CONTINGENT ADVISORY COMPENSATION ARRANGEMENTS

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940
Release No. 721

May 16, 1980

TEXT:

ACTION: Statement of staff interpretive position.

SUMMARY: The Commission is announcing the interpretive views of its Division of Investment Management ("staff") as to the application of the performance fee prohibitions of the Investment Advisers Act of 1940 ("Advisers Act") to investment advisory compensation arrangements which are contingent on the investment performance of the funds of advisory clients. The purpose of this release is to provide general interpretive guidance to the public regarding the application of the Advisers Act to the variety of contingent advisory compensation arrangements which have come to the staff's attention, and thereby to obviate the need for further requests for staff interpretive or no action advise concerning such compensation arrangements where the requests do not present any novel factual or interpretive issues.

FOR FURTHER INFORMATION CONTACT:

Michael J. Eizelman, Esq. (202) 272-2079, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

Section 205(1) n1 of the Advisers Act, n2 with certain exceptions, prohibits an investment adviser, unless exempt from registration pursuant to Section 203(b) of the Advisers Act, n3 from entering into, extending, renewing or performing any investment advisory contract which "provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." The staff's position, as previously articulated in a number of no action and interpretive letters, is that Section 205(1) generally prohibits an investment adviser from being a party to any advisory contract which provides that advisory fees will be waived or refunded, in whole or in part, if a client's account does not meet a specified level of performance or which otherwise makes receipt of advisory fees contingent on the investment performance of the funds of advisory clients. n4 In the view of the staff, the realization of "contingent" fees is dependent on a client's account achieving a specified level of capital gains or appreciation. Thus, such fees, in effect, are based on a share of capital gains or appreciation of the funds of a client within the meaning of Section 205(1), and are therefore proscribed by that section. n5

Section 205(1) of the Advisers Act was intended "to prohibit arrangements for contingent compensation to investment advisers based on profit-sharing arrangements with clients which encourage advisers to take undue risks with the funds of clients." n6 The concerns about undue speculation n7 which prompted the Congress to adopt Section 205(1) are as apposite to advisory fees which are contingent upon an advisory account obtained a certain level of performance as they are to fees which vary directly with capital gains or appreciation. For example, an investment adviser whose compensation was contingent on a discretionary account achieving a certain level of performance might be inclined to purchase for the account speculative securities, involving a high potential reward and a high risk, if the account's value was below that necessary for the adviser to earn his fee. In this regard, the Commission report which helped form the basis for the Advisers Act contained the following views of industry representatives:

Arrangements for contingent compensation to investment counselors, such as percentage of profits, [were] strongly condemned [by industry representatives] as inimical to the interest of the client, for. . ., aside from the 'heads I win, tails you lose' aspect of such arrangements, such a basis for compensation 'encouraged the advisor to recommend a degree of risk that the investor himself would not knowingly undertake, inasmuch as the advisor has everything to gain if he is successful and nothing to lose if he is wrong' and may have been a strong temptation to take unusual risks, to speculate or to over-trade. n8

To the extent there is any question as to whether Section 205(1) directly prohibits contingent advisory compensation arrangements, the staff believes that such arrangements are prohibited by Section 208(d) of the Advisers Act. n9 Section 208(d) provides, among other things, that it shall be unlawful for any person indirectly to do any act or thing which it would be unlawful to do directly under the provisions of the Advisers Act. If Section 208(d), together with Section 205(1), were not construed to prohibit contingent advisory compensation arrangements, an investment adviser who was subject to Section 205(1) could employ indirectly a compensation arrangement which was the practical equivalent of a fee structure directly proscribed by Section 205(1) and thereby frustrate the prophylactic purposes of that section. For example, rather than charging a fee which was a direct share of the capital appreciation of a client's account, and which was thus expressly prohibited by Section 205(1), a registered investment adviser might choose to approximate such a fee by charging a fixed fee which it would agree to waive or refund, in whole or in part, if the client's account did not achieve a specified level of appreciation.

Among the proposed contingent advisory compensation arrangements that have come to the attention of the staff are those in which (i) fees are waived or refunded, in whole or in part, by an adviser if a specified level of investment performance in a client's account is not achieved, n10 (ii) fees are contingent upon an advisory account having sufficient capital gains or appreciation during a specified period to pay the fees, n11 (iii) fees are waived if recommended securities do not appreciate in value within a designated period of time, n12 and (iv) fees are contingent upon an account either not decreasing in value or avoiding a specified amount of capital depreciation. n13 For the reasons discussed above, the staff believes that the foregoing contingent advisory compensation arrangements, which each pose the inherent conflicts of interest that Section 205(1) was intended to prevent, are properly characterized as involving a fee based upon a share of capital gains or appreciation of the funds of a client and, thus, are proscribed by Section 205(1).

The general interpretive guidance provided in this release should obviate the need, in most instances, for further requests for no action or interpretive advice from the staff relating to contingent advisory compensation arrangements. Accordingly, the staff will not respond to such requests unless they present novel factual or interpretive issues, such as departures from the specific contingent compensation arrangements described above.

Part 276 of Chapter II of Title 17 of the Code of Federal Regulations is amended by adding Investment Advisers Act Release No. IA-721 -- Statement of the staff as to the application of the Investment Advisers Act to contingent advisory compensation arrangements.

By the Commission.

Endnotes

n1 15 U.S.C. 80b-5(1).

n2 15 U.S.C. 80b-1 et seq.

n3 15 U.S.C. 80b-3(b).

n4 See, e.g., McCuen & Russell, Inc. (avail. Apr. 27, 1979); Tessco Management Corporation (avail. Apr. 24, 1979); V.L. McKenzie (avail. Sept. 29, 1975); Bruce Bennett (avail. May 10, 1973); and Robert Reinhart, Jr. (avail. Sept. 21, 1971), reprinted in [71-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) para 78,464.

n5 Section 205(1), by its express terms, applies only to compensation arrangements based upon a share of capital gains or appreciation of the funds of an advisory client. Thus, the Advisers Act does not prohibit, for example, a fee arrangement based upon the interest income (exclusive of capital gains or appreciation) derived from the funds of a client, assuming, of course, compliance with the antifraud provisions of Section 206 thereof. See, e.g., Welch & Forbes, Inc. (avail. Jan. 26, 1974).

n6 H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940).

n7 Id. See also Hearings on S. 3580 before Subcomm. of Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, at 252 (1940). For a discussion of the legislative history of the prohibition against profit-sharing and other contingent fee arrangements, see SEC Institutional Investor Study Report, H.R. Doc. No. 64, 92d Cong., 1st Sess., pt. 1, 259-263 (1971).

n8 See Securities and Exchange Commission, Investment Counsel, Investment Management, Investment Supervisor and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. at 30 (1939).

n9 15 U.S.C. 80b-8(d).

n10 See, e.g., McCuen & Russell, Inc., (avail. Apr. 27, 1979).

n11 See e.g., Stanley F. Raczynski, (avail. Dec. 5, 1973).

n12 See, e.g., V.L. McKenzie, (avail. Sept. 20, 1975).

n13 See, e.g., Pension Investment Associates of America, (avail. Jan. 25, 1977). Although an argument could be made that Section 205(1) literally does not extend to fees based upon "negative" capital gains or appreciation, the staff believes that, for the reasons discussed above regarding contingent fees in general, such fees come within the purview of Section 205(1). As one commentator has observed,

It seems. . . clear that, in a falling market, an adviser may not [under Section 205(1)] compensate himself on the basis of a percentage of the saving of capital loss or depreciation which he has effected by selling out certain securities and buying others whose market price did not fall as much; such a scheme of compensation, which is in effect based on a share of 'negative gains,' involves the same temptations as a profit-sharing scheme which comes within the letter of the statutory provision.