

Broker-Dealer/Investment Adviser Program

Report to the California State Legislature and Department of Finance

January 2019

**Jan Lynn Owen
Commissioner of Business Oversight**





STATE OF CALIFORNIA

Department of Business Oversight

GOVERNOR **Gavin Newsom** • COMMISSIONER **Jan Lynn Owen**

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Commissioner of Business Oversight

January 10, 2019

Dear Senator/Assemblymember:

The Department of Business Oversight (DBO) respectfully submits the attached 2019 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 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 JanLynn.Owen@dbo.ca.gov, or Indira McDonald, legislative deputy, at (916) 324-9011 or 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.

Sincerely,

A handwritten signature in blue ink that reads "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 by Fiscal Year (FY)

Workload Measure	2015-16	2016-17	2017-18
Investment Adviser Firms	3,737	3,808	3,759
Investment Adviser Representatives	52,580	53,834	54,833
Broker-Dealer Firms	2,906	2,834	2,742
Broker-Dealer Agents	286,148	287,740	291,333
Broker-Dealer Branch Offices	17,791	17,384	16,996

1. Number of positions authorized and filled

The BDIA Program has a total of 90 authorized positions, and currently 85 of the 90 positions are filled. BDIA is actively working on filling 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 2015-16.

Licensee Type	Number of Licensees			Number of Exams Completed			Percent of Licensees Examined		
	2015-16	2016-17	2017-18	2015-16	2016-17	2017-18	2015-16	2016-17	2017-18
Investment Adviser Firms	3,737	3,808	3,759	232	387	432	6.21%	10.16%	11.50%
Broker-Dealer (In-State)	453	437	427	23	3	11	5.10%	0.70%	2.58%
Broker-Dealer (Out-of-State)	2,453	2,397	2,315	0	0	0	0 %	0%	0%
Broker-Dealer Branch Offices	17,791	17,384	16,996	14	17	27	0.08%	0.10%	0.16%
Total	24,434	24,026	23,497	269	407	470	1.10%	1.69%	2.00%

3. Results and outcomes of examinations

In FY 2014-15, the Legislature approved the BDIA Program's Budget Change Proposal (BCP) for 36 additional 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 from FY 2015-16 to FY 2016-17, as shown in the table on the previous page. 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 seven positions were filled, and ongoing training provided, resulting in an increase in examinations during FY 2017-18, as shown in the table on the previous page. The remaining eight positions will be filled in FY 2018-19.

The program completed 470 examinations of broker-dealers, broker-dealer branch offices and investment advisers in FY 2017-18. Ten of the examinations found violations that resulted in referrals to the DBO's Enforcement Division for administrative actions and/or penalties. The remaining 460 examinations identified violations for which the licensees took corrective action by implementing procedures to mitigate future violations.

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 streamlined its work efforts beginning in FY 2016-17 to increase the number of examinations of investment adviser firms. The DBO has regulatory authority over broker-dealer firms and broker-dealer branch offices. Moreover, these licensees receive additional oversight from the U.S. Securities and Exchange Commission (SEC), and the firms' home-state regulators. Additionally, the Financial Industry Regulatory Authority (FINRA), a private organization that acts as a self-regulatory organization also regulates 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. The DBO focuses its examination efforts on broker-dealer firms located in California to maximize protection of California investors. For broker-dealers 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 3,759 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, 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 exam questionnaires of firms with a principal place of business outside California. In FY 2018-19, these new procedures were implemented by the DBO sending out 621 exam questionnaires on October 1, 2018. As of November 15, 2018, the DBO had received 501 examinations and anticipated receiving another 73 that were in process. Through the implementation of exam questionnaires, the DBO expects to see an increase in the total percentage of investment adviser licensees examined for FY 2018-19.

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 2,742 broker-dealer firms are registered with the DBO. Of these, 427 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 427 firms.

The SEC, other home 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 2017-18 is 16,996. 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. 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 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.

Number of Broker-Dealer Branch Locations	Number of Associated Individuals with Disclosures at the identified branch office locations in column 1	Identified Risk Levels
965	3 or more individuals	High risk
959	2 individuals	Medium risk
4,432	1 individual	Low risk
10,640	0 individuals with disclosures	Very low risk
Total: 16,996		

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	3,759	4	940	80	75,200	1,660	45
Broker-Dealer Firms (In-state)	427	4	107	100	10,700	1,660	6
Broker-Dealer Branch Offices (high-risk)	965	4	241	80	19,280	1,660	12
Totals	5,151		1,289		105,260	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 90 authorized positions for FY 2018-19. Of these positions, 61 are allocated to perform examinations, 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 two 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	61
Additional Examiners Needed	2

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 of any new considerations and examination results in next year's annual report.