Chapter 6

Performance Based Advisory Compensation

I. Introduction and Summary of Recommendations

Section 205(a)(1) of the Investment Advisers Act[1] generally prohibits a registered investment adviser from receiving compensation on the basis of a share of capital gains in or capital appreciation of a client's account, or any portion thereof?[2] Commonly referred to as a "performance fee,"[3] this type of compensation arrangement can take various forms. For example, fees equaling ten percent of the gains in an account or of the gains exceeding the performance of a designated securities index or other benchmark are performance fees. Another example of a performance fee is waiver by an adviser of its customary fee unless there is a gain in an account.

The performance fee prohibition was included in the Advisers Act because of Congressional concern that performance fees created incentives for advisers to take inappropriate risks in managing a client's account in order to increase advisory fees.[4] Performance fees in use at the time typically rewarded an adviser, above and beyond its customary fee, for good performance, without penalizing it for poor performance. Congress concluded that performance fees

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[1]Investment Advisers Act of 1940, 15 U.S.C. § 80b.

[2]15 U.S.C. § 80b-5(a)(1). Section 205(a)(1) provides in relevant part:

> No investment adviser, unless exempt from registration pursuant to section 203(b), shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew an investment advisory contract, or in any way to perform any investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract --
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> > (1) 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.

[3]We use the term "performance fee" to refer to those types of compensation arrangements based on capital gains or capital appreciation that are prohibited by section 205(a)(1). Compensation arrangements based on other measures of performance, such as net income, are not prohibited by the Advisers Act.

[4]H.R. REP. No. 2639, 76th Cong., 2d Sess. 29 (1940).

encouraged advisers to speculate unduly because they had everything to gain and little to lose.

As originally enacted, section 205(a)(1) did not cover contracts between registered investment advisers and investment companies registered under the Investment Company Act? In 1970, however, Congress extended the performance fee prohibition to advisory contracts with registered investment companies based, in part, on information that revealed many registered investment companies had performance based fee arrangements that allowed their advisers to earn a bonus for good performance without imposing a comparable penalty for poor performance.

At the same time, Congress acknowledged that not all performance fees are inherently undesirable and exempted from the performance fee prohibition a type of fee known as a "fulcrum fee."[6] With a fulcrum fee, an adviser's compensation increases or decreases depending on how an account performs relative to an appropriate index or other measure of performance over a specified period.[7] Under the statute, fulcrum fee arrangements may be made only with registered investment companies or persons with whom the adviser has contracted to manage at least $1 million in assets.

Congress in 1970 also gave the Commission broad authority to exempt, among other things, performance fee arrangements. The Commission exercised its authority in 1985, adopting a rule providing for a second limited exemption from the performance fee prohibition for advisory contracts with wealthy clients having at least $500,000 under the management of the investment adviser or a net worth exceeding $1 million, if certain conditions and restrictions contained in the rule are met.[8]

[5] Investment Company Act of 1940, 15 U.S.C. § 80a.

[6] Advisers Act § 205(b)(2), 15 U.S.C. § 80b-5(b)(2).

[7] Advisers Act rules 205-1 and 205-2 (17 C.F.R. §§ 275.205-1, .205-2) contain requirements regarding how the investment performance of an account and the investment record of an index may be measured and compared.

[8] Investment Advisers Act Release No. 996 (Nov. 14, 1985), 50 FR 48556 (adopting rule 205-3).

Section 205(a)(1) always has been controversial? Supporters of the prohibition on performance fees point to the potential for excessive risk taking.[10] They believe performance fees may have anti-competitive effects, favoring well-capitalized advisers.[11] They also challenge whether there is any basis, theoretical or actual, for believing that performance fees will improve performance.[12] In addition, some have expressed concern that performance fees would act to the detriment of clients that do not pay performance fees because advisers would devote more of their time and resources to the clients that do.[13]

Critics of the prohibition argue that performance fees are a rational means of compensating advisers because they create a coincidence of advisory and client goals by linking advisory compensation to performance.[14] They assert that performance fees encourage the establishment of new advisory firms and provide an incentive for advisers to service smaller accounts that otherwise would be deprived of advisory services.[15] They also argue that performance fees reduce

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[9]*See, e.g.,* Julie Roher, *The Great Debate Over Performance Fees,* 17 INSTITUTIONAL INVESTOR 123 (Nov. 1983); Richard Grinold and Andrew Rudd, *Incentive Fees: Who Wins? Who Loses?,* 43 FIN. ANALYSTS J. 27 (Jan.-Feb. 1987); Lawrence K. Davanzo and Stephen L. Nesbitt, *Performance Fees For Investment Management,* 43 FIN. ANALYSTS J. 14 (Jan.-Feb. 1987); Mark P. Kritzman, *Incentive Fees: Some Problems and Some Solutions,* 43 FIN. ANALYSTS J. 21 (Jan.-Feb. 1987); Eugene E. Record, Jr. and Mary Ann Tynan, *Incentive Fees: The Basic Issues,* 43 FIN. ANALYSTS J. 39 (Jan.-Feb. 1987); Laura T. Starks, *Performance Incentive Fees: An Agency Theoretic Approach,* 22 J. FIN. AND QUANTITATIVE ANALYSIS 17 (Mar. 1987); Linda Parham, *Plan Sponsors Cautiously Approach Performance-Based Fees,* 25 PENSION WORLD 24 (June 1989); Charles W. Gregor, *What Are Investment Managers Saying About Performance Based Fees?,* 22 PENSION WORLD 20 (Dec. 1986); HARVEY E. BINES, THE LAW OF INVESTMENT MANAGEMENT ¶ 5.03[2][a] (1978 & Supp. 1986).

[10]Roher, *supra* note 9, at 127.

[11]Grinold & Rudd, *supra* note 9, at 37.

[12]*See, e.g.,* Roher, *supra* note 9, at 128 (noting that incentives for good performance already exist since advisers are compensated on the basis of account size and must perform well in order to retain their clients). *See also* BINES, *supra* note 9, at 5-36 (indicating that there is no demonstrable connection between performance fees and superior performance).

[13]Letter from the Honorable John D. Dingell, Chairman, House Committee on Energy and Commerce, to John S.R. Shad, Chairman, SEC (Mar. 23, 1983).

[14]Grinold & Rudd, *supra* note 9, at 37. *See also* BINES, *supra* note 9, ¶ 5.03[2][b], at 5-43 (observing that the principal justification for performance fees is that they permit the uncertainty in the quality of the product – the management of the portfolio -- to be shared between the adviser and the client).

[15]Roher, *supa* note 9, at 124. Critics also argue that performance fees permit advisers to stay smaller than they otherwise would under traditional compensation arrangements because,
(continued...)

advisory costs, encourage better performance, and reward good performance.[16] On a practical level, critics charge that clients not needing the protections of the prohibition should be able to structure advisory fees on whatever terms they consider appropriate.

Finally, critics say the prohibition harms domestic advisers[17] when they compete for foreign clients because in many countries performance fee arrangements are not only legal, they are acceptable and customary.[18] Some have suggested that registered advisers be permitted to enter into performance fee contracts with foreign clients to the extent that the laws of a foreign client's home country do not prohibit these fee arrangements.[19]

The Division believes that some of the criticisms of the performance fee prohibition are valid and that modification of the prohibition is warranted. Specifically, we recommend that the Commission transmit to Congress legislation clarifying the Commission's authority under the Advisers Act to exempt from the performance fee prohibition investment advisory contracts with (1) persons whom the Commission determines do not need the protections of the prohibition, based on factors such as wealth and financial sophistication, or (2) persons not residing in the United States, to the extent that performance fees are lawful in the person's country of residence. Although the Commission could expand the existing performance fee exemptive rule to permit certain sophisticated clients of investment advisers to enter into performance fee arrangements, the Division

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assuming an adviser can successfully manage its clients' portfolios, it can generate sufficient income without having to attract a large asset base. *Id.*

[16]BINES, *supra* note **9,** at **5-36** to **5-37.** Properly drafted performance fees can reduce total management fees during periods of market decline when investors are less willing to pay sizable advisory fees and increase fees during periods of rising returns when investor attitudes are quite different. *Id.*

[17]We use "domestic adviser" to refer to an adviser whose offices and personnel are located in the United States and "foreign adviser" to refer to an adviser whose offices and personnel are located outside the United States.

[18]Commenters responding to the Commission's release regarding the reform of investment company regulation (SEC Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. **17534** (June **15, 1990), 55** FR **25322)** were particularly concerned about the anti-competitive effects of the prohibition. *See, e.g.,* Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC **40-44** (Oct. 10, 1990), File No. **S7-11-90.** *See also* Edward F. Greene, Mitchell S. Dupler, and Alan **B.** Cohen, *Jurisdictional Reach of the Investment Advisers Act* of *1940*, **4 INSIGHTS 21, 24-25, 28** (Oct. **1990).**

[19]*See, e.g.,* Stanley **B.** Judd, *International Investment Advisers,* **19 REV. OF SEC. & COMM. REG. 1, 7 (1986).**

believes it is preferable to obtain from Congress explicit authority to adopt rules effecting the proposed changes?'

This chapter begins with an historical overview of the performance fee prohibition. It then analyzes why broad exemptions from the performance fee prohibition are appropriate for advisory contracts with financially sophisticated clients and foreign clients. Finally, the chapter discusses the recommended legislation.

II. An Overview of the Performance Fee Prohibition

As originally enacted, the Advisers Act prohibited registered investment advisers from charging performance fees. The prohibition was prompted more by concerns about the inherent nature of performance fees, rather than by evidence of any actual abuse. Congress believed that performance fees encouraged a degree of risk taking by advisers seeking to increase advisory fees.[21] **Also,** studies indicated that performance fees could induce an investment adviser to advise some clients to buy and others to sell the same securities?' In addition, the Code of Professional Practice of the Investment Counsel Association of America expressly prohibited performance fees.[23]

The performance fee prohibition was not absolute. Contracts between investment advisers and investment companies were excluded from the

[20]The Division believes that, absent statutory amendments, the Commission could not exempt performance fee arrangements with less sophisticated foreign clients.

[21]H.R. REP. NO. 2639, *supra* note 4, at 29; S. REP. NO. 1775, 76th Cong., 3d Sess. 22 (1940). See *also* SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. No. 477, 3d Sess. 30 (1939) [hereinafter INVESTMENT TRUST STUDY] (stating that performance fees encourage advisers to recommend a degree of risk that investors themselves would not knowingly undertake, as advisers have everything to gain and nothing to lose). The INVESTMENT TRUST STUDY found that a number of investment companies paid performance fees, typically 25% of profits, to their investment advisers. INVESTMENT TRUST STUDY, *supra*, at 17. *See also* TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS 646 (1935) (citing with disapproval investment advisers who "conduct speculative operations with other people's money for a percentage of the profits without liability for losses").

[22]*Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate* Comm. *on Banking and Currency,* 76th Cong., 3d Sess., pt. 2, 1004-17 (1940) [hereinafter 1940 *Senate Hearings]* (referring to findings of the Research Department of the Illinois Legislative Council). In the normal course of the market, some of the accounts receiving advice would profit. Thus, an adviser receiving a performance fee for conflicting advice about the same security would be reasonably assured of profiting from its advice. *Id.* at 1012.

[23]*Id.* at 726 (statement of Dwight C. Rose, President, Investment Counsel Ass'n).

prohibition.[24] The investment company industry had argued successfully that performance fees closely linked the interests of investors and management throughout the life of the investment and that the basis of compensation should not be specified by statute as long as the chosen basis was disclosed adequately to shareholders.[25]

The industry's position on performance fees was challenged in 1966, when the Commission issued a report that, among other things, recommended that the performance fee prohibition be extended to investment company contracts.[26] Although the report contained no specific examples of abuse, the Commission subsequently furnished Congress with information that, out of 137 registered investment companies with performance fee arrangements, 48 allowed the adviser to earn a bonus for good performance without imposing a penalty for poor performance.[27] An additional 45 investment companies had performance fee arrangements in which the potential rewards were substantially greater than the penalties.[28] Based in part on the Commission's recommendation, bills were introduced in Congress to extend the performance fee prohibition to contracts with investment companies.

Ultimately, in 1970, Congress enacted amendments to the Advisers Act that, among other things, extended the erformance fee prohibition to contracts with registered investment companies?' At the same time, however, Congress exempted contracts with registered investment companies and certain advisory

[24]S. 3580, the bill that ultimately became the Investment Company and Advisers Acts, at first included in its declaration of policy a statement that "the national public interest and the interests of investors are adversely affected when advisory compensation is based on profit sharing contracts and other contingent arrangements conducive to excessive speculation and trading." This statement was deleted from the bill as enacted and contracts with investment companies were excluded from the performance fee prohibition.

[25]*1940 Senate Hearings, supra* note 22, at 664,1055.

[26]SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 345 (1966).

[27]*Mutual Fund Amendments: Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce on H.R. 11995, S. 2224, HR. 13754 and H.R. 14737,* 91st Cong., 1st Sess. 207 (1969).

[28]*Id.*

[29]Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 25, 84 Stat. 1413 (1970) (codified at 15 U.S.C. § 80b-5(b)(1)).

accounts in excess of $1 million that used fulcrum fees?' Congress believed that limiting investment company performance fees to those of the fulcrum variety "would insulate investment company shareholders from arrangements that give investment managers a direct pecuniary interest in pursuing high risk investment policies."[31]

Congress also added section 206A to the Advisers Act, giving the Commission general exemptive authority.[32] In enacting section 206A, Congress expressly contemplated Commission action in appropriate cases "to exempt persons . . . from the ban on performance-based advisory compensation in . . . section [205(a)(1)] of the Advisers Act. . . ."[33]

Thereafter, the Commission issued several orders exempting performance fee arrangements. Generally, the orders applied to contracts with wealthy and financially sophisticated investors, where the advisers made their own substantial investments in the accounts, thus reducing their incentive to take undue risks.[34]

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[30]*Id.* (codified at 15 U.S.C. § 80b-5(b)(2)). This exemption does not apply to accounts organized as trusts, governmental plans, collective trust funds, or separate accounts (essentially, most employee benefit plans).

[31]H.R. REP. NO. 1382, 91st Cong., 2d *Sess.* 41 (1970); S. REP. NO. 184, 91st Cong., 1st Sess. 45 (1969).

[32]Pub. L. No. 91-547, **supra** note 29, at § 26 (codified at 15 U.S.C. § 80b-6a). Section 206A is substantially similar to section 6(c) of the Investment Company Act (15 U.S.C. § 80a-6(c)). Congress intended this section to give the Commission greater flexibility in administering the Advisers Act. Section 206A provides:

> The Commission, by rules and regulations, upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction or any class or classes or persons, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

[33]*See, e.g., S.* REP. NO. **184, supra** note 31, at 46.

[34]*See, e.g.,* Foster Management Company, Investment Advisers Act Release Nos. 646 (Nov. 1, 1978), 43 FR 52313 (Notice of Application) and 651 (Nov. 28, 1978), 16 SEC Docket 316 (Order); Weiss, Peck & Greer, Investment Advisers Act Release Nos. 623 (Mar. 28, 1978), 43 FR 14193 (Notice of Application) and 625 (Apr. 25, 1978), 14 SEC Docket 946 (Order); Connecticut Mutual Life Ins. Co., Investment Advisers Act Release Nos. 459 (May 7, 1975), 40 FR 20992 (Notice of Application) and 461 (June 5, 1975), 16 SEC Docket 316 (Order).

The Commission also issued a number of orders exempting advisers to business development companies ("BDCs").[35]

In 1985, the Commission adopted rule **205-3,** establishing a limited performance fee exemption for advisers to certain wealthy clients.[36] The rule sets forth alternative objective tests -- $500,000 under the adviser's management or a $1 million net worth – for measuring a client's eligibility to enter into a performance fee contract. The rule also sets forth two different methods for calculating the compensation paid to an adviser for a given period depending

[35]BDCs generally invest in small, growing companies whose financing needs cannot be met by the traditional public and institutional financial capital markets. BDC officers and directors usually provide managerial assistance to issuers whose securities are held by the BDC. The developing companies in which the BDC invests typically do not have the funds to compensate the BDC for the efforts of its officers and directors. Therefore, the developing company usually provides compensation in the form of common stock, which, it is hoped, will appreciate in value. Such a compensation arrangement would fall within section 205(a)(1). *See generally* Reginald L. Thomas & Paul F. Roye, *Regulation of Business Development Companies under the Investment Company Act,* 55 *S.* CAL. L. REV. 895 (1982). Until 1978, when an adverse court decision (Abrahamson v. Fletcher, 568 F.2d 862 (2d Cir. 1977), *cert. denied,* 436 U.S. 913 (1978)) changed matters, these advisers had relied on an exemption from the registration requirements of the Advisers Act and thus were not subject to the performance fee prohibition. Congress ultimately prescribed special provisions for BDCs. *See* The Small Business Incentive Investment Act of 1980, Pub. L. No. 96-477, § 203, 94 Stat. 2275 (1980). The legislation, among other things, created a limited exemption from section 205(a)(1) to permit a registered investment adviser to a BDC to receive performance based compensation limited to not more than 20% of the BDC's net realized capital gains. *See* Advisers Act § 205(b)(3), 15 U.S.C. § 80b-5(b)(3). In the interim, the Commission proposed a rule, rule 205-3, which would have permitted BDC advisers to receive performance fees under certain circumstances. *See* Investment Advisers Act Release No. 680 (June 19, 1979), 44 FR 37470. The proposed rule would have permitted certain BDC advisers to receive performance fees, provided the BDC's investors were sophisticated and able to bear the economic risk of their investment. Commenters on the proposed rule supported the Commission's efforts to facilitate the flow of capital to small and developing businesses but criticized the rule's restrictive nature. The Commission subsequently withdrew the proposal. Investment Advisers Act Release No. 750 (Feb. 20, 1981), 46 FR 14353.

[36]Inv. Adv. Act Rel. 996, ***supra*** note ?. The Commission previously had proposed a different version of rule 205-3. That version would have provided general exemptive relief from section 205(a)(1), if the clients were wealthy and knowledgeable and did not need the protections that the prohibition was intended to provide. Investment Advisers Act Release No. 865 (June 10, 1983), 48 **FR** 2771. The proposal would have required the adviser to find that the client or his representative was sufficiently sophisticated in financial and business matters to understand the merits and risks of the performance fee contract. It also would have required the contract to relate to a minimum of $150,000 in assets, The Commission later withdrew the proposal. Investment Advisers Act Release No. 911 (May 2, 1984), 49 FR 19524.

upon the nature of the securities being managed.[37] In addition, the rule requires that any performance fee be based on the gains less the losses in the client's account for a period of not less than one year.[38]

Rule **205-3** also requires an adviser to disclose any potential conflicts of interest that the arrangement may create, the periods which will be used to measure investment performance, the nature and significance of any index that will be used as a comparative measure of investment performance, and the reason the adviser believes the index is appropriate. Where the adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, the adviser is also required to disclose how the securities will be valued and the extent to which the valuation will be independently determined. In essence, the rule places on the adviser the burden of demonstrating that the fee is fair.

III. Discussion

In enacting the statutory exemptions to the performance fee prohibition, Congress has acknowledged that performance fees are appropriate in certain circumstances. Existing exemptions, however, preclude the use of performance fees in advisory contracts in a number of situations, even where the clients are institutions or are otherwise sophisticated. The Division believes that, where a client appreciates the risk of performance fees and is in a position to protect itself from overreaching by the adviser, the determination of whether such fees provide value is best left to the client. The Division also is concerned that the inability of United States investment advisers to enter into performance fee contracts with their foreign clients, even where these arrangements are legal and customary in a client's country of residence, may prevent United States advisers from competing with non-United States advisers in attracting foreign clients. Accordingly, the Division believes that additional exemptions from the performance fee prohibition are warranted.

[37] For securities for which market quotations are readily available, the formula must include realized capital losses and unrealized capital depreciation of the securities over the period. For securities for which market quotations are not readily available, the formula still must include realized capital losses, but need not include unrealized capital depreciation unless it also includes unrealized capital appreciation. 17 C.F.R. § 205-3(c).

[38] Advisers may use any method for receiving payment of the performance fee, but it must be consistently applied and fully disclosed to clients. For example, the fee could be paid annually after each year's performance or the fee could be paid on a rolling basis beginning at the end of a year's performance. Regardless of the method chosen, no part of a performance fee may be paid for any period of less than one year. See Inv. Adv. Act Rel. 996, supra note ?, at n.14.

A. Financially Sophisticated Clients

Neither of the two limited performance fee exemptions available for advisory contracts with financially sophisticated clients is sufficiently flexible to permit advisers to enter into unconditional performance fee arrangements with those clients. Advisers relying on the fulcrum fee exemption must structure their performance fee arrangements to increase and decrease proportionately. Many institutional investors, however, prefer to structure performance fee arrangements with a low base fee, with satisfactory performance resulting in additional compensation. Such a fee does not qualify as a fulcrum fee.

Rule 205-3 provides an alternative for sophisticated investors that do not wish to use a fulcrum fee arrangement. Rule 205-3 contains a number of conditions that, while they are intended to protect investors and might well be insisted upon by a sophisticated client, preclude the use of certain types of performance fee arrangements. For example, some clients may wish to employ performance fees in short-term investment situations (*e.g.,* less than one year). Or, in cases where market quotations are not readily available, clients may wish to exclude realized capital losses or unrealized capital depreciation (even if unrealized capital appreciation is included) from performance fee calculations. Rule 205-3 prohibits either of these situations no matter how sophisticated the client.

Advisory clients that are financially sophisticated, or have the resources to obtain sophisticated financial advice, and that can negotiate fee arrangements on an arm's length basis should be permitted to employ performance fees on terms they consider appropriate. In these instances, we believe that such clients can take steps to protect themselves against overreaching by an adviser?'

B. Foreign Clients

Historically, the Division has taken the position that the Advisers Act applies to all activities of foreign advisers registered under the Act. One consequence of this position is that, unless a foreign adviser establishes an "independent" affiliate registered under the Advisers Act in accordance with conditions set forth by the Division, the adviser is subject to the performance fee prohibition with respect to its foreign clients as well as its United States clients. **As** discussed in Chapter **5,** the Division now believes that the Commission should employ a "conduct" and "effects" approach to the application of the Advisers Act. Under that approach, the Advisers Act's provisions, including the performance

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[39]Of course, advisers entering into performance fee arrangements with sophisticated clients would continue to be subject to the antifraud prohibitions of Advisers Act section 206 (15 U.S.C. § Bob-6).

fee prohibition, generally would not apply to a foreign adviser's dealings with non-United States clients. The dealings of domestic advisers with foreign clients, however, would remain subject to the Advisers Act. Thus, without further modifications, domestic advisers still would be restricted in charging performance fees to foreign clients, even where performance fees are legal and customary in the client's country of residence.

Many foreign countries do not restrict the use of performance fees by advisers.[40] In countries where performance fees are an accepted practice, foreign advisory clients may be discouraged from employing domestic advisers because those advisers only may enter into performance fee arrangements that meet the requirements of one of the two available exemptions. These limitations likely reduce the ability of domestic advisers to compete effectively with foreign advisers in foreign markets.

The Division has concluded that domestic advisers should be permitted to enter into performance fee contracts with foreign clients on terms that are lawful in a given client's country of residence. While the Commission has a strong interest in regulating the conduct of investment advisers resident in the United States to ensure that our shores do not become a base for the export of fraud, the Commission's interest in restricting the use by domestic advisers of performance fee contracts with their foreign clients is less compelling given the limited purposes of section 205(a)(1). Indeed, Congress has acknowledged that performance fees are not inherently fraudulent.

Of course, a foreign client may choose a domestic adviser precisely because the adviser is subject to United States regulatory requirements, including the performance fee prohibition. In that case, the foreign client would be free to refuse to contract for advisory services on a performance fee basis. If a domestic adviser were to impose a performance fee contract on a foreign client in a misleading manner (*e.g.,* either the client was unaware he was entering into a performance fee contract, or was misled as to the nature of the fee arrangement), the adviser's conduct would continue to be subject to the antifraud prohibitions of Advisers Act section 206.

IV. Recommendations

We recommend legislation authorizing the Commission generally to provide exemptions from the performance fee prohibition for advisory contracts

[40] *See, e.g.,* Rule 5 of the Rules of the Investment Management Regulatory Organization Limited. *See also* Debevoise & Plimpton, *International Survey of Investment Adviser Regulation* (Aug. 1990) (providing analyses of the investment advisory laws of Australia, Brazil, France, Germany, Japan, Switzerland, and the United Kingdom).

with (1) any person whom the Commission determines does not need the protections of the prohibition and (2) foreign clients, to the extent that performance fees are lawful in the client's country of residence?' Although the Commission probably could use its section 206A authority to provide further exemptions from the performance fee prohibition for advisory contracts with sophisticated investors, absent specific legislative authority the Commission could not provide performance fee exemptions for advisory contracts with less sophisticated foreign clients. Therefore, because the Commission will need Congressional authority to institute a foreign client exemption, we suggest that Congress, at the same time, clarify through legislation the Commission's ability to provide unconditional exemptions for advisory contracts with sophisticated investors.

Under the proposed legislation, the Commission could adopt a rule permitting United States advisers to enter into performance fee arrangements with their foreign clients to the extent those arrangements were lawful in the client's country of residence.[42] The Division would expect to recommend a rule under this authority that would place on the adviser the burden of determining whether and to what extent the law of a foreign country ermits the use of performance fees by advisers resident within that jurisdiction! The rule would provide that violations of a foreign country's law by an adviser with respect to performance fees would result in the adviser's loss of the exemption and, absent the availability of another exemption, a violation of section 205(a)(1). We also would expect to recommend that United States advisers be required to keep records regarding their performance fee contracts with foreign clients to enable the Commission to monitor these activities through its inspection program.

The legislation would not establish specific eligibility requirements for persons with whom an adviser may contract for performance fees; instead the Commission would set those requirements by rule. This approach will provide more flexibility in administering the exemptions. Writing directly into the statute an unconditional sophisticated client exemption based solely on a financial means test would require the Commission to seek statutory amendments if the monetary level chosen became anachronistic. Similarly, writing a foreign client exemption directly into the statute would, absent statutory amendments, preclude Commission revision or rescission of the exemption if problems arose. In addition, the specific criteria for identifying sophisticated advisory clients not

[41]The recommended statutory language appears in Appendix 6-A at the end of this chapter.

[42]As discussed previously, these advisers' activities would continue to be subject to the antifraud provisions of Advisers Act section 206.

[43]Placing this burden on advisers would mean that the Commission would not have to commit substantial resources to make these determinations on a case-by-case basis.

requiring the protections of a prohibition on performance fees may be subject to debate, as may be the exact terms of an exemption for foreign clients.

APPENDIX 6-A

Red-Lined Version of Proposed Amendment to the Investment Advisers Act of 1940

(new language is shaded; ~~deleted language is struck through~~)

Section 205 [15 U.S.C. § 80b-5].

* * *

(e). The Commission, by rules and regulations, upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction, or any class or classes of persons or transactions, from paragraph (1) of subsection (a) if and to the extent the exemption relates to an investment advisory contract with (i) any person whom the Commission shall have determined does not need the protections of paragraph (1) of subsection (a) on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, or such other factors as the Commission may determine are consistent with the intent of this provision, or (ii) a person who is not a resident of the United States, provided the exemption is consistent with the laws of the person's country of residence.