OCIE Publishes Risk Alert Regarding Most Frequent Advisory Fee and Expense Issues Identified in Investment Adviser Examinations

On April 12, 2018, the staff of the Office of Compliance Inspections and Examinations ("OCIE") published a National Exam Program Risk Alert (the "Risk Alert") on the most frequent compliance issues relating to advisory fees and expenses charged by registered investment advisers identified in deficiency letters from OCIE examinations of investment advisers.[1] The Risk Alert reflects issues identified in deficiency letters generated in the course of over 1,500 adviser examinations conducted by OCIE staff over the past two years. The most frequent deficiencies identified by OCIE staff were reported in the following six primary areas:

1. *Fee-Billing Based on Incorrect Account Valuations*

   OCIE staff observed that advisers frequently incorrectly valued client assets, resulting in overbilled advisory fees. For example, OCIE staff observed that certain advisers valued client assets using a different metric or valuation process than was specified in the client's advisory agreement.

2. *Billing Fees in Advance or with Improper Frequency*

   OCIE staff observed that advisers (1) billed fees on a monthly basis instead of a quarterly basis as stated in the client's advisory agreement or in the adviser's Form ADV Part 2; (2) billed fees in advance, despite disclosure in the client's advisory agreement that clients would be billed in arrears; (3) billed new clients for advisory fees in advance for an entire billing cycle instead of pro-rating the fees to reflect that the advisory services began mid-billing cycle; and/or (4) did not reimburse a pro-rated portion of a client's advisory fees when the client terminated the advisory services mid-billing cycle.

3. *Applying Incorrect Fee Rate*

   OCIE staff observed that advisers applied a higher fee rate than was agreed to in the advisory agreement, double-billed clients, and/or charged performance fees to a non-qualified client.

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

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4. *Omitting Rebates and Applying Discounts Incorrectly*

   OCIE staff observed that advisers did not apply certain discounts or rebates to their clients' advisory fees, as stated in the clients' advisory agreements. For example, certain advisers did not apply fee reductions when the value of a client's account reached a certain prearranged breakpoint level, and certain advisers charged wrap program clients additional fees for transactions that qualified for the program's bundled fee.

5. *Disclosure Issues Involving Advisory Fees*

   OCIE staff observed that advisers made Form ADV disclosures that were inconsistent with their actual practices, such as advisers that disclosed a maximum advisory fee rate in their Form ADV, but nevertheless charged a client a fee rate exceeding the disclosed maximum rate. OCIE staff also observed that advisers did not disclose certain additional fees or markups in addition to the advisory fees, such as expenses for third-party execution and clearing services and fee sharing arrangements with affiliates.

6. *Expense Misallocations*

   OCIE staff observed that advisers allocated distribution and marketing expenses, regulatory filing fees, and travel expenses to clients in contravention of provisions in the applicable client agreements or other disclosures made by the adviser.

The Risk Alert highlights the recent focus of the U.S. Securities and Exchange Commission (the "SEC") on the fee and expense practices of, and related disclosures by, registered investment advisers. In the past several years, the SEC has brought numerous enforcement actions against registered investment advisers for, among other things, inadequate disclosures regarding fee and expense practices, misallocation of fees and expenses, and improper calculation or billing of advisory fees. The Risk Alert encourages advisers to assess their advisory fee and expense practices and related disclosures to ensure that they are complying with the U.S. Investment Advisers Act of 1940, as amended, the rules thereunder, and their fiduciary duty. The Risk Alert also encourages investment advisers to review the adequacy and effectiveness of their compliance programs. As with other OCIE risk alerts, this Risk Alert could serve to signal the industry that the SEC is unlikely to be lenient in future enforcement cases regarding fee and expense practices, and all investment advisers should review their current fee and expense practices to ensure compliance with their stated policies, procedures, and disclosures to clients.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed on the next page:

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