EVOLUTION REVOLUTION 2006

A Profile of the Investment Adviser Profession

Investment Adviser Association

National Regulatory Services

Investment Adviser Association

1050 17th Street NW, Suite 725
Washington, D.C. 20036-5503
202.293.4222
Fax 202.293.4223
www.investmentadviser.org

David G. Tittsworth
Executive Director
202.293.4222
david.tittsworth@investmentadviser.org

Karen L. Barr
General Counsel
202.293.4222
karen.barr@investmentadviser.org

Paul D. Glenn
Counsel
202.293.4222
paul.glenn@investmentadviser.org

National Regulatory Services
A Division of SourceMedia

323A Main Street, PO Box 71
Lakeville, CT 06039
860.435.0200
Fax 860.435.0031
www.nrs-inc.com

Keith Marks
Manager, IA Services
860.435.2541 ext.1849
kmarks@nrs-inc.com

Robert Miles
Director, Information Technology
860.435.2541 ext.1830
bmiles@nrs-inc.com

Catherine Reynolds
Director of Marketing
860.435.2541 ext.1862
creynolds@nrs-inc.com

The Investment Adviser Association and National Regulatory Services are pleased to present our sixth annual report on the state of the investment adviser profession. These annual reports provide an opportunity to identify significant trends and developments taking place in the investment advisory profession.

This report presents information on SEC-registered advisers based on the latest data from the Investment Adviser Registration Depository (IARD), the electronic filing system that investment advisers must use to file information required under regulations adopted by the Securities and Exchange Commission (SEC).

Executive Summary

Our analysis of the 2006 IARD data pertaining to SEC-registered entities reveals several key findings.

- *Dramatic growth in number of advisers.* The universe of SEC-registered advisers has expanded dramatically during the past year. The number of entities registered as investment advisers on April 7, 2006 was 10,290 compared to 8,614 in 2005 – representing a 19.5% increase. Much of this growth is attributable to first-time filings by hedge fund advisers.
- *Significant growth in assets under management*. Total assets under management (AUM) reported by SEC-registered investment advisers continued to grow and reached an all-time high of $31.4 trillion as of April 2006, increasing 17.2% over the $26.8 trillion reported in 2005.
- *Significant growth in number of hedge fund advisers*. The most significant development is the dramatic increase in the number of hedge fund advisers that are now registered with the SEC. As of April 7, 2006, there were 2,423 advisers that reported advising at least one hedge fund.[1] Of these, 1,336 reported that more than 75 percent of their clients are "pooled investment vehicles (*e.g.*, hedge funds)." In light of the recent court decision that strikes down the SEC's hedge fund rule, there is significant uncertainty as to whether the SEC (or perhaps Congress) will take action to find an alternative basis for requiring hedge fund advisers to register under the Investment Advisers Act. If an alternative is not found, some hedge fund advisers may choose to withdraw their SEC registration.
- *Hedge Fund Adviser Assets*. The 2,423 hedge fund advisers registered with the SEC manage hedge funds with a reported aggregate value of $2.4 trillion.[2]
- *Performance Fees.* The increase in hedge fund advisers[3] drove an increase in the percentage of advisers charging performance-based fee compensation from 26% in 2005 to 34.4% in 2006.
- *Custody.* The influx of hedge fund advisers resulted in more than a 50% increase in the number of firms reporting custody of client funds and securities.
- *Chief Compliance Officer.* 95% of all SEC-registered adviser firms have identified a chief compliance officer on Form ADV as required, in stark contrast to last year when only 54.6% had done so.[4]
- *Vast Majority of Advisers Are Small Businesses.* 9,321 SEC-registered advisers (90%) reported that

2006 "Typical" SEC-Registered Investment Adviser

- ❒ Has discretionary authority over client accounts
- ❒ $96 million in discretionary AUM (median)
- ❒ 6-10 employees (median)
- ❒ 26-100 clients (median)
- ❒ Clients include individuals, high net worth individuals, and pension and profit sharing plans

they have 50 or fewer employees, an increase of 1,530 from 2005. We continue to underscore the fact that the vast majority of investment advisory firms are small businesses.

- *Largest Firms Continue to Control Disproportionate Share of Assets Under Management.* Despite the fact that most investment advisers are small businesses, the largest firms continue to increase their disproportionate share of assets under management. Only 415 firms (4%) reported that they manage more than $10 billion AUM, but these firms reported $23.55 trillion in aggregate discretionary AUM, representing 82% of all discretionary AUM reported by all investment advisers.
- *Disciplinary History.* 15% of all SEC-registered advisers reported a "yes" response to some disciplinary question in Form ADV, Part 1A. While only 8.5% of newly registered advisers reported a disciplinary event, 17% of previously registered advisers reported an event.

Universe of SEC-Registered Investment Advisers

The universe of SEC-registered investment advisers dramatically increased from 8,614 on April 5, 2005 to 10,290 on April 7, 2006. This single-year increase of 1,676, or 19.5%, represents significant growth. Much of this growth is attributable to new registrations pursuant to SEC rule changes requiring that certain previously unregistered hedge fund managers register as investment advisers by February 1, 2006.[5]

This report is based on IARD data as of April 7, 2006, and is intended to reflect the most recently updated data available. Because almost 90 percent of advisers operate on a calendar year basis[6] and SEC regulations require advisers to update Form ADV within 90 days after the end of the adviser's fiscal year end, most advisers were required to update their SEC filings by March 31, 2006. Likewise, because hedge fund managers affected by the SEC's registration rule were required to be registered by February 1, 2006, the data used in this report reflects the effect of the SEC's new rule.

Under the National Securities Markets Improvement Act of 1996 (NSMIA), investment advisers that manage less than $25 million in assets (AUM) are regulated by the states, whereas investment advisers that manage in excess of $25 million are regulated by the SEC.[7] 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. In addition, most states require that state-registered advisers file on the IARD system.[8]

NSMIA was passed, in part, to give the SEC a smaller universe of advisers to oversee. At the time of its passage, Congress "was concerned that the Commission's resources were inadequate to supervise the growing number of investment advisers registered with the Commission," which had reached 23,350 in 1996.[9] In fact, the law worked as intended. In 1999, for example, after the law was implemented, the number of SEC-registered investment advisers fell to 6,360.[10] Following the 2001 implementation of the IARD, 6,649 firms filed as SEC-registered investment advisers. In 2002, the number increased to 7,581;[11] in 2003 to 7,852; in 2004 to 8,302, and to 8,614 in 2005. Total growth from 1999 to 2005 equaled 35%, or approximately 7% per year.

In absolute terms, the number of SEC-registered investment advisers increased by a total of 2,254 advisers from 1999 until 2005; an average of almost 400 per year. During the past year alone, however, 2,216 "new" investment advisers filed Form ADV with the SEC (resulting in a net increase of 1,676 advisers).[12] Of these newly registered advisers, 1,124 do not appear to advise hedge funds.[13] The remaining 1,092 (49%) new advisers reported advising at least one hedge fund.

The significant growth of SEC-registered investment advisers in the past year may have substantial ramifications for the SEC's Office of Compliance Inspections and Examinations (OCIE). During its 2005 fiscal year, OCIE conducted 1,530 examinations of investment advisers, of which 932 examinations were so-called "routine" examinations. This represented a slight decrease from the 1,543 examinations conducted in 2004.[14] The SEC attributed this slight decrease to the need for more extensive reviews of advisers based on new rules.[15] Based on this examination rate, however, a complete cycle of routine-only examinations may take more than 10 years.[16]

Hedge Fund Advisers

The most significant development this year is the addition of more than 1,000 hedge fund advisers to the SEC's database of registered investment advisers. The influx of these advisers has substantially affected the year-to-year comparisons in many areas of this report.

As of April 7, 2006, a total of 2,423 hedge fund advisers were registered with the SEC (*i.e.*, registered advisers that report advising at least one hedge fund client), representing 23.6% of all SEC-registered investment advisers.[17] These advisers reported managing hedge funds with an aggregate value of $2.4 trillion. Of these advisers, 1,336 can be characterized as firms that primarily advise hedge funds (more than 75% of clients are hedge funds) and 1,092 are firms that have registered during the past year.

A recent court decision, however, has created great uncertainty about the future of hedge fund adviser registrations. On June 23, 2006, the Circuit Court of Appeals for the District of Columbia struck down the SEC's hedge fund rule.[18] Currently, the SEC is considering a wide range of options, including: (1) allowing the court's ruling to stand (in effect, withdrawing the rule); (2) appealing the court's decision; or (3) re-proposing or re-drafting the rule based on alternate legal grounds. In addition, Congress could choose to legislate in this area. If an alternative is not found, some hedge fund advisers may choose to withdraw their registrations.

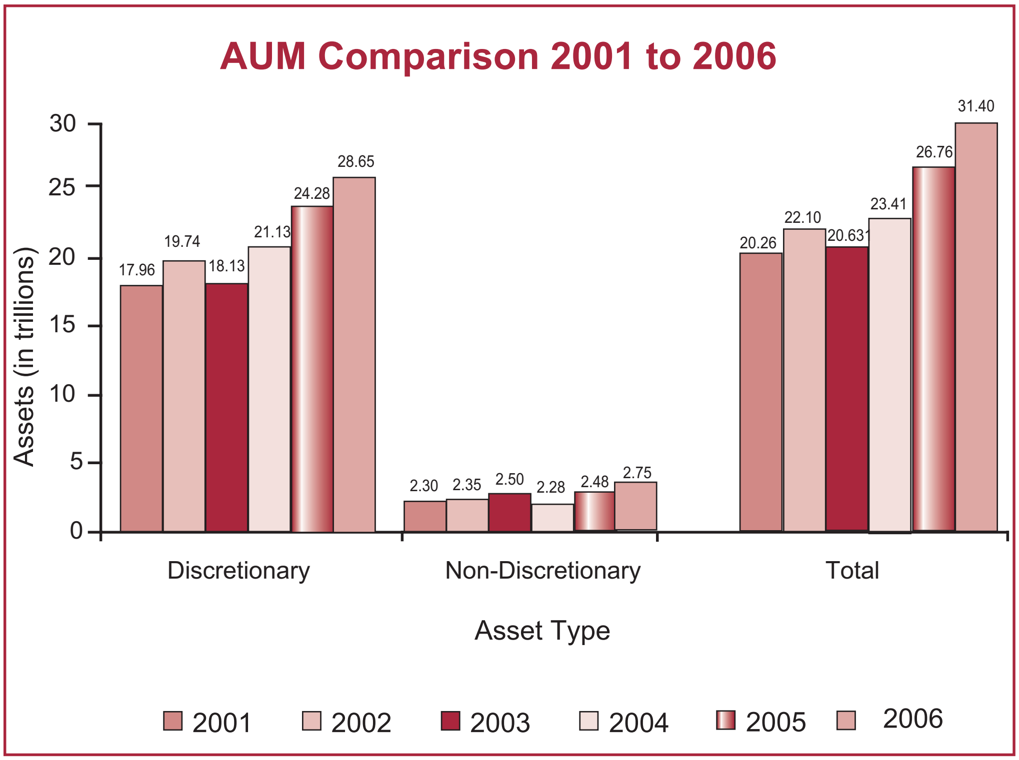
Assets Under Management

Total assets under management (AUM) reported by SEC-registered investment advisers reached an all-time high of $31.4 trillion as of April 7, 2006,[19] representing a 17.2% increase above the $26.8 trillion reported in 2005. Assets held in discretionary accounts grew a significant 18% from $24.3 trillion to $28.6 trillion in 2006. The following chart illustrates the strong growth in discretionary assets reported by investment advisers in all AUM categories.

Discretionary Assets				
Category of IA by Assets Under Management (AUM)	**2006 AUM (in $ Trillions)**	**2005 AUM (in $ Trillions)**	**Increase or (Decrease) AUM (in $ Trillions)**	**Percent Change**
>$100 Billion	$12.927	$11.197	$1.73	+15.5
$50-100 Billion	4.092	3.338	.75	+22.5
$10-50 Billion	6.535	5.599	.94	+16.8
$5-10 Billion	1.503	1.354	.15	+11.1
$1-5 Billion	2.309	1.779	.53	+29.8
$100 Million – 1 Billion	1.110	.871	.24	+27.6
$25-100 Million	.166	.138	.03	+21.7
<$25 Million	.007	.007	-	-
Total	$28.649	$24.283	$4.37	+18.0

As discussed further below, the growth in hedge fund adviser registrations has contributed only partially to this increase. Of the $4.37 trillion increase in discretionary assets, 32.5% is attributable to all newly registered advisers, while 23.1% is attributable to all newly registered hedge fund advisers. Indeed only 12.8% of the $4.37 trillion increase is attributable to newly registered advisers reporting more than 75% of clients as hedge funds.

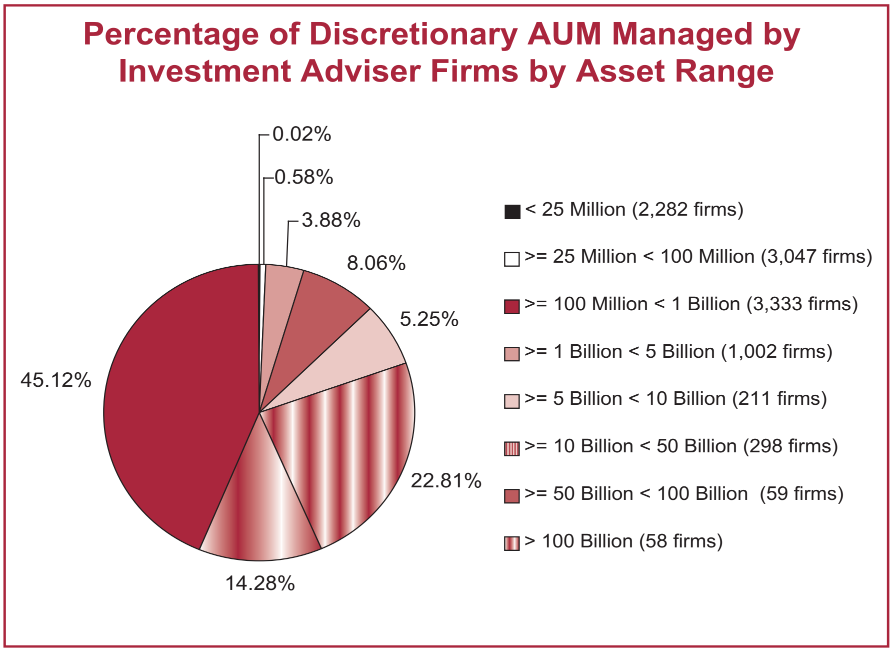
Interestingly, of the 8,074 investment advisers that filed Form ADV for both 2005 and 2006, 5,467 (53%) reported growth in their total assets under management (vs. 62% last year), 1,809 (22%) reported shrinkage of their total managed assets, up from last year's 17%; and 798 (10%) reported no change at all vs. 21% last year. Thus, the total of reported assets increased during the past year, despite the fact that a significant number of advisers reported some decrease in their managed assets. The large decrease in investment advisers reporting no change in total assets perhaps indicates that more advisers are taking a closer look at how their AUM are calculated when completing their required SEC filings.



A relatively few large firms continue to dominate in terms of assets under management. Only 415 firms (4% of all registered investment advisers) reported managing over $10 billion in discretionary assets in 2006 - up from 359 firms (4.2%) in 2005 and 312 firms (3.8%) in 2004. However, these firms collectively accounted for $23.55 trillion in discretionary assets in 2006 - up from $20.13 trillion in 2005 - representing 82.2% of all discretionary AUM. For these large firms, the increase in AUM during the past year was 17%.

Firms in each asset range experienced increases in discretionary assets this past year continuing the upward trend we saw beginning two years ago. For example, the aggregate discretionary assets managed by firms with more than $100 billion AUM increased by 15.5% from $11.197 trillion in 2005 to $12.927 trillion in 2006. The aggregate discretionary assets managed by firms with $50 - $100 billion AUM increased by 22.6% from $3.338 trillion in 2005 to $4.092 trillion in 2006.

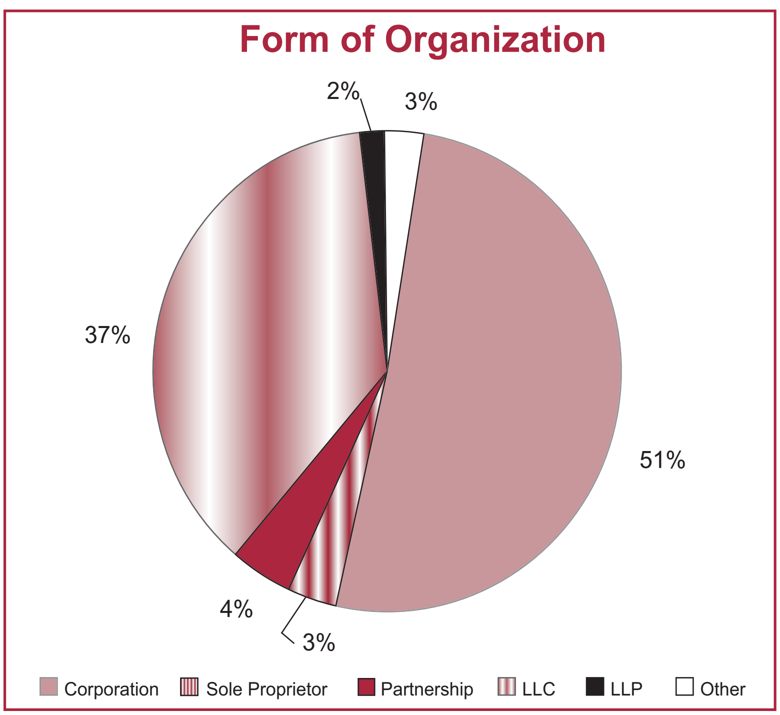
Finally, 1,139 entities reported total AUM of less than $25 million, compared with 1,035 in 2005. These entities represent a significant part (11%) of all SEC-registered investment advisers. Of these entities, 701 report no managed assets (10% more than 2005). Included in this category are 200 pension consultants (28.5%), 294 control affiliates (41.9%), and eight newly formed advisers (1.1%). 113 firms report they are now ineligible for SEC registration (9.9%) and will withdraw their registrations. The remaining 325 firms (28.5%) qualify for SEC registration on some additional basis.[20]



Characteristics of Investment Advisory Firms

Form of Organization

As shown in the pie chart, the majority of investment advisory firms (5,252) continue to be organized as corporations. However, limited liability companies (LLCs) continue to show the largest growth trend, increasing 36% in the last year, while corporations are trending down. Since 2001, the number of LLCs has almost tripled from 1,331 to the current 3,802. Of the 2006 growth in the number of LLCs, 60% can be attributed to the newly registered hedge fund advisers. Corporations account for 51% of all adviser organizations, down 6% since last year. The number of firms organized as sole proprietors continues to remain fairly flat over the last two years. However unlike prior years, partnerships rose 45% and hedge fund advisers now account for 58% of firms organized as partnerships. Interestingly, the 'Other' form of organization has had significant growth of 42% in the last year and 38.5% of advisers reporting "other" organizational forms (up from 18.7% in 2005) can be characterized as hedge fund advisers.



Ownership Structure

The ownership of investment advisory firms is structured in a number of ways. To take one slice of the universe, there are 58 investment advisory firms that manage more than $100 billion in discretionary assets. These 58 firms collectively manage $12.9 trillion. Of these firms, four are owned entirely by individuals – the partners/members or employees of the firm. Most of the 58 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 (24 firms are related to 11 affiliated groups), there would be only 45 (rather than 58) consolidated entities in this category, further accentuating the concentration of assets in a small number of firms. Many of these firms are also affiliated with numerous firms in other AUM categories. On the other hand, 7,590 (74%) firms are owned at least in part by an individual.[21]

International Business

825 investment advisers (8%) report that they are registered with a foreign financial regulatory authority. This number has grown by 52% in the past year. Of this growth, 29% can be attributed to newly registered advisers reporting more than 75% of clients as hedge funds. Overall, 48% of advisers registered with a foreign financial regulatory authority are hedge fund advisers.

This year, 630 SEC-registered firms (6.1%) listed non-US addresses as their principal places of business, compared to 541 last year, an increase of 16.5%.

Employees

The number of advisers with five or fewer employees rose by 736 firms during the past year. Firms with 6-10 employees increased by 424 and firms with 11-50 employees increased by 390. As in prior years, firms with 50 or fewer employees continued to comprise 90% of all SEC-registered advisers. Only 283 firms (2.7%) reported having more than 250 employees and of these only 96 firms (.9%) reported that they employ more than 1,000 persons.

Advisers reporting that they have no employees who perform investment advisory functions remains constant from last year at 1.8%.[22] 6,662 firms (64.7%, down slightly from 65.4% in 2005) have between one and five employees who perform investment advisory functions, while 1,596 (15.5%) firms employ between six and ten people in this capacity. These percentages continue to remain relatively the same as reported in prior years. The percentage of firms employing more than 500 persons who perform investment advisory functions decreased from .66% in 2005 to .56% in 2006.

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	N/A	184	6,584
1 to 5	4,971	6,662	2,322
6 to 10	2,059	1,596	503
11 to 50	2,291	1,391	544
51 to 250	686	350	203
251 to 500	107	49	53
501 to 1,000	80	28	34
More than 1,000	96	30	47

As reported in the past, the majority of advisers (6,584 or 64%) do not employ any persons who are also registered representatives of a broker-dealer; this majority continues to grow, up from 2005 when 5,144 firms (59.7%) reported no employees as registered representatives. 2,322 firms (22.5%) employ between one and five registered representatives, down from 2,171 in 2005. 81 (.8%) firms employ more than 500 registered representatives; of these firms, 65 are registered as both an investment adviser and a broker-dealer.

Web Site

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 66.5% in 2006.

Solicitors

The percentage of investment advisers that use third-party solicitors has remained relatively static over the past several years. 3,324 investment advisers have engaged between one and five firms or individuals to solicit on their behalf; this represents 32.3% of all advisers, up slightly from 31.7% last year. 29 firms reported using more than 250 third-party solicitors, up from 26 in 2005. 6,265 investment adviser firms (61%) do not use third-party solicitors, the same percentage reported over the past two years.

Advisory Activities

The IARD information reflects that 1,017 investment advisers (9.9%) act as portfolio managers for wrap fee programs and 435 (4.2%) act as sponsors of wrap fee programs. This represents a slight decrease from the percentages we reported for the past four years. In addition, 265 investment adviser firms reported that they both sponsor wrap fee programs and serve as portfolio managers for such programs. The chart below shows the various types of advisory services provided by SEC-registered advisers. Notably, the majority of advisers provide portfolio management for individual and institutional clients. Approximately one-third of advisers provide financial planning services. 15% of advisers provide pension consulting services.

Investment Advisory Services

Type of Advisory Activity	# of IA Firms providing advisory services	% of IA Firms providing advisory services
Financial planning services	3,502	34.0%
Portfolio management for individuals and/or small businesses	7,107	69.1%
Portfolio management for investment companies	1,419	13.8%
Portfolio management for businesses or institutional clients (other than ICs)	6,492	63.1%
Pension consulting services	1,536	14.9%
Selection of other advisers	2,692	26.2%
Publication of periodicals or newsletters	696	6.8%
Security ratings or pricing services	45	.4%
Market timing services	181	1.8%
Other	2,433	23.6%

Other Business Activities

A total of 66.5% of all advisory firms indicated that they are not actively engaged in any business other than giving investment advice, a 4% increase over last year. A fewer number of advisers are involved in non-advisory activities: 611 investment advisers (5.9%) are dually registered as broker-dealers, a decrease from 7.1% reported last year; 919 advisers (8.9%) are also registered representatives of a broker-dealer;[23] 497 advisers (4.8%) are registered as a futures commission merchant, commodity pool operator, or commodity trading adviser; 76 advisers (0.7%) are real estate brokers, dealers, or agents; 1,180 advisers (11.5%) are also insurance brokers or agents; 72 advisers (.7%) are either a bank or a separately identifiable department or division of a bank; 2,476 advisers (24%) sell products or provide services other than investment advice to advisory clients.

Financial Services Industry Affiliations

A large number of registered investment advisers have related persons that are engaged in diverse segments of the financial services industry.[24] However, the year-over-year numbers reflect a trend toward decreasing affiliations. Of note, firms affiliated with broker-dealers decreased by 3% after having decreased by 2% each of the last two years. Approximately 27% of registered advisers are now affiliated with broker-dealers and 34% are affiliated with other investment advisers. Affiliations with insurance companies decreased by 3% as well.

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

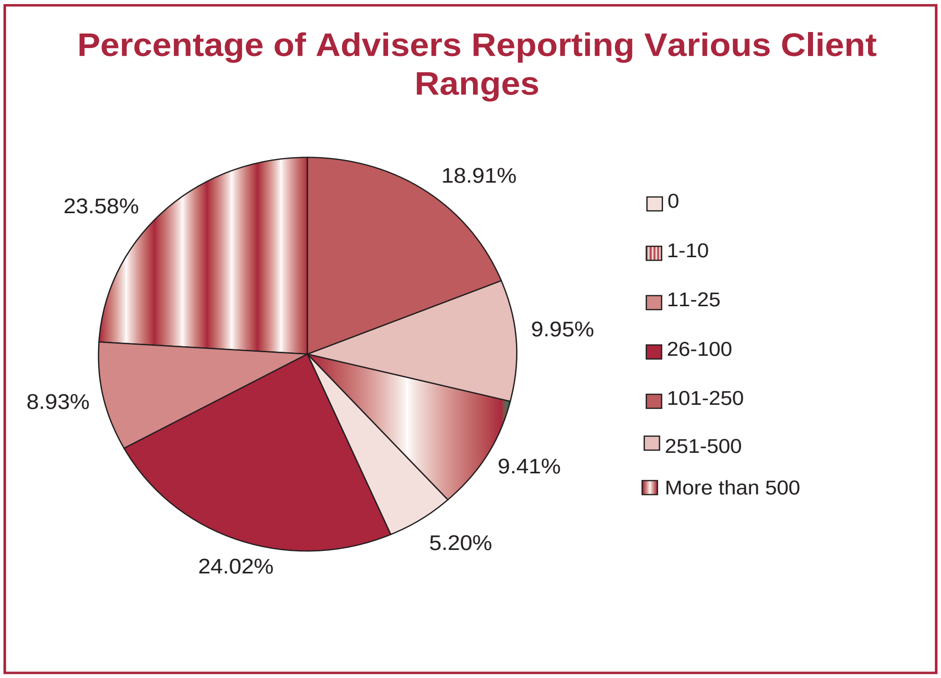
- 2,729 (27%) are affiliated with broker-dealers
- 1,627 (16%) are affiliated with investment companies
- 3,457 (34%) are affiliated with other investment advisers
- 1,033 (10%) are affiliated with futures commission merchants, commodity pool operators, or commodity trading advisers
- 1,193 (12%) are affiliated with banks or thrifts
- 910 (9%) are affiliated with accountants or accounting firms
- 575 (6%) are affiliated with lawyers or law firms[25]
- 1,811 (18%) are affiliated with insurance companies or agencies
- 626 (6%) are affiliated with pension consultants
- 548 (5%) are affiliated with real estate firms
- 1,501 (15%) are affiliated with sponsors or syndicators of limited partnerships

Approximately 42% (4,369) of all investment advisers are independent, *i.e.*, they are not affiliated with any other financial industry entity (up from 41%, 3,519 in 2005). Of these firms, 3,307 (32% of all firms) are not only independent, but also are not engaged in any business other than providing investment advisory services. These percentages have increased since last year, also reflecting the decreasing affiliation trend.

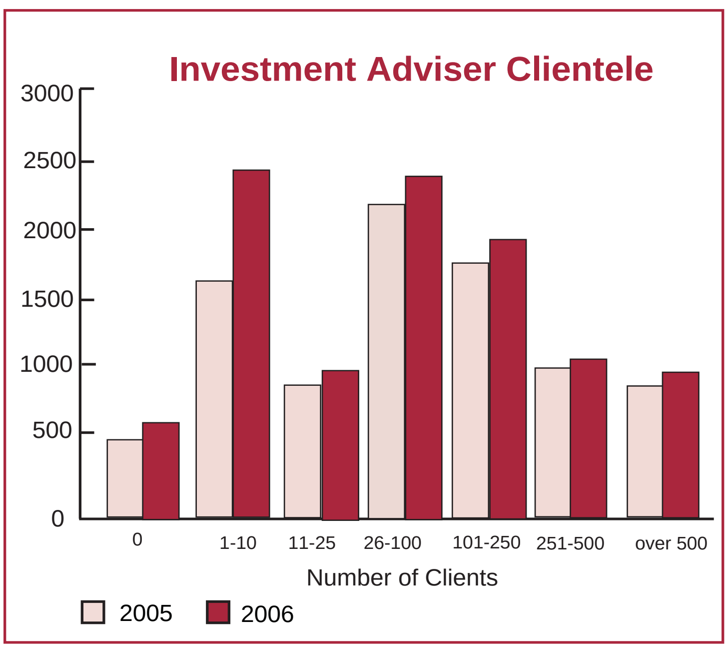
In 2006, 4,497 advisers (43.7%) reported that they or their related persons are general partners in an investment-related partnership or manager of an investment-related LLC or advise a private fund. This increase from 3,225 advisers (37%) in 2005 again reflects the growth of hedge fund advisers.

Clientele of Investment Advisers

Number of Clients



Form ADV requires advisers to report how many clients they have by certain categories. The following chart shows that 2,472 advisers (24%) have between 26 and 100 clients, the largest category of "number of clients." The large increase in advisers with 1-10 clients - from 1,543 in 2005 to 2,426 in 2006 - may be attributable to the registration of hedge fund advisers.[26] 968 advisers (9.4%) provide investment advisory services to 500 or more clients. Of these, 131 advisers also provide financial planning services to more than 500 clients. 368 such advisers also act as portfolio managers in wrap fee programs. An interesting unexplained anomaly is that 535 advisers report that they have no clients, but 194 of this group reported having assets under management.



Types of Clients

SEC-registered advisers provide services to various types of clients, including individuals, corporations, charitable organizations, and others. Form ADV requires advisers to report client types in the categories listed in the chart on the following page. The chart shows how each client type is represented in an adviser's overall clientele make-up. For example, 4,749 advisers (46.2%) report that they have corporations as clients. High net worth clients are the most prevalent client type, with 66.9% of all advisers reporting serving such clients. The chart also shows, among other things, client types that are not generally serviced by a large number of advisers. For example, 9,057 advisers (88%) do not provide advisory services to state or municipal government entities and 8,723 advisers (84.8%) do not provide advisory services to investment companies. We have added the first column to show what percentage of the total 10,290 advisers provide services to each type of client.

Hedge Funds/Pooled Vehicles. 3,371 firms (32.8%) reported that they provide advisory services to "other pooled vehicles (*e.g.* hedge funds)." This number is higher than the number of "hedge fund advisers" discussed earlier in part because "other pooled vehicles" could also include private equity or venture capital funds, for example. There are 1,260 more advisers reporting hedge fund/pooled vehicle clients in 2006 than in 2005 (2,111), a 59.7% increase. As in previous years, 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 hedge funds). In 2006, 1,661 registered investment advisers reported that they specialize in hedge fund management compared to 735 in 2005, a 126% increase. The 1,661 specialists reported discretionary AUM of $1.665 trillion (up significantly from $830 billion in 2005, $540 billion in 2004, and $479 billion in 2003). The SEC's new rule requiring hedge fund adviser registration by February 1, 2006 was the catalyst for these dramatically increased numbers.

Types of Clients

Percent offering to:	Types of Clients	None	Up to 10%	11-25%	26-50%	51-75%	More than 75%
57.0%	Individuals (other than high net worth individuals)	4,422	1,346	1,029	1,279	1,103	1,111
66.9%	High net worth individuals	3,403	1,436	1,210	1,588	1,363	1,290
9.3%	Banking or thrift institutions	9,335	771	92	46	8	38
15.2%	Investment companies (including mutual funds)	8,723	785	192	140	71	379
54.4%	Pension and profit sharing plans (other than plan participants)	4,693	3,684	987	470	184	272
32.8%	Other pooled investment vehicles (*e.g.*, hedge funds)	6,919	1,014	233	259	204	1,661
39.2%	Charitable organizations	6,254	3,438	438	114	28	18
46.2%	Corporations or other businesses not listed above	5,541	3,753	590	235	69	102
12.0%	State or municipal government entities	9,057	871	196	87	32	47
9.2%	Other	9,340	538	145	93	33	141

Retail and High Net Worth Clients. The percentage of advisers with no retail clients[27] increased to 43% (up from 38% in 2005 and 36% in 2004). This significant increase is undoubtedly due to the addition of hedge fund advisers who are not required to report fund investors as "clients" on Form ADV. By aggregating the "none" and "up to 10%" categories, we conclude that 56% of all advisers have little or no individual retail business, an increase from recent years (52% in 2005, 50% in 2004, and 53% in 2003). 45 advisers provide services to only retail clients. Approximately 31.2% of advisers have no individual clients (either retail or high net worth) [28] while 10% of advisers (1,036) have only individual clients.[29]

Mutual Funds. 1,567 firms reported that they provide advice to investment companies, including mutual funds. While the actual number of mutual fund advisers has increased since 2005, such advisers represent only 15.2% of the total number of advisers, continuing a steady percentage decrease from 20% in 2002, 19% in 2003, 18% in 2004 and 17% in 2005. The 379 advisers with 75% or more of their clients as mutual funds (3.7% of advisers) managed discretionary AUM in 2006 of $5.98 trillion (20.8% of all discretionary AUM). While the media typically equate 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. Almost all advisers report charging asset-based fees (95.3%). The percentage of such advisers increased 0.8% from 2005. 3,192 advisers (31%) charge hourly fees, an increase of 273 more advisers than in 2005. 3,999 advisers (38.9%) charge fixed fees, an increase of 389 from 2005. The percentages of advisers charging fixed and hourly fees have declined significantly from 2005 because of the influx of hedge fund advisers who do not use such fee arrangements.

The number of firms charging performance-based fee compensation increased significantly from last year and is clearly due to the new hedge fund advisers. This year, 1,250 more advisers reported that they charge performance-based fees, rising as a percentage of advisers from 24% in 2002 and 2003, 25% in 2004, and 26% in 2005 to 34.4% in 2006. This year's significant increase in performance fees clearly is tied to the increase in registrations by hedge fund advisers; 60% of the total number of advisers reporting performance-based fees are attributable to hedge fund advisers.

The number of advisers who use commissions as compensation for advisory services increased by 54 but the percentage continued to decline to 9.4% in 2006, from 11% in 2005, and from 12% in 2002-2004.

Participation or Interest in Client Transactions

Form ADV, Part 1, Item 8 requests information about an investment adviser's participation or interest in client transactions, including aspects of investment and brokerage discretion over client accounts. Because the questions solicit responses regarding the adviser or any of its related persons, it is not possible to determine whether the responses apply to the specific entity filing the form or whether it applies to the firm's advisory affiliates and any person under common control with the adviser. However, certain trends and market characteristics are apparent from this year's data relative to last year's.

The most noticeable trend this year is that the increase in the number of advisers with investment discretion virtually matches the total increase in the number of SEC-registered advisers (1,676 total new advisers v. 1,638 advisers with discretion to select securities). The correlation between the increase in advisers and the increase in advisers with brokerage discretion responses is also high (an increase of 1,342 advisers with discretion to select brokers). These responses seem to indicate that the vast majority of newly registered hedge fund advisers reported that they have investment and brokerage discretion.

We have examined data relating to the number of advisers reporting proprietary or sales interests in client transactions in light of the influx of newly registered hedge fund advisers. Of the 1,092 newly registered hedge fund advisers, 458 (42%) reported a proprietary interest in securities recommended to clients compared to an increase of 591 or 27.5% of all advisers, from 2,147 in 2005 to 2,738 in 2006.[30] In addition, 470 (43%) newly registered hedge fund advisers reported recommending securities to clients in which the adviser or a related person serves as an underwriter, a general or managing partner, or a purchaser representative compared to an increase of 585 or 31.6% of all advisers from 1,854 in 2005 to 2,439 in 2006.[31] We had expected that the increase in the number of hedge fund advisers would have correlated more closely with the responses relating to proprietary and sales transactions.

This lack of correlation suggests that hedge fund advisers are interpreting inconsistently whether only the private fund itself, rather than the private fund investors, is the "client" for the purpose of responding to questions concerning sales and proprietary interests in client transactions. The hedge fund registration rule requires that investors in private funds be treated as clients only for the purpose of determining whether an adviser meets the *de minimis* registration thresholds of Rule 203 of the Investment Advisers Act. However, Form ADV releases and instructions do not provide specific information about how hedge fund advisers should respond to ADV questions regarding proprietary and sales interests. Additional SEC guidance would be helpful in clarifying these issues.

Soft Dollars

The only question in Form ADV, Part 1 that directly relates to soft dollars is Item 8.E: "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?" Last year we noted there may have been confusion over this question because only 58% of advisers responded affirmatively. We commented that we were skeptical that 42% of advisers did not receive *any* non-execution products or services from brokers. The SEC responded to this issue by updating its Form ADV Frequently Asked Questions as follows:

> *Answer "Yes" to Item 8.E. if you receive any research or other product or service that is not execution from a broker-dealer or a third party in connection with client securities transactions. The source of the research, i.e., whether it is produced by a third party or the executing broker, does not determine your answer to Item 8.E.*

With this clarification from the SEC, a "yes" answer is required notwithstanding the fact that the services are not part of a traditional soft dollar research arrangement and are not directly tied to the amount of trading or commissions paid.

While the number of advisers this year indicating the receipt of non-execution products and services rose to 6,232 advisers (61%), this may be more the result of new hedge fund adviser registrations rather than a change by previously registered advisers. 850 more advisers still report they have the discretion to select brokers than advisers that report they receive products and services from brokers in connection with clients' securities transactions.

Following are the 2006 statistics from Form ADV, Part 1, Item 8 responses:

Proprietary Interest in Client Transactions

- 8% (in 2005, 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), an increase of 130 advisers from 697 in 2005 to 827 in 2006.
- 73% (in 2005, 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).

- 27% (in 2005, 25%) of advisers or their related persons recommend securities in which the advisory firm or a related person has an interest.

Sales Interest in Client Transactions

- 7% (in 2005, 8%) of advisers or their related persons engage in agency cross transactions, increasing from 663 in 2005 to 690 in 2006.

- 24% (in 2005, 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.

- 12% (in 2005, 13%) recommend securities to clients for which the firm or a related person has any other sales interests (other than commissions as a broker), from 1,077 in 2005 to 1,252 in 2006.

Investment Discretion or Brokerage Discretion

- 9,076, or 88% (in 2005, 7,438 or 86%) investment advisers or related persons have discretionary authority to select securities to be bought or sold for a client's account.

- 9,077, or 88% (in 2005, 7,434 or 86%) have discretionary authority to determine the amount of securities to be bought or sold for a client's account.

- 7,082, or 69% (in 2005, 5,729 or 67%) have discretionary authority to select brokers.

- 6,392 or 62% (in 2005, 5,140 or 60%) have discretionary authority to determine the commission rates paid to brokers.

Additional, Related Questions

- 6,848, or 67% (in 2005, 5,906 or 69%) of investment advisers or their related persons recommend brokers or dealers to clients.

- 6,232, or 61% (in 2005, 4,989 or 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).

- 4,733, or 46% (in 2005, 3,916 or 45%) directly or indirectly compensate employees or third parties for client referrals.

Custody

In 2006, 2,528 or 24.6% of all SEC-registered advisers reported having "custody" of client funds – a 54% increase over last year. In addition, 2,422 advisers (23.5%) reported having custody of client securities – a 55% increase from 2005. These dramatic increases are undoubtedly attributable to the influx of hedge fund advisers discussed earlier. This growth in advisers deemed to have custody follows increases of 57% in 2004 and 23% in 2005.[32]

2,198 (21.4%) advisers have related persons with custody of client funds while 2,117 (20.6%) have related persons with custody of client securities. The actual number of advisers reporting related persons with custody rose by more than 50% this year: 754 additional with funds, 729 additional with securities. Of the advisers reporting related persons that have custody, 374 report that the related person that has custody is a broker-dealer, continuing the gradual decline from 382 in 2005 and 392 in 2004 and 2003.

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 of Form ADV, Item 11 are not 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 reporting firm during that time. In addition, the same disciplinary event at one firm may be reported by multiple separate affiliates, and the same disciplinary event may generate affirmative answers to several different questions.[33]

Subject to these limitations, we make the following observations:

- 8,750 (85%) registered investment advisers reported no disciplinary history at all. In 2005, 7,205 (83.6%) registered advisers reported no disciplinary history, which had been just a one-half percent higher than in 2004 (6,900). Last year, we commented that the one-half percent increase from 2004 to 2005 may reflect that new firms presumably start with a clean slate. This observation is supported by the fact that this year only 189 (8.5%) of the 2,216 newly registered advisers reported any disciplinary event. While the 2,216 new advisers make up 22% of the total universe of advisers (10,290), the 189 newly registered advisers reporting disciplinary history make up only 12% of the 1,540 advisers now reporting such history.

- In contrast, 1,351 (17%) of the 8,074 previously registered firms reported at least one disciplinary event, an increase of 38 firms that were registered in both 2005 and 2006. Of the 1,092 newly registered hedge fund advisers, 86 (8%) provided a “yes” response to a disciplinary question. Thus, previously unregistered advisers with hedge fund clients are no more likely to have disciplinary history than previously unregistered advisers without hedge fund clients.

- Of the 1,540 firms reporting at least one answer in the affirmative to the disciplinary questions,133 advisers reported only pending charges and had no final outcomes on their records. This number is down slightly from 139 last year and 150 the previous year. Also, the number of firms reporting pending civil proceedings increased only slightly (from 206 firms in 2005 to 209 in 2006).

The number of firms responding affirmatively to individual disciplinary questions has remained quite steady from year to year, with modest increases in absolute numbers responding affirmatively. While this trend has continued, the increase in the total number of advisers has led to a lower percentage responding to the following questions, which overall have generated the most “yes” responses.

- 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? 684 “yes” responses (6.6% vs. 7.5% in 2005 and 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? 589 “yes” responses (5.7% vs. 6.6% in 2005 and 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? 635 “yes” responses (6.2% vs. 6.5% in 2005 and 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? 362 “yes” responses (3.5% vs. 4% in 2005 and 2004, 4.4% in 2003, and 4.9% in 2002)

Basis for SEC Registration

The vast majority of advisers (8,918, or 86.7%) qualified for SEC registration because they manage more than $25 million in client assets – roughly the same percentage as last year. This number represents an increase of 1,539 advisers in this category (up 20.9% over 7,379 in 2005). Only 233 firms (2.3% overall) that manage more than $25 million chose to qualify for SEC registration on a different basis than assets under management.

1,041 advisers (10.1%) registered on the basis that they serve as an investment adviser to a registered investment company. The number of these advisers dropped by 65 (5.9%) after remaining exactly the same for the past two years. However, 1,567 (15.2%) reported that they provide advice to registered investment companies, indicating either that 526 of these advisers selected a different basis for registration or inaccurately reported their types of clients.

The 225 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 – catapulted to an all-time high (up 88 or 64.2%) following an unusual year where the number 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 had declined significantly by 31% to 137 in 2005.

The number of advisers that selected principal office and place of business outside the U.S. dramatically increased from 328 to 588, due to the influx of non-U.S. hedge fund advisers. The number of advisers indicating that they are no longer qualified for SEC registration (115) increased by 13 or 12.7% from the same time last year, reversing a downward trend from a peak of 148 in 2003. Advisers that indicated they qualified for SEC registration based on their locations in the U.S. Virgin Islands or Wyoming increased by 6 or 9.4%.[34] Of the 70 advisers who selected this basis, however, only 21 are principally located in Wyoming and six are in the U.S. Virgin Islands. Obviously, many advisers erroneously selected this basis for registration.

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

- 8,918 selected assets under management of $25 million or more (a significant increase of 1,539 or 20.9%).

- 70 selected principal office and place of business in U.S. Virgin Islands or Wyoming (an increase of 6 or 9.4%).

- 588 selected principal office and place of business outside the U.S. (a dramatic increase of 260 or 79.3%). Of these, 257 (43.7%) are hedge fund managers.
- 1,041 selected adviser to registered investment company (a decrease of 65 or 5.9%).
- 5 selected nationally recognized statistical rating organization (NRSSO) (no change).
- 321 selected pension consultant (an increase of 2).
- 421 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 (an increase of 3).
- 225 selected newly formed adviser expecting to be eligible within 120 days (a dramatic increase of 88 or 64.2%).
- 50 selected multi-state adviser (an increase of 6 or 13.6%)
- 26 selected Internet-based adviser (an increase of 1).
- 4 selected SEC exemptive order (a decrease of 3 or 42.9%).
- 115 reported they are no longer eligible for SEC registration (an increase of 13 or 12.7%).

Endnotes

[1] There are no legal definitions of "hedge fund" or "hedge fund adviser." For purposes of this report, we have followed the SEC's method of determining whether an investment adviser is a "hedge fund adviser" based on the following items on Form ADV, Part 1A: (1) if a registrant indicates that its clients include "other pooled investment vehicles (*e.g.*, hedge funds)" in Item 5.D.(6); (2) if a registrant indicates in Item 7.B. that it, or a related person, is a general partner in an investment-related limited partnership, or manager of an investment-related limited liability company, or advises any other "private fund" as defined in the SEC's hedge fund rule; AND (3) the registrant indicates that at least one fund listed in Schedule D, Item 7.B. is a "private fund" as defined in the SEC's hedge fund rule.
[2] This number was derived by aggregating the value reported of all "private funds" listed by hedge fund advisers on Schedule D, Item 7.B. as discussed in Note 1. The $2.4 trillion aggregate value reported may significantly overstate the size of the hedge fund industry due to multiple firms reporting with respect to the same funds. *See Double Trouble Valuing the Hedge Fund Industry*, Wall Street Journal, p. B3 (July 8, 2006).
[3] Unless otherwise specified, when this report uses the term "hedge fund adviser" we refer to all advisers that reported advising at least one hedge fund, as discussed in Note 1 above.
[4] On April 10, 2006, a WebCRD/IARD completeness check was implemented to require that all future filings by SEC-registered advisers include the exact words "Chief Compliance Officer" in the appropriate column of Form ADV, Schedule A. Based on this system change, all SEC-registered advisers should have identified their CCO by this time next year.
[5] *See Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Rel. No. IA-2333 (Dec. 2, 2004). As noted, this rule has been struck down by the D.C. Circuit Court of Appeals.
[6] 9,241 of 10,290 registered advisers (89.8%) have a reported fiscal year-end of December. Despite the large increase in the number of advisers, fiscal year end dates remained strikingly similar to 2005, when 89.4% reported December fiscal year ends. This indicates that most newly registered hedge fund advisers have a December fiscal year end.
[7] Advisers managing between $25 and $30 million may voluntarily select registration with a state(s) or the SEC.
[8] As of April 1, 2006, 13,090 state registered advisers had filed Form ADV, Part 1A via the IARD system, an increase of more than 1,000 over last year.
[9] *See Rules Implementing Amendments to the Investment Advisers Act of 1940*, Rel. No. IA-1633 (May 15, 1997).
[10] 1999 Annual Report of the U.S. Securities and Exchange Commission, at p. 68.
[11] In 2002 we noted that the large increase from 2001 (6,649 advisers) to 2002 (7,581 advisers) was partially attributable to delinquent transitions to the IARD system. The 2001 filing number therefore was likely understated.

[12] While the total universe of SEC registered advisers increased by 1,676 from 2005 to 2006, the actual number of new registrations was 2,216. This indicates that 540 advisers that had been registered in 2005 withdrew from the SEC for various reasons.
[13] *See* Note 1 above.
[14] 2005 Annual Report of the Securities and Exchange Commission, at p. 37.
[15] *Id.* The SEC's 2005 Annual Report stated that "[d]ue to recently adopted rules that require examiners to undertake more extensive reviews of email files, conduct appropriate forensic tests, and review compliance, the total number of examinations completed [in FY 2005] was lower than in FY 2004."
[16] Between 1997 and 2003, a pillar of OCIE's inspection program was the goal of conducting a routine examination of all SEC-registered investment advisers no less frequently than once every five years. More recently, the SEC has indicated that the investment adviser program has transitioned to a risk-based program that seeks to target larger and riskier firms more frequently.
[17] *See* Note 1 above.
[18] *Philip Goldstein, et al. v. Securities and Exchange Commission* (June 23, 2006).
[19] 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.
[20] For example, firms that are Internet-only 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 Advisers Act section 203A(a) and rule 203A-2(f).
[21] 2,700 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, 7,590 have at least one individual that owns at least 5% of the firm.
[22] Approximately 15% of these advisers have qualified for SEC registration because they control, are controlled by, or are under common control with an SEC-registered adviser and have the same principal office and place of business. *See* rule 203A-2(c).
[23] The way this question is phrased on Form ADV, only the 350 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 (919) indicates that most of the advisers checking this response did not understand the question. It is likely that these other advisers have employees who are registered representatives of a broker-dealer.
[24] "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.
[25] We question why the Commission seeks information regarding whether any of the adviser's officers, directors, or employees are lawyers or accountants. This question could be narrowed to gather more relevant information regarding a firm's affiliates.
[26] Although hedge fund advisers must "look through" the funds to count the number of investors for purposes of registration requirements, no such "look through" applies to other requirements, including responses to client ranges on Form ADV.
[27] As defined in Form ADV, Part 1A, Item 5.D., 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 joint net worth with spouse.
[28] These figures include the 273 advisers that marked the "none" response for every type of client listed in Item 5.D, including "other."
[29] Of these firms, 256 advisers marked the "none" response for every type of client.
[30] Form ADV, Part 1, Item 8.A.(3)
[31] Form ADV, Part 1, Item 8.B.(2)
[32] The 2004 growth resulted from the SEC's revised custody rule (effective April 1, 2004), under which all advisers that hold "directly or indirectly, client funds or securities or [have] any authority to obtain possession of them" are required to report having custody. The custody rule labels those advisers as having custody who act as trustees for clients, have any 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 merely debit fees directly from client accounts are deemed to have custody but are not required to report in Form ADV that they have custody.
[33] In fact, a total of 4,611 "yes" responses are provided by all investment advisers, which would represent just over three "yes" responses per adviser with at least one "yes" response. Nevertheless, because we do not have the disclosure information about each "yes" response, it cannot be determined how many responses cover the same event, act or occurrence, or the seriousness of any particular reportable disclosure.
[34] On February 13, 2005, the Virgin Islands Uniform Securities Act first became effective. Advisers in the Virgin Islands may no longer use their locations as the basis for SEC registration. However, of the six SEC-registered firms principally located in the U.S. Virgin Islands, five have more than $25 million in AUM and the sixth has indicated it is no longer eligible for SEC registration.

INVESTMENT ADVISER ASSOCIATION

The Investment Adviser Association (IAA) is a not-for-profit organization that exclusively represents the interests of SEC-registered investment adviser firms. The Association was founded in 1937 and played a major role in the enactment of the Investment Advisers Act of 1940, the federal law regulating the investment advisory profession. Today, the IAA consists of more than 450 SEC-registered investment advisory firms that collectively manage in excess of $6 trillion in assets for a wide variety of institutional and individual clients. For more information, please visit www.investmentadviser.org.

NRS

National Regulatory Services (NRS), a division of SourceMedia, is a leading national provider of compliance and registration services for Investment Advisers, Broker-Dealers, and Insurance institutions. NRS provides initial registration, compliance consulting, policies and procedures manuals, and software solutions designed to assist in meeting regulatory requirements. In addition, NRS established the Center for Compliance Professionals which offers the first Investment Adviser Chief Compliance Officer certification. NRS also provides Spring and Fall Compliance conferences and Desktop Seminars, as well as customized training. Visit www.nrs-inc.com for more information.