FACTORS TO BE CONSIDERED IN CONNECTION WITH INVESTMENT COMPANY ADVISORY CONTRACTS CONTAINING INCENTIVE FEE ARRANGEMENTS

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940, Release No. 7113;
INVESTMENT ADVISORS ACT OF 1940, Release No. 315

April 6, 1972

TEXT:

The Securities and Exchange Commission today called the attention of all registered investment companies, their officers and directors and their investment advisers to certain factors which must be considered in connection with investment company incentive fee arrangements in view of the provisions of the Investment Company Amendments Act of 1970, Public Law 91-547 ("1970 Act").

Section 205 of the Advisers Act was amended by the 1970 Act in order to provide protection against performance fee arrangements which are unfair to investment companies. It prohibits all performance fees unless compensation under them increases and decreases proportionately with the investment performance of the company 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. The point from which increases and decreases in incentive compensation are measured must be the fee which is paid or earned when the investment performance of the company is equivalent to that of the index or other measure of performance.

Section 15 of the Investment Company Act ("the Act") sets forth the requirements for approval of advisory contracts of registered investment companies. Section 15(c), as amended, requires investment company directors to request and evaluate, and the investment adviser to furnish, such information as may reasonably be necessary to evaluate the terms of the advisory contract. n1

Prior to the amendment of Section 205 many investment company performance fee arrangements were unfair to investment companies. Many incentive fees did not decrease for poor performance, or if they did, decreases were disproportionate to the increases. In addition, in some cases, the index against which investment company performance was measured was inappropriate and prejudicial to investment companies.

The Commission has surveyed the performance fee arrangements of registered investment companies in effect as of January 3, 1972, in order to evaluate such arrangements in view of the requirements of amended Section 205 of the Advisers Act and the fiduciary standards of the Investment Company Act. Of 999 management open-end and closed-end investment companies, 103 had performance fee arrangements on that date. The survey indicated that although many of the unfair features of previous performance fee arrangements have been eliminated, some performance fee arrangements still contain features which create bias against investment companies and do not conform to the provisions of Section 205 of the Advisers Act or the fiduciary standards of the Investment Company Act. These features include selection of an inappropriate index, computation of investment company average net assets and performance over different intervals and failure to reflect the reinvestment of dividends paid from investment income in computing investment company investment performance and of all cash distributions in computing the investment record of the index. n2 As is explained below, these practices result in measuring investment company performance on a basis that is unfair to the investment company and which does not relate to the investment record of the index.

The Commission is also concerned with incentive fee arrangements which permit significant fee adjustments based on random or insignificant differences rather than meaningful differences in the

performance of the investment company and the index. This may occur, for example, where the maximum incentive fee or penalty is paid for the slightest performance difference or where significant performance fee adjustments are based on random or insignificant performance differences.

The Fairness of the Fulcrum Fee

Any consideration of the fairness of a performance fee arrangement must start with the midpoint or "fulcrum fee" (the fee paid when the investment company's performance equals that of the index). The maximum and minimum incentive fee rates and all performance increments are measured from the fulcrum fee. Thus, the selection of a fair fulcrum fee is a critical prerequisite to a fair performance fee. This means that the same factors should be considered in arriving at a fair fulcrum fee as are taken into account in establishing the proper fee under advisory contracts which do not involve incentive compensation. n3

Selection of an Appropriate Index

As indicated above, Section 205 requires that the investment performance of the investment company be measured against the investment record of an appropriate index of securities prices. In determining whether an index is appropriate for a particular investment company, directors should consider factors such as the volatility, diversification of holdings, types of securities owned and objectives of the investment company. For example, for investment companies that invest in a broad range of common stocks, a broadly based market value weighted index of common stocks ordinarily would be an appropriate index, n4 but an index based upon a relatively few large "blue chip" stocks would not. For investment companies that invest exclusively in a particular type of security or industry, either a specialized index that adequately represents the performance of that type of security or a broadly based market value weighted index ordinarily would be considered appropriate. n5 Of course, if an investment company invests in a particular type of security an index which measures the performance of another particular type of security would not be appropriate. n6

Variations in Periods Used for Computing Average Asset Values and Performance

In computing compensation for incentive fee arrangements, variations in the time interval over which average asset value and investment performance are computed can make a significant difference. The larger the asset base, the greater the amount of compensation which will be added or deducted for performance and the more volatile performance compensation will be. For example, if average assets are based upon average daily assets over the last 3 months of a 36 month performance period (or the last month of an annual performance period) it is possible that, as a result of accumulated sales, there would be greater average assets than there would be if assets were averaged over the entire period. Thus, the amount of assets to which the performance fee rate would be applied would be greater. In effect, the use of the shorter period will have raised the "performance ante." Ironically, it will also cause the amount of compensation, which supposedly is paid for "performance", to be related significantly to the amount of sales. n7

Section 205 of the Advisers Act requires that compensation be based on the asset value of the company averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company over a specified period in relation to the investment record of an appropriate index of securities prices. The use of different periods for averaging assets and computing investment performance would be unfair to the investment company and would violate Section 205. n8

Length of Period over which Performance is Computed

Although Section 205 of the Advisers Act does not require that performance be measured over a period of any particular length, there is a fiduciary obligation to use an interval sufficiently long to provide a reasonable basis for indicating the adviser's performance. All 103 investment companies surveyed

measured their performance over a period of at least one year. Use of at least a one year interval minimizes the possibility that payments will be based upon random or short term fluctuations.

Computation of Performance Over a "Rolling Period"

Over 43 percent of the companies surveyed (45 companies) measured their performance on the basis of a rolling period, a moving average of the number of subperiods (i.e., months or quarters) included in the full period over which performance is measured. Section 205 of the Advisers Act does not specify that either a rolling period or a flat period be used. However, there are a number of advantages, both from the shareholders' and the adviser's point of view, in using a rolling average.

For example, since Section 205 requires that performance be measured over a "specified period", in the absence of a specified fixed or rolling period, compensation cannot be precisely computed or paid until that period has expired and the investment company's performance for the entire period is known. In other words, interim payments based upon interim performance are not permissible under Section 205. n9 Use of a rolling period for computation of a performance fee avoids the problem of interim payments. It permits payments based upon performance to be made more frequently than annually, since each payment would be based upon performance over the preceding twelve months or longer period adopted.

Rule 2a-4 under the Investment Company Act requires that investment company shares be sold at their approximate net asset value. To do this, amounts reflecting the performance fee must be accrued on a daily basis. Use of a rolling period avoids accruing a performance fee on the basis of periods of substantially less than one year and smoothes out accruals resulting from short term fluctuations in performance. For contracts computed on the basis of a period of one year or more, but without the use of a rolling period, accruals for the performance fee near the beginning of the period would be based upon periods of substantially less than a year. Under a rolling period contract, accruals for the performance fee can be computed on the basis of a period of at least 11 months or three quarters of a year (the time elapsed, depending upon the sub-periods adopted, when the daily accrual in the current computation period commences) and thus the effects on accruals of short-term performance would be minimized and accruals would better reflect overall performance and the fee ultimately payable.

Performance Fee Transitional Periods

A difficulty arises in connection with the "start-up" or transitional period for performance fees when a performance fee is based upon a period for which investment results are already known or for which the adviser has already received compensation under the previous contract. To the extent that performance during the earlier period adds to the adviser's compensation, in essence he will be compensated twice for the same period and the same performance. Moreover, the investment company's positive performance during the period prior to adoption of the performance fee gives the adviser a "running start" on the index. If such an arrangement were permitted, the investment company would not have to outperform the index during the balance of the period covered by the performance fee in order that its adviser collect a performance fee. If the investment company merely maintained its relative performance for the balance of the specified period, the adviser nevertheless would collect a fee for "outperforming" the index. For example, if a 36 month rolling performance fee were adopted which included 18 months for which performance results were already known, and during which the performance of the investment company was greater than that of the index, the investment performance of the investment company could be the same as that of the index over the next 18 months but the adviser, nevertheless, would receive a performance fee for "outperforming" the index. Elementary fiduciary standards require that performance compensation be based only upon results obtained after such contracts take effect. In other words, a performance fee contract may be instituted on a prospective basis only. n10

A transitional problem may also result if a contract containing an investment company performance fee arrangement is cancelled before its expiration date and the same adviser is rehired under a straight

percentage of assets contract. Assume, for example, that an investment company's performance over the first half of the period specified in its contract is significantly worse than the investment record of the index and that it appears unlikely that the adviser will earn any incentive fee, or even the fulcrum fee, over the full term of the contract. It may be to the adviser's advantage to attempt to renegotiate his contract and to substitute a contract without a performance fee, but at a fee higher than that which it could earn under the original contract. Such substitution would be unfair to the investment company. If an adviser could cancel a performance contract during a period for which a performance fee is to be computed and recontract on a percentage of assets basis, such contracts would once again amount to the kind of "one way street" that existed prior to the enactment of Section 205. To prevent this, such a new contract should provide that the fee payable until the end of the performance fee computation period of the original contract shall be the lesser of the amount which would have been paid under the original contract or the amount payable under the new contract.

Similarly, cancellation of a "rolling" performance fee contract during a period of substandard performance could be unfair to the investment company if a percentage of assets or different performance fee contract with the same adviser were substituted. The appropriate method of "winding down" a rolling performance fee contract would be to give the investment company substantial advance notice, (i.e., not less than half of the fee computation period specified in the contract) of the adviser's intention to cancel the contract and to provide that the fee payable during such "winding down" period shall be the lesser of the amount which would have been due under the original contract or the fee payable under the new contract.

Computation of the "Investment Performance" of the Investment Company and the "Investment Record" of the Index with Respect to Payment of Dividends from Investment Income and Distributions of Realized Capital Gains

As indicated in the Institutional Investor Study, the best measure of the total benefits received by investment company shareholders during a specified period is one that reflects changes in net asset value of the company's shares with adjustments to compensate for the payment of any realized capital gains distributions and dividends from investment income during the evaluation period. This measure gives effect to all increments in value received by stockholders and has been widely used without any serious challenge to its propriety. n11

Section 205 of the Advisers Act requires that compensation increase and decrease proportionately based upon investment performance of the investment company in relation to the investment record of the index, as distinguished from the index price. In 93 percent of investment companies with performance fee arrangements capital gains distributions were treated as reinvested in computing investment performance. Such reinvestment is necessary in order that investment company performance be computed on the same basis as the index, since capital gains are neither realized nor distributed with respect to the companies comprising the index. Unless investment company capital gains distributions are treated as reinvested in computing investment company investment performance, such performance would not relate to the investment record of the index.

Similarly, dividends paid from investment income on investment company shares and cash distributions on the securities which comprise the index are significant factors which cannot be overlooked in computing the "investment record" of the index and in relating investment company investment performance to that investment record. On the average, the dividends paid from investment income by investment companies with performance fee arrangements have been less than the cash dividends paid on the securities of the companies which comprise the indices used in performance comparisons. Thus, in many cases, ignoring dividends and any other cash distributions in relating investment company investment performance to the investment record of the index can give investment advisers a substantial advantage.

To correct this, the Commission, pursuant to its authority under Sections 205 and 211 of the Advisers Act, has proposed rules defining the terms "investment performance" and "investment record" as they are used in Section 205 of that Act n12 to make clear that such provision requires inclusion of dividends paid from investment income and realized capital gains distributions of the investment company and of cash distributions on the securities of companies which comprise the index.

In structuring incentive fee arrangements it is important to build in a degree of confidence that any significant incentive payments (or penalties) are attributable to the adviser's skill, or lack of skill, rather than to random fluctuations. Most investment company incentive fee contracts have "step rates". n13 Generally, these contracts have recognized the principle that small performance differences should not result in significant fee adjustments by providing a "null zone" (an interval around the point at which the performance of the investment company equals the performance of the index in which no performance fee adjustment, up or down, is payable). Other performance fee contracts decrease the significance of the payments made for slight performance differences through the use of continuous fees. n14 Only four contracts failed to include either a null zone or a continuous fee.

Despite the recognition of the principle that significant fee adjustments should not be based upon small performance differences, the survey revealed several instances where the maximum fee adjustment (i.e., the amount added to the fulcrum fee which yields the largest total fee payable under the contract) could result from insignificant performance differences. Under a number of contracts the maximum fee adjustment resulted from any difference, no matter how slight, in performance between the fund and the index. Under other contracts performance differences were measured in terms of a percent of the investment performance of the index rather than in terms of percentage point differences. Using percent differences may result in a maximum fee adjustment for small absolute differences in performance. n15 Similarly, under a substantial number of contracts the maximum fee adjustment may result from a performance difference of less than 10 percentage points. Under other incentive fee arrangements, a significant portion of the maximum fee adjustment may also result from insignificant performance differences.

As a matter of elementary fairness the performance differences from which the maximum fee adjustment results should be set so as to preclude such maximum fee adjustment resulting from insignificant or random differences. Through a statistical analysis of the performance of the investment company relative to the performance of the index throughout the year, it is possible to determine whether or not the investment performance of the investment company differs significantly from the investment record of the index. Ideally, under any particular performance fee contract there should be at least a 90 percent probability that the maximum fee adjustment will not result from random fluctuations in performance.

Although the appropriate performance difference may vary from one investment company to another and from time to time, preliminary studies of the Division of Corporate Regulation indicate that as a "rule of thumb", the performance difference should be at least +/- 10 percentage points in order to provide a 90 percent probability that the maximum fee adjustment will not result from random fluctuations or insignificant differences between the performance of the investment company and the index. n16

Because of the preliminary nature of these studies, the Commission is not recommending, at this time, that any particular performance difference exist before the maximum fee adjustment may be made. n17 However, investment company directors should consider what a significant performance difference would be under the incentive fee contracts of the investment companies they serve, taking into account the company's size, volatility (i.e., how the investment company's performance has changed in relation to that of the index over long and short term periods), diversification and variability of performance differences. They should satisfy themselves that the maximum performance adjustment will be made only for performance differences that can reasonably be considered significant.

Of course, similar considerations are required for fee adjustments that are less than the maximum. In other words, meaningful fee adjustments may occur at levels which are less than the maximum and therefore, like maximum adjustments, they should be based upon significant performance differences. n18 This may be accomplished by the use of null zones of appropriate size or of a fee structure under which the effect of small performance differences is not proportionally greater than the effect of large performance differences.

Footnotes

n1 The Commission has previously issued a release setting forth certain of its views with respect to the approval of advisory contracts under the 1970 Act (IC Release No. 6336, February 2, 1971) and another release setting forth certain views of its Division of Corporate Regulation respecting the fiduciary duties of directors under Section 36(a) of the 1970 Act (IC Release No. 6480, May 10, 1971).

n2 Reinvestment means treating amounts distributed by an investment company as invested in shares of the investment company at the record dates of the distributions and treating amounts distributed by the companies which comprise the index as invested in the securities which comprise the index as soon as possible after their ex-dividend or record dates, rather than at the end of the measurement period. Such treatment gives proper effect to dividends and distributions during the measurement period.

n3 The Report of the Committee on Interestate and Foreign Commerce of the House of Representatives on the 1970 Act states that "(T)he fiduciary duty with respect to management compensation contained in . . . new section 36(b) of the Act would apply to compensation received pursuant to a performance-related contract permitted by section 205 to the same extent as it does to other types of investment advisory contracts." H. Rep. 91-1382, p. 41 (91st Cong., 2nd Sess., August 7, 1970). See also S. Rep. 91-184, p. 45 (91st Cong., 1st Sess., May 21, 1969).

n4 See the Institutional Investor Study, Vol. 2, H. Doc. 92-64, 92nd Cong., 1st Sess. Pt. 2, March 10, 1971, p. 408.

n5 An index may be computed on a weighted or unweighted basis, but in no event should the index be weighted by fortuitous considerations such as the price per share. Certain averages which are weighted by price give greater weight to the stocks in the index having higher market prices. An effect of this is to give proportionately less weight to stocks after price appreciation leads to a stock split. These completely fortuitous considerations penalize growth and make such averages inappropriate, regardless of the type of securities held by the investment company, as a basis for comparison with investment company investment performance.

n6 Technical methods for specifying incentive fees based upon risk or volatility adjusted returns are now being explored by the staff and a number of industry and academic groups as well as commercial enterprises. However, the Commission has not, at this time, arrived at any conclusions with respect to these methods.

n7 On the other hand, if performance has been poor, the impact of declining asset values and decreased sales could be greatest at the end of the period. This would tend to lower the asset base for investment companies which have had poor performance.

n8 Similarly, if the period over which net asset values are averaged for computing the fulcrum fee differs from the period over which net asset values are averaged for computing the performance related portion of the fee, it could result in incentive payments having a disproportionate relationship to the fulcrum fee. The Section 205 requirement that "compensation" be based upon the asset value of the company "averaged over a specified period" means that the same period must be used for computing average assets for the fulcrum fee and the performance fee segments of the adviser's compensation.

n9 Of course, if a fee schedule provides for the payment of a minimum fee regardless of performance, interim payments based solely on the minimum fee would be permissible.

n10 Of course, under any performance fee arrangement incentive compensation is based upon results achieved over an earlier period. However, those results have not been determined before the contract is adopted.

n11 Institutional Investor Study Report, Vol. 2, H. Doc. 92-64, 92nd Cong., 1st Sess. Part 2, March 10, 1971, p. 409.

n12 See Investment Advisers Act Release No. 316. Avoid Basing Significant Fee Adjustments upon Random or Insignificant Differences

n13 Under such contracts fee adjustments occur only after whole percentage point performance differences.

n14 Under contracts with continuous fees, payments increase or decrease with slight performance differences and fractional differences are usually prorated.

n15 The percent method may tend to be a misleading indicator of small differences. For example, if the index increased by 1%, an investment company whose net asset value increased by 3% would outperform the index by 200%. This may be confusing since persons may tend to associate a much larger difference with a 200% difference. On the other hand, when there are large changes in the index, measuring differences in percents may prevent a performance fee adjustment even where a performance difference, expressed in percentage points, is substantial.

n16 A somewhat lower performance difference may be significant for large, well-diversifed, investment companies. For investment companies which are small or are not well-diversified a significantly higher performance difference than +/- 10 percentage points would be required. This "rule of thumb" is based upon a measuring period of one year and the "investment record" of the S&P 500 Stock Composite Index.

n17 The Division's studies applied standard statistical tests of significance to incentive fee contracts. The formula used by the Division will be made available to interested persons upon written request. The Commission would appreciate receiving comments with respect to it from interested persons, particularly those with technical expertise.

n18 The level of confidence that such lesser fee adjustments are based upon meaningful performance differences may be less than 90%.