Investment Management Alert

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The SEC's Multipronged Focus on Advisory Fees—Implications for Private Fund Managers

November 30, 2021

Any doubts over whether the U.S. Securities and Exchange Commission considers advisory fees to be a focus area for 2022 were dispelled over the past several weeks. In four separate public statements, the SEC and the Staff of the Division of Examinations have set the stage for a comprehensive review of the "market" for advisory fees in a private funds context, as well as for a potentially intense review of how fees are disclosed, calculated, and assessed by private fund managers.

The Tone at the Top

The highest profile statement on advisory fees came from SEC Chairman Gary Gensler, who, in recent remarks at the Institutional Limited Partners Association Summit,[1] asserted that fees in the registered funds space have come down considerably since his time on Wall Street, while those in the private funds space have not dropped to the same degree—even as aggregate private fund assets have increased. Benchmarking off the "2-and-20 model," the Chairman argued that advisory fees, when combined with fees for other services that private equity sponsors and other private fund managers may charge, are "pretty significant to our economy and our capital markets. Hundreds of billions of dollars in fees and expenses are standing between investors and businesses." The Chairman announced that he has asked the SEC Staff, in an effort to stimulate "more competition" and "greater efficiencies" to the private funds space, to consider rulemaking recommendations aimed at "greater transparency to fee arrangements."

Guidance from the Examinations Staff

Chairman Gensler's focus on fee transparency is directionally consistent with three recent Risk Alerts from the Division of Examinations:

- *Investment Advisers' Fee Calculations Risk Alert*. In a November 10, 2021 Risk Alert, the Division of Examinations Staff summarized numerous shortcomings and deficiencies from a national initiative focused on advisory fees, comprising approximately 130 examinations of retail advisers. The Staff reported numerous errors in the actual calculation of fees, as well as "a range of disclosure issues" regarding advisory fees. Advisers, for example, reportedly used inaccurate account valuations for fee calculations for clients, as well as incorrect fee schedules. In

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addition, many of the advisers examined in the sweep "did not maintain written policies and procedures addressing advisory fee billing, monitoring of fee calculations and billing, or both."

- *Registered Investment Company Exam Initiative Risk Alert*. In late October, the Division of Examinations Division Staff published the results of a two-year review of advisers to registered funds. Among other things, the Staff observed weaknesses in these advisers' oversight of fees and expenses. This Risk Alert cited advisers that failed to properly monitor the allocation of expenses between funds and their advisers, as well as failures to surveil for discrepancies between a fund's actual expense calculations and the governing expense provisions. The Staff further highlighted the failure of many advisers' compliance programs to ensure that fee and expense disclosures in fund advertisements and sales literature were "fair, balanced and not misleading within the context they are made."
- *Electronic Investment Advice Risk Alert*. A third Risk Alert, issued a day prior to the "Fee Calculations" Risk Alert, focused on advisers that provide electronic investment advice (e.g., "robo-advisers"). The Staff's fee-related guidance in this publication echoed the themes of the Risk Alerts discussed above: The Staff reported encountering inaccurate or incomplete disclosure of fees on Form ADVs, as well as inconsistent disclosures in different documents regarding how advisory fees are calculated.

Next Steps for Private Fund Managers

While some in the private funds industry may seek to downplay or dismiss these three Risk Alerts—given their focus on retail investors and publicly accessible investment vehicles—that would be a mistake. While these examinations focused on advisers servicing retail clients, almost all of the areas of concern are transferable to private fund managers. Chairman Gensler's message may well serve as a clarion call, not just to the rulemaking personnel of the SEC to change disclosure standards, but to the Staff of the Divisions of Examinations and Enforcement to actively uncover and sanction wrongful or negligent activities associated with the administration of advisory fees in the private fund arena.

Accordingly, private fund managers should consider taking steps to make sure their compliance programs—literally—operate as advertised. The trio of Risk Alerts encourages managers to consider some or all of the following actions:

- A critical and wholesale review of fee disclosures to ensure that disclosures are internally consistent and that the disclosures in offering documents match the fee provisions of the funds' constituent documents.
- A forensic review of the fee administration process to ensure that the manner and scope of fees collected match the applicable disclosures.
- Targeted testing to ensure the fee calculations are correct in design and application.

In addition, private fund managers should consider whether they need to add or revise their policies and procedures related to assessing advisory fees to accommodate the conclusions of any review.

Private fund managers should also determine if their internal resources are sufficient to conduct any review, or whether it would be prudent to engage external specialists to assist or oversee any review (or remediation) process. The level of documentation of

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this review, and whether it should be conducted in a privileged environment, should also be carefully considered.

[1] Gary Gensler, Prepared Remarks At the Institutional Limited Partners Association Summit Nov. 10, 2021

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