

Chapman Client Alert

April 16, 2018

Current Issues Relevant to Our Clients

SEC Staff Highlights Investment Adviser Fee Compliance Issues

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") recently published a Risk Alert that highlights frequently-identified investment adviser fee and expense compliance issues from exams of over 1,500 investment adviser examinations during the past two years. The Risk Alert highlights the following deficiency areas:

- Incorrect account valuations
- Improper timing or frequency
- Incorrect fee rate
- Incorrect or omitted discounts and rebates
- Disclosure issues
- Improper expense allocations to private and registered funds

Investment advisers should consider reviewing their practices and compliance policies related to these issues to ensure compliance with fee and expense provisions in advisory agreements (and related agreements) and disclosures to clients. An adviser who fails to adhere to the terms of these agreements and disclosures may violate Section 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act") and related rules, antifraud rules, the adviser's own compliance policies and procedures required under the Advisers Act rules, and the advisory agreement and related agreements with its client. The Risk Alert is available [here](#).

Fee-Billing Based on Incorrect Account Valuations

OCIE observed advisers that incorrectly valued certain assets in clients' accounts resulting in overbilled advisory fees. These issues included using a different metric or different process than specified in the advisory agreement. For example, an adviser might have used an asset's original cost rather than fair market value or an adviser might have used the market value of assets in an account at the end of a billing cycle instead of using the average daily balance over the entire billing cycle.

Billing Fees in Advance or with Improper Frequency

OCIE observed issues with the timing and frequency of billing advisory fees. For example, this could include billing fees monthly when an advisory agreement or Form ADV provided for quarterly billing, billing fees in advance when an agreement provides for billing in arrears, or failing to pro-rate fees for new clients or reimburse clients who terminate services mid-cycle contrary to agreements or Form ADV disclosures.

Applying Incorrect Fee Rate

OCIE found cases where advisers applied an incorrect fee rate when calculating the advisory fees charged to certain clients or double-billed a client. OCIE also found cases where an adviser charged performance fees based on capital gains to non-qualified clients in violation of Advisers Act Section 205(a)(1) and Rule 205-3.

Omitting Rebates and Applying Discounts Incorrectly

OCIE observed advisers that did not apply discounts or rebates as specified in advisory agreements or Form ADV disclosure. These instances included not aggregating accounts for members of the same household when agreements or Form ADV provided for breakpoint aggregation, not reducing fees at stated breakpoints and charging additional fees (e.g., brokerage fees) when a client was in a wrap fee program and transactions qualified for a bundled fee.

Disclosure Issues Involving Advisory Fees

OCIE noted various issues relating to disclosure of fees or billing practices. OCIE noted cases where an adviser's actual practices were inconsistent with Form ADV disclosure, such as charging certain clients fees in excess of a maximum rate stated in Form ADV. OCIE also found cases where advisers did not disclose additional fees or markups collected by the adviser. These cases included failure to disclose that an adviser collected expenses from a client for third-party execution and clearing services that exceeded the actual fee charged for those services by the outside clearing broker or that an adviser earned additional compensation on certain asset purchases for client accounts or that they had fee sharing arrangements with affiliates.

Adviser Expense Misallocations

OCIE observed advisers to private and registered funds that misallocated expenses of the funds, including allocating

distribution and marketing expenses, regulatory filing fees and travel expenses to the clients instead of the adviser, in contravention of advisory agreements, related agreements or other disclosures.

What To Do Now

Advisers should review their advisory fee and expense compliance policies and procedures, as well as actual practices, in light of the Risk Alert to ensure that all billing practices are consistent with all client agreements and disclosures to clients as well as regulatory and fiduciary obligations.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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