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Mandatory Third Party Compliance Examinations for Investment Advisers: An SEC Waterloo?

Mercer Bullard

MANDATORY THIRD PARTY COMPLIANCE EXAMINATIONS FOR INVESTMENT ADVISERS: AN SEC WATERLOO?

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ABSTRACT

The Securities and Exchange Commission (SEC or Commission) appears to be on the verge of requiring investment advisers to undergo third party examinations. One justification for the rulemaking is that the Commission lacks sufficient resources to examine advisers frequently enough. Another is to create indirectly a self-regulatory organization (SRO) for investments advisers. Both may leave a rulemaking particularly vulnerable to challenge as arbitrary and capricious under the Administrative Procedures Act. This Article considers three novel grounds on which a rulemaking may be successfully challenged. Congress has repeatedly rejected SEC requests to provide additional funding for examinations or to create an adviser SRO. This Article speculates that the rulemaking could be successfully challenged on the grounds that it usurps Congress's power of the purse by imposing an unauthorized tax on investment advisers, and/or Congress's authority to authorize the creation of an adviser SRO. On firmer ground, the Article discusses the risk that Section 206(4) of the Investment Advisers Act of 1940, under which a third party examination rule would likely be adopted, does not authorize such broad rulemaking. Such a challenge could not only defeat the rulemaking, but also undermine the viability of other rules adopted under Section 206(4). This Article also considers some of the numerous examples of third party examiners that could provide useful models for a third party examination rule for advisers. It surveys seven types of third party examiners in order to provide a framework for thinking about how a third party compliance rule might be designed: nationally recognized statistical rating organizations, proxy firm advisors, the CFA Institute, public company auditors, compliance consultants, chief compliance officers, and surprise and internal controls auditors. Each examiner serves a distinctly different third party examination role and their regulation is equally varied, if not always consistent.

I. INTRODUCTION

In recent years, a chorus of commentators has contended that investment advisers regulated by the Securities and Exchange Commission (SEC or

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Commission) are not examined frequently enough. In response to this critique, the Commission appears to be on the verge of proposing to require investment advisers to engage third parties to examine advisers' compliance policies and procedures. However, an increase in the frequency of adviser examinations may not alone provide an adequate basis for rulemaking in an environment in which courts are demanding that regulators base their rulemakings on rigorous cost-benefit analyses.

The debate surrounding the third party examination concept has focused almost exclusively on its potential to increase the frequency of adviser examinations. There has been virtually no discussion of exactly what benefits more frequent exams would create, much less what benefits examinations by third parties would create, or what the costs of such examinations would be and whether they would outweigh the benefits. If the Commission fails to develop a reasoned basis for requiring third party adviser examinations, its rulemaking runs a significant risk of being vacated pursuant to a legal challenge.

A third party examination rule may also be challenged on somewhat more speculative grounds. The SEC's goal of increasing the frequency of adviser examinations arguably casts the rule as an attempt to subvert Congress's authority in two respects. First, imposing a kind of tax on investment advisers to pay for third party examinations could be viewed as usurping Congress's power of the purse, especially in light of Congress's repeated rebuffing of requests for additional SEC funding for examinations and its rejection of a bill that would impose a tax on investment advisers for the same purpose. Second, a third party examination rule could be viewed as usurping Congress's legislative prerogative to create an investment adviser self-regulatory organization (SRO). Congress has repeatedly rejected proposals to create a SRO for investment advisers, including, specifically, an SRO authorized only to conduct examinations of investment advisers.

On firmer ground, a third party examination rule may be challenged on the theory that the Commission lacks the authority under the Investment Advisers Act of 1940 (Advisers Act) to adopt the rule. The rule would likely be adopted under Section 206(4) of the Advisers Act, which requires the Commission to adopt rules that "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[1] A failure to retain a third party compliance examiner is not fraud, and it is questionable whether requiring third party examinations is "reasonably necessary" to prevent fraud. The Commission has adopted a number of rules under Section 206(4) that raise the same issue. An adverse ruling on the SEC's authority to adopt a third

1. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 80b-6(4) (2012)).

party examination rule could affect the continued viability of these rules as well, and thereby significantly weaken the SEC's ability to regulate investment advisers.

Fortunately for the Commission, the numerous examples of preexisting third party compliance examiners and similar constructs provide strong precedent for a third party examination rule for investment advisers. The role and regulation of these examiners may also provide a helpful guide for the SEC's cost-benefit analysis of a third party examination rule for investment advisers. Some of these involve third party examinations that the Commission has directly or indirectly required for investment advisers, such as: (1) surprise and internal controls audits, which are required for advisers that have custody of client assets, (2) chief compliance officers (CCOs), who must be designated by advisers, (3) compliance consultants, who must be retained by an adviser as a condition of settling an enforcement action, and (4) advisers' investment performance calculations under the Global Investment Performance Standards (GIPS) promulgated by the CFA Institute.

These third party examiner models are particularly relevant because they entail the direct or indirect examination of investment adviser legal compliance. A third party examiner rule for investment advisers is likely to incorporate specific elements of each or even replace them wholesale. These third party examiner models have the disadvantage, however, of having been the subject of limited debate and having led virtually static lives. As a result, they have left a relatively thin record by which to evaluate their efficacy.

In contrast, there are prominent third party examiner models that have undergone vigorous debate and substantial reforms, which have created a voluminous record of public vetting. Credit rating agencies that the Commission has designated "nationally recognized statistical rating organizations" (NRSROs) and accounting firms that audit public companies bore the lion's share of blame for the Enron-Worldcom scandals of 2002 and the Financial Crisis of 2008.[2] As a result, from 2002 to 2010, the regulation

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2. At least one member of Congress has already referenced the NRSRO experience in questioning the propriety of requiring third party examination for investment advisers. *See Oversight of the SEC's Division of Investment Management: Hearing before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters., H. Comm. on Fin. Servs.*, 114th Cong. (Oct. 23, 2015) [hereinafter *Oversight Hearing*] (quoting Representative Brad Sherman, "I'm a bit concerned about the idea of using third parties because I've seen what happened in the bond rating area where they basically created the greatest catastrophe of our lifetimes because the bond rating agency is selected by the issuer. If we're going to have these outside firms come in are they going to be selected by the fund or would the SEC have a panel and assign the way, say, bankruptcy trustees are assigned from a panel. And wouldn't my grades have been much better if I could have determined which professor graded my paper and paid him . . . . The idea that you're going to have an outside grader who's paid and selected by the people that are grading didn't work out so well in 2008 and you ought to take a look at a system where those doing the grading can't become more profitable by putting out the word they are easy graders.").

of NRSROs and public-company auditors was transformed.[3]Unlike public company auditors, NRSROs have a direct connection to investment advisers. They have a close relationship with advisers because advisers are primary users of NRSRO debt ratings, and the ratings provide an indirect means by which advisers comply with certain regulations.

Another prominent third party examiner model, the proxy advisory firm, has recently been subject to a high level of scrutiny and may be on the brink of a major regulatory overhaul.[4] Like NRSROs, proxy advisory firms do not examine investment advisers as such, but they have a close relationship with advisers because the proxy advisory firm's voting recommendations provide a means by which investment advisers achieve legal compliance. There has been very little analysis of third party examinations for investment advisers.[5]

This Article sets the stage for consideration of a third party examiner rule for investment advisers. Part I describes how the SEC's interest in such a rulemaking has evolved and the risk of a successful legal challenge to the rulemaking on cost-benefit grounds. Part II discusses novel grounds for challenging the rulemaking, including claims that the rulemaking would usurp Congress's power of the purse or its power to create an investment adviser SRO, or would otherwise exceed the SEC's rulemaking power under the Advisers Act's antifraud provisions. Part III discusses the function and characteristics of numerous third party examiner models and surveys the regulation of these models.

I. BACKGROUND

A. EVOLUTION OF THE SEC'S CURRENT INTEREST IN A THIRD PARTY EXAMINATION RULE

In the space of less than two years, the prospect that the Commission will require registered investment advisers to engage third party compliance examiners has evolved from a shot across the bow to a missile approaching its target. Interest in the issue had lain dormant since 2003, when the Commission floated mandatory third party examinations as one of four options for improving investment adviser compliance.[6] The SEC's interest was reignited in 2014, when former SEC Commissioner Daniel Gallagher suggested that mandatory third party examinations for advisers would

3. *See infra* Parts IV(A) and (D).

4. *See infra* Part IV(C).

5. *See* JAMES ANGEL, CENTER FOR FINANCIAL MARKETS AND POLICY ON THE REGULATION OF INVESTMENT ADVISORY SERVICES: WHERE DO WE GO FROM HERE? (2011), http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/AngelWhereDoWeGofromHere.pdf. The possibility of requiring third party examinations was the topic of a 2010 roundtable discussion hosted by this author. A memorandum on the roundtable is on file with this author and available upon request.

6. *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2107, 79 SEC Docket 1696 (Feb. 5, 2003) (codified at 17 C.F.R. pts. 270, 275).

address the perceived inadequacy of the SEC's adviser examination program.[7]

Commissioner Gallagher's original proposal to require third party examinations of advisers referred to his perception that the greater frequency of broker-dealer examinations created a statistical imbalance between the amount of reported misconduct by broker-dealers and investment advisers.[8] He complained of a "common misconception" that misconduct was "exclusively or even primarily a broker-dealer problem rather than an investment adviser problem as well."[9] Commissioner Gallagher subsequently added, in connection with comments regarding the level of SEC adviser examinations, that he was "worried that the SEC might miss the next huge investor rip-off along the lines of the multibillion-dollar Ponzi scheme perpetrated by Bernard Madoff."[10]

Commissioner Gallagher's comments received a fair of amount of attention in the financial press, eventually leading SEC Chair Mary Jo White to express interest in the concept,[11] then to ask her staff to evaluate it,[12] and later to state that she believed that the Commission "will need to 'move to a program of third-party compliance exams.'"[13] One reporter appeared to

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7. Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at the 46th Annual Rocky Mountain Securities Conference, Denver, Colorado (May 9, 2014) [hereinafter 2014 Gallagher Remarks], https://www.sec.gov/News/Speech/Detail/Speech/1370541779229. *See also Wall Street Reform: Assessing and Enhancing the Financial Regulatory System: Hearing before the S. Comm. on Banking, Hous. & Urban Affairs* (Sep. 9, 2014) (testimony of Mary Jo White, Chair, U.S Sec. & Exch. Comm'n). The Commission examined 9% of advisers in fiscal year (FY) 2013.

8. *See* 2014 Gallagher Remarks, *supra* note 7. *Cf.* U.S. SEC. & EXCH. COMM'N, FY 2016 BUDGET REQUEST BY PROGRAM 67 (2015) [hereinafter FY 2016 BUDGET REQUEST BY PROGRAM], https://www.sec.gov/about/reports/sec-fy2016-budget-request-by-program.pdf (stating that the Commission "examined approximately ten percent of registered [investment] advisers in FY 2014 . . . . regulators are examining well below one percent of the approximately 160,000 branch offices each year").

9. 2014 Gallagher Remarks, *supra* note 7.

10. Mark Schoeff, Jr., *RIAs Should Be Forced to Hire Outside Examiners: Gallagher*, INVESTMENT NEWS (May 20, 2014, 2:35 PM), http://www.investmentnews.com/article/20140520/FREE/140529989. It is not clear how the Madoff scandal supports increasing adviser examinations relative to broker-dealer examinations. All the misconduct in which Madoff engaged occurred during the time he was associated with a broker-dealer and very little occurred when his firm was a registered investment adviser. *See* Mercer Bullard, *Madoff Scandal: Who Was Really Asleep at the Switch?*, MORNINGSTAR (June 18, 2009, 6:00 AM), http://news.morningstar.com/articlenet/article.aspx?id=295708.

11. Mark Schoeff, Jr., *SEC's White Calls Third-Party Adviser Exam Idea 'Creative'*, INVESTMENT NEWS (May 22, 2014, 12:01 PM) http://www.investmentnews.com/article/20140522/FREE/140529966 (quoting Chair White, referring to Commissioner Gallagher's third party examiner proposal: "[h]is suggestion is a creative one").

12. *See* Mark Schoeff, Jr., *SEC's White Defends Coverage of Investment Advisers*, INVESTMENT NEWS (Dec. 17, 2014, 4:40 PM), http://www.investmentnews.com/article/20141217/FREE/141219920/secs-white-defends-coverage-of-investment-advisers (quoting Chair White, "I have asked the staff to do a current evaluation of the third-party compliance review concept.").

13. Michael J. Missal et. al., *Heard at the SIFMA Conference*, K&L GATES: LEGAL INSIGHT 2, (Apr. 6, 2015), http://www.klgateshub.com/files/Publication/3fc49320-6b73-4af1-968e-dbaf3eb

paraphrase Chair White as stating that "[t]he move would be designed to help the agency's Office of Compliance Inspections and Examinations increase its oversight of advisers."[14] Other than the general goal of "improv[ing] overall compliance by registered investment advisers," Chair White has not specifically cited any potential benefit other than increasing the frequency of adviser examinations.

In October 2015, SEC Division of Investment Management (IM) Director David Grim confirmed in testimony before Congress that the staff was "developing a recommendation for the Commission's consideration that, if proposed and adopted, would establish a program of third-party compliance reviews for registered investment advisers."[15]The only reference in his testimony to the purpose of a third party examination rule was his view that it would "improve compliance by registered investment advisers."[16] He did not elaborate further in comments at the related hearing. Chair White stated in February 2016 that she would seek to introduce a program for third party compliance reviews,[17] and as of this writing she is reportedly reviewing a draft proposal.[18]

Chair White has had more to say about the potential costs of third party examinations than the potential benefits. In a letter to Congress, she noted three concerns that had been identified in the SEC's 2003 Concept Release:

894ba/Presentation/PublicationAttachment/271af39c-b38e-4f4f-8ecf-a6f83fdb5da1/GE_Alert_04 062015.pdf [hereinafter *SIFMA Conference*].

14. Mark Schoeff, Jr., *SEC Fiduciary Push Gives Momentum to Third-Party Exams,* INVESTMENT NEWS (Mar. 18, 2015, 1:55 PM), http://www.investmentnews.com/article/20150318/FREE/150319897/sec-fiduciary-push-gives-momentum-to-third-party-exams. *See SIFMA Conference, supra* note 13, at 2 (summarizing Chair White's comments that she intends to require third party examinations "in order to get out and examine more registered investment advisers"). *See* Letter from Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, to Jeb Hensarling, Chairman, H. Comm. on Fin. Servs. (Dec. 16, 2014) [hereinafter White Letter], https://www.investmentadviser.org/eWeb/docs/Public/141216secltr.pdf. Third party examinations could "increase the frequency with which our staff could examine funds and advisers." *Id.* at 2.

15. *Oversight Hearing*, *supra* note 2 (testimony of David W. Grim, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm'n). *See also* SEC. & EXCH. COMM'N, AGENCY FINANCIAL REPORT, FISCAL YEAR 2015 34 (2015) (listed among "Major Regulatory Initiatives": "Develop . . . a program of third-party compliance reviews for registered investment advisors.").

16. *Oversight Hearing*, *supra* note 2 (testimony of David W. Grim).

17. Mark Schoeff, Jr., *White Vows to Forge Ahead on Fiduciary Duty, Third-Party Exams Despite Diminished SEC*, INVESTMENT NEWS (Feb. 19, 2016, 11:45 AM), http://www.investmentnews.com/article/20160219/FREE/160219915/white-vows-to-forge-ahead-on-fiduciary-duty-third-party-exams?NLID=daily&NL_issueDate=20160219&utm_source=Daily-20160219&utm_medium=email&utm_campaign=investmentnews&utm_visit=178886. *See also* Schoeff, Jr, *supra* note 10 (paraphrasing Commissioner Gallagher as "want[ing] registered investment advisers to be forced to hire third-party contractors to conduct examinations"); Schoeff, Jr., *supra* note 14 (stating that Chair "White said Tuesday the SEC also should implement a program of third-party compliance exams of advisers").

18. Mark Schoeff, Jr., *SEC Gets Staff Recommendation to Allow Third-Party Exams,* INVESTMENT NEWS (Sep. 27, 2016, 12:18 PM), http://www.investmentnews.com/article/20160927/FREE/160929926/sec-gets-staff-recommendation-to-allow-third-party-exams (quoting White, "The staff has completed their recommendation [to allow third-party exams]: a proposal which is now with my fellow commissioners"),

1. The costs of a third party review (particularly as it relates to small advisers);
2. Standards for or expertise of the reviewers; and
3. Potential conflicts of interest which may impact the quality of reviews given that third parties may be incentivized to maintain their professional relationships.[19]

The SEC's sensitivity to the potential costs of third party examinations will be important in weathering objections, including legal challenges, to a third party examination rulemaking.

As of this writing, it appears that the Commission is leaning toward releasing a proposal for third party examinations, rather than a release requesting comments on the concept.[20] Issuing a proposal, rather than a concept release, suggests that the Commission has developed an adequate cost-benefit structure within which to propose a rule that meets cost-benefit standards. This is certainly possible based on the SEC staff's internal analysis and its experience with similar past proposals. As discussed immediately below, a strong cost-benefit analysis may be critical to the rule's survival.

B. SEC RULEMAKING COST-BENEFIT REQUIREMENTS AND LEGAL CHALLENGES

Scrutiny of SEC cost-benefit analysis has become a focal point for Congress and the courts.[21] Although SEC rulemaking is not subject to an explicit cost-benefit analysis requirement as such, it is subject to the Administrative Procedure Act's (APA) arbitrary and capricious standard, which may amount to the same thing.[22] The Advisers Act requires the Commission to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation" when adopting rules, which require a finding that the rule is "necessary or

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19. *See* White Letter, *supra* note 14, at 2.

20. *See id.*

21. *See generally* John C. Coates, IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 882 (2015).

22. *See, e.g.*, Chamber of Commerce v. SEC, 412 F.3d 133, 143–44 (D.C. Cir. 2005) (basing arbitrary and capricious finding on failure to satisfy Investment Company Act requirement to "consider . . . whether the [rule] will promote efficiency, competition, and capital formation"). *See generally* Nadelle Grossman, *The Sixth Commissioner*, 49 GEO. L. REV. 693, 700–02 (2015); Robert L. Jackson, *Cost-Benefit Analysis and the Courts*, 78 L. & CONTEMP. PROB. 55, 62 (2015); Donna M. Nagy, *The Costs of Mandatory Cost-Benefit Analysis in Sec Rulemaking*, 57 ARIZ. L. REV. 129, 141–42 (2015). SEC rulemaking is also required to minimize its rules' paperwork burdens and burdens on small businesses, and to submit rules to the U.S. Comptroller General, which is required to provide an assessment to Congress on any "major" rule, i.e., a rule that is expected to have an economic impact of $100 million or more. *See* Regulatory Planning and Review, Executive Order No. 12866, 58 Fed. Reg. 51,735 (Sept. 30, 1993). The rule's effect is suspended from the date the Comptroller's assessment is submitted, during which time Congress has the power to veto the rule by joint resolution, subject only to a veto by the President. *See* 5 U.S.C. § 802 (2012).

appropriate in the public interest."[23] The Commission has taken the position that it will comply with the cost-benefit analysis guidance in Executive Orders 12866 and 13563.[24] The Commission is also likely to be somewhat inhibited by the shadow of numerous bills that have been floated in Congress that would impose additional cost-benefit restrictions on SEC rulemaking.

Putting a fine edge on its cost-benefit analysis obligations, the Commission has recently seen a number of its rules vacated by the U.S. Court of Appeals for the District of Columbia Circuit.[25] For example, the D.C. Circuit has vacated, on cost-benefit grounds, separate SEC proposals to require mutual fund boards to appoint an independent chair and a 75 percent independent board (twice), treat fixed-index annuities as securities, require public companies to provide information on shareholder-nominated board candidates, and require certain designations regarding public companies' use of conflict minerals.[26] The D.C. Circuit also vacated the SEC's proposal to exempt certain brokers from being regulated as investments advisers and its attempt to require advisers to private funds to register as investment advisers, in each case on the ground that the rule exceeded the SEC's authority.[27] The challenge to the broker-dealer exemption was brought by the Financial Planning Association, which would have a strong interest against a third party examination rule and may be first in line to challenge it.

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23. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 80b-2(c) (2012)). Notably, this requirement does not apply to rulemaking under the Advisers Act's antifraud provision, which does not require such a "necessary and appropriate" finding. *See id.* § 80b-6(4).

24. *See* Memorandum from the U.S. Sec. & Exch. Comm'n, Div. of Risk, Strategy, and Fin. Innovation and Office of Gen. Counsel on the Current Guidance on Economic Analysis in SEC Rulemakings to Staff of the Rulewriting Divisions and Offices 3–4 (Mar. 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf. *See generally* U.S. SEC. & EXCH. COMM'N, OFFICE OF INSPECTOR GEN., FOLLOW-UP REVIEW OF COST-BENEFIT ANALYSES IN SELECTED SEC DODD-FRANK ACT RULEMAKINGS (Jan. 27, 2012), https://www.sec.gov/about/offices/oig/reports/audits/2012/rpt499_followupreviewofd-f_costbenefitanalyses_508.pdf; U.S. SEC. & EXCH. COMM'N, OFFICE OF INSPECTOR GEN., REPORT OF REVIEW OF ECONOMIC ANALYSES CONDUCTED BY THE SEC. AND EXCH. COMM'N IN CONNECTION WITH DODD-FRANK ACT RULEMAKINGS (2011), https://www.sec.gov/about/offices/oig/reports/audits/2011/report_6_13_11.pdf. *The SEC's Aversion to Cost-Benefit Analysis, Hearing before the H. Subcomm. on Oversight & Gov't Reform* (2011) (testimony of Mercer Bullard).

25. *See* James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1814 (2012) ("Until very recent years, SEC-adopted rules enjoyed a blissful existence before the D.C. Circuit. The turning point came in 2005 when, in Chamber of Commerce v. SEC, the Chamber challenged rules the SEC adopted under the Investment Company Act.").

26. Nat'l Ass'n Mfr. v. SEC, 748 F.3d 359 (D.C. Cir. 2014) (conflict minerals); Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (board candidates); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2009) (fixed indexed annuities); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005) (fund boards); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006) (fund boards).

27. *See* Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007) (broker-dealer exemption); Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (hedge fund registration). The same court also rejected the SEC's position that viatical settlements are securities. *See* SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996).

The twice vacated independent mutual fund chairman rule may have special relevance to a third party examination rulemaking. The role of an independent mutual fund chair is somewhat analogous to that of a third party examiner. Mutual fund directors' primary responsibilities entail compliance oversight, particularly with respect to the conflict of interest between a fund and its investment adviser.[28] An independent mutual fund chair offers, at least for fund advisers, a potential alternative to requiring a third party examiner. Fund boards have the authority to require third party examinations and frequently do, which will beg the question of why an independent chair is not already in the best position to evaluate whether expanded use of third party examinations is appropriate. The vast majority of funds already have a majority of independent directors, and more than half already have an independent chair.[29] The failure to adequately consider alternatives was one basis for the D.C. Circuit's rejection of the mutual fund independent chairman rule. Additionally, the industry may contend that third party examinations would be more burdensome than the independent chair requirement that a court has twice vacated.

The cases in which Advisers Act rules were challenged may create more significant problems for the Commission.[30] In both cases, the court found that the Commission had exceeded its authority under the Advisers Act. As discussed in Part C of the immediately following section, there are compelling arguments that a third party examination rule also would exceed the SEC's authority.

If the Commission intends to justify a third party examination requirement on the ground that it lacks the resources to conduct adequate inspections of investment advisers, then it may have to make a stronger case than it has made in the past. In a 2014 report, for example, the SEC staff appeared to attribute declines in the number of examinations primarily to declines in staff levels,[31] but the data tell a different story. The most significant decline discussed in the report occurred from 2008 to 2010, when adviser examinations declined from 1,521 in 2008, to 1,244 in 2009 and to 1,083 in 2010. However, the number of examiners dedicated to adviser

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28. *See SEC Adopts Rules Designed to Enhance Effectiveness of Mutual Fund Directors*, SEC NEWS DIGEST 2001-2 (Jan. 3, 2001), https://www.sec.gov/news/press/2001-1.txt ("Mutual fund independent directors are an investor's front-line defense against conflicts of interest and other potential abuses."); Am. Bar. Ass'n et. al., *Fund Director's Guidebook*, 52 BUS. LAW. 229, 259 (1996) (describing directors' compliance responsibilities).

29. *See* MUT. FUND DIRS. FORUM, COST IMPLICATIONS OF AN INDEPENDENT CHAIR AND A 75 PERCENT INDEPENDENT BOARD 2–3 (Aug. 30, 2005), http://mfdf.org/images/DirResPDFs/ReportofSurvey_1.pdf (thirty-six of forty-five fund complexes surveyed had an independent chair and forty-one of forty-five had a board that was at least 75% independent).

30. *See generally Financial Planning Ass'n*, 482 F.3d at 481–501; *Goldstein,* 451 F.3d at 873–84.

31. U.S. SEC. & EXCH. COMM'N, DIV. OF INV. MGMT., STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 38 (2011) [hereinafter SECTION 914 SEC STUDY], https://www.sec.gov/news/studies/2011/914studyfinal.pdf.

examinations increased during this period, from 425 to 447 to 460.[32] Inspections rose from 1,346 to 1,379 from 2006 to 2007, but the number of adviser examiners declined from 475 to 425. The staff indicated that the decline was partly attributable to its devoting more resources to (1) for-cause examinations and examinations of higher-risk advisers (which take longer) and (2) "additional resource intensive procedures such as enhanced asset verification to detect fraud and misappropriation of investor assets."[33] This second factor suggests that the number of examinations is more closely linked to the allocation of resources, rather than the number of examiners.[34]

II. NOVEL CHALLENGES TO A THIRD PARTY EXAMINATIONS RULE

In addition to the kind of cost-benefit challenge discussed *supra*, another novel challenge to a third party examination rule for investment advisers may be based on the argument that the Commission lacks the authority to adopt the rule under the Advisers Act's antifraud provision. Specifically, Section 206(4) of the Act provides that the Commission shall adopt rules that "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[35] The Commission has interpreted broadly the range of requirements that are "reasonably designed to prevent" fraud.[36] A mandatory third party examination requirement may nevertheless exceed the limits of this authority.

Another novel, but far more speculative ground for challenging a third party examination rule is that it usurps Congressional authority. As discussed *supra*, a primary justification for the rule is that the Commission lacks the resources to conduct a satisfactory level of examinations, and mandatory third party examinations—paid for by investment advisers—would solve this problem. However, Congress has specifically considered and declined to act on proposals to increase the SEC's funding to provide for more frequent examinations. Some have expressed the view that mandatory third party

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32. *Id.* at 11, 14. *See also* Letter from Jeb Hensarling, Chairman, Comm. on Fin. Serv., U.S. House of Representatives, & Scott Garrett, Chairman, Subcomm. on Capital Mkts. & Gov't Sponsored Enters., Comm. on Fin. Servs., U.S. House of Representatives, to Chair, U.S. Sec. & Exch. Comm'n, Mary Jo White n.1 [hereinafter Hensarling-Garrett Letter] (Nov. 24, 2014) (citing same data), https://www.investmentadviser.org/eWeb/docs/Public/141124_lttr.pdf.

33. *Id.* at 14–15.

34. This view is reinforced by the SEC's recent shift of broker-dealer examiners to investment adviser examinations, which subsequently triggered the assignment of about forty-five SEC staff to oversee FINRA "because [the Commission] will be somewhat more dependent on them for broker-dealer exams in the first instance." Elizabeth Dilts, *SEC Says to Monitor Partner Regulator's Brokerage Oversight*, REUTERS (Oct. 17, 2016, 9:15 PM), http://www.reuters.com/article/us-sec-regulations-finra-idUSKBN12H2AG (discussing SEC's shifting of examination staff and creating a FINRA and Securities Industry Oversight group).

35. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 80b-6(4) (2012)).

36. *See, e.g.*, 17 C.F.R. § 275.206(4)-1(a)(1) (2016) (prohibiting the use of testimonials).

examinations would also provide a means of establishing a SRO for investment advisers, but Congress has also specifically considered and declined to act on proposals to create an investment adviser SRO. The SEC's plans beg the question of whether a third party examination requirement would constitute a usurpation of Congressional authority.

A. Third Party Examinations and the SEC's Antifraud Rulemaking Authority

The Commission would likely adopt a third party examination rule for investment advisers under Section 206(4) of the Advisers Act. Section 206 of the Act makes it unlawful for an investment adviser:

1. To employ any device, scheme, or artifice to defraud any client or prospective client;[37] or
2. To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.[38]

Section 206(4) makes it unlawful for an investment adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and requires the Commission adopt rules that "define, and prescribe means reasonably designed to prevent" fraudulent, deceptive, or manipulative acts, practices or courses of business.[39] Relying on this authority, the Commission has adopted rules requiring surprise and internal controls audits, chief compliance officers and CCO reports, and written compliance procedures of general scope and specifically related to proxy

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37. 15 U.S.C. § 80b-6(1) (2012).

38. *Id.* § 80b-6(2). Section 206(3) prohibits principal trading between advisers and their clients. *See id.* § 80b–6(3). Advisers Act Section 206 is similar to Securities Act Section 17 and Exchange Act Rule 10b-5. Section 206 makes it unlawful, inter alia

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . . or (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

Id. §§ 80b–6(1), (2), (4). Section 17 makes it unlawful, inter alia, "(1) to employ any device, scheme, or artifice to defraud, . . . or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." *Id.* §§ 77q(a)(1), (3). Rule 10b-5 makes it unlawful, inter alia, "(a) To employ any device, scheme, or artifice to defraud, . . . or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. §§ 240.10b-5(a), (c). The Supreme Court has held that investment advisers have a fiduciary duty to their clients under Section 206. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181–82 (1963).

39. 15 U.S.C. § 80b-6(4). Unlike Section 206, Exchange Act Section 10(b), under which Rule 10b-5 was adopted, is not self-executing. Section 10(b) makes it unlawful to "to use or employ, in connection with the purchase or sale of [a security,] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." *Id.* § 78j(b). Section 17 of the Securities Act does not specifically authorize SEC rulemaking. *See id.* § 77q.

voting. The Commission would most likely adopt a third party examination rule under that same authority.[40]

The scope of the SEC's authority under Section 206(4) has not received much scrutiny. This provision could be read to authorize two types of rules: (1) rules that "define" fraudulent, deceptive, or manipulative acts (hereinafter, "fraud"), and (2) rules that "are reasonably designed to prevent" fraud. The first category would not apply, because failing to retain a third party to conduct a compliance examination would not be fraudulent. A third party examination rule presumably would fall under the "reasonably designed to prevent" fraud category.

In some cases, antifraud rules under Section 206(4) appear to fit squarely within the "reasonably designed to prevent" fraud category. For example, Rule 206(4)-2 (the Custody Rule) requires that, when an adviser has custody of client assets, the assets be kept "[i]n a separate account for each client under that client's name."[41] Commingling client assets might not be per se fraud, but it is closely related to the risk of embezzlement. The relationship reflects a strong nexus between the rule's "design" and a type of fraud that it would prevent. The Custody Rule's anti-commingling provision, therefore, would appear to meet the standard for the "reasonably designed to prevent" fraud category under Section 206(4). This analysis treats the issue of whether the provision is "reasonably" designed as a question of whether the nexus between the "design" and fraud prevention was sufficiently strong.

In other cases, antifraud rules under Section 206(4) neither prohibit fraud nor reflect a strong nexus between a type of fraud and the rule's design. The Custody Rule also requires that client assets be held by a Qualified Custodian (e.g., a bank, broker-dealer, futures commission merchant, or foreign

40. It is possible, although unlikely, that the Commission could adopt the rule under authority granted by Section 913(f) of the Dodd-Frank Act of 2010, which permits the Commission to "commence a rulemaking . . . to address the legal or regulatory standards of care" for investment advisers in providing personalized advice to retail investors. Dodd-Frank § 913(f).

41. Investment Advisers Act, 50 Fed. Reg. 42,909 (Oct. 23, 1985) (codified at 17 C.F.R. § 275.206(4)-2(a)(1)(i) (2016)). *See also* Treasury Regulation, 25 Fed. Reg. 14,021 (codified at 26 C.F.R. § 1.408-2 (2016)) (prohibiting commingling of Individual Retirement Account assets). The Supreme Court has addressed and narrowed the scope of the SEC's rulemaking authority under Exchange Act Section 10(b), but that Section authorizes only rules identifying deceptive conduct. *See supra* notes 37–38*;* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. Nor have we been cited to any evidence in the legislative history that would support a departure from the language of the statute."); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213–14 (1976) ("The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.' Thus, despite the broad view of [Rule 10b-5] advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b)." (internal citations omitted)). Unlike Section 206(4), Section 10(b) does not also authorize rules "reasonably designed to prevent" deceptive conduct. *See supra* note 38.

financial institution).[42] Using a non-Qualified Custodian could not be described as inherently fraudulent, which leaves only the "reasonably designed to prevent" authority. But the "Qualified Custodian" requirement is not nearly as closely (or "reasonably") connected to the risk of fraud as the commingling prohibition.[43] Banks' custodial contracts may provide far less protection to client assets than the protection that an investment adviser might provide.[44]

This issue is presented more starkly by Advisers Act Rule 206(4)-1(a)(1), which unconditionally prohibits advisers from using testimonials in advertisements.[45] There is nothing inherently fraudulent about using testimonials, which, again, leaves only the "reasonably designed to prevent" authority. However, the nexus between the testimonial prohibition and a particular fraud is weak, at best. Commingling leans in one direction—toward fraud. In contrast, a testimonial may provide useful information as well as disseminate misrepresentations. If the term "reasonably" requires a strong connection between a requirement that is "designed to prevent" fraud and a specific fraud or type of fraud, then the testimonial prohibition sits near, if not well beyond, the outer limits of this requirement.

The same issue arises in the context of broad based compliance requirements. The requirements that advisers retain a CCO and adopt written compliance policies and procedures are not designed to prevent a particular fraud or type of fraud. They are broadly designed to prevent violations of federal securities law. In the context of Section 206(4), "broadly" designed rules and "reasonably" designed rules may be mutually exclusive. If Section 206(4) does not authorize the CCO and written procedures requirements, then neither would it authorize a third party examination requirement.

The two-category reading of Section 206(4) set forth above is not beyond doubt. The rule requires rules that "define, and prescribe means reasonably designed to prevent," fraud. Under accepted grammatical usage, the commas following "define" and "prevent" would be read to describe only one category of rule, that is, a rule that *both* defined and was reasonably designed to prevent fraud. Under this reading, Section 206(4) does not, technically,

42. The rule's Qualified Custodian requirement is akin to the statutory requirement that an IRA custodian generally be a bank. *See* I.R.C. § 408(h) (2012). However, Congress authorized the IRS to permit nonbanks to custody IRA assets, and the IRS has exercised this authority with respect to dozens of non-bank entities that would not be Qualified Custodians under Rule 206(4)-2. *See Nonbank Trustees Approved as of February 1, 2016*, (Feb. 2, 2016), https://www.irs.gov/pub/irs-tege/nonbank_trustee_list.pdf.

43. *Cf.* OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SIGNIFICANT DEFICIENCIES INVOLVING ADVISER CUSTODY AND SAFETY OF CLIENT ASSETS (Mar. 4, 2013), https://www.sec.gov/info/iaiccco/iaiccco-custody.pdf (listing adviser deficiencies relating to custody that relate directly to the risk of fraud, e.g., client assets being held in the adviser's name).

44. *See, e.g.*, Szulik v. State St. Bank & Tr. Co., 935 F. Supp. 2d 240, 262 (D. Mass. 2013) (rejecting a breach of contract claim on the ground that terms of custodial contract did not prohibit custodian from "disbursing funds in connection with facially irregular transactions").

45. 17 C.F.R. § 275.206(4)-1(a)(1) (prohibiting the use of testimonials).

authorize any rule that does not "define" the relevant fraudulent conduct. Thus, the anti-commingling rule would be authorized only to the extent that the rule both defined the fraud, e.g., embezzlement, and was reasonably designed to prevent it.

In the case of the commingling prohibition, this may be a distinction without a difference. The fraud that the anti-commingling provision is designed to prevent is somewhat self-evident. Requiring the Commission to "spell it out" would be unnecessarily hyper technical. Similarly, but with less certainty, surprise and internal controls audits and proxy voting conflict-of-interest procedures are designed to prevent frauds that are arguably self-evident.[46]

However, there is no specific fraud that mandatory CCOs, CCO reports, or general compliance procedures are designed to prevent. These rules are intended to prevent fraud, but not a *defined* fraud as Section 206(4) could be read to require. The same would be true for a third party examination rule for investment advisers, which is intended to promote general compliance.[47] The fraud that such a rule would be designed to prevent could not be defined in any meaningful sense.

A middle ground would interpret the two-category approach in light of a grammatical structure. Under this reading, a rule would be "reasonably designed to prevent" fraud only if there exists a strong nexus between a defined fraud and the rule's requirements. This interpretation might provide a fairly strong basis for requiring surprise and internal controls audits and proxy voting conflict-of-interest procedures because of the greater leeway allowed in showing the nexus between the rule and the particular fraud that it is intended to prevent. But this interpretive approach would still leave broad based compliance requirements in limbo.

A third party examination rule may provide fertile ground for testing the scope of the SEC's rulemaking authority under Section 206(4). Such a challenge would threaten not only the implementation of that rule, but also the continued viability of a number of other rules promulgated under Section 206(4). However, as discussed *infra* in Part IV, the SEC has a long and varied history of requiring third party examinations or their equivalents, which would bode poorly for a such a challenge and, as discussed immediately below, the claim that a third party examination requirement for advisers usurps Congressional authority.

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46. However, this position requires an answer to a difficult existential question: at what point, if any, would a series of separate compliance procedures rules, each targeted at a specific area of compliance and, therefore, a particular fraud, as a group exceed the authority granted by Section 206(4)?

47. *See Oversight of the U.S. Securities and Exchange Commission, Hearing before the S. Comm. on Banking, Hous. & Urban Affairs* (June 14, 2016) (testimony of Chair White) (stating that third party adviser examinations "would be designed to improve overall compliance by registered investment advisers").

B. THIRD PARTY EXAMINATIONS AS EXERCISE OF APPROPRIATION/TAXATION AUTHORITY

One purpose of a third party examination requirement for advisers appears to be to remedy the inadequacy of SEC funding to examine advisers with sufficient frequency. The Commission has specifically asked Congress for additional funding for adviser examinations,[48] but Congress has not granted its request. Some members of Congress have contended that the Commission could increase the frequency of adviser examinations by managing its examinations more efficiently.[49]

In 2013, the ranking member of the House Financial Services Committee introduced a bill that would provide for more funding by authorizing a user tax on investment advisers.[50] The tax would be earmarked for investment adviser examinations and allow for more frequent examinations. Like the SEC's requests for more taxpayer funding specifically for increased adviser examinations, the user fee failed to gain sufficient Congressional support.

Congress's declining to approve additional funding for examinations or a user fee to be collected from investment advisers begs the question of whether a third party examination requirement paid for by advisers is an end run around Congress. A third party examination rule could be viewed as indirectly increasing the SEC's budget by reducing the expenditure of resources that it otherwise would have incurred. Similarly, advisers' paying for third party examinations would be an indirect user fee that is "collected" by the Commission by reason of the offset against SEC expenditures on examinations.

However, there is nothing new, of course, about regulators' adopting rules that require regulated entities to incur additional costs. Nor is there anything new about rules that shift expenses to regulated entities that a regulator might otherwise incur. The SEC's requirement that investment advisers retain an accountant to conduct an annual surprise audit illustrates both points. However, the impetus for that requirement was not, or at least was not characterized as, inadequate SEC resources. Nor was it adopted in the face of Congress's repeated declining to provide additional funding for surprise audits.

SEC resource constraints have been explicitly cited as the primary justification for mandating third party investment adviser examinations.

48. *See, e.g.*, Melanie Waddell, *SEC's White Pleads for Advisor Exam Funds; Rep. Waters 'Pushing Hard' for User Fees Bill*, THINKADVISOR (Apr. 29, 2014), http://www.thinkadvisor.com/2014/04/29/secs-white-pleads-for-advisor-exam-funds-rep-water.

49. *See, e.g.*, Hensarling-Garrett Letter, *supra* note 32, at 3 (recommending that the SEC consider increasing adviser examinations by "reallocate[ing] existing . . . resources" and "consider creative solutions").

50. *See* Investment Adviser Examination Improvement Act of 2013, H.R. 1627, 113th Cong. (2013) (introduced by Rep. Maxine Waters).

Chair White has directly connected inadequate funding and the planned move to third party examinations, reportedly stating that:

> [t]he SEC is going to need more funding in order to get out and examine more registered investment advisers, and will continue to press Congress for more funding for the agency. However, Ms. White noted that the SEC will need to 'move to a program of third-party compliance exams' for advisers.[51]

While the Commission will certainly supplement this justification with investor protection arguments, the Commission will not be able to contend that the rule has no cost-savings purpose.

Members of Congress may view the SEC's rulemaking as a usurpation of its appropriation and taxation powers. The rule would essentially moot Congress's views on whether additional funds should be allocated to the Commission for advisers' examinations and on whether investment advisers should be subject to a user fee. By adopting the rule, the Commission can take the decision out of Congress's hands.

Congress has granted the Commission substantial discretion in allocating its budget among different activities, and the Commission uses that discretion to hire additional staff to examine advisers.[52] Chair White recently announced that the Commission would shift resources dedicated to broker-dealer examinations to investment adviser examinations,[53] which reflects a solution to inadequate investment adviser examinations that falls squarely within the SEC's traditional authority. Transferring internal expenses to regulated entities is inconsistent with this approach.

There are many instances in which agencies impose taxes to be used for the agency's operations, but Congress expressly authorizes the taxes in these instances. The most relevant example here is the Financial Industry Regulatory Authority (FINRA), which imposes fees on broker-dealers that

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51. *See SIFMA Conference*, *supra* note 13.

52. *See Fiscal Year 2017 Budget Request of the U.S. Securities and Exchange Commission, Hearing before the Subcomm. on Fin. Servs. & General Gov't*, *Comm. on Appropriations* (Apr. 12, 2016) (testimony of Chair White) (stating that under FY 2017 budget request, "a top priority will be to hire 127 additional examiners, primarily to conduct additional examinations of investment advisers").

53. *See* Mark Schoeff, Jr., *Shift of SEC Resources to RIA Oversight Not Likely to Stop Push for Third-Party Exams*, INVESTMENT NEWS (Feb. 1, 2016, 1:47 PM), http://www.investmentnews.com/article/20160201/FREE/160209994/shift-of-sec-resources-to-ria-oversight-not-likely-to-stop-push-for (stating that the Commission plans to increase adviser examiners from 530 to 630 in 2016, in part by shifting broker-dealer examiners to adviser examinations). To the extent that FINRA would make up for reduced SEC examinations of broker-dealers, the Commission would be indirectly imposing additional taxes on the broker-dealers that fund FINRA operations. *See id.* A "decrease in the number of SEC staff doing broker exams [probably] will put more pressure on FINRA to pick up the slack." *Id.* Schoeff quotes Skip Schweiss, Managing Director, TD Ameritrade Institutional: "[t]his is robbing Peter to pay Paul." *Id.; see generally* FY 2016 BUDGET REQUEST BY PROGRAM, *supra* note 8, at 67 ("[R]egulators are examining well below one percent of the approximately 160,000 branch offices each year.").

directly finance FINRA broker-dealer examinations.[54] The Public Company Accounting Oversight Board (PCAOB) is authorized to collect fees from public companies and broker-dealers subject to its oversight, and the Federal Communications Commission (FCC) sets and collects fees for the purpose of promoting "universal service." Challenges to FCC fees on nondelegation of powers grounds have failed,[55] but the case at hand is different. A third party examination rule would reflect the exercise of *undelegated* taxation authority; also, the user fees would not be paid directly to the Commission. If mandating third party examinations to improve overall compliance is akin to the FCC's collecting fees to promote universal service, and assuming that the FCC could not collect the fees if not delegated the authority to do so, it is not necessarily clear that the fact that the Commission would not collect the fee paid for third party examinations (at least not directly) should make a difference for purposes of the separation of powers.

A related question is how and whether a cost-benefit analysis should include the shifting of financial responsibility for investment adviser examinations from the Commission to users of that service. The Commission could shift enough internal resources to provide for an adequate examination program, in which case the out-of-pocket cost to advisers would be zero. If such an examination program could be achieved at zero cost, then would it necessarily be arbitrary and capricious to impose fees on advisers to obtain a benefit that could otherwise be obtained for free? If the APA requires the consideration of alternatives, then how could the alternative of shifting internal resources to solve the examination program not be considered superior to a third party examination program?

The courts' application of cost-benefit principles seems quaintly naïve when one opens up the cost-benefit inquiry to the full scope of political economics. For example, the Advisers Act requires the Commission, for some rulemakings, to "consider . . . whether the [rule] will promote efficiency, competition, and capital formation."[56] A user tax reflects the economic theory that the optimal production of a good or service requires that negative externalities incurred in its production be included in the price of the good or service.[57] The SEC's expenditures on adviser examinations represent a negative externality imposed on taxpayers; shifting this expense to advisers and, thereby, to their advisory clients would internalize the cost

54. *See* SECTION 914 SEC STUDY, *supra* note 31, at 25–26 (citing as examples fees collected by agencies from regulated persons).

55. *See, e.g.*, Tex. Office of Pub. Util. Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999). *See generally* Seafarers Int'l Union of N. Am. v. U.S. Coast Guard, 81 F.3d 179 (D.C. Cir. 1996); Nat'l Cable Television Ass'n, Inc. v. United States, 415 U.S. 336 (1974). In another case, the Supreme Court did not address PCAOB financing in its decision on the legality of the PCAOB. *See* PCAOB Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477 (2010).

56. 15 U.S.C. § 80b-2(c) (2012).

57. For example, a company that profitably sells widgets for $10 each while causing $20 of environmental harm per widget is inefficient.

of investment advice and increase efficiency. Along the same lines, competition could be promoted by leveling the playing field with broker-dealers, which finance their own examinations through dues paid to FINRA. Capital formation could thereby be promoted by removing a distortion in the cost of capital for broker-dealers relative to investment advisers. Yet this analysis seems outside the bounds of what Congress intended by considerations of "efficiency, competition and capital formation." Perhaps the reason is that this kind of economic analysis is a legislative prerogative reflected in its taxation/appropriation authority, but it is Congress that instructed the Commission to consider these factors when promulgating rules.

A full treatment of the question of whether a third party examination rule would improperly usurp Congress's appropriation/taxation authority is beyond the scope of this Article. However, in theory there must be some point at which an agency rulemaking is so strongly motivated by the desire to shift its own expenses to regulated entities and/or to remedy the agency's perceived underfunding that the rulemaking is not a permissible exercise of administrative authority. To date, the SEC's plan to require third party examinations appears to offer a suitable candidate for testing this proposition. Adding fuel to this fire is the added concern that the rulemaking would usurp Congress's authority to create an investment adviser SRO, as discussed immediately below.

C. THIRD PARTY EXAMINERS AS LEGISLATING A DE FACTO ADVISER SRO

A secondary purpose of the SEC's planned third party examination rule appears to be to create indirectly an SRO with examination authority over investment advisers. Congress authorized SEC approval of SROs for broker-dealers, a role that has been filled by FINRA. However, Congress has repeatedly considered and declined to authorize an SRO for investment advisers, which again raises the question of whether an SEC rulemaking could be viewed as an exercise of legislative power.

Commissioner Gallagher offered his initial third party examination proposal in the context of a discussion about the need for an adviser SRO. Indeed, his comments could more fairly be viewed as a call to create an adviser SRO, with third party examinations being offered as an indirect means of doing so. Regarding the concern that broker-dealers were subject to more frequent examinations than investment advisers, he noted that "one way to address this imbalance would be to provide for third party examiners of investment advisors—including, potentially, defining the term 'third party' to include SROs in order to allow the SROs currently involved in broker-dealer oversight to conduct examinations of 'dual hatted' investment advisors as well."[58] Commissioner Gallagher complained, "[w]e have no [FINRA CEO] Rick Ketchum on the adviser side and no SRO. We are sitting there with our chins out, waiting to get pummeled."[59]

Commissioner Gallagher's position reflects longstanding SEC support for establishing an adviser SRO.[60] In 1963, it recommended that registered investment advisers be required to be members of an SRO,[61] and in 1976 it asked Congress for the authority to conduct a study of the feasibility of this option.[62] In 1983, it requested comment on designating an SRO for mutual funds and their advisers that would have only inspection authority,[63] and in 1989 the SEC recommended to Congress that it grant the Commission the authority to designate one or more adviser SROs.[64] That same year, bills were introduced in the House and Senate that would have granted the Commission such authority,[65] and four years later the House passed a bill that would have created an inspection-only SRO for all registered investment advisers.[66] None of the efforts reached fruition. In 2003, the Commission requested comment on the creation of an SRO for advisers, but that did not lead to any proposal.[67] In 2012, the Chairman of the House Financial Services Committee introduced the Investment Adviser Oversight Act of 2012, which would have required advisers to be members of an SEC-approved SRO.[68] This effort failed, but some members of Congress continue to express interest in an adviser SRO.[69]

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58. 2014 Gallagher Remarks, *supra* note 7 (internal citation omitted).

59. Schoeff, Jr., *supra* note 10.

60. *See generally* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2107, 79 SEC Docket 1696 (Feb. 5, 2003) (codified at 17 C.F.R. pts. 270, 275).

61. *See* REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SEC, H.R. DOC. NO. 88-95, pt. 4, 722 (1963).

62. *See* S. REP. NO. 94-910, at 10 (1976). A similar bill was considered by the Senate but did not pass. *See* SECTION 914 SEC STUDY, *supra* note 31, at n.54.

63. *See* Concept of Utilizing Private Entities in Investment Company Examinations and Imposing Examination Fees, Investment Company Act Release No. 13,044 (Feb. 23, 1983) (codified at 17 C.F.R. pt. 270 (2016)).

64. *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2107, 79 SEC Docket 1696, at text accompanying n.71.

65. *See* S. 1410, 101st Cong. (1989); H.R. 3054, 101st Cong. (1989).

66. H.R. 578, 103rd Cong. (1993).

67. *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25,925, Part II.E(3) (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 270, 205).

68. *See* H.R. 4624, 112th Cong. (2012). *See generally* David Tittsworth, *H.R. 4624: The Pitfalls of a Self-Regulatory Organization for Investment Advisers and Why User Fees Would Better Accomplish the Goal of Investment Adviser Accountability*, 87 ST. JOHN'S L. REV. 477 (2013); Mercer Bullard*, The New Self-Regulator for Advisors: A Taxing Affair for Small Businesses and Small Investors*, MORNINGSTAR (May 10, 2012), http://www.morningstar.com/advisor/t/56178352/the-new-self-regulator-for-advisors-a-taxing-affair-for-small-businesses-and-small-investors.htm.

69. *See* Arthur Postal, *Congressman Wants FINRA To Examine Investment Advisors*, INS. NEWS NET (May 29, 2015), http://insurancenewsnet.com/innarticle/congressman-wants-finra-to-examine-investment-advisors ("Rep. French Hill, R-Ark., said he is considering legislation that would give

The impression that the Commission views third party examinations as a proxy for an adviser SRO is reinforced by its coupling of the two concepts in the past. For example, in 2003, it requested comment on various options whereby it could "rely more heavily on the private sector."[70] The two most prominent options were (1) "to require each fund and adviser to undergo *periodic compliance reviews by a third party* that would produce a report of its findings and recommendations," and/or (2) to form "*one or more self-regulatory organizations (SROs) for funds and/or advisers*."[71] The request for comment was partly prompted by declining examination resources relative to industry growth,[72] similar to the impetus for the current interest in mandating third party examinations.

One might argue that Congressional action should be viewed as necessary only to create an SRO modeled on the Exchange Act's SRO provisions, which grants rulemaking, examination, prosecutorial, and adjudicative powers. Perhaps an SRO with only examination authority should be within the SEC's power. However, the Commission has previously recommended legislation that would have authorized precisely the examination-only SROs for advisers that a third party examination rule would mirror.[73] Congress declined to create such an SRO. The fact that the Commission asked Congress to create an examination-only SRO for advisers implies that it believes it lacks the authority do so itself.

The taint of rent-seeking may exacerbate the impression that the Commission is usurping Congressional authority. Broker-dealers that compete with investment advisers would gain a competitive benefit if investment advisers' operating expenses were increased.[74] FINRA would benefit by increasing its turf from being placed in a strong competitive position to act as a third party examiner for advisers.[75] Both broker-dealers

FINRA authority to examine investment advisors. He said his motivation for doing so is to increase the percentage of advisors examined annually.").

70. *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25,925, at Part II.E.

71. *Id.* at Parts II.E.1 & 3 (emphasis added). The other options were "to require investment advisers to obtain fidelity bonds from insurance companies" and "to expand the role of independent public accountants that audit fund financial statements to include an examination of fund compliance controls." *Id.* at 1704.

72. The Commission claimed that, by using third party examination "reports to identify quickly areas that required attention," it could "increase the frequency with which [its] staff could examine funds and advisers." *Id.* at Part II.E.1. Conversely, "[f]unds and advisers with reports indicating that they have effective compliance programs could be examined less frequently, which would reduce the burdens on them of undergoing more frequent examination by our staff." *Id.*

73. *See* SECTION 914 SEC STUDY, *supra* note 31, at n.54.

74. This benefit would arguably only level the playing field, however, as broker-dealers currently fund FINRA examinations through fees paid to FINRA. *See* FIN. INDUS. REGULATORY AUTH., FINRA 2015 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 19 (2016), http://www.finra.org/sites/default/files/2015_YIR_AFR.pdf.

75. *Cf.* Letter from David G. Tittsworth, President & Chief Exec. Officer, Inv. Adviser Ass'n, to Comm'r Gallagher (June 9, 2014) (citing report finding that approximately 81% of advisers prefer SEC over FINRA oversight).

and FINRA have strongly supported creating an investment adviser SRO and would benefit from a third party adviser examination mandate.

A full analysis of the SEC's authority to create a de facto examination-only adviser SRO is, again, beyond the scope of this Article. Like the taxation/appropriation argument discussed *supra*, this claim ultimately may have no purchase. The surprise audit requirement creates a narrow form of examiner SRO for advisers, but that rulemaking has not been viewed as a usurpation of Congressional authority. There are significant differences between the SRO model and a third party examination requirement. A third party examination rule probably would allow investment advisers broad discretion to choose their examiner, whereas the SRO model has proved ill-equipped to offer more than one SRO option.[76] Another distinguishing factor is that it is unlikely that third party examiners would be required to register with the Commission. These differences make the usurpation of Congressional authority argument far less compelling. But the strong connections between third party adviser examiners and an adviser SRO, in combination with the power of the taxation/appropriation argument discussed *supra*, would make a third party examination rule an appealing opportunity to test the limits of the SEC's authority and the power of the Fourth Branch.

III. THIRD PARTY EXAMINATION MODELS

The use of third party examiners is not a novel concept. For decades, Congress and the Commission have applied a third party examiner model in a variety of contexts. The most prominent example is the reliance on public accounting firms to audit public company financial statements in order to satisfy a variety of legal requirements. Federal law long relied on credit ratings provided by NRSROs to satisfy legal mandates relating to the creditworthiness of issuers. For decades, SROs have operated as a kind of third party examiner, including FINRA, which has primary regulatory authority over hundreds of thousands of registered representatives who are also associated with a registered investment adviser.[77]

Some of these models rely on private parties not only to evaluate regulated entities' compliance, but also, in varying degrees, to legislate, police, and adjudicate substantive standards and punish violators. Private actors control much of the Fourth Branch. These private oversight models have experienced varied success. After the collapse of WorldCom and Enron in 2002, Congress substantially revised the regulation of public company audits, including the creation of the PCAOB.[78] The Financial Crisis of 2008

76. *See* 15 U.S.C. § 78o (2012) (authorizing the Commission to approve an SRO for broker-dealers). FINRA is the only SRO that has been created under the Exchange Act.

77. *See* SECTION 914 SEC STUDY, *supra* note 31, at 37.

78. *See, e.g.*, Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), Pub. L. No. 107-204, 116 Stat. 745 (codified as amended at 15 U.S.C. §§ 7211–19, 7231–34 (2012)).

led to Congress's substantially curtailing the third party examination role of NRSROs.[79]

Third party examiners play a significant role in the investment adviser space. The Commission has directly or indirectly used third party investment adviser examiners in the form of NRSRO ratings, outsourced CCO services, mandatory custody audits, proxy firms' recommendations, appointed compliance consultants, and investment performance standard setters. Additionally, many advisers use third parties to draft and evaluate their compliance policies, incorporate third party systems in their day-to-day compliance procedures, and retain third parties to conduct compliance audits. The SEC staff has directly or indirectly afforded a degree of credence to these third party arrangements when conducting inspections.

This part of the Article discusses certain third party examination models. They vary greatly and reflect a broad interpretation of the concept of a third party examination. For example, the CFA Institute produces the GIPS but does not examine compliance with its requirements. The CFA Institute is a kind of third party examiner by reason of the GIPS' comprising a third party source of law by which securities law compliance may be evaluated.

Like the CFA Institute, proxy firms and NRSROs establish conduct standards that assume a kind of legal status. Unlike the Institute, they also evaluate whether those standards have been met, and both are unusual in that it is generally not the examinee whose regulatory compliance is at issue. NRSROs and proxy firms both "examine" issuers, but other parties, such as investment advisers, use their findings for compliance purposes. None of these three examiners formally reports its findings to the Commission, although NRSROs' ratings are publicly disclosed and proxy firms' recommendations are often widely available.

Public company auditors, and auditors that conduct surprise audits and/or produce internal control reports pursuant to the Custody Rule, fit a more conventional model of a third party examiner. They examine their examinees' compliance with legal rules, although only a narrow set thereof. Unlike users of the GIPS, proxy firms, and NRSROs, examinees are required to retain an independent auditor to attest to their compliance. Auditors' findings are, to a greater or lesser extent, formally reported to the Commission.

Compliance consultants resemble what a third party examiner might look like under a third party examination rule for investment advisers. Compliance consultants typically are hired as a condition of an investment adviser's settlement of an SEC enforcement action. Their mandate is usually much broader than that of an auditor in that they may examine for compliance for a variety of rules. Like auditors, they formally report their findings and

79. *See, e.g.*, Dodd-Frank, Pub. L. No. 111-203, § 931–939H, 124 Stat. 1376, 1872 (2010) (codified as amended in scattered sections of U.S.C.)).

recommendations to the Commission. They are different from other third party examiners, however, in that they do not play an ongoing role. Once the examination has been completed, the engagement terminates.

CCO's represent a hybrid third party examiner model in that the CCO can be an internal employee or an outside firm. In most cases, the CCO is an employee of the adviser and frequently serves in other roles as well. These CCOs are third parties only in the very broad sense that they represent a rule-defined, externally sourced presence and function in relation to an investment adviser's compliance.

Many firms retain third parties to act as their CCO, in which case the CCO's function may closely resemble the role that an SEC mandated third party examiner might play under a third party examiner rule. The CCO requirement for mutual funds offers some interesting twists on the general CCO requirement under the Advisers Act, including independent control over the CCO's hiring, firing, and compensation.

This set of third party examiner models is by no means exhaustive, but it comprises models that will, or at least should, strongly influence an SEC third party examiner rulemaking. There are inconsistencies across different models that a third party examiner rule would have to resolve. A third party examiner rulemaking may even lead the Commission to reconsider rules for some of these preexisting models. The purpose of the following discussion is to provide a useful starting point for this analysis.

A. NATIONALLY RECOGNIZED STATISTICAL RATINGS ORGANIZATIONS

The NRSRO model offers a uniquely rich history from which to draw in considering a third party examiner rule. In response to loud and fairly constant criticism after each of the last two financial crises, NRSRO regulations have been repeatedly reevaluated and reformed. NRSROs are also unique in that they have, at times, held far more power than other examiners. Finally, NRSROs are special because, to a large extent, they are perceived to have failed as third party examiners. The history of NRSROs' fall from grace as third party examiners provides important lessons for a third party examiner rule.

The NRSRO model reflects a particularly strong form of third party compliance services. The NRSRO itself establishes the relevant legal requirement, which in this case is a level of creditworthiness that satisfies an applicable credit rating. For example, in the past a money market fund would not satisfy applicable creditworthiness requirements if its portfolio securities did not satisfy NRSRO rating standards.[80] Money market fund regulation has

80. Rule 2a-7 under the Investment Company Act sets forth various diversification, maturity and creditworthiness requirements for money market funds. *See* 17 C.F.R. § 270.2a-7 (2016). Mutual fund compliance is, in effect, accomplished by the fund's sponsor, and the sponsor is usually

essentially assigned NRSROs the role of quasi-rule makers in that they have determined the standards pursuant to which a form of legal compliance is measured. As of 2002, NRSRO ratings were being used as benchmarks in at least eight federal statutes, forty-seven federal regulations, and more than one hundred state laws and regulations.[81]

Credit ratings as a source of law are very different from, for example, rules under the Advisers Act. One reason is that no entity is legally required to obtain a rating or be assigned any particular rating grade. Yet ratings have legal authority because a security receiving a particular rating permits many types of investors to purchase that security in compliance with the law. Another reason is that the person inspected, the issuer, is not the person whose legal compliance is at issue. In contrast, under a third party examiner rule, examiners would examine for compliance with rules that apply directly to the advisers they examine.

A second source of NRSRO power lies in its exclusive role as an examiner. The NRSRO, and only the NRSRO, gathers and analyzes issuer information to evaluate the issuer's initial and continuing satisfaction of a rating standard. As examiner, the NRSRO has even been afforded quasi-governmental status by the Commission, through granting them special access to confidential issuer information. The Commission previously exempted issuers from Regulation FD disclosure restrictions with respect to information they provide to NRSROs.[82]

A third source of NRSRO power is its exclusive enforcement and judicial authority. An NRSRO has exclusive authority to "prosecute" an issuer found, through examination, to have failed to sustain the creditworthiness necessary to keep a rating and to adjudicate that prosecution by deciding whether to downgrade an issuer's securities.[83] A downgrade may lead to immediate noncompliance on the part of entities that own the securities.

Historically, NRSROs have been unaccountable for the exercise of their power. There is no higher authority to which their ratings may be appealed. Laws and rules that use ratings as proxies for creditworthiness generally do not provide for practicable substitutes. The Commission generally has not revoked or conditioned its granting of NRSRO status on NRSROs' ratings decisions. In 2002, Congress expressly prohibited the Commission from regulating the "substance of credit ratings" or the "procedures or methodologies" used to determine them.[84]

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the fund's investment adviser. *See* Mutual Funds Guide, 2010 WL 11248679 (2010) (mutual funds are externally managed). Thus, mutual fund rules are generally a form of de facto investment adviser regulation. Mutual Funds Guide, 2010 WL 11248679 (2010).

81. S. REP. NO. 107-75, at 100 (2002).

82. *See* 17 C.F.R. § 243.100(b)(2)(iii). This exemption was repealed pursuant to Section 938B of the Dodd-Frank Act.

83. *See* S. REP. NO. 107-75, at 106–07 (describing rating systems).

84. Credit Rating Agency Reform Act of 2006 (CRARA), Pub. L. No. 109-291, § 4(a), 120 Stat. 1332 (2006) (codified as amended at 15 U.S.C. § 78*o*-7(c)(2) (2012)).

NRSROs have been relatively immune to public and private liability. They have been exempt from private liability under Section 11 of the Securities Act of 1933 and have successfully claimed that, in any event, their opinions are protected First Amendment speech.[85] One court went so far as to grant a NRSRO's communications with an issuer the privilege afforded to journalists in denying a production request.[86] Courts have found that NRSROs could not be treated as a "seller" under Section 12 of the Securities Act or be subject to control person liability.[87] NRSROs have generally been susceptible only to claims of fraud or intentional misrepresentation, but even then at least one court has found that their conflicts of interest are so well known that omitting disclosure of them was not a material omission.[88]

Understanding the scope of NRSROs' third party examiner power is an important backdrop for reviewing how their third party examiner role has been regulated. Over the last two decades, the regulation of NRSROs has undergone a dramatic change not only in degree, but also in kind. Today, NRSRO ratings have been stripped of their legal force under federal law and rules. The uniquely broad power of NRSROs must be kept in mind when evaluating the current state of NRSRO regulation relative to the regulation of other third party examiner models.

Credit ratings have long played a role in regulation, but it was the Commission that created the concept of a formally approved NRSRO. In 1975, the Commission was concerned regarding how broker-dealers were implementing minimum capital requirements under the SEC's net capital rule.[89] To address its concerns, the SEC took the position that it would not recommend an enforcement action if a broker-dealer used a credit rating agency's ratings in applying the net capital rule, if the Commission had designated the agency as an NRSRO. The regulatory role of NRSROs snowballed from there.[90]

Over the years, reliance on ratings issued by NRSROs expanded to a host of federal and state, statutory and regulatory provisions.[91] The growing role of NRSROs prompted the Commission to issue, in 1994, a concept release soliciting comments on the role of NRSROs and the need to regulate them.[92]

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85. *See* S. REP. NO. 107-75, at 104–05, 123–24.

86. *See In re* Pan Am Corp., 161 B.R. 577, 581–83 (S.D.N.Y. 1993) (quashing subpoena to NRSRO based on qualified journalist's privilege because "S&P functions as a journalist when gathering information in connection with its ratings process").

87. *See* THOMAS LEE HAZEN, REGULATION OF SEC. RATINGS AGENCIES, TREATISE ON THE LAW OF SECURITIES REGULATION 14:184 (2016).

88. *See id.*

89. *See* S. REP. NO. 107-75, at 101.

90. *See id.*

91. *See id.*

92. *See* Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34,616, 59 Fed. Reg. 46,314 (Aug. 31, 1994).

In 1997, the Commission proposed a rule that would have defined "NRSRO," but the rule was never adopted.[93]

Then came the Enron-WorldCom scandals of 2002. Congress was nonplussed that NRSROs had rated Enron as a good credit risk just four days before it declared the then largest bankruptcy in U.S. history.[94] Much of Congress's wrath was vented on the accounting industry, but it also had a number of concerns about NRSROs, including: credit rating agencies' role in evaluating issuers, their importance in the securities markets, impediments to accurate ratings, barriers to entry to the credit rating business, their conflicts of interest, and the public availability of information regarding the credit rating process.[95] Congress required the Commission to conduct a study of credit rating agencies that addressed these concerns.[96]

Additionally, a 2002 Senate Staff Report found that the NRSROs' evaluation lacked diligence, in part due to their lack of legal accountability.[97] The Report recommended that the Commission establish rating and training standards for NRSROs and examine them for compliance with those standards.[98] However, the Commission did not act on the Report's recommendations. The Senate Staff Report identified a range of issues for further consideration,[99] many of which were the subject of a subsequently issued SEC concept release,[100] but the Commission took no further action.

Congress took the next step by enacting the Credit Rating Agency Reform Act of 2006 (CRARA),[101] which dramatically expanded the regulation of NRSROs. CRARA defined the term "nationally recognized statistical rating organization," which definition included the requirements that an NRSRO had been in operation for at least three years and be registered with the Commission.[102] Congress required that the registration application be made publicly available and include: the applicant's "credit ratings performance measurement statistics;" "procedures and methodologies" used in determining ratings; any conflict of interest relating to the issuance of the ratings; and, on a confidential basis, a list of rated issuers and revenues

93. *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 39,457, 62 Fed. Reg. 68,018 (Dec. 30, 1994).

94. *Rating the Raters: Enron and the Credit Rating Agencies, Hearings Before the S. Comm. on Governmental Affairs*, 107th Cong. 4 (2002) (statement of Senator Thompson).

95. *See* Sarbanes-Oxley, Pub. L. No. 107-204, § 702(a), 116 Stat. 745 (codified as amended at 15 U.S.C. §§ 7211–19, 7231–34 (2012)).

96. *Id.* § 702(b).

97. *See* S. REP. NO. 107-75, at 104–05 (2002).

98. *Id.* at 127.

99. *See* S. REP. NO. 107-75, at 125–27.

100. *See generally* Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Exchange Act Release No. 47,972, Investment Company Release No. 26,066, 80 SEC Docket 1003 (June 4, 2003).

101. CRARA, Pub. L. No. 109-291, 120 Stat. 1332 (codified in scattered sections of the U.S.C.).

102. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55,857, 72 Fed. Reg. 33,564, 33,572 (June 18, 2007).

received from them in the preceding fiscal year.[103] CRARA authorized the Commission to deny an agency's application if it found that the agency did "not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed . . . . "[104] An NRSRO agency was required annually to certify its registration and to update it upon the occurrence of any material changes.[105]

CRARA required that NRSROs establish written policies and procedures to address conflicts of interest, and that the Commission adopt rules prohibiting or requiring the management and disclosure of conflicts. CRARA deemed such conflicts to include those relating to the way in which issuers compensate the NRSRO, consulting or other services provided by the NRSRO to the issuer, and any other business relationships between the NRSRO and the issuer.[106] CRARA also required NRSROs to designate a compliance officer.[107]

CRARA further authorized the Commission to prohibit "unfair, coercive or abusive" conduct by NRSROs.[108] It listed the following types of conduct as candidates for such rules:

1. Conditioning or threatening to condition ratings on the issuer's purchase of other NRSRO services or products (e.g., "pre-credit rating assessment product");
2. Lowering or threatening to lower a rating or refusing to rate instruments issued by an asset pool unless the NRSRO rated all of the instruments in the pool; and
3. Modifying or threatening to modify a rating or otherwise departing from the NRSRO's policies and methodologies based on whether the issuer purchased the rating or any other NRSRO service or product.[109]

CRARA granted the Commission recordkeeping, reporting, and examination authority over NRSROs and the authority to assess penalties for violations, and further required the Commission to submit an annual report to Congress on NRSRO registrations and the SEC's views "on the state of competition, transparency, and conflicts of interest among [NRSROs]."[110] CRARA expressly stated that it created no private cause of action, including no cause of action under Section 18 of the Securities Exchange Act of 1934,[111] but

103. CRARA § 4(a), 15 U.S.C. § 78*o*-7(a)(3) (2012) (requiring public availability).
104. *Id.*, 15 U.S.C. § 78*o*-7(a)(2)(C)(ii)(I)).
105. *See id.*, 15 U.S.C. § 78*o*-7(b)(2)).
106. *See id.*, 15 U.S.C. § 78*o*-7(h)(2)).
107. *See id.*, 15 U.S.C. § 78*o*-7(j)).
108. *Id.*, 15 U.S.C. § 78*o*-7(i)).
109. *See id.*, 15 U.S.C. §§ 78*o*-7(i)(1)(A), (B), (C)).
110. CRARA § 6.
111. *See* CRARA § 4(a), 15 U.S.C. § 78*o*-7(m)).

CRARA provided, through mandatory public disclosure, grist for private claims based on fraud of misrepresentation.

The NRSROs' fall from grace continued in the early stages of the Financial Crisis of 2008, when three prominent groups issued reports recommending the removal of the imprimatur of regulatory approval from various regulations.[112] The Commission agreed with the groups' concern that including ratings in various rules implied an "official seal of approval'" for ratings "that could adversely affect the quality of [ratings-related] due diligence and investment analysis."[113] In July 2008, it proposed to remove references to NRSRO ratings from certain SEC regulations and forms.[114]

Before the Commission could take final action on most of these proposals,[115] Congress required that it do so in Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).[116] Dodd-Frank also removed NRSRO references in other federal laws and rules,[117] amplified many of the requirements CRARA had imposed, and

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112. *See, e.g.*, Memorandum from Henry M. Paulson Jr., on the President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (Mar. 13, 2008), https://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf; FIN. STABILITY FORUM, THE REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE (2008), http://www.fsb.org/wp-content/uploads/r_0804.pdf?page_moved=1; TECH. COMM. OF THE INT'L ORG. OF SEC. COMM'NS, CONSULTATION REPORT: THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS (2008), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf.

113. References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28,327 (July 1, 2008) (to be codified at 17 C.F.R. pts. 270, 275).

114. *See id.* (proposing to remove NRSRO references in six rules under the Investment Company and Advisers Acts); Security Ratings, Securities Act Release No. 8940 (July 1, 2008) (to be codified at 17 C.F.R. pts. 229, 230, 239, 240) (proposing to remove NRSRO references in Forms S-3, S-4, F-3, F-4, and F-9, and Rules 138, 168, and 169, and Regulation AB under the Securities Act; Form F-3 under the Exchange Act); References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58,070 (July 1, 2008) (to be codified at 17 C.F.R. pts. 240, 242, 249) (proposing to remove NRSRO references in Rules 3a1-1, 10b-10, 15c3-1, and 15c3-3, Rules 101 and 102 of Regulation M, Regulation ATS, and Forms ATS-R, PILOT, and X-17A-5 Part IIB).

115. The Commission adopted amendments eliminating a small number of NRSRO references, but deferred action on most. *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60,789 (Oct. 5, 2009) (to be codified at 17 C.F.R. pts. 240, 242, 249, 270).

116. Pursuant to this mandate, the Commission adopted rules removing references to NRSRO ratings in 2011 and 2013. *See* Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, Exchange Act Release No. 71,194 (Dec. 27, 2013) (to be codified at 17 C.F.R. pts. 240, 249); Removal of Certain References to Credit Ratings Under the Investment Company Act, Investment Company Act Release No. 30,847 (Dec. 27, 2013) (to be codified at 17 C.F.R. pts. 239, 270, 274). Section 939A of the Dodd-Frank Act also required other federal agencies to remove NRSRO references in their rules. *See* Security Ratings, Securities Act Release No. 9245 (July 27, 2011) (to be codified at 17 C.F.R. pts. 200, 229, 230, 232, 239, 240, 249).

117. Dodd-Frank, Pub. L. No. 111-203, § 939, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 80b-6(4) (2012)).

removed many protections and freedoms that NRSROs had historically enjoyed.

Dodd-Frank mandated a number of measures directed at NRSROs' internal compliance. It required NRSROs to establish an effective internal control structure and submit reports on their control structure to the Commission.[118] An NRSRO must report to the Commission instances in which a person involved in the ratings process subsequently became employed by a rated issuer.[119] Dodd-Frank required NRSROs to establish procedures for the handling and retention of complaints.[120] It even turned NRSROs into a kind of government informant by imposing an affirmative duty to report credible information provided by a third party that alleges a material violation of law by a rated issuer.[121]

Dodd-Frank enhanced the role of quasi-third party examiners by expanding the role of NRSRO compliance officers and the independence and responsibilities of NRSRO boards. It required that independent directors with five-year, nonrenewable terms comprise at least half of an NRSRO's board, the independent directors' compensation not be linked to the "business performance" of the NRSRO, and be structured so as to ensure independence, and for the board to include users of ratings.[122] It also assigned an NRSRO's board with specific oversight responsibilities as to the NRSRO's ratings process, its policies and procedures designed to manage and disclose conflicts of interest, the effectiveness of its internal control systems, and its compensation and promotion policies.[123]

As to NRSRO compliance personnel, Dodd-Frank prohibited the compensation of an NRSRO compliance officer from being linked to the NRSRO's financial performance and required that it be structured so as to ensure independence.[124] An NRSRO's designated compliance officer must submit an annual compliance report to the NRSRO and the Commission.[125] Under Dodd-Frank's mandated rules, the Commission prohibited NRSRO personnel engaged in ratings activities from also engaging in sales and marketing activities, and forbade compliance officers from participating in either.[126]

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118. *See id.* § 932, 15 U.S.C. § 78o-7(h)(5).

119. Section 15E of Dodd-Frank was amended to require NRSROs to report to the Commission any case of a person being employed by a rated issuer within the preceding five years if that person was, within twelvemonths prior to such employment as a senior officer of the NRSRO, a person who participated in determining ratings or a supervisor of such a person. *See id.* § 932(a), 15 U.S.C. § 78o-7(h)(5)(A)).

120. *See id.*

121. *Id.* § 934, 15 U.S.C. § 78o-7(u)).

122. *See id.* § 934, 15 U.S.C. § 78o-7(t)(2)).

123. *See id.* § 932.

124. *See id.*

125. *See id.*

126. *See id.*

Dodd-Frank countered CRARA's position on NRSRO private liability by removing the NRSRO exemption from liability under Section 11.[127] It established a pleading standard for private claims against NRSROs under the Exchange Act[128] and eliminated NRSROs' Regulation FD exemption.[129] Dodd-Frank expanded enforcement penalties to match those applicable to public company auditors, established penalties for persons associated with an NRSRO, and added a failure to supervise to the category of punishable conduct.[130]

Dodd-Frank includes a number of provisions that substantially expanded the SEC's role as NRSRO regulator. It requires that the Commission review each NRSRO's code of ethics and conflicts of interest policy annually and when materially amended.[131] It also requires examinations of the examiner by mandating that a newly created SEC Office of Credit Ratings conduct an annual inspection of every NRSRO.[132]

In addition to receiving both annual reports from NRSROs on their internal controls and notices of conflicts created by NRSRO personnel being employed by rated issuers, the Commission was required by Dodd-Frank to publish an annual public report summarizing its examination findings and responses by NRSROs to identified material deficiencies. It also required SEC studies on the feasibility and desirability of requiring standardization of various aspects of the ratings system and independence of NRSROs, and Government Accountability Office studies on compensation models for NRSROs that would create incentives to provide more accurate ratings and the feasibility and merits of establishing a professional oversight body for credit ratings analysts employed by NRSROs.[133]

The SEC's expanded role included provisions that, in effect, compromised CRARA's prohibition against substantive SEC interference in NRSROs' ratings determinations. For example, it required the Commission to issue rules designed to ensure that NRSRO analysts have adequate training, experience, and competence, and are tested for "knowledge of the

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127. *See id.* § 939G (declaring 17 C.F.R. § 230.436(g) to have no force or effect).

128. Dodd-Frank Section 933 provides that the pleading standard for a private claim under the Exchange shall be satisfied if the plaintiff states,

> with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed (i) to conduct a reasonable investigation of the rated security with respect the factual elements relied upon by its own methodology for evaluating credit risk or (ii) to obtain reasonable verification of such factual elements from sources that are independent of the issuer and deemed competent by the NRSRO.

Id. § 933, 15 U.S.C. §§ 78u-4(m), 78u-4(b)(2).

129. *Id.* § 939B.

130. *Id.* § 932.

131. *See id.*

132. *See id.*

133. *Id.* §§ 939(H) (standardization), 939C (independence), 939D (alternative compensation models), 939E (professional organization).

credit rating process."[134] Dodd-Frank required the Commission to extend NRSROs' historical performance reporting to multiple years and to consider whether an NRSRO has failed to produce accurate ratings over a sustained period.[135]

Dodd-Frank established further direct or indirect substantive standards for the determination of credit ratings in other respects. For example, it required NRSROs to adopt written policies and procedures that assess the probability that an issuer will default.[136] It also required NRSROs to identify and define symbols used to denote a rating and apply any such symbols "in a manner that is consistent for all types of securities and money market instruments for which the symbol is used."[137]

Dodd-Frank's transformation of the role and power of NRSROs was extraordinary. In 2006, NRSROs were virtually unregulated, unaccountable arbiters of creditworthiness in the U.S. market for purposes of dozens of legally enforceable standards. Only four years later, they were converted to closely examined, quasi-governmental utilities subject to significant public and private liability risk, with no authority to dictate creditworthiness for purposes of federal laws and rules and substantially narrowed discretion to determine how and what ratings were assigned.

B. PROXY ADVISORY FIRMS

Proxy advisory firms provide advice on how to vote company proxies, most typically to investment advisers and institutional investors who are responsible for voting proxies on their advisory clients' behalf. In many respects they are similar to NRSROs. They establish the standards by which management proposals are evaluated,[138] examine the proposals by applying their standards, and act as prosecutor and judge by vetting the results of their examination internally and issuing judgments on how shareholders should vote. They have virtually no direct accountability for their recommendations, in part because their recommendations are essentially opinions, but probably also because it would be extremely difficult to show that their opinions, unlike NRSRO ratings, caused investor losses.

There is generally no express legal requirement that an adviser obtain third party proxy recommendations, just as there has not been such a requirement for an issuer to obtain a bond rating. Also, although a proxy firm's recommendation serves a compliance purpose, it has not been formally

134. *Id.* § 936.
135. *See id.* § 932.
136. *See id.* § 938.
137. *See id.*
138. *See Examining the Market Power and Impact of Proxy Advisory Firms*, *Hearing before the Subcomm. On Capital Mkts. and Gov't Sponsored Enters., Comm. On Fin. Servs.*, 113th Cong. 189 (2013) [hereinafter *Proxy Firms Hearing*] (former SEC Chairman Harvey L. Pitt stating: "ISS and Glass Lewis have become the de facto standard setters for corporate governance policies in the U.S.").

adopted as legally sufficient.[139] Advisers who rely on proxy firm recommendations are ultimately responsible for ensuring that their reliance is reasonable. The market for proxy advice has been even more concentrated than the market for NRSROs; two proxy firms dominate their market: Institutional Shareholder Services (ISS) and Glass Lewis & Co.[140]

Proxy firms are also very different from NRSROs. Proxy firms are paid for their recommendations by persons responsible for voting on proposals rather than by the companies that seek their approval. These companies do pay proxy firms, however, for services that include advice on policies and activities that are the subject of proxy votes.[141] Proxy firms are also different because their opinions are not limited to management proposals; they also provide recommendations on shareholder proposals and provide consulting services to activist shareholders. In contrast, an NRSRO provides opinions only on issuers' securities.

Proxy firms' influence is substantial.[142] Their influence may be attributable to their role in helping investment fiduciaries fulfill their legal duties to clients with respect to their management of client assets. The Department of Labor (DOL) has a longstanding position that managers of retirement funds have a fiduciary duty to vote proxies in the best interests of beneficiaries.[143] The Commission similarly takes the view that an investment adviser has a fiduciary duty to vote proxies in its clients' best interests.[144] In 2003, the Commission required mutual funds to disclose how they vote proxies, partly in response to the view that mutual funds were "passive investors."[145] The Commission also adopted an antifraud rule that required

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139. One scenario in which a third party recommendation is both dispositive and mandatory arises under the Bank Holding Company Act, which may require outsourcing a shareholder's vote if the ownership stake could be viewed as a controlling interest. *See* Susanne Craig & Jessica Silver-Greenberg, *Small Firm Could Turn the Vote on Dimon*, N.Y. TIMES (May 7, 2013, 8:08 AM), http://dealbook.nytimes.com/2013/05/07/small-firm-could-turn-the-vote-on-dimon/?_r=0 (stating that as required by the Act, BlackRock outsourced voting to third party regarding separation of chairman and CEO positions at JP Morgan).

140. *Id.*

141. Twenty-nine percent of governance business revenues were attributable to corporate services. MSCI INC., FORM 10-K ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 10 (2014).

142. *See, e.g.*, David Larcker, Allan McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173 (2015) (finding that proxy firms' recommendations substantial affect on say-on-pay voting outcomes and changes in compensation proposals between recommendations and votes; and that firms' influence is negatively correlated with stock market performance); *see Proxy Firms Hearing*, *supra* note 138, at 189 (testimony of former SEC Chairman Harvey L. Pitt stating that ISS and Glass Lewis control 97% of the proxy market and citing an estimate that they control 38% of the shareholder vote).

143. *See* Interpretive Bulletin Relating to Exercise of Shareholder Rights. 73 Fed. Reg. 61,731 at n.1 (Oct. 17, 2008) (codified at 29 C.F.R. pt. 2509).

144. *See* Proxy Voting by Investment Advisers, Advisers Act Release No. 2106, 79 SEC Docket 1673 (Jan. 31, 2003).

145. Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2107, 79 SEC Docket 1696, at text accompanying n.4 (Feb. 5, 2003) (codified at 17 C.F.R. pts. 270, 275).

investment advisers to implement written policies and procedures that were designed to ensure that they voted proxies in their clients' best interests.[146]

Both the DOL's and SEC's positions have created incentives for advisers to minimize liability risk by offloading proxy voting decisions to expert proxy firms. The Commission has implicitly acknowledged that using a proxy firm can provide a kind of safe harbor.[147] For example, the Commission has stated "an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a predetermined policy, based upon the recommendations of an independent third party."[148] Former SEC Commissioner Gallagher described this safe harbor as "akin to what the Commission had earlier done with credit rating agencies – essentially, mandating the use of third party opinions."[149]

Proxy firms' power has increased with the recent awakening of shareholder democracy. Beginning around 2002, shareholder votes began to shift from being ratifications of foregone conclusions to, on occasion, genuine battles over corporate policy. The first indication of a change in the dynamics of corporate governance came with successful campaigns to eliminate staggered boards, which drove the number of classified boards among S&P 500 companies from 303 in 1999 to 126 in 2012.[150] Increased shareholder activism may also be a response to the Enron-WorldCom scandals of 2002. In 2010, Congress further intensified the focus on proxy voting by requiring companies to put executive compensation plans to a shareholder vote.[151]

Proxy firms have recently been the subjects of the same kinds of concerns that led to major regulatory reforms for NRSROs. In 2013, SEC Commissioner Gallagher recommended that the Commission explore rulemaking reforms for proxy firms, including:

> requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the

146. Rule 206(4)-6 under the Advisers Act provides that it is a "fraudulent, deceptive, or manipulative act, practice or course of business" for a registered investment adviser to vote client proxies unless the adviser: (1) adopts and implements written policies procedures that are designed to ensure that proxies are voted in clients' best interests and that address material conflicts of interest; (2) discloses to clients how they may obtain information about how the adviser votes proxies; and (3) describes the adviser's policies and procedures to clients and furnishes them with a copy upon request. 17 C.F.R. § 275.206(4)-6 (2016).

147. Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at Society of Corporate Secretaries & Governance Professionals, Seattle, Washington (July 11, 2013) [hereinafter Gallagher Remarks at Society of Corp. Sec.] (describing the SEC as "enabler" of advisers treating proxy voting based on "more of a compliance mindset than a fiduciary mindset").

148. Proxy Voting by Investment Advisers, Advisers Act Release No. 2106, 79 SEC Docket 1673, at text accompanying n.25.

149. Gallagher Remarks at Society of Corp. Sec., *supra* note 147, at 4.

150. *See* Lucian Bebchuk, Scott Hirst & June Rhee, *Toward the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157, 165 (2013).

151. *See* Dodd-Frank, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 78n-1 (2012)).

> transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability.[152]

Commissioner Gallagher's concerns were reflected in testimony before a House Subcommittee in which former SEC Chairman Harvey L. Pitt, speaking on behalf of the U.S. Chamber of Commerce, criticized SEC positions in no-action letters issued to ISS and Glass Lewis in which the staff recognized the power of a proxy firm's proxy recommendation to "cleanse the vote" of an adviser that had a conflict of interest.[153] He also noted that the staff took the position that an adviser need not make "a case-by-case evaluation of a proxy voting firm's potential conflicts," but that general reliance on the firm's conflict of interest procedures would be sufficient.[154] Chairman Pitt also contended that proxy firms generally provide little or no opportunity to companies to respond to voting recommendations, which undermined the accuracy of the information on which they relied.[155]

In 2014, the Commission issued a Staff Legal Bulletin that responded to these concerns.[156] The Bulletin appeared to reflect the SEC's expectation that advisers exercise greater diligence in evaluating proxy firms. For example, the Commission expected advisers to conduct an ongoing review of the firm's conflicts of interest and adopt procedures designed to identify and address firm conflicts that may arise on an ongoing basis, such as requiring the firm to "update the investment adviser of business changes the investment adviser considers relevant . . . or conflicts policies and procedures."[157] However, the guidance did not suggest a change in the staff's position that advisers need not be apprised on a "case-by-case" basis of a firm's business relationships with a company that is involved in the vote.

As to the proxy firm's competence, the Commission required that an adviser "ascertain that a proxy advisory firm has the competency and capacity to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information."[158] This statement appears to emphasize ensuring the accuracy of information, but it may also be a response to charges that proxy firms routinely make recommendations without having obtained information from the company

152. Gallagher Remarks at Society of Corp. Sec., *supra* note 147, at 6.

153. *Proxy Firms Hearing*, *supra* note 138, at 198 (citing No-Action Letter from U.S. Sec. & Exch. Comm'n, Egan-Jones Proxy Services (May 27, 2004), https://www.sec.gov/divisions/investment/noaction/egan052704.htm).

154. *Id.* at 197–98 (citing No-Action Letter from U.S. Sec. & Exch. Comm'n, Institutional Shareholder Servs., Inc. (Sept. 15, 2004), https://www.sec.gov/divisions/investment/noaction/iss091504.htm).

155. *Id.* at 193.

156. *Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, U.S. SEC. & EXCH. COMM'N (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm [hereinafter *Proxy Voting Responsibilities*].

157. *Id.* at 3.

158. *Id.*

involved in the vote. The Commission may expect advisers to confirm that proxy firms' recommendations are based on company-specific information.

Another source of proxy firm regulation is proxy regulation or, rather, exemptions from proxy regulation. Providing advice on proxy votes constitutes a solicitation that triggers proxy rules. These rules would be exceedingly burdensome for proxy firms, so they rely on an exemption from the rules that imposes four conditions as follows:

1. The proxy firm "renders financial advice in the ordinary course of its business;"
2. The proxy firm disclosed to advice recipients: (1) "any significant relationship" with the issuer or an affiliate, "or a security holder proponent of the matter on which advice is given," and (2) "any material interests" in the matter;
3. The proxy firm receives no special compensation for furnishing the advice from persons other than those who receive the advice or similar advice; and
4. The advice is not furnished on behalf of any person soliciting proxies or certain participants in an election.[159]

Like the SEC's guidance to investment advisers,[160] these conditions require general disclosure of a "significant relationship" with a company or material interest in the matter.

For purposes of determining whether consulting services created a significant relationship or constituted material interest, the Commission stated that the proxy firm "would likely consider:"

> the type of service being offered to the company or security holder proponent, the amount of compensation that the proxy advisory firm receives for such service, and the extent to which the advice given to its advisory client relates to the same subject matter as the transaction giving rise to the relationship with the company or security holder proponent.[161]

The Commission added that the significant or material standards would be met if "knowledge of the relationship or interest would reasonably be expected to affect the recipient's assessment of the reliability and objectivity of the advisor and the advice."[162] This guidance suggests that the Commission expects proxy firms to pay close attention to conflicts disclosures, but does not reflect a substantive change in the SEC's earlier positions. Although the

159. Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.14a-2(b)(3) (2016). Alternatively, a proxy firm that only distributes reports containing voting recommendations and does not vote proxies or apply a client's voting guidelines in determining how to vote generally may rely on the exemption in Rule 14a-2(b)(1). *See* 17 C.F.R. § 240.14a-2(b)(3) (2016)).

160. *See generally* Dodd-Frank, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 78n-1 (2012)).

161. *Proxy Voting Responsibilities*, *supra* note 156, at 5.

162. *Id.*

Commission stated that proxy firms had an affirmative duty to make required disclosures, it did not require that the disclosures be made in the document containing the voting recommendation.[163]

The Staff Legal Bulletin may not be the last word on proxy advisory firm regulation. On June 16, 2016, the House Financial Services Committee approved the Corporate Governance Reform and Transparency Act of 2016 (Transparency Act).[164] The Transparency Act would require proxy advisory firms to register with the Commission and to disclose publicly both the procedures and methodologies used in developing proxy recommendations (including the relevance of a company's size) and any conflicts of interest, including services provided to and revenues received from corporate issuers.[165] It would require that firms implement written policies and procedures designed to "address and manage any conflicts of interest that can arise" from their business.[166]

The Transparency Act would require that firms have "staff sufficient to produce proxy voting recommendations that are based on accurate and current information," permit issuers reasonable time to comment on draft recommendations, and retain an ombudsman to receive complaints about proxy voting information and resolve them prior to the vote.[167] The original version of the Transparency Act created a private right of action for a "subject of a proxy advisory firm voting recommendation aggrieved by a proxy advisory firm's failure to comply" with these requirements.[168]

A proxy firm would be required to designate a CCO who is responsible for the firm's compliance policies and procedures. It would also have to file confidential financial statements with the Commission and submit an annual report stating the number of recommendations made and shareholder proposals reviewed, the number of staff conducting the reviews and formulating the recommendations, and the number of recommendations made where the proponent was a client of or received services from the firm.

Echoing the regulation of NRSROs, the Transparency Act requires the Commission to adopt rules that prohibit firms from:

1. Conditioning or threatening to condition recommendations on the issuer's purchase of other firm services or products; and
2. Modifying a recommendation or otherwise departing from the firm's adopted procedures and methodologies based on whether the issuer subscribes to other firm services.[169]

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163. *Id.* at 6.
164. *See* Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. (2016).
165. *See id.* § 3.
166. *See id.*
167. *See id.*
168. *See id.*
169. *See id.*

The Commission also must file annual reports that provide a broad qualitative assessment of proxy firms, including firms' "policies and methodologies" and "quality of proxy advisory services issued by proxy advisory firms."[170]

C. THE CFA INSTITUTE

Investment advisers routinely advertise the investment performance of their clients' accounts. While the Commission has adopted standardized calculations for the investment performance of mutual funds, there are no such requirements for other types of advisory accounts. Investment advisers are subject to fiduciary duties under the Advisers Act, and to various SEC rules, interpretations, and no-action positions under the Act, but none directly addresses how investment performance should be calculated and presented.

The CFA Institute, which owns and awards the Certified Financial Analyst designation,[171] has substantially filled this void with the GIPS.[172] The GIPS constitute a set of rules for the calculation and presentation of investment performance. The CFA Institute is similar to an NRSRO and proxy advisory firm in that it is a standard setter, arguably *the* standard setter, for a narrow category of conduct. A 2011 survey found that 75% of responding institutional money managers claimed GIPS compliance.[173] However, the CFA Institute does not examine advisory firms for compliance with the GIPS or play any role in any kind of adjudication of their compliance. Thus, the CFA Institute's role is much narrower than that of NRSROs and proxy advisory firms.

The GIPS, like bond ratings and voting recommendations, provide an indirect means of complying with regulatory requirements. Although compliance with GIPS is not legally required, many investment advisers claim compliance with GIPS and many advisers view GIPS compliance as a means of satisfying regulatory requirements,[174] which implies some degree of SEC acceptance of the GIPS as demonstrating that an adviser's investment performance advertising satisfies antifraud provisions of the Advisers Act.

Although the CFA Institute does not examine advisers for compliance with GIPS, third party verification of GIPS compliance is a thriving business. One survey found that more than 80% of GIPS compliant money managers obtain third party verification of their GIPS compliance, with 30% citing

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170. *See id.*

171. The CFA Institute is a global, not-for-profit professional association of investment analysts, advisers, portfolio managers, and other investment professionals. *See generally* CFA INST., www.cfainstitute.org (last visited Sept. 10, 2016).

172. CFA INST., GLOBAL INVESTMENT PERFORMANCE STANDARDS (2010), https://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2010.n5.1.aspx.

173. ACA COMPLIANCE GRP. & EVESTMENT ALL., THE VALUE OF GIPS COMPLIANCE: 2012 MANAGER AND CONSULTANT SURVEY 7–8 (2012) [hereinafter 2012 MANAGER AND CONSULTANT SURVEY], http://www.gipsstandards.org/news/Documents/aca_ea_gips_survey_2012.pdf.

174. In one survey, 37% of advisers indicated that they had adopted GIPS at least in part to satisfy "regulatory requirements." *Id.* at 8.

"regulatory requirements" as one of the top three reasons for doing so.[175]Many consider GIPS compliance to be necessary for an institutional money manager to win new business, just as a minimum credit rating may be necessary to establish adequate creditworthiness.[176]Software system providers for investment advisers have incorporated GIPS compliant reporting features as an important selling point.[177]

Firms that claim GIPS compliance effectively grant the GIPS the force of law. The Commission has brought enforcement actions against firms that falsely claim compliance with the GIPS.[178] As one compliance consultant stated, "the SEC and savvy institutional investors act as *de facto* policing agents for the [GIPS]."[179] The Commission takes the position that a GIPS-compliant firm that fails to satisfy the GIPS has violated the law even if the firm's investment performance presentation is not otherwise misleading or fraudulent. Thus, the failure of a firm claiming GIPS compliance to actually comply with the GIPS is, in and of itself, an antifraud violation.

There is even evidence that the investment adviser community would prefer that the GIPS, rather than the government, be the source of performance advertising requirements. One survey found that 84% of respondents agreed that money managers should be required to comply with the GIPS or some type of reporting standard; only 52% believed that a regulator should "develop more detailed performance advertising rules and regulations."[180] The CFA Institute has even asked that the Commission formalize its apparent approval of the GIPS by requiring that investment advisers disclose whether they comply with the standard.[181]

The potential for GIPS-based violations illustrates one way in which third party compliance standards can create unnecessary liability risk. For

175. *Id.* at 9.

176. "GIPS compliance is generally expected in many markets in order for investment management firms to win new mandates, especially those that serve the institutional marketplace." Amy Jones & Arin Stancil, *SEC Enforcement of GIPS® Compliance: A Closer Look*, PRAC. COMPLIANCE & RISK MGMT. SEC. INDUSTRY, Nov.–Dec. 2014, at 23, http://www.guardianperformancesolutions.com/wp-content/uploads/2015/01/SEC-Enforcement-of-GIPS%C2%AE-Compliance-A-Closer-Look.pdf.

177. Michael Kitces, *Is GIPS Compliant Performance Reporting Becoming A New RIA Differentiator?*, KITCES (Aug. 18, 2014, 7:01 AM), https://www.kitces.com/blog/is-gips-compliant-performance-reporting-becoming-a-new-ria-differentiator/.

178. *See, e.g.*, ZPR Inv. Mgmt., Inc., Initial Decision Release No. 602, 108 SEC Docket 4502, (May 27, 2014) (misrepresenting GIPS compliance in magazine and investment report); *In re* Locke Capital Mgmt., Inc., Initial Decision Release No. 450, 102 SEC Docket 3628, (Feb. 6, 2012) (misrepresenting GIPS compliance).

179. BOBBY ANKAR, THE CCO'S GUIDE TO THE GIPS STANDARDS: ESSENTIALS FOR AN EFFECTIVE COMPLIANCE PROGRAM 1 (2013), http://www.acacompliancegroup.com/documents/The%20CCO's%20Guide%20to%20the%20GIPS%20Standards%20-%20Essentials%20for%20an%20Effective%20Compliance%20Program.pdf.

180. *See* 2012 MANAGER AND CONSULTANT SURVEY, *supra* note 173, at 13.

181. Letter from Kurt Schacht, Managing Dir., & Linda Rittenhouse, Dir., CFA Inst., to Brent Fields, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 10, 2015), https://www.sec.gov/comments/s7-09-15/s70915-20.pdf.

example, claiming GIPS compliance may subject a firm to a more rigorous SEC examination. If SEC staff members are trained in the GIPS, then they may be more likely to find deficiencies. In 2013, one compliance consultant opined that the SEC staff was examining GIPS compliance in greater detail, becoming more proficient in the GIPS, and making comments that were "much more technical and granular."[182] The detailed, prescriptive nature of the GIPS standards may provide an easier path for the staff to find deficiencies that provide a basis for a deficiency letter. It is possible that using individualized investment performance policies and procedures may be less likely to result in deficiencies than using GIPS.

A similar problem can be created to the extent that the GIPS impose a higher standard than what is legally required. The Commission takes the position that an adviser's GIPS-compliance claim means *complete* compliance. If a firm violates an aspect of GIPS that exceeds legal standards, and the firm's performance claims are not false or misleading except in claiming GIPS compliance, the firm may be found liable both for the inaccurate claim and for not following its own procedures.[183] In that scenario, an adviser that seeks to provide better disclosure may thereby bootstrap itself into higher legal obligations—a kind of regulatory arbitrage in reverse. It has been asserted with respect to at least one SEC GIPS-compliance enforcement action that the violation would not otherwise have been problematic under antifraud principles.[184] In this case, the defendant's GIPS-compliance claim arguably created a kind of self-imposed liability risk.

The SEC staff has recognized the potential for self-imposed liability. For example, the staff has specifically complained about advisers' failure to follow compliance policies and procedures "in areas that registrants included in their policies and procedures, but that are not expressly required to be reviewed by regulations (e.g., quarterly review of employees' e-mails)."[185] Rather than rewarding firms that seek higher compliance, the staff may be more likely to punish them. This kind of penumbral liability arises not only in the GIPS context, but whenever a firm, in holding itself to a higher standard, adopts policies and procedures the violation of which leads to a self-created enforcement action.[186]

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182. ANKAR, *supra* note 179, at 1.

183. *See* Kitces, *supra* note 177.

184. *See* ZPR Inv. Mgmt., Inc., Initial Decision Release No. 602, 108 SEC Docket 4502.

185. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, EXAMINATIONS OF ADVISERS AND FUNDS THAT OUTSOURCE THEIR CHIEF COMPLIANCE OFFICERS 5 (2015) [hereinafter EXAMINATIONS OF ADVISERS].

186. *See* Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-7 (2016). GIPS compliance liability could arise even if a firm never held itself as GIPS compliant. Investment advisers are required to adopt and implement policies and procedures that are reasonably designed to ensure compliance with securities laws, including antifraud provisions as applied to investment performance advertising. If a firm's internal policies and procedures provided that it would calculate and present performance pursuant to GIPS, then GIPS noncompliance, regardless of whether noncompliance arises from misleading performance calculations, presumably could

Reliance on GIPS compliance also creates the risk that the standards are underinclusive. Compliance with the GIPS will not necessarily satisfy all legal standards for the calculation and presentation of investment performance results. There are many published legal guides that catalogue the compliance requirements that even perfect GIPS compliance will not satisfy.[187] A third party standard such as the GIPS, like a bond rating or voting recommendation, creates the risk that firms will mistake full compliance with the standard with full compliance with the law. In contrast, NRSRO ratings historically have been coextensive with legal creditworthiness. When NRSRO references in federal laws and rules were removed, NRSRO ratings, like the GIPS, become simply a private brand that is indicative, but not dispositive, of compliance.

D. PUBLIC COMPANY AUDITORS

Public company auditors, unlike NRSROs, proxy voting firms, and the CFA Institute, reflect the quintessential model of a third party examiner. Public companies are required to report their financial condition in financial statements that have been audited by an independent public accountant.[188] Although public company auditors serve this examination function, they do not establish the accounting standards that they audit or participate in the formal adjudication of compliance with accounting standards. Their only role is that of third party compliance examiner.

This has not always been the case. Prior to the enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), the accounting industry controlled accounting standards through the Financial Account Standards Board (FASB), which was funded and substantially controlled by public accounting firms. After Enron's auditor failed to recognize its true financial condition, Congress began to doubt the independence of the FASB.[189] In 2002, Congress formally vested private standard setters with the authority to establish generally accepted accounting principles[190] and mandated that such standard

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constitute a failure to implement, and violate Rule 206(4)-7. Although this reflects the SEC's position, it is not clear whether a court would accept the agency's theory of self-created legal standards.

187. *See, e.g.*, U.S. INV. PERF. COMM., PERFORMANCE ADVERTISING – RECONCILING THE GIPS® STANDARDS WITH THE INVESTMENT ADVISERS ACT OF 1940, https://www.gipsstandards.org/compliance/Documents/sec_gips_white_paper_final.pdf.

188. Broker-dealers must be audited by a PCAOB accountant annually. 15 U.S.C. § 78q(e)(1)(A) (2012). This audit must include a review of the broker-dealer's custody procedures, which must be sufficient for the auditor to provide reasonable assurance that material inadequacies do not exist. *See* General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.17a-5(g).

189. In the Sarbanes-Oxley Act, Congress took the unusual step of naming Enron and with Global Crossing, another firm the failure of which was associated with accounting abuses. *See* Sarbanes-Oxley, Pub. L. No. 107-204, §705a, 116 Stat. 745 (codified as amended at 15 U.S.C. §§ 7211–19, 7231–34 (2012)).

190. *See id.* § 108, 15 U.S.C. § 7218.

setters be funded by issuers rather than by the accounting industry.[191] Industry control over FASB was further diluted by Sarbanes-Oxley's requirement that a majority of a standard setter's board be persons who have not been associated with a registered accounting firm during the preceding two years.[192]

Congress also created the PCAOB to oversee public company auditors. Prior to the Enron scandal, a former chairman of PricewaterhouseCoopers LLP testified that the accounting "profession's combination of public oversight and voluntary self-regulation is extensive, Byzantine, and insufficient."[193] This Byzantine system was substantially replaced by the PCAOB, a five-member, SEC-appointed, self-regulatory entity tasked with overseeing public company auditors.

Sarbanes-Oxley granted the PCAOB the authority, subject to SEC oversight, to register public accounting firms; establish standards for the audit of public companies; and inspect, investigate, and sanction registered firms.[194] To strengthen the independence of the PCAOB, Sarbanes-Oxley required that at least a majority of the PCAOB be non-CPAs and that the Chair not have practiced public accounting in the preceding five years.[195]

Congress created yet another overseer of public company auditors by mandating, in effect, that public companies create audit committees.[196] The audit committee must be comprised of independent directors and have both the authority to hire and fire the auditor and sufficient funding to pay the auditor.[197] Sarbanes-Oxley required the auditor to report to the audit committee all critical accounting policies and practices, alternative Generally Accepted Accounting Principles (GAAP) treatments discussed with management, their significance and the auditor's preference, and all written communications between the auditor and management.

Congress also established new requirements that were designed to strengthen auditors' independence.[198] Sarbanes-Oxley created what is known as "mandatory partner rotation." Specifically, auditors were prohibited from auditing a firm if the audit partner having primary responsibility for the audit had performed audit services for the issuer in each of the preceding five years.[199] Sarbanes-Oxley did not, however, require auditor rotation,

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191. *Id.* §§ 108(b), 109, 15 U.S.C. § 7266.
192. *Id.* § 108(b), 15 U.S.C. § 7266.
193. S. REP. NO. 107-205, at 5 (2002).
194. *See* Sarbanes-Oxley § 101, 15 U.S.C. § 7211.
195. *See id.*
196. *See id.* § 204 (amending 15 U.S.C. § 78j-1). Although the Act did not require the formation of an audit committee, it deemed the entire board to be an audit committee in the absence of one, which made it impracticable not to form an audit committee.
197. *Id.* § 301, 15 U.S.C. § 78f.
198. *See infra* notes 199–208 and accompanying text.
199. *See* Sarbanes-Oxley § 203 (amending 15 U.S.C. § 78j-1).

notwithstanding the long tenure of many auditors with their clients,[200] but instructed the Office of Government Accountability to study the issue.[201] Relatedly, Sarbanes-Oxley prohibited auditors from auditing a company if a senior executive officer of the company had been employed by the auditor and participated in the issuer audit within the twelve months preceding the audit.[202]

Other independence reforms essentially codified preexisting SEC rules. For example, Sarbanes-Oxley prohibited auditors from providing the following non-audit services: bookkeeping and other services related to a company's accounting records or financial statements, financial information systems design and implementation, appraisal, valuation or fairness opinions, actuarial, internal audit, management functions, human resources, broker/dealer, investment adviser, or investment banking services, or legal and expert services.[203] As to other non-audit services, Sarbanes-Oxley required the auditor to disclose them in SEC filings and obtain preapproval from the audit committee, with the exception of certain de minimis non-audit services that may be approved at any time prior to the completion of the audit.[204]

Sarbanes-Oxley prohibited any person, in violation of SEC rules, from acting on behalf of an issuer to influence improperly an accountant in the performance of the issuer's audit, for the purpose of rendering the audited financial statements materially misleading.[205]This provision authorized civil enforcement of its terms by the Commission.[206]

Sarbanes-Oxley required that the auditor's financial report reflect any "material correcting adjustments" the auditor has identified[207] and that the auditor make quarterly and annual disclosure of significant off-balance sheet items. It required the auditor letter to describe the scope of the auditor's

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200. In 2003, the tenure of auditors of Fortune 1000 companies averaged twenty-two years. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-04-216, REPORT TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS AND THE HOUSE COMMITTEE ON FINANCIAL SERVICES, REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION 6 (2003) [hereinafter MANDATORY AUDIT FIRM ROTATION].

201. *See* Sarbanes-Oxley § 207.

202. *Id.* § 206 (amending 15 U.S.C. § 78j-1) (officers include the chief executive officer, controller, chief financial officer and others in equivalent positions).

203. *Id.* § 201 (amending 15 U.S.C. § 78j-1). These requirements had, for the most part, been imposed by the Commission as a condition of an auditor being treated as independent with the exception that the SEC requirements apply during full period of the professional engagement. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6044 (Feb. 5, 2003) (codified at 17 C.F.R. § 210.2-01(c)(4)(i)–(ix) (2016)). Prior to the Sarbanes-Oxley Act, big 4 revenues for non-audit services averaged 50 percent of total revenues. *See* S. REP. NO. 107-75, at 14 (2002).

204. *See* Sarbanes-Oxley § 202 (amending 15 U.S.C. § 78j-1).

205. *See id.* § 303, 15 U.S.C. § 7242.

206. *See id.*

207. *See id.* § 401(a)(i), 15 U.S.C. § 7261.

testing of the company's internal controls and its findings regarding those controls.[208]

Congress was also concerned about concentration in the auditor marketplace but took no specific steps to remedy the problem. It ordered the GAO to study the issue and make recommendations. The GAO confirmed Congress's concerns in finding that, in 2003, about 70% of the approximately 15,000 public company clients of 700 accounting firms were audited by one of only four accounting firms (the Big 4).[209]

Whereas the Financial Crisis of 2008 prompted a massive overhaul of NRSRO regulation, it led to few changes to public company auditor regulation. One small but high profile change required that companies that use conflict minerals submit an annual report to the Commission, which includes an independent private sector audit of the report and identifies the auditor.[210] The audit is subject to the GAO's Government Auditing Standards, which can be satisfied by meeting the standards for Attestations Engagements or Performance Audits.[211] Only the former must be conducted by a CPA firm.[212] The auditor of a company's financial statements is permitted to conduct the private audit, but it will be treated as a non-audit service requiring pre-approval.[213] Although the Act did not characterize the

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208. *See id.* § 103(a)(2)(A)(iii), 15 U.S.C. § 7213. *See also* Dodd-Frank, Pub. L. No. 111-203, § 404(b), 124 Stat. 1376 (codified as amended at 15 U.S.C. § 7262 (2012)) (requiring public companies to adopt internal controls). However, the Commission exempted small issuers from the internal controls requirement, thereby obviating the auditor attestation, and Congress codified that exemption in 2010. *See* Dodd-Frank § 989G(c). Dodd-Frank required the Commission to study exempting midsized companies as well, but the Commission ultimately recommended against taking that step. *See* U.S. SEC. & EXCH. COMM'N, STUDY AND RECOMMENDATIONS ON SECTION 404(B) OF THE SARBANES-OXLEY ACT OF 2002 FOR ISSUERS WITH PUBLIC FLOAT BETWEEN $75 AND $250 MILLION Part VI.B.1 (2011).

209. *See* MANDATORY AUDIT FIRM ROTATION, *supra* note 200, at 10–11 (the 700 firms were the members of the American Institute of Certified Public Accountants' former self-regulatory program for audit quality; the four firms were: PricewaterhouseCoopers LLP, Ernst & Young LLP, Deloitte & Touche LLP, and KPMG LLP; the remaining 30% were audited by approximately 688 firms).

210. Sarbanes-Oxley § 1502.

211. Conflict Minerals, Exchange Act Release No. 67,716, (Nov. 13, 2012) (codified at 17 C.F.R. pts. 240, 249(b)). In 2013 and 2014, half of private sector audits were conducted pursuant to the Attestation Standard. *See* Christine Robinson & Kristen Sullivan, *Anticipating the Independent Private Sector Audit after the Year 2 Conflict Minerals Reporting Cycle*, DELOITTE (Aug. 25, 2015), http://www.iasplus.com/en/publications/us/heads-up/2015/issue-29. The independence requirements under GAGAS are primarily principles-based, with certain specifically prohibited non-audit services. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-331G, GOVERNMENT AUDITING STANDARDS 3.01–3.59 (2011) (prohibiting non-audit management services at 3.35, preparation of audited records at 3.50, and preparation of the audited report at 3.51). It is likely that these independence requirements would substantially overlap with the SEC's independence requirements for public company auditors.

212. U.S. Sec. & Exch. Comm'n, Frequently Asked Questions, Conflict Materials, U.S. SEC. & EXCH. COMM'N (Apr. 17, 2014), https://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm?_ga=1.158378170.1289200159.1469974041.

213. *See* Conflict Minerals, Exchange Act Rel. No. 67,716 at text accompanying n.650. In 2013 and 2014, half of private sector audits were conducted pursuant to the Attestation Standard. *See* Robinson & Sullivan, *supra* note 211..

report as a filing, the Commission takes the position that the report, and therefore the audit, is subject to liability under Section 18 of the Exchange Act.[214]

Subsequent reforms have included the Jumpstart Our Business Startups (JOBS) Act of 2012's extension of the internal controls audit exemption to emerging growth companies,[215] and the PCAOB's requirements, effective in 2017, that auditors name the engagement partner and provide information on other firms that participated in the audit.[216]

E. CHIEF COMPLIANCE OFFICERS

The CCO mandate for investment advisers establishes yet another kind of third party compliance examiner. Rule 206(4)-7 under the Advisers Act requires that registered investment advisers designate a CCO who is responsible for administering the adviser's compliance policies and procedures (CCO Rule).[217] Although the CCO normally is not a third party but an employee of the adviser, some advisers retain third party CCOs and many outsource CCO functions. A Charles Schwab study found that, in 2011, 38% of advisory firms outsourced at least part of their compliance function, up from 27% the previous year.[218] Thus, the CCO function is often outsourced to third parties, which may include, for example, third party verifiers of GIPS compliance.

The CCO Rule provides no qualification or independence requirements for the CCO, but the Commission has suggested what characteristics it expects of CCOs:

> An adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. . . . [and] should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.[219]

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214. *See* Conflict Minerals, *supra*, at text accompanying nn. 339 - 42.

215. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 103, 126 Stat. 306 (2012) (codified as amended at 15 U.S.C. § 78j-1 (2012)).

216. *See* Order Granting Approval of Proposed Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards, Exchange Act Release No. 77,787, 2016 WL 2621668 (May 9, 2016) (approving requirements to name partner and identify participating accounting firms in audit reports issued after, respectively January, 1, 2017, and June 30, 2017).

217. *See* 17 C.F.R. § 275.206(4)-7(c) (2016).

218. *See* EXAMINATIONS OF ADVISERS, *supra* note 185, at 1 n.2 (citing Press Release, Independent Advisors' Revenue and Assets Rebound for Record Year, Says 2011 Charles Schwab RIA Benchmarking Study (July 5, 2011), http://pressroom.aboutschwab.com/press-release/schwab-advisor-services-news/independent-advisors-revenue-and-assets-rebound-record-ye).

219. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26,299, 81 SEC Docket 2775 (Dec. 17, 2003).

The Commission conducted an Outsourced CCO Initiative for the purpose of evaluating the outsourcing of the CCO function, which provides further insight into what the agency expects from a third party examiner.[220] For example, the staff applauded CCOs "who frequently and personally interacted with advisory and fund employees (in contrast with impersonal interaction, such as electronic communication or pre-defined checklists)."[221] In some cases, the SEC staff has provided detailed guidance as to compliance procedures that CCOs should implement.[222]

The staff also emphasized the importance of CCOs' authority to exercise control over compliance functions, such as by determining independently what records the CCO would review. In a 2015 enforcement action against an outside CCO, the Commission specifically complained that the CCO relied on information provided by the adviser regarding assets under management and the number of accounts.[223]

The Commission has adopted a companion rule that requires that mutual funds designate a CCO and take steps to ensure the CCO's independence from a fund's service providers (Mutual Fund CCO Rule).[224] Mutual funds are technically independent of their service providers, but as a practical matter they are controlled by their sponsor, which is usually the fund's investment adviser. The Mutual Fund CCO Rule, like money market fund creditworthiness rules, therefore operates as a de facto third party examiner for investment advisers.

The Mutual Fund CCO Rule takes a very different approach from that of the CCO Rule. For example, the Mutual Fund CCO Rule specifically addresses the potential for undue influence by the sponsor, by prohibiting the sponsor from "directly or indirectly tak[ing] any action to coerce, manipulate, mislead, or fraudulently influence the fund's chief compliance officer in the performance of his or her duties. . . ."[225] Additionally, directors of the fund who are independent of the fund's sponsor must control the designation, compensation, and removal of the CCO.[226]

A mutual fund CCO must provide an annual written compliance report to the fund's board and meet annually with its independent directors. The report must identify material compliance matters, which are defined to include not only violations of the federal securities laws, but also any

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220. *See* EXAMINATIONS OF ADVISERS, *supra* note 185, at 3.

221. *Id.* at 3–4.

222. *See, e.g.*, U.S. SEC. & EXCH. COMM'N OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SAFEGUARDING CLIENTS' ASSETS UNDER MANAGEMENT THROUGH ASSET VERIFICATION AND RECONCILIATION (2009), https://www.sec.gov/info/iaiccco/iaiccco-custody.pdf.

223. *See* EXAMINATIONS OF ADVISERS, *supra* note 185, at 5 n.13 (citing Aegis Capital, LLC, Exchange Act Release No. 74,608, Advisors Act Release No. 4054, Investment Company Act Release No. 31,541, 2015 WL 1407563 (Mar. 30, 2015).

224. Investment Company Act of 1940, 17 C.F.R. § 270.38a-1 (2016).

225. *Id.*

226. *Id.* § 270.38a-1(a)(4).

"weakness in the design or implementation of the policies and procedures of the fund" or its primary service providers.[227]

Like public company auditors, CCOs are exposed to personal liability. The Commission has brought a number of enforcement actions based on CCOs' failure to provide adequate compliance oversight,[228] and the defendant in at least one case was a third party.[229] In response to two of these cases involving internal CCOs, Commissioner Gallagher accused the Commission of having "unfairly contorted the rule to treat the compliance function as a new business line, with compliance officers assuming the role of business heads," and interpreted the CCO Rule "as being targeted at CCOs."[230] He contended further that the SEC's enforcement actions would "disincentivize a vigorous compliance function at investment advisers."

F. COMPLIANCE CONSULTANTS

In a number of settled enforcement actions, the Commission has required that the defendant agree to retain an independent compliance consultant to review and make recommendations regarding the defendant's compliance program. The terms of the consultant requirement are generally quite similar.[231] The adviser must hire an independent consultant "not unacceptable to the staff of the Commission" to conduct a comprehensive review of and recommend corrective measures concerning the adviser's policies and procedures with respect to designated areas of compliance. The areas covered may be specific (e.g., "due diligence prior to adding new clients") or quite broad (e.g., "detecting and addressing fraud").

The SEC's settlement with Apex Fund Services reflects the standard terms that the Commission requires.[232] For example, it required that the consultant be retained within forty-five days and that the Commission be provided with a copy of the engagement letter within thirty days thereafter. The consultant was required to submit an initial report to the Commission within ninety days of retention, which describes the compliance review, the consultant's conclusions and recommendations, and procedures for implementing the recommendations. The adviser was required to implement

227. *Id. See generally* BlackRock Advisors LLC, Advisers Act Release No. 4065, Investment Company Act Release No. 31,558, 2015 WL 1776222 (Apr. 20, 2015) (charging CCO with failure to report material compliance matter).

228. *See, e.g.*, *id.* Thomas R. Delaney II, Initial Decision Release No. 755, 109 SEC Docket 962 (Mar. 18, 2015).

229. *See* Aegis Capital, LLC, Exchange Act Release No. 74,608, Advisors Act Release No. 4054, Investment Company Act Release No. 31,541, 2015 WL 1407563 (Mar. 30, 2015)

230. Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html.

231. *See, e.g.*, Apex Fund Services (US), Inc., Investment Advisers Act Release No. 4429, 2016 WL 3345650 (June 16, 2016).

232. *See generally id.*

the recommendations within ninety days after the initial report, and a final report was due within nine months of the order, which describes the implementation of the recommendations. The adviser had the right to appeal, in effect, the consultant's recommendations to the SEC staff. The adviser had to complete implementation of the recommendations no more than one year following the settlement, and certify compliance with the consultant requirement no later than sixty days after completion.

The orders do not define "Independent Consultant"[233] or otherwise address the consultant's qualifications or experience except for the double negative that the consultant shall not be unacceptable to the SEC staff. However, the order generally requires, in order "[t]o ensure the independence of the Consultant," that the adviser: (1) not be able to fire the consultant without SEC staff approval, (2) compensate the consultant "at their reasonable and customary rates," and (3) not "invoke the attorney-client or other doctrine or privilege to prevent the Consultant from communicating with or transmitting any information, reports or documents to the Commission's staff."[234]

A separate provision also appears to address, without specifically referencing, the issue of the compliance consultant's independence. The adviser must require the consultant to agree not to provide any professional services to the adviser or its affiliates during the engagement, and two years thereafter, and to require the consultant's affiliates to not provide services as well.[235] Including the timeline described above, the practical effect is to prohibit future work for approximately three years after the engagement, but there is no restriction on the consultant's prior relationship with the adviser.[236]

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233. *See, e.g.*, *id.* (the Commission appears to use "Independent Compliance Consultant" as a title rather than a defined term).

234. *See, e.g.*, *id.*

235. This requirement was the subject of complaints by two SEC Commissioners in connection with an SEC order that did not impose such an independence requirement. *See* Luis A. Aguilar & Kara M. Stein, Comm'r, U.S. Sec. & Exch. Comm'n, Dissenting Statement in the Matter of Oppenheimer & Co., Inc. (Feb. 4, 2015), https://www.sec.gov/news/statement/dissenting-statement-oppenheimer-inc.html#_edn10. The Commissioners objected that the settlement did not require that the consultant be "qualified or independent — i.e., one that has not worked for Oppenheimer in the past, much less on Rule 506 matters. This is unacceptable, and a departure from the Commission's usual practice." *Id.*

236. Some orders include additional terms. *See, e.g.*, Royal Alliance Assoc., Inc., Exchange Act Release No. 77,362, Investment Advisers Act Release No. 4351, 2016 WL 945975 (Mar. 14, 2014) (requiring that consultant be provided access to materials and personnel as needed to conduct review and keep preserve records of compliance with consultant undertaking for six years); Guggenheim Partners Inv. Mgmt., LLC, Investment Advisers Act Release No. 4163, 2015 WL 4720298 at *8 (Aug. 10, 2015) (firm "shall not be in, or have an attorney-client relationship with" the consultant or invoke the privilege to prevent consultant transmissions to the staff; records of compliance with consultant undertaking shall be preserved for six years); BlackRock Advisors LLC, Advisers Act Release No. 4065, Investment Company Act Release No. 31,558, 2015 WL 1776222 (Apr. 20, 2015) (requiring that consultant be provided access to materials and personnel as needed to conduct review, and records of compliance with consultant undertaking be preserved for five years);

In some cases, settling firms appear to have avoided the compliance consultant requirement as a formal condition by retaining a compliance consultant prior to settlement.[237] The order typically notes that the firm has retained a compliance consultant and describes some aspects of the relationship. However, the order does not require the engagement as a specific undertaking, much less set forth its specific terms.[238]

G. SURPRISE AND INTERNAL CONTROLS AUDITORS

The closest that current law comes to a third party adviser examination requirement is the mandatory custody audit under the Custody Rule.[239] The Custody Rule requires, among other things, that registered investment advisers that have custody of client assets[240] retain an independent public accountant to conduct a surprise custody audit each calendar year.[241] In some cases, an adviser may be required to obtain an internal control report from an

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Barclays Capital Inc., Exchange Act Release No. 73,183, Investment Advisers Release No. 3929, 109 SEC Docket 5029 (Sept. 23, 2014) (requiring retention of consultant within 270 days and completed review 180 days thereafter; requiring consultant be provided access to materials and personnel as needed to conduct review; firm "shall not be in, and shall not have an attorney-client relationship with" the consultant or invoke the privilege to prevent consultant transmissions to the staff; records of compliance with consultant undertaking to be preserved for six years); Equitas Capital Advisors, LLC, Exchange Act Release No. 70,743, Investment Advisers Act Release No. 3704, 107 SEC Docket 273 (Oct. 13, 2013) (requiring three annual reviews and omitting condition regarding attorney-client privilege); Northern Lights Compliance Services, LLC, Investment Company Act Release No. 30,502, 106 SEC Docket 1134 (May 2, 2013) (same as in Blackrock Advisors).

237. *See, e.g.*, Cranshire Capital Advisors, LLC, Investment Advisers Act Release No. 4277, 2015 WL 7423035 (Nov. 23, 2015); Virtus Inv. Advisers, Inc., Investment Advisers Act Release No. 4266, Investment Company Act Release No. 31,901, 2015 WL 7179719 (Nov. 16, 2015) (settlement reflects firm's prior retention of consultant); Stephen Derby Gisclair, Exchange Act Release No. 70,742, Investment Advisers Act Release No. 3703, 107 SEC Docket 2728 (Oct. 23, 2015) (prior hiring of "independent consultant" is undertaking for which certification must be provided).

238. *See, e.g.*, Cranshire Capital Advisors, LLC, Investment Advisers Act Release No. 4277, 2015 WL 7423035 (Nov. 23, 2015); Virtus Inv. Advisers, Inc., Investment Advisers Act Release No. 4266, Investment Company Act Release No. 31,901, 2015 WL 7179719 (Nov. 16, 2015) (settlement reflects firm's prior retention of consultant); Stephen Derby Gisclair, Exchange Act Release No. 70,742, Investment Advisers Act Release No. 3703, 107 SEC Docket 2728 (Oct. 23, 2015) (prior hiring of "independent consultant" is undertaking for which certification must be provided).

239. *See* 17 C.F.R. § 275.206(4)-2 (2016).

240. The Custody Rule refers to client "funds and securities." The Custody Rule does not apply to client assets held by an adviser that are not "funds and securities." For simplicity, the term "assets" is used herein to refer to "funds and securities."

241. The Custody Rule has included some form of surprise audit requirement since its inception. *See generally* Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Release No. 2876 at text accompanying n.13–14 (May 20, 2009). It was first adopted in 1962, when it required that all advisers with custody undergo a surprise examination by an independent public accountant. In 1997, the Commission amended the Rule to apply only to registered investment advisers. It amended the rule in 2002 to create an exemption from the surprise audit requirement when a qualified custodian held custody and provided account statements directly to clients.

independent public accountant on internal controls relating to pooled investment-vehicle assets.[242]

An adviser has custody if it or a related person[243] holds client assets or has the authority to obtain possession of them.[244] A related requirement is that all client assets must be in the custody of a "qualified custodian," a term that includes banks, broker-dealers, foreign financial institutions, and certain futures commission merchants.

The timing of the surprise audit "must be irregular from year to year, so that the adviser will be unaware of the date on which it will take place."[245] The audit must be provided pursuant to a written agreement[246] that requires the accountant to file a Form ADV-E with the Commission within 120 days of the audit, which describes the scope and nature of the examination.[247] The Custody Rule does not expressly require that the accountant identify problems, but Form ADV-E goes a bit further than the Custody Rule in requiring a "certificate of accounting."[248] The Custody Rule provides that, within four days of the termination of the arrangement, a Form ADV-E must be filed that is accompanied by a statement containing the date of the termination and explaining any examination-related problems that contributed to the termination. Form ADV-E is publicly available in the Investment Adviser Registration Depository.[249] The agreement must also require the accountant to notify the Commission by facsimile or electronic mail within one day of finding any material discrepancies in the audit.

A surprise audit is not required in three situations. First, it is not required for client assets that are solely in the custody of an "operationally independent" related person. A related person is operationally independent if there are no circumstances that would reasonably be expected to compromise

242. *Id.*

243. A related person is "any person, directly or indirectly, controlling or controlled by [the advisers], and any person that is under common control with [the adviser]." Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-2(d)(7).

244. *See id.* § 275.206(4)-2(d)(2). Custody exists, for example, when an adviser receives a check from a client, has the power to withdraw client assets, or has legal ownership of client assets (such as a trustee for a trust that holds client assets). *See id.*

245. Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Release No. 2876, at n.8. *See* 17 C.F.R. § 275.206(4)-2(a)(4).

246. The recordkeeping rule under the Act requires that the adviser keep the surprise auditor agreement for five years from the end of the fiscal year "in which the last entry was made," the first two years in an appropriate office of the adviser. 17 C.F.R. §§ 275.204-2(a)(10), (e)(1).

247. The 120 days run from the initial date of the surprise audit. Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Release No. 2876 at text accompanying n.28. In addition to the specific procedures an independent public accountant must follow during a surprise examination, the accountant should perform any additional audit procedures it deems necessary under the circumstances. *See* Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate, Advisers Act Release No. 201, 1966 WL 85149 at *1 (May 26, 1966).

248. Form ADV-E, 17 C.F.R. § 279.8.

249. *Independent Public Accountants Guide: Form ADV-E Surprise Examination Filing*, INV. ADVISER REG. DEPOSITORY, www.iard.com/pdf/formadv-e (last visited Oct. 4, 2016).

the operational independence of the related person and four requirements are satisfied: (1) the client assets are not subject to claims of the adviser's creditors; (2) no advisory personnel has possession of, access to, or otherwise the opportunity to misappropriate the client assets; (3) no personnel of the related person who has access to the assets is under common supervision with any advisory personnel; and (4) no advisory personnel holds a position with or shares premises with the related person.[250]

Second, the surprise audit is not required as to client assets of which the adviser has custody solely as a result of the authority to make withdrawals to pay the adviser's fee. However, if a related person acts as the qualified custodian of the assets, this exception applies only if the related person is operationally independent of the adviser.[251]

Third, a surprise audit is not required for the account of a limited partnership if the partnership:

1. Is audited by an independent public accountant that is registered with and subject to inspection by the PCAOB during the engagement through the end of the calendar year (PCAOB accountant);
2. Delivers annual, GAAP-based, audited financial statements to all limited partners within 120 days of the end of the fiscal year; and
3. Is audited upon liquidation and distributes the financial statements promptly after completion of the audit.[252]

Additional audit requirements apply if the adviser or a related person acts as the qualified custodian of client assets.[253] First, a PCAOB accountant must conduct the surprise audit.[254] Second, the adviser must obtain, or receive from the related person, an internal control report each calendar year that is written by an independent PCAOB accountant.[255] The report must opine on "whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to

250. *See* Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-2(d)(5). The Custody Rule does not apply to an account of a registered investment company.

251. *Id.*

252. *Id.* Only auditors that audit public companies, brokers or dealers are subject to PCAOB inspection. *See* 15 U.S.C. § 1714(a) (2012); PCAOB RULE 4020T (temporary rule subjecting auditors of brokers and dealers to PCAOB inspection).

253. Surprise custody audits are not required if a related person that acts as the qualified custodian is not operationally related to the adviser, but the adviser still must obtain an internal control report from the related person. *See* 17 § C.F.R. § 275.206(4)-2(a)(6)(ii).

254. *See* 17 C.F.R. § 275.206(4)-2(a)(6)(i); *Staff Reponses to Questions about the Custody Rule at Question II.8*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/divisions/investment/custody_faq_030510.htm (last updated Sept. 1, 2013).

255. Although the surprise audit requirement does not apply to assets held by an operationally independent related person, no such exemption applies for the internal control report. *See* 17 C.F.R. § 275.206(4)-2(a)(6)(ii).

custodial services, including the safeguarding" of client assets during the year. The report also must verify that client assets are reconciled to a custodian other than the adviser or related person.[256]

An accountant is independent if they meet the independence standards in paragraphs (b) and (c) of Rule 2-01 under Regulation S-X (Independence Rule).[257] Under paragraph (b), an accountant is not independent if a "reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."[258]

Paragraph (c) provides a non-exclusive list of circumstances that would render an accountant not independent, including:

1. A "direct financial interest or a material indirect financial interest in the accountant's audit client, such as" investments in securities issued by the client or by an entity that controls the client;
2. Lending and credit relationships, certain uninsured savings and checking accounts, employment and underwriting relationships, and certain brokerage relationships with the client;
3. Investments in the client;
4. Business relationships with the client (other than services provided in the ordinary course by the accountant);
5. Providing certain non-audit, audit-related services to the client;
6. Providing any services to the client on a contingency basis, and
7. The failure to comply with lead partner rotation requirements.[259]

These standards generally apply to affiliates of the accountant and the client, as appropriate.[260] Surprise and internal controls auditors are also subject to the lead partner rotation requirement, which prohibits an audit partner who has been the lead partner on the engagement for the preceding five years from acting as the lead partner in the ensuing five-year period.[261]

In some respects, the Independence Rule's terms do not fit the context of a surprise or internal controls audit. For example, the Independence Rule

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256. *See id.* § 275.206(4)-2.
257. *See id.* §§ 210.2-01(b), 210.2-01(c).
258. *See id.* § 210.2-01(b).
259. *See id.* § 210.2-01(c).
260. *See id.* §§ 210.2-01(f)(1), 210.2-01(f)(1)(2) ("accountant" includes any accounting firm with which the accountant is affiliated; "accounting firm" includes the firm's "parents, subsidiaries and associated entities"); *id.* §§ 210.0-01(f)(4), 210.0-01(f)(6) ("audit client" includes affiliates of the audit client, which include an entity in the audit client's control family, over which the client exercises significant influence or that exercises significant influence over the audit client).
261. *See id.* § 210.2-01(c)(6).

refers to "issuers," whereas surprise and internal controls auditors do not audit issuers as such. The SEC staff has provided limited guidance on this issue, such as by clarifying that non-audit services would be prohibited only to the extent that the non-audit services would put the auditor in the position of auditing its own work.[262] However, it appears that the Independence Rule's exemption from the rotation requirement for small firms is not available for surprise or internal controls auditors.

CONCLUSION

The Commission appears to be on the verge of requiring investment advisers to undergo third party examinations. To date, SEC officials have provided the principal justification that the Commission lacks the resources to examine investment advisers frequently enough. The rule would also indirectly accomplish the SEC goal of creating an examination-only SRO for investment advisers.

A third party examination requirement for investment advisers may be vulnerable to claims that it is arbitrary and capricious under the Administrative Procedure Act, on the general ground that the Commission has failed to conduct an adequate cost-benefit analysis. Over the last decade, courts have vacated a number of SEC rules on this basis. On somewhat more speculative grounds, the rulemaking could be challenged as usurping Congress's power of the purse by imposing an unauthorized tax on investment advisers, or Congress's authority to permit the creation of a SRO for investment advisers. The Commission would likely adopt such a rule under the authority granted under Section 206(4) of the Advisers Act, but there are strong arguments that a third party examination rule would exceed this authority. Such a challenge not only could defeat the rulemaking, but could also undermine the viability of other rules adopted under that provision.

There are numerous examples of third party examiners that could provide useful models for a third party examination rule for advisers. This article surveys seven regulatory models for third party compliance examiners in order to provide a framework for thinking about how a third party compliance rule might be designed. These examiners include: NRSROs, proxy advisory firms, the CFA Institute, public company auditors, CCOS, compliance consultants, and surprise and internal controls auditors. Each serves a distinctly different third party examination role, and their regulation is equally varied, if not always consistent.

262. *Office of the Chief Accountant, Application of Commission's Rules on Auditor Independence Frequently Asked Questions*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/info/accountants/ocafaqaudind080607.htm (last updated Dec. 13, 2011). For a surprise audit this would normally not be the case because the audit is limited to custody issues. The staff has also clarified that, for purposes of the Independence Rule, the date that the engagement agreement is executed, attest procedures begin, or the surprise examination period begins, as applicable. *Id.*