TRANSPARENCY AND ACCURACY: OBSERVATIONS FROM THE SEC RISK ALERT ON FEE AND EXPENSE DEFICIENCIES

Date: 1 May 2018

U.S. Investment Management Alert

In a recent risk alert ("Risk Alert") issued by the Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE"), OCIE Staff summarized the most frequent fee and expense deficiencies identified in recent SEC examinations of registered investment advisers. [1]

DOES THE RISK ALERT CONTAIN ANY NEW GUIDANCE FOR INVESTMENT ADVISERS?

The Staff does not intend for the Risk Alert to provide new guidance. Nevertheless, the Risk Alert identifies the top fee and expense deficiencies identified by the Staff in over 1,500 examinations over the last two years. In that respect it provides valuable information for investment advisers on the most common expense-related deficiencies, which can be used to assess one's own compliance program. The Risk Alert is intended to encourage investment advisers to assess their disclosures and the effectiveness of their compliance controls related to fees and expenses. As such, it is an important reminder to all investment advisers to rigorously review their expense and fee-related practices, to exercise care when disclosing, calculating, and collecting fees from clients and investors in managed funds, and to ensure that their policies and procedures are tailored to reflect their actual practices.

WHAT ARE SOME EXAMPLES OF THE DEFICIENCIES THAT THE RISK ALERT IDENTIFIES?

- *Errors Related to Fees and Expenses*. The Staff noted repeated examples in which billing and expense practices did not match the practices disclosed in relevant disclosure documents. The Staff highlighted issues such as the timing of fee calculations, incorrect fee rates, and failure to apply discounts or rebates disclosed or agreed to with clients and fund investors. The Staff noted that some managers have adopted periodic internal testing of billing practices and proactively reimbursed investors that were charged incorrect fees and expenses. While the Staff did not expressly state that it considers this to be a "best practice," in light of OCIE's ongoing focus on fee and expense errors and the Staff's inclusion of this observation in the Risk Alert, we believe that the Staff looks favorably on managers that engage in this practice.
- *Fees Assessed on Incorrect Valuations*. As a result of incorrect valuations, the Staff has observed that investors may be charged higher fees than would have been warranted if managers adhered to appropriate valuation practices. For example, a fund's documents may state that fees are calculated based on fair market value, while fees are actually assessed based on the cost of an asset. The Risk

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Alert also highlighted simple errors in the valuation of securities accounts used to calculate fees, such as the inclusion of cash and cash equivalents in account values where relevant disclosures and agreements call for the exclusion of cash when calculating fees.

- *Disclosure of Fees*. The Staff observed that disclosure documents often do not accurately or completely disclose fees paid to the adviser or additional markups borne by clients. For example, the Staff identified failures to disclose that a client may incur additional expenses with respect to certain transactions or that managers may benefit from fee-sharing arrangements with affiliates.
- *Adviser Expense Misallocations*. The Staff also highlighted several issues related to the misallocation of expenses charged to both private and registered funds. The Risk Alert specifically mentions the allocation of client funds to distribution and marketing expenses, regulatory filing fees, and travel expenses as common deficiencies. While these expenses may be allocated to a fund with appropriate disclosure, the Staff highlighted that such allocations must not be made in contravention of the applicable agreements and disclosures.

HOW SHOULD THE RISK ALERT BE VIEWED IN THE CONTEXT OF RECENT SEC ENFORCEMENT ACTIONS?

A series of enforcement actions brought against private equity fund managers over the last few years have demonstrated that the SEC and its Staff are focused on fee and expense transparency. [2] We believe that the Risk Alert should be viewed both as an extension of these efforts and a warning to investment advisers of all stripes that the Staff's interest in fee and expense transparency is not limited to the private equity industry. While recent enforcement actions against private equity firms have focused on the disclosure of fees prior to an investor signing a subscription agreement — and managers that disclose fee and expense practices after a subscription agreement is signed have not been spared [3] — all investment advisers, including advisers to hedge, venture capital, and real estate funds, should ensure that fee and expense disclosures are accurate and complete and that billing practices are clear and followed with care.

WHAT ARE THE PRACTICAL TAKEAWAYS FROM THE RISK ALERT?

The Risk Alert can serve as more than a warning; investment advisers should consider benchmarking their own policies and practices against the Staff's observations. Managers should also consider whether disclosures across fund governing documents, private placement memoranda, investment management agreements, Form ADV, side letters, and audited financials are consistent and accurate and whether their policies and procedures provide adequate controls to ensure that fee and expense disclosures are followed in practice. As noted above, the Risk Alert appears to endorse periodic internal testing of billing and expense practices as one way to achieve this goal.

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[1] *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, SEC (April 12, 2018).

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[2] *See, e.g., In re* TPG Capital Advisors, LLC, Advisers Act Release No. 4830 (Dec. 21, 2017); *In re* Blackstreet Capital Management, LLC and Murray N. Gunty, Securities Exchange Act Release No. 77959 (June 1, 2016); and *In re* Blackstone Management Partners, L.L.C., Advisers Act Release No. 4219 (Oct. 7, 2015).

[3] K&L Gates previously discussed the SEC's recent focus on fee and expense related issues in *SEC Broadens Enforcement Activity Related to Private Equity Fees and Expenses — And Narrows the Opportunity for Managers to Correct Past Deficiencies*; and *The SEC's Office of Compliance Inspections and Examinations and FINRA Announce 2018 Examination and Regulatory Priorities*.

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