

Report to the California State Legislature and Department of Finance

Broker-Dealer/Investment Adviser Program

January 2021

**Lourdes M. Castro Ramírez, Secretary
Business, Consumer Services, and Housing Agency**

**Manuel P. Alvarez
Commissioner of Financial Protection and Innovation**





STATE OF CALIFORNIA

Department of Financial Protection and Innovation

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

January 10, 2021

Dear Senators/Assemblymembers:

The Department of Financial Protection and Innovation (DFPI) respectfully submits the attached 2021 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 DFPI 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 DFPI 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 2019-2020 fiscal year information on the number of positions authorized and filled, the number and share of licensees examined, results and outcomes of examinations, examination program recommendations and estimated staffing levels required to achieve the targeted examination cycles for licensees.

I hope you find the report informative and useful. Please do not hesitate to contact Nicole Hisatomi, Deputy Commissioner of Legislation, at (916) 539-0181 or Nicole.Hisatomi@dfpi.ca.gov, if you have questions or concerns. The report also can be found on the DFPI website at www.dfpi.ca.gov.

Sincerely,

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

Manuel P. Alvarez

Commissioner

Department of Financial Protection and Innovation

Broker-Dealer / Investment Adviser Program 2021 Report to the Legislature

The Broker Dealer/Investment Adviser (BDIA) Program, under the Corporate Securities Law of 1968, licenses and regulates investment advisers, investment adviser representatives, broker-dealers and broker-dealer agents. Regulatory oversight protects the investing public from unethical and fraudulent activities and ensures 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	2017-18	2018-19	2019-20
Investment Adviser Firms	3,759	3,729	3,743
Investment Adviser Representatives	54,833	55,752	56,685
Broker-Dealer Firms	2,742	2,674	2,618
Broker-Dealer Agents	291,333	294,532	296,366
Broker-Dealer Branch Offices	16,996	16,814	16,740

1. Number of positions authorized and filled

The BDIA Program has a total of 89 authorized positions, and currently 82 of the 89 positions are filled. BDIA is active in the recruitment process to fill all vacant positions.

2. Number and share of licensees examined by fiscal year

The following table shows the number of examinations completed and the percentage of licensees examined since FY 2017-18.

Licensee Type	Number of Licensees			Number of Exams Completed			Percent of Licensees Examined		
	2017-18	2018-19	2019-20	2017-18	2018-19	2019-20	2017-18	2018-19	2019-20
Investment Adviser Firms	3,759	3,729	3,743	432	1,001*	693**	11.50%	26.84%	18.51%
Broker-Dealer (In-State)	427	408	407	11	14	16	2.58%	3.43%	3.93%
Broker-Dealer (Out-of-State)	2,315	2,266	2,211	0	0	0	0%	0%	0%
Broker-Dealer Branch Offices	16,996	16,814	16,740	27	51	32	0.16%	0.30%	0.19%
Total	23,497	23,217	23,101	470	1,066	741	14.24%	30.57%	22.63%

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

**The total Investment Adviser examinations number includes 176 examinations conducted by examination questionnaire.

3. Results and outcomes of examinations

The BDIA Program completed 741 examinations of broker-dealers, broker-dealer branch offices and investment advisers in FY 2019-20. Of the total examinations, 176 of the investment adviser examinations were done by online examination. In 2018, the DFPI created a streamlined examination that licensees can take and submit through a secure online application. Initially, the examination was sent to all California registered investment adviser firms that maintain their principal place of business in another state (598 examinations for FY 2018-19). Beginning in FY 2019-20, the DFPI began implementing a four-year cycle of staggered examinations for out-of-state licensees, representing 25% of this population of licensees each year (176 examinations for FY 2019-20). Of the 741 total examinations completed, violations were found in 19 of the examinations, which resulted in referrals to the DFPI's Enforcement Division for administrative actions and/or penalties. The remaining 722 examinations identified books and records violations for which the licensees took corrective action by implementing procedures to mitigate future violations.

As a result of the COVID-19 pandemic, the DFPI staff moved to emergency telework in March 2020 as did many licensees. The BDIA program has efficiently and effectively adopted measures to examine its licensees through remote desk exams conducted primarily by employees working from home. Program staff have been amenable and responsive to the concerns and needs of its licensees in scheduling examinations, providing adequate time to gather books and records, and respond to Department inquiries regarding the examination. These are unprecedented times, and the DFPI remains committed to its licensees through its flexible approach.

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

Since BDIA is the sole regulatory authority over state-registered investment advisers, the Department has placed a priority on their examination. 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 DFPI focuses its examination efforts on broker-dealer firms located in California to maximize protection of California investors. For broker-dealer firms located outside of California, the DFPI 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 DFPI 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 3,743 investment adviser firms are registered with the DFPI. In order to promote consumer protection, the BDIA Program strives to conduct regulatory examinations of all investment adviser firms using a risk-based approach. Additional examination methods have been explored to preserve regulatory oversight, and increase efficiency and cost effectiveness, while promoting investor protection. Based on our findings and efforts, in FY 2017-18 the DFPI implemented desk examinations of lower-risk firms and developed new procedures for firms with a principal place of business outside California through on-line examination questionnaires.

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

Broker-Dealer Firms

A total of 2,618 broker-dealer firms are registered with the DFPI. Of these, 407 have their principal place of business or home office in California. To increase protection of California consumers, the BDIA Program maximizes the efficiency and cost effectiveness of its oversight by prioritizing and conducting regulatory examinations of these 407 firms.

The SEC, other states, and FINRA also oversee and conduct routine regulatory examinations of the broker-dealer firms located outside California. The DFPI and FINRA hold quarterly discussions on upcoming exam cycles, trends, significant investigations, and enforcement matters. The DFPI and the SEC also share upcoming exam plans and work together on enforcement matters. The DFPI 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 2019-20 is 16,740. The DFPI licenses broker-dealer firms and reporting branch offices 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 1-3 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 DFPI has reviewed options, such as prioritizing and conducting examinations of higher-risk branch offices. The following table identifies the level of risk involved at branch locations with associated individuals who have disclosed criminal, regulatory, civil, judicial, or customer complaint events.

The BDIA Program creates an annual branch exam plan to examine branches representing different categories. The program continues to examine branches at all levels of risk based on tips, complaints, and referrals. The number of broker-dealer branch locations determined to be high risk is used to calculate the required number of examiners. This is illustrated in the table 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
826	3 or more individuals	High risk
838	2 individuals	Medium risk
4,098	1 individual	Low risk
10,978	0 individuals with disclosures	Very low risk
Total: 16,740		

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	3,743	4	936	80	74,880	1,660	45
Broker-Dealer Firms (In-state)	407	4	102	100	10,200	1,660	7
Broker-Dealer Branch Offices (high-risk)	826	4	207	80	16,560	1,660	10
Totals	4,976		1,245		101,640	1,660	62

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

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

5. Estimated required staffing levels

The BDIA Program has 89 authorized positions for FY 2020-21. Of these positions, 57 are allocated to perform examinations; eight perform licensing functions and 24 manage or provide support to the program.

Based on current information, the BDIA Program estimates it needs at least five 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 is considering 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	62
Available Examination Staff	57
Additional Examiners Needed	5

The BDIA program has identified potential options for increasing efficiencies in its supervision of BDIA licensees. These include: prioritizing investment adviser examinations, implementing desk exams and exam questionnaires, and checking regularly with the SEC and FINRA to maximize available resources and eliminate exam duplication. DFPI will continue to participate in quarterly discussions with FINRA on exam strategies and data regarding broker-dealers and broker-dealer branches. The DFPI will report its findings relative to any new considerations and examination results in next year's annual report.