Top Six Advisory Fee and Expense Deficiencies Identified by OCIE

On April 12, 2018, the Office of Compliance Inspections and Examinations (OCIE), an agency of the Securities and Exchange Commission (SEC), published its latest Risk Alert[1], which summarizes the six most frequent advisory fee and expense compliance issues that OCIE staff has observed in its examinations of SEC-registered investment advisers (advisers). OCIE staff identified these six issues in deficiency letters from over 1,500 adviser examinations conducted by staff during the past two years.

The Risk Alert is intended to highlight for advisers certain risks and compliance issues associated with advisory fees and expenses. Specifically, OCIE indicated that its objective in publishing the Risk Alert is "to encourage advisers to assess their advisory fee and expense practices and related disclosures to ensure that they are complying with the Advisers Act, the relevant rules, and their fiduciary duty, and review the adequacy and effectiveness of their compliance programs." OCIE reminds advisers in the Risk Alert that the disclosure that clients receive, especially regarding advisory fees and expenses, is critical to their ability to make informed decisions, including regarding whether to engage or retain an adviser.

An adviser must disclose in its Form ADV details regarding the advisory fees and expenses that it charges to clients. Such fees and expenses are typically also set forth in client advisory agreements. An adviser's failure to disclose such fee and expense terms, or its deviation from previously disclosed fee and expense practices, places such adviser at risk of being in violation of the Investment Advisers Act of 1940 (Advisers Act) and subject to an enforcement action. Advisers must also adopt and implement written policies and procedures reasonably designed to prevent such violations.

The six deficiencies pertaining to advisory fees and expenses identified by OCIE are discussed in further detail below.

1. Free Billing Based on Incorrect Account Valuations

OCIE observed advisers incorrectly valuing assets in client accounts resulting in overbilled advisory fees. Examples of such practices included (i) valuing client assets using a metric that differs from the one specified in the client's advisory agreement (for example, using cost to value an illiquid asset instead of fair market value) and (ii) valuing client assets using a process that differs from the one specified in the advisory agreement (for example, using the market value of the account's assets at the end of the billing cycle instead of the average daily balance, and including certain assets in the fee calculation that should have been excluded by the terms of the advisory agreement).

2. Billing Fees in Advance or with Improper Frequency

This category of deficiency involves the timing and frequency of advisory fee billing, including practices such as (i) billing fees monthly instead of quarterly and billing in advance instead of in arrears (contrary to the terms of the advisory agreement and/or the disclosure in the adviser's Form ADV), and (ii) failing to prorate or refund advisory fees for services that commenced or terminated at a time other than the beginning or end of a billing cycle.

3. Applying Incorrect Fee Rates

OCIE observed advisers calculating advisory fees using incorrect rates and charging performance fees to non-*qualified clients*.

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

4. OMITTING REBATES AND APPLYING DISCOUNTS INCORRECTLY

OCIE identified advisers overcharging clients because they failed to apply certain agreed upon discounts or rebates to advisory fees, including by (i) not aggregating client account values for members of the same household as specified in the advisory agreement or the adviser's Form ADV, (ii) not reducing a fee rate on the value of a client account upon reaching an agreed breakpoint level, and (iii) charging additional fees when they were already being charged as part of a bundled fee.

5. DISCLOSURE ISSUES INVOLVING ADVISORY FEE

OCIE observed issues regarding the disclosure of fees and billing practices, including instances when an adviser (i) acted inconsistently with disclosures made in its Form ADV, and (ii) charged additional fees or markups to clients without proper disclosure.

6. ADVISER EXPENSE MISALLOCATIONS

OCIE observed advisers to private and registered funds misallocating expenses to the funds, such as charging distribution and marketing expenses, regulatory filing fees, and travel expenses to the funds instead of to the adviser, in contravention of applicable advisory agreements, operating agreements, or other disclosure to clients.

NOW WHAT?

In light of OCIE's Risk Alert, advisers (both registered and unregistered) should be on notice of the above six fee and expense deficiencies. To the extent terms relating to fees and expenses are agreed and disclosed in advisory agreements, regulatory filings and other disclosure documents, advisers must adhere to such terms or risk being in violation of the Advisers Act and subject to an enforcement action. Advisers should preemptively evaluate their advisory fee and expense practices and related disclosures to ensure compliance and if deficiencies are identified, advisers should proactively effect changes to bring themselves into compliance. As OCIE notes in the Risk Alert, in response to its observations, some advisers have already elected to change their practices, enhance their policies and procedures, and reimburse clients for overbilled fees and expenses. Other advisers have 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.

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For more information or if you have any questions regarding the topic discussed above, please contact the attorney with whom you work regularly or any of the following in our Financial Services, Private Funds and Capital Markets practice group:

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