

**Report to the California State Legislature**  
**Broker-Dealer/Investment Adviser Program**

**January 2018**

**Jan Lynn Owen**  
**Commissioner of Business Oversight**



**DEPARTMENT OF BUSINESS OVERSIGHT***Ensuring a Fair and Secure Financial Services Marketplace for all Californians***Jan Lynn Owen****Commissioner of Business Oversight**

January 10, 2018

Dear Senator/Assemblymember:

The Department of Business Oversight (DBO) respectfully submits the attached 2018 Report on the Broker-Dealer/Investment Adviser (BDIA) Program as required by the Budget Act of 2014 and the Supplemental Report of the 2017 Budget Act. Beginning in 2016, pursuant to the Budget Act, the DBO must provide the Legislature and Department of Finance an annual report on the BDIA program by January 10 of each year.

Recognizing the need for proper oversight of broker-dealers and investment advisers, the Legislature enacted SB 538 (Chapter 335, Statutes of 2013), which authorized the DBO to collect annual registration renewal fees from broker-dealers and investment advisers to support regular examination of its licensees. Regular and periodic examinations help ensure broker-dealers, investment advisers, and their employees who perform important functions on behalf of Californians, adhere to the law and their duties to investors.

Upon authorizing the BDIA program to spend the revenue from the renewal fees, the Legislature also required annual reporting on the BDIA program. Specifically, this report includes information on the number of positions authorized and filled, the number and share of licensees examined, results and outcomes of examinations, examination program recommendations and estimated staffing levels required to achieve the targeted examination cycles for licensees under the program.

I hope you find the report informative and useful. Please do not hesitate to contact me at (916) 324-9011 or [JanLynn.Owen@dbo.ca.gov](mailto:JanLynn.Owen@dbo.ca.gov), or Indira McDonald, legislative deputy, at (916) 324-9011 or [Indira.McDonald@dbo.ca.gov](mailto:Indira.McDonald@dbo.ca.gov), if you have questions or concerns. The report also can be found on the DBO website at [www.dbo.ca.gov](http://www.dbo.ca.gov).

Sincerely,

A handwritten signature in black ink, appearing to read "Jan Lynn Owen".  
Jan Lynn Owen  
Commissioner of Business Oversight

The Broker Dealer/Investment Adviser (BDIA) Program, under the Corporate Securities Law of 1968, licenses and regulates investment advisers, investment adviser representatives, broker-dealers and broker-dealer agents. Regulatory oversight helps protect the investing public from unethical and fraudulent activities and ensure California's financial services market is secure, fair and transparent. The BDIA program carries out its oversight duties by performing detailed licensing reviews and regulatory examinations of licensees. The following table shows historical numbers of licensees.

#### Workload History

| Workload Measure                   | 2012-13 | 2013-14 | 2014-15 | 2015-16 | 2016-17 |
|------------------------------------|---------|---------|---------|---------|---------|
| Investment Adviser Firms           | 3,677   | 3,712   | 3,711   | 3,737   | 3,808   |
| Investment Adviser Representatives | 52,154  | 50,980  | 51,627  | 52,580  | 53,834  |
| Broker-Dealer Firms                | 3,098   | 3,019   | 2,980   | 2,906   | 2,834   |
| Broker-Dealer Agents               | 278,496 | 278,532 | 281,349 | 286,148 | 287,740 |
| Broker-Dealer Branch Offices       | 17,902  | 18,046  | 18,033  | 17,791  | 17,384  |

**1. Number of positions authorized and filled.**

As of July 1, 2017, the BDIA program has 82 authorized positions, including 67 which are currently filled. The 15 vacant positions were approved by the Legislature in response to our 2017-18 Budget Change Proposal and will be filled in two phases of seven and eight positions, respectively, over the next two fiscal years.

**2. Number and share of licensees examined.**

The following table shows the number of examinations completed and the percentage of licensees examined since fiscal year 2014-15 by the BDIA program.

| Licensee Type                | Number of Licensees |               |               | Exams Completed by Fiscal Year |            |            | Percent of Licensees Examined |              |              |
|------------------------------|---------------------|---------------|---------------|--------------------------------|------------|------------|-------------------------------|--------------|--------------|
|                              | 2014-15             | 2015-16       | 2016-17       | 2014-15                        | 2015-16    | 2016-17    | 2014-15                       | 2015-16      | 2016-17      |
| Investment Adviser           | 3,711               | 3,737         | 3,808         | 54                             | 232        | 387        | 1.46%                         | 6.21%        | 10.16%       |
| Broker-Dealer (In-State)     | 468                 | 453           | 437           | 8                              | 23         | 3          | 1.71%                         | 5.10%        | 0.70%        |
| Broker-Dealer (Out-of-State) | 2,512               | 2,453         | 2,397         | 0                              | 0          | 0          | 0%                            | 0%           | 0%           |
| Broker-Dealer Branch Offices | 18,033              | 17,791        | 17,384        | 10                             | 14         | 17         | 0.06%                         | 0.08%        | 0.10%        |
| <b>Total</b>                 | <b>24,724</b>       | <b>24,434</b> | <b>24,026</b> | <b>72</b>                      | <b>269</b> | <b>407</b> | <b>0.29%</b>                  | <b>1.10%</b> | <b>1.69%</b> |

### **3. Results and outcomes of examinations**

In fiscal year 2014-15, the Legislature approved the BDIA program's Budget Change Proposal for 36 additional positions to examine BDIA licensees. These positions were filled over the past two years, resulting in significant increases in examinations during fiscal years 2015-16 and 2016-17, as shown in the table above.

The program completed 407 examinations of broker-dealers, broker-dealer branch offices and investment advisers in fiscal year 2016-17. Thirteen cases revealed violations that resulted in referrals to the DBO's Enforcement Division for license revocations. The remaining 394 examinations identified various violations for which the licensees took corrective action.

The DBO has sole regulatory authority and oversight over all state investment advisers and, therefore, places a high priority on them. To fully utilize program resources and maximize consumer protections, the BDIA program reallocated its resources in fiscal year 2016-17 to increase the number of examinations of investment adviser firms. Broker-dealer firms and broker-dealer branch offices receive additional oversight from the U.S. Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA) and the firms' home states. These regulatory entities also conduct routine examinations of these licensees. Therefore, to avoid unnecessary duplication of efforts, the DBO continues enhanced coordination and works with its federal and state counterparts to examine these entities. In addition, the program continues to conduct examinations based on consumer complaints and referrals on investment advisers, broker-dealers and broker-dealer branch offices.

### **4. Examination program recommendations**

Investment Adviser firms:

A total of 3,808 investment adviser firms are registered with the DBO. In order to promote consumer protection, the BDIA program strives to conduct regulatory examinations of all investment adviser firms. Additional examination methods have been explored and findings reviewed to make changes that will preserve regulatory oversight, increase efficiency and cost effectiveness while promoting investor protection. Based on our findings and efforts, the DBO plans to conduct desk examinations of lower-risk firms and annual examinations through exam questionnaires of firms with a principal place of business outside California. These options are being implemented in 2018 and will result in an increase in the number of examinations. In addition, the program has reviewed the scope of its examinations and restructured exam work modules to create a more streamlined examination process. The BDIA program began implementation and use of the new work modules in May 2017.

**Broker-Dealer firms:**

A total of 2,834 broker-dealer firms are registered with the DBO. Of these, 437 have their principal place of business or home office in California. To increase protection of California consumers, the BDIA program plans to maximize the efficiency and cost effectiveness of its oversight by prioritizing and conducting regulatory examinations on firms with a home office in California. The SEC, FINRA and other home states also oversee and conduct routine regulatory examinations of the broker-dealer firms located outside California. The DBO and FINRA hold quarterly discussions on upcoming exam cycles, trends, significant investigations and enforcement matters. The DBO and the SEC also share upcoming exam plans and work together on enforcement matters. The DBO continues to coordinate with these entities to provide oversight and avoid unnecessary duplication of examinations. The number of broker-dealer firms headquartered in California is used in the calculation of the required number of examiners below.

**Broker-Dealer Branch offices:**

The total number of broker-dealer branch offices reported in California is 17,384. The DBO licenses broker-dealer firms. Branch offices are reported as additional offices working under the license of the principal firm. Broker-dealer firms are responsible for supervising all business activities at branch offices and conducting routine on-site branch inspections every one to three years. Broker-dealer firms and branch offices obtain membership and registration through FINRA, giving FINRA oversight authority to examine the operations of the entities. FINRA conducts routine cycle examinations of the broker-dealer firms and their branch offices. To prioritize examinations and avoid unnecessary duplication of branch office examinations, the BDIA program continues to work with FINRA. The DBO has reviewed options, such as focusing on higher risk categories listed in the table below, to prioritize examinations of higher risk branch offices. The table below identifies the level of risk involved at branch locations with associated individuals who have disclosures of criminal, regulatory, civil judicial or customer complaint events. The BDIA program continues to explore additional options to examine medium-risk and lower-risk branches and to examine branches at all levels of risk based on tips, complaints, and referrals. The number of broker-dealer branch locations set as high risk is used to calculate the required number of examiners below.

| <b>Number of Broker-Dealer branch locations</b> | <b>Number of Associated Individuals with Disclosures</b> | <b>Identified risk levels</b> |
|---|--|-------------------------------|
| 1,001   | 3 or more individuals                                    | High risk                     |
| 976   | 2 individuals  | Medium risk                   |
| 4,620   | 1 individual   | Low risk                      |
| 10,787  | 0 individuals with disclosures                           | Very low risk                 |
| <b>Total: 17,384</b>                            |  |                               |

### Calculation of Required Number of Examiners for BDIA Program

|   | Number of Firms | Exam Cycle (years) | Estimated exams per year (total DBO workload) | Average number of staff hours per exam | Total number of ongoing workload hours (DBO-wide) | Annual hours available per examiner* | Estimated total number of required examiners |
|---|-----------------|--------------------|---|--|---|--------------------------------------|--|
| <b>Investment Advisers</b>                      | 3,808           | 4                  | 952   | 80                                     | 76,160  | 1,660                                | 46   |
| <b>Broker-Dealer firms</b>                      | 437             | 4                  | 110   | 100                                    | 11,000  | 1,660                                | 7  |
| <b>Broker-Dealer Branch Offices (high-risk)</b> | 1,001           | 4                  | 251   | 80                                     | 20,080  | 1,660                                | 12   |
| <b>Totals</b>                                   | <b>5,246</b>    |                    | <b>1,313</b>                                  |  | <b>107,240</b>                                    | <b>1,660</b>                         | <b>65</b>                                    |

\* Of the total number of position hours (1,760), 1,660 hours are available per examiner with 100 hours needed for formal training.



## 5. Estimated required staffing levels.

The BDIA program has 82 authorized positions for 2017-18. Of these positions, 53 are allocated to perform examinations (seven positions to be filled in the 2017-18 fiscal year and eight to be filled in the 2018-19 fiscal year), eight perform licensing functions and 21 manage or provide support to the program. Based on current information, the BDIA program estimates it needs at least 12 additional examiners to meet the target four-year examination cycle for investment adviser firms, broker-dealer firms (in-state) and high-risk broker-dealer branch offices. As previously proposed in the 2014-15 BCP, the program also may consider options for varying the length of exam cycles to five years for broker-dealers with home offices in California and ten years for broker-dealer branch offices.

|  |         |
|--|---------|
| <b>Current Staffing:</b>                               |         |
| <b>Available Examination Staff</b>                     | 53      |
| <b>Available Annual Hours per Staff</b>                | 1,660   |
| <b>Total Available Hours</b>                           | 87,980  |
| <b>Ongoing Workload Exams (in hours)</b>               | 107,240 |
| <b>Less: Total Current Available Staff Hours</b>       | 87,980  |
| <b>Unmet Staff Needs (in hours)</b>                    | 19,260  |
| <b>Total Positions Needed (Unmet Need/1,660 hours)</b> | 12      |

The BDIA program has identified potential options for increasing efficiency and cost-effectiveness of oversight over BDIA licensees. These include prioritizing investment adviser examinations, implementing desk exams and exam questionnaires, and checking regularly with the SEC and FINRA to ensure we are not duplicating efforts and are maximizing available resources. We will continue to participate in quarterly discussions with FINRA on exam strategies and data regarding broker-dealers and broker-dealer branches. The DBO will report its findings and results in the next year.