COLORADO DEPARTMENT OF REGULATORY AGENCIES
OFFICE OF POLICY AND RESEARCH

INVESTMENT ADVISORS

1997 SUNRISE REVIEW

January 27, 1998

Members of the General Assembly
c/o Doug Brown, Director
Office of Legislative Legal Services
State Capitol Building
Denver, Colorado 80203

Dear Members of the Colorado General Assembly:

We have completed our evaluation of the sunrise application for licensure of investment advisers and are pleased to submit this written report. The report is submitted pursuant to §24-34-104.1, Colorado Revised Statutes, 1988 Repl. Vol., (the "Sunrise Act") which provides that the Department of Regulatory Agencies shall conduct an analysis and evaluation of proposed regulation to determine whether the public needs, and would benefit from, the regulation.

The report discusses the question of whether there is a need for the regulation in order to protect the public from potential harm, whether regulation would serve to mitigate the potential harm and, whether the public can be adequately protected by other means in a more cost-effective manner.

Sincerely,

Joseph A. Garcia
Executive Director

Table of Contents

INTRODUCTION 1

DEFINITION 1
SCOPE OF PRACTICE, WORK SETTING, AND SUPERVISION 1
NUMBER OF PRACTITIONERS 2

THE SEC AND STATE OVERSIGHT OF THE INDUSTRY 3

CURRENT SECURITIES REGULATION 3
INVESTMENT ADVISER REGULATION 4
COLORADO REGULATION OF SECURITIES 7
STATE SURVEYS OF INVESTMENT ADVISER REGULATION 8

PUBLIC HARM 10

ACTUAL HARM 10
POTENTIAL HARM 10

ANALYSIS/CONCLUSION 14

RECOMMENDATIONS 15

APPENDICES 16

APPENDIX A - EXAMPLES OF INVESTMENT ADVISER HARM IN COLORADO 17

INTRODUCTION

The Colorado Department of Regulatory Agencies (DORA) prepared this report in response to a sunrise application received from the Institute of Certified Financial Planners ("ICFP") and the Colorado Society of the ICFP. DORA considered the applicants' concerns and the public benefit of the proposal using the required statutory criteria identified in §24-34-104.1 of the Colorado Revised Statutes which states the following:

I. Whether the unregulated practice of the occupation or profession clearly harms or endangers the health, safety or welfare of the public, and whether the potential for harm is easily recognizable and not remote or dependent on tenuous argument;

II. Whether the public needs and can be reasonably expected to benefit from an assurance of initial and continuing professional or occupational competence; and

III. Whether the public can be adequately protected by other means in a more cost-effective manner.

Definition

The occupational group for which the applicant is seeking regulation are investment advisers. Generally, the term "investment adviser" includes anyone who offers advice as to the value of securities or advises on the investing in, purchasing, or selling of securities in return for compensation.

There are many other occupational titles commonly used to describe the investment advisory activities of an individual. These include financial planner, financial consultant, financial adviser, financial counselor, investment management consultant, asset manager, retirement management specialist, and wealth managers, among others.

Scope of Practice, Work Setting, and Supervision

According to the applicant, the functions of an investment adviser vary greatly depending upon the needs and net worth of the client. The typical investment adviser works in a small office, although an individual may be an independent contractor affiliated with a branch office of a large national firm. For example, the applicant reports that half of the members of the Institute of Financial Planners are sole proprietors and 70 percent of the members have fewer than five financial planners in their firm.

Depending upon the structure of the advisory firm, representatives of the firm may or may not be subject to internal supervision. Functions of each occupational group may vary, depending upon the primary focus of the individual's business. For example, an attorney engaged in estate planning may provide incidental advice on investments to a client while an asset manager or financial planner may focus full time on investment advisory services and be granted full discretionary authority to manage millions of dollars of a client's assets.

The amount of authority granted to investment advisers also varies. Some investment advisers have custody over their client's accounts and may withdraw money to use as they see fit. Other advisers have discretionary authority over their client's money to move investments to different funds but may not withdraw the money. Most advisers provide only advice to clients with recommended courses of action that the client may follow if the client chooses.

Those who use investment advisers vary widely. They may include institutional clients, high net worth clients, middle income families and young professionals. The applicant reports that clients of Certified Financial Planners tend to be middle aged people with annual discretionary funds of $10,000.

Number of Practitioners

Currently, the U.S. Securities and Exchange Commission (SEC) regulates investment adviser companies, but not individuals who work for those companies, in the state of Colorado. The SEC reports that there are approximately 650 investment adviser firms in the state and the applicant suggests that there would be approximately 2,000 individuals in Colorado that would fall under the regulation of the broader title of investment adviser defined by the applicant.

There are no minimum competency requirements to be an investment adviser. Several higher education institutes provide courses and curricula related to investment advisers. The College of Financial Planning in Denver provides curricula that, among other things, includes instruction on helping a client meet his or her financial goals through effective asset allocation techniques. Similar approved programs by the CFP Board of Standards are accredited through Metro State College and by Colorado State University in Fort Collins. The applicant believes that courses and curricula are available in other Colorado educational institutions that provide courses in investment advisory knowledge.

The investment adviser profession includes many other professions that are regulated independently. For example, attorneys and insurance agents are regulated by the State Supreme Court and the Division of Insurance, respectively. Other professions attempt to promote higher standards through the use of private credentials. These include certified financial planners and certified public accountants whose private certification standards generally exceed the requirements of individual investment advisers in other states.

THE SEC AND STATE OVERSIGHT OF THE INDUSTRY

Current Securities Regulation

In any discussion of investment advisers, it is necessary to first discuss the overall regulation of securities to understand the proper perspective of this profession. State regulation began in the early 1900's when states first determined that regulation of the sales of securities was necessary to protect the public. State securities regulation predates the creation of the federal Securities and Exchange Commission (SEC) by more than two decades. Regulation of securities offerings and the licensing of broker dealers and their agents by a state is known as "blue sky" law. The first modern state blue sky law was adopted in 1911 in Kansas. The term "blue sky" referred to speculative schemes that, in the words of a judge of the period, had no more substance than so many feet of "blue sky." The Kansas law served as the nationwide model for state regulation. [1] Colorado adopted its securities law in 1921.

In the wake of the Great Depression, the Stock Market crash of 1929, and instances of fraud and self dealing that had preceded this time, Congress began to look at federal securities laws that would provide a more uniform regulatory approach to securities regulation. As a result, Congress created a four-pronged approach designed to provide mandatory disclosure of securities, regulate those who bought or sold securities, and regulate those who advise investors on what securities to buy and sell.

In 1933, Congress passed the Securities Act of 1933 ("'33 Act").[2] This act mandated that in order to offer securities to the public, the offering party had to register that security with the SEC and provide full disclosure of all material facts of the security to the investor. The following year, Congress enacted the Securities Exchange Act of 1934 ("'34 Act")[3] which focused on the regulation of the securities profession and created the (SEC). In addition to reporting requirements of sales of securities, the '34 Act regulated those individuals who purchased and sold securities. In coordination with the states, brokers and dealer representatives of securities must pass written examinations and submit a detailed background application to be licensed by the state to offer or sell securities.

The enactment of the Investment Company Act of 1940 ("Company Act")[4] and the Investment Advisers Act of 1940 ("Advisers Act") concluded the regulatory quadrumvirate. This Company Act requires companies primarily engaged in the business of investing in securities and whose own securities are sold to the public (i.e. mutual funds) to register with the SEC. Investment companies also must disclose their financial condition,

[1] North American Securities Administrators Association, ("NASAA"), specific language identified in Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917)
[2] Securities Act of 1933, 15 U.S.C. §77 (1997)
[3] Securities Exchange Act or 1934, 15 U.S.C. §78 (1997)
[4] Investment Company Act of 1940, 15 U.S.C. § 80a (1997)

investment policies, performance, investment risks, fees, operating data and other restrictions. The Adviser Act provides more substantive reporting requirements than the "'33" and "'34" Acts and establishes a registration and enforcement system for investment advisers.[5]

Today, these laws continue to provide the major outline of federal securities regulation. Bolstered by additional state regulatory requirements, they provide a cohesive system that proactively regulates and punitively enforces the securities community which assists the public in ensuring a safe and fair securities market.

Investment Adviser Regulation

Under the Advisers Act, state and federal securities agencies had the authority to register and examine the books of all investment advisers operating in their state. In an effort to reduce duplication and enhance regulatory presence, Congress made significant changes to states' and the SEC's responsibilities regarding securities regulation through the National Securities Markets Improvement Act of 1996 ("NSMIA").[6] NSMIA divided the regulatory responsibilities of investment adviser companies between the SEC and the states. Those investment adviser firms with $25 million or more in assets under management and adviser firms to registered investment companies, as well as any state that does not have an investment adviser regulatory program, are solely registered with the SEC. The remaining advisers, those with less than $25 million in assets ("small investment advisers") are registered solely with the states.[7]

A major reason for this division in regulation was the lack of SEC resources to routinely examine all investment adviser firms. In 1995, the SEC reported that it audited small investment adviser firms once every 44 years while the inspection cycle for larger investment firms was five to six years.[8] The enactment of NSMIA by Congress is designed to better use available federal and state resources in order to provide more oversight of investment advisers.

[5] Investment Advisers Act of 1940. 15 U.S.C. §80b (1997)
[6] Pub. L. No. 104-290, 110 stat. 3416 (1996)
[7] Report of the Task Force on the Future of Shared State and federal Securities Regulation, October 1997, p. 19.
[8] Address by Aurther Levitt, Chairman, U.S. Securities and Exchange Commission at the NASAA Fall Conference, Vancouver, British Columbia (Oct. 1995) as reported in the Task Force Report, supra note at 18.

Many states over the years have enacted legislation that enhances regulatory oversight of the investment adviser profession. This legislation includes more stringent application requirements and a different audit focus which augments the SEC's audit procedures (i.e. market conduct versus capitalization). Perhaps the greatest state enhancement to investment adviser regulation has been the state regulation of individual investment advisers. Whereas the federal government regulates firms and individuals who purchase and sell securities, states felt the same regulatory approach was necessary for investment advisers. Consequently, there are 33 states that require individual investment advisers, called investment adviser representatives, to register with the appropriate state securities division.[9] The attached chart outlines the current regulatory structure of securities regulation. Additionally chart two provides a list of states that regulate investment adviser representatives.

CURRENT INVESTMENT ADVISER REGULATION

	Investment Adviser Firms With Assets Greater Than $25 Million	**Investment Adviser Firms With Assets Less $25 Million**
Current Investment Adviser Regulation for all but CO,IA,WY,OH	SEC	STATES
CO Investment Adviser Regulation	SEC	SEC

Many states also require investment advisers to be bonded. Bonding requirements vary among states depending upon the authority that the investment adviser has towards the client's funds. Generally, this authority can be separated into three categories; 1) custody, 2) discretionary authority, and 3) advisory authority. In those cases where investment advisers have **custody** over a client's funds, the investment adviser, through a power of attorney, has direct access to the client's money and the authority to control where that money is placed. Where the investment adviser has **discretionary** authority over the management of the client's funds, the investment adviser does not have physical control over the client's money, as with custody, but the investment adviser does have discretion to move the client's money into different securities. Under **advisory** authority, the investment adviser's power is limited to only advice and never is involved with the client's funds. Chart 2 on the following page provides a survey of state bonding requirements.[10]

[9] Reported by the North American Securities Administrators Association ("NASAA"). See also Chart 2 on pg. 6.
[10] Information for Chart 2 was obtained from the North American Securities Administrators Association, NASAA.

Chart 2: Survey of State Investment Adviser and Investment Adviser Representatives Regulation

State	License Investment Advisers	License Investment Adviser Representatives	Bonding Rule	
			Amount	Dependent on Custody / Discretion?
Alabama	Yes	YES	$50,000	Yes
Alaska	Yes	YES	$5,000	No
Arizona	Yes	YES	None	N/A
Arkansas	Yes	YES	$50,000	No
California	Yes	NO	No	N/A
Colorado	NO	NO	N/A	N/A
Connecticut	Yes	YES	None	N/A
Delaware	Yes	YES	None	N/A
Florida	Yes	YES	No	N/A
Georgia	Yes	YES	None	N/A
Hawaii	Yes	YES	$50,000 (if custody); $5,000 (if no custody)	Yes
Idaho	Yes	YES	$25,000	Yes
Illinois	Yes	YES	No	N/A
Indiana	Yes	YES	Up to $25,000	No
Iowa	No	NO	----------	---------
Kansas	Yes	NO	No	N/A
Kentucky	Yes	NO	Up to $25,000	No
Louisiana	Yes	NO	None	No
Maine	Yes	NO	No	No
Maryland	Yes	YES	Up to $10,000	Yes
Massachusetts	Yes	YES	At least $10,000	Yes
Michigan	Yes	NO	None	N/A
Minnesota	Yes	NO	$25,000	Yes
Mississippi	Yes	YES	$30,000 if custody	Yes
Missouri	Yes	NO	No	No
Montana	Yes	YES	None	N/A
Nebraska	Yes	NO	$25,000	No
Nevada	Yes	YES	None	N/A
New Hampshire	Yes	NO	at least $25,000	No
New Jersey	Yes	YES	$25,000	Yes
New Mexico	Yes	YES	$100,000	Yes
New York	Yes	NO	No	No
North Carolina	Yes	YES	At least $35,000	Yes
North Dakota	Yes	YES	No	Unknown
Ohio	No	NO	--------	----------
Oklahoma	Yes	YES	$10,000	No

State	License Investment Advisers	License Investment Adviser Representatives	Bonding Rule	
			Amount	Dependent on Custody / Discretion?
Oregon	Yes	YES	$10,000	No
Pennsylvania	Yes	YES	Same as capital	Yes
Puerto Rico	Yes	NO	$10,000	No
Rhode Island	Yes	YES	$100,000 to $1,000,000	Yes
South Carolina	Yes	YES	$50,000; an extra $10,000 if advisers are SEC registered	No
South Dakota	Yes	YES	None	
Tennessee	Yes	NO	None	
Texas	Yes	YES	None	NA
Utah	Yes	YES	$10,000	Yes
Vermont	Yes	YES	$25,000, $10,000	Yes
Virginia	Yes	YES	$25,000	No
Washington	Yes	YES	None	N/A
West Virginia	Yes	NO	$10,000	No
Wisconsin	Yes	NO	No	No
Wyoming	No	NO	NA	NA
TOTAL	**48**	**32**		

Colorado Regulation Of Securities

Whereas Colorado is consistent in its regulation of securities brokers/dealers and representatives around the nation, Colorado is one of four states (the others being Ohio, Wyoming, and Iowa) that does not require state regulation of investment advisers.[11] In these states, regulation is provided by the SEC who have regional offices around the country. Colorado is fortunate to have the SEC regional office in Denver, as their presence makes enforcement and audits of investment advisers easier than those states to where SEC representatives must travel. The SEC requirements to operate as an investment adviser are completion of a simple registration form, and a list of principals.[12]

Colorado also does not regulate investment adviser representatives. Unless an individual is listed as a principal or receives a complaint under its adviser rules, the SEC does not regulate investment adviser representatives.

[11] See Chart 2 on pg. 7 for a listing of state investment adviser regulations
[12] Conversation with the U.S. Securities and Exchange Commission (Jan. 1998)

State Surveys Of Investment Adviser Regulation

Office of Policy and Research Survey

As part of its sunrise review, the Office of Policy and Research conducted an informal survey of surrounding states who regulate investment advisers and investment adviser representatives[13]. The survey revealed that states took very few disciplinary actions against investment advisers, but all believed that the initial screening of applicants is very effective as a proactive regulatory step of keeping bad actors out of the industry. Utah reported approximately 1% of all applicants of investment adviser representatives either had their application revoked or voluntarily withdrew their application. Additionally, states felt an examination also ensured up-front competency. Wisconsin revealed that registration of investment advisers is increasing 20% to 30% a year as more and more broker dealers/representatives change professions to this field or add it to their existing business.

Consumer Federation of America Survey

In 1996, prior to the enactment of NSMIA, the Consumer Federation of America (CFA) surveyed 40 states on the adequacy of regulation of investment advisers.[14] While noting that most states failed to provide adequate protections against fraud and abuse (only 11 states reported having all or nearly all of the elements identified as essential to an adequate oversight program), the CFA did find that despite these inadequacies most states offered additional consumer protection absent from federal law. These included licensing of investment adviser representatives and more stringent application requirements.[15]

[13] OPR informally surveyed via telephone the following states: AZ, KS, NM, NV, TX, UT, and WI.
[14] Barbara Roper, *Investment Adviser Regulation: New Legislative Proposal Threatens To Reduce Already Deficient Oversight*, Consumer Federation of America, (July 15, 1996)
[15] Id. at 2

Specific areas identified by the CFA where states provide valuable protection included the following:

- Most states require both investment adviser and investment adviser representative registration or licensing where the SEC only registers investment advisers.
- SEC registration does not require large firms to list all of their employees in their application. In firms with five or more individuals providing investment advice to consumers, the applicant is required to list only the supervisors. Since not all employees are listed, the SEC has no easy method of identifying individuals with prior disciplinary records.
- Most states have broader authority than the SEC to deny registration.
- Most states have tighter restrictions and perform a more thorough background check on those advisers than the SEC, and
- Most states require investment advisers representatives to meet some minimum level of qualification. The SEC has no set standards.

PUBLIC HARM

Actual Harm

Conversations with the applicant and the Division of Securities reveals some incidences of actual harm. Over the last five years, the Colorado Division of Securities has been involved with a few cases where investment advisers either acting alone or through broker/dealers defrauded clients. Appendix A provides a summary of some of these cases. The Division of Securities maintains that some of these financial damages may have been mitigated by a state investment adviser regulatory program.

As the main regulatory agent of investment adviser regulation in Colorado, the SEC can show many other examples of investment adviser problems in addition to fraud. The SEC reports they regulate approximately 650 small investment adviser companies in Colorado. The SEC performs approximately 15-20 examinations per year of which 95% of those examined receive deficiency letters and approximately 2-4 per year are referred to enforcement for fraud and other inappropriate behavior.

Potential Harm

A stronger argument can be made for potential harm to the public. The potential lies in the convergence of two specific occurrences; the large amount of money the public is investing in securities coupled with the inadequate regulation of this industry.

Growth of the Industry

The popularity of the 401(k) retirement plan and other investment packages offered by employers has resulted in tremendous growth of the securities industry and more investment decisions by individual consumers. Today, employers are offering their employees various investment options and many employees are turning toward investment advisers for assistance. An example of this growth may be seen in examining the four large investment adviser firms in Denver: Founders, Invesco, Janus, and Berger. In 1988, these companies controlled a combined asset amount of $6 billion and offered customers 35 different portfolios. In 1997, the asset figures grew to $75 billion with 92 different investment funds.[16]

[16] Conversation with the U.S. Securities and Exchange Commission (Jan. 98)

Nationwide, mutual funds make up nearly $4 trillion in investments assets.[17] Companies now offer more and more investment plans designed for different ages and lifestyles. Additionally, individuals change jobs more frequently than in the past, many of whom must reinvest their investments with their new employer. Altogether, they result in the public making more investment decisions than in the past. Consequently, the public is turning to investment advisers for assistance.

The financial services industry is mobilizing to provide these services which has resulted in a large increase in investment advisers. Most major brokerages are expanding their representative's duties and are calling them consultants who offer comprehensive financial planning[18]. Rather than just selling or buying securities, these groups are also providing advice on what securities to buy or sell. In the last two decades, "financial planning" has evolved into a multi-billion-dollar industry, with thousands of advisers who plan and monitor investors' overall finances, rather than just a single aspect or two.[19] Fewer than 10,000 investment advisers are registered with the SEC. It is estimated that there are 200,000 self-proclaimed financial planners in the United States, which means that many thousands who should be registered as investment advisers under federal and state law are not.[20] The financial planning industry is in the midst of a meteoric rise today, fueled by the emergence of well-heeled young professionals, two-income families, the graying of the American population and aggressive advertising. Industry groups estimate that there are 10 million Americans, many of them middle-income wage earners, who could use financial planning services.[21]

Impact of Money to Investor

The money that individuals invest have a substantial impact on their lives. Often these investments are for retirement, their children's education, a new home, etc. If money is lost due to fraud or incompetence, the harm is great and often can never be replaced. When problems with investment advisers do occur, they generally do not have the money for restitution to customers. Even if a bad actor has $1,000 in excess income a month, it would take years to pay back only $100,000. Often the financial burden is much greater.

This potential harm affects all areas of the population. Prior cases suggest that not only the elderly, but also professionals (especially baby-boomers who have set aside little or no money for retirement) are easy prey for those people promising large rates of return without explaining the risks.

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[17] Tom Petruno, A Growing Army of Financial Advisors Is Jockeying for Your Ear—and Wallet. *How Do You Pick One?* Los Angeles Times, June 29, 1997
[18] Id. at 2
[19] The New England Better Business Bureau, January 20, 1998 from their web page www.bosbbb.org/lit/053.htm
[20] NASAA
[21] NASAA

In cases dealing with fraud, the "adviser" is sophisticated and presents an outward appearance of success driving expensive automobiles, living in upscale neighborhoods, and gaining referrals among similar clients. It is not until one or more investors wishes to withdraw their money that it is discovered they have been defrauded. Schemes may go on for years if the individual can continue to find new clients whose money is used to offset that which he or she has embezzled from earlier clients.

Insufficient Regulation of Investment Advisers

With limited SEC resources and a greater focus on larger firms due to the enactment of NSMIA, the SEC enforcement efforts against smaller firms is diminishing. From 1986-1990, the SEC performed on average approximately 60 audits a year on smaller firms. That number in 1997 is now 15-20 per year.[22] As stated earlier, the SEC notes that recent audits show approximately 95% of small Colorado investment adviser firms (less than $25 million) audited were given deficiency letters. This high number of problems suggest that that there are potentially more problems with other smaller firms than the SEC can address. These numbers, compounded with the rise in the number of investment adviser firms, suggest that more, rather than less, of a regulatory presence is necessary.

Some regulators believe that most of the severe problems with investment adviser firms lie with the smaller investment firms which, when short on cash, misappropriate their client's funds. Unlike the large companies that have tremendous capital, smaller firms in times of trouble may not have sufficient cash reserves and are more susceptible to misappropriate their client's money or take unreasonable risks with their client's money to recover the shortfall. Without a strong regulatory presence to address these issues, there is a great potential for future problems in this area. Due to the tremendous growth in the stock market, the last eight years have seen double digit positive gains. With such a strong market, bad investment management or advice is difficult to detect until the market turns down. Damages can be mitigated with a strong enforcement program designed to detect potential problems before they cause much harm.

No Regulation of Investment Adviser Representatives

Currently, there is no regulation of investment adviser representatives in Colorado. While the SEC does provide registration requirements for adviser firms, there is no thorough background check of each individual within the firm as there is with securities broker/dealers. As a broker/dealer, certain restrictions are required in his/her practice that does not apply to investment advisers. For example, a broker/dealer may only provide advice on those securities that he/she is registered to sell. As a registered investment

[22] Conversation with the U.S. Securities and Exchange Commission (SEC) (Jan. 1988)

adviser, that individual may provide advice on any investment. This creates a potential loop-hole in the regulation of securities. Many broker/dealers are becoming investment advisers due to the relaxed regulation of that profession. With this blurring of lines of regulatory authority, it may be difficult to successfully prosecute bad actors since they may be shielded under the least restrictive regulatory requirement. There is also the potential that an unscrupulous broker dealer denied licensure in Colorado could instead practice as an investment adviser in the state.

Without regulation of investment adviser representatives it is also possible for an individual investment adviser to leave taking his/her clients and working as a sole practitioner. Should this occur, the investment adviser and his/her investments would not be regulated by anyone.

According to representatives in the industry, many people portray themselves as investment advisers that do not have the necessary background. For example, they may be in a financial line of work, (i.e. insurance or banking) and offer other products that are not in the best financial planning interest of the client, but provide the adviser with more commissions. Securities products that carry a large commission create a conflict of interest between what is best for the client and the commission for the representative.

One of the greatest potentials for abuse of investment advisers are those individuals who have custody of their client's funds or discretionary authority to invest their client's money. Due to the high potential for abuse, safeguards are necessary to prevent bad actors from taking advantage of their clients money. Background checks of applicants in Utah result in approximately 1% of the applicants either having their licenses revoked or voluntarily withdrawing their application. It is conceivable that the same percentage of investment advisers would not be licensed in Colorado. There is also the potential that an unscrupulous broker dealer denied licensure in Colorado can currently practice as an investment adviser in the state. As there is no background check on individuals in Colorado who provide investment advice, it is very difficult to identify bad actors until they have financially harmed investors.

ANALYSIS/ CONCLUSION

DORA has consistently held that adequate regulation closest to the people is the most effective form of government. State regulation, when appropriate, is more flexible to meet the demands of Colorado citizens and provides for greater accountability of the regulator than federal regulation. Unlike federal regulations, which focus on national concerns, state authority can more easily identify and address securities issues particular to the state of Colorado and its citizens. Although investment adviser firms are currently regulated by the SEC, NSMIA's refocus of the SEC on larger investment firms and mutual funds along with their tremendous growth has resulted in fewer resources to regulate smaller firms.

There has been a reduction in efforts by the SEC over the past few years to oversee smaller firms. In the late 1980s, the SEC performed over 60 audits per year on smaller Colorado investment firms. Today that number is approximately 20. This reduction in audits becomes more significant with the increase in investment adviser firms. Fewer audits by the SEC coupled by the high rate of deficiency letters from audits (approximately 90%) suggests that stronger regulation is required.

Currently there is no regulation in Colorado of individuals who provide investment advice. The growth of this occupation, along with the potential for unscrupulous or incompetent individuals to have access to clients monies, suggest a strong need for state regulation. A background check coupled with a competency and jurisprudence exam will help ensure the protection of Coloradans who use investment advisers. The North American Securities Administrators Association,(NASAA), is currently developing a competency examination to be used by states investment adviser representatives This exam will assist states where individuals have met a base-line knowledge and competency in this profession. Additionally, a required jurisprudence examination will help assure that individuals are knowledgeable of the state and federal securities laws.

Whereas the licensing and background checks of investment adviser representatives would provide a proactive tool to detect bad actors from operating in Colorado, it cannot catch everyone who defrauds consumers. Licensing will not prevent individuals who are determined to operate outside the law. A review of Colorado Division of Securities actions identify approximately one case per year where an individual has absconded with client funds. Due to the inadequacy of restitution by these rogue individuals, the only way to help ensure that consumers are protected is to require a bond for those investment advisers who have some authority over their clients funds.

State regulation of investment advisers and investment adviser representatives will place Colorado into a national regulatory system that provides for both federal and state oversight of the securities industry, while maintaining the appropriate enforcement tools for this industry. Colorado will have the authority to better regulate the small investment adviser firm as well as ensuring the competency and honesty of those individuals who wish to provide investment advice. Currently, 46 states regulate investment adviser firms and over 30 states regulate investment adviser representatives. Through a state regulatory program, Colorado is also gaining regulatory assistance from a national network of state agencies that perform similar functions. In today's mobile workforce, this network will proactively assist Colorado in keeping individuals and firms with prior disciplinary actions out of the industry and out of Colorado.

The general approach to securities regulation has created shared division of securities regulation under which the states focus primarily on individual investor protection issues, while the SEC deals with matters of broad-based market concerns. Similar to the difference in focus of law enforcement duties between the Federal Bureau of Investigation (FBI) and local police departments, the state securities agencies, with their local presence, are uniquely suited to address the needs and concerns of individual investors. The adoption of a state investment adviser act Colorado will provide for tighter regulation of this industry.

Recommendations

The Department of Regulatory Agencies recommends state regulation of the investment adviser field. Specifically, DORA recommends the following regulatory measures:

- State regulation of Investment Advisers
- State regulation of Investment Adviser Representatives, requiring a jurisprudence and competency examination
- No waiver for any profession that provides investment advice and does not meet the minimum licensing requirements
- Increased audit cycle of investment advisers than currently provided by the SEC to ensure adequate protection of Colorado citizens.
- A bond requirement for those investment advisers that have discretionary or authority or custody over their clients funds.

APPENDICES

Appendix A - Examples of Investment Adviser Harm in Colorado

Alexa Group -- James P. Dufficy from Littleton formed an investment organization in 1993 called the Alexa Group. From 1993 to 1996, he persuaded 50 investors to invest $950,000. Mr. Dufficy told the investors that he had a computer-based stock options strategy that would outperform the Standard & Poors 500 Index. Instead, he took the investor's money to finance his daughter's private education as well as purchase a home in Nevada and engage in several gambling sprees. He ultimately lost $522,000. In December of 1997, he was convicted of one count of securities fraud and sentenced to six years in prison.

O'D Agency -- Richard O'Donnell, a financial consultant and insurance agent, was sentenced to 16 years in prison in July 1997. Mr. O'Donnell was convicted on 30 counts of bilking mostly elderly clients with phony investment schemes promising high rates of return. In addition, he was ordered to pay $861,473 in restitution to his victims. Many of his elderly victims do not have the ability to earn enough money to recoup their losses. Mr. O'Donnell pitched investment to clients promising a 13 percent return. Instead, he spent the money or paid off earlier investors in a classic Ponzi scheme.

Chaussee Financial Services -- In March of 1996, Jon Scott Chaussee, a Vail financial planner, received a 12-year prison sentence after violating terms of an earlier plea bargain. Earlier, Chaussee pled guilty to charges of securities fraud and was sentenced to serve no more than six years in a day treatment center under the State's community corrections program. Mr. Chaussee's conviction was based on the fact that he took money from friends and colleagues, supposedly for investment in mutual funds. However, the money was never invested on behalf of the customers. Mr. Chaussee's case unfolded when he disappeared for a period of time after he was accused of taking money from clients.

Colorado Financial Planning Services -- In January of 1995, Randy Romero, a Denver financial planner, was sentenced to four years in prison and ordered to pay $98,000 in restitution to his defrauded clients. Mr. Romero, originally charged with 23 counts of securities fraud, pled guilty to three counts. Mr. Romero, who once lived in a $287,000 house and drove a black Porsche, also used religious devotion to earn the trust of some investors. He prayed with a Lakewood minister, convincing him to turn over $92,000 for investments that went sour. He misrepresented to investors that the securities he was selling were liquid, safe, riskless, and would pay annual returns of 11 to 12.5 percent. Among the victims was Mr. Romero's own nephew who entrusted $40,000 with him.

Hedged Investments Associates -- Perhaps the largest investment swindle ever conducted in Colorado was by an Englewood man, James Donahue, principal of Hedged Investments Associates. Over 1,200 clients invested approximately $300 million with him. Mr. Donahue told investors that he would engage in a complex hedging program to cover investment losses while taking advantage of stock price swings. But instead of hedging, he speculated on one side or the other of his options trades incurring enormous financial losses. Mr. Donahue's strategy resulted in actual investor losses of $195 million. His investors included many local and national celebrities, members of his church, several pension funds, and other companies throughout the country. He pled guilty to one count of fraud, was convicted and sentenced to five years in prison in 1992.

Steven Wymer In May of 1993, Steven Wymer, a California investment adviser, was sentenced to 15 years in federal prison. He pleaded guilty to 9 counts of racketeering, securities fraud, mail fraud, bank fraud, and obstruction of justice. The court also ordered him to pay $92 million in restitution to his defrauded clients. Mr. Wymer conducted a fraudulent Ponzi scheme against his clients, principally small cities and towns, local government agencies, and financial institutions throughout the country. He claimed to offer high returns for their investment funds, but in reality, he diverted their funds to cover the trading losses of his company, to cover the expenses of his firm's operations, and to pay for his lavish life style. The City of Torrance, California lost over $6.2 million. The Jefferson Bank and Trust Company of Lakewood, Colorado lost $43 million and subsequently failed. The City of Orange, California lost $7.5 million and the City of Marshalltown, Iowa that lost $2.8 million.