Investment Adviser Association National Regulatory Services

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A Profile of the Investment Advisory Profession



Investment Adviser Association

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INTRODUCTION

The Investment Adviser Association and National Regulatory Services are pleased to present our report on the state of the investment adviser profession. This report updates the information on SEC-registered advisers that we have presented for the last four years using the latest data from the Investment Adviser Registration Depository (IARD). These annual reports provide an opportunity to identify significant trends and developments taking place in the advisory profession.

Our analysis of the 2005 IARD data pertaining to SEC-registered entities reveals several key findings:

- The universe of SEC-registered advisers continues to grow significantly. The number of entities registered with the SEC as investment advisers as of April 5, 2005 is 8,614, compared with 8,302 registered one year ago. In fact, the total number of SEC-registered advisers has increased 13.6% since April 2002. Such continued growth in the future may pose a significant additional burden on the SEC's resources.
- The total amount of assets managed by SEC-registered advisers continues to climb substantially to \$26.8 trillion in 2005 representing 21% growth from 2002. In the aggregate, discretionary assets under management grew a significant 15% from \$21.13 trillion in 2004 to \$24.3 trillion in 2005.
- The largest firms continue to control the vast majority of managed assets. The 359 firms that manage \$10 billion or more collectively manage 83% of all reported discretionary assets under management (up from 82% in 2004), despite the fact that these firms represent only 4.1% of all registered investment advisers.
- The number of SEC-registered investment advisers reporting that they provide advice to hedge funds continues to grow dramatically. 24.5% of advisers now report that they provide such services (a 10% increase from 2004), while the number of firms that provide advice primarily to hedge funds grew by 22% during the past year, from 601 to 735. A substantial number of these firms indicate that they have fewer than 10 clients and thus appear to have voluntarily registered with the SEC in advance of the February 2006 deadline for hedge fund adviser registration. The 735 advisers that primarily advise hedge funds manage \$830 billion on a discretionary basis, up from \$540 billion last year.
- Contrary to the perception that virtually all advisers engage in soft dollar arrangements, only 58% of advisers reported that they receive research and other products using client commissions. This number potentially may be understated due to confusion about the wording of this and related questions in Form ADV, Part 1.
- The percentage of investment advisory firms reporting that they provide advice to mutual funds (fund advisers) has steadily declined over the past four years, from 20% in 2002 to 17% in 2005. The number of fund advisers has also decreased slightly in an absolute sense, from 1,500 in 2002 to 1,471 in 2005.
- The number of firms reporting that they have "custody" of client funds continues to rise significantly to 19% in 2005 from 16% in 2004. At least some of this increase may be attributable to the increase in the number of hedge fund advisers.
- The popularity of organizing advisory firms as limited liability companies continues. In 2005, 32% of advisory firms report that they are organized as LLCs, having steadily increased from 23.5% in 2002. Since 2001, the number of LLCs registered as advisers has increased in a greater absolute number than the total increase in all SEC advisers.
- More than one-third (41%) of all investment advisers reported that they are not affiliated with any other financial services industry entity.
- Only 54.6% of registered investment adviser firms have named a chief compliance officer on Form ADV as required, while an additional 6.2% of firms have identified an individual with "compliance" in his or her title.

Universe of SEC-Registered Investment Advisers

Under the National Securities Markets Improvement Act of 1996 (NSMIA), investment advisers that manage less than \$25 million in assets are generally regulated by the states, whereas investment advisers that manage in excess of \$25 million are regulated by the SEC. SEC-registered advisers are required to register with the SEC by filing Form ADV, Part 1A via the IARD, an electronic filing system maintained by NASD. Virtually all states require that state-registered advisers file on the IARD system as well.

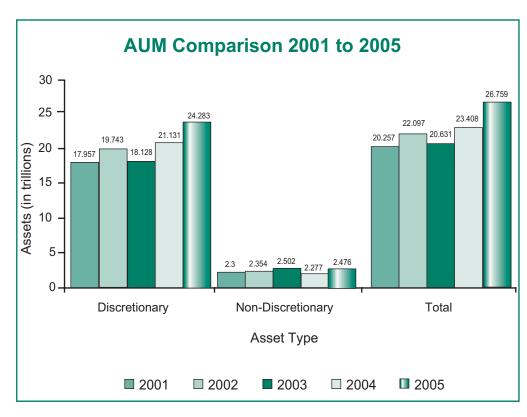
This report is based on IARD data as of April 5, 2005. Because the vast majority of advisers operate on a calendar year basis,³ and because SEC regulations require advisers to update Form ADV within 90 days after the end of the fiscal year, the report is intended to reflect the most recent data available.

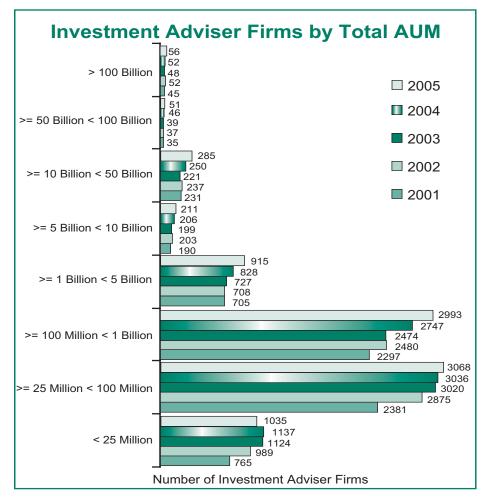
As of April 5, 2005, 8,614 entities were registered with the SEC as investment advisers. This represents a 3.7% increase from the 8,302 advisers registered at this time last year, which reflects slower growth from the 5.7% increase reported last year, but in line with the 3.6% increase reported in 2003.⁴ Since 2002, the number of advisers registered with the SEC has increased 13.6%. This robust growth indicates the continuing attractiveness of the investment adviser industry. According to the data, 11.3% of newly registered advisers are advisers to hedge funds and 29.5% were state-registered prior to transitioning to SEC registration.

It is worth remembering that NSMIA was passed, in part, to give the SEC a smaller universe of advisers to oversee. In light of the growth in the number of SEC-registered advisers, with the required registration of hedge fund advisers looming in February 2006, and with additional broker-dealers possibly registering due to their financial planning activities and maintenance of discretionary accounts,⁵ it will be interesting to see if the SEC will consider revising the criteria for investment adviser registration. The SEC's new risk-based inspection program may help manage the increased number of advisers it oversees.⁶

ASSETS UNDER MANAGEMENT

Total assets under management (AUM) by SEC-registered investment advisers have reached an alltime high of \$26.8 trillion as of April 2005.7 This is an increase from the \$23.4 trillion reported last year. Assets held in discretionary accounts on an aggregate basis grew a significant 15% from \$21.1 trillion in 2004 to \$24.3 trillion in 2005.8 As discussed further below, the growth in hedge fund adviser registrations has contributed only partially to this increase. Of the \$3.17 trillion increase, only 8.2% can be





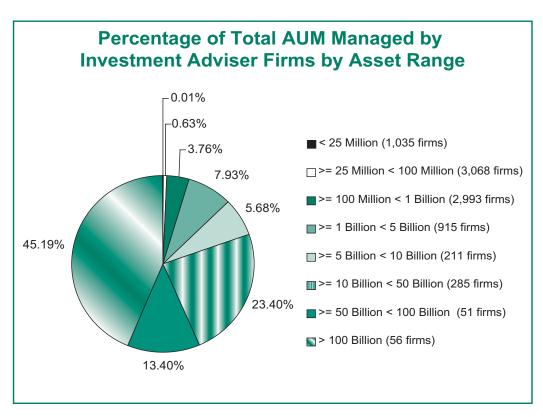
attributed to new advisers and less than 1% to newly registered hedge fund advisers.

Interestingly, of the 7,676 firms that filed Form ADV for both 2004 and 2005, 62% reported growth in their managed assets (vs. 67.4% last year), 17% reported shrinkage of their managed assets, up slightly from last year's 16%, and 21% reported no change at all (vs. 16.6% last year). This increase in the number of firms that reported no change in AUM may suggest that more advisers are not performing the detailed calculations required by the SEC.

A relatively few large firms continue to dominate in terms of assets under management.⁹ Only 359 firms reported managing over \$10 billion in discretionary assets in 2005 (up more than 10% from 312 in 2004 and 274 in 2003). However, these firms collectively accounted for \$20.13 trillion

in discretionary assets in 2005 (up from \$17.29 trillion in 2004), representing 83% of all discretionary

AUM (up slightly from 82% in 2004). Firms in all asset ranges except those managing less than \$25 million experienced increases in discretionary assets this past year, continuing the upward trend we saw beginning last year.¹⁰ For example, the aggregate discretionary assets managed by firms with more than \$100 billion under management increased by 16% from \$9.6 trillion in 2004 to \$11.2 trillion in 2005. Similarly, the aggregate discretionary assets managed by firms with between \$50



and \$100 billion under management increased by 26% from \$2.65 trillion in 2004 to \$3.34 trillion in 2005.

Finally, we note that there are 1,035 entities that reported assets of less than \$25 million under management, as compared with 1,137 in 2004. Although down slightly from last year, these entities continue to represent a significant part of the SEC universe - 12% of registered advisers. Of these firms, 637 claim to have no managed assets; 73% of these firms are pension consultants, control affiliates, and newly formed advisers. 102 firms reported that they are now ineligible for SEC registration and will withdraw their registrations. The remaining firms with less than \$25 million under management qualify for SEC registration on some other basis.¹¹

CHARACTERISTICS OF INVESTMENT ADVISORY FIRMS

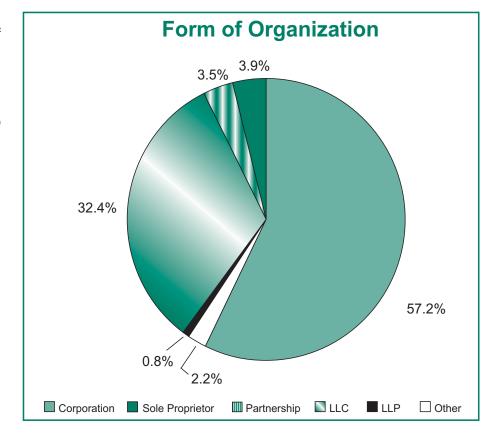
Form of Organization

As shown in the pie chart, the majority of investment advisory firms are, as historically has been the case, organized as corporations – 4,928 (57.2%). However, limited liability companies continue to increase at a steady rate as a form of business organization. Since 2001, the number of LLCs has more than doubled from 1,331 to the current 2,788. This increase is greater than the total number of

SEC-registered advisers added over that same period. LLCs now account for 32% of advisers, up 13% since 2001. Corporations account for 57%, down 8% since 2002. The number of firms organized as sole proprietors and partnerships continues to remain fairly flat over the last two years. It is interesting to note that the 'Other' form of organization has had growth, albeit small, since we began reporting.



The ownership of investment advisory firms is structured in a number of ways. To take one slice of the universe, there are 53 investment advisory firms that manage more than \$100 billion in discretionary assets. These 53 firms collectively manage \$11.2 trillion. Of these firms, only 3 are owned entirely by individuals: *i.e.*, the partners/



members or employees of the firm. Most of the 53 firms are wholly owned by publicly traded companies. Many of these largest advisory firms are related to each other through common parents. Accounting for firms with related ownership, there would be only 41 (rather than 53) consolidated entities in this category, further accentuating the concentration of assets in a small number of firms.

Although most of the very largest advisory firms are owned by public companies, 6,381 (74%) firms are owned at least in part by an individual.¹²

International Business

541 investment advisers (6.2%) report that they are registered with a foreign financial regulatory authority. This percentage level has remained stable during the past four years.

Internet

Despite the predominance of smaller firms, more and more advisers are maintaining an Internet presence. The percentage of firms that report having a web site continues to increase from 59.5% in 2003 to 62.4% in 2004 to 64.7% in 2005.

Employees

Advisers with five or fewer employees rose by only 73 firms in the past year and the percentage of such advisers decreased from 50% to 49%. Firms with 6-10 employees increased by 114 and firms with 11-50 employees increased by 106. In total, firms with fewer than 50 employees continued to comprise 90% of all SEC-registered advisers. 3% of firms continue to report having more than 250 employees and only 95 firms (1.1%) reported that they employ more than 1,000 persons.

Down from prior years, a small percentage of advisers (1.8% in 2005 vs. 2.1% in 2004) reported that they have no employees who perform investment advisory functions. 5,634 firms (65.4%) have between one and five employees who perform investment advisory functions, while an additional 1,282 (14.88%) employ between six and ten people in this capacity. These percentages continue to remain relatively the same as reported in prior years. Up slightly from last year, 57 firms (0.66%) employ more than 500 persons who perform investment advisory functions.

The majority of advisers (5,144 firms, or 59.7%) do not employ any persons who are also registered representatives of a broker-dealer; this figure is up from 2004, when 4,832 firms (58.2%) reported that no employees were registered representatives. 2,171 firms (25.3%) employ between one and five registered representatives, down slightly from 2004. 83 firms (less than 1%) employ more than 500 registered representatives; of these firms, 65 are registered as both an investment adviser and a broker-dealer.

Employees of Investment Adviser Firms

Number of Employees	# of IA Firms with "x" number of employees	# of IA Firms with "x" number of employees who perform investment advisory functions	# of IA Firms with "x" number of employees who are registered representatives of a broker-dealer
0		157	5,144
1 to 5	4,235	5,634	2,171
6 to 10	1,635	1,282	505
11 to 50	1,901	1,141	481
51 to 250	574	291	182
251 to 500	102	52	48
501 to 1,000	72	32	38
More than 1,000	95	25	45

Solicitors

The percentage of investment advisers that use third-party solicitors has remained relatively static. 2,732 investment advisers have engaged between one and five firms or individuals to solicit on their behalf; this represents 31.7% of all advisers, relatively unchanged from last year. 26 firms reported using more than 250 third-party solicitors, down from 29 in 2004. 5,264 investment adviser firms (61%) do not use third-party solicitors, which is the same percentage reported last year.

Advisory Activities

The IARD information reflects that 937 investment advisers (10.6%) act as portfolio managers for wrap fee programs and 399 (4.6%) act as sponsors of wrap fee programs. These numbers are down only slightly from the percentages that we reported for the past three years. In addition, 236 investment adviser firms reported that they both sponsor wrap fee programs and serve as portfolio managers for such programs. The chart on the next page shows the various types of advisory services provided by SEC-registered advisers.

Other Business Activities

Consistent with the last two years' data, a total of 62.5% of all advisory firms indicated that they are not actively engaged in any business other than giving investment advice. Possibly given the complexity of compliance, fewer advisers are involved in non-advisory activities: 613 investment advisers (7.1%) are dually registered as broker-dealers, a slight decrease from last year; 905 advisers (10.5%) are also registered representatives of a broker-dealer; 14 383 advisers (4.4%) are registered as a futures commission merchant, commodity pool operator or commodity trading adviser; 76 advisers (0.8%) are real estate brokers, dealers or agents; 1,118 advisers (13%) are also insurance brokers or agents; 73 advisers (1%) are either a bank or a separately identifiable department or division of a bank; and 2,249 advisers (26%) sell products or provide services other than investment advice to advisory clients.

Financial Services Industry Affiliations

The IARD information reflects that a large number of registered investment advisers have related persons that are engaged in diverse segments of the financial services industry. The year-over-year numbers do not indicate any obvious or dramatic shifts or trends. The percentage of firms with such affiliations decreased by approximately one percent or remained stable in many categories, with firms affiliated with broker-dealers decreasing by 2% as it had last year. Slightly less than one-third of registered advisers are affiliated with broker-dealers and slightly more than a third are affiliated with other investment advisers.

INVESTMENT ADVISORY SERVICES

Type of Advisory Activity		
Financial planning services	2,997	
Portfolio management for individuals and/or small businesses	6,213	
Portfolio management for investment companies	1,463	
Portfolio management for businesses or institutional clients (other than investment companies)	5,185	
Pension consulting services	1,366	
Selection of other advisers	2,179	
Publication of periodicals or newsletters	652	
Security ratings or pricing services	42	
Market timing services	225	
Other	1,408	

This year's statistics with regard to investment adviser affiliations with financial services industry entities are below:

- 2,573 (30%) are affiliated with broker-dealers¹⁶
- 1,589 (18%) are affiliated with investment companies
- 2,962 (34%) are affiliated with other investment advisers
- 898 (10%) are affiliated with futures commission merchants, commodity pool operators, or commodity trading advisers
- 1,154 (13%) are affiliated with banks or thrifts
- 823 (9%) are affiliated with accountants or accounting firms
- 480 (6%) are affiliated with lawyers or law firms
- 1,767 (21%) are affiliated with insurance companies or agencies

- 600 (7%) are affiliated with pension consultants
- 525 (6%) are affiliated with real estate firms
- 1,256 (15%) are affiliated with sponsors or syndicators of limited partnerships

More than one-third (41% or 3,519) of all investment advisers are independent, *i.e.*, they are not affiliated with any other financial industry entity. Of these firms, 2,590 (30% of all firms) are not only independent, but also are not engaged in any business other than providing investment advisory services. These numbers have increased by approximately one percent since last year.

3,225 advisers (37%) reported that they or their related persons are general partners in an investment-related partnership, or manager of an investment-related LLC or advise a private fund. This represents a two percent increase from last year, perhaps reflecting the SEC's revision to Item 7B of Form ADV, Part 1A to implement the new hedge fund adviser rule and the increasing number of hedge fund advisers that are registering.¹⁷

CLIENTELE OF INVESTMENT ADVISERS

Types of Clients

SEC-registered advisers provide services to various types of clients, including individuals, corporations, charitable organizations, and others. The chart below provides a list of client types requested by Form ADV and shows how each client type is represented in an adviser's overall clientele make-up. For example, corporations represent up to 10% of an adviser's clientele for at least 3,369 advisers (or 39% of advisers). The chart also indicates, among other things, client types that are not generally serviced by a large number of advisers. For example, 7,410 advisers (or 86% of advisers) do not provide advisory services to state or municipal government entities and 7,143 advisers (or 83% of advisers) do not provide advisory services to investment companies.

Percentages of Various Client Types

Types of Clients	None	Up to 10%	11-25%	26-50%	51-75%	More than 75%
Individuals (other than high net worth individuals)	3,259	1,232	907	1,188	1,008	1,020
High net worth individuals	2,369	1,352	1,089	1,413	1,235	1,156
Banking or thrift institutions	7,743	699	77	47	10	38
Investment companies (including mutual funds)	7,143	708	169	131	75	388
Pension and profit sharing plans (other than plan participants)	3,388	3,377	916	477	184	272
Other pooled investment vehicles (e.g. hedge funds)	6,503	904	187	177	108	735
Charitable organizations	4,842	3,176	423	125	29	19
Corporations or other businesses not listed above	4,355	3,369	546	188	56	100
State or municipal government entities	7,410	835	197	88	28	56
Other	7,778	494	119	71	31	121

Number of Clients

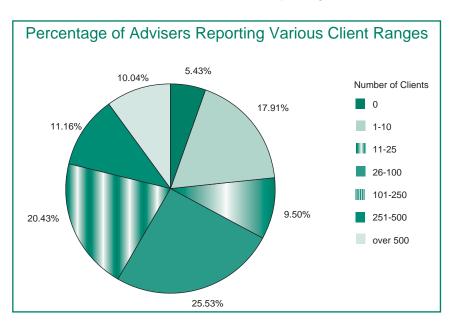
As shown in the following charts, approximately 26% of advisers provide investment advisory services to between 26 and 100 clients. 864 advisers, or approximately 10% of advisers, provide advisory

services to 500 or more clients. Within this group, 116 advisers also provide financial planning services to more than 500 clients, and 325 advisers also act as portfolio managers in wrap fee programs. This highlights that offering financial planning services and wrap fee options may increase a firm's ability to serve a large number of clients. Interestingly, 468 advisers report that they have no clients, but 188 of this group reported having assets under management.

Hedge Fund Advisers

2,111 firms provide advisory services to hedge funds, ¹⁸ an 11% increase from 2004 and a 20% increase from 2003. As in 2003 and 2004, most of this growth has occurred in firms that specialize in hedge fund management (*i.e.*, more than 75% of a firm's clients are represented by hedge funds). There are

now 735 specialist hedge fund advisers, representing a 22% increase over the past year. Interestingly, 77% of these specialist hedge fund advisers indicated that they have between zero and ten clients. Therefore, these advisers may not yet be required to register with the SEC if, in addition to having fewer than 15 clients they do not, among other things, generally hold themselves out as an investment adviser to the public. These firms may have voluntarily registered with the SEC for a number of reasons. For example, some may be registering now in response to new SEC regulations requiring most hedge fund advisers to register with the SEC by



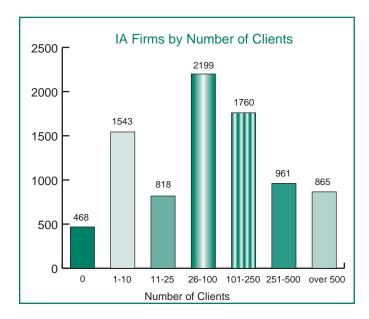
February 2006.¹⁹ Some firms may have found that their institutional hedge fund clients prefer to deal with registered entities. Some may be "holding themselves out" to the public by using the Internet to communicate with prospective investors. The 735 specialist hedge fund advisers provided discretionary management for \$830 billion in client assets (up significantly from \$540 billion in 2004 and \$479 billion in 2003).

Retail and High Net Worth Clients

The percentage of advisers with no retail clients²⁰ increased to 38% (up from last year's 36% and mirroring 2003's numbers). By aggregating the "none" and "up to 10%" client number categories, we conclude that 52% of all advisers have little or no retail business, which is roughly in line with the 2003 and 2004 data (50% in 2004 and 53% in 2003). Only 35 firms reported that they provide services only to retail clients. Approximately 25% of advisers have no individual clients (either retail or high net worth)²¹ while approximately 11% of advisers have only individual clients.

Mutual Funds

1,471 firms reported that they provide advice to investment companies, including mutual funds. This represents 17% of the total number of advisers, continuing a steady decrease from 20% in 2002, 19% in 2003 and 18% in 2004. The number of firms advising mutual funds has also decreased slightly in an absolute sense. While the media typically equates investment advisers with large mutual funds, nothing could be further from reality. The vast majority of investment advisers are small businesses that have nothing to do with mutual funds.



Compensation

Approximately 94.5% of all advisers charge fees based on the amount of assets under management. This represents a 0.5% increase from each of the past three years. However, advisers also increasingly charge hourly fees (34% in 2005, 33% in 2004, 32% in 2003, and 31% in 2002) and fixed fees (42% in 2005, 41% in 2004, 39% in 2003, and 37% in 2002). The percentage of advisers charging performancebased fees has risen from 24% in 2002 and 2003 and 25% in 2004 to approximately 26% in 2005, which may reflect the increasing number of hedge fund advisers. The number of advisers who use commissions as compensation for advisory services has declined to 11% from 12% in 2002-2004, perhaps reflecting the popularity of fee-based programs at firms dually registered as brokers and advisers.

Participation or Interest in Client Transactions

Form ADV, Part 1A requests information about an investment adviser's participation or interest in client transactions. However, because the questions solicit responses regarding the adviser or any of its related persons, it is impossible to determine whether the responses apply to the specific entity filing the form or whether they apply to the firm's advisory affiliates and any person under common control with the adviser. The percentages of firms reporting affirmatively regarding proprietary or sales interest in client transactions and investment or brokerage discretion have remained fairly steady over the last few years.

Soft Dollars

The only question in Part 1A that directly relates to soft dollars is: "Do you or any related person receive research or other products or services other than execution from a broker-dealer or third party in connection with client securities transactions?"²² Responses from advisers reveal certain anomalous results, indicating confusion about the meaning of this question.

4,989 of all advisers (58%) reported receiving research or other products other than execution in connection with securities transactions. Frankly, we are skeptical that 42% of advisers do not receive *any* non-execution products or services from brokers. Even considering that only 5,729 advisers have discretion to determine the broker or dealer to be used for a client's transactions, ²³ 1,799 of these advisers report that they do not receive products or services in connection with such transactions. We suspect that many advisers may not consider receipt of bundled proprietary products to require an affirmative answer to the question.

In addition, 242 advisers reported that they do not have discretionary authority over client accounts but do receive research and products in connection with securities transactions. Similarly, 1,059 advisers reported they do not have discretion to select the broker to be used for a transaction, but do receive products and services in connection with transactions. Presumably, when the client selects the broker, the adviser is not "paying up" for such products or services but is receiving them gratis or as part of an institutional platform.

If the SEC is interested in more accurate information regarding the use of soft dollars, it should, we respectfully submit, consider substituting a more precise question, adding an instruction to the Form, or providing additional guidance to advisers.

Proprietary Interest in Client Transactions

- 8% of advisers or their related persons engage in principal transactions (*i.e.*, buying securities from an advisory client or selling securities the adviser owns to a client).
- 73% of advisers or their related persons buy or sell securities (other than mutual fund shares) they also recommend to clients (personal or proprietary trading). Considering that 8,193 (95%) advisers report providing continuous asset management services, 73% appears to be a significant under reporting, or a reflection that advisers have implemented very strict restrictions on personal trading by supervised persons.
- 25% of advisers or their related persons recommend securities in which the advisory firm or a related person has some other proprietary interest.

Sales Interest in Client Transactions

- 8% of advisers or their related persons engage in agency cross transactions.
- 22% recommend securities to clients where the advisory firm or a related person serves as underwriter, general or managing partner, or purchaser representative of the issuer.
- 13% recommend securities to clients for which the firm or a related person has any other sales interests (other than commissions as a broker).²⁴

Investment Discretion or Brokerage Discretion

- 7,438 (86%) investment advisers or their related persons have discretionary authority to select securities to be bought or sold for a client's account.
- 7,434 (86%) have discretionary authority to determine the amount of securities to be bought or sold for a client's account.
- 5,729 (67%) have discretionary authority to select brokers.
- 5,140 (60%) have discretionary authority to determine the commission rates paid to brokers. The disparity with the preceding data may indicate that some advisers do not understand what is meant by the phrase "discretion to determine."
- 5,906 (69%) investment advisers or related persons recommend brokers or dealers to clients.
- 4,989 (58%) receive research or other products or services other than execution from a broker or third party in connection with securities transactions (*e.g.*, soft dollars).
- 3,916 (45%) directly or indirectly compensate employees or third parties for client referrals.

CUSTODY

Under a revised SEC rule effective April 1, 2004,²⁵ all advisers holding "directly or indirectly, client funds or securities or having any authority to obtain possession of them" are required to report having custody. The new rule labels those advisers as having custody who act as trustees for clients, have general power of attorney (including check writing authority), and act in any capacity that gives the adviser legal ownership of, or access to, the client funds or securities (including a firm that acts as both a control person and investment adviser to a hedge fund). Advisers who directly debit fees from client accounts are not required to report in Form ADV that they have custody.²⁶

This rule change contributed to a 57% rise from 2003 to 2004 in the number of advisers that reported having custody of client funds. The trend continued with an additional 23% rise from 2004 to 2005. Some of the continued rise may be attributable to the increase in the number of hedge fund advisers from 2004 to 2005, as discussed earlier.

In 2005, 1,642 (19%) (vs. 1,330 in 2004) advisers reported that they have custody of client funds. 1,557 (18%) (vs. 15% in 2004) have custody of client securities. 1,444 (17%) (vs. 15% in 2004) advisers have related persons with custody of client funds while 1,388 (10%) (vs. 12% in 2004) have related persons with custody of client securities. Of the advisers reporting related persons who have custody, 382 report that the related person who has custody is a broker-dealer, which is a small drop from 2003 and 2004 (392 both years).

DISCIPLINARY INFORMATION

It is difficult to draw meaningful conclusions from the disciplinary disclosure information provided in Form ADV, Part 1A for several reasons. The details contained in the disciplinary disclosure reporting pages have not been made available to us in aggregate form from IARD filings. Also, the information is reported for the advisory firm and its employees, officers, directors, and advisory affiliates for the past ten years, whether or not these persons or entities were affiliated with the firm during that time. Thus, the information reported does not necessarily reflect the actions of the firm actually filing the Form ADV. The same disciplinary event at one firm may be reported by multiple separate affiliates. Also, the same disciplinary event may generate affirmative answers to several different questions. It is thus impossible from the current data to discern an accurate number or analysis of the separate events reported.

Subject to these limitations, we make the following observations:

- 7,205 (83.6%) registered investment advisers reported no disciplinary history at all, up one-half percent from last year and up 305 firms since last year. This increase may reflect the new firms registering with the SEC, which presumably start with a clean slate.
- 1,409 (16.4%) firms reported at least one answer in the affirmative to the disciplinary questions, either related to them or to an advisory affiliate. Of these firms, 139 advisers reported only pending charges, with no final outcomes, down slightly from 150 last year. This decrease may be related to resolution of previously pending charges in the mutual fund late trading/market timing cases. Further, despite increased press attention regarding lawsuits against investment management firms, the number of firms reporting pending civil proceedings decreased slightly on both an absolute and percentage basis (from 210 firms in 2004 to 206 in 2005).

On a percentage basis, the number of firms responding affirmatively to the disciplinary questions has remained quite steady compared with last year, with modest increases in absolute numbers responding affirmatively. This shows a leveling off of disciplinary events from the steady decreases in prior years. In addition, the questions listed below generated by far the most "yes" responses, consistent with the past two years:

- Has any federal, state, or foreign regulatory agency (other than the SEC or CFTC) found you or any advisory affiliate to have been involved in a violation of investment-related regulations or statutes? 646 "yes" responses (7.5% in 2005 vs. 7.5% in 2004, 7.9% in 2003, and 8.2% in 2002)
- Has any federal, state or foreign regulatory agency (other than the SEC or CFTC) entered an order against you or any advisory affiliate in connection with an investment-related activity? 571 "yes" responses (6.6% in 2005 vs. 6.6% in 2004, 7.5% in 2003, and 7.9% in 2002)
- Has any self-regulatory organization or commodities exchange found you or any advisory affiliate to have been involved in a violation of its rules? 558 "yes" responses (6.5% in 2005 vs. 6.5% in 2004, 7% in 2003, and 7.3% in 2002)
- Has the SEC or CFTC found you or any advisory affiliate to have been involved in a violation of SEC or CFTC regulations or statutes? 341 "yes" responses (4% in 2005 vs. 4% in 2004, 4.4% in 2003, and 4.9% in 2002)

BASIS FOR SEC REGISTRATION

The vast majority of advisers (7,379, or 86% of reporting advisers) qualified for SEC registration because they manage more than \$25 million in client assets. This represents an increase of 419 advisers in this category from the previous year, a number larger than the total increase of 312 SEC-registered advisers. Presumably, at least some previously registered advisers also increased their assets under management and amended their registration status to rely on this most common qualification for SEC registration. In addition, 200 (2%) firms that manage more than \$25 million chose to qualify for SEC registration on a different basis than their assets under management. Only 12% of reporting SEC-registered advisers (1,035 firms) reported less than \$25 million under management and were required to register on other bases.²⁷ Although 1,198 firms selected more than one basis for SEC registration on Form ADV, firms need only select one.

After decreasing 14% from 1,122 advisers in 2003, the number of advisers registered on the basis that they serve as an investment adviser to a registered investment company remained at exactly 1,106 (13%) from 2004 to 2005.

The number of newly formed advisers who registered with the SEC – based on the expectation that they will qualify for SEC registration within 120 days of becoming registered – fell off for the first time in five years. After rising successively from 86 (2001) to 109 (2002) to 169 (2003) and to 199 (2004), the number declined significantly by 31% to 137 in 2005. While the total number of SEC-registered advisers increased in 2005, perhaps the effect of new SEC rules increasing compliance burdens have begun to create barriers to entry in the industry for new, start-up firms.

The number of advisers indicating that they are no longer qualified for SEC registration declined by 12% to 102 from the same time last year, which continues a downward trend from a peak of 148 in 2003. Advisers registered based on their locations in the U.S. Virgin Islands²⁸ or Wyoming declined 15%. Advisers registered based on common control and location with another SEC-registered adviser decreased by 10% from 462 to 418. Multi-state advisers and nationally recognized statistical rating organizations showed small declines.

Last year, we surmised that the number of Internet-based advisers had apparently risen from 7 in 2003 to 17 in 2004 – a 143% increase.²⁹ The number increased another significant 47% from 17 in 2004 to 25 in 2005. This number now surpasses for the first time the SEC's stated estimate of 20 such advisers cited in its rule release adopting the exemption in 2002.³⁰

This year's statistics on advisers' selection for the basis of registration with the SEC are as follows:

- 7,379 selected assets under management of \$25 million or more (an increase of 419 advisers from 2004 to 2005)
- 64 selected principal office and place of business in U.S. Virgin Islands or Wyoming (a decrease of 11 advisers)
- 328 selected principal office and place of business outside the U.S. (an increase of 9)
- 1,106 selected adviser to registered investment company (no change)
- 5 selected nationally recognized statistical rating organization (a decrease of 1)
- 319 selected pension consultant (an increase of 2)³¹
- 418 reported that the investment adviser controls, is controlled by, or is under common control
 with an SEC-registered investment adviser with the same principal office and place of business
 (a decrease of 44)
- 137 selected newly formed adviser expecting to be eligible within 120 days (a decrease of 62)
- 44 selected multi-state adviser (a decrease of 5)
- 25 selected Internet-based adviser (an increase of 8)
- 7 selected SEC exemptive order (an increase of 1)
- 102 reported they are no longer eligible for SEC registration (a decrease of 14)

ENDNOTES

- ¹ Pursuant to a variety of exemptions, certain types of advisers that do not manage in excess of \$25 million are permitted to register with the SEC (e.g., advisers to mutual funds, Internet advisers, multi-state advisers, and pension consultants).
- Approximately 12,000 of the estimated 15,000 or more state-registered advisers have filed Form ADV, Part 1 on the IARD system, which is an increase of 1,000 from last year. 199 firms registered both with the SEC and at least one state.
- More than 89% of all SEC-registered investment advisers have a December 31 fiscal year-end.
- It appears that only 7,676 of the 8,614 investment adviser firms filed Form ADV with the SEC in both 2004 and 2005. This suggests that there is more than triple the number of new firms (938) than the 312 suggested by first glance at the data (subtracting 8,302 from 8,614). Of course, some of these "new" firms may have simply reorganized under a new name and registration number.
- Some Orthogonal Many later simply later simply later and the later than the later and legislation later. See Certain Broker-Dealers Deemed Not to be Investment Advisers, Rel. No. IA-2376, n. 229, 230-240 (Apr.19, 2005) (estimating that approximately (i) 100 broker-dealers will be required to register under the Advisers Act as a consequence of holding themselves out as financial planners; and (ii) 95 broker-dealers will be required to register under the Advisers Act as a consequence of continuing to maintain discretionary accounts).
- ⁶ See Speech by Commissioner Paul S. Atkins before the California '40 Acts Institute (Apr. 27, 2005) (noting risk-based approach to exams is an attempt to allocate the Commission's resources more wisely, given the growing number of advisers and funds it oversees).
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 The AUM reported by investment advisers in all three categories (discretionary, non-discretionary and total) overstates actual AUM because more than one investment adviser can "claim" the same AUM. For example, an adviser that allocates assets among mutual funds on a discretionary basis will report a subset of the same assets that the advisers to these funds report. Similarly, a sub-adviser to a fund may count the same AUM as the primary manager of the fund. We do not know, however, the extent to which AUM figures are overstated.

 Advisers managing more than \$100 billion reported discretionary AUM of \$1.1.197 trillion in 2005 and \$9.607 trillion in 2004. Advisers managing \$50 \$100 billion reported discretionary AUM of \$3.337 trillion in 2005 and \$2.648 trillion in 2004. Advisers managing between \$10 billion reported discretionary AUM of \$5.598 trillion in 2005 and \$5.035 trillion in 2004. Advisers managing between \$1 50 billion reported discretionary AUM of \$1.354 trillion in 2005 and \$1.306 trillion in 2004. Advisers managing between \$1 5 billion reported discretionary AUM of \$1.778 trillion in 2005 and \$1.602 trillion in 2004. Advisers managing between \$100 million 1 billion reported discretionary AUM of \$871 billion in 2005 and \$791 billion in 2004. Advisers managing \$25 100 million reported discretionary AUM of \$7.10 billion in 2005 and \$7.58 billion in 2004. Advisers managing less than \$25 million reported discretionary AUM of \$7.10 billion in 2005 and \$7.58 billion in 2004. billion in 2004.
- The assets managed by large firms are even more concentrated than they first appear in the statistics. For example, several of the 53 firms that manage more than \$100 billion in discretionary assets are affiliated with other firms in this category. Indeed there are at least 3 separately-registered entities affiliated with one another in this category alone that each manage more than \$100 billion.
- The percentage of firms reporting total AUM in the \$25-100 million range decreased by .9% (36.5% of firms in 2004 to 35.6% in 2005), also reflecting the trend of growth of assets to higher ranges in 2005.
- 11 For example, firms that are Internet investment advisers or that have their principal place of business in Wyoming or outside the U.S. are eligible for SEC registration even if they have less than \$25 million in assets under management. See Investment Adviser Act section 203A(a) and rule 203A-2(f).

 12 2,295 firms have no individuals listed on Form ADV, Schedule A as owners (that is, any individuals listed on these firms' Schedule A indicate
- "NA" in the Ownership Code field). Accordingly, 6,381 have at least one individual that owns at least 5% of the firm.

 13 Approximately 17% of these advisers have qualified for SEC registration because they control, are controlled by, or are under comon control
- ¹³ Approximately 17% of these advisers have qualified for SEC registration because they control, are controlled by, or are under comon control with an SEC-registered adviser and have the same principal office and place of business. *See* rule 203A-2(c).

 ¹⁴ The way this question is phrased on Form ADV, only advisers organized as sole proprietorships could correctly answer that they are also registered representatives of a broker-dealer. The large number of responses to this question indicates that most of the advisers checking this response did not understand the question. It is likely that these advisers have employees who are registered representatives of a broker-dealer.

 ¹⁵ "Related persons" include the adviser's officers, partners, directors, employees (other than those performing clerical, administrative, or support), and persons (including entities) directly or indirectly controlling or controlled by the adviser or under common control with the adviser.

 ¹⁶ This percentage may be overstated as independent advisers who employ registered representatives of a broker dealer may be mistakenly checking this item. checking this item.
- checking this item.

 To Form ADV, Part 1A, Item 7B. The SEC changed Item 7B on the IARD in mid-March 2005 to include advisers to "private funds" (i.e. hedge funds). Because the SEC wanted all advisers to respond to the newly crafted question, all previous answers to 7B were deleted to make sure all advisers submitting Form ADV after March 2005 answered the revised question. The 3,225 figure was provided by NASD as of May 25, 2005 and was derived from adding the 2,328 advisers who submitted a revised Form ADV after mid-March 2005 to answer "yes" to this new question to the 897 advisers who submitted Form ADV prior to March 2005 and had answered "yes" to the old question but have not since amended the Form. The 3,225 figure may be understated because it does not account for firms that had previously answered "no" but will be required to answer "yes" to the part time they are not form ADV. "yes" the next time they amend Form ADV.

 18 Form ADV, Part 1A, Item 5D(6).
- In December 2004, the SEC issued a release adopting a new rule and rule amendments under the Investment Advisers Act of 1940 requiring hedge fund and certain other private fund advisers to register as investment advisers. Generally, the final rule requires hedge fund advisers with more than 14 investors and \$30 million or more under management to register with the SEC. Under the new rule, advisers will no longer be able to count a hedge fund as a single client. Instead, the new rule requires advisers to look through a hedge fund and count the investors in the fund as
- ²⁰ As defined in Form ADV, Part1A, Item 5D, retail clients are individuals other than high net worth individuals, i.e., individuals with less than \$750,000 managed by the adviser or less than \$1.5 million net worth.

 These figures include the 233 advisers that marked the "none" response for every type of client listed in Item 5D, including "other".
- ²² Form ADV, Part 1A, Item 8E.
- ²³ Form ADV, Part 1A, Item 8C(3).
- ²⁴ It has been our experience that some advisers are confused by the "other" proprietary interest and "other" sales interest questions. It is possible, therefore, that the percentage of advisers with "other proprietary interests" (25%) and with "other sales interests" (13%) in client transactions may be understated.
- The amendments to rule 206(4)-2 under the Investment Advisers Act of 1940 are described in Final Rule: Custody of Funds and Securities by Investment Advisers, Rel. No. IA-176 (Sept. 25, 2003).
- ²⁶ While the SEC considers advisers who directly debit fees from client accounts to have custody, these advisers are not required to state that they have custody when answering Item 9 on Form ADV.
- ²⁷ See n.1 supra ²⁸ The U.S. Virgin Islands now has a statute under which entities may register as an investment adviser. Therefore, advisers located in the U.S.
- Virgin Islands may no longer use their location as a basis for federal registration.

 2º 2004 was the first year in which Form ADV included a newer qualification for advisers who provide advice primarily through the Internet. In 2003, before Form ADV was updated, Internet-based advisers were required to state that they qualified for SEC registration by virtue of an SEC exemptive order. The increase in Internet advisers in 2004, therefore, was calculated based on the decrease of advisers relying on the SEC exemptive order category from 2003 to 2004.
- of Final Rule: Exemption for Certain Investment Advisers Operating through the Internet, Rel. No. IA 2091(Dec. 20, 2004).

 In May 2005, the SEC staff issued a report regarding pension fund consultants indicating there are 1,742 SEC-registered investment advisers who provide pension consulting services. The SEC staff chose 24 advisers, who are also pension consultants, to examine for purposes of the report. Our data indicating there are 1,427 advisers reporting they provide pension consulting services appears to be inconsistent with the SEC staff's report. Perhaps the SEC staff derived its figure from some combination of this pool and the 319 advisers that registered as advisers on the basis of acting as a pension consultant. See Staff Report Concerning Examinations of Select Pension Consultants (May 16, 2005).