SEC Division of Examinations Risk Alert:
Investment Advisers' Fee Calculations

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. - *Risk Alert, November 10, 2021*

On November 10, 2021, the SEC Division of Examinations (the "Division" or "EXAMS") issued a risk alert highlighting common observations resulting from a national initiative focused on advisory fees. While the initiative focused on retail clients, these observations apply to institutional clients as well. In each of the last four years, the Division has identified disclosures regarding fees as an examination priority. The Division commonly reviews whether advisers have adopted policies and procedures that are reasonably designed to result in the fair and accurate charging of fees, and whether advisers have disclosed their fees clearly.

Staff Observations of Deficiencies

The Risk Alert provided a summary of Staff observations which highlighted advisory fee calculations, false or misleading disclosures, missing or inadequate polices and procedures, and inaccurate financial statements. Examples include:

- **Inaccurate charging of advisory fees** due to incorrect percentages being used in the calculations, double billing the client, not correctly applying breakpoint or tiered billing rates, incorrectly calculating the householding of client accounts, or using incorrect account valuations.
    - Account valuation is particularly relevant for advisers that recommend illiquid alternative investments and private equity. Staff observed inadequate valuation methodologies, including (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).
- **Failure to refund prepaid fees** on terminated accounts or improperly assess fees for new accounts on a pro-rata basis.
- **Issues with fee-related disclosures** surrounding the Form ADV Part 2 brochure and/or other disclosures. The Staff observed disclosures that were inconsistent with the advisers' practice regarding cash flows from clients and the timing of advisory fee billing, for example:
    - Disclosing that fees would be billed in advance but billing in arrears in practice; and
    - Using the month end account values rather that the disclosed average daily account values.
- **Inadequate policies and procedures** addressing advisory fee billing or monitoring of fee calculations. The Staff noted that advisers had policies that were generic and did not address specifics related to the processes for computing, billing, and testing advisory fees. Additionally, policies were missing critical advisory fee components such as valuation of illiquid assets used in the calculation of fees, fee offsets, fee reimbursements for terminated accounts, and family account aggregation or the application of breakpoints for fee calculations.
- **Inaccuracies with financial statements** with respect to advisory fees. There were instances where advisers did not record fee income and compensation expenses because they were exchanged for other goods and services (e.g., IT support). The Staff also observed instances where cash basis accounting was used but financial statements were prepared on an accrual basis of accounting.

Staff Observations of Effective Practices

The Risk Alert also provided examples of effective practices that set the tone for the industry, and provided the following practices and policies that advisers should ensure are in place:

- **Maintain 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.
- **Create checklists and other resources for reconciling client fee calculations** with client advisory agreements.
- **Properly record all advisory expenses and fees** charged to and received from clients, including those paid directly to advisory personnel.

In summary, the Staff continues to prioritize fee calculations during examinations, and 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. This is a standing area that should be reviewed as part of an adviser's compliance program monitoring and testing. Advisers should ensure fee calculations and valuations are accurate; have detailed policies and procedures that specifically address fee calculations related to the processes for computing, billing, and testing advisory fees; and review their disclosures regarding advisory fees to ensure that clients are provided with full and fair disclosure of all fees and expenses and related material conflicts.

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