BCG

THE BOSTON CONSULTING GROUP

Investment Adviser Oversight

Economic Analysis of Options

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The Boston Consulting Group ("BCG"), a global management consulting firm, was engaged by a group of organizations with Investment Adviser ("IA") stakeholders to conduct an economic analysis of IA oversight scenarios. These scenarios are based on recommended options contained in the Securities and Exchange Commission's ("SEC") study released in January 2011, which was conducted per Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The objective of this report is to establish an economic fact base, informed by publicly available information.

The economic analysis relied upon publicly available research, studies, and reports, as well as more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts. The BCG team involved in this effort was not involved in any prior BCG work for related organizations. Further, the BCG team conducted this analysis independently of any prior related work performed by the firm. The SEC and the Financial Industry Regulatory Authority ("FINRA") were not interviewed or consulted as part of this effort. They did not provide any input, feedback or guidance on the materials or on the analysis contained in this report.

This report does not consider, evaluate, or comment on the benefits of any specific IA oversight scenario, in terms of effectiveness, ease of implementation, or other relevant criteria. This report, any statement made therein, or any statements made by BCG or by any other organization regarding this report, does not constitute a BCG endorsement or recommendation of any of the specific IA oversight scenarios referenced in this report or of any specific approach to IA oversight more generally, and should not be interpreted as such.

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I. Executive summary

As required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Securities and Exchange Commission ("SEC") released a study in January 2011 ("SEC Section 914 Study") that identified three recommended options to Congress regarding examination of SEC-registered Investment Advisers ("IAs"), all of which would require federal legislation before they could be implemented[1]. To inform the discussion on this issue, a group of organizations with IA stakeholders ("Clients") commissioned The Boston Consulting Group ("BCG") to perform an independent and objective economic analysis including an estimate of the level of funding required for each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[2]

BCG profiled and modeled three core scenarios, informed by the first two recommended options in the SEC Section 914 Study. The three core scenarios are:

1. Enhance SEC examination capabilities ("Enhanced SEC"): Achieve an acceptable frequency of IA examinations by hiring additional Office of Compliance Inspections and Examinations ("OCIE") staff, funded by user fees;[3]

2. Authorize a FINRA SRO for IAs ("FINRA-IA SRO"): Authorize the Financial Industry Regulatory Authority ("FINRA"), the self-regulatory organization ("SRO") for Broker-Dealers ("B-Ds"), to develop an IA SRO capability with an IA examination and enforcement mandate,[4] funded by membership fees, and overseen by the SEC; and

3. Authorize a new SRO for IAs ("New-IA SRO"): Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The estimated cost of each of the three core scenarios is summarized in Table 1 below.[5,6,7] The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years:

[1] The implementation timelines cited in this report are independent of any timelines related to legislative action.
[2] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 and is examined as an additional scenario in Section III.3.3.
[3] Only the cost of examination is funded via user fees, and the SEC would continue to rely on pre-existing sources of funds to support other aspects of its administration of the Investment Advisers Act of 1940 (SEC Section 914 Study, p. 25). However, the estimated costs of enforcement are included in Section III.1.2 for comparative purposes.
[4] SROs typically have rulemaking, examination, and enforcement authority. An enforcement mandate is included along with examination in this analysis, as it is reasonable to assume that an SRO would have authority to discipline its members. Rulemaking is considered separately in section III.3.1 due to possible exclusion from an SRO's mandate.
[5] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[6] Enhanced SEC scenario costs are shown both as incremental OCIE IA costs (i.e., additional IA examiners needed to achieve the target frequency of examinations) and full OCIE costs (i.e., both existing and incremental OCIE IA costs).
[7] Estimates reflect the direct costs of regulatory operations and not the total cost of compliance to IA firms.

Table 1: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Setup costs	$6 – 8M (7)	$6 – 8M (7)	$200 – 255M (230)	$255 – 310M (280)
Estimated setup time	6 – 12 months		12 – 18 months	18 – 24 months
Ongoing mandate costs	$100 – 110M (105)	$240 - 270M (255)	$460 – 510M (485)	$515 – 565M (540)
SEC oversight of an SRO costs	Not required		$90 – 100M (95)	$95 – 105M (100)
Total annual costs	**$100 – 110M (105)**	**$240 – 270M (255)**	**$540 – 610M (580)**	**$610 – 670M (640)**

The estimated costs are described below, and further elaborated on in Section III of the report:

Setup costs[8]

- Setup of the Enhanced SEC scenario involves the hiring of additional IA examination staff, and may be achieved in 6-12 months at an estimated cost of $6-8M.
- Setup of a FINRA-IA SRO may be achieved in 12-18 months at an estimated cost of $200-255M. A FINRA-IA SRO could leverage some existing infrastructure that supports B-D oversight activity (e.g., corporate functions, senior management, and potentially some regional offices).
- Setup of a New-IA SRO may be achieved in 18-24 months at an estimated cost of $255-310M. A New-IA SRO is assumed to have no existing infrastructure to leverage.

Ongoing mandate costs[9]

- Per the SEC Section 914 Study, the ongoing costs of the Enhanced SEC scenario are limited to examination costs and do not include enforcement costs. Estimated ongoing examination costs are $240-270M in total or $100-110M more than the current cost of OCIE's IA examination program.
- Ongoing costs of a FINRA-IA SRO or a New-IA SRO include both examination and enforcement costs and are estimated at $460-510M and $515-565M, respectively. Estimated overhead costs per examiner are higher in these two scenarios than in the Enhanced SEC scenario based on current FINRA overhead costs. The estimated ongoing mandate cost of a FINRA-IA SRO reflects scale benefits not available to a New-IA SRO.

Costs of SEC oversight of an SRO

- Cost of SEC oversight of an SRO (either FINRA-IA SRO or a New-IA SRO) are estimated at $90-105M, and includes oversight of SRO examination and enforcement activities. This activity is not required under the Enhanced SEC scenario.

[8] Estimated setup times are the point at which roughly half of examination staff will be hired and the SRO will begin examination of IAs, based on the reference points cited in Appendix Section IV.4.
[9] Ongoing mandate costs are adjusted to allocate the benefits of scale provided by additional IA personnel to all non-administrative staff across the entire organization to reflect standard accounting practice.

User fees paid to the SEC and/or membership fees paid to an SRO are assumed to provide the funding source for setup and ongoing mandate costs; no assumption is made regarding the source of funding for the costs of SEC oversight of an SRO. Fees are identified in the SEC Section 914 Study as a potential source of funding. Fees collected during the setup period might be relied upon to fund the setup costs.

The estimated level of funding and associated average fee per IA firm is indicated in Table 2 below.[10] This report does not evaluate the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to setting fees.

Table 2: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated funding required for ongoing mandate costs	$100 – 110M (105)	$240 – 270M (255)	$460 – 510M (485)	$515 – 565M (540)
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[11]

Beyond the three core scenarios, BCG also examined three additional scenarios:

- Rulemaking mandate for an SRO: If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of an SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC costs for SRO oversight by an estimated ~$10M.[12] Given rulemaking is within the current SEC mandate, this variation is not relevant to the Enhanced SEC scenario.
- Investment Adviser Oversight Act of 2011 draft ("IAO Draft"): If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond estimates in Table 2 under the two SRO scenarios, as ~1,810 currently-registered IA firms (16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (38% of total ADV-reported assets), would be removed from the funding base.[13]

[10] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[11] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[12] An SRO rulemaking organization is assumed to be similar in size to that of the SEC for IA rulemaking today.
[13] This total does not include ~780 additional private investment fund advisers that will be added in 2012, as per the Dodd-Frank Act. This scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Only IA firms with more than $100M AuM are

- Dual-registered IA / B-Ds (third recommended option of the SEC Section 914 Study): If the IA examination mandate for dual-registered IAs / B-Ds, of which there are ~580, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC, the estimated costs of IA examination are $30M for FINRA and $240M for the SEC. In this scenario, the average annual fee per IA firm is estimated to be $53,900 for firms under the jurisdiction of FINRA, and $27,300 for firms under the jurisdiction of an Enhanced SEC (full OCIE costs). As dually-registered firms are estimated to represent 6% of the IA population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. In this scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

considered in this calculation, as per the Dodd-Frank Act. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison across the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the 4% increase in the core SRO scenarios. See Section III.3.1 for more details.

II. Context and methodology

II.1 Context

As required by Section 914 of the Dodd-Frank Act, the SEC released a study in January 2011 (the SEC Section 914 Study) that made recommendations to Congress regarding examination of SEC-registered IAs. The SEC Section 914 Study examined the growth in the investment adviser industry over the last six years and the SEC's challenges in maintaining an acceptable level of examination frequency of SEC-registered IAs. The Study determined that the anticipated growth of IAs would outstrip the SEC's resources absent additional funding. The Study recommended consideration of three options to ensure more stable and scalable funding for IA examinations, all of which would require federal legislation before being implemented:

- Impose user fees on IAs (to fund the SEC), set at a level appropriate for achieving an acceptable frequency of IA examinations (by the SEC);
- Authorize one or more SROs to examine all SEC-registered IAs, subject to SEC oversight; or
- Permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 ("Advisers Act").[14]

A group of organizations with IA stakeholders commissioned BCG to perform an independent and objective economic analysis of the recommended options in the SEC Section 914 Study, with a focus on the first two.

II.2 Objectives

The objective of this report is to perform an independent and objective economic analysis including an estimate of the level of funding required under each of the recommended options in the SEC Section 914 Study, with a focus on the first two options.[15]

The economics of each scenario reflect:

- Direct Costs incurred to:
  - Setup IA examination infrastructure to achieve an acceptable frequency of examinations under each scenario and includes the costs of moving from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
  - Ongoing IA examination for all scenarios, at an acceptable frequency, and ongoing enforcement in the FINRA-IA SRO and New-IA SRO scenarios and includes the costs of salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
  - SEC oversight of SRO examination and enforcement activities in the FINRA-IA SRO and New-IA SRO scenarios and includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities

[14] See footnote 2.

[15] The third recommended option in the SEC Section 914 Study would permit FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940 is examined as an additional scenario in Section II.3.3.

as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).

- Level of funding and potential fees:
  - Level of funding for each scenario is composed of ongoing mandate costs. This report assumes that the funding will be covered by user fees paid by IA firms to the SEC or membership fees paid by IA firms to one or more SROs.
  - Fees paid by IA firms during the setup period might be used to fund setup costs.
  - No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).[16]

II.3 Methodology

BCG conducted an objective and fact-based analysis, drawing on relevant benchmarks and publicly available cost data (current and historical), research, and other studies and reports to estimate the setup costs, ongoing mandate costs, and the costs of SEC oversight of SRO examination and enforcement activity.

BCG validated the analysis with a bottom-up review of the primary cost components. BCG also conducted more than 40 in-depth interviews with investment advisory firms, relevant industry organizations, former regulatory officials, and other industry experts to identify, corroborate, and better inform relevant assumptions and key sensitivities.

The three core scenarios modeled in this report are characterized along four key dimensions:

- Regulator options: Which regulatory body should oversee IAs?
  - Options: the SEC, a FINRA-IA SRO, or a New-IA SRO
  - In the SRO scenarios, the SEC oversees the SRO.
- Mandate: What mandate should the regulator possess?
  - Options: Examination or examination and enforcement
  - In all scenarios, the study assumes the regulator is authorized to examine and the SEC retains rulemaking authority. In the SRO scenarios, limited rulemaking authority incidental to the execution of examination or enforcement would likely be granted.[17]
  - A scenario whereby the SRO is given a full rulemaking mandate is explored in Section III.3.1.
- Jurisdiction: Which IAs will be required to register with the SEC or an SRO?
  - Default: IA registration requirement as per the Dodd-Frank Act[18]
  - A variation based on the IAO Draft, which exempts a sub-set of IAs from the jurisdiction of an SRO based on the type of assets and investors, is examined in Section III.3.2.

[16] Fees are just one potential funding source; we focus on fees in this report as the SEC Section 914 Study did so.

[17] The cost of limited rulemaking incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations) is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

[18] Includes IA firms with AuM above $100M plus those below $100M that are registered with the SEC (e.g., IA firms with principal offices in New York or Wyoming; those permitted to register with the SEC because they would otherwise be required to register with 15 or more states). Also includes private investment fund advisers with AuM of $150M or more.

- Funding: How much funding and what level of fees per IA firm may be required to cover the cost of ongoing examination and enforcement activities?
    - Funding level options: Cover all setup and/or all ongoing mandate costs
    - Fee level: Many approaches to apportioning fees to IA firms are available and will need to be considered. This report estimates the average fee per IA firm for illustrative purposes.

Based on these dimensions, and informed by the first two recommended options described in the SEC Section 914 Study, three core scenarios were defined and modeled in this report. The three core scenarios are:

1. Enhanced SEC: Achieve an acceptable frequency of IA examinations by hiring additional OCIE staff, funded by user fees;[19]

2. FINRA-IA SRO: Authorize FINRA, the SRO for B-Ds, to develop an IA SRO with an IA examination and enforcement mandate,[20] funded by membership fees, and overseen by the SEC; and

3. New-IA SRO: Authorize the creation of a new IA-focused SRO, with an IA examination and enforcement mandate, funded by membership fees, and overseen by the SEC.

The analysis assumes that the type and scope of IA examinations remains unchanged from the current SEC approach, but that on average, IA firms are examined once every four years, rather than the current frequency of once every 10-11 years. The analysis focuses on 2012, and does not estimate how the number of IAs and the associated ongoing mandate costs to the SEC or to IAs via user fees or membership fees might change over time.

[19] See footnote 3.
[20] See footnote 4.

III. Economic analysis

III.1 Cost analysis

This section details the direct setup costs, ongoing mandate costs, and the costs of SEC oversight of an SRO examination and enforcement activity, under each of the three core scenarios.[21] The indirect costs of compliance incurred by IA firms and how indirect costs might vary across the three core scenarios were not estimated or examined.

III.1.1 Assumptions and inputs

The economic analysis reflects the following inputs and assumptions, which are further elaborated upon in Appendix Section IV.2-IV.6:

- Size of the IA population to be examined: 9,440 IAs in 2012
  - Based on the number of IAs in 2011 adjusted for the estimated impact of the Dodd-Frank Act and projected growth from 2011 to 2012.
- Number of examiners required to achieve the target exam frequency: 787 examiners
  - Target exam frequency is once every four years per IA firm on average.
  - Rate of exams per examiner per year is assumed to be 3.0, which is the current average number of IA exams conducted by an SEC examiner per year.
- Setup costs are estimated based on benchmarks identified in recent SEC budget requests and the setup costs of other relevant, similarly located organizations.
- Ongoing mandate costs are estimated based on fully loaded costs per examination and enforcement employee derived from publicly available SEC and FINRA budget data for 2010, adjusted to account for scale and appropriate allocation of any scale benefits.
- Costs of SEC oversight of a SRO examination and enforcement activity are estimated based on current SEC oversight costs for FINRA B-D activity, but reduced by 50% to reflect reduced complexity of SEC oversight of an SRO in an IA context.[22]

[21] See Appendix Section IV.1 for more detail.
[22] See Appendix Section IV.6 for more detail.

III.1.2 Results of cost analysis

The estimated 2012 costs are detailed in Table 3, below:[23]

Table 3: Estimated range (mid-point)	**SEC** (existing)	**Enhanced SEC** (incremental OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Setup costs:	-	**$6-8M (10)**	**$200-255M (230)**	**$255-310M (280)**
– Examination	-	7	145 - 185	185 - 225
– *Enforcement*[A]	-	*3*	55 - 70	70 - 85
Ongoing mandate costs:	**$150M**	**$100-110M (105)**	**$460-510M (485)**	**$515-565M (540)**
– Examination	150	105	355	395
– *Enforcement*[A]	*60*	*40*	130	145
SEC oversight of an SRO:	-	-	**$90-100M (95)**	**$95-105M (100)**
– Examination	-	-	60	65
– *Enforcement*[A]	-	-	35	35
Total annual costs (excl. setup):	**$150M**	**$100-110M (105)**	**$540-610M (580)**	**$610-670M (640)**
– Examination	150	105	415	460
– *Enforcement*[A]	*60*	*40*	165	180

A. Examination and enforcement costs are shown in Table 3 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 3 under the Enhanced SEC scenario, enforcement costs are not included in the totals (Setup costs, Ongoing mandate costs, SEC oversight of SRO costs and Total annual costs), as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

Differences in setup costs across the three core scenarios are driven by the gap between current and required capabilities and capacity, as well as the time required to set up:

- The estimated up-front cost to enhance SEC IA capabilities is $6-8M. Increasing examiner capacity would drive the majority of the estimated setup costs. The SEC already holds the IA examination, enforcement, and rulemaking mandates, and the majority of the effort relates to increasing capacity of existing capabilities. The SEC may be able to set up in 6-12 months.
- FINRA-IA SRO setup costs are estimated at $200-255M. FINRA may be able to set up an IA SRO in 12-18 months. FINRA does not currently oversee IAs and would need to build a new and separate IA examination organization. FINRA may be able to leverage parts of its existing B-D-focused infrastructure (e.g., corporate functions, senior management, some regional offices).
- New-IA SRO setup costs are estimated at $255-310M. A New-IA SRO may be able to set up in 18-24 months. A New-IA SRO would have no existing infrastructure to leverage, instead needing to build, acquire, or outsource all capabilities.

Differences in ongoing mandate costs across the three core scenarios are driven by differing overhead costs and available scale benefits:[24]

- The incremental OCIE examination costs under the Enhanced SEC scenario are estimated at $100-110M, bringing total costs of OCIE examination to $240-270M. Enforcement costs would also likely increase as examination frequency increases.

[23] Estimates are modeled and rounded to the nearest $5M in annual cost and therefore may not add up precisely.
[24] See footnote 9.

Overhead costs on a per-examiner basis under the Enhanced SEC scenario are estimated to be lower than under the SRO scenarios because current SEC overhead costs are lower than FINRA's overhead costs. Scale benefits from the existing SEC organization and infrastructure are estimated, but only a portion of the benefit is attributed to IA examinations, as the benefits would be shared across the SEC organization.

- FINRA-IA SRO ongoing annual examination and enforcement costs are estimated at $460-510M. Estimated overhead costs are lower than in a New-IA SRO scenario due to scale advantages resulting from leveraging FINRA's existing B-D infrastructure.
- New-IA SRO annual ongoing examination and enforcement costs are estimated at $515-565M.

Cost of SEC oversight of an SRO in either SRO scenario are estimated at $90-105M The costs include oversight of SRO examinations, direct examinations of IAs, and both SEC-initiated and SRO-referred enforcement actions as well as appeals from an SRO. Costs of SEC oversight of a FINRA-IA SRO are lower than for a New-IA SRO because the SEC already oversees the FINRA organization, providing some opportunity to share resources and costs that would not be available in the New-IA SRO scenario. SEC oversight is not required under the Enhanced SEC scenario.

III.2 Level of funding and fees

This section describes the estimated level of funding to support the ongoing mandate costs described in the previous section, at the IA industry- and firm-level through user fees paid to the SEC or membership fees paid to one or more SROs.

III.2.1 Assumptions and inputs

The estimated level of funding is driven by the ongoing mandate costs, which includes full OCIE examination costs for the Enhanced SEC scenario, including both baseline and incremental OCIE staff, and all examination and enforcement costs for a FINRA-IA SRO and a New-IA SRO. Setup costs are not included in the estimated level of funding, although fees collected during the setup period might be relied upon to fund the setup costs, similar to the approach used by the Public Company Accounting Oversight Board ("PCAOB").[25] The costs of SEC oversight of an SRO are also not included in the estimated level of funding. The source of funding for SEC oversight of an SRO is not examined in this report.

[25] The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

III.2.2 Results of funding analysis

The estimated level of funding under the three core scenarios are described in Table 4 below, with both the incremental and full OCIE cost scenarios shown for the Enhanced SEC scenario:[26]

Table 4: Estimated range (mid-point)	**Enhanced SEC** (incremental OCIE)	**Enhanced SEC** (full OCIE)	**FINRA-IA SRO**	**New-IA SRO**
Estimated level of funding (ongoing mandate costs): – Examination – *Enforcement*[A]	$100 – 110M 105 *60*	$240 – 270M 255 *40*	$460 – 510M 355 130	$515 – 565M 395 145
Estimated average annual fee per IA firm required to fund scenario	$11,300	$27,300	$51,700	$57,400

A. Examination and enforcement costs are shown in Table 4 for each core scenario to allow for comparison across three core scenarios. However, please note that in Table 4 under the Enhanced SEC scenario, enforcement costs are not included in the total "Estimate level of funding (ongoing mandate costs", as per SEC Section 914 Study, which referenced user fees as a potential source of funding for examination costs, but did not similarly reference enforcement costs.

It is important to note: Beyond estimating the average fee per IA firm, this report does not examine the many mechanisms available to collect funds in the form of fees from the relevant IA population, and does not recommend any specific approach to apportioning fees to IA firms. Apportionment of fees might be accomplished with a flat or variable fee structure and reflect firm characteristics such as firm size (e.g., AuM, revenue, number of clients) or firm risk profile (e.g., custody, investment strategies, types of assets), or a combination of both.[27]

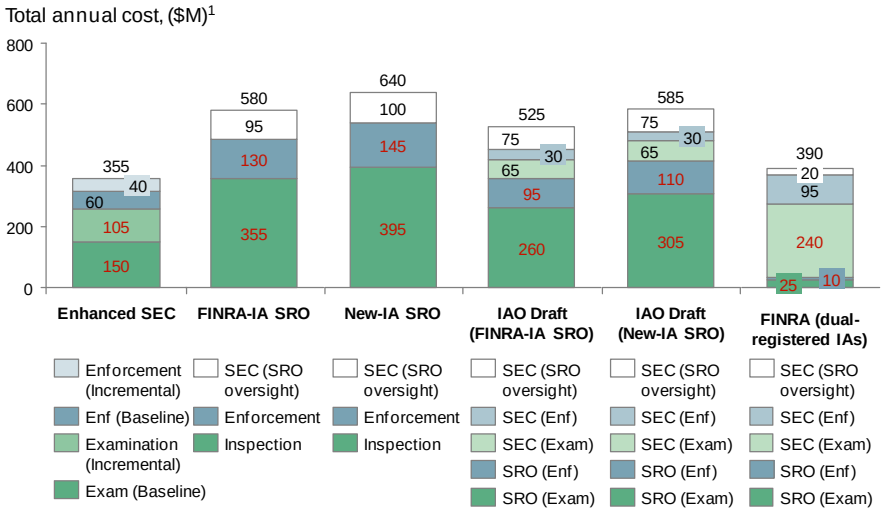
We estimate the level of funding needed for the FINRA-IA SRO and New-IA SRO scenarios to be 90% and 110% higher than the Enhanced SEC scenario's full OCIE cost scenario, respectively.[28]

[26] Estimates are modeled and rounded to the nearest $5M in annual cost and to the nearest $100 annual cost per IA firm, and therefore may not add up precisely.
[27] The apportionment formula would be in accordance with any authorizing legislation and may be delegated to the SEC or an SRO, where applicable.
[28] The difference in funding requirements would increase slightly if rulemaking was included in the SRO's mandate.

III.3 Other scenarios examined

In addition to the three core scenarios, BCG explored three additional scenarios, the latter two of which are included in Table 5, for comparison against the three core scenarios. For comparison purposes, full rulemaking authority is not included in the IAO Draft and FINRA dual-registered scenarios.

Table 5:



	Enhanced SEC	FINRA-IA SRO	New-IA SRO	IAO Draft (FINRA-IA SRO)	IAO Draft (New-IA SRO)	FINRA (dual-registered IAs)
Estimated level of fee-based funding ($M)	105 / 255[4]	485	540	355	415	240 & 30[3]
Estimated average fee per firm ($)	11,300 / 27,300	51,700	57,400	52,100	60,700	27,300 & 53,900
# of IA firms registered with SEC	9,440	0	0	2,590[2]	2,590[2]	8,860
# of firms registered with SRO	0	9,440	9,440	6,850	6,850	580

Note: Numbers may not add up due to rounding error. 1. Total annual cost is defined as the cost of examination and enforcement mandates as well as any SEC IA-SRO oversight costs. 2. Includes IA firms with >90% AuM attributable to private funds, mutual funds, clients with more than $25M in investments, and other type of IAs as discussed in the draft of "Investment Adviser Oversight Act of 2011". SRO-exempt firms include 1,810 currently registered firms as well as 780 newly register private funds. 3. $240M is funding needed for SEC-registered firms (non-dual reg. IAs) and $30M is funding needed for FINRA-registered firms (dual-reg. IAs). 4. $105M is the funding need to cover the SEC's incremental examination costs. $255M is the funding needed to cover the full examination costs.

III.3.1 Rulemaking mandate for an SRO

If full rulemaking authority is added to the FINRA-IA SRO or New-IA SRO scenarios, the ongoing mandate costs of the SRO are expected to increase by ~4%, or ~$20M, while also increasing SEC oversight of the SRO costs by ~$10M. Given rulemaking is within the current mandate of the SEC, this variation is not relevant to the Enhanced SEC scenario. Full rulemaking is differentiated from the limited rulemaking that would be incidental to examination and enforcement (e.g., developing data requests to be deployed during examinations), the cost of which is assumed to be *de minimis* and would be subsumed as part of examination and enforcement costs.

III.3.2 IAO Draft

If the IAO Draft released on September 7, 2011, is adopted, then the level of fees payable by smaller firms would increase beyond the estimates in Table in Table 4, under the two SRO scenarios, as ~1,810 currently registered IA firms (~16% of the registered IA firm population), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that will be required to register with the SEC in 2012 as a result of the Dodd-Frank Act. However, those firms are included in the table above for comparative purposes. Only IA firms with more than $100M AuM are considered in this calculation, as per the Dodd-Frank Act. This

scenario assumes that only one SRO is formed, although the IAO Draft does allow for the creation of one or more SROs. Also, while the IAO Draft grants rulemaking authority to an SRO, the cost of rulemaking was not included in the cost analysis for this scenario to enable direct comparison to the three core scenarios. The cost increase associated with adding rulemaking to the IAO Draft scenario is likely comparable to the estimated 4% increase under the core SRO scenarios.

III.3.3 FINRA jurisdiction over dual-registered IA / B-Ds

This additional scenario is the third recommended option of the SEC Section 914 Study, whereby the IA examination mandate for dually-registered IAs / B-Ds, of which there will be an estimated ~580 in 2012, is assigned to FINRA, while the remaining ~8,860 IA firms are examined by the SEC.

In this scenario, the estimated costs of IA examination are ~$240M for the SEC and ~$30M for FINRA. The estimated average fee per IA firm is ~$27,300 for IA firms under the jurisdiction of an Enhanced SEC (full OCIE costs), and ~$53,900 for IA firms under FINRA jurisdiction.

As dually-registered firms are estimated to represent 6% of the IA firm population in 2012, shifting examination of these IA firms from the SEC to FINRA is not expected to result in significant cost savings to the SEC. Also, under this additional scenario, the estimated cost of SEC oversight of FINRA's dual-registered IA examination activity is ~$20M.

IV. Appendix

This section describes the methodologies and assumptions used in the analyses described in this report.

IV.1 Description of costs and required level of funding

- Setup costs: Includes the costs of moving the organization from the current to the estimated IA examination capacity and resource levels, including physical and technical infrastructure; hiring and training of examiners; associated overhead; and the initial development of organizational structures and operational procedures.
- Ongoing mandate costs: Includes the ongoing annual costs of an IA examination program and the associated costs of enforcement. Ongoing mandate costs include salaries and benefits for examiners and support staff; information technology; real estate expenses; and other overhead items.
- SEC oversight of an SRO costs: Includes recurring annual employee and overhead costs associated with, for example, examination of an SRO's activities as well as some direct SEC examinations and enforcement activities (as is currently done by the SEC in regard to B-Ds).
- Total annual costs: Includes ongoing mandate costs and the costs of SEC oversight of an SRO, and is referred to as total annual costs.
- Level of funding and potential fees: Level of funding for each scenario, is determined by ongoing mandate costs. This report assumes that the ongoing mandate costs will be covered by user fees (to the SEC) or membership fees (to one or more SROs). No assumption is made as to how the costs of SEC oversight of an SRO would be funded (various options including direct fees and SEC appropriations might be considered).

IV.2 Estimation of the number of SEC-registered IAs in 2012

The 2011 IA population is 11,529 (IAA/NRS Evolution Revolution report). 3,200 IAs with less than $90M AuM were removed from the population, based on estimates from the SEC Section 914 Study.[29] 750 private fund-oriented IAs with AuM greater than $150M were added to the population, based on the Dodd-Frank Act. Subsequently, an annual growth rate of 4% was applied based on the average 5-year compound annual growth rate (CAGR) for each major IA AuM segment, which results in a projected population of ~9,440 SEC-registered IAs in 2012.[30]

IV.3 Estimation of the number of IA examiners needed to meet a target examination rate

The target examination rate is assumed to be once every four years, on average. The current rate is once every 10-11 years, and the most frequent average examination rate achieved by the SEC in recent history is once every six years (SEC Section 914 Study). The average examiner productivity is assumed to be 3.0 examinations per examiner per year, based on the five year SEC average of 3.0 IA examinations per examiner per year.[31] In order to achieve an average

[29] $90M is used due to a buffer below the $100M threshold specified in the SEC Section 914 Study.
[30] IA firms were segmented by AuM into groups, to which the 5-year historical growth rate was calculated and utilized to project forward from 2011 to 2012, for the AuM segments that will remain in scope.
[31] The SEC examination rate of 3.0 is used because it is the best available reference point for the anticipated productivity level of examiners of IA firms. Examination rate benchmarks from other organizations were analyzed but, in the end, not included due to incomparability of exam populations, targeting methodology, scope, and other reasons.

examination frequency of once every four years, with examiner productivity of 3.0 examinations per examiner per year, 787 examiners are required.

IV.4 Estimation of the setup costs for each of the three core scenarios

IV.4.1 Enhanced SEC

The cost of adding incremental examination capacity under the Enhanced SEC scenario was estimated at $24,000 – 26,000, and was informed by the following:

- SEC 2012 budget request
- Public information regarding costs of other recent moves to Washington, D.C., by relevant organizations

IV.4.2 New-IA SRO

The setup costs of a New-IA SRO were informed by the following, after adjusting for size and resource requirements:

- PCAOB setup experience, and review of their 2003-2004 budget
    - PCAOB took two years to setup before reaching a steady state of ~240 examiners and 5 offices
    - PCAOB costs of $117M, normalized by adjusting cost items, (e.g., salary/benefits, office space, equipment, IT) for differences in size, scale and time period

- Consumer Financial Protection Bureau (CFPB July 2011 report) setup experience
    - CFPB incurred $60M in costs in its first eight months
    - Full setup costs for the CFPB estimated to be ~$125M, resulting in an organization of ~550 people, or about half of a New-IA SRO, normalized by adjusting cost items based on differences in size and scale

IV.4.3 FINRA-IA SRO

Interviews with subject matter experts suggested that the setup time for a FINRA-IA SRO would be roughly 6 months less than for a New-IA SRO. FINRA's ability to leverage existing physical, technological, and organizational infrastructure, could result in ~20% lower setup costs than for a New-IA SRO.

IV.5 Estimation of ongoing mandate costs

IV.5.1 Estimation of examination costs

Average examiner salary and benefits are estimated to be ~$189K. Overhead expenses per examiner are estimated to be ~$134K, or 27% of total SEC overhead expenses, based on the number of OCIE employees as a percent of total employees. The resulting fully loaded total average cost per employee was estimated to be ~$323K.

IV.5.2 Estimation of enforcement costs

Interviews with subject matter experts, including former SEC employees, resulted in estimated costs attributable to IAs of 14% of the Division of Enforcement's total costs and ~7% of the Division of Investment Management's total costs. Including overhead, this implies a cost per employee of ~$353K in the Division of Enforcement and ~$363K in the Division of Investment Management.

Applying the ratio of 2.8 IA examiners per IA enforcement full-time equivalent ("FTE") at the SEC provides an estimate of the additional enforcement FTEs required to handle an expected increase in enforcement activity.[32]

IV.5.3 Estimation of costs specific to a FINRA-IA SRO and a New-IA SRO

Costs associated with a FINRA-IA SRO and a New-IA SRO were informed by the following

- Examination and enforcement employee ratios and salary costs at the SEC
- Overhead cost per examiner at the SEC adjusted to reflect higher ratio of professional staff to administrative staff at FINRA than at the SEC
- FINRA's 2010 budget of fees (regulatory and user fees) from B-D examiners.

IV.5.4 Estimation of the impact of scale

A scale factor of 19% was applied to the overhead costs of the Enhanced SEC and FINRA-IA SRO scenarios. The scale factor was derived from BCG benchmarks and analysis of similar organizations that indicates that, as an organization doubles in size, overhead costs increase by 81%. The scale benefits were shared across the entire organization, so that the scale benefits attributed to the IA examination costs under the Enhanced SEC and FINRA-IA SRO were only 12% and 40% of the scale-driven savings, respectively.[33]

The New-IA SRO, starting from a base of zero employees, experiences some scale disadvantage relative to the SEC and FINRA. The scale disadvantages were measured in relation to FINRA's current organization size.

IV.6 Estimation of the costs of SEC oversight of an SRO

SEC oversight of FINRA today was used to estimate the costs of SEC oversight in the SRO scenarios. There are ~380 SEC examiners overseeing roughly 840 FINRA B-D examiners, indicating a ratio of 2.2 FINRA examiners per SEC oversight examiner.[34] IA examinations (and oversight of those examinations) are likely to be less resource-intensive, on average, than B-D examinations, so the ratio of examiners per SEC oversight examiner was adjusted accordingly.[35]

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[32] We assume the ratio holds constant rather than assume changes in productivity or operating procedures related to enforcement.

[33] See footnote 9.

[34] Includes oversight of operations of an SRO by conducting oversight examinations of the SRO, considering appeals from sanctions imposed by the SRO, and approving SRO fee changes (SEC Section 914 Study).

[35] The SEC is expected to conduct primary investigations of IAs at a lower rate/level than is the case of B-Ds for two reasons: the SEC already has experience and familiarity with IA examinations as a result of its current mandate, and IA investigations tend to be less complex than B-D examinations and therefore less likely to warrant direct SEC involvement in the examination. If, in practice, the SEC conducts more

As such, for a New-IA SRO with 787 examiners, the SEC would need ~178 IA oversight examiners. Assuming similar average costs for these examiners as well as similar ratios for enforcement and rulemaking as stated above, the SEC would incur ~$100M in oversight costs. The costs of overseeing a FINRA-IA SRO are slightly less than for a New-IA SRO, because the SEC already oversees the FINRA organization.

IV.7 Other scenarios examined

IV.7.1 Rulemaking mandate for an SRO

SRO rulemaking cost estimates were informed by

- SEC rulemaking costs and subject matter expert interviews indicating that
  - IA-related rulemaking costs represent ~13% of the costs of the Division of Investment Management and ~14% of the costs of the General Counsel's office
  - Including overhead, per employee costs of ~$363K at the Division of Investment Management and ~$355K at the General Counsel's office
  - SEC IA examiner per IA rule maker ratio of ~15.7
- SRO overhead cost estimates per examiner

Resulting cost estimate for SRO rulemaking is $20M, or ~4% of the estimated ongoing mandate costs. SEC oversight of SRO rulemaking costs are estimated at ~$10M. In the enhanced SEC scenario, it is assumed that rulemaking costs would not change.

IV.7.2 IAO Draft

Under the IAO Draft, certain IAs would be excluded from the requirement to register with an SRO, and instead would be required to register with the SEC. The exclusion applies to all IA firms with 90% or more of their assets under management attributable to one or more of the following client types:

- Registered investment companies;
- Advisers to non-US clients;
- Clients with more than $25,000,000 in investments;
- 3(c)(10) funds (e.g., charitable trusts);
- 3(c)(11) funds (e.g., DB and DC plans);
- Private funds (e.g. hedge funds and private equity funds); and
- Venture capital funds.

An estimated ~1,810 currently registered IA firms (~16% of SEC-registered IAs), with an average of ~$9B of ADV-reported assets per firm (~38% of total ADV-reported assets), would be removed from the funding base. This does not factor in ~780 private fund advisers that are required to register with the SEC in 2012 as a result of the Dodd-Frank Act.[36]

The level of funding needed for a FINRA-IA SRO is estimated at ~$435M and for a New-IA SRO at ~$485M. This estimate does not include the costs of rulemaking that is granted to an SRO in the IAO Draft, to enable direct comparison to the three core scenarios. The estimated funding

primary investigations of IAs than assumed in this analysis, then the costs of SEC oversight of an SRO will be higher than the current estimate.

[36] The ~750 private investment fund advisers estimated by the SEC in 2011 plus another 30 from normal annual growth in firm count.

level is slightly below the estimated funding level in the core SRO scenarios because of the exclusion of the ~1,810 IA firms described above. The resulting estimated average user fee per IA firm is ~$51,810 for a FINRA-IA SRO and ~$58,500 for a New-IA SRO.

While reduction in the IA firm population would reduce the costs of IA examination for an SRO, and estimated average fees per IA firm would not change significantly, the membership fees paid by the remaining IA firms would increase by ~20% if apportioned on a per AuM basis.