

OCIE Risk Alert Highlights the Most Frequent Adviser Fees and Expenses Deficiencies

On April 12, 2018, the SEC's Office of Compliance Inspections and Examinations ("OCIE") released a [Risk Alert](#) identifying the most frequently cited compliance deficiencies relating to fees and expenses charged by SEC registered investment advisers to their clients. The Risk Alert serves as a reminder to registered investment advisers to review their advisory contracts, Form ADVs and marketing materials to ensure that disclosures are consistent with current firm practices. Advisers with inconsistent disclosures or practices with respect to fees and expenses may find themselves in violation of the Investment Advisers Act of 1940 (the "Advisers Act"), including the anti-fraud provisions.

OCIE's Risk Alert reflected issues identified in deficiency letters from over 1,500 examinations completed during the past two years. The same day of the Risk Alert's release, the SEC held its Compliance Outreach Program National Seminar where fees and expenses and disclosures by private fund advisers were discussed as an area where issues frequently arise due to the multiple hats that advisers may wear in relation to their private funds. A summary of the key advisory fee and expense compliance issues that were highlighted in OCIE's Risk Alert can be found below.

Fees Billed Based on Incorrect Account Valuations

Advisers that incorrectly valued assets in client accounts run the risk of overbilling clients for advisory fees. OCIE provided a number of examples of incorrect account valuations that resulted in compliance deficiencies for advisers:

- Advisers that valued assets for billing fees using a metric that was different than what was specified in client advisory agreements, for instance, using the original cost of assets instead of fair market value as the valuation metric;
- Advisers that used a different method to value assets in client accounts than the one specified in client advisory agreements, for instance, valuing assets at the end of a billing cycle instead of using the average daily balance as the valuation method; and
- Advisers that included assets, such as cash or cash equivalents, alternative

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investments or variable annuities, that should have been excluded in fee calculations per the client advisory agreements.

Fees Billed in Advance or with Improper Frequency

Improper billing practices by advisers were also cautioned against as OCIE highlighted issues with the timing and frequency of fees billed by advisers when the practices were inconsistent with disclosures to clients. Examples of such compliance deficiencies included:

- Advisers that billed advisory fees on a monthly basis instead of quarterly, as disclosed in client advisory agreements or the adviser's Form ADV Part 2A brochure;
- Advisers that billed clients in advance when advisory agreements stated that advisory fees would be billed in arrears;
- Advisers that billed new clients fees in advance of the entire billing cycle instead of prorating fees to reflect services that began mid-billing cycle; and
- Advisers that failed to reimburse clients for prorated portions of billed advisory fees when clients terminated advisory services mid-billing cycle, even though the Form ADV Part 2A brochure stated that such advisory fees would be reimbursed to terminated clients.

Applying the Incorrect Fee Rate

OCIE cited instances where advisers charged fees to their clients at rates that were higher than the rate provided in client advisory agreements. Advisers were also found to have double-billed clients and to have charged a performance fee to non-qualified clients, which is inconsistent with Section 205(a)(1) of the Advisers Act.

Omitting Rebates and Applying Discounts Incorrectly

Through its examinations of SEC registered investment advisers, OCIE also identified clients who were overcharged because they did not receive the rebates or discounts that were described in their advisory agreements or the Form ADV Part 2A brochure of the adviser. Examples of this compliance deficiency where clients were entitled to but did not receive a lower fee rate included:

- Advisers that did not aggregate client account values for members of the same household for fee billing purposes;
- Advisers that did not reduce advisory fees when the value of a client's account reached a prearranged breakpoint level; and
- Advisers that charged clients additional fees, such as brokerage fees to clients in a wrap fee program where the transactions would have qualified for a bundled fee.

Disclosure Issues Involving Advisory Fees

OCIE found that adviser Form ADV disclosures regarding advisory fees and billing practices were frequently found to be inconsistent with the actual practices of advisers. One such example provided included advisers that disclosed a maximum advisory fee rate in their Form ADV, but entered into client advisory agreements that charged fees

exceeding the disclosed maximum rate. In addition, OCIE outlined other instances where advisers failed to disclose additional fees or markups in addition to advisory fees, by not disclosing that expenses collected from clients for third-party execution and clearing would be higher than the actual fee charged by the third-party for such services, or that advisers would earn additional compensation on certain asset purchases for clients or through fee sharing arrangements with its affiliates.

Adviser Expense Misallocations Related to Private and Registered Funds

Advisers to both private funds and registered funds were found to have misallocated expenses to such funds. Examples of such deficiencies provided by OCIE included advisers that allocated distribution and marketing expenses, regulatory filing fees and travel expenses to clients when such costs should have been borne by the adviser per the applicable client advisory agreements, operating agreements or other disclosures.

Fees and expenses, related disclosures and actual practices of investment advisers continue to be an area of focus for enforcement by the SEC. As discussed during Dorsey's fourth annual Federal Enforcement Forum last December, there have been a number of enforcement actions where the SEC has essentially brought strict liability cases based on the systematic failure and inadequate supervisory procedures of advisers relating to these matters. An article by Tom O. Gorman, a partner in Dorsey's Government Enforcement & Corporate Investigation practice, discussing a number of these enforcement actions can be found [here](#), as well as by visiting Dorsey's blog, [SEC Actions](#).

Accordingly, SEC registered investment advisers should work with their counsel to evaluate their current advisory agreements, Form ADV disclosures, and compliance policies and procedures to ensure that none of the highlighted issues are found in their firm's practices and if necessary, to determine how best to proactively address any issues that are found. For more information, please contact Genna Garver.