The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
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Comment Letter on SEC's Proposed Amendments to Investment Advisers Act, January 1998

January 16, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 6-9
Washington, D.C. 20549

Re: Proposed Amendments to Performance Fee Rule
(File No. S7-29-97)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to express its views on the Securities and Exchange Commission's proposed amendments to Rule 205-3 under the Investment Advisers Act of 1940 ("Investment Advisers Act"), the rule that permits investment advisers to charge certain clients performance fees.[2] The proposed amendments are intended to provide investment advisers with more flexibility to structure performance fee arrangements with clients that are capable of protecting their own interests. In particular, the proposed amendments would modify the rule's criteria for clients eligible to enter into a performance fee arrangement and would eliminate the rule's requirements regarding the calculation of performance fees and the provision of certain specific disclosures. The Institute supports the proposed amendments. In addition, the Institute seeks clarification of the extent to which certain clients may be charged fulcrum fees pursuant to Rule 205-3.

I. Qualified Clients

The Institute supports the Commission's proposed amendments to Rule 205-3 that would permit investment advisers to enter into performance fee arrangements with any client with a net worth (together, in the case of a natural person, with assets held jointly with a spouse) in excess of $1,500,000 or assets under the management of the investment adviser of at least $750,000 ("qualified clients"). It is reasonable to revise the thresholds in the current rule, as proposed, to reflect the effects of inflation since Rule 205-3 was adopted[3] and further to revisit the thresholds on a periodic basis as necessary to prevent future effective lowering of the amounts.[4] The Institute strongly supports permitting investment advisers and their clients to maintain any existing performance fee arrangements entered into before the effective date of the rule amendments notwithstanding the clients' failure to meet the increased thresholds. This aspect of the proposal is important to prevent disrupting existing adviser-client relationships. The Institute recommends that the Commission similarly "grandfather" existing performance fee arrangements when proposing, and ultimately adopting, any future changes to the rule's criteria (e.g., changes to reflect the effects of inflation).

The Institute recommends that the Commission revise the meaning of qualified clients to include certain "knowledgeable employees" of the investment adviser even if they do not meet the rule's criteria regarding net worth or assets under management. Because of their financial acumen and experience as a result of working in the investment advisory industry, these persons should be capable of protecting their own interests in negotiating performance fees.[5]

II. Elimination of Contract Terms and Disclosures

Rule 205-3 currently requires advisers to comply with several conditions in addition to limiting performance fees to qualified clients. The compensation paid to an adviser must be based on the rule's prescribed methodologies, and the adviser must disclose to the client, before entering into the contract, all material information concerning the advisory arrangement, including several specific disclosures. The Institute strongly supports the proposed elimination of these conditions. We believe that qualified clients are capable

of protecting their own interests and, therefore, the particulars of any performance fee arrangement are best left to negotiation between the client and the adviser. In addition, despite the elimination of the rule's specific requirements, clients still would have the protections of the Investment Advisers Act—any performance fee arrangement would be required to be consistent with an adviser's fiduciary duties and advisers would be required to fully and fairly disclose any performance fee arrangements.[6]

III. Clarification of Applicability of Rule 205-3

Section 205(b) of the Investment Advisers Act provides a narrow exemption from the Act's general prohibition on performance fees, permitting certain persons to be charged fulcrum fees, but the exemption does not cover a trust, governmental plan, collective trust fund, or separate account referred to in Section 3(c)(11) of the Investment Company Act.[7] Rule 205-3 currently provides for a broader exemption from the Act's prohibition on performance fees by permitting any company (including any trust, governmental plan, collective trust fund, and separate account referred to in Section 3(c)(11) that meets the Act's definition of company) that meets the rule's eligibility criteria to be charged a fee based on the gains less the losses (computed in accordance with the rules) in the client's account for a period of not less than one year.[8] Thus, a fulcrum fee is permitted to be charged under Rule 205-3. Rule 205-3, as proposed to be amended, would provide for additional flexibility by permitting any company that meets the rule's eligibility criteria to be charged any type of performance fee, including a fulcrum fee.

The existence of a narrow statutory exemption for fulcrum fees that does not cover a trust, governmental plan, collective trust fund, or separate account referred to in Section 3(c)(11) raises a question as to whether these entities may be charged a fulcrum fee under Rule 205-3. To eliminate any ambiguity raised by the interplay of Section 205 and Rule 205-3, we respectfully request the Commission to explicitly state that any trust, governmental plan, collective trust fund, or separate account referred to in Section 3(c)(11) of the Investment Company Act may be charged a fulcrum fee (or any other kind of performance fee) in compliance with the conditions of Rule 205-3.

The Institute appreciates the opportunity to comment on the proposed rule amendments. If you have any questions concerning our comments or would like additional information, please contact me at 202/326-5821.

Sincerely,

Dorothy M. Donohue
Associate Counsel

cc: Robert E. Plaze, Associate Director
Division of Investment Management

Jennifer S. Choi, Special Counsel
Division of Investment Management

Kathy D. Ireland, Attorney
Division of Investment Management

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,742 open-end investment companies ("mutual funds"), 442 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.359 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 472 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

[2] Investment Advisers Act Rel. No. 1682 (Nov. 13, 1997).

[3] Rule 205-3 currently requires any person entering into a performance fee arrangement to have net worth in excess of $1,000,000 or assets under the management of the investment adviser of at least $500,000.

[4] The Institute believes that using a client's net worth or assets under management as eligibility criteria in Rule 205-3 continues to be appropriate, notwithstanding the potential effect of inflation on the criteria. It is, however, advisable to evaluate the criteria periodically and revisit the thresholds as necessary. The Institute opposes indexing or another similar mechanical rule requirement that would place the burden of determining the appropriate eligibility criteria on investment advisers.

[5] Knowledgeable employees could be defined to include directors, trustees, executive officers, general partners, advisory board

members, or persons serving in a similar capacity, of the investment adviser, and employees of the investment adviser who, in connection with their regular duties, participate in the adviser's investment activities, provided that any such employee has been performing such duties for or on behalf of the investment adviser or substantially similar duties for or on behalf of another company for at least 12 months. The recommended definition is consistent with Rule 3c-5 under the Investment Company Act and Regulation D under the Securities Act of 1933.

[6] See, e.g., Release at 8-9.

[7] Section 205(a) prohibits any investment adviser, unless exempt from registration, from entering into any advisory contract that provides for a performance fee. Section 205(b) provides a narrow exemption from this general prohibition, permitting registered investment companies and any other person (except a trust, governmental plan, collective trust fund, or separate account referred to in Section 3(c)(11) of the Investment Company Act) to be charged a fulcrum fee, provided that the contract relates to the investment of assets in excess of $1 million. A fulcrum fee provides for compensation based on the asset value of the company or funds under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify.

[8] See PSG Asset Management, Inc. (pub avail. Jan. 9, 1989) (where the staff agreed not to recommend enforcement action if pension and profit-sharing plans are treated as companies for purposes of Rule 205-3).
