The Pros and Cons of a Self-Regulatory Organization for Advisers and Mutual Funds

by Tamar Frankel

Congress is seriously considering bills to establish self-regulatory organizations (SROs) for investment advisers (advisers) and investment companies (Funds). These bills would require members of the investment management industry to regulate themselves under the watchful eye of the Securities and Exchange Commission (SEC), similar in approach to the regulation of broker-dealers by the National Association of Securities Dealers, Inc. (NASD) and the securities exchanges. Proposals to establish an SRO for investment advisers have arisen before. However, those proposals did not cover Funds and their advisers.

The pros and cons of SROs for the securities industry have been analyzed and debated for years. While SROs reduce government regulatory costs, this gain is offset by the cost of supervising the SRO, and by the implementation of an added layer of regulation. On the positive side, SROs' regulators, familiar with industry practices, could be more efficient than government employees. Arguably, however, these regulators pose the same problems as any bureaucracy, and could conflict with the objectives of the laws they enforce. The securities industry has favored SROs because they are more flexible and cheaper regulators than the government, and because they translate the members from direct, often undesirable government incursions. SROs, such as exchanges, enable the industry as a whole to meet its social responsibilities, oversee the market place, educate the public and the industry regarding the market place, and inculcate industry members with ethical standards.

Arguments against SROs focus on the anti-competitive effect of the SROs' power to discipline members, deny membership, and prohibit members from doing business with non-members. By and large, however, there is a consensus that the stock exchanges and the NASD have been highly successful in achieving numerous goals of divergent constituencies and the public interest.

It is not surprising that the proposal to establish an SRO for the investment management industry has been revived. It is driven mainly by the government's increased cost of regulating the industry. These costs have risen with the recent dramatic growth of the industry in terms of the number of advisers and assets under their management. Similarly, the number of Funds and the assets under Fund management have increased. Never before have Funds constituted such a significant segment of the financial system, hence, preventive measures, like examinations, seem more important than ever and pressure is growing to increase the frequency and depth of industry members' examinations.

In an efficient examination system, however, is costly, and would result in an expansion of SEC staff at a time when government personnel are being reduced. On balance, it may be appropriate to establish SROs for non-institutional advisers, but it is inappropriate to establish an SRO for Funds and Fund advisers because such an SRO would require a fundamental change in the Investment Company Act of 1940 (1940 Act). It would be a serious and costly mistake.
Successful SROs

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owstanding the success of SROs in the securities industry and the pressures to establish SROs for members of the investment management industry, such SROs did not develop either for Funds and their advisers or for other, non-institutional advisers. Advisers have organized various trade organizations, e.g., the Investment Company Institute (ICI), but the ICI does not regulate its members. Other advisers have established similar organizations, such as the Investment Counsel Association of America that impose Codes of Ethics on members.** In general, however, as the cost of regulation has mounted and the government has proposed SROs for the investment management industry, the industry has resisted the proposals. The question is: why? Numerous SROs have been floated in this country for quite some time. Successful SROs include professional, trade, and manufacturing organizations. An analysis of these SROs can help predict how effective SROs for advisers would be.

There are few reasons for advisers to organize an SRO. Although Fund advisers constitute a more homogeneous group, they share all the other characteristics of advisers that lead to resisting an SRO.

SROs protect the members' reputation for quality and reliability of services and products by requiring members to acquire and maintain expertise and ethical standards.** Because reputation reduces the consumers' costs of ascertaining the quality of what they buy from any member, consumers will pay higher prices for reputable goods and services, and that benefits all members. Similarly, when the financial strength of the industry members is crucial to the group's reputation, SROs may organize a guarantee fund to support members in temporary financial difficulties, and regulate the members to ensure their potential operations. Second, qualification requirements benefit SRO members by limiting entry to the practice and by reducing competition.** Third, SROs benefit specialized professionals by facilitating referral systems among themselves. Fourth, since the practice of most professions and trade requires expertise, members prefer to be governed by their peers, rather than by non-practicing government bureaucrats, and to avoid greater burdens of direct government regulation.**

Fifth, for traders, SROs facilitate orderly dealings among the members, such as by establishing networks, fees or exchanges, and effective and inexpensive dispute resolution processes.** Thus, books have organized bunk check regist-

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If the industry is flourishing under a particular regulatory system, which the Fund industry is, there should be a presumption in favor of maintaining the regulatory status quo, and no fundamental changes should be introduced without serious investigation into alternatives. In this case, there may be reasons to maintain SEC regulation. The existing regulation of Funds does not seem "vicious" and so need not be "fixed." The Fund industry's success, however, is based upon broad investor confidence, and this confidence is even more crucial today. The growth of Funds has increased their visibility and public scrutiny concerning, for example, the compensation of Fund advisers, the performance of Fund independent directors, the performance of particular Fund managers, and, above all, their commitment to investors' interests.

If investors may withdraw their money only if securities prices fall, and not only if they suspect dishonesty and manipulation by Fund managers, but also if they believe they are unfairly treated, and if advisers take advantage of them. Such withdrawals can have a detrimental effect on Funds of the same type, on Funds managed by the same adviser, and on the secondary markets in the securities in which these Funds have invested. Further, Funds are the only substantial segment of the financial system without government guarantees; they have no equivalent in the Securities Investor Protection Corporation, the Federal Deposit Insurance Corporation, or the Pension Benefit Guaranty Corporation. The Fund industry's success in maintaining the public's confidence and scandal-free regulation is due largely to this strict compliance with the 1940 Act and to the SEC's diligent enforcement of the Act—its only form of government support the industry receives.

Additionally, the risks and consequences of losing public confidence may be greater today than they have been in the past. During the past twenty years, the SEC has allowed advisers and sponsors greater flexibility in structuring funds and advisory fees. Overall, this greater flexibility has helped growth and innovation in the industry, but it has also imposed greater complexity, which has increased the costs of market and government monitoring. Public perception about Fund management and the public's confidence in the Funds can be affected by the new entities, such as banks, into the Fund business. In their core business operation, these institutions are usually subject to quite different, and in many respects more lax, conflicts of interest regulation than that imposed by the 1940 Act. New entrants unfamiliar with the 1940 Act may make mistakes or innocently confuse the public. These mistakes and confusing facts, when published, could erode trust in the Funds involved.

Thus, while the 1940 Act has served the industry and the public well, Funds are more vulnerable today to loss of public confidence than ever before. This may be the time to signal the markets that the government stands ready to strengthen the Funds' regulation, as it has done in the past so successfully, rather than to introduce self-regulation—a different, untested scheme of regulation that signals reduced regulatory supervision.

Other Options to Address Possible Problems in the Fund Industry

The current regulation of Funds is deficient, solutions other than an SRO could be far more advantageous to investors, the industry and the SEC. The main impediment to creating an SRO seems to be the need for more examiners of advisers and Funds, and the impracticality of government funding the cost of such examinations. Yet, alternatives to SROs should be explored. SEC examinations may be revised to provide more efficient and focused government inspections, or new technology could be introduced, similar to the SEC's control of the securities exchanges. The SEC could work with the regulators of new entities into the industry, such as the bank regulators, and utilize their examiners to reduce the SEC's needs for examiners and to avoid duplication. Certified public accountants or other qualified professionals expert in evaluating portfolio risks and internal controls could be required to perform regular audits of the Funds and their advisers, especially in evaluating legal compliance. The taxes may be eased upon to regulate small advisers.

To the extent that more examiners are necessary to regulate Funds, perhaps the costs of such examination could
be charged to the institution that is examined or to the member of the industry as a whole (through a fund to which all contribute by certain measures). These alternatives should be immediately studied before instituting a drastic and fundamental change in the regulation of the Fund industry.

Conclusion

SROs for non-institutional advisers may be advantageous for investors and the industry. SROs can absorb some of the government’s costs of regulating non-distinguished advisers. Required minimum qualifications may give the added incentive necessary for advisers to organize one or more effective SROs. If the SROs induce advisers to maintain high quality services and integrity, and at the same time lower government costs, these benefits may offset the reduced competition that will result from these organizations.

On the other hand, a fundamental change in the regulatory system of Funds could approach the problem with greater caution, such a change should be introduced if, and only if, after serious study, less drastic alternatives are not feasible. The idea of a self-regulatory industry is not an attractive one; in theory it may work even better than the SEC’s inspection program. But innovations can become thebane of financial institutions. Such regulatory change is risky because we cannot predict all their direct or indirect effects.

If an SRO of Funds were to prove ineffective or deleterious, a successful segment of the financial system that provides satisfactory services to millions of Americans may be adversely affected.

NOTES

1. Oversight Hearings on the Mutual Fund Industry. On the Importance of Mutual Funds to the Economy and to Investors and to Look at the Advocacy of Current Federal Oversight. Over the Industry and the Possible Need for Legislative or Regulatory Changes. Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, 105th Cong., 1st Sess., 2, 93, 103-382 (Nov. 10, 1993) (hereinafter the 1993 Hearings) ("... in general, as SRO has been known to be one of the most effective ways of managing a growing complex of financial services in our society, and it’s a way that I am seriously considering with regard to investment companies and even considering more seriously with respect to investment advisers.")

The House bill, Investment Advisor Regulatory Enhancements and Disclosure Act of 1993 (I.R. 578; passed the House in May 4, 1993). In: (i) authorizes the SEC to collect registration fees from advisers, to suspend advisers’ registration for failure to pay fees, and to use the fees to delay specific critical of regulating advisers, (ii) authorizes the SEC to designate SROs is exempt, to dischargefin as non-compliance, and to collect examination fees from members and affiliates (except affiliates primarily engaged in investment advisory activities, and placed; (iii) directs the SEC to arrange for inspecting advisers and to survey and report to Congress on advisers that failed to register, to establish a toll-free number for inquiries concerning advisers, and to promulgate protective rules, setting bonds for certain adviser’s cover larger and embarrassment; (iv) qualifies certain persons (convicted of a felony etc.) from acting as adviser; (v) prohibits adviser from engaging in certain transactions, including giving unsuitable advice and disclosing confidential client information; and (vi) requires adviser to disclose certain information to clients, including referral fee arrangements. See: See Bill Tracking Report I.R. 578, 105th Cong., 1st Sess., available in LEXIS, Congressional Research Service.

The Senate bill, Investment Advisor Oversight Act of 1993 (S. 423), passed the Senate on Nov. 20, 1993. It is more limited. It amends the Investment Advisers Act of 1940 (hereinafter the Adviser Act) authorizing the SEC to (i) establish registration fees and filing fees for other applica-

15. See October Mutual Fund Sales Total $4.5 Billion, Investment Co. Couns. Rev. (Nov. 19, 1993), available in LEXIS, Nexis Library, PRIMRWS file (as of the end of October, 1993, the assets of all mutual funds totaled $1.97 trillion).

16. Concern about the paucity of examinations of investment companies is not new. See the 1935 Proposal, supra note 2, at 846-847 (proposing to establish an examination program for investment companies). Citing the weaknesses in the existing examination system, the proposal called for a comprehensive examination program to ensure the stability of the mutual fund industry.


20. 1993 Hearings, supra note 1, at 12 (statement of Arthur J. Levie, Chairman, SEC). In general, an SRO has proven to be one of the effective ways of preventing growing complex of financial services in our society... .

21. 1993 Hearings, supra note 1, at 8-9, 11 (statement of Arthur J. Levie, Chairman, SEC) (stating the realities of SROs and the need for regulators to be in the game of a growing mutual fund market); id. at 22 (explaining that SEC self-funding is one of the reasons for advocating the establishment of an SRO).

22. SEC in Act Congress for Legislation to Permit Creation of Advisers Act) at 4949-50 (statement of the number of registered investment advisers has increased from around 4,500 in 1980 to 15,106 as of April 1989).

23. Id. (listing the value of assets under management that has grown from $44 billion in 1980 to $24.6 million as of 1989).
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