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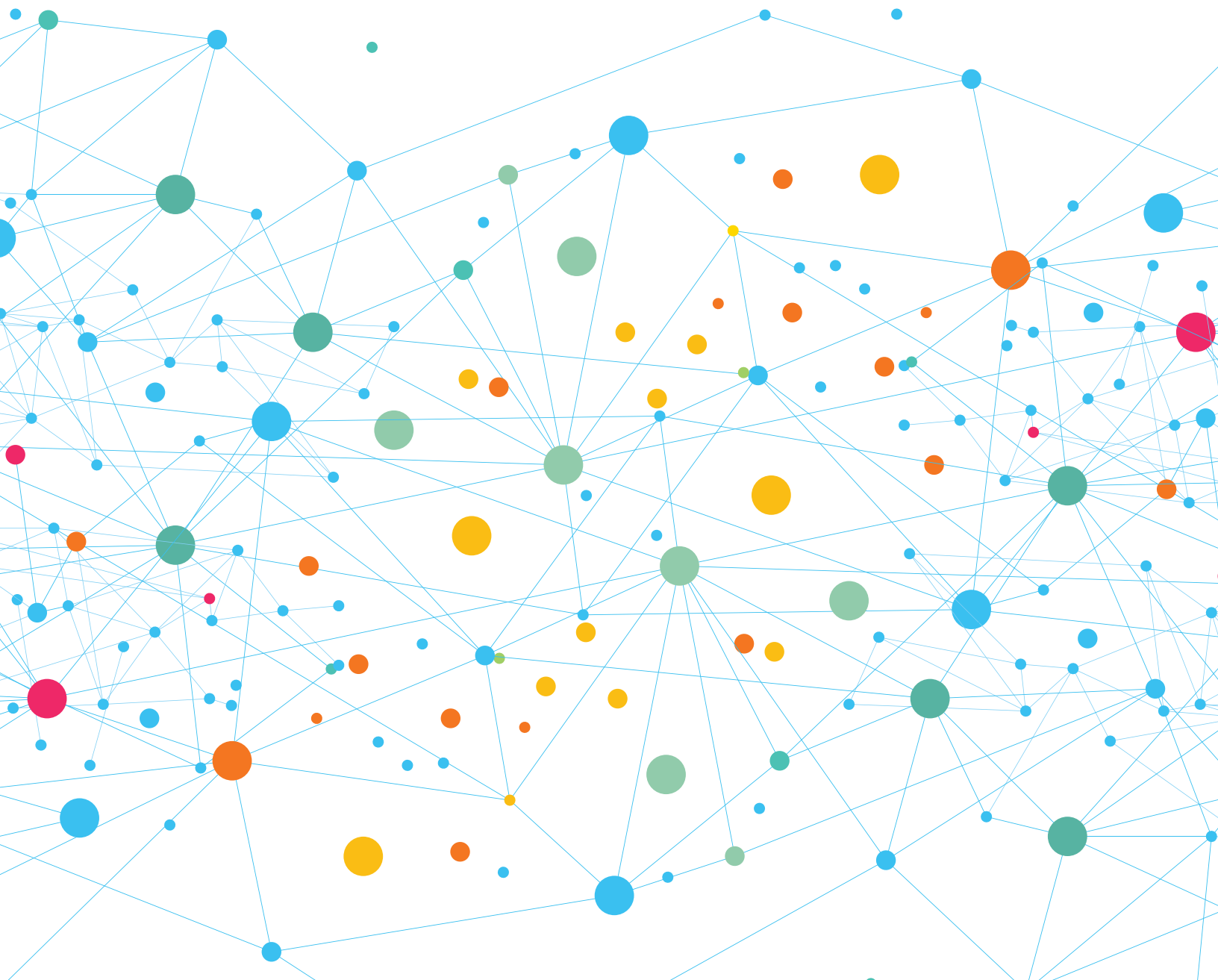
» Compliance Confidence

IAA INVESTMENT ADVISER
ASSOCIATION

2018

Evolution Revolution

A Profile of the Investment Adviser Profession





The Investment Adviser Association (IAA), based in Washington, DC, is the leading organization solely dedicated to representing the interests of SEC-registered investment advisory firms. The IAA's members collectively manage assets of approximately \$20 trillion for a wide variety of individual and institutional clients, including trusts, endowments, pension plans, private funds, mutual funds, and corporations. In addition to serving as the voice of the advisory profession on Capitol Hill and before the SEC, DOL, CFTC, and other U.S. and international regulators, the IAA provides extensive compliance and educational services and resources to its membership. For more information, visit www.investmentadviser.org.

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The 2018 “Typical”^{*} SEC-Registered Investment Adviser



Most of its clients are individuals



Highly likely to have at least one pension/profit sharing plan as a client



\$359 million

in regulatory assets under management

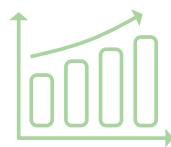
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employees

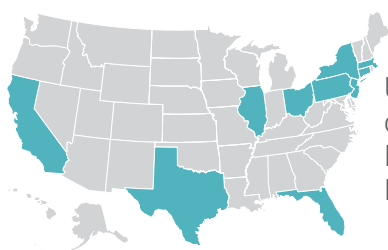


124

accounts



Exercises discretionary authority over most accounts



U.S.-based limited liability company headquartered in NY, CA, TX, MA, IL, FL, PA, CT, NJ, or OH



Does not have actual physical custody of client assets or securities

^{*}(median)

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The Investment Adviser Profession: Evolving to meet the needs of an expanding market

The Investment Adviser Association and National Regulatory Services are pleased to present our 18th annual *Evolution Revolution* report, the most comprehensive profile of SEC-registered investment advisers available. This year's report contains data on 12,578 firms that manage \$82.5 trillion for more than 34 million clients. This dynamic profession continues to be critically important to investors, our economy, and the capital markets.

Indeed, over the past five years, the number of clients benefitting from investment advice grew by more than 20 percent. To meet this expanding demand for investment advice, investment advisers employ a total of 805,623 non-clerical workers, a 13.9 percent increase over the same five-year period. Over 415,000 of these workers perform investment advisory functions. Thus, the investment adviser industry remains a powerful provider of high-quality jobs to the economy, including in small businesses. The investment adviser profession has always been dominated by small businesses and this year was no exception, as over 11,000 firms reported employing 50 or fewer individuals.

This year's report contains new information derived from advisers' first reports on the recently amended Form ADV. The SEC amended the form to increase its ability to identify and monitor risk at individual advisers for both policy and inspection purposes. We now have additional or more precise data in a number of areas, including: number of clients, amount of RAUM attributable to non-U.S. clients, advisers that participate in wrap fee programs, social media accounts, advisers with multiple offices, custodians, and private fund advisers operating as a single advisory business – so-called “umbrella registration.” These additional details will help us to provide new insights about the industry. One of the most highly-anticipated areas of amended Form ADV is the additional data about separately managed account clients (SMAs). In this year's report, we take a look for the first time at the types of assets owned by SMA clients. In addition, we now have a window into certain advisers' activities with respect to borrowings and the use of derivatives in SMAs, and a deeper understanding of these activities will develop as trends can be analyzed in the future.

2018 Evolution Revolution provides a full portrait of the SEC-registered investment adviser profession, presenting data on these major themes as well as on industry concentration, compensation, non-core business activities, financial industry affiliations, geographic concentrations, disciplinary information, and more.

It is our hope that our 2018 report provides information and analysis of value not just to investment advisers but to the public, policymakers, and the millions of clients SEC-registered advisers serve.

Karen L. Barr
President & CEO
IAA

John Gebauer
President
NRS

Executive Summary

By all measures, the investment adviser industry is experiencing robust growth indicative of an attractive business model for financial services professionals and an expanding market for advisory services.

The number of SEC-registered investment advisers continues to grow – and has reached a record high. The universe of SEC-registered investment advisers continues to grow at a steady pace. This report contains data on 12,578 federally registered advisers, reflecting a net increase of 3.3 percent since the 2017 report.

The industry continues to experience strong job growth, creating a record number of investment advisory positions. In 2018, SEC-registered advisers reported a total of 805,623 non-clerical employees – up 3.6 percent since 2017. Of these employees, more than half (415,971) provide investment advisory services (including research) – a healthy increase of over 15,000 since 2017.

The aggregate RAUM managed by SEC-registered advisers has grown substantially to a record \$82.5 trillion. RAUM managed by advisers grew 16.7 percent from \$70.7 trillion in 2017 to \$82.5 trillion this year. This RAUM growth is likely primarily a function of strong stock market performance in the past year.

While all SEC-registered advisers are fiduciaries providing investment advice to clients, the industry is highly diverse in size and type of firms, services offered and clients served.

The vast majority of SEC-registered investment advisers are small businesses. Small businesses are the core of the investment adviser industry. In 2018, 56.8 percent (7,147) of advisory firms reported that they employ 10 or fewer non-clerical employees, and 87.5 percent (11,011) reported employing 50 or fewer individuals. At the opposite end of the spectrum, the largest 108 firms employ 52.5% of all non-clerical employees in the entire industry.

SEC-registered investment advisers serve more than 34 million clients – based on a new, more precise reporting method. Individuals comprise the largest category of advisory clients. Individual clients (94.1 percent) – in particular, non-high net worth individuals (81.8 percent of total clients) – comprise the vast majority of clients by a wide margin. High net worth individuals make up 12.3 percent of total clients. Investment advisers manage \$9.9 trillion on behalf of individuals.

The bulk of RAUM resides in pooled vehicles. Registered investment companies (\$29.0 trillion) and private investment vehicles (\$19.9 trillion) together represent \$48.9 trillion – nearly 60 percent – of the total \$82.5 trillion RAUM.

Private equity funds are becoming more prevalent than hedge funds. In 2018, 4,654 advisers reported advising 36,095 private funds with a total gross asset value of \$13.3 trillion (up from 4,574, 34,409, and \$11.5 trillion, respectively, in 2017). While the percentage of hedge funds and private equity funds was exactly equal two years ago their popularity as a pool of choice has diverged, with private equity funds making gains (advisers reported 1,104 additional private equity funds) as the number of hedge funds declined. Private equity funds now make up 38.5 percent of privately offered funds and hedge funds represent 31.7 percent in the private fund space.

Nearly three-quarters of advisers have RAUM attributable to separately managed accounts, but relatively few advisers engage in borrowing or derivative transactions in SMAs. 8,690 advisers (71.8 percent) have RAUM attributable to separately managed account clients. It is more common for smaller advisers to invest 100 percent of their clients' SMA RAUM in a single asset type than it is for larger advisers. 1,396 advisers (11.1 percent) engage in borrowing transactions on behalf of any of the separately managed account clients that they advise. 1,540 advisers (12.2 percent) engage in derivative transactions on behalf of any of the separately managed account clients that they advise.

What's in a Name? A Note on Terminology

The terms “investment adviser,” “financial advisor,” and “adviser” are used imprecisely in the press and by market participants and are often employed when referring to a wide range of financial services professionals, including agents representing life insurance companies and registered representatives of a broker-dealer. This is unfortunate and adds to the general public's confusion regarding the different types of providers in the financial services industry. Throughout this report, the term “investment adviser” refers to an entity that is registered as such with the SEC, based on the definition set forth in the Investment Advisers Act of 1940.¹

In April 2018, as part of its package of proposals to raise the standard of conduct for broker-dealers and address investor confusion, the SEC proposed required disclosures in retail communications about the registration status of broker-dealers, investment advisers, and their financial professionals, and restrictions on the use of the term “adviser” or “advisor” by broker-dealers who are not also registered as investment advisers.

That said, the term “investment adviser” describes a broad range of companies and people in the business of giving advice about investing in securities. In addition to investment adviser, they may use other titles such as investment manager, wealth adviser, financial planner, investment counsel, asset manager, wealth manager, or portfolio manager. Investment advisers typically provide ongoing management of investments based on the client's objectives, often with the client giving the adviser authority to make investment decisions without having to get prior approval from the client for each transaction (called discretionary authority).

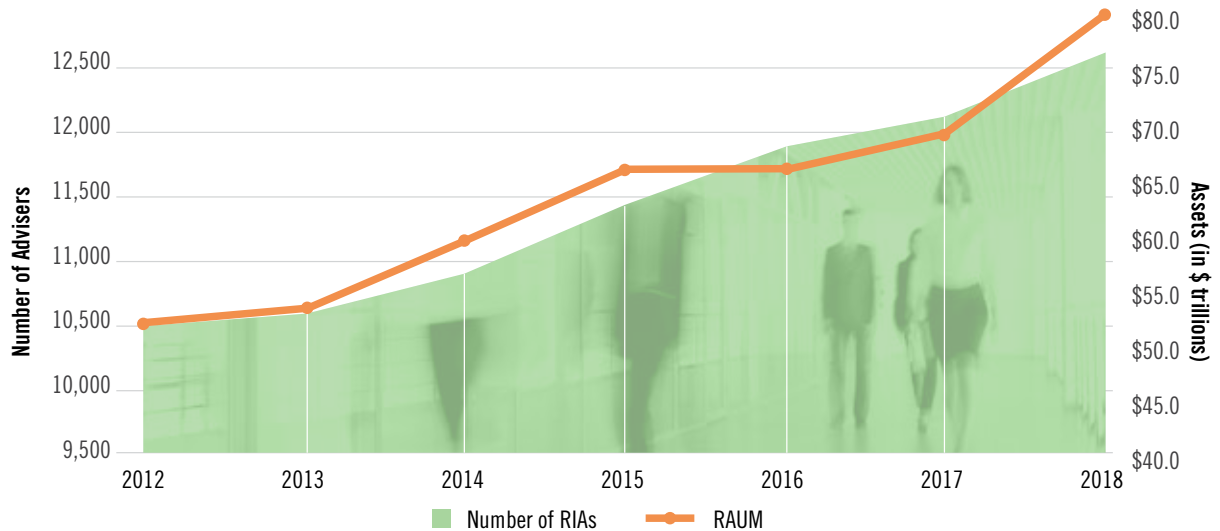
The terms “broker” and “broker-dealer” refer to companies in the business of buying and selling securities (called trading) on behalf of customers. Individual salespeople employed by brokerage firms are registered representatives of the brokerage firm. But these individuals also use many other titles, including financial consultant, financial professional, financial advisor, advisor, wealth manager, and investment consultant.

¹ Section 202 of the Investment Advisers Act defines an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities...” Section 202 also excludes certain entities under certain circumstances, including banks, bank holding companies, broker-dealers, and publishers of bona fide news publications.

Number of Investment Advisers

This report contains data on 12,578 SEC-registered investment advisers, which represents a net increase of 406 advisers or 3.3 percent since the 2017 report. This increase continues the trend from the previous year, when there was a 2.7 percent increase in advisers. The aggregate RAUM managed by SEC-registered advisers is \$82.5 trillion, a 16.7 percent increase from \$70.7 trillion in 2017, which is the largest percentage increase since 2014.

Chart 1: Industry Continues to Show Robust Growth



	2012	% Change	2013	% Change	2014	% Change	2015	% Change	2016	% Change	2017	% Change	2018	% Change
# of Advisers	10,511	(8.9)%	10,533	0.2%	10,895	3.4%	11,473	5.3%	11,847	3.3%	12,172	2.7%	12,578	3.3%
RAUM	49.4	12.8%	54.8	10.9%	61.7	12.6%	66.7	8.1%	66.8	0.2%	70.7	5.8%	82.5	16.7%

Chart 2: Number of SEC-Registered Investment Advisers by RAUM Category
2013-2018



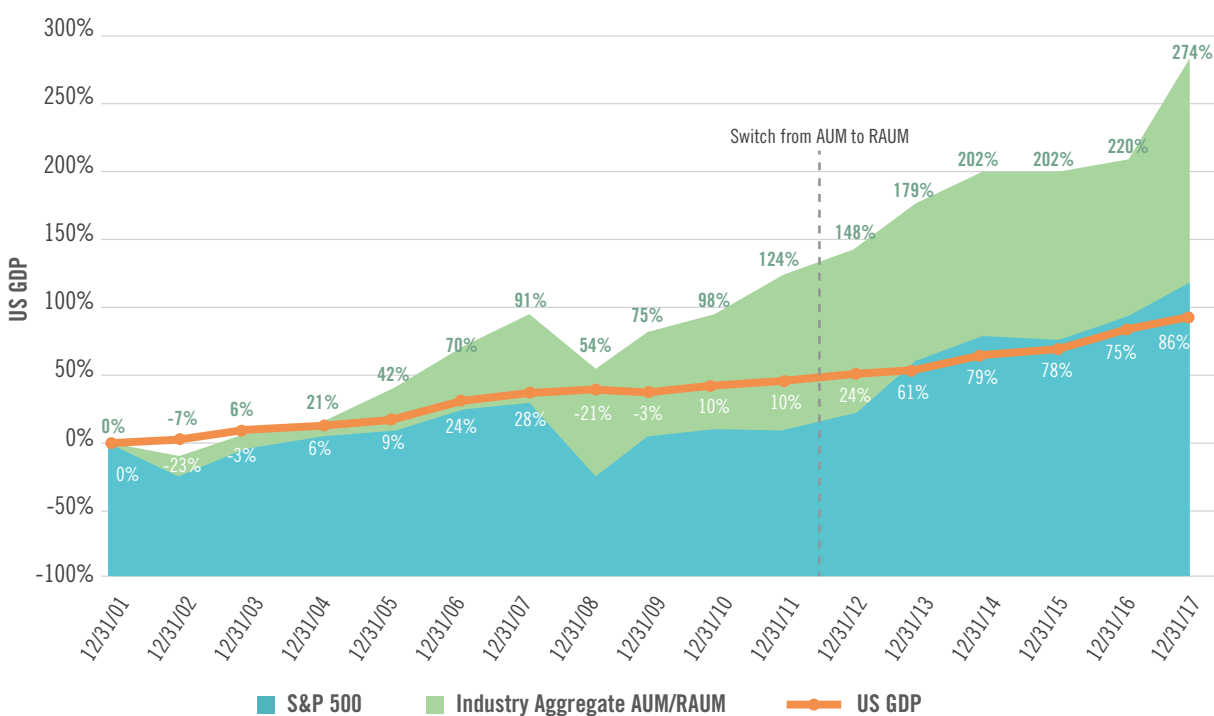
As in past years, more than half of all SEC-registered advisers have RAUM between \$100 million and \$1 billion. In a sharp reversal from the prior year, the number of advisers with RAUM under \$25 million showed the largest percentage decrease during the period, decreasing 6.6 percent from 1,026 to 958 advisers, with 83 of those advisers having moved into the \$25 million to \$100 million RAUM category and 126 having moved into the \$100 million to \$1 billion RAUM category this year. The largest percentage increase in growth was advisers with RAUM over \$100 billion, which increased by 18.5 percent from 124 to 147.

Regulatory Assets Under Management

Regulatory assets under management (RAUM) reported in 2018 increased to \$82.5 trillion from \$70.7 trillion in 2017, a one-year growth of approximately \$11.8 trillion or 16.7 percent. This significant RAUM growth is likely primarily a function of strong stock market performance in the past year. The largest firm (as measured by RAUM) alone gained over \$1 trillion since 2017. The top 10 firms by RAUM experienced net growth in RAUM of \$3.3 trillion. The top 100 firms by RAUM added \$7.4 trillion in RAUM just in the past year.

The historical growth of the industry's aggregate assets under management (AUM) or RAUM (depending on the prevailing regulations) has been quite impressive since our first report in 2001. The \$82.5 trillion RAUM that registered investment advisers now manage has more than quadrupled 2001 AUM levels.² The total industry aggregate AUM/RAUM has grown 274 percent since 2001 – a compound annual growth rate (CAGR) of 8.6 percent. By way of comparison, during the same period, the S&P 500 Index and the US Gross Domestic Product produced cumulative growth of 133 percent (5.4 percent CAGR) and 86 percent (4.0 percent CAGR), respectively.

Chart 3: Total RAUM has Grown at a Faster Pace than the Overall Economy



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595 advisers report client assets in their brochure (Form ADV Part 2A) that are computed using a different method than the method used to compute their RAUM.

² In 2012, the methodology for calculating RAUM changed significantly from the methodology used to calculate AUM in previous years.

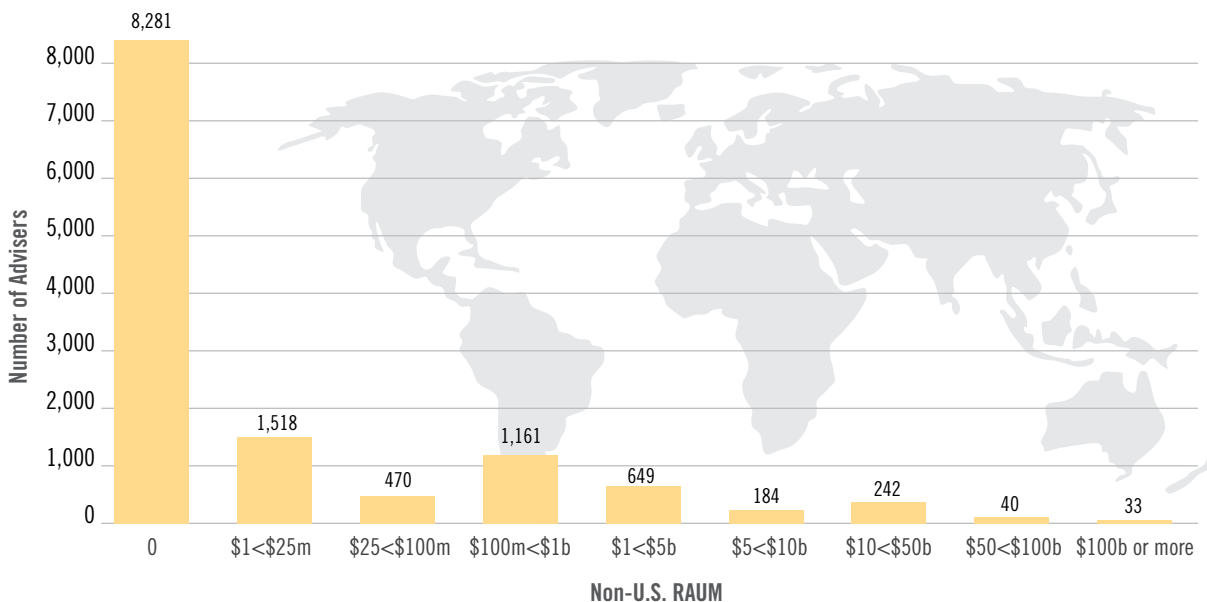
Since the first edition of *Evolution Revolution*, we have reported that the vast majority of assets are managed on a discretionary rather than a non-discretionary basis. This year, 92.1 percent of the total reported RAUM are discretionary assets, a 17.3 percent increase over last year and at the high end of the historical values that have ranged since 2001 from 87.9 percent to 92.1 percent.

RAUM is the best metric available to measure the relative size of the investment adviser market on a year-to-year basis. RAUM is rigorously calculated by each adviser according to the same rules. As an absolute measure, however, RAUM has several flaws. First, as we've reported in past years, the aggregate RAUM reported across the industry overstates actual RAUM because more than one adviser can "claim" the same assets. For example, an adviser that allocates assets among mutual funds on a discretionary basis and the adviser to those funds will both correctly include those assets in their RAUM calculation. Similarly, a sub-adviser to a fund will count the assets it sub-advises as RAUM, as will the primary manager of the fund. In addition, we note that the RAUM figure includes assets in addition to those actually currently invested for clients. For example, RAUM includes uncalled capital commitments and proprietary assets.³

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New to Form ADV this year is the approximate amount of total RAUM attributable to clients who are non-U.S. persons. Nearly two-thirds of advisers report having none.

Chart 4: RAUM Attributable to Non-U.S. Clients



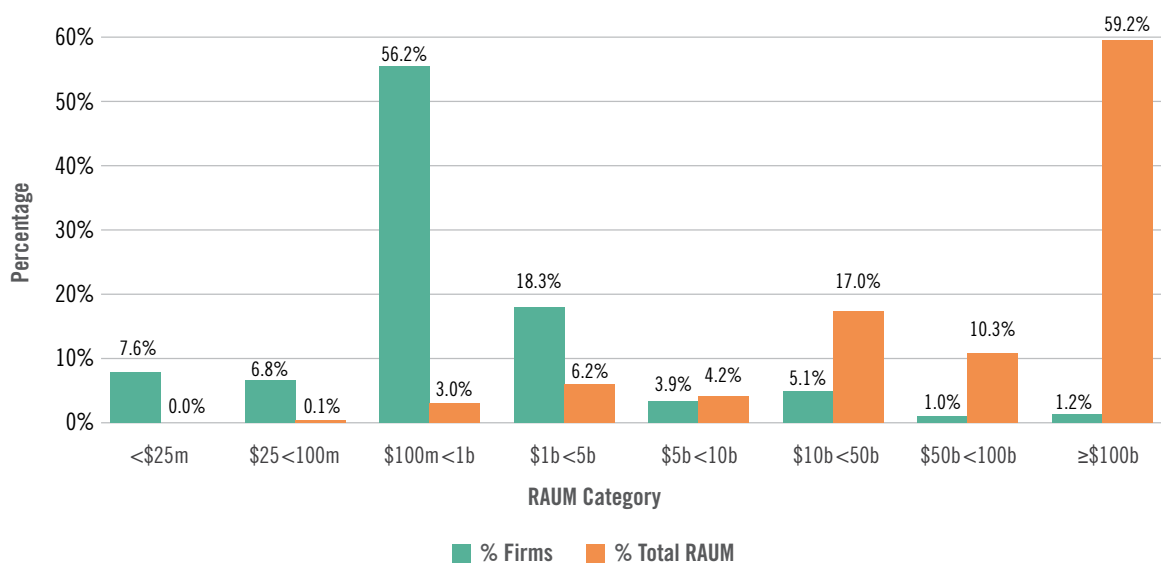
³ Additionally, the timing of Form ADV filings can impact the accuracy of the aggregate RAUM. Form ADV requires advisers to calculate and report their RAUM within 90 days of the filing. Most advisers calculate their RAUM as of December 31, but 769 (6.1 percent) have a different fiscal year end. Depending on the timing of the RAUM calculations made by each adviser, the aggregate RAUM may include some temporal variations in market value.

Industry Concentration

The recent trend toward increased industry concentration continued this year, with a majority of all RAUM being managed by a very small group of large advisers. The number of advisers that reported managing over \$100 billion in RAUM increased 18.6 percent to 147 following last year’s 2.5 percent increase. Despite accounting for only 1.2 percent of SEC-registered advisers, these 147 firms collectively managed 59.2 percent of all reported RAUM.

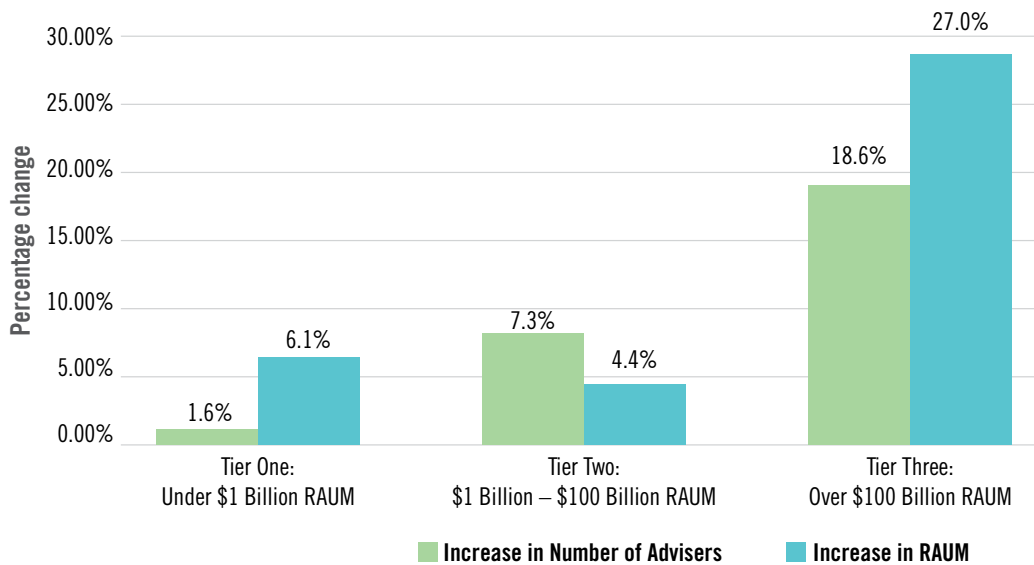
At the other end of the spectrum, 70.6 percent of all advisers managed less than \$1 billion RAUM, and they collectively managed only three percent of all reported RAUM.

**Chart 5: The Industry Barbell –
The Largest Firms Manage More than Half the Assets**



When viewed in tier groups of under \$1 billion, \$1 billion to \$100 billion, and over \$100 billion, the data shows a continuation of last year’s increases across all tier groups in both number of advisers and RAUM. While the under \$1 billion tier group increased in number by only 1.6 percent, its RAUM increased by 6.1 percent. The \$1 billion to \$100 billion tier group grew by 7.3 percent, while the RAUM managed by the tier group increased by 4.4 percent. The over \$100 billion tier group outpaced the other groups in both metrics; the number of advisers grew by 18.5 percent (from 124 to 147) and RAUM increased 27 percent.

Chart 6: Largest Advisers Expand Dominance in Growth Metrics



	Increase in Number of Advisers	Increase in RAUM
Tier One: Under \$1 Billion RAUM	1.6%	6.1%
Tier Two: \$1 Billion - \$100 Billion RAUM	7.3%	4.4%
Tier Three: Over \$100 Billion RAUM	18.6%	27.0%

Enhanced Data Reporting: A Note About the New Form ADV Part 1 Amendments

This year's *Evolution Revolution* report is the first one reflecting the amended version of Form ADV Part 1, which became effective on October 1, 2017.

As of April 10, 2018, 12,096 advisers filed a Form ADV using the amended version. However, an additional 482 advisers continue to have the prior version of Form ADV on file. Some of these advisers were not yet required to switch to the amended version because they have a fiscal year end other than December 31.

For purposes of this report, we have included this additional group in calculating total RAUM, total number of investment advisers, number of advisers that employ 50 or fewer non-clerical employees, and number of advisers that employ 10 or fewer non-clerical employees. In other areas, where the amended items in Form ADV are new or no longer facilitate direct comparisons to the prior version of the form (e.g., type of client), we have excluded this additional group.

Clients of Investment Advisers

Form ADV now requires advisers to report the approximate number of their clients (as opposed to the percentage of clients) and the amount of RAUM attributable to each type of client. This data provides several insights into the industry.

Advisers by Number of Clients

SEC-registered advisers in 2018 reported a total of at least 34 million clients. While this appears to be down from the 35.6 million clients reported in 2017,⁴ the method for reporting an adviser's number of clients changed – and is now more precise – in the amended Form ADV. 31.0 million clients are reported in 13 specific categories, plus a catch-all “other” category. Advisers reported providing investment advisory services to an additional 3.4 million clients for whom they do not have RAUM (e.g., certain non-discretionary accounts or a one-time financial plan). The fact remains that, in aggregate, SEC-registered advisers have reported significant client growth over the past five years – nearly nine million clients.

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Amended Form ADV now requires advisers to report the specific number of clients in each of 13 categories – plus a catch-all “other” category – providing more precise data than under the prior version of Form ADV, which only required advisers to select a certain range of percentages. Previously, advisers were required to provide a specific number only if they had more than 100 clients, and advisers were permitted to round to the nearest 100.

Advisers also now have the option to report that they have fewer than five clients in a particular category (other than investment companies, business development companies, and pooled investment vehicles). This option was included to address concerns regarding the potential disclosure of confidential or proprietary information.

Because of these changes in reporting, for purposes of the “Clients of Investment Advisers” section of this report, the data is derived from the 12,096 advisers that filed a Form ADV using the amended version. It does not include the additional 482 advisers that filed a Form ADV using the prior version.

⁴ The Form ADV data shows that advisers had 31,048,690 clients (excluding certain non-discretionary accounts), down from 35,636,603 clients in 2017. This data has limitations. For example, for purposes of this section, we only use Form ADV responses that provided a specific number of clients. Advisers are permitted to check that they have fewer than five clients in a particular category, rather than respond with a specific number. In 12,884 instances, advisers reported that they have fewer than five clients in one of those categories. In addition, the number of reported clients for certain advisers may include individuals eligible to receive investment advisory services on the basis of retirement plan participation.

Chart 7: Number of Clients

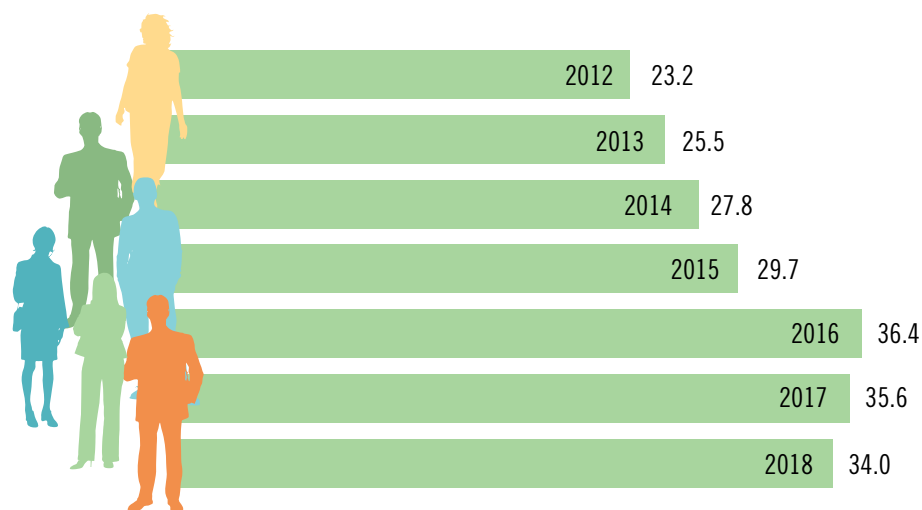
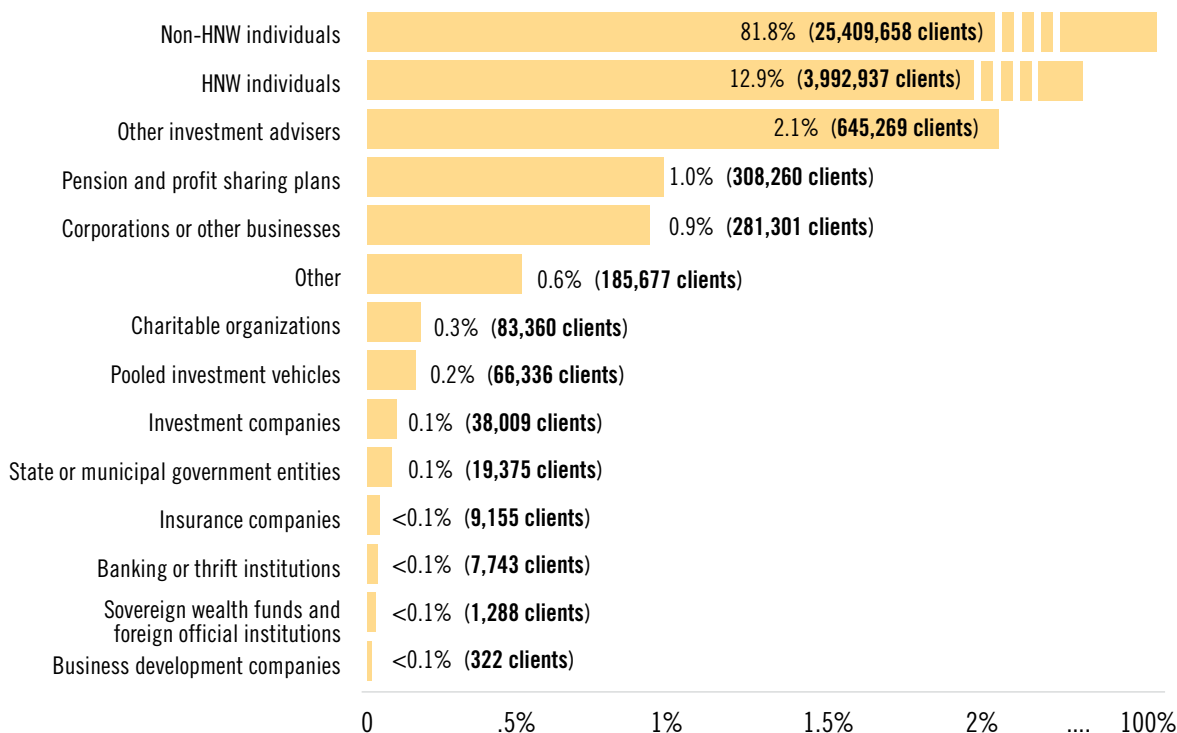


Chart 8: Advisers by Number of Clients—Most Advisers Have Individual Clients



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“Sovereign wealth funds and foreign official institutions” is a new category.

Also, Form ADV now specifies that “state or municipal government entities” include government pension plans, and that government pension plans should not be counted as pension and profit sharing plans.

Category and Type of Client

Form ADV requires advisers to report client types by indicating the approximate number of clients and the amount of total RAUM that is attributable to each type of client. Form ADV includes 13 identified client types and a catch-all “other” category, and asks for separate responses based on the number of clients and based on the adviser’s RAUM. If an adviser has fewer than five clients in a particular category (other than investment companies, business development companies, and pooled investment vehicles), the adviser may check a “fewer than 5 clients” box, rather than report the exact number of clients in that category.

The 13 specific client types fall into three distinct categories: individuals, pools, and institutions. These categories, along with the estimated portion of the \$78.6 trillion RAUM reported for each type of client,⁵ are:

 <p>Individuals</p> <ul style="list-style-type: none"> • High net worth individuals⁶ • Other individuals 	<p>\$5.7 trillion – 7.3%</p> <p>\$4.2 trillion – 5.3%</p>
 <p>Pools</p> <ul style="list-style-type: none"> • Investment companies • Business development companies • Pooled investment vehicles other than investment companies and BDCs (private funds) 	<p>\$29.0 trillion – 37.3%</p> <p>\$122 billion – 0.2%</p> <p>\$19.9 trillion – 25.6%</p>
 <p>Institutions</p> <ul style="list-style-type: none"> • Banking or thrift institutions • Pension and profit sharing plans • Charitable organizations • Corporations or other businesses • State or municipal government entities • Other investment advisers • Insurance companies • Sovereign wealth funds and foreign official institutions 	<p>\$582 billion – 0.7%</p> <p>\$5.3 trillion – 6.8%</p> <p>\$993 billion – 1.3%</p> <p>\$2.4 trillion – 3.1%</p> <p>\$2.6 trillion – 3.3%</p> <p>\$1.1 trillion – 1.4%</p> <p>\$4.8 trillion – 6.2%</p> <p>\$1.2 trillion – 1.5%</p>

The following pages take a closer look at advisers to individuals, pools, or institutions.

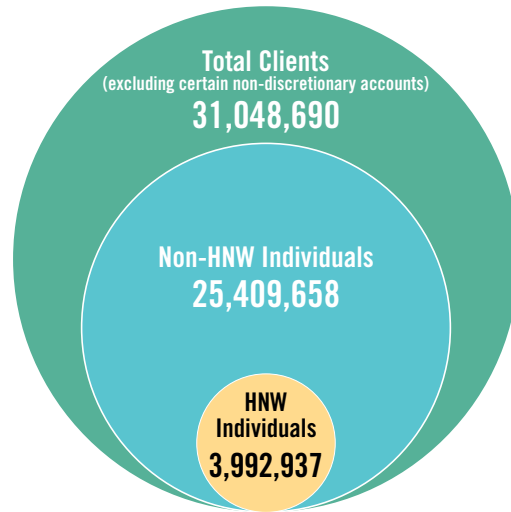
⁵ These categories do not include \$900 billion reported as an “other” type of client. It appears that some of the responses included as “other” could have been included in one of the specified category choices. Total RAUM in these categories (\$78.6 trillion) differs from industry-wide RAUM (\$82.5 trillion) due primarily to some advisers not having answered new Form ADV Part 1 Question 5.D. due to an other than calendar year fiscal year end.

⁶ A “high net worth individual” is an individual who is a “qualified client” as defined in rule 205-3 under the Investment Advisers Act or who is a “qualified purchaser” as defined in section 2(a)(51)(A) of the Investment Company Act. Generally, this means a natural person with at least \$1,000,000 assets under the management of an adviser, or whose net worth exceeds \$2,100,000 (excluding the value of his or her primary residence).

A Closer Look at Advisers to Individual Clients

Individuals remain important to a great many investment advisers and continue to comprise the largest type of advisory clients.

Chart 9: Individuals Comprise the Largest Categories of Advisory Clients



Individual clients (94.9 percent) – in particular, non-HNW individuals (81.8 percent of total clients) – comprise the bulk of clients by a wide margin. Other investment advisers is the next-most-prevalent type of client; however, 599,150 (92.9 percent) of that category is attributed to a single automated advice platform (e.g., robo adviser), which we understand represents the number of underlying clients that it serves in its capacity as sub-adviser to other investment advisers. Two of the top five number of advisers as measured by number of non-HNW individual clients served are automated advice platforms, representing 3.2 million clients.⁷

⁷ The number of advisers reporting that they provide advice exclusively through an interactive website increased by seven firms – nearly five percent – to 153.

A Closer Look at Advisers to Pools

Advisers report having a total of 104,667 clients that are some type of pool, which represents 0.3 percent of all clients.

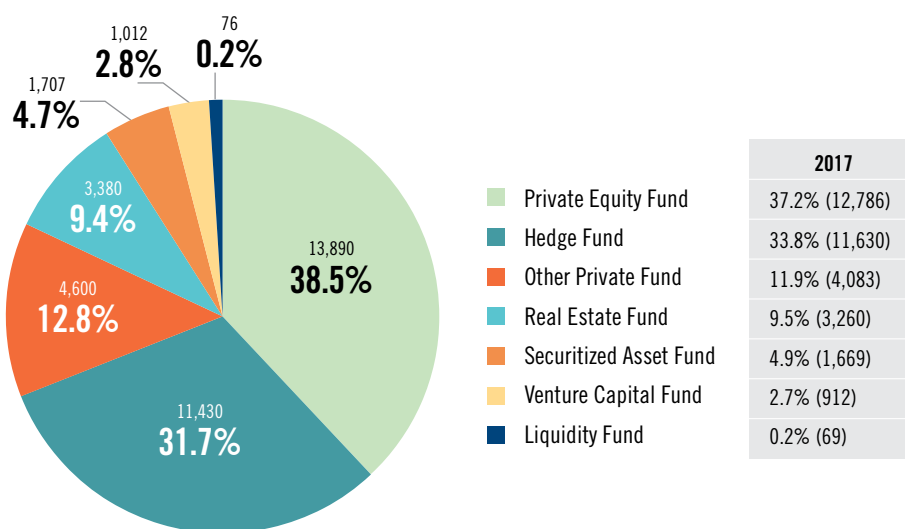
66,336 of these clients are private funds, 38,009 are registered funds, and 322 are business development companies.

Form ADV provides detailed data on advisers to private funds. In 2018, 4,654 advisers (37.0 percent) reported advising 36,095 private funds, 25.0 percent of which are funds of funds. The raw numbers of private funds increased from 2017; in 2017 there were 4,574 advisers or 37.6 percent, advising 34,409 private funds, 25.1 percent of which were funds of funds.⁸

Hedge funds and private equity funds continue to represent the largest portions of the private funds group, comprising 70.2 percent of all reported private funds, with private equity funds making up 38.5 percent and hedge funds representing 31.7 percent. While the percentage of hedge funds and private equity funds was exactly equal two years ago and began to diverge last year, there is now an even greater divergence, with private equity funds making gains (advisers reported 1,104 additional private equity funds) while hedge fund growth is flat (the number of reported hedge funds declined by 200).

The total gross asset value of reported private funds is approximately \$13.3 trillion (a 15.4 percent increase above \$11.5 trillion in 2017), more than 16.1 percent of all reported RAUM with an average gross asset value of \$367.2 million. The median gross asset value, on the other hand, is \$53.1 million. The difference between the median and average is attributable to a relatively small number of very large private funds. The number of beneficial owners of private funds also continues to vary widely, with most funds reporting few beneficial owners and a small number of funds reporting a very large number of beneficial owners. The median number of beneficial owners is 14, while the average number is 54.

Chart 10: Private Equity Funds Making Gains While Hedge Fund Growth is Flat



⁸ 715 advisers reported advising at least one private fund that is reported by another adviser (e.g., sub-advisory relationships).

A Closer Look at Advisers to Institutional Clients

The most common type of institutional client is other investment advisers – over 600,000 – far more than any other single type of institutional client. The importance of pension clients is evident here as well, as advisers serve over 300,000 pension clients and profit sharing plans. Other institutional clients include corporations, banks, insurance companies, charities, governmental entities, and sovereign wealth funds.

NEW THIS YEAR

An adviser that participates in wrap fee programs must report the amount of RAUM attributable to acting as a: (1) sponsor to a wrap fee program; (2) portfolio manager for a wrap fee program; or (3) both sponsor to, and portfolio manager for, the same wrap fee program.

A wrap fee program is an arrangement under which a client receives a combination of services – including investment advisory, brokerage, clearing, custodial and/or administrative services – in a bundled form, for a specified all-inclusive – or “wrap” – fee, usually based on a percentage of assets under management in the wrap fee account.

An investment adviser may be a sponsor of a wrap fee program or it may enter into arrangements with a sponsor (broker-dealer, bank or insurance company), whereby the sponsor offers a client a choice of an adviser as a portfolio manager of the wrap fee account.

“Participating” in a wrap fee program refers to serving as the sponsor and/or a portfolio manager, as distinguished from merely placing (or recommending the placement of) client funds in one or more programs sponsored by unaffiliated third parties.

Chart 11: Wrap Fee Programs

1,852 (14.7%) advisers participate in a wrap fee program



\$2.0 trillion
RAUM

is attributable to acting as a sponsor to a wrap fee program



\$949 billion
RAUM

is attributable to acting as portfolio manager for a wrap fee program



\$3.7 trillion
RAUM

is attributable to acting as both sponsor to and portfolio manager for the same wrap fee program

A Closer Look at Separately Managed Accounts

Separately managed account (SMA) client RAUM includes *all* of the adviser's RAUM *except for* RAUM attributable to three client-type categories: investment companies; business development companies; and pooled investment vehicles (other than investment companies and business development companies). If, after excluding those three types of clients, the remaining amount is at least \$10 billion in RAUM, advisers must report both mid-year and end-of-year values of the SMA RAUM, showing the percentage of RAUM attributable to each category of assets. If the remaining amount is less than \$10 billion in RAUM, advisers only report end-of-year values. For purposes of this report, we focus on end-of-year values.

NEW
THIS YEAR

One of the most highly-anticipated areas of amended Form ADV was that advisers are now required to report additional data about separately managed accounts ("SMAs"). The enhanced data collected includes information on the types of assets owned by SMA clients. In addition, certain advisers are required to provide information on borrowings and the use of derivatives, including gross notional exposure of derivatives in the aggregate held in client SMAs.

Because the term "separately managed account" as used in Form ADV is different from common usage of that term, it is possible that some amounts relating to clients are under-reported.

8,696 advisers (69.1 percent) have RAUM attributable to separately managed account clients:

- 530 advisers reported having at least \$10 billion in such RAUM.
- 8,166 advisers reported having less than \$10 billion in such RAUM.

The approximate percentage of RAUM that is attributable to each of 11 categories of assets – plus a catch-all "other" category – is as follows:

Chart 12: SMA Portfolios Include Diverse Asset Types

Asset Type	Larger Advisers End-of-Year (at least \$10 billion in SMA RAUM)		Smaller Advisers End-of-Year (less than \$10 billion in SMA RAUM)	
	% of SMA RAUM	# of Advisers	% of SMA RAUM	# of Advisers
(i) Exchange-Traded Equity Securities	0%	114	0%	1,153
	1% < 25%	153	1% < 25%	2,460
	26% < 50%	94	26% < 50%	1,435
	51% < 75%	54	51% < 75%	1,438
	76% < 99%	92	76% < 99%	1,495
	100%	23	100%	185
(ii) Non Exchange-Traded Equity Securities	0%	441	0%	6,917
	1% < 25%	77	1% < 25%	903
	26% < 50%	5	26% < 50%	158
	51% < 75%	2	51% < 75%	106
	76% < 99%	5	76% < 99%	60
	100%	0	100%	22
(iii) U.S. Government/Agency Bonds	0%	257	0%	5,411
	1% < 25%	251	1% < 25%	2,541
	26% < 50%	14	26% < 50%	119
	51% < 75%	6	51% < 75%	58
	76% < 99%	2	76% < 99%	29
	100%	0	100%	8
(iv) U.S. State and Local Bonds	0%	308	0%	4,523
	1% < 25%	202	1% < 25%	3,431
	26% < 50%	12	26% < 50%	137
	51% < 75%	3	51% < 75%	36
	76% < 99%	5	76% < 99%	30
	100%	0	100%	9
(v) Sovereign Bonds	0%	386	0%	7,738
	1% < 25%	126	1% < 25%	395
	26% < 50%	14	26% < 50%	22
	51% < 75%	4	51% < 75%	6
	76% < 99%	0	76% < 99%	5
	100%	0	100%	0
(vi) Investment Grade Corporate Bonds	0%	215	0%	4,560
	1% < 25%	232	1% < 25%	3,339
	26% < 50%	59	26% < 50%	203
	51% < 75%	22	51% < 75%	48
	76% < 99%	2	76% < 99%	13
	100%	0	100%	3
(vii) Non-Investment Grade Corporate Bonds	0%	355	0%	7,014
	1% < 25%	167	1% < 25%	1,042
	26% < 50%	4	26% < 50%	64
	51% < 75%	2	51% < 75%	23
	76% < 99%	1	76% < 99%	16
	100%	1	100%	7

Asset Type	Larger Advisers End-of-Year (at least \$10 billion in SMA RAUM)		Smaller Advisers End-of-Year (less than \$10 billion in SMA RAUM)	
	% of SMA RAUM	# of Advisers	% of SMA RAUM	# of Advisers
(viii) Derivatives	0%	441	0%	7,543
	1% < 25%	85	1% < 25%	549
	26% < 50%	1	26% < 50%	19
	51% < 75%	1	51% < 75%	12
	76% < 99%	2	76% < 99%	15
	100%	0	100%	28
(ix) Securities Issued by Registered Investment Companies or Business Development Companies	0%	302	0%	3,611
	1% < 25%	118	1% < 25%	1,428
	26% < 50%	38	26% < 50%	872
	51% < 75%	36	51% < 75%	975
	76% < 99%	29	76% < 99%	1,150
	100%	7	100%	130
(x) Securities Issued by Pooled Investment Vehicles (other than Registered Investment Companies or Business Development Companies)	0%	372	0%	6,748
	1% < 25%	116	1% < 25%	963
	26% < 50%	19	26% < 50%	179
	51% < 75%	16	51% < 75%	94
	76% < 99%	4	76% < 99%	113
	100%	3	100%	69
(xi) Cash and Cash Equivalents	0%	106	0%	1,187
	1% < 25%	410	1% < 25%	6,636
	26% < 50%	7	26% < 50%	247
	51% < 75%	4	51% < 75%	42
	76% < 99%	1	76% < 99%	33
	100%	2	100%	21
(xii) Other	0%	300	0%	6,197
	1% < 25%	169	1% < 25%	1,425
	26% < 50%	25	26% < 50%	139
	51% < 75%	10	51% < 75%	86
	76% < 99%	5	76% < 99%	145
	100%	21	100%	174

Larger Firms. The most prevalent asset types for the at least-\$10 billion group include cash and cash equivalents, exchange-traded equity securities, bonds, and registered investment companies. Other than exchange-traded equity securities (23 firms) and registered investment companies (7 firms), it is rare for 100 percent of an adviser's RAUM to be attributable to a single asset type, as expected for advisers with over \$10 billion in RAUM.

Smaller Firms. The most prevalent asset types for the under-\$10 billion group include exchange-traded equity securities, registered investment companies, bonds, and pools. Some advisers attribute 100 percent of their RAUM to a single asset type, most commonly exchange-traded equity securities (185 firms), registered investment companies (130 firms), pools (69 firms) and derivatives (28 firms).

Use of Borrowings and Derivatives in Separately Managed Accounts (SMAs)

New Items in Form ADV ask about an adviser's use of borrowings and derivative transactions in client SMAs. If an adviser answers that it engages in borrowings and/or derivative transactions on behalf of its SMA clients, then it generally must provide **additional details** relating to borrowings and derivatives (summarized in Charts 13 and 14), unless it has less than \$500 million in SMA RAUM. Different additional details are required to be reported for advisers with:

- At least \$500 million but less than \$10 billion in SMA RAUM
- \$10 billion or more in SMA RAUM

The following pages take a closer look at the additional details that advisers reported on their use of borrowings and derivatives on behalf of their SMA clients.

How Many Advisers Engage in Borrowings or Derivative Transactions on Behalf of SMA Clients?

1,396 advisers (11.1 percent) engage in **borrowing** transactions on behalf of any of the SMA clients that they advise.

1,540 advisers (12.2 percent) engage in **derivative** transactions on behalf of any of the SMA clients that they advise.

2,126 (16.9 percent) of all advisers engage in either or both borrowings and derivative transactions on behalf of their SMA clients. However, only 865 (40.7 percent) of those advisers provided additional details relating to borrowings and/or derivatives. 1,261 (59.3 percent) of the 2,126 advisers that engage in borrowings and/or derivatives did not provide **gross notional exposure (GNE)** details either because they have less than \$500 million in SMA RAUM (and do not report additional details), or because they met the \$500 million threshold but each SMA they advised was less than \$10 million, and advisers are permitted, but not required, to report additional details on those SMAs.

A Deeper Dive into Use of Borrowings and Derivatives in SMAs

632 advisers that reported having SMA RAUM of at least \$500 million but less than \$10 billion, and 215 advisers that have SMA RAUM of at least \$10 billion, provided additional details on borrowings and/or derivatives.⁹

Advisers with at least \$500 million but less than \$10 billion in SMA RAUM must annually report the amount of aggregate SMA RAUM and the dollar amount of **borrowings** attributable to those assets that correspond to three levels of **GNE** as of the end of the year. (See box on page 27, *Understanding Gross Notional Exposure*.)

What are Borrowings?

For purposes of the new SMA questions in Form ADV, **borrowings are defined by the SEC in the Glossary of Form ADV Part 1A** as including secured borrowings and unsecured borrowings, collectively.

- Secured borrowings are obligations for borrowed money in respect of which the borrower has posted collateral or other credit support. The Glossary states that secured borrowings should include reverse repos.
- Unsecured borrowings are obligations for borrowed money in respect of which the borrower has not posted collateral or other credit support.

In addition, the SEC staff issued FAQs stating that borrowings should include traditional lending activities such as client bank loans and margin accounts, other secured and unsecured borrowings, synthetic borrowings and transactions involving synthetic borrowings (*e.g.*, certain total return swaps), short sale transactions, and certain transactions involving unpaid variation margin. Advisers should not report as borrowings leverage that is embedded through the use of derivatives, securities lending, or repurchase agreements.

The SEC's broad definition of borrowings and measurement methodology make it difficult to draw conclusions about the prevalence of leverage or risk in SMAs managed by advisers.

What are Derivative Transactions?

"Derivative transactions" are not defined in the new Form ADV, but the Glossary defines the following terms: Interest rate derivative; Foreign exchange derivative; Credit derivative; Equity derivative; and Commodity derivative.

⁹ The instructions to Schedule D, Section 5.K.(2) of Form ADV provide that advisers with \$10 billion or more in SMA RAUM are to complete Question (a), and that advisers with at least \$500 million but less than \$10 billion in SMA RAUM are to complete Question (b). However, some advisers completed both Questions, contrary to the instructions.

Chart 13: Number of Responses Reporting Borrowings or Derivatives on Behalf of SMA Clients Among Advisers with \$500 Million up to \$10 Billion in SMA RAUM
(Section 5.K.(2)(b) of Schedule D)**

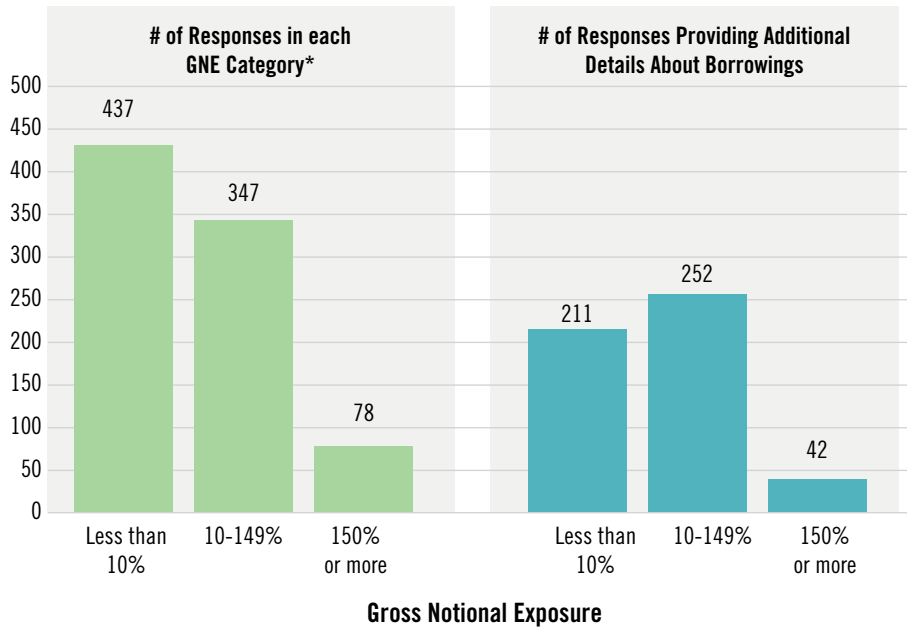


Chart 14: Number of Responses Reporting Derivative Exposures and Borrowings on Behalf of SMA Clients Among Advisers with \$10 Billion or more in SMA RAUM
(Section 5.K.(2)(a) of Schedule D)**

Gross Notional Exposure	# of Responses	# of Responses Providing Additional Details About Borrowings	# of Responses in each GNE category*					
			Interest Rate Derivative	Foreign Exchange Derivative	Credit Derivative	Equity Derivative	Commodity Derivative	Other Derivative
Less than 10%	208	82	50	56	19	80	4	16
10-149%	170	95	90	110	55	90	17	36
150% or more	84	41	59	58	35	45	19	22

* GNE is calculated by each client SMA. Because a single adviser may have reported more than one category of GNE, the responses do not reflect the number of advisers that engage in borrowings or derivative transactions.

** Advisers may exclude, but may also opt to include, any individual SMA with RAUM of less than \$10 million in these detailed reporting Sections in Schedule D.

Understanding Gross National Exposure

Form ADV looks at borrowings and derivatives in terms of the gross notional exposure (GNE) of each SMA. GNE is the percentage obtained by dividing the sum of the dollar amount of any borrowings and the gross notional value of all derivatives by the RAUM of the account.

The SEC requires that the account GNE be calculated, aggregated, and reported at three levels:

- Less than 10%
- 10-149%
- 150% or more

Note: GNE is not a measure of a firm's risk and does not reflect the ways in which derivatives are used in an SMA, such as leverage, hedging positions, or offsetting long and short positions. As a result, it is not clear whether this data is meaningful without further context. Look for next year's *2019 Evolution Revolution* report for comparative analysis on this new data.

Investment Adviser Compensation

Asset-based fees continue to dominate in the investment advisory profession. Once again this year, 95.3 percent of advisers indicate that they are compensated based on a percentage of their assets under management. Many compensation categories show little change year over year and it is likely that some fees included as “other” could have been included in one of the specified answer choices. Of the 1,830 (14.5 percent) advisers that report receiving “other” types of compensation arrangements, some of the more common types cited are a percentage of assets under advisement (e.g., non-managed assets), various fees associated with private funds, 12b-1 fees, referral fees, percentage of client net worth, percentage of plan assets, retainers, selection of other advisers fees, seminar fees, and wrap fees.

Chart 15: Asset-Based Fees Dominate Adviser Compensation Arrangements

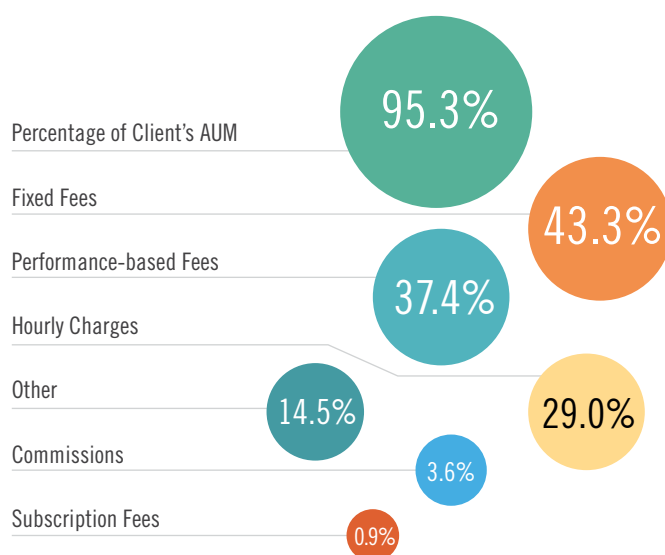


Chart 16: Investment Adviser Compensation (Past Three Years)

Category of IA Compensation	2016		2017		2018	
	# of Advisers	% of Advisers	# of Advisers	% of Advisers	# of Advisers	% of Advisers
Percentage of Client's AUM	11,274	95.2%	11,592	95.2%	11,986	95.3%
Hourly Charges	3,345	28.2%	3,475	28.5%	3,647	29.0%
Subscription Fees	122	1.0%	115	0.9%	118	0.9%
Fixed Fees	4,992	42.1%	5,144	42.3%	5,445	43.3%
Commissions	530	4.5%	506	4.1%	459	3.6%
Performance-based Fees	4,540	38.3%	4,651	38.2%	4,704	37.4%
Other	1,731	14.6%	1,769	14.5%	1,830	14.5%

The industry's recent focus on the Department of Labor's fiduciary rule is ostensibly reflected in the decrease in the number of firms charging commissions, which dropped to 3.6 percent of all advisers in 2018, down from 4.1 percent and 4.5 percent in 2017 and 2016, respectively. Another, perhaps related, trend is the increase in the number of advisers reporting charging fixed fees. Many factors are potentially contributing to this increase in fixed fees, including generational turnover as younger investors may prefer a subscription-like model when paying for financial advice.

Custody of Client Assets

Form ADV includes a number of questions about the custody of client assets. These questions – and the investment adviser custody rule¹⁰ – appear to continue to be a source of widespread confusion and inconsistent interpretations in the asset management industry. Indeed, a 2013 *Risk Alert* published by the SEC’s Office of Compliance Inspections and Examinations (OCIE) emphasized that non-compliance with the custody rule, as amended in 2009, was one of the most common issues found in routine investment adviser examinations and that, in fact, many advisers failed to realize they even had custody as defined in the rule. These issues persist today.

The confusion stems from the fact that while advisers, in general, are prohibited from having physical custody of client assets, advisers are also deemed to have custody under certain other circumstances. Many of the questions in Form ADV relate to advisers that are deemed to have custody, although to complicate matters further, advisers that are deemed to have custody for certain types of reasons (such as the ability to deduct fees) are not required to answer certain custody questions¹¹ on Form ADV and are therefore not reflected in the data we discuss below, unless otherwise indicated.

During the past year, further confusion stemmed from the SEC staff’s Inadvertent Custody Guidance Update,¹² which (1) indicates that an adviser may have “inadvertent custody” if the client’s custody agreement contains broad authority for the adviser to instruct the custodian, even where the adviser is not a party to the agreement and that authority is inconsistent with the adviser’s agreement with the client, and (2) called into question the industry’s understanding of the authorized trading exception from the custody rule, which has significant implications for instruments that do not settle on a “delivery versus payment” basis.

Moreover, the questions in Item 9 of Form ADV, Part 1 are confusing in their use of the terms “you” and “your related persons,” leading us to conclude that some advisers are double counting, and other questions embed double negatives. There also continues to be confusion about the difference between having “custody” and being a “custodian,” resulting in frequent misinterpretations.

Given this backdrop, Chart 17 shows that the number of advisers reporting that they or a related person had or were deemed to have custody increased by 1,346 (25.4 percent) to 6,635 in 2018 compared to 5,289 in 2017. In 2018 there were significant increases in the number of advisers that reported having custody of any clients’ cash or bank accounts (up 33.6 percent), securities (up 29.9 percent), total advisers and their related persons having custody of clients’ cash or bank accounts (up 24.6 percent), and total RAUM (including related persons) representing clients’ cash or bank accounts (up 23.0 percent, from 11.0 trillion last year to 13.5 trillion in 2018). The number of advisers and their related persons that act as qualified custodians stayed flat, increasing by two.

¹⁰ Rule 206(4)-2 under the Advisers Act requires an adviser with custody of client assets (with some exceptions) to: (1) maintain the assets with a “qualified custodian” (generally a bank or broker-dealer); (2) if the adviser opens the custodial account on behalf of the client, provide certain information to the client; (3) have a reasonable belief, after due inquiry, that the qualified custodian sends account statements directly to clients; and (4) undergo an annual surprise exam by an independent public accountant to verify client assets.

¹¹ According to a March 5, 2014 Form ADV, Item 9 Completion Reminder, advisers that have custody solely because they deduct fees from client accounts would respond “no” in Item 9.A, would likely respond “no” in Items 9.B. and 9.D., and likely would not need to provide information in Items 9.C. or 9.E. However, in Item 9.F., these advisers likely would need to indicate that there is at least one person acting as qualified custodian for their clients in connection with advisory services they provide to clients.

¹² See SEC Division of Investment Management Guidance Update, *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority* (No. 2017-01), available at <https://www.sec.gov/investment/im-guidance-2017-01.pdf>.

These numbers likely increased in part due to SEC staff guidance that beginning with annual updating amendments filed after October 1, 2017, an investment adviser should include client assets that are subject to a standing letter of authorization (SLOA) that result in custody in its response to Item 9 of Form ADV.¹³ This number also may have increased in response to the SEC staff's guidance on inadvertent custody.

Custodians for Separately Managed Accounts

More than half (6,681 or 53.1 percent) of advisers report that a particular custodian holds 10 percent or more of the adviser's SMA RAUM. 194 advisers report that a custodian that holds 10 percent or more of the adviser's SMA RAUM is a related person. Only 435 advisers report a non-U.S.-based custodian as holding 10 percent or more of the adviser's SMA RAUM, representing \$1.5 trillion (1.8 percent) of industry-wide RAUM.

With respect to the type of custodian, almost two-thirds (7,149 or 64.6 percent) of the responses identified custodians that are broker-dealers.

In the aggregate, \$21 trillion of RAUM is held by custodians that hold 10 percent or more of advisers' SMA RAUM, \$3.5 trillion of which (16.5 percent) is held by four large broker-dealer custodians.

Changes to the Custody Rule May Be on the Horizon

It is evident from the data reported that substantial confusion with the custody rule remains. The regulatory framework under the Advisers Act custody rule is overly complex, unduly burdensome, and has caused unnecessary confusion for advisers. We are encouraged that amendments to the custody rules for investment companies and investment advisers were added to the SEC's Regulatory Flexibility Agenda in the spring of 2018 as a long-term action:

The Division of Investment Management is considering recommending that the Commission propose amendments to rules concerning custody under the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Long-term actions are items for which agencies expect to take regulatory action more than 12 months after publication of the agenda.

¹³ See Investment Adviser Association, SEC No-Action Letter (Feb. 21, 2017), available at <https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm>.

Chart 17: Custody of Client Assets Remains Consistent

Category	2016		2017		2018	
	# of Advisers	% of Advisers	# of Advisers	% of Advisers	# of Advisers	% of Advisers
Adviser has custody of client cash/bank accounts	3,796	32.0%	3,919	32.2%	5,236	41.6%
Adviser has custody of client securities	3,746	31.6%	3,881	31.9%	5,043	40.1%
Related person(s) has custody of client cash/bank accounts	3,526	29.8%	3,638	29.9%	3,828	30.4%
Related person(s) has custody of client securities	3,477	29.3%	3,584	29.4%	3,781	30.1%
Adviser and/or related person(s) has custody of advisory client assets (answered yes to any of the above)	5,156	43.5%	5,289	43.5%	6,635	52.8%

Over forty percent of investment advisers (5,473 or 43.5 percent) reported having custody of client cash, bank accounts, and/or securities, a significant increase over 2017 (4,063 or 33.4 percent).¹⁴ However, only 83 advisers – about 0.7 percent of all advisers – reported acting as a “qualified custodian” in connection with their advisory services, meaning that they had actual physical custody of client assets. In fact, given the prohibition on having physical custody, each of these advisers is also either a broker-dealer or bank and acts as a custodian in one of those other capacities. The longer-term data shows that this already uncommon practice is becoming increasingly rare. The universe of 83 firms reflects a 16.9 percent increase in 2018 but is still down 30.8 percent since 2011, when 120 firms reported acting in such a capacity.¹⁵

Similarly, the number of advisers reporting that a related person acts as a qualified custodian also continued to trend downward (by 1.3 percent), to 367 advisers in 2018. Of these, 280 firms reported being able to demonstrate that the related person is operationally independent. These firms are not required to obtain a surprise examination for client funds or securities maintained at the related qualified custodian.

The number of advisers reporting that an independent public accountant conducts an annual surprise examination of client funds and securities increased by 67 or 4.2 percent.

It is worth noting that private fund advisers report a high incidence of custody of client assets because the SEC interprets “custody” as acting in a capacity that gives the adviser legal ownership of or access to client funds or securities (e.g., a firm that acts as both adviser and general partner (or has a related person that serves as general partner) to a limited partnership is deemed to have custody). In fact, of advisers that identified themselves as advisers to private funds, 87.7 percent also reported that they or a related person have custody of client assets.

¹⁴ As shown in the first two rows of Chart 17, advisers separately report whether they have custody of (1) client cash or bank accounts and (2) client securities. There is substantial overlap in this data, as nearly all advisers that report having custody of client cash or bank accounts also report having custody of securities.

¹⁵ The SEC’s 2009 amendments to the custody rule required advisers to provide responses to additional questions on custody in their first annual updating amendment to Form ADV after January 1, 2011.

Employees of Investment Advisory Firms

In 2018, SEC-registered advisers reported a total of 805,623 non-clerical employees, a 3.6 percent increase in employment from 2017. Of these employees, 415,971 provide investment advisory services (including research) – an increase of 15,808 or 4.0 percent over 2017.¹⁶

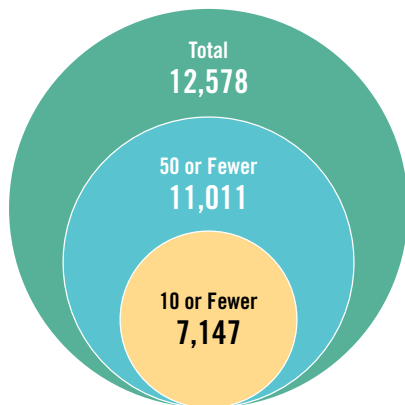
Chart 18: Investment Adviser Non-Clerical Employees

Number of Employees	2017		2018		% Change in Aggregate # of Employees
	# of Advisers	Aggregate # of Employees	# of Advisers	Aggregate # of Employees	
1 to 5	4,058	12,599	4,276	13,525	7.4%
6 to 10	2,853	22,025	2,871	22,282	1.2%
11 to 50	3,730	81,882	3,864	84,135	2.8%
51 to 250	1,137	119,450	1,171	125,856	5.4%
251 to 500	181	61,500	190	64,742	5.3%
501 to 1,000	113	81,444	98	71,783	(11.9%)
More than 1,000	100	399,102	108	423,300	6.1%
Total	12,172	778,002	12,578	805,623	3.6%
Average	–	64	–	64	–
Median	–	9	–	9	–

¹⁶ The data has some limitations, particularly in the smallest cohort, which includes 94 advisers that reported zero employees. In addition, some job growth may be attributable to firms that were previously state-registered.

The data confirms that the vast majority of SEC-registered investment advisers are small businesses. In fact, 56.8 percent (7,147) reported that they employ 10 or fewer non-clerical employees, and 87.5 percent (11,011) reported that they employ 50 or fewer non-clerical employees. These segments increased by 236 and 370 advisers, respectively, but due to growth across all segments, both of these percentages are the same or very similar to those reported in 2017 (56.8 percent and 87.4 percent). The number of advisers reporting that they have no non-clerical employees decreased slightly, going from 104 to 94.

Chart 19: The Vast Majority of Advisers are Small Businesses with 50 or Fewer Non-Clerical Employees



SEC-registered investment advisers collectively reported employing 415,971 individuals who perform investment advisory functions and 384,642 employees who are also registered representatives of a broker-dealer. The number of employees in these categories increased by 4.0 percent and decreased by 0.5 percent, respectively, and in addition, the percentage of advisers that reported no registered representative (8,982) increased by 3.8 percent from 71.1 percent to 71.4 percent in 2018.

Chart 20: Activities by Investment Adviser Employees

Number of Employees	# of advisers with employees who:				
	Perform investment advisory functions	Are registered representatives of a broker-dealer	Are registered with more than 1 state as investment adviser representatives	Are registered with more than 1 state as investment adviser representatives for another adviser	Are licensed agents of an insurance company
0	201	8,982	5,650	11,320	9,448
1 to 5	6,364	1,914	4,481	977	2,155
6 to 10	2,553	528	1,183	125	363
11 to 50	2,644	728	922	115	363
51 to 250	644	264	223	31	143
251 to 500	74	57	44	4	30
501 to 1,000	49	41	26	3	32
More than 1,000	49	64	49	3	44
Total	415,971	384,642	294,159	21,253	242,543
Average	33	31	23	2	19
Median	5	0	1	0	0

Although 201 advisers report that they have no employees who perform investment advisory functions, it is likely that those persons are shared with, and technically employed by, an affiliate of the firm.

Other Characteristics of Investment Advisory Firms

Other Business Activities

Although participation in many categories of other business activities decreased over the past year, advisers selling products or providing services other than investment advice to advisory clients increased by 5.1 percent to 2,144 advisers.

Of advisers engaged in other business activities, the most common activity by far remains commodity pool operator (CPO) or commodity trading advisor (CTA). Participation increased by 2.6 percent with 2,059 advisers listing it as an outside business activity, outpacing insurance broker/agent, the second most common activity, which was reported by 1,049 participants, a 6.9 percent increase from last year.

The number of dual registrants (entities that are both SEC-registered investment advisers and SEC-registered broker-dealers) rose 3.4 percent to 455, while the number of advisers actively engaged in business as a registered representative of a broker-dealer (e.g., sole proprietors) fell by a slight 1.5 percent. For more on dual registrants, see “Financial Industry Affiliations” below.

In 2018, as in previous years, a few of the other business activity categories account for the vast majority of all reported other business activities of investment advisers. CPO/CTA and insurance broker or agent collectively represented 67.1 percent of all activities reported, while broker-dealer and registered representative of a broker-dealer together accounted for 19.6 percent of all other business activities reported.

Financial Industry Affiliations

Form ADV requires investment advisers to disclose information regarding their affiliations and activities with other persons within the financial industry. Affiliations declined by 1.4 percent from 2017 to 2018, from a total of 21,062 reported affiliations in 2017 to 20,760 in 2018.

Chart 21: Financial Industry Affiliations

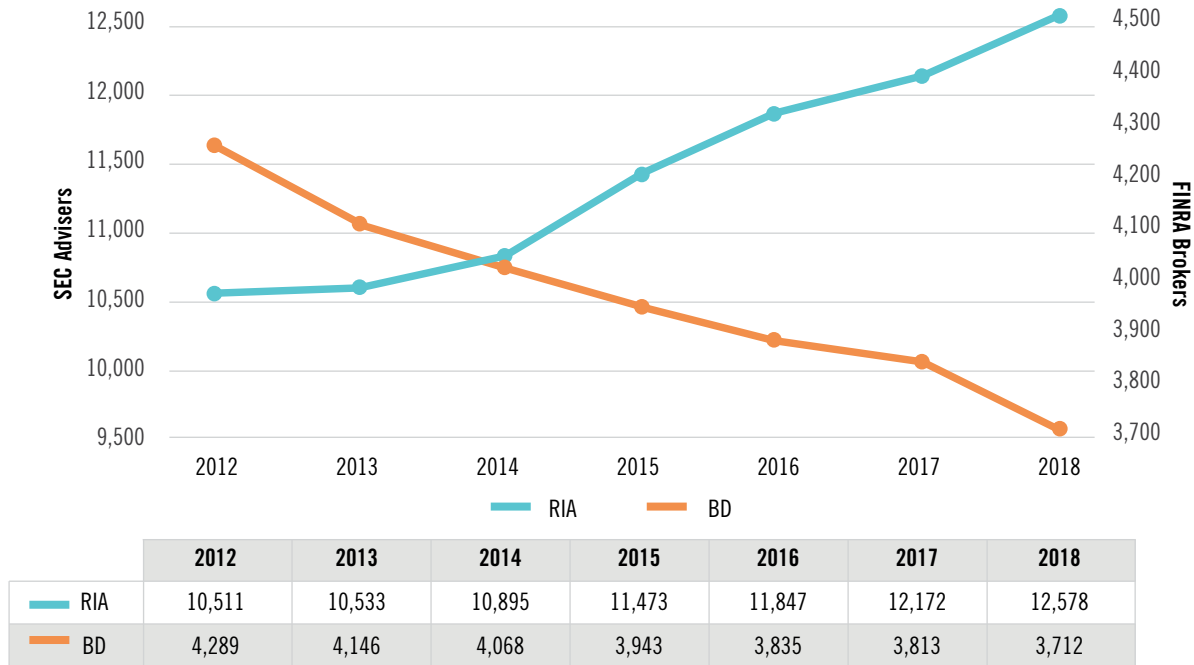
Related person is:	Number of Advisers	Percentage of Advisers
Sponsor, general partner, managing member (or equivalent) of pooled investment vehicles	4,613	36.7%
Other investment adviser (including financial planners)	4,308	34.3%
Broker-dealer, municipal securities dealer, or government securities broker or dealer	2,370	18.8%
Commodity pool operator/trading advisor (whether registered or exempt)	2,280	18.1%
Insurance company or agency	2,002	15.9%
Accountant or accounting firm	843	6.7%
Trust company	773	6.2%
Banking or thrift institution	772	6.1%
Sponsor or syndicator of limited partnerships (or equivalent), excluding pooled investment vehicles	636	5.1%
Pension consultant	613	4.9%
Real estate broker or dealer	506	4.0%
Lawyer or law firm	456	3.6%
Registered municipal advisor	307	2.4%
Futures commission merchant	197	1.6%
Registered security-based swap dealer	76	0.6%
Major security-based swap participant	8	0.1%

The most common affiliation reported in 2018 among investment advisers is with sponsors, general partners, or managing members (or equivalent) of pooled investment vehicles, with 4,613 (36.7%) reporting such an affiliation, up 1.4 percent since 2017.

Included in the numbers cited under “Other Business Activities” and “Financial Industry Affiliations” are broker-dealer relationships, where investment advisers are either dually registered as broker-dealers or are affiliated (through common ownership and/or control) with broker-dealers. Those advisers affiliated with broker-dealers decreased by 3.1 percent this year to 2,370, which is consistent with industry-wide trends. Since 2013, FINRA membership has fallen 11.7 percent from 4,146 to 3,712 in April 2018, while the number of securities registered representatives stayed flat, decreasing from 630,796 to 629,112, during the same period.¹⁷ These trends signal that more broker-dealers are choosing to add registered investment advisers to their business models through firm acquisitions, and that consolidation of broker-dealers has not resulted in the loss of jobs for registered representatives.

¹⁷ <https://www.finra.org/newsroom/statistics>

Chart 22: Number of Advisers Rises While Number of Broker-Dealers Falls



Solicitors and Referral Compensation

Advisers were less likely to have solicitor relationships with third parties in 2018 than in prior years. The number of advisers that paid third parties for referrals declined 21 percent (from 4,386 in 2017 to 3,481 in 2018), while the number of advisers that had relationships in which they were paid for referring clients to third parties declined 40 percent (from 1,360 to 812).

Much of this decline is likely due to the fact that the Department of Labor’s fiduciary rule was originally scheduled to become fully effective in 2017. Under this rule, solicitors whose clients included “retirement investors” (including IRA owners, among others) would become fiduciaries to retirement investors and would be subject to a panoply of new and complex requirements and prohibitions. On June 21, 2018 the U.S. Court of Appeals for the Fifth Circuit vacated the fiduciary rule, and it will be interesting to see if advisers become more willing to establish solicitor relationships in the years ahead.

NEW THIS YEAR

New to Form ADV this year is how many advisers compensated their related persons (including employees and affiliates) for client referrals. This question asked for cash or non-cash compensation above and beyond what might be included in an employee’s regular salary. Almost 19 percent of investment advisers (2,238 firms) indicated that they paid referral compensation to their related persons.

Websites and Social Media

The number of investment advisers with at least one website continued to increase, going from 10,524 in 2017 to 11,070 in 2018. While a small majority of advisers (5,718) had only one website, a substantial minority (5,352) reported additional social media platforms or multiple websites. Firms with multiple websites are typically those that allow their investment adviser representatives to operate their own websites (subject to firm supervision). Indeed, 90 firms reported over 20 web addresses, with one firm reporting 428 separate web addresses.

NEW THIS YEAR

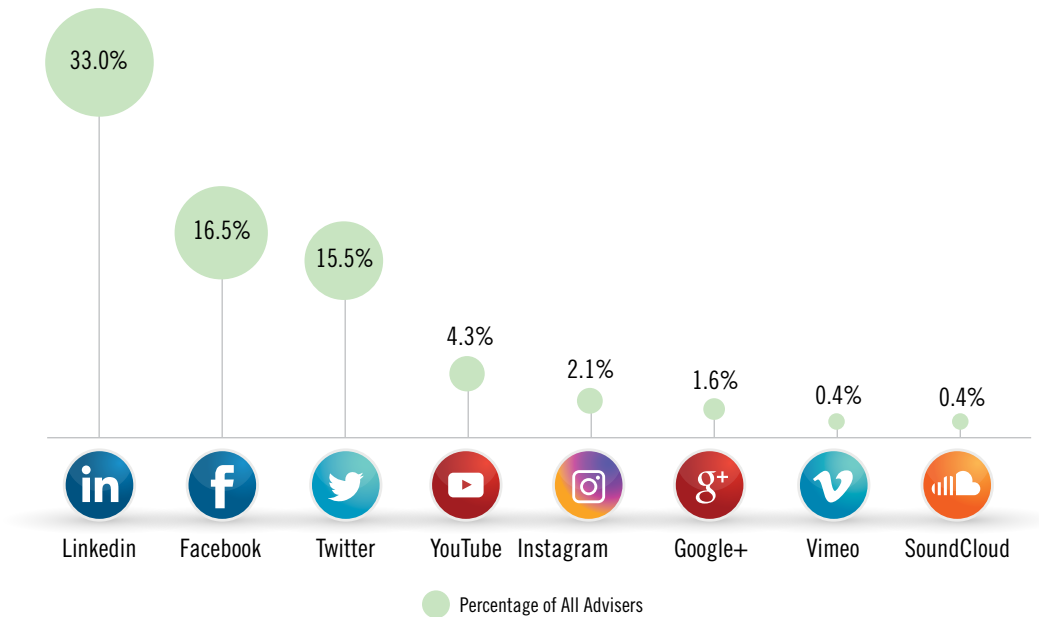
This was the first year in which Form ADV asked firms using social media platforms to provide addresses to those platforms. Any and all social media accounts will most likely meet the SEC's very broad definition of an "advertisement." Given that the advertising rules of the Advisers Act are quite restrictive (prohibiting, among other things, testimonials in general and references to past specific profitable investment recommendations or portfolio performance without substantial disclosure), providing compliant advertisements in traditional media is already a challenge. Moreover, the advertising rules themselves were adopted over 50 years ago, and while the SEC has used no-action letters, enforcement cases, and interpretive releases to apply these rules to changing circumstances, there are few bright lines to help advisers readily apply the rules to interactive environments. As most social media platforms permit some form of interactive content, the majority of advisory firms appear to be reluctant to try to apply these rules to interactive social media platforms.

Among advisers that do use social media, LinkedIn leads the pack with one-third of all advisers (3,993) reporting at least one LinkedIn page. While LinkedIn is typically considered a business and professional networking platform, it does offer marketing and advertising services.

Consumer-oriented services such as Facebook and Twitter are by far the next most popular platforms among advisers, with 1,995 and 1,874 adviser users, respectively. The fact that such sizable numbers of firms are using at least one of these platforms despite the compliance challenges in doing so suggests that these leading social media providers are becoming essential ways to market advisory services to a significant segment of the investing public.

Some adventurous advisers are also using YouTube (516), Instagram (251) and Google+ (192). A handful of advisers are using YouTube competitor Vimeo (45), and a very small number are joining the podcast and music distribution audio streaming site SoundCloud (43).

Chart 23: Investment Adviser Social Media Use



Changes to the Advertising Rule May Be on the Horizon

The advertising rule has not been materially amended since its adoption in 1961. The current regulatory framework governing advertising by investment advisers is unnecessarily complex, overly broad in reach, unduly prescriptive, and involves a complex maze of enforcement actions and SEC staff no-action letters that are difficult to decipher and apply to evolving circumstances.

However, help may be on the way. We are encouraged that amending the advertising rule (rule 206(4)-1) and cash solicitation rule (rule 206(4)-3) under the Advisers Act regarding marketing communications and practices by investment advisers was moved from the SEC's long-term Regulatory Flexibility Agenda to the proposed rule stage list in the spring of 2018.

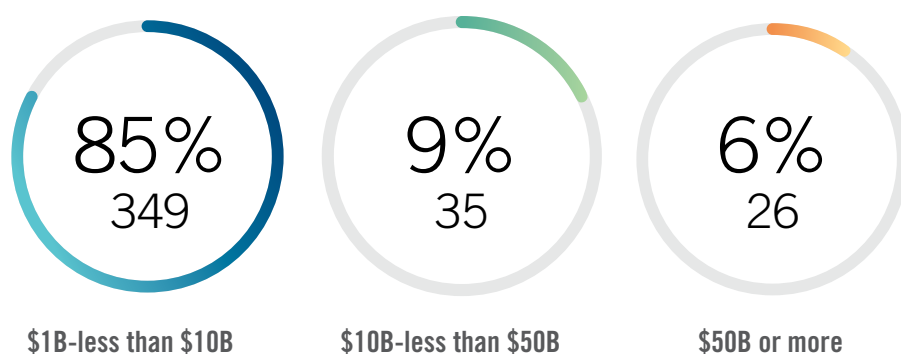
Items in the proposed rule stage are actions for which agencies plan to publish proposed rules within 12 months after publication of the agenda.

Adviser Balance Sheets

As noted in previous years, several Items in Form ADV Part 1A are commonly misunderstood and answers are misreported. For example, Item 1.0. asks “Did you have \$1 billion or more in assets on the last day of your most recent fiscal year?” Although the question refers to the adviser’s balance sheet, many advisers responded based on their RAUM. For example, in 2018, 437 advisers claimed to have more than \$1 billion on their own balance sheets, but publicly available financial data shows that very few advisers have such large balance sheets.

With that caveat, here is how the 410 firms that reported the approximate amount of their assets responded to a Form ADV question added in 2018.

Chart 24: Advisers with Balance Sheet Assets Over \$1 Billion



NEW
THIS YEAR

In an effort to obtain more precise data for use in SEC rulemaking arising from ongoing Dodd-Frank Act implementation, Item 1.0 of Form ADV was amended to require advisers with assets of \$1 billion or more to report their assets within one of three specified ranges.

Despite the inclusion of a new instruction explaining that “assets” refers to the adviser’s total assets rather than the assets that it manages on behalf of clients, it appears that many advisers still respond based on their RAUM.

Umbrella Registration

731 advisers (6.0 percent) used Form ADV to register more than one investment adviser under an umbrella registration. 2,455 responses identifying relying advisers are listed. Look for next year's *2019 Evolution Revolution* report for comparative analysis on this new data.

NEW THIS YEAR

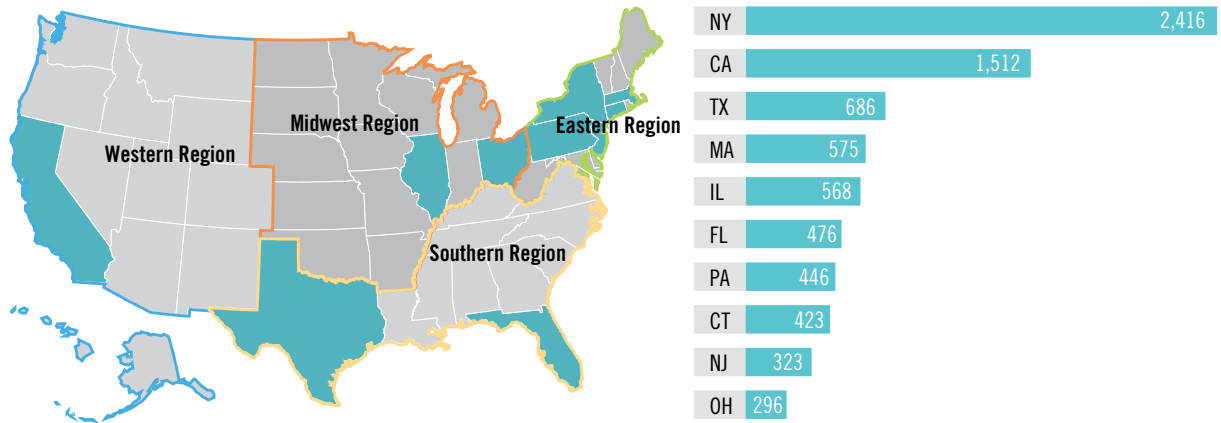
The Form ADV rules now permit a single registration for certain groups of private fund advisers operating as a single advisory business. Conditions for using this so-called “umbrella registration” include:

- The filing adviser and each relying adviser: (1) advises only private funds and clients in SMAs that are qualified clients (2) that are otherwise eligible to invest in the private funds advised by the filing or a relying adviser and (3) whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds;
- The filing adviser has its principal office and place of business in the United States;
- Each relying adviser, its employees, and the persons acting on its behalf are subject to the filing adviser’s supervision and control and are “persons associated with” the filing adviser;
- The advisory activities of each relying adviser are subject to the Investment Advisers Act and the rules thereunder, and each relying adviser is subject to examination by the SEC; and
- The filing and each relying adviser operate under a single code of ethics under the Investment Advisers Act and a single set of written policies and procedures under Rule 206(4)-7 that is administered by a single CCO.

Location of Investment Advisers

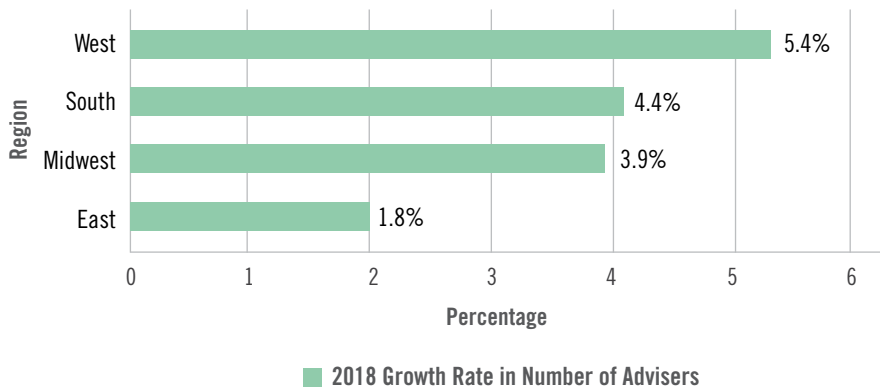
Although the vast majority of advisers continue to remain in and around traditional financial centers, growth in new and emerging financial centers continues to increase. The states comprising the top 10 investment adviser locations remain unchanged from 2017, reflecting advisers' proximity to financial and population centers.

Chart 25: Top Ten States for Advisers



When considered on a regional basis, all regions reported an increase in advisers, led by a 5.4 percent increase in the West. Although the East did experience growth, its 1.8 percent rate of increase was about half that of the Midwest at 3.9 percent and the South at 4.4 percent, perhaps foreshadowing the impending transition away from the long-standing numerical dominance of East Coast-based advisers.

Chart 26: The West Emerges



Among the tea leaves to consider when pondering future trends in this area are tax, demographic, and technological developments. Recent tax law changes reducing the deductibility of property taxes in higher-tax states may encourage advisers to consider relocating to states with more advantageous tax environments. It is also possible that advisers will follow demographic trends and choose locations in states popular among retirees or vacation destinations, as technological advances such as automated investment advice will allow virtual proximity to financial centers from other desirable locations.

Investment Advisers with Multiple Offices

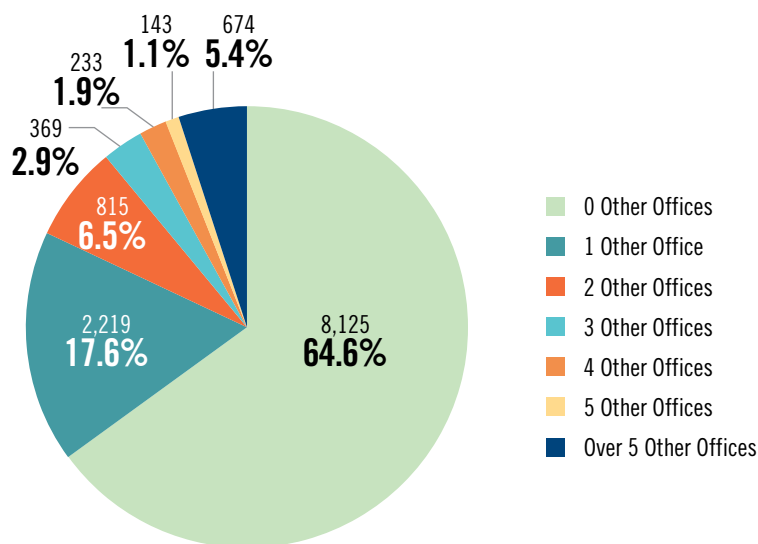
4,453 investment adviser firms (35.4 percent of all advisers) reported having at least one office at which they conduct investment advisory business other than their principal office and place of business. Just over 50 percent of advisers with multiple offices had more than one other office, with 15 percent of these firms reporting more than five other offices. The median number of employees performing advisory functions from each office location was three.

NEW
THIS YEAR

This was the first year in which advisers with multiple offices were instructed to disclose any other investment-related activities conducted at their other offices. The wording of the question is vague, in that it does not specify whether the response should be limited to other business activities of the advisory firm itself, or if it should include all non-advisory activities conducted in the office regardless of whether those activities were under the advisory firm's supervision and control.

The results show that most advisers with multiple offices (74%) provide additional services at those offices. Of firms with other offices offering multiple services, the most common other business functions occurring at those locations were brokerage and insurance services (19% each), followed by commodity pool operator or commodity trading advisor and accountant or accounting firm (6% each).

Chart 27: Investment Advisers with Multiple Offices



Disciplinary Information

It is difficult to draw meaningful conclusions from the disciplinary disclosure information provided in Form ADV, Part 1, in large part because the “true or false” and “yes or no” nature of the questions is not particularly revealing. Gleaning information contained in the disciplinary disclosure reporting pages for Form ADV, Part 1, Item 11 requires delving deep into the specifics of each disclosure event, which may or may not provide clarity or facilitate “apples to apples” comparisons. Also, the information required to be disclosed is provided for the advisory firm and its employees, officers, directors, and advisory affiliates for the past 10 years, whether or not these persons or entities were affiliated with the reporting firm during that time. However, firms can specify whether any of the events reported involve the firm or its supervised persons. 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:

- 10,863 registered investment advisers (86.4 percent) reported no disciplinary history at all, which is the same percentage of advisers that reported no disciplinary history last year.
- 145 registered investment advisers (1.2 percent) reported that they or an advisory affiliate were, at the time of filing, the subject of a regulatory proceeding that could result in a “yes” answer to any part of Item 11.C, 11.D, or 11.E. This is an 18.9 percent increase from the previous year, in which 122 firms answered the question affirmatively, but represented less than one percent of all advisers.
- Similar to last year’s reporting in the category, 163 firms or advisory affiliates (1.3 percent) reported that the SEC or the Commodity Futures Trading Commission (CFTC) found them to have made a false statement or omission; 541 firms (4.3 percent) reported that they have been involved in a violation of SEC or CFTC regulations or statutes, which is up by one firm from last year. Only 15 firms reported that they or an advisory affiliate have been found by the SEC or CFTC to have been the cause of an investment-related business having its authorization to conduct business denied, suspended, revoked, or restricted, which is unchanged from the previous year.
- 533 firms or advisory affiliates (4.2 percent) reported that the SEC or the CFTC imposed a civil money penalty on the adviser or its affiliate or were ordered to cease and desist from an activity; this represents a slight decrease from the prior year.

Of the 1,715 advisers reporting at least one disciplinary event, 902 advisers (52.6 percent) attributed the disclosure events to an affiliate and not directly to the adviser or its supervised persons.

Explanation of Report Data

Evolution Revolution and its findings are based on Form ADV, Part 1 data filed by all SEC-registered investment advisers as of April 10, 2018. Advisers are required to file specific information electronically using the Investment Adviser Registration Depository (IARD) system.

17,688 investment advisers are registered with the states, and there are 10,101 SEC notice-filed investment advisers.¹⁸ This report focuses solely on the 12,578 investment advisers that are registered as such with the SEC.

Form ADV, Part 1 has significant limitations and anomalies. Please consult the text of Form ADV (available on the SEC's website at <http://www.sec.gov/about/forms/formadv.pdf>) for a more thorough understanding of the underlying data included in this report.

The IAA and NRS have independently tabulated all the data in this report. Whenever a number is rounded, it is rounded from the original data source. This method of rounding creates more accurate percentages, but may create complementary percentages that do not sum to 100 percent. Unless otherwise stated in this report, a null response to a "Yes or No" question is considered a "No," and a null response to any other question is not included in the data set.

When obvious errors have been found in the reported data, we have made certain corrections or omissions to avoid skewed results.

Several items in Form ADV, Part 1 are commonly misunderstood and answers are misreported. Areas that are commonly misinterpreted include how to calculate RAUM, reporting of \$1 billion or more in the adviser's balance sheet assets, custody, and disciplinary history questions.

¹⁷ See the North American Securities Administrators Association (NASAA) 2018 Investment Adviser Section Annual Report, available at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2018/05/2018-NASAA-IA-Report-Online.pdf>.



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