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SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

INVESTMENT COMPANY ACT OF 1940
Release No. 7265
INVESTMENT ADVISERS ACT OF 1940
Release No. 323

NOTICE OF PROPOSAL UNDER THE INVESTMENT ADVISERS
ACT OF 1940, AS AMENDED, TO ADOPT RULE 205-2
DEFINING "SPECIFIED PERIOD" OVER WHICH THE ASSET
VALUE OF THE COMPANY OR FUND UNDER MANAGEMENT
IS AVERAGED

File No. S7-445

NOTICE IS HEREBY GIVEN that the Securities and Exchange Commission has under consideration the adoption of a Rule under the Investment Advisers Act of 1940 ("the Act"), as amended by the Investment Company Amendments Act of 1970 (the "1970 Act"). The proposed rule is designed primarily to make clear that under amended Section 205 of the Act, which became effective on December 14, 1971, the "specified period" over which the asset value of the company or fund under management is averaged shall mean the same period over which investment performance is computed. The rule would be adopted pursuant to the authority granted the Commission under Sections 205, 206A and 211 of the Act.

Prior to the amendment of Section 205 many investment company performance fee arrangements were unfair to investment companies. Many such fees did not decrease for poor performance; or, if they did, decreases were disproportionate to increases. The amendments to Section 205 were designed to align, as nearly as possible, the interests of the adviser and the investment company by correcting imbalances in incentive fee arrangements. Thus, under the section, as amended, all performance fees are prohibited unless compensation under them increases and decreases proportionately with 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 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.

Section 211 of the Act gives the Commission authority to issue such rules and regulations as are necessary or appropriate to the exercise of the functions and powers conferred upon it under the Act.

Section 206A of the Act authorizes the Commission by rules and regulations to conditionally or unconditionally exempt any transaction from any provision of the Act or of any rule or regulation thereunder if and to the extent such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policies and provisions of the Act.

In Investment Company Act Release No. 7113 (Investment Advisers Act Release No. 315) the Commission set forth its views on various elements of incentive fee arrangements in order to assist officers and directors of investment companies and their investment advisers in evaluating the fairness of such arrangements in connection with the renewal and adoption of investment company advisory contracts in the future. This was the seventh in the series of interpretative statements and guidelines published by the Commission to assist investment company officers and directors and investment advisers in understanding their responsibilities in connection with the 1970 Act. ^{1/} It was not intended to indicate that the Commission questioned the legality of any existing contract which did not comply with the interpretations announced for the first time in the release.

Included in Release No. 7113 under the heading "Variations in Periods Used For Computing Average Asset Values and Performance" was a discussion of the consequences of using different periods for averaging assets and computing performance under incentive fee arrangements. This aspect of the release was designed to call attention to the difficulties which can arise through the use of different periods for averaging assets and computing performance.

The proposed rule requires that, under a contract containing an incentive fee arrangement, assets should be averaged over the same period performance is computed. An exemption for contracts providing for a "rolling period" is contained in paragraph (c) of the proposal. It would permit the specified period over which the asset value of the company or fund is averaged for computing the "fulcrum fee" to differ from the period over which asset value is averaged for computing the performance related portion of the fee. Under this exemption the fulcrum fee may be computed on the basis of asset values averaged over the most recent subperiod of the rolling period. For example, this exemption would permit a fee structure under which the performance related portion of the fee could be based upon a 12 quarter "rolling period" and the "fulcrum fee" could be computed on the basis of the

^{1/} Other releases in the series included Investment Company Act Release Nos. 6336 (February 2, 1971); 6392 (March 19, 1971); 6430 (April 2, 1971); 6440 (April 6, 1971); 6506 (May 5, 1971); and 6568 (June 11, 1971).

most recent quarter of such rolling period. It would also permit a rolling period of 365 days and daily computation of the performance related portion of the fee and of the fulcrum fee. Of course, as stated in Investment Company Act Release No. 7113, interim payments greater than the minimum fee are not permitted under any incentive arrangements.

Although the proposed rule would permit the fulcrum fee to relate more closely to current assets than the interpretation contained in Investment Company Act Release No. 7113, the rule is consistent with that interpretation. Both would require that the performance portion of the fee be based upon the assets upon which such performance was achieved and that the amount of compensation paid for performance not be influenced unduly by the amount of sales (or redemptions). The proposed rule, if adopted, would be made effective prospectively.

The text of the proposed rule is as follows:

Rule 205-2. Definition of "specified period" over which the investment performance of the investment company is computed.

(a) For purposes of this rule:

(1) "Fulcrum fee" shall mean the fee which is paid or earned when the investment company's performance is equivalent to that of the index or other measure of performance.

(2) "Rolling period" shall mean a period consisting of a specified number of subperiods of definite length in which the most recent subperiod is substituted for the earliest subperiod as time passes.

(b) The specified period over which the asset value of the company or fund under management is averaged shall mean the period over which the investment performance of the company or fund and the investment record of an appropriate index of securities prices or such other measure of investment performance are computed.

(c) Notwithstanding paragraph (b), the specified period over which the asset value of the company or fund is averaged for the purpose of computing the fulcrum fee may differ from the period over which the asset value is averaged for computing the performance related portion of the fee, only if

(1) the performance related portion of the fee is computed over a rolling period and the total fee is payable at the end of each subperiod of the rolling period; and

(2) the fulcrum fee is computed on the basis of the asset value averaged over the most recent subperiod or subperiods of the rolling period.

All interested persons are invited to submit their written views and comments on the proposed rule to Ronald F. Hunt, Secretary, Securities and Exchange Commission, Washington, D. C. 20549, on or before August 18, 1972 . All communications to the Secretary, in this regard should refer to File No. S7- 445, and will be available for public inspection.

Ronald F. Hunt
Secretary

NOTICE

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