

GUEST COLUMN

Are Smaller Investment Managers Being Regulated Out of Business?

BY ROBERT STOWSKY

These last couple of years, the investment industry has seen investment managers and advisers face a host of new laws and regulatory requirements, to address concerns ranging from corporate governance within a firm to unlawful activities by its customers. In the United States, the laws passed by Congress in this area that are of concern for investment managers include the USA Patriot Act's Rule 326, commonly referred to as the "Know Your Customer" Rule, the well-known Sarbanes-Oxley Act dealing with financial reporting and accounting practices and the Gramm-Leach-Bliley Act that includes sections that seek to protect clients' privacy.

These laws, in turn, have motivated the Securities and Exchange Commission to create regulations insuring that these laws are not violated. In addition, there is the specter of the SEC severely limiting or eliminating the use of soft dollars that many small firms rely on for research and market access.

The impact of these laws and regulations on investment managers touches firms' personnel structure, operations and technology infrastructure. The combined impact of these rules may be a devastating blow to smaller institutions in terms of the cost required for implementation.

Knowing Your Customer

Rule 326 of the Patriot Act requires that financial institutions have in place customer identification programs allowing for the collection of a customer's information when a new account is opened, and the comparison of that information to a number of lists containing data about known criminals. Another section of the Patriot Act, Rule 314, mandates the reporting of suspicious activity by a firm's customer to federal law enforcement agencies. In addition, the SEC introduced new books-and-records regulations. Both the Patriot Act and SEC rules increase the amount of information that must be collected and maintained on client accounts and activities.

The Gramm-Leach-Bliley Act, which was passed at the end of 1999, is mostly known for repealing the provision in the Glass-Stea-

gall Act that prevented a single company from owning banks, insurance companies, and investment and securities firms. This represented a boon for firms, enabling them to acquire new businesses and then be able to cross-market products from their various subsidiaries to customers of each business. The information collected from a customer signing up for a checking account could now be distributed to the insurance and investment businesses, resulting in the customer receiving solicitations for insurance policies and investment opportunities.

Congress recognized that a single firm



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would be able to amass a tremendous amount of personal information on each customer that used these multiple services within the same company. As a result, a provision was added to the Act that restricted how customer information could be shared with outside entities. The Patriot and Gramm-Leach-Bliley acts, when taken together with the SEC books-and-records regulations, created a need for a firm to have the technology in place to securely acquire, store and communicate a large quantity of information about its customers. This represents a significant cost in both creating these systems and training employees in new procedures for opening and maintaining customer accounts.

Knowing Your Firm

On the other side of these laws and regulations are the ones that pertain to a company's internal information. The Sarbanes-Oxley Act defines new requirements for all public companies for the retaining of financial documents and records to ensure accurate reporting and timely updates on events affecting a firm's financial situation. For its part, the SEC has introduced new regula-

tions for investment managers and advisors regarding compliance. In light of the recent scandals involving investment management and securities firms, the industry is also anticipating the possibility of Congress passing laws similar to Sarbanes-Oxley but focused specifically on investment firms, whether they are publicly or privately held.

Both Sarbanes-Oxley and the SEC compliance rules are heavy with requirements for new procedures to be created within a firm. The SEC compliance rules in particular require firms to define and implement their own written procedures. The SEC also requires

firms to designate a chief compliance officer, or CCO, who is charged with the ongoing maintenance and annual review of these procedures. Similar to the laws and regulations concerning customer information, the rules aimed at company information carry with them the implementation costs associated with people and technology. By mandating the post of CCO, for example, the SEC is requiring many firms to make organizational changes by elevating the role of compliance to the executive level. Such a change is bound to have a rip-

ple effect throughout a firm. The function of compliance will be added to everyone's job definition as new procedures are put into place. New technology investments will need to be made to monitor everything from portfolio management and trading decisions to e-mail and instant messaging content.

Impact Relative to Size

These laws and regulations apply to investment management firms regardless of their number of employees, customers or assets under management. According to the Investment Counsel Association of America, a trade organization representing registered investment adviser (RIA) firms that collectively manage in excess of \$4 trillion in assets, there are close to 8,000 RIAs registered with the SEC. Of these 8,000, more than 5,000 have 10 or fewer employees. Although on a much smaller scale than a Fidelity, Merrill or Wellington, these small shops will have to make the investments necessary to be in compliance with the new rules.

A one-person shop may have 10 clients and \$100 million under management. This lone manager's entire infrastructure may only

consist of a Bloomberg terminal, a telephone and an Internet connection. Yet under the new rules, this person will need to create written policies and procedures, and be able to store and provide the required information to the relevant government agencies. The easiest, and least expensive, task lone investment managers will have in meeting the new laws and regulations is appointing themselves as the chief compliance officer. For the larger firms, there is an economy of scale in implementing infrastructure that is not enjoyed by the smaller players. Even for small firms that do find solutions, the cost of business will go up.

Favoring the Large Firms

The difference in how new regulations impact large vs. small firms is nowhere more apparent than in the current debate over soft dollars. In a comment letter to the SEC regarding soft dollar regulation, the Investment Company Institute, which represents some of the largest mutual fund companies and wealth managers, recommended that the following goods and services be excluded from the safe harbor provided by Section 28(e) of the Securities Exchange Act:

- Computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making;
- Publications, including books, periodicals, newspapers and electronic publications, that are available to the general public;
- Third-party research services.

If the SEC follows the soft dollar recommendations of the ICI, the days of the sole investment manager running with nothing more than a Bloomberg terminal and a telephone would certainly be numbered.

Regulation Equality

It's a fact that the world has changed dramatically in the last three years. In addressing the threat of global terrorism or corporate malfeasance, laws and regulations need to be kept updated to protect the public interest. However, this necessity should not preclude law-abiding individuals and firms from continuing to serve their customers. It's important that lawmakers and regulators fairly assess how rules impact both the very large and very small participants in the areas they regulate, whether in the investment business or any other industry. ■

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