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SEC Highlights Latest Advisory Fee/Expense Compliance Issues

In recent years, the Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") has been paying close attention to the fees and expenses charged by private funds and their investment advisers. On April 12, 2018, the staff of OCIE released a risk alert that identified the latest list of compliance issues regarding advisory fees and expenses that frequently arise from its examination of SEC-registered investment advisers. This note briefly summarizes the issues identified by the OCIE staff and discusses best practices for private fund advisers to address these issues.

PRIVATE FUND FEE AND EXPENSE ISSUES

- *Incorrect Account Valuations in Fee Calculation.* Investment advisers used a different valuation metric or a different accounting process than what was disclosed, resulting in incorrect valuations and, therefore, given that fees are usually charged based upon those valuations, incorrect fee charges.
- *Improper Billing Frequency.* Investment advisers failed to follow their billing practice as stated in the advisory agreement or as disclosed in Form ADV Part 2. Specifically, OCIE staff noted instances where investment advisers billed their clients more frequently than what was disclosed, where they billed a new client in advance instead of in arrears as agreed upon in the advisory agreement and where they failed to prorate charges when the service began or terminated mid-cycle.
- *Incorrect Fee Rate.* Investment advisers applied a higher rate than what was in the advisory agreement, double charged a client or charged a non-qualified client performance fees based on a percentage of their capital gains in violation of Section 205(a)(1) of the Advisers Act.
- *Erroneous Application of Rebates and/or Discounts.* Investment advisers failed to apply discounts or rebates that a client is eligible for when calculating their advisory fees. This includes fee breaks when a client's account reaches a certain pre-arranged breakpoint level and any pre-agreed programs in which a client participated.



- *Insufficient Disclosure.* Investment advisers did not reflect their actual fees and billing practices accurately in Form ADVs. For instance, despite the maximum fee rate as disclosed in the Form ADV, a separate agreement was reached to charge a client in excess of such rate. Further, investment advisers failed to disclose certain fees and expenses that would be charged against their clients' accounts, in particular those incurred in connection with fees and service arrangements with third-party service providers as well as adviser's affiliates.
- *Expense Misallocations.* Fees and expenses were allocated to the wrong entity, usually resulting in a client's account rather than the adviser's account bearing the expense, in contravention of the applicable advisory agreement or Form ADV.

BEST PRACTICE FOR PRIVATE FUND ADVISERS

In light of the list above, it appears that, consistent with their past remarks and practices, the OCIE staff remains focused on fees and expenses, including, but not limited to, management, advisory and performance fees, whether such fees are properly disclosed, and whether clients are charged at the correct time for the correct amount. Therefore, investment advisers should review and assess (1) whether their regulatory filings, including Form ADVs, fund agreements, advisory agreements, private placement memoranda, pitch books and other marketing materials, investor due diligence questionnaires, and any other applicable disclosure documents have adequately and accurately captured all the fees and expenses charged to their clients, and (2) whether their actual practice is consistent with what has been disclosed. The foregoing is critical not only during a fundraising and offering process but also throughout the day-to-day operation of a private fund.

Additionally, investment advisers should adopt and implement written policies and procedures to identify any deficiencies in their disclosure regarding fees and expenses that they are charging or propose to charge. If a written program is already in place, investment advisers should consider whether it needs improvements in any of the areas highlighted in the above list. In any case, all policies and procedures should include a clear and effective mechanism to mitigate and cure any deficiencies identified. Moreover, they should also provide for periodic internal testing of billing practices to ensure compliance, as specifically noted by the OCIE staff. In cases where incorrect fees and expenses were charged, investment advisers should proactively address such mistakes, promptly reimburse their clients (including potentially with interest) and remediate any issues identified during the process.

Finally, investment advisers should allocate fees and expenses in accordance with the fiduciary duty they owe to each of the funds they manage. It is worth noting that over the past few years, the SEC has brought several enforcement actions related to expense misallocations against private fund advisers. By including this issue in their latest risk alert, OCIE staff again highlighted the significance for private fund advisers to develop and institute a written policy clearly describing their methodology of expense allocation, which should specify all expenses borne by the adviser and those borne by the fund and how they are determined during the actual fund operation period. Advisers that manage multiple funds should also address how fees and expenses incurred on behalf of more than one fund are allocated among those funds. Similar to fee billing procedures, allocation policies should be disclosed in regulatory filings, fund governance agreements, offering and marketing materials, information shared during investor due diligence process, and any other public disclosures. In practice, investment advisers should ensure their allocation policies are applied consistently and evaluated regularly to account for any changes in circumstances.

CONCLUSION

This latest risk alert signals that the SEC still views fees and expenses as one of the most important issues in adviser examinations. Investment advisers should consider taking measures to ensure their specific fee structure and relevant disclosure are in compliance with the Advisers Act, the rules promulgated thereunder and their fiduciary duty. The



Private Funds group at King & Spalding LLP is available to assist clients with their review and implementation of appropriate compliance procedures.

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