

## Insights

# THE SEC'S RECENT OBSERVATIONS FROM EXAMINATIONS INTO ADVISERS' FEE CALCULATIONS

Dec 20, 2021

## SUMMARY

### Key Takeaways:

- On November 10, 2021, the SEC released a Risk Alert which provides observations from recent examinations into advisers' fee calculations. A copy of that Alert can be found [HERE](#).
- In yet another bleak report, the SEC declared that "most" of its recent examinations related to this topic resulted in the issuance of deficiency letters.
- The noted infractions included inadequate compliance programs, inaccurate fee calculations, disclosures that did not match the advisory agreements, and books and records violations. These problems "often" resulted in financial harm to clients and were violations of the advisers' fiduciary duties under the Investment Advisers Act.

Below is a summary of the SEC's observations as to the compliance failures and its suggestions for ways in which investment advisers can improve in this area.

## OVERVIEW

The SEC's Division of Examinations (the "Division") recently concluded a national initiative (the "Initiative") that focused on the effectiveness of advisers' compliance programs regarding advisory fees and the accuracy and adequacy of their fee calculations, disclosures, and books and records. As is becoming increasingly common, the SEC noted that "most" of the examinations into this topic resulted in findings of compliance deficiencies and the issuance of deficiency letters.

The topic of advisory fees is not novel, as it has appeared in the Division's Examination Priorities every year since 2018. It was also the topic of another risk alert released by the SEC in April 2018, which can be found [HERE](#). Given advisers' continued difficulties with compliance in these areas, as reflected in the examination results below, it is very unlikely that this topic will fall out of favor with the SEC anytime soon.

## **CHARACTERISTICS COMMON ACROSS ADVISERS**

In reporting the results of the Initiative, the SEC observed some common and acceptable characteristics in the billing practices of investment advisers, including:

1. advisers have standard fee schedules with tiered fee levels based upon assets under management;
2. advisory fees are assessed quarterly;
3. advisory fees are deducted directly from clients' accounts;
4. advisory fees are calculated based on the account value at the beginning or ending date of the billing period;
5. advisers frequently use software or third-party service providers to calculate fees;
6. advisory fees are memorialized through written advisory agreements or contracts; and
7. combining client and family account values results in lower fees (i.e., house-holding of accounts).

## **FREQUENT COMPLIANCE DEFICIENCIES IDENTIFIED BY THE SEC**

The SEC noted frequent problems with advisers' fee calculations, disclosures, written policies and procedures, and the way that advisory fees were reflected in the advisers' own financial statements. Specifically, the SEC found problems with the following:

### **Advisory Fee Calculations:**

- Advisory fees were calculated incorrectly, including:
  - Fees calculated using rates inconsistent with contractual agreements;
  - Fees calculated using the incorrect fee schedule; and
  - Fees calculated with out of date fee schedules, sometimes resulting in inconsistencies across firm clients.
- Advisory fees were double billed due to oversight or outdated systems.
- Breakpoint or tiered billing rates were incorrectly calculated, including instances in which the tiered rates were not being applied correctly or at all.
- Client and family accounts were not properly aggregated to provide the most advantageous rates for clients.

- Assets were included for valuation purposes that the disclosure indicated would be excluded.
- Fees were not properly assessed on a pro-rata basis for accounts which opened or closed mid-cycle.
- Prepaid fees on terminated accounts were only refunded upon the client's request, or refunds were made years after the fact.

### **False or Misleading Disclosures:**

The SEC noted that many disclosures failed:

- To make complete and accurate disclosures on ADV Part 2 brochures, including failure to:
  - Reflect current fees charged;
  - Indicate whether the fees were negotiable (including some disclosures which falsely stated fees were non-negotiable);
  - Accurately describe how the fees were calculated and billed; and
  - Be consistent with the related client agreements.
- To disclose how cash flow, such as large deposits made in the middle of a billing cycle, would impact advisory fees.
- To accurately disclose the timing of fee billing, such as disclosing that the fees would be calculated and charged in advance, when in actuality they were calculated and billed in arrears.
- To accurately disclose account valuations used for billing purposes, such as disclosing the use of month end values, when in fact a daily average value was used.
- To accurately disclose minimum or maximum fees that could be charged to a client.
- Some advisers failed to document fee amounts charged to clients at all.

### **Omitted or Inadequate Policies:**

- The SEC noted that many advisers failed to design and implement policies and procedures addressing advisory fee billing, including the computing, billing, monitoring and testing of fee calculations.
- Examiners found that many policies and procedures were silent on how material components of the billing would be calculated, including:

- Valuations for illiquid or difficult-to-value assets;
- Fee offsets, such as those offered for 12b-1 fees;
- Fee reimbursements for terminated accounts;
- Prorating fees for cash being deposited into or removed from the accounts; and
- Family account aggregation or the application of breakpoints for fee calculations.

### **Inaccuracies in Advisors' Own Financial Statements:**

Many of the examined advisers had inaccurate fee entries in their books and records, including:

- Failures to record pre-paid advisory fees as liabilities on financial statements.
- Failures to record all advisory fee income, administrative fee revenue, and compensation expenses in general ledgers on financial statements. Fee income was missing from the ledgers when advisers accepted goods and services (such as IT services) in lieu of advisory fees, or when clients paid fees directly to investment adviser representatives.
- Advisers used a cash and modified cash basis of accounting in practice, but prepared financial statements using an accrual basis. This discrepancy caused advisory fees to show up as accounts receivable on financial statements when they were not.

### **SEC'S SUGGESTIONS FOR IMPROVEMENT**

- Adopt and implement written policies and procedures addressing advisory fee calculations and billing processes,
- Adopt and implement written policies and procedures for the periodic testing and validation of fee calculations.
- Centralize the fee billing process within the firm.
- Conduct periodic testing and validation to ensure the fees billed to clients are consistent with compliance procedures, advisory contracts, and disclosures.
- Utilize checklists and other tools when testing and validating fee calculations, to ensure that all personnel are performing these tasks consistently.
- Properly record all advisory fees assessed to and received from clients including those paid out directly to advisory personnel.

## **CONCLUSION**

The subject of advisory fees remains a hot topic with the SEC and we anticipate that the widespread compliance failures noted herein will lead to some repetition in this space until the SEC becomes more comfortable with wider compliance. Accordingly, all firms offering advisory services to clients would be best advised to undertake a comprehensive review of their advisory fee practices, including fee calculations, disclosures, client agreements, policies, procedures, and books and records to ensure compliance with the SEC's concerns. If you have questions on this topic or need assistance with securities, regulatory or litigation matters, please reach out to us.

## **RELATED PRACTICE AREAS**

- Securities Litigation and Enforcement
- Regulation, Compliance & Advisory
- Broker-Dealer and Investment Advisor Regulatory Enforcement, Disputes and Investigations

## MEET THE TEAM



### **Shea O. Hicks**

St. Louis

[shea.hicks@bclplaw.com](mailto:shea.hicks@bclplaw.com)

[+1 314 259 2659](tel:+13142592659)



### **Shannon M. Wheaton**

St. Louis

[shannon.wheaton@bclplaw.com](mailto:shannon.wheaton@bclplaw.com)

[+1 314 259 2296](tel:+13142592296)



### **Eric Martin**

St. Louis / Los Angeles

[eric.martin@bclplaw.com](mailto:eric.martin@bclplaw.com)

[+1 314 259 2324](tel:+13142592324)

---

This material is not comprehensive, is for informational purposes only, and is not legal advice. Your use or receipt of this material does not create an attorney-client relationship between us. If you require legal advice, you should consult an attorney regarding your particular circumstances. The choice of a lawyer is an important decision and should not be based solely upon advertisements. This material may be “Attorney Advertising” under the ethics and professional rules of certain jurisdictions. For advertising purposes, St. Louis, Missouri, is designated BCLP’s principal office and Kathrine Dixon ([kathrine.dixon@bclplaw.com](mailto:kathrine.dixon@bclplaw.com)) as the responsible attorney.