Risk Alerts: SEC Again Finds Litany of Failures in RIA Fee Calculations, Puts Robo Advisors on Alert to Pay Attention to Compliance

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On November 9, 2021, the SEC's Division of Examinations issued a Risk Alert describing its observations from examining advisors that provide investment advice electronically, commonly referred to as "robo-advisors." Initially, it should be noted that, while the SEC was focused on "robo-advisors," there is a difference between SEC-registered firms that qualify as "internet only" advisors and those that are considered "robo-advisors." While every "internet only" advisor is a "robo-advisor," not every "robo-advisor" is "internet only." A firm that wants to qualify for SEC registration as an "internet only" adviser must provide its investment advice solely through an interactive website. It cannot, for example, provide one-on-one, person-to-person investment advice beyond the de minimis exemption fewer than 15 clients during a 12-month period). On the other hand, a robo-advisor, may have other programs that it offers to individuals whereby personal investment advice is provided outside of the interactive website. If that's the case, then that advisor must have another reason to qualify for SEC registration (Such as having $100 million in regulatory assets under management or qualifying for the multi-state exemption). If they don't qualify for SEC registration, then the advisor may need to register with one or more states.

The litany of compliance problems the SEC noted in the Risk Alert runs the gamut of nearly everything one could find wrong with an investment advisor. The Commission noted problems involving: insufficient suitability (or know your customer) determinations and information gathering; improper use of hedge clauses in agreements; performance advertising; best execution; conflicts of interest; fee calculations; ownership disclosure issues; Code of Ethics supervision; trade errors; cybersecurity; and, the 3a-4 safe harbor provision of the Investment Company Act (relating to discretionary model portfolios and the definition of an investment company).

As an example, if an advisor is not relying on the internet only exemption to qualify for SEC registration because the firm offers investment advice outside of the interactive website, the SEC reminds firms that they need to make sure their policies and procedures address both types of advisory services including the conflicts of interest that can arise.

Another example of an unanticipated problem is evidenced by the SoFi Wealth enforcement action the Commission noted in the Risk Alert. In that instance, the advisor failed to address conflicts of interest that arose when its AI ("artificial intelligence") software referred clients to the Firm's own proprietary products without adequate disclosures or suitability review.

In the Alert, the SEC offers the broad outlines of what it expects robo-advisers to focus on: effective and robust compliance policies and procedures; testing their AI or algorithms; and cybersecurity issues. The SEC also noted that its findings in the next few exam cycles will determine whether, and to what extent, new or revised rules may be needed.

With that said, there may be some modifications to the internet-only exemption that might be implemented in the future, although there is nothing specific from the Commission at this time. It is anticipated that, in the near term, the SEC will have robo-advisers on their radar and will place special emphasis on those programs over the course of the next few exam cycles.

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On November 10, 2021, the SEC issued another Risk Alert with its observations relating to advisors' fee calculations. The Commission noted concerns with advisors overbilling due to not householding accounts to meet breakpoints or otherwise not meeting breakpoints in tiered fee schedules, as well as failure to refund fees paid in advance upon a termination, including inadequate disclosures. It's noted that oftentimes advisors want to get creative with their billing methodology or fee structures and doing so needlessly complicates things. While there can be any number of reasons why a billing reconciliation may not balance, when clients can't easily calculate their fees to ensure they're being billed accurately, examiners are likely going to question the advisor's methodology.

The SEC, generally speaking, does not like anything that could be seen as "unearned compensation." Whether that is due to failing to refund fees or charging a set-up or a termination fee, advisors need to be certain they can justify their fee in relation to the service being provided.

Additionally, billing on cash balances has been receiving a lot of focus recently. As it relates to fee billing, advisors with clients who have large cash balance positions or who hold those positions for an extended period of time need to be aware of the service provided (or not being provided) relating to those “assets.” If an advisor is not managing a cash position, it may be difficult to justify charging an advisory fee on that portion of the portfolio. As a best practice, an advisor should develop procedures to periodically review cash holdings to determine whether or not a fee should be charged.

Finally, valuation of non-exchange traded assets is always a concern for SEC examiners, particularly for proprietary products like private funds. Consequently, advisors should ensure they have adequate valuation disclosures and policies and procedures in place to address fair valuation methods and that they are following those procedures and documenting them accordingly.

As is evident from these Risk Alerts, there are many different pitfalls advisors can run into, not only with regards to providing electronic investment advice and fee billing and calculations, but in many other areas as well. Foreside can help advisors navigate their way around these challenges.