

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-4388; File No. S7-08-16

Performance-Based Investment Advisory Fees

AGENCY: Securities and Exchange Commission.

ACTION: Notice of intent to issue order.

SUMMARY: The Securities and Exchange Commission (“Commission”) intends to issue an order that would adjust for inflation, as appropriate, dollar amount thresholds in the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge performance-based fees to “qualified clients.” Under that rule, an investment adviser may charge performance-based fees if a “qualified client” has a certain minimum net worth or minimum dollar amount of assets under the management of the adviser. The Commission’s order would increase, to reflect inflation, the minimum net worth that a “qualified client” must have under the rule. The order would not increase the minimum dollar amount of assets under management.

HEARING OR NOTIFICATION OF HEARING: An order adjusting the dollar amount tests specified in the definition of “qualified client” will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission’s Secretary. Hearing requests should be received by the Commission’s Office of the Secretary by 5:30 p.m. on June 13, 2016. Hearing requests should state the nature of the writer’s interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission’s Secretary.

ADDRESS: Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

FOR FURTHER INFORMATION CONTACT: Amanda Hollander Wagner, Senior Counsel, Investment Company Rulemaking Office, at (202) 551-6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission intends to issue an order under the Investment Advisers Act of 1940 (“Advisers Act” or “Act”).¹

I. BACKGROUND

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client.² Congress prohibited these compensation arrangements (also known as performance compensation or performance fees) in 1940 to protect advisory clients from arrangements that Congress believed might encourage advisers to take undue risks with client funds to increase advisory fees.³ In 1970, Congress provided an exception from the prohibition for advisory contracts relating to the investment of assets in excess of \$1,000,000,⁴ if an

¹ 15 U.S.C. 80b. Unless otherwise noted, all references to statutory sections are to the Investment Advisers Act, and all references to rules under the Investment Advisers Act, including rule 205-3, are to Title 17, Part 275 of the Code of Federal Regulations [17 CFR 275].

² 15 U.S.C. 80b-5(a)(1).

³ H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). Performance fees were characterized as “heads I win, tails you lose” arrangements in which the adviser had everything to gain if successful and little, if anything, to lose if not. S. Rep No. 1775, 76th Cong., 3d Sess. 22 (1940).

⁴ 15 U.S.C. 80b-5(b)(2). Trusts, governmental plans, collective trust funds, and separate accounts referred to in section 3(c)(11) of the Investment Company Act of 1940 (“Investment Company Act”) [15 U.S.C. 80a-3(c)(11)] are not eligible for this exception from the performance fee prohibition under section 205(b)(2)(B) of the Advisers Act.

appropriate “fulcrum fee” is used.⁵ Congress subsequently authorized the Commission to exempt, by rule or order, any advisory contract from the performance fee prohibition if the contract is with persons who the Commission determines do not need the protections of that prohibition.⁶

The Commission adopted rule 205-3 in 1985 to exempt an investment adviser from the prohibition against charging a client performance fees in certain circumstances.⁷ The rule, when adopted, allowed an adviser to charge performance fees if the client had at least \$500,000 under management with the adviser immediately after entering into the advisory contract (“assets-under-management test”) or if the adviser reasonably believed, immediately prior to entering into the advisory contract, that the client had a net worth of more than \$1,000,000 at the time the contract was entered into (“net worth test”). The Commission stated that these standards would limit the availability of the exemption to clients who are financially experienced

⁵ 15 U.S.C. 80b-5(b). A fulcrum fee generally involves averaging the adviser’s fee over a specified period and increasing or decreasing the fee proportionately with the investment performance of the company or fund in relation to the investment record of an appropriate index of securities prices. *See* rule 205-2 under the Advisers Act; Adoption of Rule 205-2 under the Investment Advisers Act of 1940, As Amended, Definition of “Specified Period” Over Which Asset Value of Company or Fund Under Management is Averaged, Investment Advisers Act Release No. 347 (Nov. 10, 1972) [37 FR 24895 (Nov. 23, 1972)].

In 1980, Congress added another exception to the prohibition against charging performance fees, for contracts involving business development companies under certain conditions. *See* section 205(b)(3) of the Advisers Act.

⁶ Section 205(e) of the Advisers Act. Section 205(e) of the Advisers Act authorizes the Commission to exempt conditionally or unconditionally from the performance fee prohibition advisory contracts with persons who the Commission determines do not need its protections. Section 205(e) provides that the Commission may determine that persons do not need the protections of section 205(a)(1) on the basis of such factors as “financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with [section 205].”

⁷ Exemption To Allow Registered Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client’s Account, Investment Advisers Act Release No. 996 (Nov. 14, 1985) [50 FR 48556 (Nov. 26, 1985)] (“1985 Adopting Release”). The exemption applies to the entrance into, performance, renewal, and extension of advisory contracts. *See* rule 205-3(a).

and able to bear the risks of performance fee arrangements.⁸ In 1998, the Commission amended rule 205-3 to, among other things, change the dollar amounts of the assets-under-management test and net worth test to adjust for the effects of inflation since 1985.⁹ The Commission revised the former from \$500,000 to \$750,000, and the latter from \$1,000,000 to \$1,500,000.¹⁰

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)¹¹ amended section 205(e) of the Advisers Act to provide that, by July 21, 2011 and every five years thereafter, the Commission shall adjust for inflation the dollar amount thresholds included in rules issued under section 205(e), rounded to the nearest \$100,000.¹² In May 2011, the Commission published a release (the “May 2011 Release”) that included a notice of intent to issue an order revising the dollar amount thresholds of the assets-under-management test (from \$750,000 to \$1,000,000) and the net worth test (from \$1,500,000 to \$2,000,000).¹³ The Commission issued an order to revise the dollar amount thresholds of the assets-under-management and net worth tests, as described above, on July 12, 2011.¹⁴

⁸ See 1985 Adopting Release, *supra* note 7, at Sections I.C and II.B. The rule also imposed other conditions, including specific disclosure requirements and restrictions on calculation of performance fees. See *id.* at Sections II.C – E.

⁹ See Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client’s Account, Investment Advisers Act Release No. 1731 (July 15, 1998) [63 FR 39022 (July 21, 1998)].

¹⁰ See *id.* at Section II.B.1.

¹¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹² See section 418 of the Dodd-Frank Act (requiring the Commission to issue an order every five years revising dollar amount thresholds in a rule that exempts a person or transaction from section 205(a)(1) of the Advisers Act if the dollar amount threshold was a factor in the Commission’s determination that the persons do not need the protections of that section).

¹³ See Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3198 (May 10, 2011) [76 FR 27959 (May 13, 2011)].

¹⁴ See Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3236 (July 12, 2011) [76 FR 41838 (July 15, 2011)] (“2011 Order”). The 2011 Order was effective as of September 19, 2011. *Id.* The 2011 Order applies to contractual relationships entered into on or after the

The May 2011 Release also proposed amendments to rule 205-3 providing, among other things, that the Commission would issue an order every five years in the future adjusting the rule's dollar amount thresholds for inflation.¹⁵ On February 15, 2012, the Commission adopted these proposed amendments, which amended rule 205-3 in three ways to carry out the inflation adjustment of the rule's dollar amount thresholds.¹⁶ First, the amendments revised the dollar amount thresholds in rule 205-3, in order to codify the order the Commission issued on July 12, 2011.¹⁷ Second, the amendments added to rule 205-3, as proposed, a new paragraph stating that the Commission will issue an order on or about May 1, 2016, and approximately every five years thereafter, adjusting for inflation the dollar amount thresholds of the rule's assets-under-management and net worth tests.¹⁸ Finally, the amendments to rule 205-3 specify the price index on which future inflation adjustments will be based—the Personal Consumption Expenditures Chain-Type Price Index (“PCE Index”), which is published by the United States Department of Commerce.¹⁹ The PCE Index is an indicator of inflation in the personal sector of the U.S. economy²⁰ and is used in other provisions of the federal securities laws, including the

effective date and does not apply retroactively to contractual relationships previously in existence.

¹⁵ See May 2011 Release, *supra* note 13.

¹⁶ See Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3372 (Feb. 15, 2012) [77 FR 10358 (Feb. 22, 2012)].

¹⁷ See rule 205-3(d)(1)(i)-(ii).

¹⁸ See rule 205-3(e).

¹⁹ See rule 205-3(e)(1).

²⁰ See, e.g., Jo Craven McGinty, *CPI vs. PCE: Untangling the Alphabet Soup of Inflation Gauges*, The Wall Street Journal (Mar. 20, 2015), available at <http://www.wsj.com/articles/cpi-vs-pce-untangling-the-alphabet-soup-of-inflation-gauges-1426867398>; Clinton P. McCully, Brian C. Moyer, and Kenneth J. Stewart, “Comparing the Consumer Price Index and the Personal Consumption Expenditures Price Index,” Survey of Current Business (Nov. 2007) at 26 n.1 (PCE Index measures changes in “prices paid for goods and services by the personal sector in the U.S. national income and product accounts” and is primarily used for macroeconomic analysis and forecasting).

determination of whether a person meets a specific net worth minimum in Regulation R under the Securities Exchange Act of 1934 [15 U.S.C. 78a].²¹

II. DISCUSSION

A. Order Adjusting Dollar Amount Tests

Pursuant to section 418 of the Dodd-Frank Act and rule 205-3(e), today we are providing notice²² that the Commission intends to issue an order making the required inflation adjustment to the assets-under-management test and the net worth test in the definition of “qualified client” in rule 205-3. As discussed above, section 418 of the Dodd-Frank Act and rule 205-3(e) require that we adjust the dollar amount thresholds of the rule by order on or about May 1, 2016 and every five years thereafter.²³ We intend to issue an order that would maintain the dollar amount of the assets-under-management test at \$1,000,000, and would increase the dollar amount of the net worth test from \$2,000,000 to \$2,100,000. As required under rule 205-3, both dollar amounts would take into account the effects of inflation by reference to historic and current levels of the PCE Index. While the dollar amount of the assets-under-management test would not change, because the amount of the Commission’s inflation adjustment calculation is smaller

²¹ See Definitions of Terms and Exemptions Relating to the “Broker” Exceptions for Banks, Securities Exchange Act Release No. 56501 (Sept. 24, 2007) [72 FR 56514 (Oct. 3, 2007)] (adopting periodic inflation adjustments to the fixed-dollar thresholds for both “institutional customers” and “high net worth customers” under Rule 701 of Regulation R); *see also* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) [75 FR 49234 (Aug. 12, 2010)] (increasing for inflation the threshold amount for prepayment of advisory fees that triggers an adviser’s duty to provide clients with an audited balance sheet and the dollar threshold triggering the exception to the delivery of brochures to advisory clients receiving only impersonal advice).

The Dodd-Frank Act also requires the use of the PCE Index to calculate inflation adjustments for the cash limit protection of each investor under the Securities Investor Protection Act of 1970. *See* section 929H(a) of the Dodd-Frank Act.

²² *See* section 211(c) of the Advisers Act (requiring the Commission to provide appropriate notice of and opportunity for hearing for orders issued under the Advisers Act).

²³ *See supra* notes 12 and 18 and accompanying text.

than the rounding amount specified under rule 205-3, the dollar amount of the net worth test would be adjusted as a result of the Commission's inflation adjustment calculation effected pursuant to the rule.²⁴

We anticipate that future changes to the dollar amount tests that are issued by order will be reflected in technical amendments to rule 205-3(d), which would be adopted after such order is issued.²⁵

B. Effective Date

We anticipate that, if we issue the order described above, the effective date will be 60 days following the order date.²⁶ To the extent that contractual relationships are entered into prior to the order's effective date, the dollar amount test adjustments in the order would not generally

²⁴ Specifically, rule 205-3(e) provides that the adjusted dollar amounts shall be computed by: 1) dividing the year-end value of the PCE Index (or any successor index thereto) for the calendar year preceding the calendar year in which the order is being issued (in this case, 2015), by the year-end value of the PCE Index (or successor) for the calendar year 1997 (such quotient, the "Adjustment Percentage"); 2) for the assets-under-management test, multiplying \$750,000 by the Adjustment Percentage and rounding the product to the nearest multiple of \$100,000; and 3) for the net worth test, multiplying \$1,500,000 by the Adjustment Percentage and rounding the product to the nearest multiple of \$100,000.

As of April 8, 2016, the end-of-year 2015 PCE Index was 109.819, and the end-of-year 1997 PCE Index was 79.657. Assets-under-management test calculation to adjust for the effects of inflation: $(109.819/79.657) \times \$750,000 = \$1,033,986.34$; \$1,033,986.34 rounded to the nearest multiple of \$100,000 = \$1,000,000. Net worth test calculation to adjust for the effects of inflation: $(109.819/79.657) \times \$1,500,000 = \$2,067,972.68$; \$2,067,972.68 rounded to the nearest multiple of \$100,000 = \$2,100,000.

The values of the PCE Index are available from the Bureau of Economic Analysis, a bureau of the United States Department of Commerce. See <http://www.bea.gov>; see also Bureau of Economic Analysis, Table 2.3.4., "Price Indexes for Personal Consumption Expenditures by Major Type of Product," available at <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=1&isuri=1&903=64> (last visited April 8, 2016).

²⁵ See May 2011 Release, *supra* note 13, at n.27 (noting that the Commission anticipated, when it issued its notice of intent to issue an order revising the dollar amount thresholds of the assets-under-management test and the net worth test, that "future changes to the dollar amount test that are issued by order, will be reflected in technical amendments to rule 205-3").

²⁶ When the Commission issued the 2011 Order adjusting the dollar amount tests of rule 205-3 as described above, the 2011 Order's effective date was approximately 60 days following its issuance. See *supra* note 14.

apply retroactively to such contractual relationships, subject to the transition rules incorporated in rule 205-3.²⁷

By the Commission.

Brent J. Fields
Secretary

Dated: May 18, 2016

²⁷ See rule 205-3(c)(1) (“If a registered investment adviser entered into a contract and satisfied the conditions of this section that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of this section; Provided, however, that if a natural person or company who was not a party to the contract becomes a party (including an equity owner of a private investment company advised by the adviser), the conditions of this section in effect at that time will apply with regard to that person or company.”); *see also* May 2011 Release, *supra* note 13, at section II.B.3.