Proskauer

SEC Staff Issues Risk Alert on the Six Most Frequent Fee and Expense Compliance Issues

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On April 12, 2018, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a risk alert listing the most common compliance issues concerning fees and expenses charged by SEC-registered investment advisers. This follows remarks delivered on September 14, 2017 by Peter B. Driscoll, now Director of OCIE, announcing that the SEC staff was planning on issuing more risk alerts that summarize common exam findings across an array of topics. Recently, OCIE has issued risk alerts on advertisements, cybersecurity and supervision practices.

This latest risk alert cited six different types of deficiencies involving client fees and expenses identified by OCIE staff, and was accompanied by a reminder that advisers must adopt and implement written policies and procedures reasonably designed to prevent such violations. The six areas cited are as follows:

1. **Fee-Billing Based on Incorrect Account Valuations**

Common deficiencies in this area involved incorrect valuation of client assets, resulting in collection of excessive advisory fees. OCIE observed that certain advisers had (i) valued assets in a client's account using a different metric than specified in the advisory agreement, such as use of original cost rather than fair market value, and (ii) valued a client's account using a process that differed from the process specified in the client's advisory agreement, such as using the account value at the end of the billing period rather than the average daily balance.

2. **Billing Fees in Advance or with Improper Frequency**

The risk alert noted that the staff had observed deficiencies related to the timing and frequency for which advisory fees were billed, such as (i) billing advisory fees on a monthly basis, instead of on a quarterly basis as stated in the advisory agreement or disclosed in Form ADV Part 2, and (ii) failure to pro rate fees for periods during which the adviser provided advice for only a portion of the period.

3. **Applying Incorrect Fee Rates**

The OCIE staff observed advisers that had applied an incorrect fee rate when calculating advisory fees, including a "performance fee" calculated inconsistently with the requirements of the advisory contract.

4. **Omitting Rebates and Applying Discounts Incorrectly**

The OCIE staff noted overcharging by advisers as a result of failing to apply certain discounts to the advisory fee charged. Overcharges resulted from the failure to (i) aggregate client account values for members of the same household for fee-billing purposes, (ii) give effect to breakpoints when the value of that client's account reached an agreed-upon level, and (iii) rebate fees that were supposed to be covered by a wrap fee arrangement.

5. **Disclosure Issues Involving Advisory Fees**

Instances of non-compliance in this area included (i) disclosures in Form ADV that were inconsistent with advisers' actual billing practices, and (ii) failures to disclose certain additional fees or markups that clients were required to pay in addition to the advisory fees.

6. **Adviser Expense Misallocations**

The OCIE staff had observed advisers to private and registered funds that misallocated expenses to the funds they advised that presumably should have been properly allocated to the adviser or another client. For example, staff observed advisers that allocated distribution and marketing expenses, regulatory filing fees, and travel expenses to clients instead of the adviser, in contravention of the applicable advisory agreements, operating agreements, or other disclosures to clients.

Takeaways

The principal takeaway from this risk alert is that investment advisers must follow what their documents say they are going to do, including, without limitation, as to how fees are calculated and how expenses are allocated. Further, all investment advisers should periodically review their offering documents, constituent documents, advisory agreement, management agreement, managed account agreements, other client agreements, Form ADV and marketing materials to insure that they are consistent with each other.

The latest risk alert noted that, in response to OCIE staff's observations, some advisers had elected to change their practices, enhance policies and procedures, and reimburse clients by the overbilled amount of advisory fees and expenses. OCIE staff also observed advisers that proactively reimbursed clients for incorrect fees and expenses that they identified through the implementation of policies and procedures that provided for periodic internal testing of billing practices.

Although it is not discussed in the risk alert, presumably miscalculation of fees is only a violation of Section 206 of the Advisers Act when the miscalculation results in the adviser obtaining a larger fee from a client than it is entitled to collect. Nonetheless, poor calculation and billing practices may be deemed to be a violation of the rule 206(4)-7, the compliance rule, regardless of whether the adviser benefits from the miscalculation. Advisers should review their practices, policies, and procedures to ensure compliance with their advisory agreements and representations to clients in light of the fee and expense issues noted in the risk alert.

Related Professionals

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