



RISK ALERT

DIVISION OF EXAMINATIONS

November 10, 2021

Division of Examinations Observations: Investment Advisers' Fee Calculations*

I. Introduction

It is important for clients to receive timely and accurate information regarding fees and expenses when hiring an investment adviser because every dollar an investor pays in fees and expenses is a dollar not invested for the investor's benefit. Thus, the staff from the Division of Examinations (the "Division") often reviews whether advisers, among other things: have adopted and are following policies and procedures that are reasonably designed to result in the fair and accurate charging of fees; and have disclosed their fees with sufficient clarity for their clients to understand the costs associated with their services.¹

The Division recently concluded a national initiative that focused on advisory fees, predominantly those charged to retail clients ("Advisory Fees Initiative" or "Initiative"). This Initiative assessed the various ways in which investment advisers charge fees for their services, as well as evaluated the adequacy of fee disclosures and the accuracy of fee calculations.² The staff conducted approximately 130 examinations of SEC-registered investment advisers under this Initiative ("examined advisers") and identified deficiencies related to the advisory fees charged during most of these examinations.

The advisory fee-related deficiencies observed often resulted in financial harm to clients, including: (1) advisory fee calculation errors, such as over-billing of advisory fees, inaccurate calculations of tiered or breakpoint fees, and inaccurate calculations due to incorrect householding of accounts;³ and (2) not crediting certain fees due to clients, such as prepaid fees

* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

¹ The Division has identified disclosures regarding the costs of investing as an examination priority since 2018 (*see* Division, Examination Priorities for [2018](#), [2019](#), [2020](#), and [2021](#)).

² Other types of compensation, such as fees received in connection with client investments, were included within the scope of the Initiative to the extent that these fees related to the advisory fee calculations (*e.g.*, advisory fees were to be reduced by any transaction-based compensation received by the advisers' supervised persons). The staff also focused on additional compensation-based conflicts of interest identified during the examinations, if applicable.

³ *See, e.g.*, In re Retirement Capital Strategies Inc., Advisers Act Rel. No. 5065 (Nov. 19, 2018) (settled) (alleging that the adviser inconsistently applied tiered "breakpoints" that reduced advisory fees as the total amount of client assets under

for terminated accounts or pro-rated fees for onboarding clients. In addition, the staff observed fee-related compliance and disclosure issues. The Investment Advisers Act of 1940 (“Advisers Act”) establishes a fiduciary duty for investment advisers.⁴ Advisers that fail to adhere to the terms of their agreement and disclosures, or otherwise engage in inappropriate fee billing and expense practices, may violate their fiduciary duties and the Advisers Act, including its antifraud provisions.⁵

The Division previously published a Risk Alert highlighting compliance issues observed by the staff related to advisory fees (“[Advisory Fees Risk Alert](#)”).⁶ In this follow up Risk Alert, the Division is supplementing the [Advisory Fees Risk Alert](#) by providing greater detail on certain compliance issues observed during the recent Advisory Fees Initiative examinations, including additional details regarding the staff’s observations in the two areas outlined above.

II. Focus of Advisory Fees Initiative

All of the examined advisers provided investment advice to retail clients; however, they had a wide range of assets under management, business operations, staffing levels, and affiliations. The scope of the Advisory Fees Initiative included a review of the examined advisers’ compliance policies, procedures, and practices related to advisory or other fees charged and the related disclosures provided to clients. More specifically, examiners typically reviewed the following areas:

- *The accuracy of the fees charged by the examined advisers.* The staff reviewed the accuracy of the advisory fees charged and whether the advisers overcharged clients.
- *The accuracy and adequacy of the examined advisers’ disclosures.* The staff reviewed the disclosures provided to clients related to the advisory fees billed, including whether certain types of assets should be excluded for fee billing purposes.⁷
- *The effectiveness of the examined advisers’ compliance programs and accuracy of their books and records.* When reviewing advisers’ compliance programs, the staff reviewed the

management increased and failed to aggregate or “household” related account balances of the same client and clients within the same household for the purposes of achieving the advisory fee breakpoint discounts).

⁴ An adviser’s federal fiduciary obligations are enforceable through Advisers Act Section 206. See, generally, [Commission Interpretation Regarding Standard of Conduct for Investment Advisers](#), Advisers Act Rel. No. 5248 (June 5, 2019) (“[Fiduciary Interp.](#)”).

⁵ See [Fiduciary Interp.](#), *supra* note 4 (“The investment adviser’s fiduciary duty is broad and applies to the entire adviser-client relationship”). See also, [In re Barclays Capital Inc.](#), Advisers Act Rel. No. 4705 (May 10, 2017) (settled) (alleging that the adviser violated Advisers Act Section 206(2) by incorrectly calculating the advisory fees based on, among other things, a billing methodology that differed from the advisory agreements); [In re Morgan Stanley Smith Barney, LLC](#), Advisers Act Rel. No. 4607 (Jan. 13, 2017) (settled) (alleging that the adviser violated Advisers Act Section 206(2) by charging clients advisory fees that did not reflect negotiated discounts).

⁶ Division, [Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers](#) (Apr. 12, 2018).

⁷ See [Fiduciary Interp.](#), *supra* note 4 (“In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent”). See also Advisers Act Section 207 (stating that it is unlawful for advisers to make untrue statements or omit any material facts in applications or reports filed with the Commission).

adequacy of policies and procedures or other operational documents related to advisory fee billing practices and the calculation of assets under management used for fee billing purposes.⁸ In addition, the staff reviewed policies and procedures related to the valuation of unique or hard-to-value assets.⁹ Lastly, the staff assessed whether the examined advisers made and kept books and records that were true and accurate.¹⁰

An adviser that engages in inappropriate fee billing and other fee-related deficient practices may have regulatory implications beyond these areas of focus. Therefore, the staff recommends reviewing this Risk Alert in conjunction with the [Advisory Fees Risk Alert](#) and other SEC and staff-issued guidance for a discussion of the legal requirements and helpful resources regarding Commission actions and interpretative guidance relevant to this topic.¹¹

III. Staff Observations¹²

While investment advisers continue to have assorted advisory fee arrangements and use a wide variety of calculation methodologies, the staff observed that the typical examined adviser: (1) had a standard fee schedule with tiered fee levels based upon assets under management; (2) quarterly assessed its advisory fees; (3) deducted advisory fees directly from clients' accounts; (4) calculated fees based on the account value at the beginning or ending date of the billing period; (5) used software or third-party service providers to calculate fees; (6) documented advisory fees with clients through written advisory agreements or contracts; and (7) combined family account values when such actions resulted in lower fees (*i.e.*, householding of accounts). Understanding these general characteristics may be helpful when reviewing the deficiencies noted below.

⁸ See Advisers Act Rule 206(4)-7 (requiring any adviser that is registered or required to be registered under the Advisers Act to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and the rules thereunder, review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering their policies and procedures).

⁹ See [Final Rule: Compliance Programs of Investment Companies and Investment Advisers](#), Advisers Act Rel. No. 2242 (Dec. 17, 2003) (noting that an adviser's compliance policies and procedures should, among other things, address its "processes to value client holdings and assess fees based on those valuations").

¹⁰ Advisers Act Rule 204-2 requires every adviser registered or required to be registered with the Commission to make and keep true, accurate, and current certain books and records relating to its advisory business.

¹¹ See, e.g., [Form ADV Part 2, Item 5 and General Instruction 3](#) (requiring an adviser to disclose its compensation arrangements and reminds advisers of their fiduciary duty and related disclosure obligations, including providing "sufficiently specific facts" to allow clients to understand the adviser's conflicts and business practices and give informed consent or reject them); and Division of Investment Management, [Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation](#) (last modified Oct. 18, 2019) (discussing certain compensation arrangements and related disclosure obligations arising from both the adviser's fiduciary duty and Form ADV).

¹² While the staff's observations focus on advisers' calculations of retail client fees, many of the principles and disclosure obligations also apply to other types of client accounts (*e.g.*, institutional and fund clients) and forms of compensation (*e.g.*, direct or indirect receipt of services, fees, or payments from third-parties servicing client accounts).

A. Notable Deficient Practices

Advisory Fee Calculations

- *Several examined advisers charged advisory fees inaccurately.* These inaccurate calculations were due to a variety of errors, including:
 - *Inaccurate percentages were used to calculate advisory fees.* For example, the staff identified examined advisers that, among other things: (1) charged fees that were different from contractually agreed-upon rates; (2) used the incorrect fee schedule (*e.g.*, used the schedule intended for clients domiciled in a country other than the United States); (3) failed to convert all clients to their new or updated fee schedule; and (4) had errors in fee percentages manually entered into their portfolio management systems.
 - *Advisory fees were double-billed.* Such errors were typically due to oversights, such as not updating a system following a change in billing practices.
 - *Breakpoint or tiered billing rates were not correctly calculated.* Often these issues related to tiered fee schedules not being applied correctly or applied at all.
 - *Householding of client accounts were not correctly calculated.* In such instances, the examined advisers did not aggregate client or family accounts and/or apply the declining fee schedule, as applicable.
 - *Incorrect client account valuations were used.* For example, examined advisers included in their account valuations: (1) assets that disclosures stated would be excluded from the fee calculations, such as legacy positions; (2) stale account balance information as a result of the loss of data during transitions of portfolio management systems; (3) incorrect valuation dates for client billings; and (4) inaccurate account 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 available balance).
- *Several examined advisers either did not refund prepaid fees on terminated accounts or did not assess fees for new accounts on a pro-rata basis.* The staff identified the following issues, among others, related to refunding prepaid fees:
 - *Inconsistently refunding unearned fees.* The examined advisers were obligated – by disclosures, advisory contracts, or both – to refund unearned advisory fees, but the examined advisers were inconsistent in providing refunds to clients (*i.e.*, provided refunds to some clients, but not others) or were unnecessarily delayed in providing such refunds, sometimes for several years post termination.
 - *Requiring clients to provide written requests to refund unearned advisory fees.* In these instances, the examined advisers had policies to refund prepaid advisory fees only upon

written notice from clients.¹³ Thus, the examined advisers kept the unearned advisory fees for clients that: (1) terminated the advisory relationship through their custodians, rather than notifying the adviser directly; or (2) did not specifically request a refund of prepaid fees when terminating the relationship.

False, Misleading or Omitted Disclosures

- *Several of the examined advisers were identified as having a range of disclosure issues.* The issues identified were related to incomplete or misleading Form ADV Part 2 brochures and/or other disclosures, including disclosure that: (1) did not reflect current fees charged or whether fees were negotiable; (2) did not accurately describe how fees would be calculated or billed; and (3) was inconsistent across advisory documents, such as stating the maximum fee in an advisory agreement that exceeded the fees disclosed in the adviser's brochure. The staff also identified examined advisers that did not have any written agreements or documentation establishing the client fee amount.

Examples of issues with fee-related disclosures the staff observed, include:

- *Cash flows and their effect on fees.* The staff observed disclosures that were inconsistent with the examined advisers' practices or were 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.* The staff observed examined advisers that provided inaccurate disclosures regarding the timing of their fee billing. In some cases, advisers disclosed that advisory fees would be billed in advance, but elected to have some or many clients billed in arrears (and vice versa). In addition, although some examined advisers' fee disclosures stated that clients would be billed based on the average-weighted daily capital balances during the quarter, many of the clients' advisory agreements stated that fees were calculated in arrears based on the value at quarter-end. Lastly, some examined advisers did not disclose any information about the timing of advisory fee billing.
- *Valuations for fee calculations.* Some examined advisers provided inaccurate disclosures about the values used to calculate advisory fees, such as using the month end account values rather than the disclosed average daily account values.
- *Minimum fees, extra fees, and discounts.* Some examined advisers did not fully disclose a variety of other fee-related topics. Examples include examined advisers that did not disclose: (1) platform administration fees assessed (and that the fees could be avoided if clients elected to have their advisory accounts managed without using the platforms); (2) actual or minimum asset-based fee rates charged to clients; (3) the negotiability of fees or falsely disclosed that fees were not negotiable when they, in fact, could be negotiated; (4) the process for implementing householding and eligibility criteria; and (5) fees related to participating in wrap fee programs and non-wrap accounts.

¹³ See, e.g., *Monitored Assets Corp., Advisers Act Rel. No. 1195* (Aug. 28, 1989) (settled) (alleging that adviser violated the anti-fraud provisions of the Advisers Act by refunding prepaid advisory fees only to certain clients).

Missing or Inadequate Policies and Procedures

- *Many of the examined advisers did not maintain written policies and procedures addressing advisory fee billing, monitoring of fee calculations and billing, or both.* Although some of these advisers had informal or unwritten practices in these areas, the staff considered such issues to be relevant to the operations of the adviser, and thus should be captured in written policies and procedures. Below are some examples of the staff's observations in this area:
 - *Policies and procedures that specifically address fee calculations.* The staff identified examined advisers with policies and procedures that were generic in nature and did not address specifics related to the processes for computing, billing, and testing advisory fees. In some cases, the examined advisers had no policies for testing or monitoring fee calculations.
 - *Policies and procedures to address material advisory fee components.* The staff observed examined advisers' policies and procedures missing a variety of critical advisory fee components that were relevant to the firms' businesses, including: (1) valuation of illiquid or difficult-to-value assets included in the assets for the calculation of advisory fees; (2) fee offsets, such as those offered for 12b-1 fees; (3) fee reimbursements for terminated accounts, where the client prepaid fees; (4) prorating fees for additions or subtractions of assets in accounts; and (5) family account aggregation (householding) or the application of breakpoints for fee calculations.

Inaccurate Financial Statements

- *The staff observed issues or inaccuracies with financial statements at several examined advisers with respect to advisory fees.* These issues included examined advisers in potential financial distress (e.g., substantial balances on loans or lines of credit)¹⁴ and examined advisers not properly: (1) recording pre-paid advisory fees as liabilities; or (2) maintaining their financial statements. Some examples include:
 - *Not recording all advisory fee income, administrative fee revenue, and compensation expenses in general ledgers and on financial statements.* These examined advisers did not record such gross revenue and expenses in their books and records because they were exchanged for other goods and services (e.g., IT support) or did not record advisory fees paid directly to investment adviser representatives.
 - *Using a cash and modified cash basis of accounting, but preparing financial statements on an accrual basis of accounting.* These examined advisers incorrectly classified client advisory fees as "accounts receivable."

¹⁴ See Form ADV, Part 2A, Item 18 (requiring an adviser to disclose any financial condition that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority or custody of client funds or securities or if the adviser requires or solicits prepayment of more than \$1,200 in fees per client, six months or more in advance).

B. Staff Observations Regarding Industry Practices

During the examinations, the staff observed advisers implementing a range of policies and practices to address their legal and regulatory obligations related to the compliance issues identified above. Recognizing that there is no such thing as a “one-size fits all” approach, the staff is providing these observed examples of policies and practices to assist advisers with compliance in these areas.

- *Adopt and implement written policies and procedures addressing advisory fee billing processes and validating fee calculations.* The staff generally observed fewer errors when the examined advisers had specific written policies and procedures addressing the supervision, calculation, review, and billing of advisory fees.
- *Centralize the fee billing process and validate that the fees charged to clients are consistent with compliance procedures, advisory contracts, and disclosures.* The staff observed that the examined advisers with centralized billing – rather than billing that was dispersed throughout the adviser with separate, supervised persons preparing and invoicing client billing statements – had fewer clients being billed incorrectly or client accounts being calculated inconsistent with the advisers’ written policies and procedures.
- *Ensure resources and tools established for reviewing fee calculations are utilized.* The staff observed that checklists and other resources for reconciling client fee calculations with client advisory agreements may be useful tools when used consistently by all advisory personnel.
- *Properly record all advisory expenses and fees assessed to and received from clients, including those paid directly to advisory personnel.*

IV. Conclusion

Advisory fee calculation and billing has been, and continues to be, an area that warrants routine review during investment adviser examinations. The staff’s observations and examination findings often lead to advisers returning money owed to clients due to fee billing and calculation errors, or to the improvement of advisers’ compliance programs, policies, and procedures that foster prevention of future advisory fee issues. In sharing the information in this Risk Alert, the Division encourages advisers to review routinely, refine, and improve, as appropriate, their fee billing policies, procedures, and practices and address new risks as they are identified. In addition, advisers should review their disclosures regarding such practices to ensure that clients are provided with full and fair disclosure of all fees and expenses and related material conflicts of interest.

This Risk Alert is intended to highlight for firms risks and issues that Examinations staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
