

FS Regulatory Briefs*

New SEC Focus on Fund Expenses

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Target Audience: Investment Advisers/Hedge Funds/Mutual Funds

A recent area of enforcement focus for the SEC is the practice of fund managers charging expenses to a fund that were outside of fees, expenses and liabilities agreed to in the fund's offering documents or prospectus. While public attention has focused on sizeable performance fees (e.g. 20% of new profits) charged by hedge fund managers, the current market crisis has turned attention to all fees and expenses charged to registered and unregistered funds. Questions of what constitutes legitimate fund expense and what expenses should be covered by a fund's management fees or otherwise born by the adviser loom large.

Most funds were down 20-40 percent or more in 2008, and expected layoffs in 2009 are significant. Thus investment advisers are under increasing pressure to get costs down. Compliance and Finance officers should review controls and testing protocols to ensure that funds are not being overcharged or made to pay for expenses outside of their legal and contractual agreements. The use of investor funds to cover personal or company expenses violates Section 206 — the antifraud provision — of the Investment Advisers Act of 1940.

Typical Disclosures

Collective investment vehicles disclose in their prospectus/offering memos the fees and expenses that will be charged to the fund. An expense budget is generally established, and reserves for estimated or accrued expenses are usually taken so that ordinary expenses are charged to a fund evenly throughout the year. Disclosures vary widely but typically state that the fund will bear its own "operating expenses" including: fees to the investment manager, the administrator, and the custodian; investment expenses (commissions and interest); directors' fees and expenses; initial organization and offering expenses; and professional fees (legal, audit, registration and licensing). Some hedge funds also disclose that certain IT costs, hardware, research or accounting software will be charged to the fund.

Management Fees

Most funds are externally managed (i.e. the fund does not have employees, and the portfolio is managed under contract with a separate investment adviser). For externally managed funds, the investment management fee (e.g. 1-2% of AUM) is usually charged to cover the operating and overhead expenses of the adviser plus (potentially) a profit. In this case, the adviser collects management fees and pays out-of-pocket for its operating and overhead items (salaries, rent, utilities, research, systems and software not related to managing the funds, etc.) In certain cases, the investment manager may contractually agree to limit fund operating expenses below a certain level (e.g. 50 bps per year). Investment management fee revenue decreases proportionally with AUM, which has led to the recent round of layoffs and cost cutting.

A related area of focus will be marketing expenses born by funds. Registered funds are prohibited from paying for distribution expenses except under a Rule 12b-1 plan overseen by a fund's board. The SEC has said that fundamental 12b-1 reform is off the table, but is has brought recent enforcement cases alleging abuse of marketing fees disguised as fees paid to other fund service providers.

Materiality

It is important to note that expenses which may be immaterial to a fund from an accounting and financial reporting perspective may be very material to an SEC examiner looking for

conflicts, or to the investing public upset about negative performance.

Points to Consider

- Fund/adviser CCOs and CFOs should review carefully all prospectus and offering memo disclosures and any other communications with investors regarding fund expenses to establish what has been agreed to. Expense-agreement details are often buried in the prospectus fine print.
- From a control standpoint, what is the process for determining what constitutes a legitimate expense of the fund vs. one that the adviser should pay for? If there is an internal discussion on a particular expense item, is the discussion documented?
- Has the adviser recently agreed to lower its performance or management fees which may put pressure on allocating other costs and expenses to the fund?
- To what extent are fund operating expenses besides management fees probed by the fund's auditors? Is it part of the audit program to routinely sample fund operating expenses and vouch these to invoices or bank statements if they are material (which they often are not)?
- If a regulator or investor were to ask for evidence that typical adviser overhead costs (rent, salaries, utilities, etc.) are being paid for by the adviser, how quickly could adequate documentation be put together?
- What assessment has a registered fund's board made of fund expenses as part of the most recent 15c review and approval of the advisory contract? Is the board aware of whether any new expense types have been charged to the fund this year?
- Has any forensic testing been performed on the cash receipts and disbursements journals for both the fund and the adviser to look for any overcharges to the fund?
- If the fund has an expense limitation or waiver agreement, has the agreement been followed? If the agreement allows for expense recapture, has the reimbursement been properly executed and accounted for?
- Has the adviser caused the fund to pay for any travel, trips, conferences, etc. for adviser employees outside of agreements and disclosures? If the fund pays for research-related travel, has this been disclosed?
- Are charitable or political contributions paid for by the fund, and do the fund documents support these expenses? If so, are the donations disclosed to investors, and does the fund receive tax benefits for having made the contribution?
- How are expenses allocated between funds? Is there any risk of allegations that funds predominantly owned by management received favorable treatment in the allocation of expenses?
- Have there been any special legal, consulting or audit fees in connection with litigation, government exams or other investigations that were charged to the fund instead of to the adviser?
- What is the role of fund directors or the fund audit committee in reviewing fund expense categories or specific expense line items?

Additional Information

If you would like additional information about the topic discussed in this FS Regulatory Brief, please call:

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