Written Statement of Stephen Brey
Staff Attorney for the State of Michigan Corporations, Securities, and Commercial Licensing Bureau, Vice Chair of the NASAA Investment Adviser Section Committee, and Co-Chair of the NASAA Investment Adviser Section Regulatory Policy and Review Project Group
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U.S. Securities and Exchange Commission
Investor Advisory Committee
"Examining the Use of Mandatory Arbitration Clauses by Registered Investment Advisers"

Hello and good morning, and almost afternoon for those of us in the eastern time zone.

My name is Stephen Brey. I am a staff attorney with the State of Michigan Corporations, Securities, and Commercial Licensing Bureau. I am also vice-chair of the Investment Adviser Section Committee and co-chair of the Investment Adviser Regulatory Policy and Review Project Group of the North American Securities Administrators Association, commonly known as NASAA. I am grateful to Christine Lazaro for organizing this panel, the other panelists for their views here today, the Commission and its staff, and the SEC Investor Advisory Committee for including NASAA and its members in today's important conversation regarding mandatory arbitration provisions in investment advisory agreements. My comments today reflect my own personal views and may not necessarily represent the official positions of NASAA, any NASAA member, or the State of Michigan.

My goal today is to provide background on NASAA and its members; the investment advisers that we regulate and the investors served by that regulated population; and, to offer some high level observations on the use of mandatory arbitration clauses by state-registered investment advisers. I would also like to re-state NASAA' long-held public position that investors should have a choice of forum when it comes to resolving disputes with their investment professionals. Investor confidence in fair and equitable recourse is critical to the stability of the securities markets and long-term investments by retail investors. NASAA has argued that participation by retail investors in our capital markets, and, by extension, job growth, is directly tied to their level of trust in having a reasonable avenue to seek recovery if they are victimized by securities fraud or other unethical conduct.

NASAA and its Mission

NASAA was organized in 1919 and is the world's oldest international organization devoted to investor protection. It is a voluntary association whose membership consists of the securities regulators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, and Guam, as well as the 13 provincial and territorial securities regulators in Canada, and the securities regulator in Mexico. Over 300 volunteers from NASAA's members participate on more than 50 committees and project groups organized by regulatory topic. They are supported by NASAA's professional corporate office staff. Relevant to today's discussion is NASAA's Investment Adviser Section, which focuses on issues facing state-registered investment advisers.

NASAA Members' Regulated Population

Who do NASAA members regulate, and what investors does that regulated population serve? State securities regulators register myriad manner of products, people, and firms. This includes securities offerings, broker-dealers, broker-dealer agents, investment advisers, and Investment Adviser Representatives.

With respect to investment advisers, NASAA members divide regulatory responsibility with the SEC. In general, small investment advisers (less than \$25 million of regulatory assets under management ("RAUM")) and mid-sized investment advisers (between \$25 million and \$100 million of RAUM) are registered with and primarily regulated by one or more state securities administrators. Conversely, large investment advisers (\$100 million and greater of RAUM) generally are registered with the SEC and are primarily subject to federal regulation instead of state regulation. In some cases, a small or mid-sized investment adviser may be permitted or required to register with the SEC instead of with one or more states and, in more limited circumstances, a small or mid-sized investment adviser may be registered with the SEC and one or more states. States also have authority to require the registration of most IARs doing business in their jurisdictions regardless of whether an individual is employed by or associated with a state firm, or a federal-covered investment adviser.

Data published in NASAA's 2024 Investment Adviser Report shows that in 2023, state-registered advisers had AUM of over \$361 billion dollars across almost 17,000 firms, while over 13,000 federal covered firms notice-filed with the states in that year. For state-registered firms, the 2024 NASAA Investment Adviser Report showed that the overwhelming majority of state-registered firms are small shops, with 83% having two or fewer employees, 16% having 3-10 employees, and less than 1% having more than that. Approximately 78% of clients of state-registered advisers are retail investors, while about 19% are high-net worth, with other entity-level client types making up the balance. The investment advisers we oversee are overwhelmingly small businesses that provide advice to Main Street retail investors. Many of these investors are unaware of the impact of mandatory arbitration provisions, fail to appreciate their significance, and are powerless to negotiate a different approach to dispute resolution with their advisers due to the "take it or leave" it nature of the clauses.

While we understand from the data that the advisers that we regulate are small businesses and the clients that they serve are primarily retail investors, the data does not provide us a complete picture on the use and effects of mandatory arbitration clauses. The SEC's Office of Ombuds and Office of Investor Advocate's June 2023 report on the issue acknowledged an absence of available information about adviser arbitration and noted that further inquiry would be required. State-registered investment advisers must disclose information about arbitration claims. However, neither state nor SEC registered firms must disclose whether they use these clauses in client agreements. Perhaps some additional questions on Form ADV Parts 1 and 2A could shed additional light on the issue to allow for a more informed discussion.

<u>Mandatory Arbitration Clauses in Advisory Contracts</u>

Next, I'd like to discuss in general terms how states might view mandatory arbitration clauses in advisory contracts, recognizing that there is limited data available publicly to assess the exact nature of the issue.

NASAA's Investment Adviser Section conducted an informal internal poll of state regulators in 2023 to gather information about mandatory arbitration. Not all members responded to the survey and, while informal, it did offer valuable insight. State perspectives on mandatory arbitration exist on a spectrum, from some states outright prohibiting them in advisory contracts by rule on one end to allowing arbitration clauses with few, if any, restrictions.

Certain jurisdictions, including Virginia and Ohio, have adopted administrative rules under an administrative procedures act process that specifically prohibit mandatory arbitration clauses in advisory contracts. Enforcement of these rules often occurs at the registration and examination level, when staff approves an adviser's initial registration application, or when a state securities examiner comes across a contract with these clauses on an examination of an adviser firm.

Other jurisdictions take the position that their state securities acts have civil liability provisions that entitle investors to file actions in a court within their state, and that a mandatory arbitration clause would be inconsistent with those civil liability provisions, or with provisions that prohibit registrants from entering into contracts that would cause investors to waive a right under their statutes.

Other state regulators view mandatory pre-dispute arbitration clauses as inconsistent with an investment adviser's fiduciary duties to clients. These states focus on client choice with respect to a forum for dispute resolution as the guidepost on the issue.

Jurisdictions in these "civil liabilities" and "fiduciary duty" baskets would similarly raise the issue at the registration phase, requiring amendments to proposed client contracts before allowing the firm to do business in the state, or requiring amendments to client contracts discovered on an examination.

Some other jurisdictions would take issue not with mandatory arbitration clauses themselves, but with any unfair cost-assignment or venue provisions within the clauses that would make it difficult or impossible for a client to seek recompense from their advisers. Forcing a client to pursue an arbitration that will cost the client more in forum fees and/or travel costs than the claim is worth is hardly in the best interests of any retail investor.

A number of states reported that they either do not encounter mandatory arbitration clauses in advisory contracts in the registration or examination process, or do not view them as an issue for investors in their jurisdictions.

None of the foregoing is intended to suggest that any forum is better or worse than others, but rather to highlight that investors should have the choice of forum when pursuing claims against their investment professionals. If arbitration truly offers investors the opportunity to efficiently and fairly settle disputes, then investors will choose that option. But investors should also have the choice to pursue remedies in court, should they view that option as superior to arbitration.

While not applicable to the states, Section 921 of the Dodd-Frank Act gives the SEC explicit rulemaking authority to prohibit or limit the use of mandatory pre-dispute arbitration agreements if it finds that doing so is in the public interest and for the protection of investors. Although Congress gave the SEC an important tool to act in this area, in the 14 years since the Dodd-Frank Act was passed, the SEC has not exercised its authority to conduct rulemaking regarding mandatory pre-dispute arbitration clauses. I believe that the Investor Advisory Committee should urge the SEC to use its authority under Section 921 to provide investors with choice when it comes to dispute resolution forums or, at minimum, to at least prohibit the use of arbitration clauses that effectively deprive the client of any means of seeking recovery for alleged wrongdoing.

Conclusion

I would like to close where I began, by encouraging investor choice of forum to resolve disputes with their advisers, be it arbitration or a court of law. NASAA has supported legislative efforts that would empower investors by giving them a choice when it comes to resolving disputes with financial professionals. The Investor Advisory Committee should recommend that the SEC utilize its Section 921 authority to prohibit mandatory pre-dispute arbitration provisions in investment adviser contracts or to at least prohibit mandatory arbitration clauses that effectively deprive investors of a chance to have their claims heard in a fair forum. Barring these recommendations, the Committee should recommend amendments to Form ADV parts 1 and 2A designed to gather additional information on the use of pre-dispute mandatory arbitration clauses by investment advisers space so that additional conversation on the topic may be more fully informed. Finally, I encourage the SEC and its staff to continue engaging with NASAA and other stakeholders on this and other issues affecting retail investors. Thank you for the opportunity to be here with you today.