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Fulcrum Fees: Registered Funds' Alternative Fee Structure

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As has been widely reported in the mainstream financial press and specialized industry publications, hedge fund and private equity fund managers have begun to explore the world of investment companies registered under the Investment Company Act of 1940, as amended (the 1940 Act). In doing so, they have faced certain challenges which have deterred some of the most skilled asset managers from entering the 1940 Act space. One significant deterrent is that unlike advisers to hedge funds and private equity funds, advisers to registered investment companies (that is, mutual funds and closed-end funds) are prohibited under most circumstances from charging a performance fee.

However, new entrants to the 1940 Act space may not be aware that they are in fact permitted to charge a type of performance fee known as a "fulcrum" fee. While this type of performance fee is complex and may not appeal to some managers, others may be interested in understanding how a fulcrum fee works to align a manager's incentives with those of a fund and its shareholders. The purpose of this article is to briefly review the laws and regulations which permit a registered adviser to charge a fulcrum fee, and to discuss related guidance from the Securities and Exchange Commission (SEC) and its Staff, and from the American Institute of Certified Public Accountants (AICPA).[1]

I. Fulcrum Fee Exception Under Section 205 of the Investment Advisers Act

Statutory Exception for Fulcrum Fees. Section 205(a)(1) of the Investment Advisers Act of 1940, as amended (Advisers Act) generally prohibits a registered investment adviser from entering into an advisory contract that provides for compensation to the adviser on the basis of a share of capital gains or capital appreciation on any portion of a client's account. However, Section 205(b)(2) of the Advisers Act grants an exemption for an advisory contract with a registered investment company (fund) that provides for:

> compensation based on the asset value of the company or fund under management averaged over a specified period, and increasing or decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices.

Section 205(c) of the Advisers Act states that for purposes of Section 205(b)(2), the point from which increases and decreases in the adviser's compensation are measured must be the fee that is paid or earned when the investment performance of the fund

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matches the investment record of the index. This fee, which is the fixed portion of the advisory fee, is known as the "fulcrum" or "base" fee. (In this article, we will refer to this portion of the total advisory fee as the "base" fee, and the performance-based portion as the "performance adjustment.") Importantly, the increases and decreases in adviser compensation from the base fee must be proportionate to one another. This means the adviser will be punished for bad performance to the same extent as the adviser is rewarded for good performance.[2] (This may be a hard pill to swallow for some managers that are accustomed to receiving a performance fee regardless of whether or not a private fund has outperformed or underperformed relative to a benchmark index.)

Fulcrum Fee Rules Under Section 205. In 1972, the SEC adopted Rule 205-1 and Rule 205-2 under the Advisers Act to further clarify how performance-based advisory fees should be calculated and charged. Rule 205-1 specifies that:

- the fund's investment performance must be calculated based on the fund's net asset value (NAV)[3]; and
- the investment record of the index must include cash distributions made by companies who securities comprise the index.

Rule 205-2(a) sets forth the definition of the base fee (that is, the fee that is paid or earned when the investment performance of the fund matches the investment record of the index). Rule 205-2(b) provides that when calculating a performance-based advisory fee, the period over which the fund's net assets are averaged should be the same as the period over which the investment performance of the fund, and the investment record of the index, are measured (that is, the performance period). This means that both the base fee and the performance adjustment are required to be calculated on the fund's NAV averaged over the performance period. Rule 205-2(c), however, provides an exception; under certain conditions, a fund's NAV may be averaged over one period for purposes of calculating the base fee, but over a *different* period for purposes of calculating the performance adjustment. Those conditions are that:

- the base fee is calculated based on the fund's NAV averaged over the most recent sub-period of the performance period;
- the performance adjustment is calculated based on the fund's NAV averaged over a rolling performance period; and
- the total advisory fee is payable at the end of each sub-period.

A performance-based fee that relies on Rule 205-2(c) is known as a "bifurcated" fulcrum fee. Many advisers rely on Rule 205-2(c) to adopt rolling performance periods of 12, 24 or 36 months. They receive advisory fees at the end of each sub-period of that rolling performance period (for example, at the end of each month, quarter or semi-annual period), and the base fee is calculated based on the fund's NAV averaged over the prior month, quarter, or semi-annual period. Funds that rely on Rule 205-2(c) have a total advisory fee that is based more on current assets than if the base fee and the performance adjustment were both based on net assets averaged over the performance period. If a fund's current assets are notably higher than its assets averaged over the performance period, the adviser will receive a higher total fee under this method (as the base fee will be calculated on a higher NAV).

Example of a bifurcated fulcrum fee: Assume a fund has an annual Base Fee of 60 basis points (bps), the fund pays the adviser the advisory fee on a monthly basis, and the fund calculates a daily NAV. Using the month of March as an example, for each business day in March, the annual Base Fee of 60 bps will be calculated based upon the average daily value of the fund's net assets.[4] On the last business day of March, the

(*Continued*)

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daily calculations of the Base Fee will be adjusted upward or downward, based upon the application of a performance adjustment. If the rolling period selected by the fund for the performance adjustment is a rolling 12-month period, then the performance adjustment factor will be applied to the average net assets of the fund, based on the amount that the fund outperformed or underperformed a selected index over the rolling 12-month period (for example, the period beginning on April 1st of the prior year and ending on March 31st of the current year). On the last business day of March, the fund will pay its adviser the monthly advisory fee, which will consist of the sum of the daily calculations throughout the month of the Base Fee, as modified by the performance adjustment.

Since 2009, the SEC Staff has emphasized that if a fund decides to use a bifurcated fulcrum fee, the fund should be consistent in applying it.[5] The SEC Staff has also referred funds to AICPA guidance published in 2009, stating that with respect to the incentive portion of the fee, Rule 205-2 requires the performance adjustment to be applied to average net assets over the rolling performance measurement period (and not to current level average net assets), even where, as permitted by Rule 205-2(c), the base fee is applied to current level average net assets.[6] The SEC accounting Staff has, in giving comments to funds on registration statements and proxy statements, supported the AICPA approach towards calculating the performance adjustment.[7]

Considerations in Structuring a Fulcrum Fee. There are several factors that influence the terms of a performance-based advisory fee. First, an adviser must be careful in proposing the level of the base fee and the performance adjustments. Like any other advisory fee, the aggregate fee paid by the fund must be fair. In fulfilling their obligations with respect to the approval of advisory contracts under Section 15(c) of the 1940 Act, fund boards of directors weigh the same factors when evaluating the fairness of a performance-based advisory fee and determining whether to recommend the submission of the advisory contract to a vote of shareholders.[8] Second, the adviser has a fiduciary obligation to use a performance period that is long enough to provide a reasonable basis for the measurement of the adviser's performance (typically, at least 12 months).[9] A longer performance period will mean that the performance adjustment, since it is applied to average net assets, will be more closely tied to the fund's past performance (for example, over a number of years), whereas a shorter performance period will mean that the performance adjustment is tied more closely to current net assets and more recent performance (for example, over the past year). Finally, the adviser must recommend a benchmark index that is appropriate given the fund's volatility, diversification of holdings, types of securities owned, and investment objectives.[10] The fund's board of directors can preserve, in the advisory contract, the ability to modify (by a vote of the board) the benchmark index in the event that it is terminated or discontinued, or if the board later determines that another securities index is a more appropriate measure of performance.[11]

Some performance-based advisory fees provide for "null zones," which means that the performance adjustment is applied to the base fee only after certain levels of performance above or below the index have been achieved (for example, the performance of the fund must exceed or trail the performance of the index by two percentage points before the performance adjustment is applied). Others provide for the application of the performance adjustment as a result of any performance difference (for example, the performance adjustment is applied continuously). In addition, the SEC has taken the view that performance adjustments should reflect "the adviser's skill, or lack of skill, rather than … random fluctuation."[12] This means that the amount of the performance adjustment should reflect a meaningful difference between the fund's performance and that of the index.[13] What constitutes a "meaningful"

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difference for this purpose may vary depending on the fund's size, volatility, diversification and other factors. The SEC has also articulated that the maximum performance adjustment should be reached when the performance difference is at least 10 percentage points. Most funds set maximum and minimum performance adjustments, such that if the fund outperforms or underperforms the index by more than, for example, 10 percentage points, the base fee will not be adjusted by more than the designated maximum performance adjustment.

Example of a bifurcated fulcrum fee, with "null zones" and a minimum and maximum adjustment: Assume the same facts as in the prior example. If the fund sets a "null zone" of two percentage points, then if the fund's performance is not greater than, or less than, the performance of the selected index by more than two percentage points during the performance period, the Base Fee will not be adjusted by the performance adjustment. If the fund also sets a minimum and maximum performance adjustment of 10 percentage points, then if the fund's performance is greater than, or less than, the performance of the selected index by more than 10 percentage points, the Base Fee will only be adjusted upward or downward by the maximum performance adjustment, regardless of the fund's actual performance over the performance period in excess of 10 percentage points relative to the selected index.

II. SEC Staff Consideration of Fulcrum Fees

The Staff of the Securities and Exchange Commission (SEC) has, since 2009, articulated a particular interest in "bifurcated" fulcrum fees because in such an arrangement, the total advisory fee can vary widely if the fund's assets increase or decrease significantly over the performance period. In some cases, the fee could even be negative, which would result in a reimbursement to the fund by the adviser. This could occur where (i) fund assets decrease significantly over the performance period, resulting in a situation in which the asset base used to calculate the performance adjustment is higher than the asset base used to calculate the base fee *and* (ii) the fund significantly underperforms the benchmark index, resulting in a downward performance adjustment. Under this scenario, the dollar amount of the performance adjustment would be greater than the dollar amount of the base fee. Subtracting the performance adjustment from the base fee would result in a negative total advisory fee. The SEC Staff takes the position that the proportionality principle in Section 205 of the Advisers Act requires that the adviser reimburse the fund under these circumstances.[14] The director of the SEC's Division of Investment Management noted during a speech that "some funds … try to implement a floor total fee, which would limit the downside to an adviser by providing it with a minimum cash payment and prevent the adviser from ever having to reimburse the fund" but that this approach is not permissible under Section 205, because it "only limits the downside without proportionally limiting the adviser's upside."[15]

In reviewing bifurcated fulcrum fee arrangements, the SEC Staff has asked registrants to disclose, in fund proxy statements and registration statements, the possibility that the total advisory fee in a bifurcated fulcrum fee structure could be negative and result in a reimbursement by the adviser to the fund.[16] However, such disclosure may not be appropriate if the fund does not anticipate significant fluctuations in its assets. For example, closed-end funds do not issue redeemable securities, and therefore do not experience inflows and outflows from shareholder redemptions, as open-end funds do. Closed-end funds may repurchase their own shares in the open market or through tender offers, but typically these events are infrequent or are not in significant amounts. Therefore, the likelihood of a negative advisory fee for a closed-end fund is

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reduced, even under circumstances of significant underperformance. Some closed-end funds have been successful in arguing that disclosure relating to the possibility of a negative fee is not necessary.

Conclusion

The rules governing the implementation of performance-based advisory fees are technical. Since 2009, the SEC Staff has demonstrated its interest in ensuring that such fees are properly structured, calculated and disclosed to shareholders. Notwithstanding these considerations, fund boards and fund managers should not be discouraged from considering adoption of a fulcrum fee, and may find the adoption of a fulcrum fee regime to be an appropriate and attractive component to a fund offering.

Proper fund compliance procedures and board oversight relating to calculation of fulcrum fees require additional effort, including ongoing attention by the adviser's fund accounting function and review by the fund CCO with periodic reporting to the fund's board. If attainable, a fund's board should request confirmation by the fund auditors, during preparation of the semiannual report and annual report, that the method of calculation and actual calculations of the fund's fulcrum fee are appropriate and consistent with current regulatory and audit guidance. A fund board should consider fund performance and its impact on the fulcrum fee paid to the adviser, and the continued appropriateness of a fulcrum fee, during a fund's annual Section 15(c) advisory contract review.

Advisers to registered funds may find fulcrum fees attractive, especially for funds with non-traditional investment strategies. Boards of funds may find the inclusion of a fulcrum fee in a registered fund's investment management contract an inducement to attracting managers which have previously not managed registered funds. Managers that choose to implement performance-based advisory fees should solicit the input of legal counsel and audit firms to be sure they are structured properly. For the manager that is willing to address these challenges upfront, and is prepared to put proper policies, procedures, and practices into place prior to the commencement of a fulcrum fee compensation system, performance-based advisory fees may be utilized, and both a fund board and a fund advisor may determine a fulcrum fee to be an attractive component of the fund, further aligning the incentives of the manager with the performance of the fund and the best interests of the fund's shareholders.

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NOTES

1 For additional background and detail regarding fulcrum fees, *see also* Jack W. Murphy and Julien Bourgeois, "Mutual Fund Performance Fees: Discussion and Observations," *The Investment Lawyer* (November 2006).

2 However, the SEC Staff has granted no-action relief where a fulcrum fee decreased twice as fast as it increased, noting that "Congress primarily sought to ensure that performance-based fees would not increase by an amount or rate greater than that by which they decreased." Royce Value Trust, Inc., SEC No-Action Letter (pub. avail. Dec. 22, 1986).

3 By basing investment performance on NAV, an investment adviser cannot earn a performance fee when shareholders did not benefit from the performance after the deduction of fees and expenses.

4 This example assumes that the fund does not use leverage – and therefore, that the base fee is charged on net assets rather than on "managed assets" (which would include assets obtained through the use of leverage).

5 Andrew J. Donohue, *Speech by SEC Staff: Keynote Address at the Independent Directors Council Investment Company Directors Conference* (November 12, 2009), available at *www.sec.gov/news/speech/2009/spch111209ajd.htm*.

6 *See* "Fulcrum Fees Under Rule 205-2(c) of the Investment Advisers Act of 1940," *Investment*

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Companies Industry Developments—2009, AICPA Audit and Accounting Manual, §8100.71.

7 The SEC Staff has also taken issue with funds that have tried to limit the performance adjustment to a multiple of the base fee (as in that case, the performance adjustment would then be tied to current net assets). *Id*.

8 Many funds choose to implement a performance-based fee at inception, rather than after the fund has launched, as it can be difficult to obtain shareholder approval of such a fee once there are public shareholders in the fund. Approval of the investment advisory agreement requires the affirmative vote of a "majority of the outstanding voting securities" of the fund under §15 of the 1940 Act, which means the vote of 67% or more of the shares of the fund that are present at a meeting, if the holders of more than 50% of such outstanding shares are present or represented by proxy, or the vote of more than 50% of the fund's outstanding shares, whichever is less. However, some funds have successfully obtained shareholder approval of an advisory agreement containing a performance-based fee.

9 *Factors to be Considered in Connection with Investment Company Advisory Contracts Containing Incentive Arrangements*, Release No. IA-315 (April 18, 1972).

10 *Id*.

11 A change in the performance index may alter the subsequent return of the index measure, but performance prior to the change in the performance index will continue to be based on the former performance index.

12 *See supra*, n.9.

13 *Id*.

14 Likewise, under this interpretation, if the performance adjustment were extremely large, due to the fund's outperformance versus the benchmark index and an increase in fund assets over the performance period, the fund would be obligated to pay a high total advisory fee to the adviser.

15 *See* n.4, *supra*.

16 *See* n.5, *supra*. *See also AICPA Investment Companies Expert Panel Highlights*, September 9, 2009 Meeting Highlights, available at *http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/DownloadableDocuments/INV/INV_EP_Minutes/Archive/INV_EP_September_2009_meeting.pdf*.

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