

Alert

OCIE Issues Risk Alert on Fees and Expenses

April 17, 2018

On April 12, 2018, the Office of Compliance Inspections and Examinations (“OCIE”) of the SEC released a National Exam Program Risk Alert identifying several issues relating to fees and expenses charged to clients by SEC-registered investment advisers.

Fees and expenses have been a consistent focus of SEC examinations and enforcement actions for the past several years, and the Risk Alert highlights how important these issues are to OCIE. In particular, it identifies several common types of deficiencies with respect to fees and expenses. Some involve mistakes in calculations while others involve the interpretation of disclosure language and the implementation of allocation methodologies. Private fund advisers should view the Risk Alert as an impetus to (i) review their policies and practices with respect to advisory fees and expenses; (ii) confirm and document that their practices are consistent with their compliance policies and with disclosures made to clients and investors; and (iii) prepare for the requests and questions regarding fees and expenses that are likely to come up during an OCIE examination. Advisers also should try and identify possible weaknesses in their processes and evaluate the efficacy of their procedural checks and balances.

The Risk Alert covers several areas that are of significance to private fund advisers, some of which are highlighted below.

Valuation

OCIE noted a number of frequent deficiencies in advisers’ valuation of client assets, often resulting in inflated advisory fees. Specifically, OCIE cites two common types of valuation deficiencies:

- Advisers using a metric that differs from that which was disclosed (e.g., valuing an illiquid asset at cost rather than at fair market value); and
- Advisers valuing assets using a process other than that which was disclosed (e.g., using market value at the end of a cycle rather than using an average daily balance).

This is consistent with our experience advising clients in SEC examinations, where OCIE staff often requests materials related to an adviser’s valuation process, including valuation policies and procedures, valuation committee documentation (e.g., charters, agendas, meeting minutes and resolutions) and materials related to services performed by independent third-party valuation firms. OCIE staff frequently compares these materials against disclosures made to clients and investors to confirm whether internal practices align with the disclosures. In certain situations, OCIE staff will also examine the rigor of an adviser’s valuation process in order to address whether the adviser is fulfilling its fiduciary duties, even when valuation processes are consistent with applicable disclosures.

Disclosure

The Risk Alert identifies issues related to inconsistencies between advisory fee billing practices and disclosures made in the adviser's Form ADV, as well as failures to disclose additional fees, fee-sharing arrangements or other sources of compensation. Specifically, OCIE notes instances where advisers did not disclose:

- Fee-sharing arrangements with affiliates;
- Compensation on asset purchases; and
- Collection of brokerage expenses exceeding the cost for those services.

During examinations, OCIE staff often compares fee disclosures (both in the Form ADV and in the fund offering documents) against actual billing practices. It is, therefore, important to routinely benchmark an adviser's billing practices, which can change over time.

Expense Allocations

The Risk Alert reiterates the importance of allocating expenses to clients in accordance with applicable disclosure documents and, in particular, notes misallocations of:

- Marketing expenses;
- Regulatory filing fees; and
- Travel expenses incurred by advisory personnel.

OCIE notes that this has been a particular area of concern for advisers to private funds.

OCIE staff has consistently inquired about these issues during the course of examinations, including asking to interview accounting personnel to review the expense payment process, requesting expense policies and any expense allocation matrices and comparing expense allocation disclosure provided to clients against actual practices. Maintaining an up-to-date expense matrix and including expense testing as part of the annual compliance review are helpful practices to prepare for OCIE's questions during examination.

OCIE also seeks to understand advisers' financial relationships with third parties and service providers, often asking for information regarding relationships with consultants, joint ventures and other businesses in which the adviser or its personnel have an interest, to determine any undisclosed sources of compensation. To the extent that any third parties are affiliated with (or have commercial or financial ties with) an adviser, these relationships should be scrutinized in advance of an examination, and any changes to the adviser's disclosures implemented.

Substantive Review

OCIE is also focused on mistakes in the financial calculation process. The Risk Alert highlighted examples of mistaken implementation and poor internal controls that can lead to improper charges to client accounts, including:

- Improper billing frequency;
- Failing to apply fee rebates and discounts; and

- Applying incorrect fee rates.

On examination, OCIE staff frequently requests data used in fee calculations and will “check the math” on the adviser’s calculations.

This OCIE Risk Alert is a reminder of the SEC’s ongoing focus on fees and expenses, and the continued deficiencies OCIE finds. Compliance in this area requires detailed analysis of the relevant disclosures and practices, as well as an ongoing review.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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