STROOCK
SPECIAL BULLETIN

SEC Identifies Top 6 Investment Advisory Fee and Expense Compliance Issues for Investment Advisers

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I. Introduction

On April 12, 2018, the Office of Compliance Inspections and Examinations (OCIE) of the Securities and Exchange Commission (SEC) issued a Risk Alert[1] highlighting the most frequent advisory fee and expense compliance issues identified in its examinations of investment advisers (advisers) during the past two years.[2] The Risk Alert serves as a reminder to the industry that advisory fees and expenses remain a focal point of the SEC's oversight of registered investment advisers.

This *Stroock Special Bulletin* sets forth the six most frequent compliance risks and issues related to advisory fees and expenses identified by the OCIE staff. In light of the fee and expense issues noted in the Risk Alert and this *Stroock Special Bulletin*, advisers are encouraged to review their practices, policies, and procedures to ensure they are in compliance with their advisory agreements, operating agreements, disclosure materials and other representations to clients.

II. Most Frequent Compliance Issues Related to Advisory Fees and Expenses

The OCIE staff identified the following deficiencies pertaining to advisory fees and expenses: (1) fee-billing based on incorrect account valuations, (2) billing fees in advance or with improper frequency, (3) applying incorrect fee rates, (4) omitting rebates and applying discounts incorrectly, (5) disclosure issues involving advisory fees, and (6) adviser expense misallocations.

(1) *Fee-Billing Based on Incorrect Account Valuations*. Advisers commonly overbilled clients for advisory fees because the adviser incorrectly valued assets in the clients' accounts. Incorrect valuations present an issue because advisers often assess fees as a percentage of the value of the assets they manage for a client and an incorrect valuation will result in an incorrect advisory fee. Two common examples are when advisers:

- valued assets in a client's account using a different metric than that which was specified in the client's advisory agreement (e.g., using

[1] https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf

[2] The Risk Alert reflects issues identified in SEC deficiency letters from over 1,500 adviser examinations completed during the past two years.

the original cost of an illiquid asset for its current valuation rather than valuing the asset based on its fair market value); or

- valued a client's account using a process that differed from the process specified in the client's advisory agreement, such as:
  - using the market value of the account's assets at the end of the billing cycle, instead of using the average daily balance of that account over the entire billing cycle as specified in the advisory agreement; or
  - including assets in the fee calculation that were excluded by the advisory agreement from the management fee, such as cash or cash equivalents, alternative investments, or variable annuities.

(2) *Billing Fees in Advance or with Improper Frequency.* The OCIE staff noted deficiencies associated with the billing practices of advisers, in particular as such practices related to the timing and frequency for which advisory fees were billed. For example, certain advisers billed advisory fees on a monthly rather than quarterly basis as required by the terms of the applicable advisory agreement or as disclosed in the adviser's Form ADV Part 2. Other advisers failed to properly prorate their advisory fees for partial periods and instead billed clients for entire billing cycles despite the fact that the advisory services began or terminated mid-billing cycle and the terms of their advisory agreement or Form ADV disclosure provided for prorated billing.

(3) *Applying Incorrect Fee Rates.* Other advisers applied incorrect fee rates when calculating advisory fees for certain clients. For example, certain advisers:

- applied a higher rate than was agreed in the advisory agreement;
- double-billed a client; or
- charged a non-qualified client performance fees based on a percentage of their capital gains in violation of Section 205(a)(1) of the Advisers Act.[3]

(4) *Omitting Rebates and Applying Discounts Incorrectly.* Certain advisers overcharged their clients by failing to apply certain discounts or rebates to their clients' advisory fees, as specified in their advisory agreements. The OCIE staff highlighted the following examples of common deficiencies:

- failure to aggregate the value of the accounts of related clients for fee-billing purposes, which would have qualified such clients for discounted fees;
- failure to reduce a client's fee rate when the value of that client's account reached a prearranged level entitling the client to a lower fee rate; and
- charging a client additional fees beyond those permitted by the terms of the advisory agreement with the client (e.g., charging wrap fee program participants brokerage fees in excess of the program's bundled fees).

(5) *Disclosure Issues Involving Advisory Fees.* The OCIE staff also frequently found deficiencies related to the disclosure of an adviser's fees and billing practices. Common deficiencies included: (i) inconsistent disclosure between the adviser's Form ADV and its actual practices (e.g., disclosing in Form ADV that the adviser charges a maximum advisory fee rate despite the fact that the adviser has advisory agreements with clients charging a fee exceeding the maximum fee rate disclosed in the adviser's Form ADV); and (ii) failure to disclose certain additional fees, fee sharing arrangements, or markups in addition to advisory fees, such as execution and clearing fees.

(6) *Adviser Expense Misallocations.* Other advisers misallocated expenses to its private and registered funds. Common examples of

[3] *See* Advisers Act Rule 205-3 (exempting a "qualified client" from the prohibition on such fees under Advisers Act Section 205(a)(1)).

misallocated expenses included the allocation of distribution and marketing expenses, regulatory filing fees, and travel expenses to clients instead of to the adviser, in contravention of the applicable advisory agreements, operating agreements or other disclosures.

In considering each of these six frequent deficiencies identified by the OCIE staff, advisers should be aware that the SEC has brought enforcement actions, charging advisers with Advisers Act violations, based on the above types of conduct. Advisers also should be aware that the types of conduct described above can separately result in violations of ERISA, if the clients involved hold plan assets.

III. Conclusion and Next Steps

This *Stroock Special Bulletin* highlights for investment adviser firms the most common advisory fee and expense compliance issues identified by the OCIE staff over the past two years. Advisers are encouraged to assess their advisory fee and expense practices and related disclosures to ensure compliance with the Advisers Act and their fiduciary duty to clients, and use this assessment as an opportunity to review the adequacy and effectiveness of their compliance programs.

Industry best practices also include to schedule periodic testing of billing and expense practices for funds and client accounts and to establish processes to maintain compliance with the appropriate advisory agreements, operating agreements, and related disclosures.

Fund advisers are also recommended to confirm that: (i) expenses charged to their funds are disclosed in the fund's offering memorandum and authorized by the fund's governing agreement; and (ii) the adviser is calculating and charging fees to the fund in accordance with the terms of the fund's advisory agreements, operating agreements and disclosure materials, including ensuring that the assets on which the fees are based are correct.

Account advisers are advised to confirm that: (i) expenses charged to their accounts are authorized by the advisory agreement with the client; and (ii) the adviser is calculating and charging fees to the account in accordance with the terms of the advisory agreement with the client, including ensuring that the assets on which the fees are based are correct.

For all investment adviser firms, accounting, legal and compliance personnel also should confirm that their Form ADV disclosure is consistent with their actual practices and that the disclosures in their offering memoranda or advisory agreements is consistent with the disclosure included in the firm's Form ADV and other marketing materials.

These assessments should be conducted both internally and in conjunction with experienced outside counsel regularly.

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