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The SEC Is Sending Signals Regarding Advisory Fees and Expenses — Are Investment Advisers Listening?

In recent years, the U.S. Securities and Exchange Commission's Office of Inspections and Examinations ("OCIE") has prioritized, in its examinations, the review of the fee billing and expense practices of investment advisers. The examinations generally focus on (1) the adequacy of the advisers' policies and procedures and compliance programs around their fee billing and expense practices; and (2) whether the advisers' fee billing and expense practices are consistent with disclosures to clients in advisory agreements, private placement memoranda, the Form ADV, or other materials. Any deficiencies in the policies or procedures, or practices that are inappropriate or inconsistent with such policies or procedures, could result in violations of the Investment Advisers Act of 1940 ("Advisers Act") and/or other violations of the federal securities laws.

Recent enforcement actions, coupled with an OCIE Risk Alert[1] earlier this year, underscore the SEC's broadening focus on compliance in this area. The violations found in these enforcement actions mirror the most frequently identified advisory fee and expense issues outlined in the OCIE Risk Alert, which aggregated findings from deficiency letters in 1,500 adviser examinations completed during the past two years. Given the unrelenting attention to this area, advisers would be well advised to use the Risk Alert as a roadmap to the most common fee and expense compliance pitfalls, and diligently review their policies and procedures, disclosures, and practices and remediate any issues uncovered.

THE SEC'S HISTORIC FOCUS ON COMPENSATION

Advisory compensation has been an SEC priority for some time. In 2014, in response to an observation that violations frequently occur as a result of unmanaged conflicts of interest, the staff determined to review "conflicts of interest inherent in certain investment adviser business models," including compensation arrangements for the adviser and in particular, undisclosed compensation arrangements and their effect on recommendations made to

clients."[2] In 2015 and 2016, in response to a perceived market trend, the staff moved to examining the varied fee structures offered to clients for services and the disclosure surrounding those structures. The 2017 OCIE Examination Priorities report identified a more narrow focus on wrap fee programs, which charged retail investors a single bundled fee for investment advisory and brokerage services.[3] The 2018 exam priorities differed from prior statements in the breadth of the issues identified for examination surrounding "the cost of investing" and the emphasis placed on the importance of disclosures and compliance with those disclosures.[4] Indeed, OCIE stated that "[e]very dollar an investor pays in fees and expenses is a dollar not invested for his or her benefit. Therefore, the proper disclosure and calculation of fees, expenses, and other charges investors pay is critically important."[5]

SEC leadership have echoed this priority in public speeches as well. In May 2014, the then-Director of OCIE, Andrew Bowden, spoke to the Private Fund Compliance Forum offering a number of significant observations from exams of private equity advisers and stating that, "by far, the most common observation" concerned the allocation of fees and expenses.[6] Specifically, he noted that examiners had found "violations of law or material weaknesses in controls over 50% of the time" when reviewing how fees and expenses were handled by advisers to private equity funds. Bowden went on to lay out the most common deficiencies, including shifting expenses and assessing fees without proper disclosure. He cited examples of "operating partners" who look like fund employees but whose services are expensed to the fund rather than paid by the adviser, "consultants" who are similarly charged to the fund but which individuals originally were employees of the adviser and were fired and rehired as consultants without disclosure to investors, and process automation such as software used to distribute investor reports automatically, which cost is shifted to the funds even though preparing and delivering the reports is the responsibility of the adviser. With respect to undisclosed fees, Bowden listed "troubling practices" such as "charging undisclosed 'administrative' or other fees not contemplated by the limited partnership agreement; exceeding the limits set in the limited partnership agreement around transaction fees or charging transaction fees in cases not contemplated by the limited partnership agreement, such as recapitalizations; and hiring related-party service providers, who deliver services of questionable value."[7]

In a 2015 speech focused on conflicts of interest, then-Co-Chief of the SEC's Asset Management Unit Julie Riewe revealed that the Unit, in collaboration with exam staff, had developed its "Undisclosed Adviser Revenue risk-analytic initiative," which "targets undisclosed compensation arrangements between investment advisers and brokers that result in potentially tainted investment advice."[8] Riewe went on to state that "[o]n the horizon, we expect to recommend a number of conflicts cases for enforcement action," including matters involving "fee and expense misallocation issues."[9]

In November 2017, SEC Chairman Jay Clayton also gave a speech confirming that the agency is targeting "complex, obscure, or hidden fees and expenses that can harm investors," both through enforcement and by clarifying disclosure requirements.[10]

OCIE'S RECENT RISK ALERT

The April 12, 2018 OCIE Risk Alert provides a helpful overview of the most common compliance issues relating to fees and expenses charged by SEC-registered investment advisers over the past two years.[11] As with OCIE's prior statements, the theme is investor protection: the disclosures sent to clients, "especially regarding advisory fees and expenses, [are] critical to [clients'] ability to make informed decisions, including about whether to engage or retain an adviser."[12] The Risk Alert identifies the following issues as the most frequent fee and expense compliance problems:

- *Fee-Billing Based on Incorrect Account Valuations.* OCIE staff observed some advisers incorrectly valuing assets in client accounts and therefore assessing inflated advisory fees based on the percentage of assets under management. For example, staff observed advisers using a valuation process different from that specified in the advisory agreement, such as assessing the market value of client accounts at the end of the billing cycle instead of using the

average daily balance of that account over the entire cycle, or including assets in the fee calculation that were excluded by the advisory agreement, such as cash or variable annuities.

- *Billing Fees in Advance or with Improper Frequency.* OCIE staff observed issues with the timing and frequency of advisers' billing practices, such as billing on a monthly basis when the advisory agreement or Form ADV Part 2 called for quarterly billing, or billing in advance despite agreements specifying clients would be billed in arrears. OCIE staff also observed certain advisers billing in advance for an entire billing cycle and failing to pro-rate charges to reflect when advisory services began or terminated mid-cycle, despite disclosing that they would do so in the Form ADV Part 2.
- *Applying Incorrect Fee Rates.* OCIE staff observed some advisers applying a rate higher than that agreed upon in the advisory agreement, double-billing clients, or charging non-qualified clients performance fees based on a percentage of their capital gains inconsistent with the requirements of the Advisers Act.[13]
- *Omitting Rebates and Applying Discounts Incorrectly.* OCIE staff found some advisers did not apply certain discounts or rebates promised in advisory agreements, causing clients to be overcharged. For example, certain advisers did not aggregate client accounts to get a household total that would qualify such clients for discounted fees; did not reduce fee rates when client accounts reached a prearranged breakpoint level specified in the Form ADV or advisory agreement; or charged clients additional fees, such as brokerage fees, when such transactions should have qualified for a bundled fee under the adviser's wrap fee program.
- *Disclosure Issues Involving Advisory Fees.* OCIE staff observed advisers making disclosures in their Form ADV that were inconsistent with their actual practices and/or failing to disclose certain additional fees or markups in addition to advisory fees that were actually assessed to clients.
- *Adviser Expense Misallocations.* OCIE staff observed some advisers allocating distribution and marketing expenses, filing fees, or travel expenses to clients instead of to the adviser, in contravention of their controlling advisory or operating agreements.

ENFORCEMENT ACTIONS

Advisers afflicted by the compliance problems discussed above have found themselves charged by the SEC for Advisers Act violations based on this conduct, and the issuance of the OCIE Risk Alert signals a continued enforcement focus in this area. If an OCIE examination reveals that an investment adviser has engaged in significant violations that cannot be addressed through a deficiency letter, OCIE will refer the matter to the SEC's Enforcement Division. In fiscal year 2017, 7% of OCIE exams resulted in referrals to Enforcement, and in 2016 that number was 9%.[14] Enforcement staff will then independently assess the potential violations to determine whether to initiate an investigation and ultimately whether to bring charges.

The OCIE Risk Alert references enforcement actions brought against two major investment banks as examples.[15] In January 2017, the SEC found that one investment bank had violated Section 206(2) of the Advisers Act by charging clients advisory fees that did not reflect negotiated discounts in their agreements, among other problematic conduct. According to the Order, the overbilling, caused by thirty-six types of coding and other errors in its billing systems and processes, resulted in the investment bank receiving more than $16 million in excess fees from more than 149,000 advisory client accounts from 2002 to 2016. The SEC found that six types of coding errors originated in legacy accounts at predecessor firms that the investment bank failed to fix when it integrated assets, clients, and accounts to its current joint venture structure between 2011 and 2013. According to the Order, these six categories of billing errors occurred in several ways; for example, under certain circumstances when advisory accounts were transferred between branches, a system feature caused the advisory fees to default to the highest available account fee, resulting in overcharges to 5,270

accounts. The SEC found that thirty additional billing issues either carried over from the legacy accounts or originated with the joint venture investment bank, and occurred in managed programs within the advisory business. For example, according to the Order, the investment bank charged outside manager fees on assets that did not utilize an outside manager, due to a computer coding error. The investment bank reimbursed the client accounts plus interest. Without admitting or denying the SEC's findings, the investment bank agreed to comply with remedial undertakings, including to research and remediate all fee overbilling errors discovered, review open advisory accounts and remediate as necessary, provide status updates to the SEC Staff, and provide disclosure of the SEC Order, and agreed to the imposition of sanctions including a cease and desist order, a censure, and a civil monetary penalty of $13 million.

In May 2017, the SEC found that another major investment bank violated Section 206(2) of the Advisers Act by incorrectly calculating advisory fees, among other improper conduct. In a settled order, the SEC found that the investment bank overcharged certain clients in its wealth and investment management business almost $50 million in fees. According to the Order, the overbilling was due to inadequate controls around the valuation of advisory client assets leading to inaccurate prices for some securities, disparate data and account management systems that required manual workarounds introducing human error into the billing calculations and reconciliations, and a lack of appropriate oversight for account management and billing operations in that the investment bank's systems were not integrated with its clearing agent's systems. Without admitting or denying the findings, the investment bank agreed to remedial undertakings (related to the SEC's findings that it had engaged in improper conduct related to its recommendation and sales of certain share classes and its failure to perform ongoing diligence and monitoring) and sanctions including disgorgement, prejudgment interest, and a $30 million civil monetary penalty totaling approximately $93.5 million.

On September 11, 2017, Potomac Asset Management Co. Inc. ("Potomac"), settled with the SEC claims of inappropriate fee and expense allocation to two of its private equity fund clients ("Funds I and II").[16] According to the Order, between 2012 and 2013, Potomac improperly charged $2.2 million in fees to Fund I for services provided by Potomac affiliates to a portfolio company of Fund I, without authorization to charge such fees and without disclosure of such fees to Fund I's limited partners. Moreover, after the portfolio company subsequently reimbursed the cost of the fees, the SEC found that Potomac failed to offset them against the $726,000 in management fees it had charged to Fund I, as required in Fund I's limited partnership agreement, resulting in larger advisory fees to Potomac. Additionally, the SEC found that Potomac improperly used both Fund I and Fund II's assets to pay Potomac's adviser-related expenses, charging more than $703,000 in rent, compensation, and other business and regulatory expenses to the Funds without authorization or disclosure. Without admitting or denying the SEC's findings, Potomac and its principal agreed to the imposition of a cease and desist order, a censure, and jointly and severally a $300,000 civil penalty.

On September 21, 2017, Platinum Equity Advisors, LLC ("Platinum") settled claims that it violated Sections 206(2), 206(4) and Rule 206(4)-7 of the Advisers Act by charging three of its clients approximately $1.8 million in broken deal expenses.[17] Specifically, the SEC found that Platinum allocated all of its broken deal expenses to these clients and none to the co-investors who intended to participate in the deals that ultimately fell through. The funds' governing documents also did not disclose that the funds would be responsible for any expenses other than their own. Platinum settled the matter without admitting or denying the SEC's findings, and agreed to the imposition of a cease and desist order, disgorgement of more than $1.9 million, and a $1.5 million civil penalty.

On December 21, 2017, TPG Capital Advisors, LLC ("TPG") similarly settled claims with the SEC that it violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7, 206(4)-8 thereunder, arising from insufficient disclosure regarding the acceleration of monitoring fees paid by portfolio companies owned by private equity funds under TPG's management.[18] The SEC found that TPG disclosed its practice of entering into monitoring agreements with portfolio companies in its funds' private placement memoranda, limited partnership agreements, and management agreements; but the funds' formation and offering documents failed to disclose TPG's right to accelerate the fees owed to TPG upon

certain triggering events. While TPG's receipt of the accelerated monitoring fees was disclosed in its Form ADV filings, and in reports to funds' limited partner advisory committees, these disclosures were provided only after limited partners had made capital commitments to the funds. Based on these findings, the SEC found that TPG failed to adequately disclose its receipt of accelerated monitoring fees. Without admitting or denying the SEC's findings, TPG agreed to the imposition of a cease and desist order, disgorgement of over $9.8 million, and a $3 million civil penalty.

In all of these cases, the SEC also found that the investment advisers failed to implement adequate policies and procedures reasonably designed to prevent or detect overbilling, misallocations, or concealed fees.

More recently, on May 24, 2018, the SEC settled with investment adviser Aberon Capital Management, LLC and a managing member, Joseph Krigsfield, finding that they had intentionally misrepresented their hedge fund's performance and assets to investors and then received excessive advisory fees based on those inflated asset valuations.[19] As a result, the SEC found that Aberon and Krigsfield willfully violated the antifraud provisions of the Advisers Act. Without admitting or denying the SEC's findings, Aberon agreed to the imposition of a cease and desist order and a censure. Krigsfield agreed to the imposition of a cease and desist order, a collateral bar from association, and a penalty of $160,000.

PRACTICAL IMPLICATIONS

Between the SEC's OCIE Exam Priority letters, OCIE Alerts, enforcement cases, and speeches, the SEC has been transparent about its compliance expectations regarding advisory compensation and the lapses that rise to the level of a federal securities law violation. Advisers would be well advised to undertake a self-evaluation that includes the following:

- Review and update policies and procedures to ensure they are accurate, comprehensive, and reflect best practices.
- Be consistent in implementing these practices and clearly document the methodology in doing so.
- Review disclosures to investors and amend them as necessary to ensure they are consistent across all documents and with actual practice.
- Ensure that actual practices concerning assessment of fees and expenses are appropriate and comply with the Advisers Act.
- Regularly assess and refresh the compliance program to ensure it remains effective.
- Provide for periodic internal testing of billing practices to ensure compliance, as specifically noted in the Risk Alert.[20]
- Include in written procedures a clear, effective mechanism to mitigate and cure any deficiencies identified.
- Remediate any findings of improper or inaccurate charges swiftly.

Taking these steps will help prepare advisers for their next examination, and to the extent that exam deficiencies are still found, the self-evaluation and remediation undertaken may avoid an enforcement referral or action. In contrast, failure to perform a self-evaluation may tip the scales in favor of an enforcement referral, in light of the SEC's clear message.

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[1] SEC Office of Compliance Inspections and Examinations, National Exam Program Risk Alert, Vol. VII, Issue 2 (Apr. 12, 2018), *available at* https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf (hereinafter, "Risk Alert").
[2] SEC Office of Compliance Inspections and Examinations, National Exam Program Examination Priorities for 2014 at 4-5, *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.
[3] SEC Office of Compliance Inspections and Examinations, National Exam Program Examination Priorities for 2017 at 2, *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.
[4] SEC Office of Compliance Inspections and Examinations, 2018 National Exam Program Examination Priorities at 4-5, *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf.
[5] *Id.* at 4.
[6] "Spreading Sunshine in Private Equity," Andrew J. Bowden, OCIE Director, Remarks at the Private Equity International Private Fund Compliance Forum (May 6, 2014), *available at* https://www.sec.gov/news/speech/2014--spch05062014ab.html.
[7] *Id.*
[8] "Conflicts, Conflicts Everywhere," Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015), *available at* https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.
[9] *Id.*
[10] "Governance & Transparency at the Commission and in Our Markets," Chairman Jay Clayton, Remarks at the PLI 49th Annual Institute on Securities Regulation (Nov. 8, 2017), *available at* https://www.sec.gov/news/speech/speech-clayton-2017-11-08.
[11] *See also* King & Spalding, "SEC Highlights Latest Advisory Fee/Expense Compliance Issues" (Apr. 24, 2018), *available at* https://www.kslaw.com/attachments/000/005/791/original/ca042418.pdf?1524586487, for analysis of the OCIE Risk Alert.
[12] Risk Alert at 1.
[13] *See* Advisers Act § 205(a)(1) ("No investment adviser registered or required to be registered with the Commission shall enter into, extend, or renew any investment advisory contract . . . if such contract – provides for compensation to the investment advisers 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 § 205(a)(1)).
[14] *See* U.S. Securities & Exchange Commission, FY 2019 Congressional Budget Justification, FY 2017 Annual Performance Report & FY 2019 Annual Performance Plan at 106, *available at* https://www.sec.gov/files/secfy19congbudgjust.pdf. (Note that this statistic includes examinations of broker-dealer firms and other institutions, in addition to registered investment advisers.)
[15] *See* Risk Alert at 1 n.3.
[16] *In the Matter of Potomac Asset Management Co., Inc., et al.*, Advisers Act Rel. No. 4766 (Sept. 11, 2017) (settled order), *available at* https://www.sec.gov/litigation/admin/2017/ia-4766.pdf.
[17] *In the Matter of Platinum Equity Advisors, LLC*, Advisers Act Rel. No. 4772 (Sept. 21, 2017) (settled order), *available at* https://www.sec.gov/litigation/admin/2017/ia-4772.pdf.
[18] *In the Matter of TPG Capital Advisors, LLC*, Advisers Act. Rel. No. 4830 (Dec. 21, 2017) (settled order), *available at* https://www.sec.gov/litigation/admin/2017/ia-4830.pdf.
[19] *In the Matter of Aberon Capital Management, LLC & Joseph Krigsfield,* Advisers Act Rel. No. 4914 (May 24, 2018) (settled order), *available at* https://www.sec.gov/litigation/admin/2018/ia-4914.pdf.
[20] *See* Risk Alert at 4.