



SOUTHERN CALIFORNIA
COMPLIANCE
GROUP

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**2009 Regulatory Affairs:
SCCG Member Survey Results**

The Southern California Compliance Group (SCCG) is a non-profit organization made up of compliance professionals and others who work with regulated entities in San Diego, Orange, Los Angeles and Riverside counties. Our members include employees of nearly fifty local securities firms, along with independent lawyers and consultants serving the financial industry in Southern California.

In March 2009, SCCG conducted a voluntary online survey of its members. The purpose of the 2009 SCCG Members Survey was to collect demographic information about the organization and input from its members concerning financial sector regulation and compliance department operations at regional broker-dealers, investment advisory firms and dual registrants.

Demographics

Survey respondents have spent an average 13 years in the financial industry and collectively reflect over 200 years of experience. They are CEOs, COOs, CFOs, CCOs, compliance consultants and attorneys, including CPAs, JDs, MBAs, Chartered Financial Analysts and Certified Financial Planners. Half hold current securities licenses. Two-thirds are employed by registered investment advisers, with the remainder employed by broker-dealers, law firms and/or compliance consulting firms. These firms collectively manage about \$140 billion in assets and employ hundreds of Southern California residents.

Current Regulatory Environment - Reflections on Best / Worst Regulation

Members were asked their biggest concerns about the current regulatory environment. Prevalent responses included:

- Possible overreaction by Congress and regulators in responses to the current fraud scandals;
- An increase in harsh enforcement actions by the SEC against the firms with low compliance risk in order to “save face”;
- New laws and regulations that result in impractical administrative costs or burdens;
- Undermining of the self-regulatory scheme; and
- Potential for oversight of financial advisors by individuals who lack an understanding of the investment advisory business.



Members noted that the most effective compliance requirements arise from the basic securities law requirements of full and fair disclosure and customer protection, which may be achieved through:

- Written supervisory procedures and firm policy and procedure manuals providing a structure to the compliance process;
- The annual review requirement of Rules 38a-1 of the Investment Company Act and 206(4)-7 of the Investment Advisers Act, which identify control weaknesses and keep procedures fresh and relevant;
- Making the Form ADV available to the public, and requiring conflicts to be disclosed;
- Having an enforceable Code of Ethics, which helps to codify a culture of ethical behavior; and
- Mandating the protection of confidential client information through practical privacy controls.

Members were asked to identify examples of regulatory requirements that worked and others that did not. The most favored practices included:

- Annual compliance review
- Exception reporting
- Form ADV disclosures
- Training and education of employees

The disfavored requirements included:

- Email monitoring
- The current books and records rule
- Best execution reviews (if a firm only does ETF or MF transactions)

When asked the top areas in which new laws have the greatest impact on their firms in terms of time, money and resources, respondents identified the following:

- Enhanced privacy requirements
- Harmonization of IA and BD obligations to investors
- Risk-based oversight of securities firms
- Short selling restrictions
- Hedge fund registration
- Point of sale disclosures for mutual funds

When asked which securities law, rule or regulation members most wish they could abolish or re-write, members offered several comments:

- Regulations relating to affiliated IPO transactions, best execution, Form N-SAR, and Sarbanes-Oxley are perceived as inefficient as written and require improvement.
- Re-enacting rules that were repealed, such as the uptick rule and anti-money laundering requirements for investment advisers, is disfavored.



- Arbitration clauses and non-disclosure agreements should be permitted only in certain circumstances to avoid reducing industry transparency.
- A perceived overemphasis on the sufficiency of written procedures should be replaced with a focus on the effectiveness of overall compliance controls.
- Clarifying plain-English instructions and systematic format are needed for client disclosure documents such as Form ADV Parts 1 and II in order to ensure consistency in content throughout the industry.

Members were asked what they would do if they could create one new securities law, rule or regulation, and responded:

- Align state with federal rules and requirements;
- Create uniform regulatory guidance for all states, with a de minimus registration fee;
- Provide full public disclosure of all regulatory infractions by financial professionals and institutions; and
- Revamp the sales practice requirements for persons who do not hold securities registrations.

Members were specifically asked about the Hedge Fund Transparency Act of 2009, introduced in Congress on January 29, 2009 (see <http://www.levin.senate.gov/newsroom/release.cfm?id=307481>). Respondents provided the following feedback:

- Some respondents thought passage of the bill would positively impact the securities industry, but many expressed concern that it would result in wasteful over-regulation of established hedge funds.
- Members thought the bill could result in additional investments from parties who have been reluctant to pursue alternative investment strategies since the requirements for filing, registration and disclosure would be uniform and thereby facilitate due diligence .
- One member noted that it would be beneficial if the bill contained specific privacy clauses, especially for family offices, which could be required to disclose personal information under the bill as drafted.

Registration of Hedge Funds and Investment Advisers

The survey asked members if they believed hedge funds should be registered. On a scale of three to one, these compliance professionals agreed that hedge fund registration is appropriate. Respondents stated that Hedge Funds:

- Should be required to have a regulator oversee their activities;
- Should have a regulatory framework that is similar to investment companies;
- Should register if it is likely to result in enhanced investor protections; and
- Should have regulation to reduce the potentials for abuses and improve transparency.



Harmonization of IA/BD Regulation

Members had mixed reactions when asked whether broker-dealers and investment advisers should be subject to the same legal standard of care. Those who agreed with the proposition stated:

- Broker-dealers that provide investment advice and/or fee-based services should be held to the same standard as investment advisers to eliminate confusion and lead to greater transparency among the general investing public.
- Investment advisers generally receive compensation based on a percentage of assets, which helps to align the interests of the adviser and the client. Extending this pay structure to broker-dealer firms could help ameliorate sales-practice abuses resulting from commission-based compensation, which rewards the volume of transactions rather than their quality.
- Harmonization will make it easier for firms that are both broker-dealers and investment advisers to comply; however, the obligation should fit the services provided and not lead to redundancy or greater cost of compliance.

Those who did NOT think broker-dealers and investment advisers should be subject to the same standard of care stated:

- There should be different standards for firms that custody client assets and execute client transaction than for firms that do not provide these services. Firms that provide these services are at a greater risk of defrauding clients.
- Broker-dealers and investment advisers provide very different functions (i.e., investment advice vs. sales of securities) so it is appropriate to subject them to different legal standards.
- Enforcement of existing regulations rather than promulgation of new regulations is what the industry needs at this time.

Rule/Principles-Based Regulation

Members were asked if the financial industry should shift from a rule-based to a principle based system of regulation. The majority agreed with principles-based regulation, stating:

- Principle-based regulation allows firms that are very different to customize policies and procedures according to the firm's size, business model, products and services offered.
- Principle-based regulation focuses attention on areas of heightened risk, rather than the minutiae of written supervisory procedures.
- Rules can be manipulated and broken; principles cannot.

Those who preferred a rule-based scheme expressed concern that alternative could be subject to too much interpretation and inconsistent enforcement.

Compliance Costs/Burdens

Members largely, but not uniformly, agreed that there were too many compliance obligations imposed on securities firms. Responses to this inquiry included the following:



- The cost and burden of compliance is particularly great on small firms and takes time and resources away from serving the client's needs.
- Regulation, particularly in the area of record-keeping should be harmonized for firms subject to multiple regulators to reduce the cost of compliance.
- More enforcement of existing regulation, rather than more regulation, is needed to detect fraud, such as Madoff and Stanford, and protect investors.
- Changes in regulation to prevent fraud, such as Madoff and Stanford, must not come at the expense of increased cost to compliant firms and their investor clients.

Conclusion

The SCCG Survey reflects a widespread sentiment among compliance professionals in Southern California that new regulations in the securities industry may be appropriate, but recent scandals should not result in overreaching or the imposition of unreasonable burdens on an industry that is already suffering the effects of the market downturn. Accordingly, efforts in this area should carefully balance the costs of compliance with the benefits of risk reduction.