EATON & VAN WINKLE LLP

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Fee Disclosure Issues Cause Problems for Futures Fund Adviser

Improper fee disclosure has long been a red flag to SEC examiners and investigators. The problem is magnified when the failure to disclose results in overcharging clients. If the disclosure is corrected but refunds are not made to the clients, expect the agency to come calling.

Consider Equinox Fund Management, a Denver-based alternative fund manager that specializes in managed futures. The firm, which manages approximately $268 million in assets as a commodity pool operator, on January 19 reached a $6.4 million settlement with the agency over allegations that it both overcharged management fees and misled investors about how it valued assets – and then allegedly failed to refund the overcharged fees to its client.

Equinox, according to the SEC, "calculated management fees contrary to the method described in registration statements for a managed futures fund called The Frontier Fund, and the firm also deviated from its disclosed valuation methodology for some [Frontier Fund] holdings."

"Fund managers can't tell investors one thing and do another when assessing fees and valuing assets," said Division of Enforcement Asset Management Unit co-chief Marshall Sprung. "Equinox's misleading disclosures gave investors a distorted picture of how the firm determined compensation and valued significant fund holdings."

Disclosure and refund issues

Equinox ran into its fee miscalculation problems when it based its management fees on the notional trading value of the assets (total amount invested including leverage), rather than on the net asset value of each Frontier Fund series, as disclosed in the fund's registration statements from 2004 through March 2011, according to the SEC.

The result, the agency said, was that the Frontier Fund was charged $5.4 million more than it would have been if NAV had been used. "In the managed futures business, it's common to base fees on notional trading value," said Sidley Austin partner Jim Munsell. "But the disclosure must be clear." Equinox discovered the problem when the Frontier Fund's independent auditors questioned why there was a difference between the notional trading value used in practice and the NAV described in the fund's disclosure statement, according to the administrative order instituting the settlement.

Here's the rub: While Equinox then modified the Frontier Fund's Form 10-K and its registration statement appropriately to disclose that it charged management fees on notional assets, it did not refund to the fund the additional management fees it had collected – $5.4 million – prior to the modification of its documents, the agency said. "Simply stated, when the auditor advised the fund manager of this issue, how could it not reach the required end point to make the client whole?

The SEC possibly would have had a different approach if it had done that, potentially saving the firm a large expense and reputational exposure," said Eaton & Van Winkle partner Paul Lieberman. "Why wouldn't you ask your general counsel or call outside counsel to get their opinion on the right thing to do in this situation?" "If you uncover the problem, it's not enough to fix the disclosure, you have to remediate the harm," said Munsell. "By changing the disclosure, they put up a big red flag that said, 'examine me,'" but they did not have a plan to remediate."