Why Advisory Fees and Expenses Remain a Continued Regulatory Focus

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Introduction

In recent years, firms in the industry have needed to increase their focus on disclosures related to fees and expenses, particularly in light of the U.S. Securities and Exchange Commission's ("SEC") April 2018 *Risk Alert*.[1] The same compliance issues outlined in that 2018 Risk Alert continued to be echoed in the staff's examination priority letters of 2019 and 2020. In 2019, one of the most impactful statements of the SEC Exam Priority summary highlights the importance of this topic, "Every dollar an investor pays in fees and expenses is a dollar not invested. [Therefore,] it is critically important that investors are provided with proper disclosures of the fees and expenses they pay for products and services..."[2] This issue was further highlighted in the 2020 SEC Exam Priority when the staff emphasized that examiners will "continue to examine RIAs to assess whether, as fiduciaries, they have fulfilled their duties of care and loyalty....[D]uty of care concerns may arise when an RIA does not aggregate certain accounts for purposes of calculating fee discounts in accordance with its disclosures."[3]

Fast forwarding to the 2020 *Risk Alerts*, the SEC's Office of Compliance Inspections and Examinations ("OCIE") continued its crusade for protecting investors' assets. In the August 12, 2020 *Risk Alert*, "Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers" the staff highlighted the need for compliance efforts to focus on practices relating to fees and expenses during the pandemic. Specifically, the staff noted the concern for misconduct involving advisory fee calculation errors resulting in overbilling, inaccurate calculation of tiered fees from failure to aggregate client accounts and provide breakpoints and failure to refund prepaid fees for terminated accounts.[4] These issues were further reiterated just three months later in the November 9, 2020 *Risk Alert,* "Observations from OCIE's Examination of Investment Advisers: Supervision, Compliance and Multiple Branch Offices." The staff shared that they observed weaknesses in policies and procedures related to fees and expenses and stressed, "most fee billing issues were related to the lack of oversight over fee billing processes... [which] resulted in overcharges to clients."[5]

In this article, we will focus on why calculation of advisory fees and expenses remain at the top of the SEC's examination priority list. We will consider the challenges that investment advisers face and using a case study, explore potential internal controls that compliance programs may wish to consider going forward to address these concerns.

Why Advisory Fee and Expense Issues are So Prevalent

When an investment adviser commences business, strategic decisions are made about what products and services will be offered and the fees that will be assessed. In order to remain competitive in the marketplace, some investment advisers decided to have a tiered fee schedule, so that as a client's asset size grew, the adviser would lower the client's advisory fee. Frequently, as clients gained confidence in the adviser's capabilities, over time those clients would add additional assets for the investment adviser to manage. Other times, to encourage additional asset transference, the advisory firm's sales team would stress that when additional assets were added to the client's account, that could entitle all accounts to a breakpoint (or lower fee). The lower tiered fees were generally memorialized in the adviser's Form ADV Part 2A and the client's investment advisory agreement.

1. *See* https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.
2. *See* https://www.sec.gov/files/OCIE%202019%20Priorities.pdf at page 6.
3. *See* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf at page 10.
4. *See* https://www.sec.gov/files/Risk%20Alert%20-%20COVID-19%20Compliance.pdf at page 4.
5. *See* https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf at page 4.

Over time, particularly as advisory businesses grew and geographically dispersed branch offices opened, the methodology for aggregating client accounts for purposes of achieving a breakpoint were not consistently applied or communicated. In some instances, advisory firms allowed the investment adviser representative ("IAR") to bill the client directly and "negotiate" the client's fees. In other instances, the IAR decided not to aggregate certain client accounts because the client was concerned that the household members would be able to calculate how much in assets that individual client had, which the client did not wish to disclose. Alternatively, some IARs did not wish to aggregate accounts due to the amount of servicing that the IAR provided to the end client. However, in nearly all cases the compliance issue was easy to identify: investment advisers failed to define and disclose who is in a "household," failed to disclose when a higher or lower advisory fee could be assessed and how this would be communicated; failed to disclose when and under what circumstances an additional fee or expense could be assessed and failed to have a uniform policy for consistently calculating the firm's advisory fee.

As the SEC and state regulators continue to examine advisory fee and expense issues, it is important for advisory firms to assess how they are calculating advisory fees. Consider how the firm:

- Values client assets and by whom (e.g., as of the last day of the calendar quarter as calculated by the qualified custodian);
- Defines a household (e.g., by all persons living at the same residential address or by relational definition – husband/wife/partner and minor offspring);
- Reimburses terminated client accounts;
- Offsets 12b-1 fees from certain mutual fund purchases;
- Discloses additional expenses that it may impose on clients (e.g., an additional client reporting fee);
- Allows for and documents exceptions for fees charged differently than the published tiered fee schedule; and
- Trains IARs on how to present the concept of fee aggregation and related conflicts of interest to clients.

Advisers have a fiduciary obligation to do what is in the best interest for all of the firm's clients. This duty must be viewed at an enterprise level and not on an individual IAR by IAR level. During regulatory exams, if the staff determines that clients have been inappropriately charged (e.g., due to the fee billing schedule in an advisory contract being lower than what the client was actually assessed), the advisory firm is encouraged to make investors whole. Dependent upon whether there has been a systemic problem over a period of years, the reimbursement to investors could be significant.

Challenges Faced by Investment Advisers

For those investment advisers that may have independent contractor IARs, or who have recently merged with another adviser, it can be challenging to come up with a unified tiered fee schedule that is consistently applied (particularly, when historical behaviors are to negotiate advisory fees on a client by client basis). It is perhaps even more challenging to disclose in the firm's brochure, contracts and other collateral the conflicts of interest that exist if a unified fee schedule is *not* employed and consistently applied and how, under that schematic, the RIA is fulfilling its duties of loyalty and care.

Aggregation of client accounts also can pose a problem.[6] If, for example, a long-term client refers a family member (such as a brother or sister) to the firm, the IAR may be inclined to negotiate aggregation of those accounts with the other family members' accounts – even if that is counter

6. Consider other advisory fee issues highlighted *In the Matter of Transamerica Financial Advisors, Inc.*, Advisers Act Rel. No. 3808 (Apr. 3, 2014), whereby the adviser failed to apply advisory fee discounts to certain retail clients contrary to disclosures to clients and its policies and procedures.

to the firm's household policy. While exceptions can perhaps be made (dependent upon disclosures, facts and circumstances) the question remains - if an exception is granted, should it be extended to *all clients* so that they would be given an opportunity to receive their own fee discount.

Finally, the culture of the firm may not be conducive for unified fee billing. If, for example, IARs have been permitted for years to independently bill or negotiate client fees as the IAR sees fit, it will be challenging – but not impossible – to now go back and aggregate client accounts, as appropriate, for purposes of calculating fee discounts in accordance with a unified tiered fee schedule. In some cases, this could result in clients paying a lower advisory fee; but in others, this could lead to a higher fee, which will reduce the client's returns and negatively impact the client relationship.

Ultimately, each investment adviser must evaluate how it will assess advisory fees. This requires analysis of what fee schedule should be used, how client assets will be valued, what operation systems can be used to calculate fees and who will oversee the process to ensure that advisory fees are calculated accurately and in accordance with client contracts. To be effectively implemented, the advisory firm must develop internal controls to: (i) supervise fee billing, (ii) address consistent application of aggregation of client accounts, (iii) document fee billing exceptions and (iv) implement policies and procedures for supervising IARs (particularly in remote locations) and assessing their compliance with the fee billing protocols set forth by the firm, including adherence to terms of the client's investment advisory agreement.

Case Study

You are the new CCO of an East Coast advisory firm that has just acquired a large team in Arizona. You discover that the way the Arizona-based IARs traditionally have provided advisory services to their clients is very different. Each Arizona-based IAR can negotiate advisory fees directly with his/her client and has the ability to determine how accounts are aggregated. Conversely, the main office uses a uniform tiered fee schedule, aggregates accounts based on residence, typically limits exceptions and does not negotiate fees.
During COVID-19, you are challenged. Unable to travel to Arizona, you are trying to determine how to supervise the Arizona IARs and assess:

- Whether the fees being assessed are consistent with client agreements and disclosures;
- If there are risks associated with the Arizona-based advisors' fee calculation practices
- If there is a clear definition of "household" for purposes of account aggregation; and
- Whether any Arizona-based clients were overbilled as a result of potential inconsistent billing practices.

Q: What steps would you take to assess whether compliance issues exist?

There are numerous approaches that could be taken. One of the most important steps is to interview the Arizona-based IARs to determine if advisors used different approaches for aggregating client accounts that differed from disclosures provided in the client agreements. Sample the investment advisory agreements and see whether the stated advisory fee amounts

(particularly in older, legacy agreements) differ from the current fees assessed to client accounts. If they do differ, determine if the fee is greater or less than specified in the client agreement, and if higher, ascertain whether the client should receive a refund for overbilling. Throughout the process, document who was interviewed, what records were reviewed, the time period for the analysis and your findings. Involve Operations and Finance for additional feedback and

historical information. Review any standard operating procedures that the Arizona office used for calculating advisory fees and billing of clients and determine if gaps exist. Finally, determine the effectiveness of client communications when changes in advisory fee billing occurred. See if client agreements were amended to reflect the new advisory fee. Verify if training on advisory fee billing occurred and what systems, if any, were used to assist in the fee billing process. Provide findings to senior management with recommendations on how to best centralize processes for the entire organization.

Conclusion

No compliance program is one-size fits all. It is imperative for investment advisers to customize policies, procedures and practices to their firm based on the organization's business model. However, when testing and assessing internal controls, it is important to consider those higher risk areas identified by the SEC and consider the staff's observations regarding compliance best practices. This may help the adviser to determine if enhancements should be considered for a particular area.

Based on the regulatory guidance provided in 2020 for advisory fees and expenses, if possible, implementation of a centralized, uniform processes to manage client fee billing is important. This approach can help to set expectations with clients and your IARs, allow for easier implementation of systematic controls, and could help to enhance compliance monitoring and supervisory oversight. The SEC exam staff continues to focus on this area because it is directly correlated with the protection of investors. Therefore, it is prudent for all advisers to reassess their fee billing controls in accordance with the regulatory guidance provided to date. ■