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SPOTLIGHT ON

Advisory and Fee Agreements

Designing an advisory agreement and any compensation arrangements with clients are among the first and most important steps an advisor must take when setting up a registered advisory firm.

This Spotlight summarizes the main considerations facing advisors in designing these agreements.

The Advisory Contract.

The advisor-client relationship is established and defined by the contract between the advisor and the client.

Many states, but not the SEC, require that advisors memorialize their agreement in writing, through an advisory contract. Virtually all SEC-registered advisors use written advisory agreements for compliance and risk-management reasons even though not strictly required to do so.

The advisory agreement must be consistent with the advisor's regulatory filings (e.g., Form ADV) and relevant laws and regulations. A contract made in violation of the Investment Advisers Act (the "Act") or its rules, for instance, is not enforceable.

Typical advisory contract provisions

Under both state and federal law, the advisor's written agreement with clients generally details the material terms of the advisor-client relationship including:

- **The scope of the advisor's services**
    - Whether the advisor has discretion to trade the account or will simply provide investment recommendations.
    - Whether the client directs the advisor to use a designated broker (directed brokerage) or the client delegates to the advisor the authority to select brokers. If the advisor is authorized to select the broker(s), the contract will often discuss:
        - Factors the advisor considered to meet its duty of best execution;
        - Whether the advisor can use a broker affiliated with the advisor; and
        - Whether the advisor may aggregate the client's orders with orders of other clients in executing trades.

The Advisory Contract (cont.)

- **The scope of the advisor's services**
  - The fee schedule, including types of fees charged and fee calculations;
  - When fees are payable;
  - For fees based on a percentage of assets, how the market value of the account will be determined;
  - Any client authorization to the advisor to deduct advisory fees directly from the client's account (with implications under the Custody Rule discussed in our Spotlight on the topic);
  - For mutual funds, a provision stating that clients will pay a proportionate share of the mutual fund's fees and charges in addition to the advisor's fee; and
  - How brokerage commissions, stock transfer fees, and similar charges incurred for executing trades on behalf of the client will be paid.

- **Proxy voting**
  - Whether or not the advisor will be responsible for voting the proxies in connection with stock held in the advisory account.

- **Conflicts of interest**
  - Contracts typically identify any conflicts of interest and address the conflict of interest disclosures in Part 2A of the advisor's Form ADV.

- **Administrative issues**
  - Who will act as the custodian of the assets in the account;
  - How frequently the advisor will provide investment reports to the client and whether the advisor will regularly meet with the client;
  - The client's investment objectives and any investment limitations;
  - Confidential treatment of any information exchanged between the advisor and clients; and
  - That the client will be notified of any changes in the members of an advisor organized as a partnership.

- **Liability**
  - Many contracts define the scope of each party's liability.

- **Controversies and dispute resolution**
  - Contracts typically specify the law of the state or country governing the contract's terms; and
  - Some advisors include provisions requiring arbitration of disputes arising under the contract, although these provisions may not always be enforceable.

The Advisory Contract (cont.)

- **Representations and acknowledgements by the client confirming receipt of certain disclosures and documents, including:**
    - Statements regarding the advisor's registration;
    - Client acknowledgement that the client received the advisor's Part 2A of Form ADV, other client disclosure brochure, and any required brochure supplements;
    - Client acknowledgment that the advisor serves other clients and the advice given and actions taken as to other clients may differ from that given for this client's account; and
    - Client consent to the advisor trading for its own account and executing trades against the client (if applicable).

- **Termination, assignment, and amendment.**
    - The notice period parties must give before terminating the contract;
    - Whether amendments need to be in writing and signed by all parties.

Contractual provisions mandated by federal law.

Section 205 of the Investment Advisers Act of 1940 (the "Act") requires all advisory contracts entered into by SEC-registered advisors to contain certain provisions and prohibits the inclusion of other provisions in contracts.

SEC-registered advisors' contracts with their clients must include the following provisions:

- **Prohibition on assigning an advisory contract:** The contract must contain a provision prohibiting the assignment of the contract to a distinct advisory firm without consent of the client. The agreement would continue to apply if the advisory firm simply undergoes a corporate reorganization but there is no change of actual control or management of the advisor.
    - Notably, many advisory agreements provide that the agreement cannot be assigned by either party without the written consent of the other party.

- **Notification of partnership changes:** If the advisor is organized as a partnership, its advisory contracts must state that the advisor will notify the client of a change in its membership within a reasonable time after the change.

The Advisory Contract (cont.)

Contractual provisions prohibited by federal law.

SEC-registered advisors' contracts are also prohibited from containing certain types of provisions:

- **Performance-based fee provisions:** Advisors' contracts may not provide for compensation based on the performance of a client's account except to certain clients (as discussed in more detail below).

- **Hedge clauses:** The Act voids contractual provisions purporting to waive the advisor's compliance with any provision of the Act. Advisors including such provisions may be deemed to have misled their clients in violation of the Act's anti-fraud provisions by suggesting that a legal right or remedy under the federal securities laws or common law is not available.
    - Advisors typically try to avoid any implication of waiver by inserting a provision in the contract stating that any limitations on liability do not relieve the advisor of any responsibility or liability the advisor may have under state or federal law.

- **Termination penalties:** It is a violation of an advisor's fiduciary duty to its clients to enforce a provision that unreasonably limits a client's right of termination. Certain fees that may have the effect of penalizing a client for ending the advisory relationship or make the client reluctant to terminate an adviser may be inconsistent with the adviser's fiduciary duties and may violate the Act's antifraud provision.
    - Advisors that receive fees in advance must give a client that leaves a pro rata refund of prepaid fees minus reasonable expenses unless the advisor is entitled to a predetermined amount for services already rendered and this is adequately disclosed to the client.
    - Advisory agreements often include specific language providing for a pro rate refund of fees if the advisor did not serve for a complete period.

State requirements for advisory contracts.

States may require or prohibit some of the same provisions on assignments, termination penalties, and hedge clauses.

In addition, states may require their registered advisors to include other specific language in all their advisory contracts. For instance, Texas requires advisors to include language regarding the client's receipt of Part 2A of Form ADV in all advisory contracts. Advisors should research the law of their state(s) to determine if the state mandates specific provisions or contractual language.

Advisors' Compensation.

Advisors and their clients are generally free to mutually agree to any reasonable amount of compensation for the advisor and the method of calculating it, except that only certain clients can pay performance-based fees. But, as fiduciaries, advisors must make full and fair disclosure of the fees they charge clients.

At the time of entering into an advisory agreement, advisors must provide clients with the Part 2A Brochure, which contains mandated information on fees and compensation:

- The advisor's standard fee schedule and whether fees are negotiable;
- Methods for assessing and deducting fees, including whether the advisor bills clients or deducts fees directly from client accounts and how often;
- Other costs clients must pay;
- Prepayment of fees, and refunds in case of termination;
- Disclosure of brokerage practices, and the conflicts of interest they create (such as soft-dollar arrangements or relationships with brokers used); and
- Any performance-based fee arrangements with clients.

In addition to these disclosure requirements, the states and the SEC also have rules concerning the types of fees advisors may charge clients, which vary depending on the sophistication and net worth of clients.

For instance, SEC-registered advisors:

- Must set advisory fees that are reasonable in relation to the services provided;
- Cannot charge performance-based fees, i.e., fee based on a share of capital gains or capital appreciation of client funds, except to certain types of clients as discussed below; and
- Cannot charge termination fees that may have the effect of penalizing clients for ending the advisory relationship unless directly related to services already provided.

What are reasonable fees?

When determining whether an advisor's compensation is reasonable, the SEC takes the following factors into account:

- The customary fee charged by other advisors for comparable services;
- Whether the same services could be obtained by the client directly without the advisor's assistance and cost; and
- Whether the advisor has a reasonable belief that its services would generate gains in excess of the fee charged.

Advisors' Compensation (cont.)

Advisors must disclose that their advisory fee is higher than the total fee charged for similar services and that the client may obtain similar services elsewhere at a lower fee if their fees are far higher than other advisors'. Regulators have not set a bright-line standard but the SEC has opined that this disclosure is mandatory for traditional money management services when the fee is 3% of assets managed or higher, although that may not apply when the advisor performs special services or is managing a complicated portfolio.

Performance-based fees.

Section 205(a)(1) of the Act prohibits advisors from entering into a contract with certain clients that sets the advisor's fee based on a share of the capital gains or appreciation of a client's funds. The prohibition applies only to fees based on a share of capital gains or capital appreciation, not to fees based on other measures of performance, such as interest, ordinary income, or dividends. The prohibition also does not extend to fees based on a percentage of assets under management. The purpose of this rule is to discourage advisors from excessive speculation with clients' investments, i.e., chasing profits.

Despite this general prohibition, the Act allows advisors to charge performance-based fees under certain circumstances, including the following:

- **Fulcrum fees:** Advisors may charge fees to registered investment companies or clients with over $1 million in assets based on the asset value of the funds under management over a "specified period" and the fees may increase or decrease proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices" or benchmark. These "fulcrum fee" arrangements are in practice used only by mutual funds.

- **Qualified clients:** Advisors may charge performance-based fees to "qualified clients," which the SEC has defined as:
    - A natural person or company that has at least $1,000,000 under management with the adviser immediately after entering into the contract;
    - A natural person or company that the adviser reasonably believes has a net worth of more than $2 million immediately prior to entering into the contract or is a "qualified purchaser" under the Investment Company Act at the time the contract is entered into; or
    - A natural person who immediately before entering into the contract is an officer, director, trustee, or general partner (or a person serving in a similar capacity) of the adviser, or an employee who participates in investment decisions of the adviser and has done so for the advisor or another company for at least 12 months.

Advisors' Compensation (cont.)

- **Qualified purchaser funds:** Advisors may also enter into performance-based contracts with certain funds not registered under the Investment Company Act because the funds are offered only to certain wealthy or sophisticated investors. This category includes many hedge funds.

- **Non-U.S. clients:** Advisors may charge performance fees in contracts with persons who are not residents of the United States.

States generally impose restrictions on performance-based fees similar to the SEC's. But some prohibit any use of performance fees, define different categories of clients whom advisors can charge performance fees, or impose restrictions on how performance fees are calculated. Advisors should review the specific rules in the state(s) in which they do business.