EVOLUTION

2007

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A PROFILE OF THE INVESTMENT ADVISER PROFESSION

NATIONAL REGULATORY SERVICES

INVESTMENT ADVISER ASSOCIATION

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NRS

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Introduction

The Investment Adviser Association and National Regulatory Services are pleased to present our seventh 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 2007 IARD data pertaining to SEC-registered entities reveals several key findings.

- *Continued but slowing growth in number of advisers.* The universe of SEC registered advisers grew only slightly during the past year. The number of entities registered as investment advisers on April 6, 2007 was 10,446 – compared to 10,290 in 2006 – representing only a 1.5% increase. The slow down in growth appears to be primarily attributable to the number of de-registrations by hedge fund advisers.

- *Significant growth in assets under management.* Total assets under management (AUM) reported by SEC-registered investment advisers reached an all-time high of $37.65 trillion as of April 6, 2007, increasing 19.9% above the $31.4 trillion reported in 2006.

- *Hedge fund adviser de-registrations.* Since our report last year, 732 hedge fund advisers, as determined according to SEC methodology[1], have de-registered with the agency. Many of these de-registrations are the result of the court decision invalidating the SEC rule that required registration of hedge fund advisers under the Investment Advisers Act. A significant number of hedge fund advisers, however, are maintaining their SEC registration. 1,990 hedge fund advisers are registered with the SEC; of those 150 are newly registered this year and 149 amended their registration this year to indicate that they manage hedge funds.

- *Vast majority of advisers are small businesses.* 9,442 SEC-registered advisers (90.4%) reported that they have fewer than 51 employees, an increase of 121 from 2006.

- *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 472 firms (4.5%) reported that they manage more than $10 billion AUM, but these firms reported $28.91 trillion in aggregate discretionary AUM. This represents 84.3% of all discretionary AUM reported by all investment advisers.

- *Assets Managed by Hedge Fund Adviser Specialists Continued to Grow.* Consistent with this data, the number of advisers that primarily advise hedge funds and other pooled vehicles ("specialists") declined 14.5% in the last year from 1,661 to 1,421. However, these 1,421 specialists reported discretionary AUM of $2.182 trillion (up from $1.665 trillion in 2006).

2007 "Typical" SEC-Registered Investment Adviser

- **Has discretionary authority over client accounts**
- **$130 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**

Explanation of Report Data

This report is based on IARD data as of April 6, 2007. The IARD system was implemented on January 1, 2001 and all advisers registered with the SEC were required to transition to electronic filing by April 30, 2001.[2] Because 90.2% of advisers operate on a calendar year basis[3] 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, 2007. The data used in this report, therefore, should reflect updated information provided by almost all SEC-registered advisers.

Generally, an investment adviser qualifies for SEC registration if it manages $25 million or more in assets. Rule 203A-1 of the Investment Advisers Act provides that when an adviser's assets under management grow to $30 million or more, the firm *must* register with the SEC. Rule 203A-1 also provides that an adviser has the option to register with the SEC if it has assets under management of at least $25 million. Thus, an adviser with between $25 million and $30 million in assets under management is permitted, but not required, to register with the SEC.

Universe of SEC-Registered Investment Advisers

The universe of SEC-registered investment advisers increased from 10,290 on April 7, 2006 to 10,446 on April 6, 2007. This net increase of 156 advisers represents an increase of 1.5% over the previous year's total.

The 2006-2007 increase is significantly below the 2005-2006 increase of 1,676 advisers (19.5%) we reported last year. The slow down is attributable to the de-registration of hedge fund advisers as a result of the court decision that invalidated the SEC rule requiring hedge fund advisers to register under the Investment Advisers Act.[4] Of the 986 investment advisers that de-registered with the SEC during the past year, 732 were hedge fund advisers. It is significant to note that, despite the vacated hedge fund adviser registration rule, there were 150 newly registered hedge fund advisers during the past year.

It is also notable that a total of 1,142 "new" advisers registered with the SEC during the past year. These newly registered advisers may be recently formed or reorganized, or may be an existing adviser that now qualifies for SEC registration (such as an advisory firm that managed less than $25 million AUM).

Despite the slow down during the past year, the total number of SEC-registered investment advisers has grown significantly since we have been issuing these reports. For example, the total number of SEC-registered investment advisers reported on the IARD system as of May 16, 2001 was 7,322. Since then, a total of 3,124 more advisers have registered, an increase of 42.6%. Since 2001 the average annual increase in the number of SEC-registered investment advisers is about 520 advisers.

The growth and enormous diversity of the universe of SEC-registered advisers has significant implications for the SEC's examination program. The SEC's Office of Compliance Inspections and Examinations (OCIE) examined 1,346 advisers during fiscal year 2006.[5] Of these 1,346 examinations, 650 were routine inspections of advisers with higher risk profiles, 328 were routine inspections of randomly selected lower-risk advisers, and 368 were inspections of advisers that either appeared to have specific issues needing further scrutiny or that were part of a risk-targeted examination sweep.[6] This represents a significant decrease from the 1,543 examinations conducted in 2004 and the 1,530 examinations conducted in 2005.[7] Based on this examination rate, a complete cycle of examinations would take over 7.5 years. However, the SEC has transitioned to a risk-based examination methodology that aims to examine higher-risk advisers more frequently, as evidenced by the larger number of higher risk profile advisers examined in 2006.

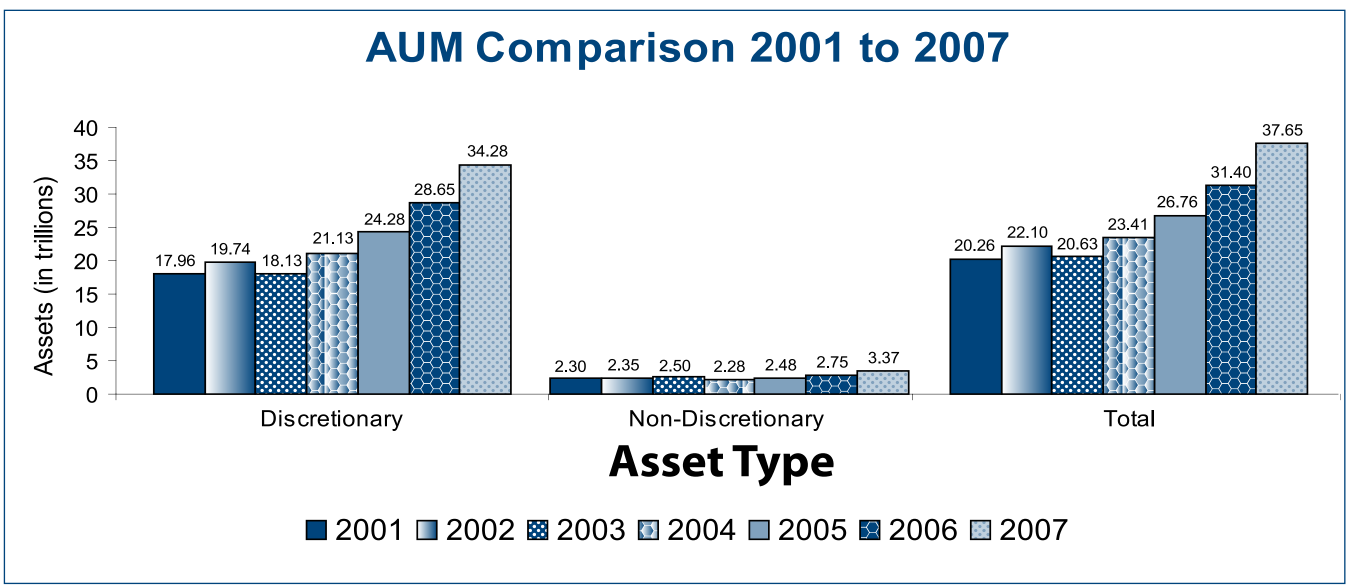
Assets Under Management

Total assets under management (AUM) reported by SEC-registered investment advisers reached an all-time high of $37.6 trillion as of April 6, 2007, representing an extraordinary 19.9% increase above the $31.4 trillion reported in 2006.[8] Total assets held in discretionary accounts grew a significant 19.9%[9] from $28.6 trillion in 2006 to $34.3 trillion in 2007. The following chart illustrates the strong growth in discretionary assets reported by investment advisers in virtually all AUM categories.

Discretionary Assets

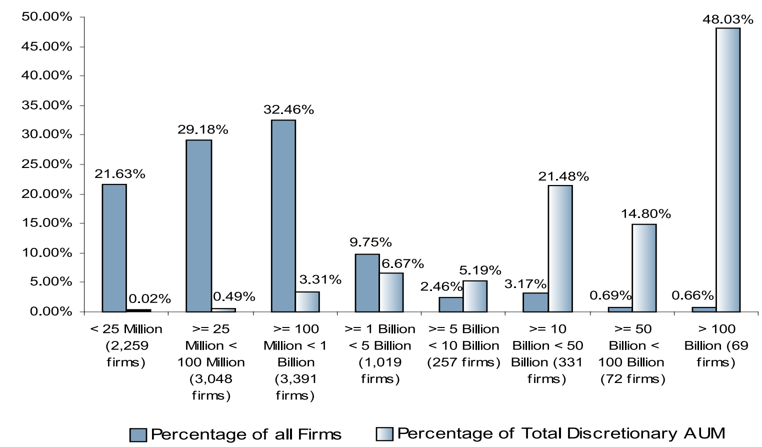
Category of IA by Assets Under Management (AUM)	*2007 AUM (in $ Trillions)*	*2006 AUM (in $ Trillions)*	*Increase or (Decrease) AUM (in $ Trillions)*	*Percent Change*
>$100 Billion	$16.467	$12.927	$3.54	+27.4
$50-100 Billion	5.073	4.092	.98	+24.0
$10-50 Billion	7.366	6.535	.83	+12.7
$5-10 Billion	1.778	1.503	.28	+18.3
$1-5 Billion	2.287	2.309	(.02)	-.01
$100 Million – 1 Billion	1.136	1.110	.03	+2.7
$25-100 Million	.168	.166	-	-
<$25 Million	.007	.007	-	-
Total	***$34.282***	***$28.649***	***$5.63***	***+19.7***

The extraordinary growth in industry assets this year is wholly attributable to organic growth of existing investment adviser firms. Investment advisers registered with the SEC both in 2006 and 2007 reported aggregate discretionary AUM growth of $6.094 trillion. Because of this dramatic growth in assets of firms registered with the SEC in both 2006 and 2007, the large number of hedge fund adviser firms de-registering did not detrimentally affect discretionary assets managed by SEC-registered firms. However, the aggregate discretionary AUM reported by newly registered investment advisers ($548 billion) was more than offset by the discretionary assets of the firms that withdrew from registration ($1.009 trillion).



Consistent with this data, of the 9,304 investment advisers that filed Form ADV for both 2006 and 2007, 6,622 (71.2%) reported growth in their total assets under management (vs. 53% last year), 1,592 (17.1%) reported shrinkage of their total managed assets, down from last year's 22.0%; and 1,090 (11.7%) reported no change at all vs.10.0% last year.

Percentage of Firms by Discretionary AUM vs. Percentage of Total Discretionary AUM



A relatively few large firms continue to dominate in terms of assets under management. Only 472 firms (4.5% of all registered investment advisers) reported managing over $10 billion in discretionary assets in 2007, up from 415 firms (4.0%) in 2006 and 359 firms (4.2%) in 2005. However, these firms collectively accounted for $28.9 trillion in discretionary assets in 2007 (84.3% of all discretionary AUM), up from $23.55 trillion in 2006. For these large firms, the increase in AUM during the past year was a substantial 22.7%.

Firms in almost every asset range experienced increases in discretionary assets during the past year continuing the upward trend that began three years ago. For example, the aggregate discretionary assets managed by firms with more than $100 billion AUM increased by 27.4% from $12.927 trillion in 2006 to $16.467 trillion in 2007. The aggregate discretionary assets managed by firms with $50 - $100 billion AUM increased by 23.9% from $4.092 trillion in 2006 to $5.073 trillion in 2007.

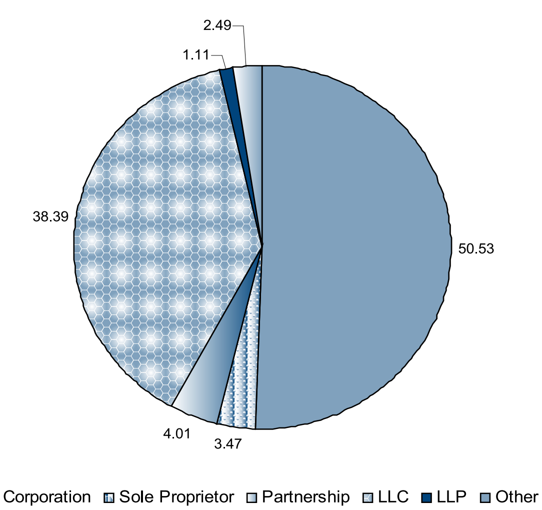
Finally, 1,077 entities reported total AUM of less than $25 million, compared with 1,139 in 2006. These entities represent a significant part (10.3%) of all SEC-registered investment advisers. Of these entities, 643 reported no managed assets (59.7% of 1,077 - 5.0% fewer than in 2006). Included in this category are 177 pension consultants (27.5% of 643), 148 controlled affiliates (23.0% of 643), and 131 newly formed advisers (20.0% of 643). 126 firms report they are now ineligible for SEC registration (11.7% of 1,077) and will withdraw their registrations. The remaining 308 firms (28.6% of 1,077) qualify for SEC registration on some additional basis.[10]

Characteristics of Investment Advisory Firms

Form of Organization

As shown in the pie chart, the majority of investment advisory firms (5,278) continue to be organized as corporations. Limited liability companies (LLCs) continue to show growth in 2007 but at a slower pace (5.5% vs. 36% in 2006). In 2007, hedge fund advisers accounted for 25% of all LLCs, down from 33% in 2006. Corporations account for 50.5% of all adviser organizations, down only .5% since last year. The number of firms organized as sole proprietors remains virtually the same at 3.47% of all investment adviser firms. However, unlike last year, limited liability partnerships saw a decrease of 31.8% and investment adviser firms organized as 'other' decreased by 5.5%.

Form of Organization



Ownership Structure

The 2007 research continues to indicate a significant concentration of assets in a relatively small number of firms. Only 69 investment advisory firms reported that they manage more than $100 billion in discretionary assets. These firms collectively manage $16.47 trillion. Of these firms, only four are owned entirely by individuals – the partners/members or employees of the firm. 49 of the 69 firms are wholly owned by publicly traded companies. Upon closer scrutiny, many of these largest advisory firms are related to each other through common parents. Accounting for firms with related ownership (29 firms are related to 11 affiliated groups), there would be only 51 (rather than 69) 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.

International Business

797 investment advisers (7.6%) report that they are registered with a foreign financial regulatory authority. This number has declined in the past year. The percentage of hedge fund advisers registered with a foreign financial regulatory authority has increased from 16.3% in 2006 to 16.7% in 2007. Overall, 41.6% of advisers registered with a foreign financial regulatory authority are hedge fund advisers, down from 48% last year.

This year, 557 SEC-registered firms (5.3%) listed non-US addresses as their principal place of business, compared to 630 last year, a decrease of 13.1%. Hedge funds account for 35.5% of the firms listing non-US addresses as their principal place of business.

Employees

The number of advisers with five or fewer employees rose by 139 firms during the past year. Firms with 6-10 employees decreased by 46 and firms with 11-50 employees increased by 28. Firms with fewer than 51 employees continued to comprise 90.4% of all SEC-registered advisers. Only 300 firms (2.9%) reported having more than 250 employees and of these only 99 firms (.9%) reported that they employ more than 1,000 persons.

Advisers reporting that they have no employees who perform investment advisory functions declined slightly from 1.8% last year to 1.7% in 2007.[11] 6,781 firms (64.9%, up from 64.7% in 2006) have between one and five employees who perform investment advisory functions, while 1,544 (14.8%) firms employ between six and ten people in this capacity. These percentages continue to remain almost the same as reported in prior years. The percentage of firms employing more than 500 persons who perform investment advisory functions rose from .56% in 2006 to .64% in 2007.

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	182	6,706
1 to 5	5,110	6,781	2,331
6 to 10	2,013	1,544	499
11 to 50	2,319	1,457	575
51 to 250	704	352	192
251 to 500	127	63	53
501 to 1,000	74	38	40
More than 1,000	99	29	50

As reported in the past, the majority of advisers (6,706 or 64.2%) do not employ any persons who are also registered representatives of a broker-dealer; this majority continues to grow, up from 2006 when 6,584 firms (64.0%) reported no employees as registered representatives. A total of 2,331 firms (22.3%) employ between one and five registered representatives, down from 2,322 in 2006. 90 firms (0.9%) employ more than 500 registered representatives; of these, 73 firms are registered as both an investment adviser and a broker-dealer.

Web Sites

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 grew from 59.5% in 2003 to 69.7% in 2007.

Solicitors

The percentage of investment advisers that use third-party solicitors has remained relatively static over the past several years. 3,326 investment advisers have engaged between one and five firms or individuals to solicit on their behalf; this represents 31.8% of all advisers, down slightly from 32.3% last year. 34 firms reported using more than 250 third-party solicitors, up from 29 in 2006. 6,416 investment adviser firms (61.4%) do not use third-party solicitors, the same percentage reported over the past two years.

Advisory Activities

The IARD information reflects that 1,068 investment advisers (10.2%) act as portfolio managers for wrap fee programs and 455 (4.4%) act as sponsors of wrap fee programs. This represents a slight increase from the percentages we reported last year. In addition, 284 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. As in prior years, the majority of advisers provide portfolio management for individual and institutional clients. More than one-third of advisers provide financial planning services, and 15.8% of advisers provide pension consulting services. The vast majority of advisers are increasing their services to individuals and small businesses.

Investment Advisory Services

Type of Advisory Activity	# of IA Firms providing advisory services	% of IA Firms providing advisory services
Financial planning services	3,802	36.40%
Portfolio management for individuals and/or small businesses	7,584	72.60%
Portfolio management for investment companies	1,419	13.58%
Portfolio management for businesses or institutional clients (other than ICs)	6,591	63.10%
Pension consulting services	1,651	15.80%
Selection of other advisers	2,953	28.27%
Publication of periodicals or newsletters	725	6.94%
Security ratings or pricing services	50	.48%
Market timing services	174	1.67%
Other	2,502	23.95%

Other Business Activities

A total of 6,924 advisory firms (66.3%) indicated that they are not actively engaged in any business other than giving investment advice, roughly the same as the 66.5% reported last year. A relatively small percentage of advisers are involved in non-advisory activities: 628 investment advisers (6.0%) are dually registered as broker-dealers, a slight increase from 5.9% reported last year; 922 advisers (8.8%)

are also registered representatives of a broker-dealer[12]; 436 advisers (4.2%) are registered as a futures commission merchant, commodity pool operator or commodity trading adviser; 87 advisers (.8%) are real estate brokers, dealers or agents; 1,266 advisers (12.1%) are also insurance brokers or agents; 52 advisers (.5%) are either a bank or a separately identifiable department or division of a bank; 2,569 advisers (24.6%) 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.[13] However, the year-over-year numbers continue to reflect a trend toward decreasing affiliations. Of note, firms affiliated with broker-dealers decreased by 2%, after having decreased by 3% last year and by 2% in each of the prior two years. Approximately 25% of registered advisers are now affiliated with broker-dealers and 33% are affiliated with other investment advisers.

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

- 2,633 (25.2%) are affiliated with broker-dealers
- 1,571 (15.0%) are affiliated with investment companies
- 3,397 (32.5%) are affiliated with other investment advisers
- 961 (9.2%) are affiliated with futures commission merchants, commodity pool operators, or commodity trading advisers
- 1,156 (11.1%) are affiliated with banks or thrifts
- 949 (9.1%) are affiliated with accountants or accounting firms
- 599 (5.7%) are affiliated with lawyers or law firms
- 1,817 (17.4%) are affiliated with insurance companies or agencies
- 654 (6.3%) are affiliated with pension consultants
- 576 (5.5%) are affiliated with real estate firms
- 1,539 (14.7%) are affiliated with sponsors or syndicators of limited partnerships

Approximately 42.9% (4,484) of all investment advisers are independent (unaffiliated with any other financial industry entity), remaining steady from 2006 (42.0%). Of these firms, 3,319 (31.8% of all firms) are not only independent, but also are not engaged in any business other than providing investment advisory services. This percentage has also remained flat over last year.

In 2007, 4,329 advisers (41.4%) reported that they or their related persons are general partners in an investment-related partnership or managers of an investment-related LLC. 46.0% of these firms are hedge fund advisers, down from 55.5% in 2006 due to de-registrations.

Clientele of Investment Advisers

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 next page. The chart shows how each client type is represented in an adviser's overall clientele. For example, 4,974 advisers (47.6%) report that they have corporations as clients. High net worth clients are the most prevalent client type, with 69.8% 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, 9,201 advisers (88.1%) do not provide advisory services to state or municipal government entities and 8,872 advisers (84.9%) do not provide advisory services to investment companies. The first column shows the percentage of advisers that provide services to each type of client.

Types of Clients

Percent serving Client Type:	Types of Clients	None	Up to 10%	11-25%	26-50%	51-75%	More than 75%
60.24%	Individuals (other than high net worth individuals)	4,153	1,398	1,091	1,395	1,212	1,197
69.80%	High net worth individuals	3,155	1,492	1,266	1,721	1,449	1,363
9.18%	Banking or thrift institutions	9,487	778	80	52	12	37
15.07%	Investment companies (including mutual funds)	8,872	769	195	140	77	393
56.04%	Pension and profit sharing plans (other than plan participants)	4,592	3,951	968	497	170	268
30.27%	Other pooled investment vehicles (e.g., hedge funds)	7,284	1,047	244	256	194	1,421
40.71%	Charitable organizations	6,193	3,653	431	123	24	22
47.62%	Corporations or other businesses not listed above	5,472	3,986	582	230	70	106
11.92%	State or municipal government entities	9,201	880	196	84	31	54
9.62%	Other	9,441	570	138	109	46	142

Hedge Funds/Pooled Vehicles

3,162 firms (30.3%) reported that they provide advisory services to "other pooled vehicles (e.g. hedge funds)." This decrease from last year's 3,371 (32.8%) is due to the court decision striking down the SEC rule requiring hedge fund adviser registration. 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. As one would expect, most of this decrease has occurred in firms that specialize in hedge fund/pooled vehicle management (i.e. more than 75% of a firm's clients are hedge funds/pooled vehicles). In 2006, 1,661 registered investment advisers specialized in hedge fund/pooled vehicle management compared to 1,421 in 2007, a 14.5% decrease. Despite the decrease in the number of hedge fund specialists, the 1,421 specialists reported discretionary AUM of $2.182 trillion (up from $1.665 trillion in 2006, $830 billion in 2005, $540 billion in 2004, and $479 billion in 2003).

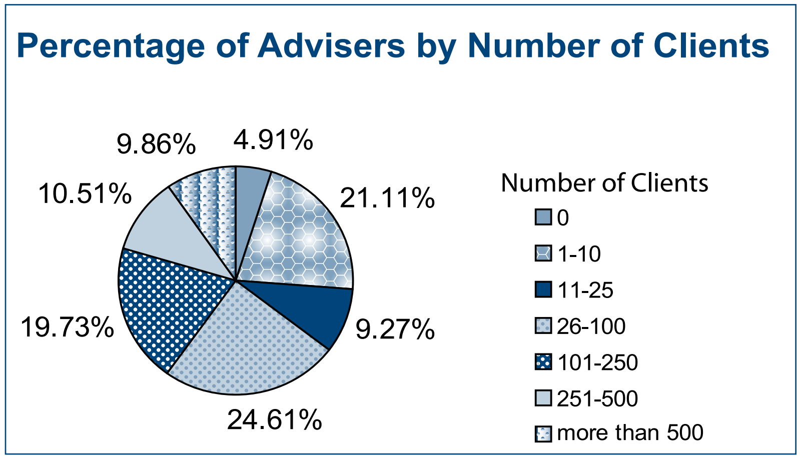
Retail and High Net Worth Clients

The percentage of advisers with no retail clients[14] in 2007 decreased to 39.8% (down from 43.0% in 2006). This decrease is likely due to the de-registration 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 53.1% of all advisers have little or no individual retail business, a decrease from 2006 (56.0%), but an increase over earlier years (52.0% in 2005, 50.0% in 2004, and 53.0% in 2003). 50 advisers provide services to only retail clients (up from 45 in 2006). Approximately 28.3% of advisers (2,952) have no individual clients (either retail or high net worth), a decrease from 2006 when 30.2% of advisers (3,155) had no individual clients.[15] 10.4% of advisers (1,089) have only individual clients, roughly steady from 2006 when 10% of advisers (1,036) had only individual clients.

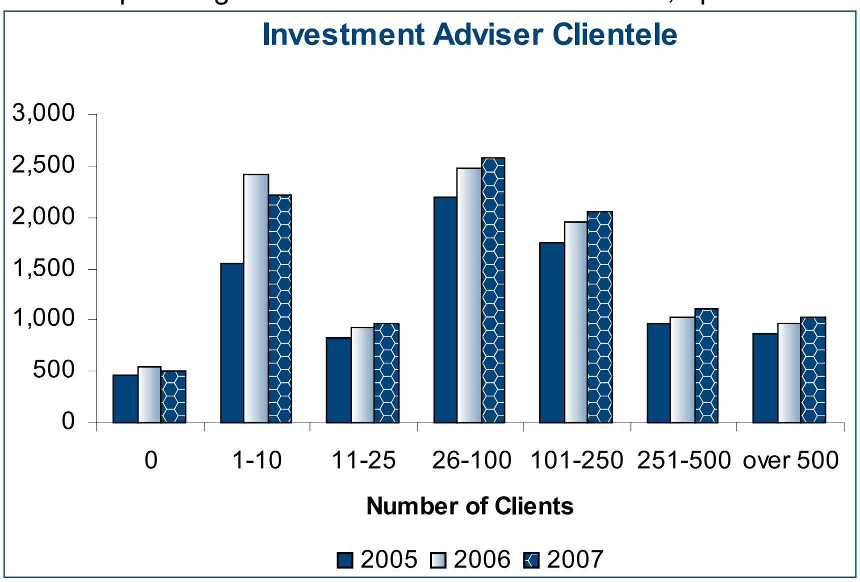
Mutual Funds

1,574 firms reported that they provide advice to investment companies, including mutual funds. While the actual number of mutual fund advisers has increased since 2006, such advisers represent only 15.1% of the total number of advisers, continuing a steady percentage decrease from 20.0% in 2002, 19.0% in 2003, 18.0% in 2004, 17.0% in 2005 and 15.2% in 2006. The 393 advisers with 75.0% or more of their clients as mutual funds (3.8% of advisers) managed discretionary AUM in 2006 of $7.21 trillion (21.0% of all discretionary AUM). While media reports often treat large mutual fund advisers as "typical," nothing could be further from reality. The vast majority of investment advisers are small businesses that have nothing to do with mutual funds.

Number of Clients



Form ADV requires advisers to report how many clients they have by certain ranges. The accompanying charts show that 2,571 advisers (24.6%) have between 26 and 100 clients, the largest category of "number of clients." The 9% decrease in advisers with 1-10 clients - from 2,426 in 2006 to 2,205 - may be attributable to the de-registration of hedge fund advisers. 1,030 advisers (9.9%) provide investment advisory services to 500 or more clients. Of these, 151 advisers also provide financial planning services to more than 500 clients, up 15.3% from 2006. 407 such advisers also act as portfolio managers in wrap fee programs. An interesting unexplained anomaly is that 513 advisers report that they have no clients, but 209 of this group reported having assets under management.



Compensation

95.4% of all advisers reported charging asset-based fees, almost the same as 2006 (95.3%). 3,474 advisers (33.3%) charge hourly fees, an increase of 282 from 2006. 4,326 advisers (41.4%) charge fixed fees, an increase of 327 from 2006.

The number of firms charging performance-based fee compensation decreased from last year due to the de-registration of hedge fund advisers. This year, 3,319 advisers reported that they charge performance-based fees, declining as a percentage of advisers from 34.4% in 2006 to 31.8% in 2007. Of the total number of advisers reporting performance-based fees, 51.3% are hedge fund advisers, down from 60% last year.

The number of advisers who use commissions as compensation for advisory services increased by 9, but the percentage – 9.3% – continued a gradual decline from 9.4% in 2006, 11.0% in 2005, and 12.0% 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 they apply to the firm's advisory affiliates and any person under common control with the adviser.

The de-registration of hedge fund advisers this year appears to have little or no effect on this year's data regarding participation in client transactions, which is little changed from last year.

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?" 6,235 advisers (60.0%) responded in the affirmative, representing a very small decrease from 61.0% in 2006.

Following are the 2007 statistics from Form ADV, Part 1, Item 8 responses:

Proprietary Interest in Client Transactions

- 7.9% (in 2006, 8.0%) 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).
- 74.4% (in 2006, 73.0%) of advisers or their related persons buy or sell securities (other than mutual fund shares) they also recommend to clients (personal or proprietary trading).
- 25.5% (in 2006, 27.0%) 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

- 6.2% (in 2006, 7.0%) of advisers or their related persons engage in agency cross transactions, decreasing from 690 in 2006 to 651 in 2007.
- 23.0% (in 2006, 24.0%) 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.
- 12.0% (in 2006, 12.0%) recommend securities to clients for which the firm or a related person has any other sales interests (other than commissions as a broker), from 1,252 in 2006 to 1,248 in 2007.

Investment Discretion or Brokerage Discretion

- 9,205, or 88.1% (in 2006, 9,076 or 88.0%) investment advisers or related persons have discretionary authority to select securities to be bought or sold for a client's account.
- 9,202, or 88.1% (in 2006, 9,077 or 88.0%) have discretionary authority to determine the amount of securities to be bought or sold for a client's account.
- 6,969, or 66.7% (in 2006, 7,082 or 69.0%) have discretionary authority to select brokers.
- 6,218, or 59.5% (in 2006, 6,392 or 62.0%) have discretionary authority to determine the commission rates paid to brokers.

Additional, Related Questions

- 7,197, or 68.9% (in 2006, 6,848 or 67.0%) of investment advisers or their related persons recommend brokers or dealers to clients.
- 6,235, or 59.7% (in 2006, 6,232 or 61.0%) 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).
- 4,756, or 45.5% (in 2006, 4,733 or 46.0%) directly or indirectly compensate employees or third parties for client referrals.

Custody

In 2007, 2,493 or 23.9% of all SEC-registered advisers reported having "custody" of client "cash or bank accounts," a decline of 1.4% from last year. 2,388 or 22.9% reported having "custody" of client "securities," also a decline of 1.4%. 2,117 advisers (20.3%) reported that a related person has "custody" of client "cash or bank accounts," a decline of 3.7%. 2,046 (19.6%) reported having a related person that has "custody" of client "securities," a decline of 3.4%. Of the advisers reporting related persons with custody, 347 reported that the related person that has custody is a broker-dealer, compared to 392 in 2003 and 2004, 382 in 2005 and 374 in 2006.

The decrease in the number of advisers reporting that they or related persons have custody is likely attributable to the decrease of SEC-registered hedge fund managers. The investment adviser custody rule provides that an adviser has custody if it acts in any capacity that gives the adviser legal ownership of, or access to, client funds or securities.[16] The Commission provided examples of when this may occur, including when a firm acts as both general partner and investment adviser to a limited partnership, which is a common occurrence with hedge fund advisers.[17]

Compliance with the SEC custody rule was required by April 1, 2004. Since then, there has been an increase of 33.3% of SEC-registered advisers reporting having "custody" of client "cash or bank accounts" and a 35.2% increase of advisers reporting having "custody" of client "securities." This trend may be due to advisers' gaining a better understanding of the SEC custody rule.

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.

Subject to these limitations, we make the following observations:
- 8,864 (84.9%) registered investment advisers reported no disciplinary history at all, the same percentage as 2006 when 8,750 reported no disciplinary history. This year only 127 (11.1%) of the 1,142 newly registered advisers reported any disciplinary event. While the 1,142 new advisers make up 10.9% of the total universe of advisers (10,446), the 127 newly registered advisers reporting disciplinary history make up only 8.0% of the 1,582 advisers now reporting such history.
- In contrast, 1,455 (15.6%) of the 9,304 previously registered firms reported at least one disciplinary event, an increase of 104 firms that were registered in both 2006 and 2007. Of the 299 new hedge fund advisers in 2007, 47 (15.7%) provided a "yes" response to a disciplinary question (up from 8.0% in 2006).
- Of the 1,582 firms reporting at least one answer in the affirmative to the disciplinary questions, 112 advisers reported only pending charges and had no final outcomes on their records. This number continues a downward trend, from 133 in 2006, 139 in 2005

and 150 in 2004. Also, the number of firms reporting pending civil proceedings increased only slightly (209 in 2006 to 215 in 2007).

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? 729 "yes" responses (7.0% vs. 6.6% in 2006, 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? 625 "yes" responses (6.0% vs. 5.7% in 2006, 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? 691 "yes" responses (6.6% vs. 6.2% in 2006, 6.5% in 2005 and 2004, 7.0% 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? 317 "yes" responses (3.6% vs. 3.5% in 2006, 4.0% in 2005 and 2004, 4.4% in 2003, and 4.9% in 2002).

Basis for SEC Registration

The vast majority of advisers (9,160, or 87.7%) 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 242 advisers in this category. Only 209 firms (2.0% overall) that manage more than $25 million chose to qualify for SEC registration on a different basis than assets under management.

1,073 advisers (10.3%) registered on the basis that they serve as an investment adviser to a registered investment company. The number of these advisers increased by 32 (3.1%), after having dropped by 65 (5.9%) between 2005 and 2006. However, 1,574 (15.1%) reported that they provide advice to registered investment companies, indicating either that 501 of these advisers selected a different basis for registration or inaccurately reported their types of clients.

The 158 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 dropped 29.8% from an all-time high in 2006 (225). After rising successively from 86 (2001), to 109 (2002), to 169 (2003), and to 199 (2004), the number had declined significantly by 31.0% to 137 in 2005, and rose to 225 in 2006.

The number of advisers that selected principal office and place of business outside the U.S. decreased from 588 to 515, due to the deregistration of non-U.S. hedge fund advisers. The number of advisers indicating that they are no longer qualified for SEC registration (135) increased by 20 or 17.4%. 34 advisers that indicated they qualified for SEC registration based on their location in Wyoming.

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

- 9,160 selected assets under management of $25 million or more.
- 34 selected principal office and place of business in Wyoming.
- 515 selected principal office and place of business outside the U.S. Of these, 146 (28.4%) are hedge fund specialists.

- 1,073 selected adviser to registered investment company (an increase of 32 or 3.1%).
- 6 selected nationally recognized statistical rating organization (NRSSO) (an increase of 1).
- 319 selected pension consultant (an decrease of 2).
- 398 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 23).
- 158 selected newly formed adviser expecting to be eligible within 120 days (a decrease of 47 or 29.8%).
- 50 selected multi-state adviser (no change).
- 33 selected Internet-based adviser (an increase of 7).
- 3 selected SEC exemptive order (a decrease of 1).
- 135 reported they are no longer eligible for SEC registration (an increase of 20 or 17.4%).

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.; (2) if a registrant indicates in Item 7.B. that it, or a related peron, 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 lists at least one entity in Schedule D, Item 7.
2. *Electronic Filing by Investment Advisers; Amendments to Form ADV SEC Rel. No. IA-1897 available at http://ftp.sec.gov/rules/final/ia-1897.htm#secib .*
3. *9,431 of 10,446 registered advisers (90.2%) have a reported fiscal year-end of December 31.*
4. On June 23, 2006, the United States Court of Appeals for the District of Columbia, in Phillip Goldstein, et al., v. Securities and Exchange Commission, vacated Rule 203(b)(3)-2, under the Investment Advisers Act of 1940, requiring certain hedge fund advisers to register with the Commission under the Advisers Act. Hedge fund advisers who withdrew their registration by February 1, 2007 were able to take advantage of certain no-action relief issued by the SEC. *See* ABA Subcommittee of Private Investment Entities, SEC Staff No-Action Letter (August 10, 2006).
5. 2006 Annual Report of the Securities and Exchange Commission, at p. 12 available at http://www.sec.gov/about/secpar/secpar2006.pdf .
6. *Id*. at p. 11.
7. *Id.* at p. 12.
8. 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.
9. As stated in the "Discretionary Assets" table, the percentage change is actually 19.7%. The .2% discrepancy is attributable to rounding.
10. 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).
11. Approximately 16% 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).
12. The way this question is phrased on Form ADV, only the 363 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 (922) 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.
13. "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.
14. 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.
15. These figures include the 241 advisers that marked the "none" response for every type of client listed in Item 5.D, including "other."
16. Custody of Funds or Securities of Clients by Investment Advisers, SEC Rel. No. IA-2176, available at http://www.sec.gov/rules/final/ia-2176.htm#P57_4850.
17. *Id.*

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 approximately 500 SEC-registered investment advisory firms that collectivelly manage in excess of $8 trillion in assets for a wide variety of institutional and individual clients. For more information, please visit www.investmentadviser.org.

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