

DIVISION OF EXAMINATIONS RISK ALERT

Division of Examinations Observations: Investment Advisers' Fee Calculations

December 2021

On Nov. 10, 2021, the SEC Division of Examinations issued a Risk Alert regarding an advisory fees examination initiative (the Initiative). The Division of Examinations conducted 130 examinations of investment advisers focused on advisory fees, predominantly those charged to retail investors. This Risk Alert supplements the Advisory Fee Risk Alert issued by the Division of Examinations on April 12, 2018.

The Initiative included a review of advisers' compliance policies, procedures and practices related to advisory or other fees charged and the related disclosures provided to clients. Generally, the Division of Examinations reviewed the following areas:

- Accuracy of fees charged;
- Adequacy of disclosures; and
- Effectiveness of advisers' compliance programs and accuracy of their books and records.

Noted Deficiencies

Advisory Fee Calculations

The Division of Examinations observed inaccurate fee calculations due to a variety of errors, including:

- Inaccurate percentages were used to calculate advisory fees.
 - Charged fees were different from contractually agreed-upon rates;
 - Incorrect fee schedules being utilized;
 - Failure to convert all clients to a new or updated fee schedule; and
 - Errors in fee percentages manually entered into the portfolio management systems
- Advisory fees were double-billed
- Breakpoint or tiered billing rates not correctly calculated.
- Householding of client accounts were not correctly calculated.

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- Incorrect client account valuations were used. As examples, advisers included in their account valuations:
 - Assets that disclosures stated would be excluded from the fee calculations, such as legacy positions;
 - Stale account balance information;
 - Incorrect valuation dates for client billings; and
 - Inaccurate values due to timing differences in cash and dividend transactions in electronic custodial feeds compared to the available balance at the custodian (e.g. certain pending deposits may be excluded from the available balance).
- Advisers either did not refund prepaid fees on terminated accounts or did not assess fees for new accounts on a pro-rata basis.

False, Misleading or Omitted Disclosures

In the Risk Alert, the Division of Examinations noted disclosure issues related to incomplete or misleading ADV Part 2A and/or other disclosures, including disclosures that:

- Did not reflect current fees charged or whether fees were negotiable;
- Did not accurately describe how fees would be calculated or billed; and
- Were inconsistent across advisory agreements, such as stating the maximum fee in an advisory agreement that exceed the fees disclosed in the adviser's Form ADV Part 2A.

In addition, the Division of Examinations noted the following disclosure issues:

- Cash flows and their effect on fees being

disclosed in a manner inconsistent with the advisers' practices or disclosures being insufficient in describing how cash flows (e.g. deposits and withdrawals) may impact client advisory fees, such as how a client will be billed for large deposits made mid-billing cycle.

- Timing of advisory fee billing being inaccurate or not disclosed in any manner.
- Valuations for fee calculations being inaccurately disclosed, such as using the month-end account values rather than the disclosed average daily account values.
- Minimum fees, extra fees and discounts disclosed incorrectly by advisers. The Division of Examinations provided the following examples of advisers not disclosing:
 - Platform administration fees assessed, and that clients could elect to have their advisory agreements managed without using the platforms;
 - Actual or minimum asset-based fees charged to clients;
 - The negotiability of fees or falsely disclosing that fees were not negotiable, when they in fact, could be negotiated;
 - The process for implementing householding and eligibility criteria; and
 - Fees related to participating in wrap fee programs and non-wrap accounts.

Missing or Inadequate Policies and Procedures

The Division of Examinations noted advisers failing to maintain policies and procedures specifically addressing fee calculations. Advisers maintained policies and procedures that were general in nature

and did not specifically address the processes for computing, billing and testing advisory fees, as well as other material components of fee billing, including:

- Valuation of illiquid or hard-to-value assets;
- Fee offsets, such as those offered for 12b-1 fees;
- Fee reimbursements for terminated accounts;
- Prorating fees for account additions or subtractions; and
- Householding or the application of breakpoints in fee calculations.

Inaccurate Financial Statements

The Division of Examinations highlights advisers failing to record pre-paid fees as liabilities, as well as generally failing to maintain up-to-date and accurate financial statements.

Observations Regarding Industry Practices

In providing there is no one-size-fits-all approach for advisers in addressing fee billing, the Division of Examinations provides examples of successful policies and procedures. These include such things as:

- Adopting and implementing written policies and procedures addressing fee-billing processes and validating fee calculations – e.g. the supervision, calculation, review and billing of advisory fees; and
- Centralizing the fee-billing process and validating that the fees charged to clients are consistent with compliance procedures, advisory contracts and disclosure.

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Questions? Contact the DCS Team

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