NASAA INVESTMENT ADVISER SECTION, REGULATORY POLICY AND REVIEW PROJECT GROUP FEE GUIDANCE[1]

SET LABELS ASIDE: INVESTMENT ADVISORY FEES MUST BE REASONABLE

I. Introduction and Overview of Advisory Fee Regulatory Issues

Investment advisers provide important services to their clients by recommending investment strategies to help clients plan and reach financial goals. These goals range from buying a first home to enjoying a financially secure retirement. Advisory services have value and are usually not provided to clients for free. Investment advisers charge their clients fees in a variety of ways, including those outlined in Item 5(E) of the Form ADV, Part 1:

- A percentage of assets under management ("AUM model");
- Hourly charges;
- Subscription fees for a newsletter or periodical;
- Fixed fees other than subscription fees;
- Commissions;
- Performance-based fees (if permitted); and
- Other fee models.

Every investment adviser brings a unique suite of skills to their relationships with clients. Different investment advisers provide different levels of service and have differing levels of experience and expertise in the industry. These differences in services, experience, and expertise can lead to varying costs for the fees assessed to clients. Similarly, different clients have different life circumstances, investment goals, risk tolerances, time horizons, and other features salient to the adviser-client relationship. The complexity of a client's investment profile undoubtedly affects how much it costs to provide appropriate investment advice to that client.

Unique traits among advisers and clients necessitate unique evaluations of how an adviser is compensated for the services it provides. However, one fact remains true across the entire spectrum of each of these relationships and the compensation an adviser receives for them: securities laws require that fees charged by an investment adviser to a client must be reasonable. What is reasonable for one client's portfolio may not be reasonable for another. There is not a single fee or fee model that is always reasonable. Instead, what is "reasonable" depends on the client's needs, the services, the fee, and whether the fee is commensurate with the services rendered by the adviser given the client's needs. Central to demonstrating that a fee is reasonable is appropriate documentation of the tasks undertaken by the adviser to provide the service.

[1] This guidance reflects the views of the Investment Adviser Section Regulatory Policy and Review Project Group (the "Project Group") and does not take a legal position on behalf of the North American Securities Administrators Association or any member jurisdiction thereof.

The AUM model is the most familiar to advisers, investors, and regulators alike. Indeed, statistics collected in 2020[2] showed that the AUM model for advisory fees continued to be the most common way that investors in the United States pay for investment advice. Annual AUM fees usually range from one to three percent of the client's assets managed by the adviser and are most frequently billed quarterly in arrears.

Hourly fees, newsletter subscription charges, fixed fees, and commissions are fee models that advisers have been using for many years, though they are less common than AUM models in the industry.[3] Performance-based fees are generally prohibited[4] by many jurisdictions unless the adviser is exempt from registration or its business model caters only to clients who meet certain wealth thresholds.[5]

Over the past several years, alternative investment adviser fee models have emerged under the "other" category in Item 5(E) of Form ADV, Part 1. These other fee model categories include more frequent use of subscription fees for advisory services that are not for newsletters or periodicals. These subscription investment adviser fee models often charge the client a monthly fee for advisory services and are often marketed as comparable to the client paying for investment advice the same way they may pay for entertainment via a streaming video service. While the comparison may make sense on the surface, regulators have taken care to note that a streaming video service is not a fiduciary to its customers; however, investment advisers are. While this distinction does not preclude the use of a subscription fee model, the distinction is important and relevant to the analysis of whether such a fee model is appropriate for any given investor. Indeed, for some clients, such a non-AUM fee model may be in the client's best interest.

This guidance document represents the views of the Project Group following a process of engagement, analysis, and consideration.[6] While NASAA always encourages uniformity in the interpretation of state and federal securities laws, the reader must keep in mind that different states have authority to interpret what "reasonable" means under their own enabling statutes. The guidance will discuss various investment adviser fee models that state securities regulators see in the industry, how those models may apply to adviser-client relationships, the nature of the

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2 *See*, *e.g.*, NASAA 2021 Investment Adviser Report (Apr. 2021), *available at* https://www.nasaa.org/wp-content/uploads/2021/04/2021-IA-Section-Report-FINAL.pdf (stating that 84 percent of state-registered investment advisers charge fees using the AUM Model).

3 *Id*.

4 *See*, *e.g.*, NASAA Contents of Investment Advisory Contract Model Rule USA 2002 502(c), *available at* https://www.nasaa.org/wp-content/uploads/2011/07/2002-Act-Model-Rule-Contents-of-Investment-Advisory-Contract-Adopted-04152013.pdf.

5 *Id*. at subparagraph (c).

6 The Project Group engaged with various stakeholders as it considered the topics to address in this document, and the most appropriate ways to address them. The Project Group held various conference calls with several external organizations as well as NASAA members to solicit feedback on the most pressing issues in the investment advisory fee space. In addition to holding conference calls with stakeholders, the Project Group invited feedback on a proposed outline of topics and welcomed written input as it considered its approach to addressing its views on those topics in this document. The Project Group received substantive written feedback on the outline of issues from external stakeholder organizations in March of 2021, and considered these important perspectives as it developed the document.

fiduciary relationship between advisers and their clients and how each of these factors overlays the ultimate requirement that an adviser charge fees that are reasonable for a client under the circumstances. The guidance will also address the intersection between financial planning fees and investment advisory fees to the extent that the investment advice is an integral component of the financial planning services.

II. Background on Fees

Investment advisers can select a number of ways to assess advisory fees. Each method has pros and cons, largely dependent on the client's needs, the services provided by the adviser, and how those services compare to similar services provided by other advisers to similarly situated clients in the same geographical market.

Asset-based fees – The AUM Model typically applies to portfolio management services and fees are charged periodically (monthly, quarterly, semi-annually, etc.) either in advance (before the period begins) or arrears (after the end of the period). AUM Model fees are calculated by applying an agreed upon percentage to the value of a managed account or "householded" group of accounts on a particular valuation date and dividing the result by the number of agreed-upon periods in a calendar year.

While an AUM-based fee shifts the pricing focus from products and sales (the "broker-dealer model") to ongoing advice and relationships, it is seen by some practitioners to create a situation where, after initially setting up and populating a portfolio for a client, there is little to no incentive for the investment adviser to continually monitor and adjust the portfolio going forward. This is particularly true of passive portfolios where, for example, the account holds an array of indexed mutual funds for an extended period. In essence, there may be very little for the adviser to do in tending to such a portfolio other than periodic rebalancing. Another potential drawback to the AUM-based fee model is that a client's account must reach a large enough value for the fee to be economically attractive to an adviser. Smaller accounts held by those who lack resources and may be in the greatest need of investment advice often end up under served, or not served at all. AUM-based fees typically range from 0.5 percent up to 3 percent, with a trend of downward pressure on these percentages over the past decade or so. In many jurisdictions, a fee exceeding 2 percent is considered unreasonable, in violation of state law and the adviser's fiduciary duties.

Fixed fees – Sometimes referred to as "flat fees," these are typically charged for financial planning services, and are generally based on the adviser's estimate of the complexity of the client's financial situation. Many fixed fees are merely the product of the adviser's estimate of the number of hours the financial plan will take to produce multiplied by an hourly rate. An adviser may contract with a client to spread out the payment of a fixed fee over time so that the fixed fee will appear more affordable overall.

Hourly fees – Many professionals, such as attorneys and accountants, are known for charging by the hour. This model may be used by investment advisers as well. Hourly fees are frequently charged for financial planning services and can be seen as more of a "pay-as-you-go" arrangement. This model may allow clients some control over cost. Of course, limiting cost also can limit the extent of the relationship, leaving a client under-serviced, or may cause an adviser to terminate a client relationship if the client does not utilize the adviser's services enough.

Subscription fees for continuing financial planning services – This fee model is akin to that charged by periodicals, streaming video platforms, and other pay-for-access services. It is intended to operate as a "pay-as-you-go" arrangement where a client pays a set monthly cost to have access to an investment adviser's services during the time that the subscription costs are paid. These arrangements may have the client pay an up-front fixed fee for the provision of a financial plan paired with a continuing fee for updates to the plan, periodic interactions with the adviser (including but not limited to financial education "homework" assigned to the client, budgeting, taxes, estate planning, student loan repayment, etc.), rebalancing, or other services traditionally provided by investment advisers. In many cases, the financial planning fee includes the adviser's management of a client's moderately sized passive portfolio. Regulators sometimes review subscription fees with extra care because the monthly fee assessment inherent in the model presents an enhanced risk that fees will be charged for a contractual period without any services being provided to a client beyond the adviser's availability. The fee-for-no-service issue conflicts with the adviser's fiduciary duty.

III. Issues for Regulators Regarding Emerging Fee Models

A. Assessing Fee Reasonability

With regard to fees charged by investment advisers, the focus of regulators is reasonability. According to Model Rule 102(a)(4)-1, *NASAA Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers*, Section (i), it is an unethical business practice for an investment adviser to charge a client an unreasonable advisory fee. While fee reasonability is affected by the nature and amount of work performed by a given investment adviser, regulators and advisers have traditionally had certain standards to guide them.

As previously noted, many regulators have adopted the position that an annual fee in excess of 2 or 3 percent for asset management services is *per se* unreasonable. In addition, financial planning fees, whether they are hourly fees or flat fees, can easily be compared to similar fees charged by similar financial planners both within the jurisdiction or nationally. Both regulatory experience and widely available data can assist a regulator in determining whether a given financial planning fee is reasonable compared to the fees charged by similarly situated advisers to similarly situated clients.

In the case of subscription fees and similar emerging fee models, the issue tends to become a bit more problematic for various reasons. Subscription fees, other than those charged for a newsletter or periodical, are relatively new in the investment advisory space. In fact, many jurisdictions have rarely or never encountered them. This lack of comparative data creates a difficulty in trying to establish points of comparison to assess reasonableness.

In addition, the contract period for which the fees are charged may present problems. For example, an investment adviser may be working with clients based on a series of ongoing contracts that renew monthly or quarterly. If the amount of work engaged in by the adviser varies from contract period to contract period, this may raise questions about the reasonableness of fees during periods when less work (or in some cases, no work at all) takes place.[7]

B. Charging for Availability and Lack of Activity or Work Product

In some instances, regulators have encountered investment advisers who seek to charge for services that include "availability." That is, the adviser considers it part of their service that the client may contact them for investment advice and other investment-related issues. Thus, in certain circumstances and within certain timeframes, no actual services will be rendered to the client. Moreover, the absence of real services will also mean that the adviser cannot document any work product, since there would be none. Regulators have seen such an "availability" problem in all modes of investment advice delivery, including asset management services, financial planning, and other modes of consultation and advice. More recently, however, it has been argued by investment advisers who charge subscription fees that this is a legitimate and reasonable basis for charging an ongoing fee without providing services in addition to their availability. However, as noted below, investment advisers should proceed with extreme caution when considering charging fees exclusively for availability.

C. Contract Period or Periodicity

Contract periods can vary substantially among investment advisers. Asset managers most often have contracts with their clients that are in effect until terminated by either party. It is not uncommon for financial planning contracts to be annual contracts, that is, for a 12-month term. Regulators have also encountered contracts that are semi-annual contracts (a six-month term), as well as other terms that are less frequent. For these calendar-based contracts, annual payments may be split into smaller periods for purposes of payment of fees. Financial planning contracts might not be for a set time period, but instead remain in effect until the services contemplated by the contract are completed.

More recently, regulators have begun to see month-to-month contracts that renew automatically. The monthly fees charged for these contracts are sometimes assessed regardless of whether any services were provided during that period. This raises a concern that the adviser, despite being a fiduciary, is contracting with the client for a set period of time where the adviser knows or has reason to know that it will collect the fee without providing any service. This situation is problematic given the fiduciary relationship between the adviser and the client.

D. Fees for Bundled Services that Include Non-Investment Advisory Functions

Investment advisers sometimes bundle a collection of different services into a package for which they charge a single ongoing fee. Such bundles may include continuing financial planning and investment management services, along with non-advisory services such as tax preparation, or "financial coaching," among others. While these additional non-advisory services may be valuable

[7] This is not an issue solely for investment advisers who charge based on an emerging fee model. Every investment adviser has a responsibility to ensure that the fees charged match the amount and the nature of the work performed during a given contract period.

to clients, they make it more difficult for regulators to determine whether an investment advice fee is fair given the totality of services provided.

In many cases, the adviser's interactions with its clients are not able to be clearly delineated between advisory and non-advisory activities, further complicating the regulator's task in determining whether investment advisory fees charged to a particular client are fair and reasonable. Project Group members have frequently discovered during examinations that the investment adviser's notes and work product for the client file reveal little to no information about the nature of the adviser's interactions with clients. The lack of documentation clearly identifying what services were provided to a client by whom, when, and for what purpose makes it difficult for regulators to assess the reasonableness of a unified fee, making it more difficult for an adviser to prove that the fees it collected from the client were justified by any actual work.

When an investment adviser's services as disclosed in its Form ADV Part 2A are represented to go beyond the traditional list as represented in Form ADV Part 1A, Item 5.G., an adviser should carefully consider whether those other services are part of the adviser-client relationship, or if they are outside business activities to be disclosed instead in Part 2A, Item 10. If an adviser reports the non-advisory services as outside business activities, the adviser should consider whether it needs to execute separate contracts and maintain separate books and records to document the outside business activities.

E. Disclosures

It is critically important that an adviser's services and fees are clearly disclosed in the adviser's Form ADV Part 2A, Items 4 (services) and 5 (fees).

This is particularly true when an adviser offers ongoing financial planning services for a continuing fee. Item 4 should contain a description of the activities and other interactions that the adviser will engage in with a continuing financial planning client. Client contacts "must," as opposed to "should" or "if necessary," take place throughout the contract period in question.

In addition, the adviser should refrain from including non-advisory services in the continuing fee, as this unnecessarily complicates the task of both the client and regulator in determining whether a fee is reasonable in light of the services provided. The manner in which the client can terminate the arrangement must be clearly presented, and the plan for disposition of any owed or prepaid fees must be clear. Transparency is also in order regarding how the amount still owing or to be refunded will be assessed.

F. Documenting Services Rendered and Work Performed

The books and records of an advisory firm are a critical component of any inquiry into the reasonableness of fees charged to a client for continuing financial planning services. The client's file, including notes covering contacts and meetings with that client, form the cornerstone of the records that will generally be used by a regulator to assess fee fairness. Therefore, the importance of evidence of interaction, including resulting work product in the client's file, is paramount, and should be emphasized in the course of the regulator's application process for an adviser with continuing financial planning indicated as a business line.

Likewise, examiners will focus on these documents when conducting examinations of registered advisers. The mere presence of a schedule showing that a meeting occurred is likely inadequate to prove that services were provided. Notes of the substance of discussions of client contacts, whether by phone, video meeting, or in-person are important to demonstrate that advisory services justifying a fee were performed by the adviser. Any follow-up action items that occurred after a client contact should be documented in sufficient detail for the examiner to be satisfied that the client's fees paid for a corresponding service by the adviser.

IV. Regulatory Approaches to Emerging Fee Models

A. Substance, Terminology, and Accuracy of Labels

New labels and terminology used to identify and describe fees have emerged as the new business models involving continuing services mature, particularly in the area of financial planning.

Having evolved from a more traditional and easily understood financial planning model where a single plan was provided for a single fee, many financial planners now seek to serve younger clients who may not have a substantial amount of investable assets. These younger clients do not have assets that would make an AUM-based relationship profitable; however, without receiving guidance about budgeting, debt and debt service, emergency funds, insurance, and saving for education and retirement, among other topics, younger people will have a much harder time building sufficient discretionary capital for the adviser to manage. Thus, the "continuing financial planning for a continuing fee" is one way advisers seek to fulfill this need while still earning enough to justify providing services to the cohort of investors. The Project Group supports the goal of reaching these investors, and hopes to facilitate an environment where advisers reach these clients and apply fee models that are clearly disclosed, work is clearly performed, and the services are clearly documented.

Some terminology causes regulators concern and will frequently be cited as objectionable. As with any evolving business practice, some new and some older terminology is being used to describe it.

For example, "retainer" is a term often applied to fees for this service. An adviser that administers continuing advisory fees in the same manner that attorneys administer their retainers will probably result in the adviser having custody because the retainer arrangement may involve the adviser having possession of client funds in excess of $500 more than six months in advance of providing the services represented by those funds. Given this concern, the use of the term "retainer" by advisers should be used with care.[8]

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[8] *See*, *e.g.*, Utah Division of Securities Retainer Fee Standards (Feb. 9, 2009), *available at* https://securities.utah.gov/wp-content/uploads/2021/09/papers_Retainer_Fees.pdf.

"Subscription" is also employed by advisers as a label for continuing fees and seems to be the more accurate and appropriate term to employ, as it does not generally involve the receipt of client fees so far in advance of the provision of services, implying a more "pay-as-you-go" scenario that is amenable to a quick and relatively simple termination process. As previously stated and discussed in further detail below, the contract period, services to be provided, and specific documentation of work product are issues that must be carefully considered when employing a subscription fee model.

B. Reasonable Fees

i. Compare with Prevailing Local Market Rates for Similar Services

In dealing with emerging fee models, regulators may have little historical experience or comparative data to rely on in determining the reasonableness of the investment advisory fees. While some advocate that reasonableness should be based on letting clients determine what they are willing to pay for services, this has never been and is unlikely to be an approach supported by regulators.[9] The standards that regulators currently apply to asset management fees and financial planning fees generally reflect industry standards. It is likely a similar approach would work best with regard to emerging fee models.

In some respects, it is inevitable that a regulator's assessment of fee reasonableness is going to be a "facts and circumstances" analysis, taking into consideration varying factors such as the complexity of a client's financial needs, the amount and types of assets involved in the planning, and the amount of attention that the client requires.

In determining the reasonableness of fees under emerging fee models, regulators are likely to be interested in industry standards, at least on a local or regional basis to get an understanding of the variations of fees being paid to different investment advisers using these models. As emerging models gain a foothold and become more mainstream, these apples-to-apples comparisons will become easier for regulators to access when assessing reasonability. Until that time comes, advisers using fee models outside of the mainstream should expect some level of regulatory scrutiny, and should have data and sufficient explanation to demonstrate how and why the fees that they charge are reasonable when compared with a mainstream model for which data does exist.

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[9] Indeed, a survey released by State Street Global Advisors in July 2021 found that, "Comprehension of investment product fees – and fees in general – is low even among those working with an advisor…" *See State Street Global Advisors Survey: Majority of Investors Don't Fully Understand Investment Costs* (July 27, 2021), *available at* https://newsroom.statestreet.com/press-releases/press-release-details/2021/State-Street-Global-Advisors-Survey-Majority-of-Investors-Dont-Fully-Understand-Investment-Costs/default.aspx. The investing public largely lacks understanding of how investment products and advice are priced. As a result, investors are at a disadvantage when negotiating how to pay for those products and services, and securities regulators will continue to enforce the regulatory requirement that advisory fees charged to clients be reasonable.

ii. Use of AUM Fee Standards and Fixed Fee Financial Planning Standards in Certain Circumstances

Regulators may encounter situations where investment advisers seek to apply emerging fee models to scenarios that reflect more traditional asset management or financial planning services. In such a case, it is more than reasonable for regulators to compare the fees being charged to those charged by investment advisers who provide these services and charge a more traditional fee. These types of benchmarks ensure that clients are not paying substantially more for services than the market generally supports.

The comparison of an emerging fee to a more traditional fee in assessing reasonableness is particularly important given that the majority of investors, even those who have an adviser, do not fully understand the nature of or reasoning behind fees charged for investment products and advice.[10]

iii. Payment in Advance Raise Concerns in Certain Situations

The use of the term "retainer" should be used with caution because it carries a clear definition in the legal services industry where a client pays in advance and the retainer balance is drawn down as services are rendered.[11] That definition carried over to an investment adviser's charging of fees for continuing financial planning services can easily be misinterpreted by the investing public, and may exacerbate significant confusion that already exists.

Further, charging fees in advance for continuing financial planning services poses a risk to the adviser that the prepaid services to come after the payment is made may not be fully or may be only partially provided, leaving the adviser with "custody" if the amount of the prepayment for services not provided within the six-month period following the payment exceeds $500. Additionally, because it is so difficult to project how engaged a client will be in the future, advisers may want to consider charging in arrears, due to the adviser's ability to review the client file to assure that sufficient services were provided during the preceding period to justify the charging of the fee.

iv. Fees Based on Income or Net Worth

Advisers in some jurisdictions have proposed charging fees based on a client's income or net worth. As with any other fee model, an adviser charging a fee based on the client's income or net worth must be able to demonstrate that the fee paid by the client is reasonable and not excessive in light of the services provided and when compared to the application of other more traditional fee models.

A primary concern among regulators with fees based on income or net worth is that the investment advisory services the client is paying for are only tangentially related to the factors used to calculate the cost for the services. A client's salary or non-managed assets and debts are unquestionably

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10 *Id*.

11 *See* Utah Division of Securities Retainer Fee Standards, *supra* note 6.

factors to be considered when determining an appropriate investment strategy for the client; however, the client's non-managed salary and non-managed assets and debts may not otherwise be within the investment adviser's purview or scope of services. This may cause a lack of a rational relationship between the fees charged to the client and the services the client is actually paying for. The absence of a nexus between non-managed income, assets, and debts gives state securities regulators reason to apply additional scrutiny to assess whether the fee model is reasonable, and to assess how it compares with more traditional fee models.

The Project Group is not suggesting that it believes such fee models are or should be prohibited, but notes that additional regulatory scrutiny should be expected when the fees charged lack a direct tie to the services being provided. Fees based on a client's income or net worth, like any other fee model, must be reasonable.

C. Advisory Activity

iv. Fee for Availability of Investment Adviser *Alone* May Be Unreasonable

Advisers should proceed with caution when considering charging fees for availability alone and should understand that charging such a fee could be considered unreasonable by regulators.

The investment adviser client relationship inherently involves the provision of services wherein investment advice is provided for a fee. Furthermore, the fiduciary duty requires an investment adviser to act in the best interest of the client, which includes not collecting money from the client without providing coinciding services. The fiduciary duties cannot be fulfilled when a client is being charged a fee but no service is being provided.[12] The fee-for-no-service situation creates a conflict of interest by incentivizing the investment adviser to minimize the amount of services provided to the client while still receiving a fee. This conflict is not one that can be readily mitigated and will be looked upon with disfavor by regulators.

In addition, it is likely that more-demanding clients will receive more services than less-demanding clients for the same or similar fee, further calling into question the reasonableness of the fee when regulators look for comparative examples in client files.

v. Investment Advisers Should Adopt, Implement, and Enforce Policies and Procedures for Documenting Lack of Activity in Client Accounts

A major area of concern with any fee model is when a fee is charged but the investment adviser is unable to demonstrate any substantial service. This standard applies across all fee models. All investment advisers should have policies and procedures in place that address lack of activity in a client's account. The policies and procedures should include how and when to approach clients about a lack of account activity, and when it may become necessary to terminate a client relationship because a fee is being collected without corresponding advisory services.

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[12] *See,* e.g., *In the Matter of Regal Investment Advisors LLC, et al*, Investment Advisers Act of 1940 Release No. 5865 (Sept. 16, 2021), *available at* https://www.sec.gov/litigation/admin/2021/34-93035.pdf. Here, the SEC found, among other violations, that a federal covered investment adviser collected fees without providing advisory services to the clients, in violation of its regulatory requirements and its fiduciary duties to its clients.

Regardless of the fee model applied, there is a period of inactivity after which it becomes unreasonable to continue charging a client. This issue can be particularly acute if the periodicity of the fee is compressed, as with a monthly fee. Regardless of the fee model or periodicity of it, investment advisers should consider adopting policies and procedures that trigger a notification to the client after a period of inactivity justifies it, and the adviser should consider whether terminating the relationship is necessary. Should the client fail to respond to that notification, the adviser should terminate the contract according to its terms.

This guidance document does not specify an exact amount of inactivity time that will trigger such an obligation on the adviser's behalf. That time period will depend upon too many factors and is not amenable to being reduced to a bright line rule. Rather, the amount of time will depend upon the agreed upon nature of the adviser-client relationship, including the contract period, fee model applied, services provided under the agreement, nature of the client's advisory needs, and other factors relevant to a specific client relationship.

At a minimum, accounts should be monitored for activity frequently, and any long-term inactivity should be discussed with the client and documented. Extended periods without advisory services should result in termination of the relationship by the investment adviser to avoid the issue of unreasonable fees. This is particularly true where the services involve non-discretionary accounts or where the client is not taking advantage of an annual review of a financial plan.

D. Contract Period

In assessing the reasonableness of fees in relation to services provided, the contract period plays a key role. Model Rule 102(a)(4)-1, *NASAA Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers*, Section (q) includes as an unethical business practice: "(e)ntering into, extending or renewing any investment advisory contract, unless such contract is in writing and discloses, in substance, . . . the amount of prepaid fee to be returned in the event of contract termination or non-performance."

This section contemplates the return of prepaid fees for non-performance of services. This becomes particularly problematic when investment advisory services are provided under automatically renewing monthly contracts if the investment adviser provides little or no substantial service to the client during the contract period. Lack of services during a contract period by any investment adviser, whether they charge asset management fees, fixed fees, or use any other fee model, has always been a basis for establishing fees as unreasonable.

Investment advisers are fiduciaries who cannot collect fees for a contract period in which they do not provide their clients sufficient services. Advisers using an emerging fee model that renews on a monthly (or other short term) basis should be aware of the enhanced risk that a contract period may elapse where fees are paid without corresponding services being provided to the client, and the accompanying regulatory scrutiny that is likely to come with that heightened risk. Regulators understand that there may be brief intervals during a contract period when fewer services may be needed or provided, but do expect that services will be provided during the contract period to justify the adviser's fee.

E. Disclosures

Investment advisers are required by statutes,[13] rules,[14] and their fiduciary duties to clients[15] to disclose the fees they intend to charge for their services. Advisers are required to disclose fees both via the written contract with the client and through regulatory disclosures on the Form ADV Part 1, item 5(E) and Part 2A, item 5. These contractual and regulatory disclosures explain not only the services to be provided and the fees to be charged, but how those fees will be calculated, assessed, and ultimately paid by the client in exchange for the adviser's services.

NASAA Model Rules 102(a)(4)-1 and USA 2002 502(c) require advisers to enter into written contracts with their clients. The contracts must clearly disclose the services the adviser will provide, how long the contract period will be, the fee to be charged, the formula for computing the fee, the amount of any prepaid fees to be refunded in the event the relationship is terminated or the adviser fails to perform, and whether the contract is assignable by either party. These contractual disclosures are intended to protect both the adviser and the client, and to ensure that each party to the agreement understands their rights and obligations with respect to the advisory relationship.

Similarly, the Form ADV Parts 1 and 2 each provide items that allow investment advisers to disclose to regulators, clients, and the world at large what their fees are and how they will be calculated and assessed. The Form ADV, Part 2, Item 5 provides advisers with a space to describe in narrative form a clear, full, truthful, and plain English articulation[16] of how they intend to charge fees to clients. This is a helpful space where an adviser seeking to charge an emerging fee model – such as a subscription fee – can describe in their own words to regulators and clients what their fees will look like and how clients will pay for their services. The narrative should be clear and easy to understand for the average investor.

The requirement to disclose the method of fee calculation is particularly relevant to the discussion of emerging fee models. Where an adviser is charging a fee that is uncommon, it is incumbent upon the adviser to be forthright in describing how the fee works and clearly state what the client will pay for the services to be provided. Similarly, the adviser needs to be able to explain to

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13 *See*, *e.g.*, section 102(a) of the 1956 Uniform Securities Act and section 502 of the 2002 Uniform Securities Act.

14 *See*, *e.g.*, NASAA Unethical Business Practices of IAs, IARs, and Federal Covered IAs Model Rule 102(a)(4)-1(j), *available at* https://www.nasaa.org/wp-content/uploads/2019/05/NASAA-IA-Unethical-Business-Practices-Model-Rule.pdf (requiring full and fair disclosure of material conflicts of interest) and (p) (requiring a written contract disclosing services, term of contract, fee, formula for computing fee, amount of refundable prepaid fees in event of nonperformance, and assignability); NASAA Prohibited Conduct of IAs, IARs, and Federal Covered IAs Model Rule USA 2002 502(b)(k), *available at* https://www.nasaa.org/wp-content/uploads/2019/05/NASAA-IA-Prohibited-Conduct-Model-Rule.pdf (requiring full and fair disclosure of material conflicts of interest); and NASAA Contents of Investment Advisory Contract Model Rule USA 2002 502(c), *supra* note 3 (requiring written contract disclosing services, term, fee, formula for computing the fee, amount of refundable prepaid fees in event of nonperformance, and assignability).

15 SEC, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act of 1940 Release No. 5248 (June 5, 2019), *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

16 *See* General Instructions for Form ADV, Part 2, *available at* https://www.sec.gov/about/forms/formadv-part2.pdf.

securities regulators what the fees will be and how they will be calculated; this is true whether in the initial registration stage or on an examination.

The infrequency of non-AUM fee models[17] by itself justifies a closer look by regulators to ensure that the math behind the fee model makes sense and will result in a reasonable fee charged to the adviser's clients. In any occupation, when one sees one practice 85 percent of the time and a collection of other practices 15 percent of the time, the less common practices by their nature invite additional scrutiny if for no other reason than to facilitate an education and understanding of their applications in the real world. This is especially true of fees charged in a fiduciary relationship. With an AUM fee model, an examiner can apply the agreed-upon percentage and divide it by four to come up with the fee based on the disclosed AUM percentage. The examiner can then compare quarterly withdrawals from a sample of client accounts with the agreed-upon fees. So long as the fees charged to the clients line up with the fees disclosed and agreed-upon and are consistent with geographical norms, the examiner can move along to other issues on the exam. Examiners who see this model 85 percent of the time are practiced in its review and application and are adept at assessing its reasonableness.

Conversely, where an examiner is presented with an emerging fee model, it is not only appropriate, but also necessary for some additional scrutiny to be applied. State securities regulators must be afforded an opportunity to understand new and novel concepts before offering blanket approvals of those concepts. The additional scrutiny is not to suggest that the fee model is unreasonable *per se*, but rather it allows the examiner to understand what the fee model proposes to achieve and how it proposes to achieve it. Indeed, there likely will be circumstances in which an emerging fee model is justifiable as a better overall fit for the needs of particular clients. Clear disclosures of the methods of calculation for alternative fee models to clients and regulators will aid examiners and registration staff in their review and approval of the models.

Another important disclosure is the contract period. The adviser must disclose clearly and in plain English to the client the time period during which services will be provided and what charges will be assessed. During any given contract period that fees are charged to a client, regulators will expect to see that work was done to earn those fees. For example, if a contract period is one month, then fees may only be reasonably charged that month if work was performed. If fees are charged for a contract period during which no work was performed, state securities regulators have routinely concluded such fees are unreasonable. Industry groups have suggested that this conclusion is unwarranted,[18] and that advisers who charge AUM fees will go months or quarters without providing a service while still collecting fees without being subject to further regulatory scrutiny. It is inaccurate to suggest that AUM advisers are permitted to collect fees without performing services for clients and documenting those services. State securities regulators require AUM advisers to demonstrate work for clients in the same manner as any other adviser. Additionally, the Project Group notes another important distinction between the way in which

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[17] In 2020, 84 percent of state-registered investment advisers used an AUM fee model. *See* NASAA 2021 Investment Adviser Report, *supra* note 1.

[18] *See*, *e.g.* Michael Kitces, *On the Bleeding Edge of Financial Planning Fee-For-Service Regulation* (Mar. 1, 2017), *available at* https://www.kitces.com/blog/regulation-of-financial-planning-subscription-and-retainer-fee-for-service/.

some emerging fee models differ from the AUM model: the contract period. The AUM model time periods are typically annual contracts billed quarterly. Less work may be performed in one quarter, but more services would be provided at some point during the annual contract term.[19] Spread across the entirety of a contract period, there is an opportunity to provide enough services to make a fee reasonable. Applying a similar analysis to a "subscription" fee model that bills monthly, a monthly billing cycle without work may still be reasonable if the contract term is annual but billed monthly or quarterly. A primary concern that regulators have with the month-to-month model is not the monthly billing, but the idea that a fiduciary can bill a contract period without performing services. Stretching that contract period out and clearly disclosing the term and terminability during that contract term may ameliorate concerns raised by state securities regulators so long as sufficient work is actually performed by the adviser during that contract period.

Regardless of the fee model applied, investment advisers should disclose to clients and regulators policies and procedures addressing any lack of activity that may occur in a client's file. If the adviser, as a fiduciary, is charging a client to provide services, it must actually provide those services. Extended periods without demonstrable services to the client will result in further regulatory scrutiny, regardless of the fee model employed. Regulators have routinely taken the position that availability itself is not a sufficient "service" for which fees can be reasonably assessed; instead, availability must be paired with other advisory services for any fee to be considered reasonable under state securities laws.

Inherent in any relationship where one person pays money to another to receive a service, conflicts of interest exist and must be disclosed. This is particularly true for investment advisers who serve as fiduciaries to their clients. All material conflicts of interest must be disclosed prior to entering the relationship, and these conflict disclosures must be updated as the relationship progresses and changes over time. Investment advisers have myriad ways of disclosing these conflicts, such as through advertising, investment advisory contracts, Form ADV, Part 2, and regular correspondence with their clients. Advisers are under a constant obligation to ensure that these conflicts are minimized and eliminated to the extent possible, while fully disclosed where minimization or elimination are not feasible.

There must be clear disclosure about how fees will be assessed. Both Form ADV Part 2A, Item 5, and the adviser's contract with a continuing financial planning client should contain clear and easily understood descriptions of how fees for this service are to be charged. It is critical that the term of the engagement, the time periods over which continuing fees will be charged, the amount of each fee, and the manner of payment be clearly laid out in the client contract.

It should be clearly disclosed how either party may terminate an existing engagement, as well as the responsibilities of each party upon termination. Each party must know if there is a financial obligation to the other upon termination, and whether the client will be provided the results of the adviser's work up to that point. In the case of a fee charged in advance, the adviser must refund

19 The Project Group also notes that an AUM model adviser who charges an AUM fee but fails to perform and document any work during that period will be considered to have charged an unreasonable fee as well. Regardless of the fee model used, advisers must charge reasonable fees in order to comply with regulatory requirements and their fiduciary duties.

any unearned prepaid fees, while an adviser charging in arrears should be able to collect any earned unpaid fees to the same point.

Advisers must clearly disclose the services to be provided and must ensure that they clearly document when those services actually are provided to a client. Disclosure of continuing financial services to be provided to a particular client should be clear, so that the client can decide whether to engage the adviser for such services and can form an expectation of the value to be derived from receiving such services. The advisory contract for such services must also be detailed, and clearly lay out the nature and extent of the services the adviser is to provide.

Some advisers, having provided a detailed description of what such services can encompass in the adviser's Form ADV Part 2A, Item 4, neglect to provide such detail in the advisory contract with the client, perhaps misunderstanding the nature and intent of each. While the ADV is a primary disclosure document for clients, the contract must also clearly delineate which services among those offered by the adviser are those which the adviser is obligated to provide to the specific client in question. In this way, the contract provides an outline of the work product and notes that will eventually populate the client file, allowing the client to form an expectation as to the nature and content of the services they are to receive from the adviser. A well-organized client contract also provides regulators the information necessary to assess the reasonableness of advisory fees when reviewing client files on an exam.

Investment advisers must be able to demonstrate that they did something to earn the fees charged regardless of the fee model used to calculate the amount that clients must pay. Documentation of work performed should include the basics of who performed the work, what the work consisted of, how it was completed, when it was completed, and approximately how long it took.

An investment adviser can demonstrate the value it provides by showing not just a final work product such as a holistic financial plan including suggesting appropriate investment advice, but also by documenting the research and effort that went into that final product. Advisers should document research, phone calls, emails, letters and other correspondence, document drafting, and any other work done on behalf of a client. Real time documentation of the work performed allows an investment adviser to demonstrate its value not just to regulators inquiring about the reasonableness of the fee charged, but also to clients who may wonder at some point if they are getting what they are paying for. A simple recordkeeping system can go a long way towards helping advisers demonstrate what they have done to earn a reasonable advisory fee.

Some investment advisers engaged in financial planning consider investment advice only a minor part of the work they perform for clients. These advisers often assert that the fees they charge may seem unreasonable for advice about investing in securities, but are reasonable in the context of the other work performed. The simple solution for advisers here is to document and demonstrate what portion of the fee is for investment advice, and what portion relates to other financial services unrelated to investing in securities. Also, who performed what work, how they performed it, when they performed it, and how long it took. If the overwhelming part of a fee that a client paid related to student loan repayment strategy, for instance, and not for investing in securities, then the adviser should be able to demonstrate what part of the fee is allocated to that non-securities work, and what part is a truly reasonable investment advisory fee. Ultimately, investment advisers must be able to demonstrate to regulators and clients alike that the fees assessed are reasonable for the investment advice that they provide.

Investment advisers must know their clients in order to provide the best advice about their investment needs. This necessitates that the adviser research, perform due diligence, and monitor recommendations to clients. These steps, particularly when well documented, inform the analysis of whether a fee is reasonable.

Investment advisers must collect sufficient information about their clients to understand the clients' needs, and must adequately document what attributes a client has and how those attributes caused the adviser to recommend a particular investment product or strategy. Similarly, an adviser must sufficiently research and understand investment products and strategies to understand their features, risks, and benefits. Without a dual understanding of the client and the investment product recommended to the client, an adviser fails to meet its fiduciary duty to its client. As a fiduciary, the adviser has an ongoing obligation to monitor the client's situation, the products recommended, and ensure that as time passes, the client and the product or strategy remain a good match. Where that is no longer the case, the adviser has an obligation to recommend new investment products and strategies. Along the way, the adviser must document the research, due diligence, and monitoring activities in the client's file.

These activities are not only necessary to comply with regulatory obligations and fiduciary duties to clients, but are crucial to providing clients with good service. Properly documented research, due diligence, and client monitoring activities are where advisory fees are earned, and proper documentation allows state securities regulators to analyze whether a given fee is reasonable.

The ultimate goal for regulators and the industry alike is to ensure that the public receives good investment advice and to protect them from unfair and deceptive practices in the process. Key to that mission is communication with clients of the efforts undertaken by an adviser to provide its services and earn its fees.

Advisers help themselves in demonstrating that their fees are reasonable by creating sufficiently detailed client file notes, invoices to clients when fees are assessed, and by maintaining copies of those notes and invoices in client files for regulator review. Such notes and invoices should reflect the activities engaged in, the assignments completed, and the work product generated during the period being billed. This allows clients and regulators alike to track progress in achieving the goals of the engagement. Documenting the tasks allows the adviser to demonstrate who did what, when and why they did it, and how. These questions are the crux of proving that fees are reasonable.

V. Conclusion

The fees that investment advisers charge their clients must be reasonable. Investment advisers provide a valuable service to investors and deserve to be fairly compensated for those services. Likewise, investors deserve to be treated fairly by their advisers when it comes to the fees being assessed. Advisers are fiduciaries to their clients, operate in a highly regulated industry, and are required by state securities laws to ensure that clients do not pay an unreasonable amount for the adviser's services.

Some in the financial planning industry have criticized state securities regulators for not differentiating financial planning from investment advice when evaluating the reasonableness of fees.[20] These critiques, while noted, frequently ignore that both the 1956 and 2002 Uniform Securities Acts define "investment adviser" to include a financial planner who for compensation provides investment advice as an integral component of the other financial services. The Project Group believes that investing in securities will almost always be "integral" to most clients' financial plans; as a result, it is doubtful that these services are severable from the scope of state securities laws.

Financial planning and investment advisory services are by their nature and by definition intertwined and related. As noted in this guidance, an adviser must clearly delineate and document what fee or part of a fee is charged for what service; must be able to explain to clients and regulators alike the reason for the fee; be able to describe the work done to earn the fee; and to clearly state how the fee is reasonable in light of the adviser's skill set and the needs of the investor.

None of the discussion in this guidance is intended to suggest that the Project Group believes any fee model is *per se* good or *per se* bad. Reasonable fees can be assessed under any model whether it is the AUM model, a flat fee, an hourly fee, or some other fee such as a properly structured subscription fee; conversely, any of these models may be assessed and applied unreasonably where insufficient advice is provided for the fee charged.

It is up to the adviser to ensure that it selects an appropriate fee model, discloses the fee model adequately before the client engagement, contracts with its clients to charge the appropriate fee, provides the services, documents the services provided for the fee, and shows how the fee is allocated to those services. The Project Group believes that when presented with appropriate and documented answers to the issues raised in this guidance, state securities regulators will be better positioned to assess whether any given fee charged pursuant to any given fee model is reasonable.

Under any fee model, the fee charged to the client must be reasonable in relation to that client's needs, the adviser's education and experience, that client's situation, the services provided by the adviser, the frequency of services provided by the adviser, the term of the contract, and the nature of the relationship that the adviser has with the client. State securities regulators and their examiners will endeavor to protect investors while appropriately fostering innovation in this space. Examiners will continue their time-tested work of sampling and reviewing client files to ensure that advisers are charging reasonable fees, regardless of how the fee model is labeled and calculated.

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20 *See* Kitces, *supra* note 16.