JACKO LAW GROUP, PC

Legal Risk Management Tip
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The SEC Reminds Advisers of the Importance of Proper Understanding, Disclosure and Assessment of Advisory Fees

A. Introduction

While it may seem obvious, proper disclosure and assessment of advisory fees is one of the most important aspects of the adviser-client relationship that some advisers are deficient in the eyes of the SEC staff. Disclosures concerning fees are paramount in allowing clients to make informed decisions as to whether to engage an adviser. Consequently, the fees actually assessed by the adviser should mirror those disclosed in advisory contracts and Form ADV. While conceptually this sounds straightforward, advisers continually find themselves in the cross-hairs of regulators for violations regarding fees. As a result, the SEC recently notified the financial industry that fees assessed to clients will be a point of emphasis during reviews. Specifically, the SEC is focusing attention on those advisers who are overcharging clients based upon fee disclosures made as part of the advisory firm's Form ADV and/or client agreement.[1]

B. Importance of Establishing Proper Advisory Fees

Prior to starting an advisory firm, and thereafter as the business model evolves, investment advisers must determine the type and amount of fees it will assess its clients for the performance of advisory services. While such fee types and amounts widely vary, firms should be mindful of applicable guidance in this area. For example, if assessing fees based upon a client's assets under management with the firm, the SEC has taken the position that advisers who charge fees that exceed industry norms (which, per the SEC, is no more than two percent (2%) of a client's assets under management[2]) may violate section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"), unless the firm discloses to existing and prospective clients that such a fee is higher than that charged by other advisers that provide the same or similar services. Certain state regulatory authorities have taken a similar approach in determining when advisory fees based upon assets under management may be excessive.[3]

There also are specific requirements that must be followed for particular fee arrangements. For example, with certain exemptions, Section 205(a) of the Advisers Act explicitly establishes a ban on performance-based fees for investment advisers. To assess such fee types, advisers must follow specific requirements set forth in exemptions within Section 205-3 of the Advisers Act.

Once the fee types and amounts are established, it is paramount that such fees are properly disclosed and assessed to the firm's clients. These processes carry several opportunities for violations of applicable regulations by advisory firms.

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[1] See *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, Office of Compliance Inspections and Examinations (Apr. 12, 2018) (pub. avail. at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf).

[2] *See* Equitable Communications Co., SEC Staff No-Action Letter (Feb. 26, 1975); Consultant Publications, Inc., SEC Staff No-Action Letter (Jan. 29, 1975); Financial Counseling Corporation, SEC Staff No-Action Letter (Dec. 7, 1974); John C. Kinnard & Co., Inc., SEC Staff No-Action Letter (Nov. 30, 1973).

[3] The State of Utah for example views advisory fees based upon assets under management that exceed 2% as "an unreasonable advisory fee" that is deemed a dishonest or unethical business practice under R164-6-1g(E)(10) of the Utah Administrative Code.

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C. Common Compliance Issues Related to Advisory Fees

In April of 2018, OCIE published a Risk Alert[4] that detailed the most frequent advisory fee and expense compliance issues identified in recent examinations of investment advisers. The areas discussed by OCIE in its report include the following:

- Fee-Billing Based on Incorrect Valuations;
- Billing Fees in Advance or with Improper Frequency;
- Applying Incorrect Fee Rate;
- Omitting Rebates and Applying Discounts Incorrectly;
- Disclosure Issues; and
- Adviser Expense Misallocations.

This is not an exhaustive list however. We've seen several instances where fees may be viewed as having been improperly assessed or disclosed. For example, OCIE has made known[5] that disclosures should be provided in the firm's Form ADV, detailing whether the firm includes cash and cash equivalents in tabulations for "assets under management" when assessing fees. Additionally, for firms utilizing margin accounts, it is very important to disclose whether the firm assesses fees on "gross" or "net" assets. In other words, will the firm only charge fees on the amount of assets in the underlying client account, or the margin portion of the account? For example, in an account reflecting $100K in equities, but $25K is attributable to margin, will only $75K will be included when determining fees or the full $100K? It is assumed that unless expressly disclosed otherwise, firms who utilize margin will only charge fees on the net amount (or the $75K amount, in the example above). Firms charging fees on the gross amount of assets must disclose this in their Form ADV and/or client agreement.

D. Practical Steps for Ensuring Compliance Related to Advisory Fees

The amount and types of advisory fees can also vary between firms and among clients or client types within a single firm, based on factors such as services provided, types of investments and structure, or type of client (*i.e.*, organized as a separate account versus private fund). Thus, the exact methodology employed by firms for the review, testing and disclosure of fees will also vary. That being said, there are steps that all firms should take to ensure compliance in this area. The following, while not an exhaustive list, provides some practical steps to be followed:

1. Review Current Disclosures

While they may occur elsewhere, disclosures related to fees must always be provided to clients as part of the firm's Form ADV disclosures and be included as part of the client agreement (often as an attached fee schedule but sometimes addressed or modified through a side letter or amendment). While advisory firms are required to update their Form ADV filings at least annually, there is no such requirement for client agreements. As such, firms will often make revisions to their Form ADV to update and amend their fee disclosures, but fail to make the corresponding revisions to their client agreement. The fees schedule that is detailed in an investment adviser's client agreements must generally match the fee schedule discussed in Item 5 of ADV Part 2A[6] and marked in Item 5.E. of Form Part 1. However, advisers may disclose that fees are negotiable without disclosing what precise lower rates have been agreed to with particular clients. If an investment adviser's business model changes, the investment adviser must ensure that any clients affected by

4 https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf).Id.

5 *Id.*

6 Such information may be omitted for any brochure offered only to certain "qualified purchasers."

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the change enter into new advisory agreements or an addendum to the current advisory agreement is made. Additional disclosures are required where fees include a performance component.[7]

2. Review Relationships with Third-Parties

Depending upon the business model of the firm, advisers will often utilize third parties to assist in certain aspects of firm activities. For example, most firms utilize the services of an unaffiliated qualified custodian to maintain custody of client assets. Often, such custodians will facilitate having advisory fees paid directly to the adviser from the client account[8] to save the adviser from having to invoice the client directly. The billing valuation and methodology employed by such custodians can vary, so it is important not to assume a particular billing practice. For instance, while it is common to value the client's assets under management as of the close of business on the last business day of the preceding calendar quarter; certain custodians instead employ an "average daily balance" valuation methodology. It is important to understand the utilized method to ensure that proper disclosures are made as part of the firm's Form ADV and client agreement.

Another example can be found when applying third-party advisers ("TPAs") to manage all or a portion of their client's assets. In these situations, the firm should disclose whether its fees are inclusive of, or in addition to, fees assessed by the TPA. If the TPA's fees are in addition to the firm's fees, it is important to also disclose when and how such fees are to be collected by the TPA.

3. Review Contracts

Advisers should periodically review client contracts, fee schedules and any related side letters to assure that fees are being billed as and at the rates set forth therein. The methods for calculating the fees and the assets on which they are charged sometimes vary and, for each client, must be as stated in the applicable agreements. This is particularly important when fees are subject to asset based breakpoints which may apply on a "householding" basis, such that the total value of a relationship might trigger a different fee rate when a breakpoint is reached at the relationship level, although no breakpoint might have been reached in any particular account within the relationship on a stand-alone basis. Additionally, advisers who agree to "most favored nation" clauses ("MFN") should make sure that they are vigilant in reviewing future contracts and contract amendments to determine if any MFN is triggered, particularly as MFNs often require a degree of similarity as to size and type of account (or exclude certain types of other clients) as a condition precedent to a notice or fee rate adjustment. Where an MFN is triggered, advisers should promptly notify the impacted client(s) benefiting from the MFN and/or proactively adjust the fee rate, as required by the particular MFN. Advisers should consider maintaining an easy reference such as a matrix of all their client contracts, including such relevant data as fee rates, breakpoints and MFNs to facilitate compliance with contractual requirements and to help in testing the adviser's billing practices.

4. Testing of Billing Practices

Advisory firms registered with the SEC are required by the Compliance Program Rule to perform an annual review of the firm's policies and procedures. Part of that review should include firm billing practices. What tests should be performed will differ based upon the activities of the firm. However, at a minimum, the following tests should be considered:

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7 In particular, advisers should describe the fees used as well as relevant risks and conflicts and, if some but not all clients pay performance-based fees, further disclosure related to "side-by-side" management conflicts must be included. *See* Form ADV, Part 2A, Item 6. Such

8 Advisers who perform such billing practices are subject to 206(4)-2, the "custody rule," under the Advisers Act.

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- Sample a statistically relevant number of client accounts that were previously billed to ensure that fees assessed match with fees disclosed in the respective client agreement and the firm's Form ADV;
- If a "sliding" or "tiered" fee schedule is utilized, test to make sure clients are being billed such amounts as may be dictated by the schedule, and that any growth/reduction in client accounts that would cause the client to receive higher/lower fees as a result is properly monitored and reflected in the billing;[9]
- Review any unique client billing arrangements or fee structures whereby the client has negotiated fees that may differ from the firm's traditional fee structure to ensure accurate billing practices;
- Review the firm's polices related to aggregation of client accounts for billing and breakpoint purposes (*i.e*., by household, by client, etc.) and sample a statistically relevant number of client accounts to ensure such aggregation practices have been followed; and
- Test any performance-based fee arrangement for conformity with the advisory contract and disclosures, proper calculation and compliance with Section 205(a)(1) of the Advisers Act or the available exceptions thereunder (*i.e.*, the qualified client exception).
- Confirm that any MFNs have not been triggered or, if triggered, an appropriate notice and/or adjustment has been provided to impacted clients.

As mentioned above, while firms should be performing such reviews no less than annually, changes in firm practices or regulatory changes could cause the firm to perform such reviews more often. The timing and frequency should be predicated upon the facts and circumstances unique to the firm.

5. Utilize Software

For those firms that employ a quarterly or monthly billing schedule, the client billing process can be onerous. Furthermore, billing clients based on the average daily account balance becomes even more difficult without technology support. It's also important to note that many state-registered advisory firms are required to send separate billing invoices to clients in addition to statements sent by the client's custodian. Investing in the proper technology can help simplify and automate the client fee billing and invoicing process to improve operational efficiency and reduce errors.

E. Conclusion

With the SEC's increased focus on the disclosures and assessment of advisory fees, it is critical that firms review their current practices to ensure they are in alignment with all applicable regulations. As stated by OCIE in their Risk Alert, "in response to OCIE staff's observations, some advisers have elected to change their practices, enhance policies and procedures, and reimburse clients by the overbilled amount of advisory fees and expenses." Whether, some or all of these, outcomes are applicable to a given firm depends on the facts and circumstances surrounding the firm's current practices. Working with an attorney, or other compliance professional familiar with these rules and regulations can assist in the review process.

[9] As noted earlier, it is important to also be cognizant of the basis on which breakpoints are measured.

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For more information on how JLG can assist in evaluating your valuation practices, please contact us at (619) 298-2880.

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