

# SEC Investment Adviser Examinations Highlight Errors

## WRITTEN BY

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The U.S. Securities and Exchange Commission (SEC) recently issued two risk alerts, highlighting issues found at investment firms that could lead to sanctions, following recent examinations of firms and advisers. Advisers have been alerted of risks relating to digital investment advisory services after an increased focus on examining these practices led to a deficiency letter being issued to nearly every examined adviser.<sup>[1]</sup> Additionally, following a sweep of over 130 firms, the SEC issued a warning to advisers that fee errors may constitute fraud.<sup>[2]</sup>

## Robo-Advisory Services

While advisers have used digital investment services for decades, there has been a spike in recent years of the use of such services, prompting the Division of Examinations (Division) to focus on these services during its examinations to assess these practices. In particular, the staff focused on how robo-advisors upheld their fiduciary duty to provide clear and adequate disclosure of the nature of the advisers' services and performance history, and act in their clients' best interests. Following the examinations, the Division issued a deficiency letter to nearly every adviser, with problems most often relating to compliance programs, portfolio management, and performance advertising. In addition to a broad review of adherence to these fiduciary duties, the staff specifically examined:

- *Compliance programs* to assess whether those particularly related to robo-advisory services were adopted, implemented, reasonably designed, and regularly tested.
  - Most advisers had inadequate compliance programs, typically resulting from a lack of written policies and procedures, inadequate policies for their common practices, or lack of regular testing. To improve, the Division recommends enhancing algorithms and data collection practices, as well as testing and reviewing the policies and procedures at least annually.
- *Formulation of investment advice* to assess if sufficient information was being gathered by clients and proper disclosures were being made.
  - Many portfolio management services lacked proper oversight to ensure compliance with their clients' investment objectives. To improve, the Division recommends implementing and reviewing current written policies, as well as conducting a detailed review of algorithms for alignment with clients' interests.
- *Marketing and performance advertising practices* for compliance with the "Advertising Rule."<sup>[3]</sup>
  - More than half of the advisers had deficiencies related to advertising, including misleading or prohibited statements. To improve, the Division recommends reviewing current practices for compliance with the

Advertising Rule and updating disclosures about currently offered services.

- *Data protection practices and registration information* to ensure compliance and protection.
  - The Division discovered an ongoing problem of advisers claiming reliance on the internet adviser exemption, while not being eligible.[\[4\]](#)

With the increase of both robo-advisory services and examinations by the Division, advisers are encouraged to review compliance with all requirements to avoid deficiency letters. The Division conducts these examinations as part of its electronic investment advice initiative (eIA Initiative) and Investment Company Act Rule 3a-4.

### **Investment Advisers' Fee Calculations**

Citing the importance of clients receiving timely and accurate information on fees and expenses, the Division often reviews whether advisers have adopted proper policies and procedures and have made proper disclosures, as every dollar paid in fees and expenses results in a dollar not invested for their benefit. A recent examination of 130 SEC-registered investment advisers identified several deficiencies, often resulting in financial harm to clients. All of the examined advisers provided investment advice to retail clients who offered widely ranged services. Most specifically reviewed were the following areas:

- *The accuracy of fees charged* and whether advisers overcharged clients.
  - Consistent errors noted were inaccurate percentages used to calculate advisory feeds, double billing, incorrectly calculated tiered billing rates, failure to refund prepaid fees or assess new fees correctly for new accounts, and incorrect client account valuations.
- *The accuracy and adequacy of the examined advisers' disclosures* of fees billed and whether certain types of assets should be excluded for fee billing purposes.
  - Areas of error include improperly refunding fees when clients are required to provide written requests for refunds, misleading brochures, inconsistent advisory documents, inaccurate disclosures of values used to calculate fees and administration fees, and failure to disclose negotiability of fees.
- *The effectiveness of the examined advisers' compliance programs and accuracy of their books and records*, including the relation to valuation of unique or hard-to-value assets.
  - Observed errors for recording pre-paid advisory fees as liabilities included missing or inadequate policies and procedures, improper recording of all financial statement requirements, and inconsistencies between accounting and financial statements.

Any adviser engaged in inappropriate fee billing or other fee-related deficient practices may have regulatory implications and other legal or monetary penalties. Therefore, all advisers and firms are encouraged to review the

risk alert and other SEC and staff-issued guidance to ensure compliance. Given the intersectionality of the issues discovered, and recognizing each adviser and firm is unique, the staff provided recommendations to include:

- Adopting and implementing written policies and procedures addressing fee billing processes and validating fee calculations.
- Centralizing the fee billing process and validating that fees charged to clients are consistent with compliance procedures, advisory contracts, and disclosures.
- Ensuring resources and tools established for reviewing fee calculations are utilized.
- Properly recording all advisory expenses and fees assessed to and received from clients, including those paid directly to advisory personnel.

## Conclusion

While SEC examinations of advisers on fee billing constitutes routine review, the errors discovered highlight areas for widespread improvement to ensure compliance and avoid penalties. Given the increase in examinations of robo-advisory services, firms and advisers are also encouraged to review and improve policies relating to these practices. When drafting, updating, and implementing these procedures please consult with a Troutman Pepper attorney for guidance and any issues related to the laws affecting your workplace.

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[1] See [Observations from Examinations of Advisers that Provide Electronic Investment Advice](#) Risk Alert (Nov. 9, 2021).

[2] See [Division of Examinations Observations: Investment Advisers' Fee Calculations](#) Risk Alert (Nov. 10, 2021).

[3] See Advisers Act Rule 206(4)-1.

[4] See, e.g., [Ajenifuja Investments, LLC](#); [Order Cancelling Registration Pursuant to Section 203\(h\) of the Investment Advisers Act of 1940](#), Advisers Act Rel. No. 5110 (Feb. 12, 2019).

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