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Fees and Expenses

OCIE Risk Alert Warns of Six Most Frequent Fee and Expense Compliance Issues

May 3, 2018

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An investment adviser must assess its advisory fee and expense practices to ensure that it is complying with the Investment Advisers Act of 1940 (Advisers Act), the rules thereunder and its fiduciary duty. If an adviser fails to adhere to the terms of its advisory agreements and disclosures, or otherwise engages in inappropriate fee billing and expense practices, the SEC may impose sanctions. See "Recent SEC Settlement Reminds Fund Managers to Strictly Adhere to Disclosed Fee and Expense Calculation Methodologies and Fully Disclose Conflicts of Interest" (Nov. 16, 2017).

The SEC Office of Compliance Inspections and Examinations (OCIE) recently issued a Risk Alert discussing the six most frequent fee- and expense-related issues identified in deficiency letters from more than 1,500 adviser examinations completed in the last two years. This article analyzes OCIE's findings and provides guidance from a former SEC examiner with expertise in this area.

For more on fee and expense allocation practices, see our three-part series: "Practices Fund Managers Should Avoid" (Aug. 25, 2016); "Flawed Disclosures to Avoid" (Sep. 8, 2016); and "Preventing and Remedying Improper Allocations" (Sep. 15, 2016).

Six Fee and Expense Compliance Issues

In general, the terms of a client's advisory fees and expenses are described in the advisory agreement, an adviser's Form ADV and other materials provided to the client, including marketing materials and client correspondence, explained Victoria Hogan, president of NorthPoint Compliance. Advisers must adhere to the terms of these agreements and disclosures to avoid violating the Advisers Act and related rules. In addition, advisers must implement written policies and procedures reasonably designed to prevent these violations.

"Advisers have limited resources, so they might only be able to test or review certain areas of their compliance programs. But, reviewing and testing fees should certainly be on the short list," Hogan observed. "This Risk Alert is great because advisers can take what is listed here and use it as a guide or checklist for when they review their own fee calculations."

Nevertheless, none of the errors identified in this Risk Alert surprised Hogan, who came across many of these same issues as an SEC examiner more than ten years ago.

1) Basing Fees on Incorrect Account Valuations

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According to the Risk Alert, OCIE staff observed advisers that incorrectly valued certain assets in clients' accounts, resulting in overbilled advisory fees. Because advisers generally assess fees as a percentage of the value of the assets they manage in each client's account, an incorrect account valuation will lead to an incorrect advisory fee being assessed to that client.

For example, advisers valued:

- assets in a client's account using a different metric than that which was specified in the client's advisory agreement, such as using the asset's original cost to value an illiquid asset rather than valuing the asset based on its fair market value; and
- 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.

Advisers should also look at the sources used to value securities and make sure that they are proper. "For example, if the adviser is investing client assets with a third-party money manager or a private fund and it is getting the mark from that entity, which is then manually entered into the portfolio management system, there could be room for error," Hogan explained. "Also, when the adviser is valuing the security itself, there is a higher risk in the area of fee calculations than for an adviser who is trading very liquid securities and getting quotes from Bloomberg."

See "Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations" (May 11, 2017); and "Three Pillars of an Effective Hedge Fund Valuation Process" (Jun. 19, 2014).

2) Billing Fees in Advance or With Improper Frequency

OCIE staff also observed issues with advisers' billing practices relating to the timing and frequency for which advisory fees were billed. Staff observed, for example, advisers that deviated from the applicable advisory agreement or Form ADV by:

- billing advisory fees on a monthly rather than a quarterly basis;
- billing advisory fees in advance rather than in arrears;
- billing a new client for advisory fees in advance for an entire billing cycle, instead of pro-rating these charges to reflect that the advisory services began mid-billing cycle; and
- failing to reimburse a client for a pro-rated portion of the advisory fees when the client terminated the advisory services mid-billing cycle.

See "Failure by Investment Advisers to Ensure Accurate Client Billing May Lead to SEC Enforcement Action and Penalties" (Feb. 2, 2017).

3) Applying an Incorrect Fee Rate

In addition, OCIE staff observed advisers that applied an incorrect fee rate when calculating the advisory fees charged to certain clients. For example, staff observed advisers that:

- applied a rate higher than what was agreed upon in the advisory agreement or double-billed a client; and
- charged a non-qualified client performance fees based on a percentage of its capital gains inconsistent with Section 205(a)(1) of the Advisers Act.

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"The types of advisers more likely to have issues in this area," said Hogan, "are those that have different fee calculation methodologies for different types of clients."

See "Deutsche Bank Alternative Investment Survey Details Hedge Fund Fee Rates, Negotiation Strategies and Structure Trends (Part Two of Two)" (Apr. 6, 2017).

4) Omitting Rebates and Applying Discounts Incorrectly

OCIE staff observed advisers that did not apply certain discounts or rebates to their clients' advisory fees, causing the clients to be overcharged. For example, staff observed advisers that:

- did not aggregate client account values for members of the same household for fee-billing purposes, which would have qualified these clients for discounted fees according to the adviser's Form ADV or advisory agreement;
- did not reduce a client's fee rate when the value of that client's account reached a prearranged breakpoint level, which entitled that client to a lower fee rate according to the adviser's Form ADV or advisory agreement; and
- charged a client additional fees, such as brokerage fees, when the client was in the adviser's wrap fee program and the transactions qualified for that program's bundled fee.

See "Ameriprise Settlement Reflects Continued SEC Focus on Conflicts of Interest and Retail Investors" (Apr. 19, 2018); and "Pay to Play, Revenue Sharing and Wrap Fees Remain on the SEC's Radar" (Apr. 20, 2017).

5) Failing to Properly Disclose Fees or Billing Practices

OCIE staff observed several issues with respect to advisers' disclosures of fees or billing practices, both in terms of the substance of disclosures that were made and the failure to make necessary disclosures. For example, staff observed advisers that:

- made disclosures that were inconsistent with their actual practices, such as disclosing a maximum advisory fee rate in the Form ADV while having an agreement with a certain client to charge a fee rate that exceeded that disclosed maximum rate; and
- failed to disclose certain additional fees or markups in addition to advisory fees, such as expenses for third-party execution and clearing services that exceeded the actual fee charged for those services by the outside clearing broker.

6) Misallocating Fund Expenses

Finally, OCIE staff observed advisers that misallocated expenses to the funds. For example, staff observed advisers that allocated distribution and marketing expenses, regulatory filing fees and travel expenses to clients instead of the adviser, in violation of the applicable advisory agreements, operating agreements or other disclosures.

"Where I have seen some advisers run afoul is when there are travel and entertainment expenses related to an investment but where that investment is held across multiple private funds," noted Hogan. "The question is if that expense is, in fact, permitted to be borne by the funds, how will it be allocated?" she queried. For example, "will it be allocated based on the amount of the fund's investment? Will it be divided equally among the funds, such as split 50/50 between two funds?

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The allocation method the adviser uses should be fair, documented and consistently applied," Hogan explained.

As to expenses related to private fund service providers, Hogan said she typically asks her clients that have more than one fund being audited whether they receive one audit invoice and allocate it internally or whether each fund gets its own invoice? The same would apply to an invoice from an attorney for legal expenses. "When the lawyer provides a legal invoice, is he itemizing what he has done and to which fund it applies, or is that allocation something that the adviser is doing internally? If the latter, the adviser needs to ensure that its allocation methodology is fair and makes sense," she said.

See "Eight Bad Excuses Fund Managers Have Raised Trying to Avoid SEC Sanctions for Fee and Expense Allocation Violations and Undisclosed Conflicts of Interest" (Oct. 13, 2016).

How to Avoid These Issues

Although these issues are not new, Hogan acknowledged that "there could be newly registered advisers or new chief compliance officers who are not necessarily aware of the areas where there is the highest risk. This Risk Alert is good for the investment adviser community because it covers the areas with the greatest number of deficiencies and thus the highest risk of violations."

Avoiding these issues requires efforts by both operations and compliance personnel. "Typically, the fee calculation and billing process lies with operations subject to compliance oversight and review," explained Hogan. She said that compliance, as part of the ongoing testing and review process, should ask operations several questions, including:

- How are you getting information on not just what the fee should be initially but also, on an ongoing basis, any changes to the fee?
- Who is ensuring that the terms of the advisory agreement are being properly communicated to you?
- Where are you getting your values?
- Where are you getting your pricing information?
- What is your process for calculating fees – is it a manual or an electronic process?
- Does just one person enter a valuation into the portfolio management system, or are there checks and balances to ensure that asset valuations are entered correctly?

Based on the answers to these questions, Hogan recommends that compliance conduct an assessment and review to identify any areas or accounts with a greater risk potential for fees to be miscalculated. "One example of such accounts would be older, legacy accounts whose fees might need to be calculated in a manner different from the methodology used for newer accounts. The adviser needs to ensure that a new methodology is not being applied to older accounts with advisory agreements that reflect a different methodology," she explained.

Another example of a higher risk account is one where the fee may change or evolve over time. "The fee may change because the client's assets have increased above a certain threshold, so now the client is eligible for a fee reduction on a portion of its assets," explained Hogan.

"Compliance testing in this area should include recalculating a selection of fees to ensure they are in accordance with the advisory agreement and disclosures," Hogan advised. An adviser's testing pool should include a larger sample of accounts that are higher risk.

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In addition, if any changes are made to the fee or expense billing terms, whether orally or in client correspondence, the advisory agreement should be revised accordingly, added Hogan. For instance, "if a wealth manager is communicating with its client about fees, the manager might verbally agree to a reduced fee. Conversely, a client may agree to a higher percentage to be more in line with current advisory billing practices," she explained. "In either case, any such oral agreements should be reflected in an addendum to the advisory agreement."

If an adviser suspects that it has made a billing mistake, Hogan said it should review its calculation and billing practices, identify any errors and, if those errors resulted in an overbilling, reimburse the client. "As a fiduciary, if the adviser has taken money that it did not properly earn, it is required to send it back to the client," she noted. "The adviser should then revise and strengthen its policies, procedures and practices to reduce the risk of the error occurring in the future."

Should the adviser discover that it has actually under-billed a client, Hogan said, "it is fair for advisers to request money that they should have billed clients for but didn't. I would, however, be hesitant to directly debit that fee on accounts where the adviser has the authority to do so," she explained. "I wouldn't suddenly hit the client with an additional fee because of the adviser's failure to invoice properly in the past." Although the adviser is entitled to the proper fee, Hogan recommended it send the client an invoice with an explanation of the error and obtain the client's authorization before directly debiting the amount owed.

Alternatively, "a lot of advisers don't want to threaten the relationship they have with their clients and will probably just eat the loss," Hogan added. Going forward, however, she advised that investment advisers should inform affected clients that they have been under-billing the clients and that they are now going to apply the fee structure contractually agreed to in the advisory agreements.

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