

Common Compliance Issues for Small and/or Newly-Registered Advisers

The SEC's examination staff* recognizes that small advisers face unique compliance issues and concerns. When the staff talks about small advisers, we do not necessarily mean small in terms of asset size, but instead, small in terms of manpower. Therefore, our discussion of small advisers focuses on those with five or fewer employees. As detailed in the table below, these small advisers make up approximately 50% of the Commission registered adviser population.

Number of Small Advisers as of September 30, 2007

	Total Number	Total Assets
All SEC-Registered Advisers	10,817	\$35.2 trillion
Small Advisers	5,385 (50%)	\$1 trillion (3%)

Many small advisers have one or more of the following characteristics:

- A key individual who has the ability to exert substantial control over the business and its operations (e.g., this person is highly involved in account management and is the primary advisory representative who interacts with clients).
- Employees performing multiple functions/serving in multiple capacities, including the possibility of having a part time CCO.
- Personnel engaged in other business activities (e.g., principals employed as accountants, attorneys, registered representatives or insurance agents).
- A modified off-the-shelf compliance program.

Additionally, these advisers often have individual client accounts rather than investment company clients. They also commonly have simple fee structures (e.g., they charge an advisory fee based on a simple percentage of assets under management or an hourly or fixed fee). Several of these factors could lead to such an adviser having a lower risk profile.

The SEC's examination program prioritizes the selection of firms to be examined because of our large population and limited resources. One of the ways we do this is by conducting a risk assessment and attempting to spend the most time on those firms that are perceived to be of higher risk. One form of risk assessment is conducted using firms' Form ADV as collected in the IARD database. This rating process uses an algorithm that

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calculates a numeric “score” based on each adviser’s responses to items contained in its most recently filed Form ADV. The algorithm places greater weight (and thereby a higher score) on certain affiliations, business activities, compensation arrangements, and other disclosure items that pose conflicts of interest. Based on this algorithm, we estimate that less than 5% of small advisers are rated high risk, compared to approximately 15% for the larger advisers. Firms may also be rated higher risk as a result of issues noted during a recent examination by the staff.

All advisers deemed high-risk are examined on a cyclical basis at least once every three years, whereas medium- and low-risk advisers (collectively, “lower risk” advisers) are examined randomly. As detailed in the table below, small advisers tend to be rated lower risk.

Based on examinations of small advisers conducted during fiscal year 2007, below is a list of the most commonly cited deficiency categories.

**Top Violations for Small Advisers
During Fiscal Year 2007**

	Most Common Categories	Most Common Issue
60%	Information Disclosures, Reporting and Filings	Inaccurate or Incomplete Filings, Reports and Disclosures
52%	Compliance Rule	Rule 206(4)-7(a): Policies and Procedures
46%	Personal Trading	Rule 204A-1: Code of Ethics
32%	Information Processing and Protection	Business Continuity Plans
27%	Portfolio Management	Rule 204-2(a)(3), (7)
27%	Performance Advertising and Marketing	Rule 206(4)-1

During the 2007 fiscal year, less than 5% of examinations of small advisers resulted in a referral to enforcement. Comparatively, 5-10% of examinations of larger advisers resulted in a referral. During the same time period, approximately 15% of small advisers were rated high risk as a result of an examination, as compared to approximately 25% for larger advisers. Finally, approximately 25% of examinations of small firms disclosed significant findings. Approximately 40% of examinations of larger advisers disclosed significant findings.

Certain deficiency categories appear to be more commonly cited at larger advisers. For example, deficiencies related to Performance Advertising and Marketing were cited

approximately 37% more often for larger advisers. Larger advisers were also cited more often in the areas of Pricing of Clients' Portfolios and Trade Allocations. Conversely, however, deficiencies related to Information Processing and Protection were cited approximately 28% more often at smaller advisers than at those with more than five employees.

Issues Related to Small Advisers

- Compliance procedures:
 - The adviser uses an off-the-shelf compliance manual; policies and procedures not tailored to the adviser's business and risks.
 - Firm personnel do not follow the procedures because they are not aware of them or because the procedures do not match the business.
 - Insufficient resources are devoted to ensure compliance with internal policies and procedures and regulatory requirements.
 - The CCO is not knowledgeable regarding the Advisers Act; qualified and experienced CCOs are possibly difficult and expensive to hire.
 - A CCO with other roles and responsibilities may not dedicate adequate time to compliance.
 - The CCO could be too junior to enforce compliance procedures against personnel of the adviser.
 - Firm may contract out the CCO position; the CCO is not on-site enough to effectively monitor compliance.
 - The CCO performs other functions at the adviser, creating a possible conflict.
 - The CCO may be a senior officer who essentially supervises him/herself.
- Trading and Execution:
 - The adviser places brokerage transactions with broker-dealers or registered representatives that refer clients, resulting in higher commission rates and does not disclose this practice to clients.
 - The adviser does not maintain supporting documentation to substantiate its review of best execution.
 - The adviser receives undisclosed gifts and services from broker-dealers.
- Limited staff:
 - The adviser does not have the ability to establish adequate separation of functions to mitigate conflicts of interest.
 - A key individual has the power to override controls in any area at any time to achieve personal gain.

- Employees do not feel safe alerting the owner about compliance problems.
- The adviser is inadequately staffed considering the number of varying strategies offered; it does not have staff to ensure that the adviser adheres to clients' stated investment guidelines.
- A key individual becomes incapacitated for an extended period of time; the adviser may be incapable of continuing the management of client funds.
- General issues:
 - The adviser may encounter financial difficulties, thereby increasing the possibility that decisions or actions will be made to better the adviser's financial condition rather than in the best interests of clients; the adviser may take loans from its clients.
 - Based on its size and the nature of its clients, the adviser has a loyal client base; clients have implicit trust in a key individual at the adviser and may overlook signs of potential harm.
 - The adviser acts as trustee to a client's account or has the ability to access an account's funds.