

**Report to the California State Legislature and
Department of Finance**

Broker-Dealer/Investment Adviser Program

January 2020

**Alexis Podesta, Secretary
Business, Consumer Services, and Housing Agency**

**Manuel P. Alvarez
Commissioner of Business Oversight**





STATE OF CALIFORNIA

Department of Business Oversight

GOVERNOR **Gavin Newsom** • COMMISSIONER **Manuel P. Alvarez**

January 10, 2020

Dear Senators/Assemblymembers:

The Department of Business Oversight (DBO) respectfully submits the attached 2020 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 provisional language in the 2014 Budget Act (Chapter 25, Statutes of 2014), 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 BDIA Program licensees. Regular and periodic examinations help ensure broker-dealers, investment advisers and their employees 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 2018-2019 fiscal year 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.

I hope you find the report informative and useful. Please do not hesitate to contact me at (916) 324-9011 or Manuel.Alvarez@dbo.ca.gov, or Bret Ladine, Assistant General Counsel, at (916) 324-9011 or Bret.Ladine@dbo.ca.gov, if you have questions or concerns. The report also can be found on the DBO website at www.dbo.ca.gov.

Sincerely,

A handwritten signature in blue ink, appearing to read "Manuel P. Alvarez".

Manuel P. Alvarez
Commissioner
Department of Business Oversight

Broker-Dealer / Investment Adviser Program 2020 Report to the Legislature

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 Measure	2016-17	2017-18	2018-19
Investment Adviser Firms	3,808	3,759	3,729
Investment Adviser Representatives	53,834	54,833	55,752
Broker-Dealer Firms	2,834	2,742	2,674
Broker-Dealer Agents	287,740	291,333	294,532
Broker-Dealer Branch Offices	17,384	16,996	16,814

Workload History by Fiscal Year (FY)

1. Number of positions authorized and filled

In FY 2014-15, the Legislature approved the BDIA Program’s Budget Change Proposal (BCP) for 36 additional positions to the program’s staff of 38 positions, to conduct regulatory examinations of the books and records of BDIA licensees. These positions were filled over a two-year period, resulting in a significant increase in examinations. In FY 2017-18, the Legislature approved a second BCP for an additional 15 positions: seven in FY 2017-18 and eight in FY 2018-19 to increase the DBO’s ability to examine a greater number of BDIA licensees. The positions were filled over a two-year period resulting in an increase in examinations during FY 2017-18 and going forward, as shown in the table below. Through staff development and promotions, the program currently has 10 vacant positions that are actively being recruited.

The BDIA Program has a total of 89 authorized positions, and currently 79 of the 89 positions are filled. BDIA is active in the recruitment process to fill all vacant positions.

2. Number and share of licensees examined by fiscal year

The following table shows the number of examinations completed and the percentage of licensees examined since FY 2016-17.

Licensee Type	Number of Licensees			Number of Exams Completed			Percent of Licensees Examined		
	2016-17	2017-18	2018-19	2016-17	2017-18	2018-19	2016-17	2017-18	2018-19
Investment Adviser Firms	3,808	3,759	3,729	387	432	1,001*	10.16%	11.50%	26.84%
Broker-Dealer (In-State)	437	427	408	3	11	14	0.70%	2.58%	3.43%
Broker-Dealer (Out-of-State)	2,397	2,315	2,266	0	0	0	0%	0%	0%
Broker-Dealer Branch Offices	17,384	16,996	16,814	17	27	51	0.10%	0.16%	0.30%
Total	24,026	23,497	23,217	407	470	1,066	10.96%	14.24%	30.57%

*The total Investment Adviser examinations number includes 598 examination conducted by examination questionnaire.

3. Results and outcomes of examinations

The BDIA Program completed 1,066 examinations of broker-dealers, broker-dealer branch offices and investment advisers in FY 2018-19. Of the total examinations, 598 of the Investment Adviser examinations were attributable to the program's first-ever online examination. The DBO created a streamlined examination that licensees can take and submit through a secure online application. The examination is sent to all California registered investment adviser firms that maintain their principal place of business in another state. Beginning with FY 2019-20, the DBO will examine this population of licensees on a four-year cycle or 25% of the total population each year. Of the 1,066 total examinations completed, violations were found in 45 of the examinations that resulted in referrals to the DBO's Enforcement Division for administrative actions and/or penalties. The remaining 1,021 examinations identified books and records violations for which the licensees took corrective action by implementing procedures to mitigate future violations.

The DBO has regulatory authority and oversight over all state investment advisers, broker-dealers, and broker-dealer branch offices. In addition to regulation from California, broker-dealers and branch offices are regulated by the U.S. Securities and Exchange Commission (SEC), the firm's home-state regulators, as well as the Financial Industry Regulatory Authority (FINRA). FINRA is a private organization that acts as a self-regulatory organization providing oversight over its member brokerage firms by writing and enforcing its rules as well as federal securities rules and laws established by the SEC. FINRA conducts regulatory examinations of its member broker-dealers and broker-dealer branch offices.

As such, BDIA has placed a high priority on examining state registered investment advisers, as DBO is the sole regulatory authority and oversight over these firms. To fully utilize program resources and maximize consumer protections, the BDIA Program streamlined its work efforts beginning in FY 2016-17 to increase the number of examinations of investment adviser firms. The DBO focuses its examination efforts on broker-dealer firms located in California to maximize protection of California investors. For broker-dealer firms located outside of California, the DBO conducts regulatory examinations of branch office locations in California. In addition, the SEC, FINRA and the firms' home states also conduct routine examinations of these licensees. To avoid unnecessary duplication of efforts, the DBO coordinates and works with its federal and state counterparts to examine these entities. The BDIA Program continues to conduct examinations of licensees based on consumer complaints and referrals.

4. Examination program recommendations

Investment Adviser Firms

A total of 3,729 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 using a risk based approach. Additional examination methods have been explored and findings reviewed to make changes that will preserve regulatory oversight, and increase efficiency and cost effectiveness, while promoting investor protection. Based on our findings and efforts, in FY 2017-18, the DBO implemented desk examinations of lower-risk firms and developed new procedures for exams through on-line examination questionnaires of firms with a principal place of business outside California. In FY 2018-19, these new procedures were implemented and the DBO received 598 completed examinations. The examination responses were reviewed for violations of the California Corporations Code, investor complaints, and other regulatory disclosures. A total of 14 referrals were made to the licensee's home state for further review and follow up.

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. As a result, the quality of examinations has increased to better promote consumer protection. Violations, findings and regulatory issues are provided to licensees through the issuance of Regulatory Examination Reports. The program will continue to refine and develop its capabilities in examinations.

Broker-Dealer Firms

A total of 2,674 broker-dealer firms are registered with the DBO. Of these, 408 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 of these 408 firms.

The SEC, other states, and FINRA 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 in 2018-19 is 16,814. As noted above, 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 their 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 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. In September 2019, the DBO, FINRA and NASAA (North American Securities Administrators Association) co-hosted a joint conference to train state examiners on conducting Broker Dealer and Broker Dealer Branch office examinations. The event was well received with participation of 116 persons from 23 states.

The DBO has reviewed options, such as prioritizing and conducting examinations of higher-risk branch offices. The following table identifies the level of risk involved at branch locations with associated individuals who have disclosed criminal, regulatory, civil judicial or customer complaint events.

The BDIA Program creates an annual branch exam plan to examine a percentage of branches from the high risk, medium risk, low risk and very low risk categories. Additionally, the program continues 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.

Number of Broker-Dealer Branch Locations	Number of Associated Individuals with Disclosures at the identified branch office locations in column 1	Identified Risk Levels
881	3 or more individuals	High risk
897	2 individuals	Medium risk
4,360	1 individual	Low risk
10,676	0 individuals with disclosures	Very low risk
Total: 16,814		

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
Investment Advisers	3,729	4	933	80	74,640	1,660	45
Broker-Dealer Firms (In-state)	408	4	102	100	10,200	1,660	7
Broker-Dealer Branch Offices (high-risk)	881	4	221	80	17,680	1,660	11
Totals	5,018		1,256		102,520	1,660	63

* Number of licensees fluctuates year after year and number of branch office examinations may change based on risk factors.

** 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 89 authorized positions for FY 2019-20. Of these positions, 57 are allocated to perform examinations, eight perform licensing functions and 24 manage or provide support to the program.

Based on current information, the BDIA Program estimates it needs at least six 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. The BDIA Program also may consider increasing the length of examination cycles to five years for broker-dealers with home offices in California and 10 years for high-risk broker-dealer branch offices.

Estimated Required Staffing:	
Number of Examination Staff Needed	63
Available Examination Staff	57
Additional Examiners Needed	6

The BDIA program has identified potential options for increasing the efficiency and cost-effectiveness of its supervision of BDIA licensees. These have included prioritizing investment adviser examinations, implementing desk exams and exam questionnaires, and checking regularly with the SEC and FINRA to maximize available resources and ensure we do not duplicate efforts. 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 relative to any new considerations and examination results in next year's annual report.