Evolution Revolution

A Profile of the U.S. Investment Advisory Profession

July 2001

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Investment Counsel Association of America

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Introduction

We trust the following overview of the SEC-registered investment advisory profession will prove both informative and thought provoking. This profile of the advisory profession represents the combined efforts of National Regulatory Services (NRS)[1] and the Investment Counsel Association of America (ICAA).[2] The source material for the compilation of this profile was derived from filings made by SEC-registered investment advisers via the Investment Adviser Registration Depository (IARD) earlier this year and compiled using NRS' IA-Info system.

Last year, the U.S. Securities and Exchange Commission issued new rules overhauling Form ADV, the basic registration and disclosure document that all registered investment advisers must file. These rules also required advisers to make filings of the revised Part 1 of Form ADV on a new electronic filing system, the IARD. This marked the culmination of years of effort by the SEC, state regulators, and others to transform a cumbersome, outdated, paper-based program into an efficient, electronic, Internet-based system.

The new system should yield major benefits to both the advisory profession and the investing public. For the first time, members of the public will be able to access, free of charge, through the Internet, important information drawn from regulatory filings that advisers are required to make through the IARD.[3] In addition, the substantial revamping of Form ADV should make the information provided by advisers more relevant and understandable for investors. And the IARD promises to ease regulatory burdens for advisers by permitting "one-stop" electronic filing to satisfy SEC as well as state filing requirements.

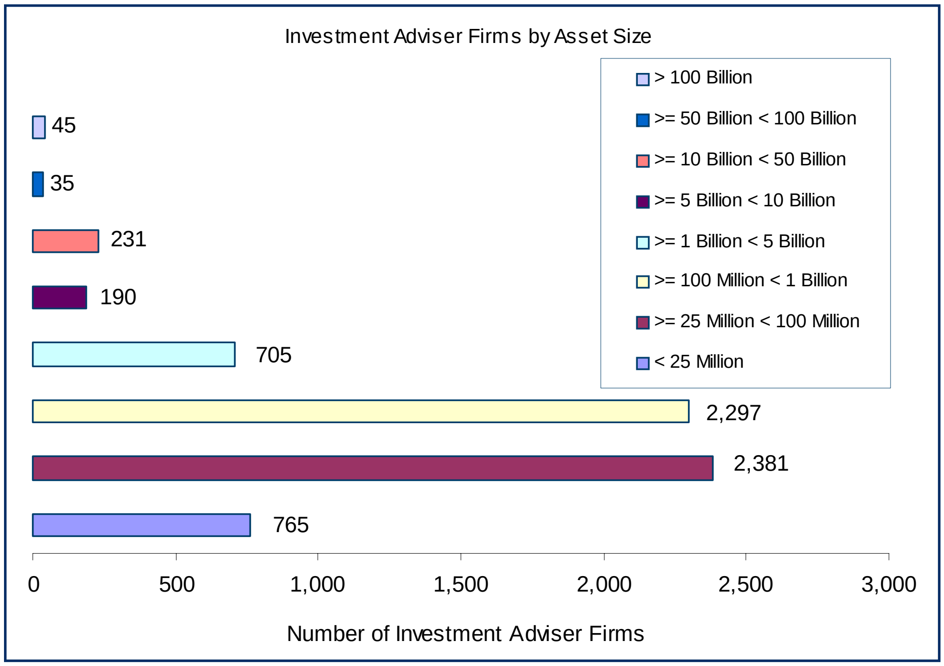
All SEC-registered investment advisers were required to submit Part 1 of Form ADV using the IARD between January and April 2001. Using data obtained from the SEC from these first-ever filings, this report provides a snapshot – and an initial benchmark – of the current state of the U.S. investment advisory profession. We note, however, that this report captures information relating only to one-third of all registered investment advisers in the U.S. The other two-thirds are state-registered advisers, the vast majority of which are not required by the states to file on the IARD.[4] While there is some movement toward mandating IARD filing by state-registered advisers, it is unfortunate that progress in this area to date has been slow.

Admittedly, any data gleaned from the IARD is only as reliable as the accuracy of the information contained on Form ADV, Part 1 that is filed on the system. For example, approximately 159 investment advisers reported that *none* of their employees perform investment advisory functions. While this is conceivably correct, it runs contrary to certain assumptions that most observers would entertain about the advisory profession. Other aggregated responses of dubious validity may come to light as IARD information becomes more widely disseminated. However, given the sheer complexity of completing a new form while also negotiating the technological shoals of operating in the new IARD virtual filing environment, some initial problems were inevitable. We trust that more accurate data will be forthcoming with further experience and exposure to the brave new world of the IARD.

On the whole, the initial aggregate IARD data are extremely helpful in outlining some core characteristics of a diverse and rapidly evolving profession. Profound developments are revolutionizing the investment advisory business. Consolidations, globalization, and technology are transforming what was once a relatively stable and low profile profession. The data from the IARD will enable us to monitor and evaluate developments that will shape the advisory profession in the coming years. Accordingly, it is critical that the SEC continue to make available all information filed on the IARD (other than private information such as social security numbers) to allow for further analysis and dissemination of aggregate data by the private sector.

The IARD will provide unprecedented real-time access to more people regarding more information about investment advisers. Whatever shortcomings may exist in this initial data, it is clear beyond dispute that the advisory profession is becoming increasingly transparent and that it will be the subject of greater scrutiny by the investing public, the regulators, the media, and members of the profession. National Regulatory Services and The Investment Counsel Association of America are pleased to present our preliminary findings from this important new source of data.

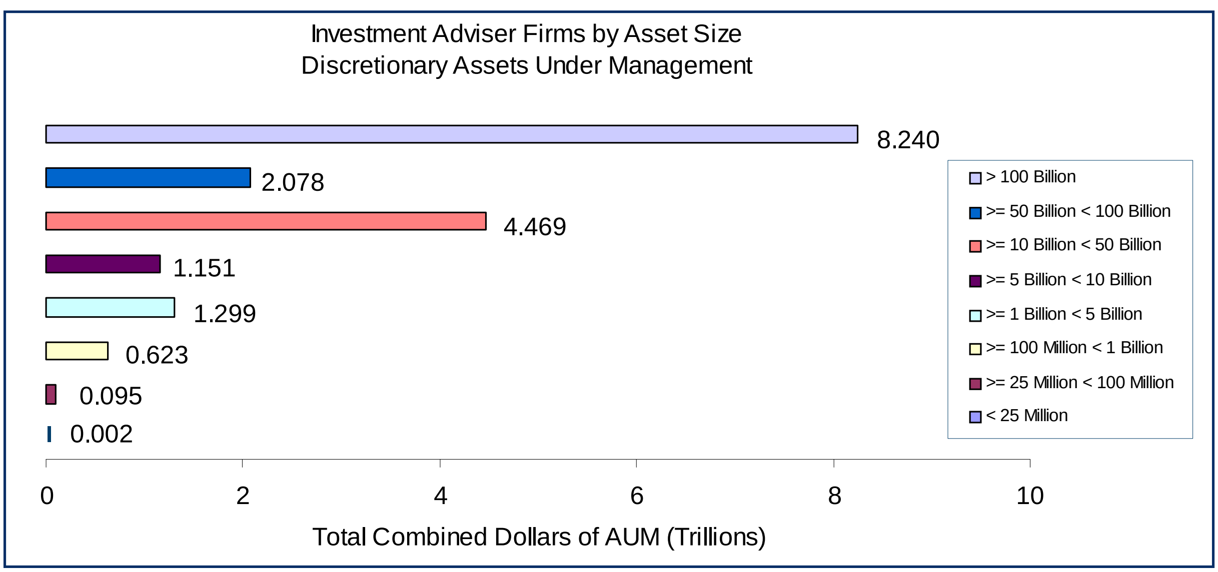
To date, 6,649 investment advisers have submitted Form ADV, Part 1 to the SEC using the IARD.[5] This number of SEC-registered investment advisers reflects modest growth in the profession from the 6,360 advisers reported by the SEC in 1999.[6] However, it is likely that the profession may well have experienced more substantial growth during this period as more than 650 advisers have applied for IARD accounts but have not yet filed Form ADV electronically.[7]



As would be expected, virtually all advisers - 95% - reported that they provide continuous and regular supervisory services to securities portfolios.

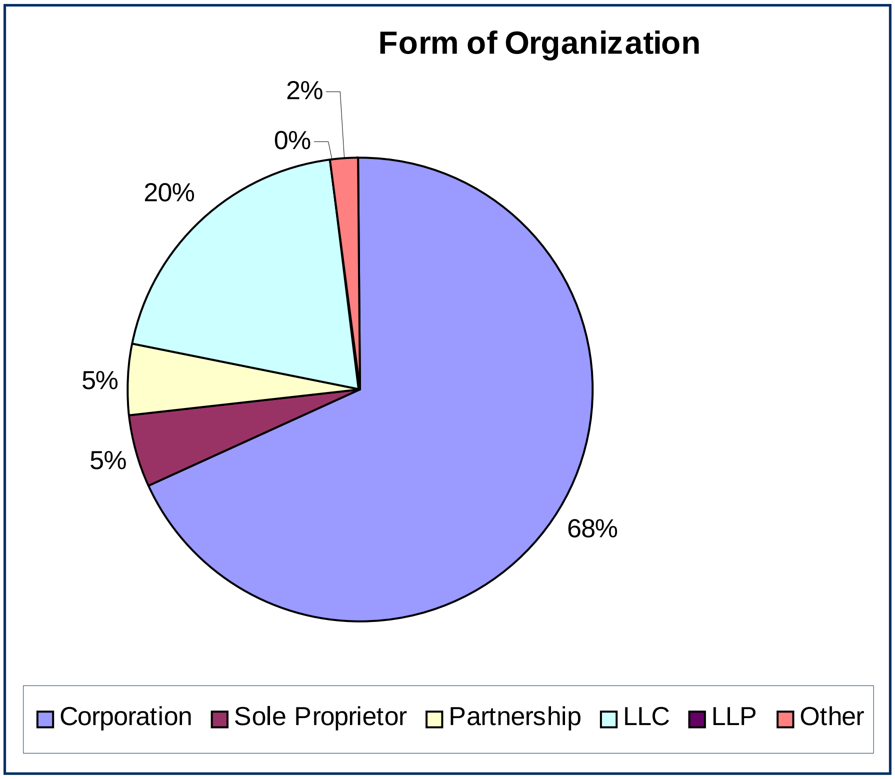
Nearly 50% of all registered investment advisers have discretionary assets under management of less than $100 million. The total discretionary assets managed by these firms are $97.5 billion. 2,297 (35%) firms manage between $100 million and $1 billion, managing aggregate discretionary assets of $623 billion. 895 (13%) advisers manage between $1 billion and $10 billion for a total of $2.45 trillion in discretionary assets.

The remaining 311 (5%) largest firms manage $14.787 trillion of the reported $17.957 trillion in total discretionary assets under management, representing 82% of all discretionary assets reported.[8] This tends to reinforce the perception that a small fraction of the advisory profession manages a disproportion-ately large piece of the available asset pie.



Form of Organization

As represented in the pie chart, the vast majority of investment adviser firms are organized as corporations – 4,538 (68%). A relatively new form of organization, the limited liability company (LLC), offers a user-friendly alternative to small business owners. Statistically, 20% of SEC-registered investment adviser firms are organized as a LLC business, confirming a recent growth in this sector. Nearly 6% of investment adviser firms are registered with a foreign financial regulator.



Employees

Most investment advisory firms are relatively small in size. 3,092 (46.5%) firms reported that they have only one to five employees.[9] 1,297 (19.5%) investment advisers reported having between six and ten employees. While the profession has been populated by "small shops" since its inception, the downstreaming of information technology and information services to small businesses over the last decade has served to maintain, if not extend, this demographic. Thus, 66% of all registered investment advisers have ten or fewer employees. On the other end of the range, 239 (3.6%) investment advisory firms employ more than 250 persons, 86 of which employ more than 1,000 persons.

EMPLOYEES OF INVESTMENT ADVISER FIRMS

Number of Employees	# of IA Firms containing "x" number of employees	# of IA Firms whose employees perform investment advisory functions	# of IA Firms whose employees are registered representatives of a broker-dealer
0		159	3,721
1 to 5	3,092	4,226	1,794
6 to 10	1,297	1,037	401
11 to 50	1,510	906	470
51 to 250	511	231	151
251 to 500	81	45	33
501 to 1,000	72	23	33
More than 1,000	86	22	46

Curiously, as shown in the chart, 159 advisers reported that *none* of their employees perform investment advisory functions; 4,226 (64%) firms have one to five employees who perform investment advisory functions; 1,037 (16%) advisers employ between six and ten individuals who perform investment advisory functions. On the other hand, only 45 (.7%) firms have more than 500 employees performing investment advisory functions; 3,721 (56%) investment advisers do not employ any individuals who are registered representatives of a broker-dealer; 1,794 (27%) employ between one and five individuals who are registered representatives. Out of 79 (1%) firms who employ more than 500 registered representatives, only 62 are dually registered.

Solicitors

The data reveal a broad range of third-party marketing practices by advisory firms; 4,225 (64%) of investment advisory firms do not use the services of third-party solicitors in any fashion; 1,976 (30%) investment advisers have between 1 and 5 firms or persons soliciting on their behalf. On the other end of the spectrum, only four firms reported that they retain more than 1,000 third-party solicitors.

Advisory Activities

The IARD data also illustrate the growth in wrap fee programs. Approximately 11% of investment advisers act as portfolio managers for wrap fee programs; 310 advisers (5%) act as sponsors of wrap programs, of which only 158 reported themselves to be dual registrants. 144 investment adviser firms reported that they both sponsor wrap fee programs and serve as portfolio managers for such programs.

INVESTMENT ADVISORY SERVICES

Type of Advisory Activity[10]	# of IA Firms providing advisory services
Financial planning services	2,169
Portfolio management for individuals and/or small businesses	4,987
Portfolio management for investment companies	1,363
Portfolio management for businesses or institutional clients (other than investment companies)	4,044
Pension consulting services	955
Selection of other advisers	1,320
Publication of periodicals or newsletters	463
Security ratings or pricing services	32
Market timing services	200
Other	855

Other Business Activities

A significant number of registered investment advisers are involved in non-advisory business activities: 588 (9%) investment advisers are dually registered as broker-dealers; 778 (12%) advisers are also registered representatives of a broker-dealer[11]; 290 (4%) investment advisers are registered as a futures commission merchant, commodity pool operator, or commodity-trading adviser; 826 (12%) investment advisers are also insurance brokers; 73 (1%) investment advisers are either a bank or a separately identifiable department or division of a bank (SID); 1,582 (24%) advisers sell products or provide services other than investment advice to advisory clients. Of note, 72% of all advisory firms indicated that they are engaged in business *solely* as an investment adviser.

Financial Services Industry Affiliations

The IARD data confirms the accelerating trend toward affiliation of investment advisers with other entities:

- 2,371 (36%) are affiliated with broker-dealers.
- 1,385 (21%) are affiliated with investment companies.
- 2,338 (35%) are affiliated with other investment advisers.
- 711 (11%) are affiliated with futures commission merchants, commodity pool operators, or commodity trading advisers.
- 957 (14%) are affiliated with banks or thrifts.
- 503 (8%) are affiliated with accountants or accounting firms.
- 332 (5%) are affiliated with lawyers or law firms.
- 1,379 (21%) are affiliated with insurance companies.
- 422 (6%) are affiliated with pension consultants.
- 374 (6%) are affiliated with real estate firms.
- 781 (12%) are affiliated with sponsors or syndicators of limited partnerships.

Consistent with the foregoing data regarding affiliations, less than half (39%) of all investment advisers are independent, *i.e.*, they are not affiliated with any other financial industry entity. Of these firms, 2,169 (33%) are not only independent, but also are not engaged in any business other than investment advisory services.

Also of interest, 2,129 advisers (32%) reported that they or their related persons are general partners in an investment-related limited partnership or manager of an investment-related LLC.[12] This response data may reflect the apparent proliferation in hedge fund investment partnerships in recent years.

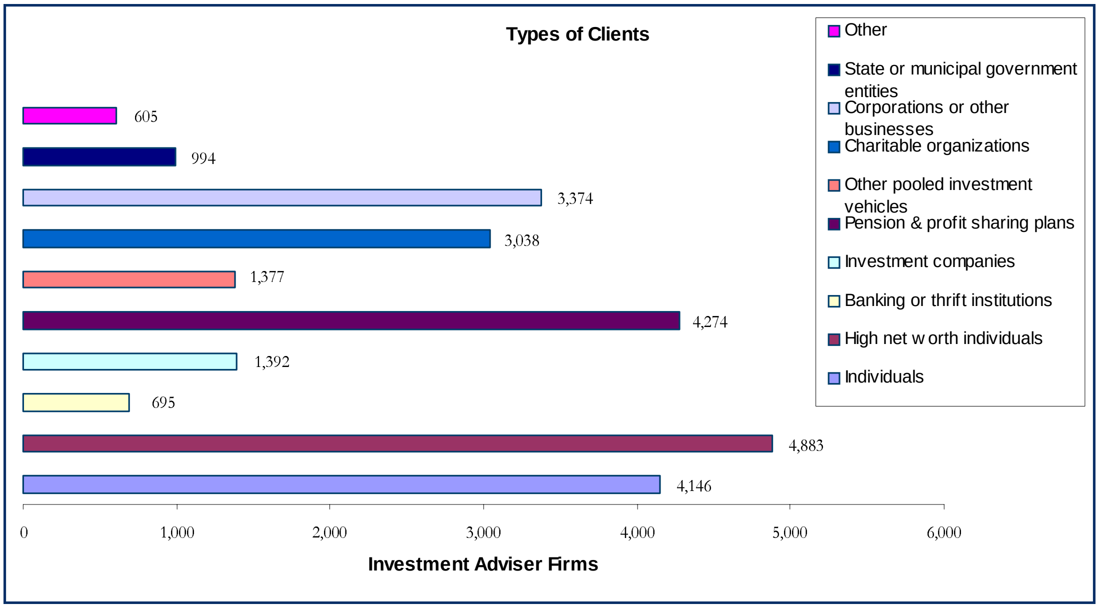
Clientele of Investment Advisers

Percentages of Various Client Types

Types of Clients[13]	None	Up to 10%	11-25%	26-50%	51-75%	More than 75%
Individuals (other than high net worth individuals)	2,503	1,026	693	831	776	820
High net worth individuals	1,766	1,135	864	1,083	910	891
Banking or thrift institutions	5,954	531	65	44	10	45
Investment companies (including mutual funds)	5,257	644	171	121	55	401
Pension and profit sharing plans (other than plan participants)	2,375	2,534	864	467	184	225
Other pooled investment vehicles (e.g. hedge funds)	5,272	710	141	128	69	329
Charitable organizations	3,611	2,498	377	129	18	16
Corporations or other businesses not listed above	3,275	2,638	408	183	49	96
State or municipal government entities	5,655	690	146	88	31	39
Other	6,044	361	90	46	21	87

Of the ranges available in Form ADV to select for number of clients, the most prevalent category chosen by advisers was 26-100 clients, reported by 28% of advisers. 631 firms (9%) had more than 500 clients. Out of these 631 firms, 210 indicated that individuals comprised more than 75% of their total number of clients. Approximately 17% of advisers had only 1 to 10 clients. Curiously, 251 investment advisory firms reported that they had *no* clients during the most recently completed fiscal year. However, out of the 251 firms with zero clients, 67 claimed having assets under management.

The chart of the types of clients served by investment advisers reflects the diversity of advisory businesses. Fully 38% of all SEC registrants have *no* retail clients[14]. Including the up to 10% category, 53% of investment advisers have little or no retail business. Approximately 23% of advisers have no individual clients at all – either retail or high net worth. On the other hand, 634 (9.5%) indicated that they have *no* institutional clients. Of note, 1,392 (21%) investment advisers reported that they provide advisory services to investment companies (mutual funds).



Compensation

Virtually all investment advisers - 95% - are compensated for at least some of their investment advisory services to clients based on a percentage of assets under management. Approximately 30% of firms also provide services based on hourly charges. 36% offer fixed fee arrangements. Most notably, only 12% are compensated in any way based on commissions. Finally, 23% of investment advisers have performance-based fee arrangements with at least some clients.

Participation or Interest in Client Transactions

Form ADV, Part 1 requests information about an investment adviser's participation or interest in client transactions. Because the questions solicit responses regarding the adviser or any of its related persons (the firm's advisory affiliates and any person under common control with the adviser), it is difficult to determine whether the responses apply to the specific entity filing the form.[15] The data, however, can be used as a benchmark to measure general trends in the future.

Proprietary Interest in Client Transactions

- 9% 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).
- 71% of advisers or their related persons buy or sell securities they also recommend to clients (personal or proprietary trading).
- 23% recommend securities in which the advisory firm or a related person has an interest.

Sales Interest in Client Transactions

- 10% of advisers or their related persons engage in agency cross transactions.
- 19% recommend securities to clients where the advisory firm or a related person serves as underwriter, partner, or purchaser representative of the issuer.
- 11% recommend securities to clients for which the firm or a related person has any other sales interest (other than commissions as a broker).

Investment or Brokerage Discretion

- 5,699 (86%) investment advisers or related persons have discretionary authority to select securities to be bought or sold for a client's account.
- 5,687 (86%) have discretionary authority to determine the amount of securities to be bought or sold.
- 4,496 (68%) have discretionary authority to select brokers.
- 4,097 (62%) have discretionary authority to determine the commission rates paid to brokers.
- 4,289 (65%) have discretionary authority to determine the broker or dealer that will be used.
- 3,858 (58%) receive research or other products or services other than execution from a broker or third party in connection with securities transactions (*i.e.* soft dollars).
- 2,851 (43%) compensate employees or third parties for client referrals.

Custody

The IARD data confirm that the vast majority of SEC-registered advisers do not have custody of client accounts or securities. 735 (11%) advisers reported that they have custody over client cash or bank accounts.[16] 674 (10%) advisers reported that they have custody over client securities. 186 dually registered firms reported that they have some type of custody.

In addition, 13% of investment advisers have related persons that have custody over their clients' cash, bank accounts or securities. 41% of these related persons are registered broker-dealers.

Disclosure Information

It is difficult to draw meaningful conclusions from the disclosure information provided in Form ADV, Part 1 for several reasons. The details contained in the disclosure reporting pages have not been made available to us. Also, the information is reported for the advisory firm *and* its employees, officers, directors, and affiliates for the past ten years, whether or not 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 the number of separate events reported.

Nevertheless, we have the following observations:

- 5,402 (81%) registered investment advisers reported no disciplinary history at all.
- 1,247 (19%) 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, 78 advisers reported only pending charges, with no final outcomes.

The questions that generated by far the most "yes" responses were:

- 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? (573 "yes" responses)
- 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? (560 "yes" responses)
- Has any self-regulatory organization or commodities exchange found you or any advisory affiliate to have been involved in a violation of its rules? (494 "yes" responses)
- 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? (340 "yes" responses)

Basis for SEC Registration

The vast majority of advisers registered with the SEC (86%) selected assets under management of more than $25 million as the basis for registration. Approximately 4,500 firms indicated more than one basis for SEC registration. More advisers than expected – 57 – have used the multi-state exception for SEC registration. It appears that 229 foreign advisers have registered with the SEC. Just within the four-month transition period, 86 newly formed advisers have filed with the SEC with the expectation that they will soon manage more than $25 million in assets.

Footnotes

[1] National Regulatory Services (NRS), a division of Thomson Financial, is the leader in compliance and registration services for Investment Advisers, Broker-Dealers, Investment Companies, and Insurance institutions. NRS provides compliance consulting, customized technology solutions and training services. To learn more about NRS please visit www.nrs-inc.com.

[2] The ICAA is a not for profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of about 300 investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[3] Legislation pending in Congress, however, could permit the operator of this system to charge persons, other than individual investors, "reasonable fees" for inquiries made of the system via the Internet.

[4] Requirement and transition of state-registered investment advisers to file on the IARD is undetermined at this time.

[5] All statistics cited in this report are current as of the end of the IARD transition period, approximately May 1, 2001.

[6] 1999 Annual Report of the U.S. Securities and Exchange Commission at p. 68.

[7] Although the database contains 7,322 total records, with no repeated SEC registration numbers, 673 of these records appear to contain only default responses. It is possible that these records reflect investment advisers that set up IARD accounts but have not yet filed their Form ADV, Part 1 on the IARD. In addition, 58 investment advisers indicated on their filings that they are no longer eligible for SEC registration. We have included the statistics from these 58 filings in this report because these advisers are considered registered until they file Form ADV-W with the SEC. We do not currently have access to Form ADV-W data.

[8] The total discretionary assets under management reported by investment advisers in aggregate probably overstates the actual total discretionary assets under management because more than one investment adviser can report the same client assets under management. For example, an investment adviser who allocates client assets among mutual funds on a discretionary basis will report a subset of the same assets that the advisers to these mutual funds report. Similarly, a sub-adviser to a fund may count the same discretionary assets as the "manager of managers" to the fund. See Instructions on Form ADV, Part 1, Item, 5(B).

[9] Employees include all persons performing investment advisory functions.

[10] Investment advisers have the ability to select more than one advisory activity on Form ADV, Part 1, Item 5(G).

[11] Only 309 firms categorized themselves as sole proprietors. This is curious because it appears that only a natural person may be a registered representative of a broker-dealer.

[12] Because the definition of related person includes officers, directors, and others who may be involved in family or other limited partnerships outside of their relationship with the adviser, this information may not be as meaningful as it first appears.

[13] Investment advisers have the ability to select more than one client type on Form ADV, Part 1, Item 5(D).

[14] Consistent with Form ADV, Part 1, Item 5(D1), retail clients are individuals other than high net worth individuals, that is individuals with less than $750,000 managed by the adviser or less than $1.5 million net worth.

[15] For example, the data indicate that 2,851 investment advisers responded "yes" to Item 8(F) regarding compensation for client referrals. However, this does not necessarily indicate that all of the "yes" respondents themselves actually compensate persons for client referrals.

[16] These statistics may be unreliable because of adviser confusion over the definition of custody. For example, some advisers may indicate they have custody under certain fee billing arrangements even though they are in compliance with the conditions of several no-action letters on this topic. Others in similar situations may not indicate that they have custody.

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