Simpson Thacher

Memorandum

SEC Risk Alert Highlighting Common Deficiencies Relating to Fees and Expenses

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Last week, the Office of Compliance Inspections and Examinations ("OCIE") of the U.S. Securities and Exchange Commission ("SEC") issued a National Exam Program Risk Alert (the "Risk Alert")[1] highlighting OCIE's observations of common examination deficiencies relating to advisory fees and expenses charged by registered investment advisers over the past two years.[2] This Risk Alert is the first OCIE has issued following the publication of its "2018 National Exam Program Examination Priorities" on February 7, 2018,[3] in which OCIE indicated that its staff have made a concerted effort to publish Risk Alerts more frequently with the ultimate goal of promoting regulatory compliance. Below is a summary of the Risk Alert and some key takeaways for registered investment advisers that manage private funds.

Risk Alert

In the introductory section of the Risk Alert, OCIE explained why it is focusing its examination efforts on advisory fees and expenses. OCIE stated its view that the disclosure of advisory fees and expenses is critical to a client's ability to make an informed decision about whether to engage or retain an adviser. According to OCIE, an adviser that fails to adhere to advisory agreement terms and disclosures pertaining to fees and expenses, or otherwise engages in inappropriate fee billing and expense practices, may violate the

[1] *Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, SEC OCIE National Exam Program Risk Alert, Volume VII, Issue 2 (Apr. 12, 2018), available at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[2] The compliance issues discussed in this Risk Alert reflect issues identified in deficiency letters from over 1,500 adviser examinations that were completed during the past two years.

[3] *2018 National Exam Program Examination Priorities*, SEC OCIE (Feb. 7, 2018), available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf.

Investment Advisers Act of 1940 (the "Advisers Act"), including the antifraud provision. OCIE also stated that advisers must adopt and implement written policies and procedures reasonably designed to prevent such violations.[4]

OCIE then identified the following as the most common deficiencies related to advisory fee and expense practices.

Fee-Billing Based on Incorrect Account Valuations

OCIE staff observed advisers that overbilled advisory fees due to incorrect valuations of client assets. For advisers that assess fees as a percentage of the value of assets in a client account, an incorrect account valuation could result in an incorrect advisory fee being billed to that client. In particular, the Risk Alert explained that advisers valued client assets using a different metric than that specified in that client's advisory agreement, such as using an illiquid asset's original cost to value that asset instead of valuing that asset based on its fair market value. The Risk Alert also noted that some advisers valued assets in a client's account using a different process than that specified in the advisory agreement. One example cited was advisers that used the market value of a client account's assets at the end of the day the billing cycle ended rather than the disclosed method of using the average daily balance of that account over that entire billing cycle. Another example cited was advisers that calculated their management fees on a portfolio that included certain assets, such as cash or cash equivalents, alternative investments, or variable annuities, that should have been excluded from the management fee calculation based on the applicable advisory agreement.

Billing Fees in Advance or with Improper Frequency

OCIE staff also described issues with respect to the timing and frequency of advisory fee billing. OCIE staff observed, for example, advisers that billed advisory fees on a monthly basis even though the client's advisory agreement or the adviser's Form ADV Part 2 provided that fees are billed on a quarterly basis. Another scenario involved advisers that billed advisory fees in advance despite language in the applicable advisory agreement that indicated the client would be billed in arrears. Yet another example involved advisers that billed advisory fees in advance for an entire billing cycle when such charges should have been prorated to reflect that the advisory services commenced mid-billing cycle. Finally, OCIE pointed to advisers that did not reimburse a client a prorated portion of advisory fees when the client terminated the advisory services mid-billing cycle despite disclosure in Form ADV Part 2 that the advisers would make such a reimbursement.

[4] In making these points, the Risk Alert cites to Sections 206(1) and 206(2) of the Advisers Act and Rule 206(4)-7 under the Advisers Act. Section 206(1) prohibits advisers from employing "any device, scheme, or artifice to defraud any client or prospective client." Section 206(2) prohibits advisers from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Rule 206(4)-7 requires advisers to "adopt and implement written policies and procedures reasonably designed to prevent violation, by [the adviser] and [its] supervised persons, of the [Advisers] Act and the rules that the [SEC] has adopted under the [Advisers] Act."

Applying Incorrect Fee Rate

OCIE staff observed that advisers applied an incorrect fee rate when calculating the advisory fees charged to certain clients by, for example, applying a higher fee rate than was agreed to in the client's advisory agreement, double-billing a client, or charging a performance fee to a non-qualified client in violation of Section 205(a)(1) of the Advisers Act.[5]

Omitting Rebates and Applying Discounts Incorrectly

OCIE staff also observed advisers that did not apply certain discounts or rebates to their clients' advisory fees in contravention of the applicable advisory agreements, causing the clients to be overcharged. In particular, the Risk Alert explained that some advisers did not aggregate client account values for members of the same household for fee-billing purposes, which would have qualified such clients for discounted fees according to the applicable advisory agreement or the adviser's Form ADV. The Risk Alert also noted that advisers 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 applicable advisory agreement or the adviser's Form ADV. In addition, the Risk Alert indicated that advisers charged a client additional fees, such as brokerage fees, when that client was in the adviser's wrap fee program and the relevant transactions qualified for the program's bundled fee.

Disclosure Issues Involving Advisory Fees

OCIE staff observed several deficiencies with respect to advisers' disclosures of advisory fees or billing practices. For example, advisers made a disclosure in Form ADV that was inconsistent with their actual practices, such as having an agreement in place with a certain client to charge a fee rate that exceeded the maximum advisory fee rate disclosed in Form ADV. The Risk Alert also noted that some advisers did not disclose certain additional fees or markups they charged in addition to advisory fees. One example cited was advisers that did not disclose that they collected expenses from a client for third-party execution and clearing services that exceeded the actual fee charged for those services by the outside clearing broker. Another example cited was advisers that earned undisclosed additional compensation on certain asset purchases for client accounts. A final example cited was advisers that received undisclosed fees pursuant to fee sharing arrangements with affiliates.

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[5] *See* Advisers Act Section 205(a)(1) ("No investment adviser registered or required to be registered with the [SEC] shall enter into, extend, or renew any investment advisory contract . . . if such contract – provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client"); *see also* Advisers Act Rule 205-3 (exempting a "qualified client" from the prohibition under Advisers Act Section 205(a)(1)).

Adviser Expense Misallocations

OCIE staff observed instances where advisers to private funds and registered funds misallocated expenses to the funds, including, for example, allocating distribution and marketing expenses, regulatory filing fees, and travel expenses to the funds instead of the adviser in contravention of the applicable advisory agreements, operating agreements, or other disclosures.

The Risk Alert concluded by noting that some advisers, in response to OCIE staff's observations, have elected to change their practices, enhance policies and procedures, and reimburse clients by overbilled amounts of advisory fees and expenses. The Risk Alert also pointed out that some advisers proactively reimbursed clients for incorrect fees and expenses they identified through the implementation of policies and procedures that provided for periodic internal testing of billing practices.

Key Takeaways for Advisers that Manage Private Funds

For the past few years, SEC staff have been focused on the fees and expenses that advisers charge to the private funds they manage.[6] This Risk Alert, and particularly its discussion of expense allocation deficiencies, demonstrates the SEC's intention to continue to focus on this area. In response, advisers to private funds should continue to pay close attention to how they disclose their fee billing and expense allocation practices in fund offering documents and in Form ADV Part 2A. And it is important that advisers ensure that their fee and expense disclosures accurately reflect their actual practices.

[6] *See e.g.*, *Spreading Sunshine in Private Equity*, Andrew J. Bowden (May 6, 2014), available at https://www.sec.gov/news/speech/2014--spch05062014ab.html ("By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.").

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