records claiming that they were not records of the adviser. This change would clarify our authority.

And, private fund and adviser information needs to be available not only to the Commission as the primary regulator in this area, but also to other regulators focusing on systemic risk in the markets and to the economy. Both the House and Dodd bills incorporate this important concept.

I believe that the registration of private fund advisers is long overdue, and the legislative initiatives are steps in the right direction. That does not mean that they are optimal, however. At least in two main areas, I have some concerns which I hope the forthcoming Senate proposals will address. First, unlike the Administration's proposal, the Dodd bill would provide exemptions from registration for venture capital and private equity fund advisers, and subject them to only recordkeeping and reporting requirements. The House bill would do the same for venture capital funds. As most rules under the Advisers Act apply only to advisers that are registered, this could result in new regulatory gaps.

The primary differences between these advisers and those managing hedge funds are their goals and the strategies they employ. I'm not sure that this justifies "partial regulation," although I understand and agree that there are important benefits these funds provide, notably seed capital for start-up businesses. And, even if a case can be made now for treating them differently, what would the consequences be for the future? And would it just create opportunities for regulatory arbitrage?

I believe that regulatory changes should address both current challenges and also anticipate those of the future. Although partial regulation is certainly better than none at all, I would prefer to see venture capital and private equity fund advisers also subject to registration requirements. This would not be unduly burdensome.

Moreover, regulators routinely contemplate the costs associated with new regulation, such as effects on the capital formation process. The SEC would take that into account in determining how best to apply the Advisers Act to registered private equity and VC fund advisers.

Second, there are proposals to increase the threshold for investment advisers before they may register with us. We estimate that increasing the threshold to $100 million would have the effect of prohibiting a large number of investment advisers that are currently registered with us from continuing to remain so. This may well result in fewer private fund advisers registered with us than are registered today. In particular, I would note that this change actually would result in a net decrease in registered hedge fund advisers, and would occur at a time when we need increased oversight of these and other private funds, not less.

To the extent that the underlying idea is to address the resource constraints of the Commission by moving some of the advisers to the states, we need to understand fully the effects of doing that. First and foremost, do the states have the resources to handle this extraordinary increase in workload? Or, are we merely moving a problem from one place to another? Will the states require those advisers to register, or retain their current exemptions leaving many advisers (perhaps even most hedge funds) unregistered? I know that some of you may disagree with my strong support of a private-public regulatory partnership to oversee advisers. But, I hope that we can agree that, rather than moving jurisdictional lines to address a funding issue, we should tackle funding head-on. Independent funding for the Commission, which would provide an important and long-needed boost to the resources that it can devote to investment adviser regulation and other critical areas, should move forward.

I would now like to turn to the regulatory inconsistency that exists for financial professionals providing virtually identical services to retail investors. The Commission has been looking carefully at this area to determine what changes in the regulation of the broker-dealer and investment adviser regimes would most appropriately address investor confusion and ensure the full protection of the securities laws, both within its current authority, which is limited, and with legislative change. As you may know, this is an area that is particularly near and dear to my heart and I have spoken in favor of harmonizing the two regimes. So have the Administration and Congress, although to differing extents.

The House bill and the bill that Chairman Dodd introduced last fall take quite different approaches to this issue. I would like to discuss them briefly and offer a few thoughts. The Dodd bill would strike the broker-dealer exception from the Advisers Act. This exception provides that broker-dealers providing investment advice that is solely incidental to their other services, and receiving no special compensation for the advice, are not investment advisers under the Advisers Act. Removing the exception would submit broker-dealers giving advice to not only the fiduciary duty requirements under Section 206 but also other Advisers Act regulation.

The House bill, however, takes a rather different route. It requires the Commission to adopt rules requiring that the standard of conduct for a financial professional giving personalized investment advice about securities to retail customers would be to act in the best interest of the customer without regard to the interests of the professional. It also prescribes that the standard shall be no less stringent than the standard applicable to investment advisers under Section 206(1) and (2) of the Advisers Act.

Although I continue to refine my thoughts on these two approaches and others, and it is ultimately unclear what will come out of the Senate Banking Committee or the full Senate, I have a few thoughts on these provisions. Generally speaking, I am pleased to see that Congress is addressing this regulatory inconsistency, which has been allowed to exist for too long and results in just too much confusion. That said, I would prefer to see a legislative approach harmonizing the regimes on a more comprehensive scale and taking into account the strengths and weaknesses of both. I won't elaborate on this point in the interest of time, but I have spoken on this in the recent past.

I would like to emphasize that regulation of a financial professional should depend on what she does, and not what she calls herself or how she is paid. As a corollary, I believe strongly that retail investors should not bear the burden of understanding distinctions between financial professionals that have become increasingly less relevant over the years. These opaque distinctions frequently lead to investor confusion and arguments about definitions that simply should not matter. This reasoning, I believe, leads to the fundamental principle that should guide our review of how to regulate financial professionals for the protection of the investing public: Investors should receive the same level of protection when they purchase comparable products and services, regardless of

the financial professional involved.

The bills have focused on a fiduciary duty for financial professionals, and I believe strongly that this duty, with its underlying concepts of loyalty and care, is critical to comprehensive investor protection. In trying to determine how it should apply, however, we've been making it too hard on ourselves. The language articulating the duty does not need to be especially complex or legalistic to capture the essence of what we all want it to mean. Just last week, for example, in a New York Times blog a reporter penned well-written and easy-to-understand language in a pledge that investors could take to their brokers to sign. Here's what it said:

"I, the undersigned, pledge to exercise my best efforts to always act in good faith and in the best interests of my client, [-and I will insert my now-famous Aunt Millie here-], and will act as a fiduciary. I will provide written disclosure, in advance, of any conflicts of interest, which could reasonably compromise the impartiality of my advice. Moreover, in advance, I will disclose any and all fees I will receive as a result of this transaction and I will disclose any and all fees I pay to others for referring this client transaction to me. This pledge covers all services provided."

I leave to another time a discussion about the implications and legal and practical feasibility of implementing a fiduciary duty through a concept like this pledge. For today, I think it's important to realize that the language seems to capture the essence of the way that all financial professionals should treat investors. Now, that wasn't so hard, was it? Let's agree here and move on to the critical issue of further harmonizing the way in which our regulatory system treats these financial professionals, and thus, the way in which they treat retail investors.

It is my hope that Congress continues to take a hard look at this area, and gains a full understanding of the effects of possible approaches. For example, although I recognize that the Dodd bill's approach may seem intuitive to some, its unintended consequences should be considered. Does it, for example, create new regulatory arbitrage opportunities for introducing broker-dealers who today are supervised under the Exchange Act and self-regulatory organization rules? If, on other hand, a significant number of today's broker-dealers become subject to the Exchange Act, SRO rules and the Advisers Act, are we unduly tilting the competitive playing field against them?

It is my hope that the forthcoming Senate bills address these concerns. One more note about them. It has been reported that the idea of a study of the broker-dealer and investment adviser regimes is being contemplated. I question whether that approach would prove to be helpful. Not too long ago, the RAND Corporation conducted a study for the Commission in this area and reported, among other things, that trends in the financial services market had blurred the boundaries between investment advisers and broker-dealers, and that retail investors were confused about the differences between these financial professionals. Although the RAND report did not provide legislative or regulatory recommendations, it confirmed that reform is necessary. Another study may duplicate that effort and delay reform in this important area.

Commission Rulemaking

Any legislative proposals that become law, and the Commission's actions to implement them, may have a significant effect on the advisory industry and on your job as compliance professionals. But, even without legislation, there are other changes underway that may affect you. You will no doubt hear detailed reports about them at this conference, but I would like to offer a few thoughts on recent Commission action in the areas of custody and pay to play.

I'll start by emphasizing that custody is central to investor protection, and I supported our staff's recent recommendations to enhance the safeguarding of assets by investment advisers. The amendments are designed to deter custody-related violations from occurring in the first place, and I believe that prophylactic rules of this nature are quite valuable-especially at this pivotal time in economic history.

That is not to say that I do not have concerns, though. For example, I worry whether the annual audit requirement for advisers to pooled investment vehicles alone will provide sufficient opportunity for independent eyes to verify the existence of assets. As you will see in the release, the staff has committed to examine this issue and I look forward to hearing their thoughts.

I am also concerned about the clients of smaller advisers who use independent custodians but have the authority to obtain possession of client funds or securities. Our staff will be evaluating the

impact of the surprise examination on these advisers and their clients, but—at least without having the benefit of the results—I would be loathe to remove them from the requirement. This is in part because investors in this space may be those most in need of legal protection. Last, I believe that our look at custody should not stop with investment advisers, and so I support the staff's efforts to look at enhanced protections in other areas—such as custody by broker-dealers.

We have also considered prophylactic rules relating to pay to play contributions by investment advisers. The management of public monies by advisers can have significant effects on our economy and the lives of millions of people, and it is vital that advisers compete for this business in a fair and legitimate manner. It has become increasingly clear, however, that pay to play contributions in this area are a significant problem. We sought to curtail these practices last summer when we proposed rules that would address political contributions by investment advisers.

The comments we received on pay to pay have been quite helpful. Many have addressed one provision in particular that would prohibit an adviser from paying a third party to solicit government business on its behalf. Finding the right balance here is important, as we want to ensure that our rules curtail adviser participation in pay to play schemes without unduly affecting legitimate business practices. I would be interested in hearing your thoughts on this issue.

Conclusion

I appreciate the opportunity to speak before you today, and share my thoughts on important regulatory developments affecting investment advisers. As always, please know that my door is open to you and I am always interested in your thoughts and ideas. And, please keep up the good work you do to assure compliance with the securities laws. Thank you, and I hope that you enjoy the remainder of the conference

NovaRes Team