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Mutual Fund Performance Fees: Perspectives After More Than 40 Years

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In 1972, the US Securities and Exchange Commission (SEC) published several releases and adopted rules relating to mutual fund performance fee arrangements.[1] In the early 2000s, SEC Staff sweep examinations related to fund performance fees and the resulting SEC enforcement actions suggested that the law governing mutual fund fulcrum fee arrangements was unclear in many respects.[2] More than 40 years later, there has been a renewed interest in performance fees by SEC Commissioners,[3] some fund investment advisers, rating agencies and journalists. In particular, interest in performance fee arrangements for actively managed funds has increased as a way to compete with passive funds.[4] This renewed interest brings into focus once again the regulation of these arrangements.

This article discusses the laws and regulations applicable to mutual fund fulcrum fee arrangements, and related questions that the authors have encountered in practice. While these topics were originally covered in an article published in 2006,[5] the authors felt that 13 years later it was an appropriate time to update their prior discussion, notably to open a discussion about whether the rules relating to performance fee arrangements remain appropriate today or whether they should be modernized.

Legal Background

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser registered under the Advisers Act from entering into an investment advisory contract that provides for compensation to the investment adviser calculated on the basis of a share of capital gains on or capital appreciation of any portion of a client's account. As originally introduced, the purpose of Section 205(a)(1) was to eliminate profit-sharing where an adviser did not participate in losses, and a proposed separate provision in the Investment Company Act of 1940 (1940 Act) would have restricted investment companies to compensating investment advisers based on either a fixed sum, income from interest and dividends, or net asset value.[6] However, the SEC softened its view after negative industry response and the final bill limited regulation of investment adviser compensation to a prohibition on payment out of capital gains or appreciation.[7] There are thus some performance fee arrangements that are not subject to Section 205(a)(1).[8] The prohibition of compensation arrangements based on capital gains or appreciation (commonly called performance fees) was included in the Advisers Act because of congressional concern that performance fees could create incentives for advisers to take inappropriate risks in managing a client's account in order to increase advisory fees[9] and to prevent contracts that were nothing more than "heads I win, tails you lose."[10]

Section 205(a)(1) did not originally cover contracts between registered investment advisers and investment companies registered under the 1940 Act. In 1970, however, Congress extended the performance fee prohibition to advisory contracts with registered investment companies. At the same time, it acknowledged that not all performance fee arrangements should be prohibited and excepted from the performance fee prohibition arrangements providing 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) also specifies that, for purposes of Section 205(b)(2), the point from which increases and decreases in compensation are measured must be the fee that is paid or earned when the investment performance of the fund is equivalent to that of the index (the fulcrum fee).

In the early 1970s, in addition to the enactments, the SEC issued the 1972 Interpretative Release and adopted Rule 205-1 and Rule 205-2 under the Advisers Act regarding mutual fund performance fees. Taken together, these interpretations and rules, as well as no-action letters issued by the SEC Staff, provide guidance on how the performance fees of registered investment companies (also called fulcrum fee arrangements) should be calculated and charged.

Rule 205-1 explains how the "investment performance" of a mutual fund and the "investment record of an appropriate index of securities prices" over a certain performance period must be calculated for purposes of complying with Section 205. The rule specifies that the return of the fund must be based upon the change in the fund's net asset value per share.[11]

Rule 205-2 defines the "fulcrum fee" as the base fee that is paid or earned when the fund's investment performance is equivalent to the investment record of the fund's benchmark index over a chosen performance period. It also is the point from which increases or decreases in compensation are to be measured. Rule 205-2(b) requires that the period over which the net asset value of the fund is averaged for purposes of fee calculation must be the same period over which the investment performance of the fund and the investment record of the index are computed (that is, the performance period). This provision implies that both the fulcrum fee (that is, the fixed portion of the fund's advisory fee) and the performance adjustment (that is, the performance-based portion of the fund's advisory fee) must be calculated on the fund's net asset value averaged over the performance period. Rule 205-2(c), however, sets out an exception to that principle, providing that the specific period over which the net asset value of the fund is averaged to calculate the fulcrum fee may differ from the period over which the net asset value is averaged for purposes of computing the performance adjustment if:

1. The fulcrum fee is computed on the basis of net asset value averaged over the most recent subperiod of the performance period;
2. The performance adjustment is computed on the basis of net asset value averaged over a rolling performance period; and
3. The total advisory fee is payable at the end of each subperiod.

In practice, Rule 205-2(c) allows fund advisers to adopt rolling performance periods (for example, 12, 24 or 36 months) and receive advisory fees at the end of each subperiod (for example, at the end of each month, quarter or semi-annual period). However, because the fulcrum fee is calculated on net assets averaged over a recent period of time, a fund's total advisory fees (that is, the fulcrum fee as modified by the performance adjustment), under this bifurcated method, tend to be based more on current assets than if both portions of the fees were based on net assets averaged over the entire performance period. Total fees under this bifurcated method are, in theory, less influenced by changes in net assets due to purchase or redemptions of fund shares during the performance period and this method also allows the adviser to receive payments periodically. However, for the reasons explained and illustrated below, bifurcating the performance periods can result in actual fees that greatly differ from the predictable advisory fee rates that advisers, industry consultants, and fund investors may anticipate. Nevertheless, it is the authors' experience that most fulcrum fee arrangements have been designed to comply with this bifurcated calculation method provided in Rule 205-2(c) under the Advisers Act.

Designing and Adopting a Fulcrum Fee Arrangement

Choosing a Fulcrum Fee

As previously explained, the fulcrum fee is the fixed portion of the fee (that is, the fee paid when the fund's performance equals that of the benchmark index). The SEC explained in the 1972 Interpretative Release that "the selection of a fair fulcrum fee is a critical prerequisite to a fair performance fee." The SEC also indicated in the release that the same factors should be considered in arriving at a fair fulcrum fee as are taken into account in establishing regular advisory fees. These factors include (1) the nature and quality of the advisory, administrative, and other services provided to the fund by the investment adviser and its affiliates; (2) profitability of the fund to the adviser/manager; (3) economies of scale realized in operating the fund; (4) fee structures of similar funds; and (5) "fall-out" benefits derived by the investment adviser and its affiliates from their relationship with the fund.[12] In practice, it would also be appropriate to consider a fulcrum fee in light of contemplated performance adjustments because the fund and its shareholders will be paying both portions of the total advisory fee.[13]

Choosing a Performance Period

Section 205 of the Advisers Act does not require that performance be measured over a specified period of time. However, the SEC indicated in the 1972 Interpretative Release that an investment adviser has a fiduciary obligation to use a period long enough to provide a reasonable basis for measuring the adviser's performance. In this regard, the SEC stated its view that the use of a period of at least one year to measure fund performance would minimize the possibility that fees will be based on random or short-term fluctuations of performance. Also, when structuring a performance fee, one must consider whether the performance period is a fixed period, in which case the total advisory fee is payable only at the end of the period, or a "rolling period," in which case advisory fees would be payable at the end of each subperiod. In practice, advisers and mutual fund boards should keep in mind that the amount of the performance adjustment to the fulcrum fee will be highly dependent upon performance relative to the index and average net assets over the performance period. If a longer performance period is selected, for example, a 36-month rolling period, then past performance and past variations in the level of net assets (primarily due to shareholder activity in the fund, which can fluctuate considerably) will influence the amount of the current subperiod's performance adjustment for a much longer time than if a shorter performance period, for example, a 12-month rolling period, is selected. This is because in the case of a shorter period the performance adjustment would be more tied to current assets, and the fee will generally be more predictable and more in line with standard advisory fee rates. The choice of a performance period will materially impact the aggregate amount of advisory fees paid by the fund and advisers and fund boards should review models under various performance asset level scenarios to understand the impact of the performance period if they do not already have experience with such arrangements. The average investment period of investors in the fund may also be a relevant factor in some circumstances.

Selecting a Benchmark Index

In determining whether an index is appropriate for a particular fund, the SEC has stated that directors should consider factors such as the volatility, diversification of holdings, types of securities owned and investment objectives of the fund.[14] Some SEC no-action letters have also discussed the "appropriateness" of an index. The SEC Staff has concluded that indices prepared by Lipper Inc., which are a measure of the performance of funds with particular investment objectives, may be appropriate indices under Section 205.[15] For example, in response to a no-action request from IDS Financial Corp., the SEC Staff determined not to recommend enforcement action if the board of the funds in question found, after consideration of the factors in the 1972 Interpretative Release, that Lipper indices were appropriate "indices of securities prices" for calculating performance fees.[16] (This no-action letter was later withdrawn because IDS had represented in its original no-action request that the Lipper indices were "calculated…using an unweighted arithmetic average of the percentage change in daily net asset values of the funds making up the index" but later determined that indices were, in fact, price-weighted indices, which the SEC Staff has stated are not appropriate indices for purposes of Section 205.[17]) Under certain circumstances, the SEC Staff has also permitted a combination of the record of several indices for the purpose of calculating performance adjustments.[18]

It must be remembered that, under current interpretations of Section 15 of the 1940 Act, it is likely that once the performance benchmark is included or referenced in the fund's advisory contract, it cannot be changed without respecting the formalities of Section 15 of the 1940 Act (which require a shareholder vote in most circumstances). This is a situation that makes it very difficult and costly to adjust fund strategies if the changes would cause a fund and its adviser(s) to question whether an index remains appropriate or otherwise if it was felt appropriate to change the fund strategy. Advisers and fund boards should thus carefully review the impact of these choices on funds (for example, fund complexes that frequently change investment strategies and indexes to adapt to a changing economic environment may question whether performance fees can be successfully adapted to their business model).

Choosing a Performance Adjustment Schedule and Establishing Upward and Downward Limits

Establishing a performance adjustment schedule (that is, the level of difference between the fund's investment performance and the benchmark index which will, in turn, determine the amount of the performance adjustment) is one of the most important and difficult tasks in designing a fulcrum fee arrangement. Here also, modeling of the contemplated schedules can be very important.

As stated in the Senate Report on the 1970 legislation that amended Section 205, the main principle that applies to the design of a performance fee schedule is that the resulting advisory fee must "provide for increases and decreases in compensation that are proportionate to each other."[19] This means that the upside performance adjustments must equal, in absolute terms, the downside performance adjustments. In other words, the adviser must be penalized for bad performance to the same extent as it may be rewarded for good performance. Applying this principle, the SEC Staff has refused to grant no-action relief in cases where the proposed fee schedule provided for potential fee increases greater than potential fee decreases.[20] However, the Staff has granted relief when a fee can decrease at a rate faster than it can increase.[21]

Performance adjustment fee schedules can be continuous (that is, any performance difference would affect the performance adjustment) or can provide for "breakpoints," also called "null zones" (that is, the performance adjustment changes only when certain levels of performance differences have been reached).

In the 1972 Interpretative Release, the SEC indicated that, in structuring a performance adjustment schedule, it is important to ensure that performance adjustments are attributable "to the adviser's skill, or lack of skill, rather than to random fluctuation." Thus, attention should be given to ensure that adjustments are due to meaningful differences between the fund's performance and the record of the benchmark index. The SEC indicated that, as a rule of thumb, the maximum or minimum performance adjustment should be reached when the difference in performance is at least 10 percentage points (although one could imagine different adjustments under reasonable circumstances). Further, it indicated that fund directors should consider what a meaningful difference would be under the proposed schedule, taking into account the fund's size, volatility, diversification, and variability of performance differences. Fund directors may wish to seek expert advice on these considerations before reviewing proposed arrangements.

In 2015, the American Institute of Certified Public Accountants (AICPA), released a summary of financial statement review comments issued by SEC Staff that included commentary on performance adjustments.[22] According to the AICPA summary, the SEC Staff has objected to (1) advisers attempting to limit performance adjustments to a multiple of the base fee because the result of such limitation results in the incentive adjustment being tied to current level net assets rather than the average net assets over the period (see a discussion of these issues, relating to "bifurcated" fulcrum fee arrangements, below); and (2) fulcrum fee arrangements where the maximum negative performance adjustment was less than the maximum positive incentive adjustment.[23]

Funds generally set maximum performance adjustment percentages in their performance adjustment schedules. For example, the maximum performance adjustment might be set at an annual rate of 0.50 percent of average net assets over the performance period. Such maximum adjustments are consistent with Section 205 and have been recognized as such by the SEC and the Staff. Similarly, the registration statement forms for open-end and closed-end management investment companies, Form N-lA and Form N-2, recognize the legitimacy of a maximum adjustment, indicating that registrants using fulcrum fees may display in the statement of additional information examples including calculations showing the maximum and minimum fee percentages that could be earned under the arrangement.[24] However, a fund may not be able to impose an absolute dollar limit on the performance adjustment amount or impose a similar limit expressed as some percentage of current net assets, for example, 0.10 percent of current net assets.

We understand that fund rating agencies look favorably on fund performance fee arrangements as a means to align the interests of advisers and funds, and may favor meaningful performance adjustment variations. In practice, however, it is very important for advisers and fund boards to understand that, with a "bifurcated" fulcrum fee arrangement designed to comply with Rule 205¬2(c) under the Advisers Act (that is, an arrangement for which the fulcrum fee is calculated based on net assets averaged over the most recent subperiod of the performance period, while the performance adjustment is calculated based on net assets averaged over the entire performance period), the maximum and minimum adjustment would apply only to the performance adjustment. As a result, by using different asset bases to calculate the fulcrum fee and the performance adjustment, the actual advisory fees paid by the fund will often differ materially from the predictable annual fee rates obtained by adding a static fulcrum fee rate to a performance fee rate.

Assume, for example, a fulcrum fee arrangement with: (1) a 36-month performance period; (2) a fulcrum fee rate of one percent of average

EXHIBIT 1: Typical Fulcrum Fee Arrangement			
% Point Difference between Performance of Fund and Index	Fulcrum Fee (annualized)	Performance Adjustment (annualized)	Expected Total Advisory Fee (annualized)
10%	1.00%	0.50%	1.50%
5%	1.00%	0.25%	1.25%
0%	1.00%	0.00%	1.00%
-5%	1.00%	-0.25%	0.75%
-10%	1.00%	-0.50%	0.50%

daily net assets on an annual basis (computed on annualized average net assets over the most recent month); and (3) a performance adjustment schedule with two breakpoints, reaching a maximum or minimum adjustment of 0.50 percent of average daily net assets on an annual basis when the fund's performance exceeds or lags the benchmark index by more than 10 percentage points over the performance period.

Under these circumstances, one might expect the fund advisory fees to be as shown in Exhibit 1. However, this scenario would occur only if the fund's net assets remain constant over the entire performance period. In reality, however, a fund's assets will almost always increase or decrease, sometimes dramatically over the performance period. Changes in asset levels can impact the calculation of advisory fees under a fulcrum fee arrangement in material and often unforeseen ways.

For example, assume that over the duration of the performance period, the fund's average net assets decrease so that during the most recent month, they average $100 million, while over the entirety of the performance period they average $250 million. Under this scenario, the advisory fees that would actually be paid would be as are shown in Exhibit 2. Opposite results would occur if the fund's assets increase over the performance period. This scenario is shown in Exhibit 3.

The actual fees in both declining and rising asset environments are remarkably different from the theoretical fee rates shown in Exhibit 1. The advisory fees actually paid by a fund will depend on a variety of factors that are largely unpredictable in advance. In general, the longer the performance period and the greater the amplitude given to a performance adjustment schedule (that is, the greater the potential change in the fee rate under the schedule), the more the advisory fees will depend on shareholder activity in the fund. As illustrated, in certain circumstances, the actual advisory fees to be paid during a month could be negative, with the result (under current SEC Staff interpretations), that the adviser would be required to pay the negative amount into the fund.[25] Members of the SEC Staff have in the past expressed the view that a bifurcated fulcrum fee may require a fund's adviser to reimburse the fund when the fund experiences a significant asset decline and poor performance, resulting in a lower base fee that is inadequate to cover a negative incentive adjustment.[26]

In our experience, this scenario happens with some regularity. In practice, advisers will bear the costs of large negative adjustments, while expense waivers and caps, commercial pressures, or fund board requests, may prevent them from fully realizing the benefit of large positive adjustments. There is little in the administrative history indicating that the SEC and its Staff fully appreciated the consequences of these bifurcated arrangements at the time the rules were adopted. Given the impact of changes in net assets, as well as the potential for required payments by the investment adviser, both fund boards and advisers should carefully consider

EXHIBIT 2: Monthly Fulcrum Fee Calculation—Declining Net Assets			
% Point Difference between Performance of Fund and Index	**Actual Fulcrum Fee (expressed as a dollar amount for the month and corresponding rates)**	**Performance Adjustment**	**Actual Total Advisory Fee (expressed as a dollar amount for the month and corresponding annual rate of current average net assets)**
10%	$83,334 [1/12th of 1.00% of $100 million on a monthly basis (or 1.00% as an annual rate)]	$104,167 [1/12th of 0.50% of $250 million on a monthly basis (or 0.50% as an annual rate)]	$187,500, which amounts to 2.25% of current average net assets on an annual basis
5%	$83,334 [1/12th of 1.00% of $100 million on a monthly basis (or 1.00% as an annual rate)]	$52,084 [1/12th of 0.25% of $250 million on a monthly basis (or 0.25% as an annual rate)]	$135,418, which amounts to 1/12th of 1.625% of current average net assets on an annual basis
0%	$83,334 [1/12th of 1.00% of $100 million on a monthly basis (or 1.00% as an annual rate)]	$0	$83,334, which amounts to 1.00% of current net assets on an annual basis
-5%	$83,334 [1/12th of 1.00% of $100 million on a monthly basis (or 1.00% as an annual rate)]	-$52,084 [1/12th of -0.25% of $250 million on a monthly basis (or -0.25% as an annual rate)]	$31,250, which amounts to 0.375% of current average net assets on an annual basis
-10%	$83,334 [1/12th of 1.00% of $100 million on a monthly basis (or 1.00% as an annual rate)]	-$104,167 [1/12th of -0.50% of $250 million on a monthly basis (or - 0.50% as an annual rate)]	-$20,833, which amounts to -0.25% of current average net assets on an annual basis

the potential impact of various economic scenarios on a proposed fee schedule. Modeling what the fees would be under various combinations of fund size and performance can provide a clearer picture of the practical consequences of a proposed fee schedule. This picture, in turn, can help a fund's board and adviser to realistically assess the impact of substantial negative performance (and the resulting negative performance adjustment) on the ability of the adviser to continue devoting sufficient resources to managing the fund, particularly in cases where the performance adjustments are meaningful and the performance periods are relatively long.

Launching a Fulcrum Fee Arrangement and Other Transitional Issues

As expressed in the 1972 Interpretive Release, the SEC's concern in relation to the launch of a fulcrum fee arrangement is that performance compensation should be based only upon performance results obtained after the arrangement takes effect. In other words, performance adjustments should not be based on performance results that are already known at the time the arrangement is implemented. For this reason, new fulcrum fee arrangements typically include a "build-up" period, during which only the flat fulcrum fee portion of the total advisory fee is payable. After a sufficiently long period (generally

EXHIBIT 3: Monthly Fulcrum Fee Calculation—Rising Net Assets			
% Point Difference between Performance of Fund and Index	**Actual Fulcrum Fee (expressed as a dollar amount for the month and corresponding rates)**	**Performance Adjustment**	**Actual Total Advisory Fee (expressed as a dollar amount for the month and corresponding annual rate of current average net assets)**
10%	$250,000 [1/12th of 1.00% of $300 million on a monthly basis (or 1.00% as an annual rate)]	$104,167 [1/12th of 0.50% of $250 million on a monthly basis (or 0.50% as an annual rate)]	$354,167, which amounts to 1.42% of current average net assets on an annual basis
5%	$250,000 [1/12th of 1.00% of $300 million on a monthly basis (or 1.00% as an annual rate)]	$52,084 [1/12th of 0.25% of $250 million on a monthly basis (or 0.25% as an annual rate)]	$302,084, which amounts to 1.21% of current average net assets on an annual basis
0%	$250,000 [1/12th of 1.00% of $300 million on a monthly basis (or 1.00% as an annual rate)]	$0	$250,000, which amounts to 1.00% of current net assets on an annual basis
-5%	$250,000 [1/12th of 1.00% of $300 million on a monthly basis (or 1.00% as an annual rate)]	-$52,084 [1/12th of -0.25% of $250 million on a monthly basis (or -0.25% as an annual rate)]	$197,916, which amounts to 0.79% of current average net assets on an annual basis
-10%	$250,000 [1/12th of 1.00% of $300 million on a monthly basis (or 1.00% as an annual rate)]	-$104,167 [1/12th of -0.50% of $250 million on a monthly basis (or - 0.50% as an annual rate)]	$145,833, which amounts to 0.58% of current average net assets on an annual basis

12 months), the performance adjustment starts being applied.

Another transitional problem arises when a fulcrum fee arrangement terminates and is replaced by another fee arrangement. In that case in order to avoid a situation in which a new fee arrangement could result in higher fees than could have been earned under the original contract, the new contract should provide that the fee payable until the end of the computation period covered by the original contract (that is, the duration of the performance period), shall not be higher than the amount that would have been payable under the original arrangement, had the computation period expired by its terms.[27] In the case of a change of the index in a fulcrum fee arrangement, a new index may be added on a prospective basis and the old index removed from the performance adjustment calculation formula gradually over the time of the performance period.

Changes in an advisory fee arrangement require the approval of a fund's board and its shareholders per the requirements of Section 15. The SEC Staff has granted no-action relief permitting the amendment of a fee arrangement without shareholder approval where the amendment was such that under no set of circumstances could the fee under the new formula exceed that under the prior formula (not just during the remainder of the earlier arrangement's performance period).[28] The SEC Staff also has granted relief permitting a fund to implement a fulcrum fee arrangement without obtaining shareholder approval where it was represented that the maximum advisory payable in case of a positive adjustment would never exceed the prior (flat) advisory fee rate.[29]

Using a Fulcrum Fee Arrangement with a Multiclass Fund

When a fund offers several classes of shares, each class usually must pay the same percentage of investment advisory fees. Rule 18f-3 under the 1940 Act, the rule that allows funds to have a multiclass structure, provides that each class "may pay a different advisory fee to the extent that any difference in the amount paid is the result of the application of the same performance fee provisions in the fund's advisory contract to the different investment performance of each class."[30] Consequently, funds can calculate performance adjustments based on the performance of each class of shares individually (which likely would result in a different performance adjustment for each class).[31]

In the 1972 Interpretative Release, which preceded the adoption of Rule 18f-3 by almost 23 years, the SEC explained that fund boards should consider the same factors in arriving at a fair fulcrum fee that they take into account when establishing the advisory fee under investment advisory contracts that do not involve incentive compensation.[32]

Of course, funds may decide to pay the same advisory fee for each class. In that case, the performance adjustment rate, calculated on the performance of a single class, would apply to all classes, even though other classes may have performed differently and thus would have generated a different performance adjustment rate had they been used for the computation. The SEC release adopting Rule 18f-3 provided specific guidance regarding the factors that may be considered by a fund's board of directors in determining whether it is appropriate to calculate a fund's performance adjustment based on the performance of a single class of shares.[33] The SEC stated that, to approve the use of a single class of shares for calculating a performance fee, a fund's board must consider all relevant factors, including:

1. The proposed performance fee schedule;
2. The effect that using one class instead of another would have on the fees to be paid;
3. The anticipated relative size of each class;
4. The expense ratio of each class;
5. The effect of any waiver or reimbursement of expenses on the performance of each class; and
6. The nature of the index to which the fund's performance will be compared.

The SEC noted in the Rule 18f-3 release that "it would appear difficult for a board to justify basing the calculation of a performance fee on the performance of a class with the lowest expenses if the result would be that shareholders of another class would pay a higher advisory fee than would be warranted given that class's performance."[34] It should be noted that a number of funds nonetheless have adopted fulcrum fee arrangements based on the performance of a class with lower expenses and, thus, higher performance. Other funds have chosen to calculate performance adjustments based on the blended performance of each class of shares. In each case, the board of the fund would generally have to conclude that the proposed fee satisfies the so-called *Gartenberg* standard under Section 36(b) of the 1940 Act (that is, that the fees that would result from the arrangements would fall within the range of what would have been negotiated at arm's length between the parties[35]). Consistent with the factors outlined, a decision to approve this type of fee arrangement may be justified for a variety of reasons. For example, one could argue that the lowest expense share class provides the best way to assess the ability of a manager to beat the fund's index, which is not subject to fees and expenses. However, in any case, the adviser and the fund board should give careful consideration to the arrangement before it is implemented.[36]

Using a Fulcrum Fee Arrangement with a Multimanager Fund

Rule 205-1 under the Advisers Act, read literally, requires that fulcrum fee arrangements be:

1. Linked to a single benchmark for the entire fund;
2. Applied to the entire fund's performance; and
3. Based on the fund's performance calculated as the change in the fund's net asset value.

Compliance with these requirements is not easily accomplished in a multimanager structure, where different advisers manage discrete portions of a fund's portfolio against specific, and frequently differing, benchmarks. The SEC has issued exemptive orders permitting

1. The calculation and payment to a subadviser of fulcrum fee arrangements for each portion of a fund's portfolio, rather than for the fund as a whole, and
2. Computing the performance adjustment portion of the fee based on each portion's gross performance rather than on changes to the net asset value per share of the entire fund.[37]

Also, in order to prevent a situation where an adviser could earn a performance fee even though fund shareholders did not derive any benefit from the adviser's performance after the deduction of fees and expenses on that account, advisers have implemented "hurdles." A hurdle requires that the difference between the gross performance of the fund and the record of the index must equal at least a certain amount before a performance adjustment is paid. These hurdles are intended to compensate for the use of gross, rather than net, performance.[38]

The use of a fulcrum fee arrangement within a multimanager fund could also present unforeseen issues for the fund. For example, it is possible to imagine a scenario in which a poor-performing sub-adviser is terminated. Until the end of the performance period, depending on the fulcrum fee arrangement calculation formula, and because of the transition considerations noted above, it could be argued that only the lowest of the historic or current sub-advisory fee rate would have to be paid. This result does not appear to comport with the fact that, if the formalities of Section 15 are followed (or a "manager of managers" exemptive order, if applicable), it should be possible to replace an investment advisory agreement with a new agreement, including one that results in higher fees.

Consistent with the scenario above, and because the amount of the performance adjustment is a function of average net assets over the performance period, a shorter performance period might be more appropriate for a sub-adviser in a multi-manager structure where the adviser might reduce the amount of assets allocated to an underperforming sub-adviser. In this unhappy circumstance, the sub-adviser's fulcrum fee, calculated on reduced assets, would be subject to a negative performance adjustment calculated on much higher average assets over a longer performance period.

Implementing and Managing a Fulcrum Fee Arrangement

Disclosing a Fulcrum Fee Arrangement

Disclosing accurately a fulcrum fee arrangement and its functioning may be a difficult exercise, in which one must reconcile the need to provide clear, easy to understand disclosure with the technical and complex nature of the arrangement. SEC Form N-1A does not provide useful guidance and sometimes requires disclosures that, if applied literally in the context of fulcrum fees, might arguably be misleading to investors. First, the prospectus fee table must disclose management fees based on amounts incurred during the fund's most recent fiscal year, which may not be indicative of the amount of fees likely to be payable for the upcoming year in the case of a fulcrum fee arrangement. Second, Form N-1A requires that a fund's statement of additional information include a fee schedule. Also, the form indicates that a fund may include examples showing fees that an adviser would earn at various levels of performance, as long as the examples include calculations showing the maximum and minimum fee percentages that could be earned under the management contract. Unfortunately, it is difficult for a tabular fee schedule, by itself, to provide a meaningful description of the management fees that may actually be paid by shareholders. As illustrated in the Exhibits contained in this article, actual management fees paid can vary depending on not only the level of the fund's performance, but also on the level of fund assets.[39]

Consequently, it may also be appropriate to disclose a variety of other facts and considerations about a fund's fulcrum fee arrangement in order to ensure that the arrangement and its consequences are fully explained to investors. It may be appropriate to disclose how the fund's investment performance and the investment record of a fund's benchmark index are calculated. Carefully explaining how the fulcrum fee and the performance adjustments are computed and the consequences of using different pools of assets to calculate each portion of the total fee may also be important. In proximity to a tabular fee schedule, it may be appropriate to explain that the total fee estimates shown on the table assume that the level of net assets will remain constant throughout the performance period and that actual numbers will vary. In the case of a multiclass or multimanager fund, extra care could be given to explaining how fees are calculated for each class of shares or portion of the fund's portfolio. It may also be appropriate to ensure that experienced accountants and attorneys review all disclosures of fulcrum fees on a regular basis to make certain they continue to be accurate and complete.

Conclusion and Recommendations

As explained, mutual fund performance fee rules may appear simple and attractive on their face, but they are extremely technical, and their application to today's fund structures is extremely complex. The fees also do not necessarily generate the results that are expected, and can precipitate fund liquidations. Advisers and fund boards should carefully consider all the implications of performance fee arrangements before they implement them. They should also consider how the arrangements are functioning on an ongoing basis and whether they are likely to bring the anticipated benefits they anticipate of aligning the interests of advisers and funds. All professional service providers to the fund should be aware of, and have experience dealing with, fulcrum fee arrangements.

Attention surrounding performance fees has increased in recent years and some rating agencies, such as Morningstar, have been vocal about the benefits of such arrangements.[40] The authors' understanding is that these agencies view performance fee arrangements as a positive, although it is not clear how they consider all of the limitations of these arrangements.

While performance fee arrangements have recently been touted as way for actively managed funds to compete with passive funds, the lack of flexibility and guidance makes it difficult to implement such fees in practice. Funds with performance fees still accounted for less than two percent of long-term mutual funds in 2016.[41] In the 13 years since this article was first published, the SEC has not provided any meaningful clarity or guidance around performance-based fees or issued guidance helping advisers and funds to address the issues raised in computing fulcrum fees. Given that more than 40 years have passed since the SEC issued its 1972 Interpretative Release, it may be time for the SEC or its Staff to reexamine the rules and the guidance in this area to assess whether the current rules and related interpretations have functioned consistently with their intended goals, or whether there may be ways to allow performance fee arrangements in a manner that could better align the interests of funds and their advisers. The authors suggest that the following steps could be considered:

- Clarify that "negative" fees, while permissible, are not necessarily a required component of fulcrum fee arrangements and that effective upside and downside caps on total advisory fees are acceptable;
- Provide formal relief to facilitate the use of performance fee arrangements in a multi-manager context without the need to obtain an exemptive order;
- Provide specific guidance on the manner in which fulcrum fees should be calculated and accrued;
- Revise the disclosure requirements in the registration forms to specifically address the complexities and peculiarities of fulcrum fee arrangements; and
- Consider permitting a broader range of performance-based fees in a fund context.

Unless and until the SEC undertakes such a review, fund advisers and boards considering fulcrum fee arrangements will continue to grapple with difficult issues, while investors and other interested parties may continue to be disappointed by the failure of funds to embrace these complex fee structures.

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The authors acknowledge Alan Rosenblat, former Counsel at Dechert LLP, who contributed substantially to the original version of this article and passed away in 2018. Mr. Rosenblat served as Chief Counsel of the SEC's Division of Investment Management from 1968 to 1976, when the rules discussed in this article were adopted. He also served as assistant general counsel at the SEC from 1976 to 1986. His inspiration lives on through this article.

NOTES

1 *Survey of Investment Company Incentive Fee Arrangements*, Release No. IC-7130 (Apr. 17, 1972); *Factors to be Considered in Connection with Investment Company Advisory Contracts Containing Incentive Arrangements*, Release No. IA-315 (Apr. 18, 1972) (hereinafter the 1972 Interpretative Release); *Notice of Proposal under the Investment Advisers Act of 1940 [(Advisers Act)] to Adopt Rule 205-1 Defining "Investment Performance" of an Investment Company and "Investment Record" of an Appropriate Index of Securities Prices*, Release No. IA-316 (Apr. 6, 1972); *Adoption of Rule 205-1 under the Advisers Act Defining "Investment Performance" of an Investment Company and "Investment Record" of an Appropriate Index of Securities Prices*, Release No. IA-327 (Aug. 8, 1972); *Notice of Proposal under the Advisers Act to Adopt Rule 205-2 Defining "Specified Period" Over Which the Asset Value of the Company or Fund Under Management is Averaged*, Release No. IA-323 (July 13, 1972); and *Adoption of Rule 205-2 Under the Advisers Act Defining "Specified Period" Over Which the Asset Value of the Company or Fund Under Management is Averaged*, Release No. IA-347 (Nov. 10, 1972) (hereinafter the Rule 205-2 Adopting Release).

2 *See In the Matter of Bridgeway Capital Management, Inc.*, Release No. IA-2294 (Sept. 15, 2004); *In the Matter of Kensington Investment Group, Inc.*, Release No. IA 2545 (Sept. 7, 2006); *In the Matter of Numeric Investors LLC*, Release No. IA-2546 (Sept. 7, 2006); *In the Matter of Putnam Investment Management, LLC*, Release No. 2547 (Sept. 7, 2006); *In the Matter of Gartmore Mutual Fund Capital Trust*, Release No. IA-2548 (Sept. 7, 2006); and *In the Matter of The Dreyfus Corporation*, Release No. IA-2549 (Sept. 7, 2006).

3 *See* Hester M. Peirce, "Pickups and Put Downs: Remarks at the Financial Planning Association 2018 Major Firms Symposium" (Oct. 2, 2018), available at *https://www.sec.gov/news/speech/speech-peirce-100218* ("Allowing actively managed funds more flexibility in designing performance fees potentially could further enable active managers to compete on price with index funds.").

4 *See* Hester M. Peirce, "Pickups and Put Downs: Remarks at the Financial Planning Association 2018 Major Firms Symposium" (Oct. 2, 2018), available at *https://www.sec.gov/news/speech/speech-peirce-100218* ("Actively managed funds have started to look for ways—using fulcrum fees permitted by the statute—to vary their fees with performance."); "Are Fulcrum Fees the Future?" Brown Brothers Harriman & Co. (Nov. 29, 2017) (quoting former AB CEO Peter Kraus as stating in 2017 that "[a]ctive managers need to level the playing field on fees and be more accountable for our performance if we're going to complete with exchange-traded funds."); Patrick Newcomb, "Leveling the Playing Field between Active and Passive Management," *Investments & Wealth Monitor*, May/June 2018, available at *https://investmentsandwealth.org/getattachment/2d67782b-f03a-48b0-8fa9-6261b3067d73/IWM18MayJun-FulcrumFees.pdf* (discussing how managers such as AB and Allianz Global Investors "are turning to performance-based, or fulcrum, fees as a potential solution to help balance the competitive scales.").

5 Murphy and Bourgeois, "Mutual Fund Performance Fees: Discussion and Observations," *The Investment Lawyer*, Vol. 13, No. 11 (Nov. 2006)

6 *See* Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency, 76th Cong., 3d Sess. 319-20 (1940) (statement of David Schenker, SEC Counsel).

7 *See* Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 98 (1940).

8 The SEC Staff has accepted fee arrangements based on income from interests and dividends. *See* Welch & Forbes, Inc., SEC No-Action Letter (pub. avail. Jan. 26, 1974). "We do not disagree with your conclusion that Section 205(1) of the Investment Advisers Act would not prohibit an investment adviser from charging a fee based upon a percentage of the dividend and interest income from the client's capital under the advisor's supervision."

9 H.R. Rep. No. 2639, 76th Cong., 2d Sess. 29 (1940).

10 S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940).

11 The rule provides detailed computation instructions. For example, Rule 205-1(a) requires that the fund's investment performance be calculated based on the net asset value of the fund, in order to prevent a situation in which an adviser could earn a performance fee even though fund shareholders did not derive any benefit from the adviser's performance after the deduction of fees and expenses. Also, Rule 205-1(b) provides that the investment record of an index must include any cash distributions made by companies whose securities comprise the index.

12 *See Jones v. Harris Associates, L.P.*, 559 U.S. 335 (2010); *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923 (2d Cir. 1982) *cert. denied sub nom.*, *Andre v. Merrill Lynch Ready Assets, Inc.*, 461 U.S. 506 (1983).

13 One also could consider whether the fulcrum fee should be calculated based on net assets over the full performance period or over the most recent subperiod (see discussion of Rule 205-2). This choice can materially impact the amount of advisory fees ultimately paid by the fund.

14 *See* 1972 Interpretative Release, at p.2. The SEC also provided several examples showing how these principles may be applied.

15 *See*, *e.g.*, Hyperion Fund, Inc., SEC No-Action Letter (pub. avail. Mar. 12, 1973) (Staff recognizing that Lipper Growth Fund Index could be considered an appropriate index for a fund of funds investing in no-load growth funds). *But see*, Mexico Fund, SEC No-Action Letter (pub. avail. Feb. 12, 1975) (Staff concluding that Lipper Growth Fund Index "would not appear to be an appropriate index of securities prices" for a fund that proposes to invest principally in debt securities). Note, however, that Section 205(c) states that "index of securities prices shall be deemed appropriate unless the Commission by order shall determine otherwise." The Commission has not issued such an order to date. The authors believe that the Staff is unlikely to recommend that the Commission do so absent some material concerns.

16 IDS Financial Corp., SEC No-Action Letter (pub. avail. Jul. 26, 1991) (recognizing that Lipper Indices were appropriate indices for funds because the funds included "are similar to the relevant [] funds in volatility, diversification, types of securities owned and investment objectives.").

17 *See* IDS Financial Corp., SEC No-Action Letter (pub. avail. Oct. 27, 1993).

18 *See* Massmutual Corporate Investors, SEC No-Action Letter (pub. avail. Aug. 31, 1988) (the Staff granted relief where a fund's performance was to be compared to the arithmetic average of the rates of return of two indices, an equity index and a bond index, because the combined indices represented investments which closely reflected the fund's investment program). Compare with Incentive Investments, Inc., SEC No-Action Letter (pub. avail. May 20, 1982) (denying no-action relief with respect to a performance fee arrangement where a composite index would be subject to weighted averages that would fluctuate depending on the composition of the fund's portfolio).

19 *See* S. Rep. No. 184, 91st Cong., 1st Sess. 45 (1969).

20 *See* Incentive Investments, Inc., SEC No-Action Letter (pub. avail. May 20, 1982) (the Staff refused to grant relief when a fulcrum fee of one percent could go up as much as five percent but down only to 0.50 percent); Lowry, Bittel, Perrot & Company Fund Advisors, Inc., SEC No-Action Letter (pub. avail. July 3, 1986) (the Staff refused to grant relief when a fulcrum fee could increase by 150 percent for extraordinary performance and decline by a lesser amount).

21 Royce Value Trust, Inc., SEC No-Action Letter (pub. avail. Dec. 22, 1986) (the Staff granted relief when a fee decreased twice as quickly 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.").

22 "AICPA Audit Risk Alert-Investment Companies Industry Developments; 'SEC Staff Comments and Observations," American Institute of CPAs (Aug. 1, 2015).

23 *Id. See also* Andrew J. Donohue, *Speech by SEC Staff: Keynote Address at the Independent Directors Council Investment Company Directors Conference* (Nov. 12, 2009) (noting that attempts to implement a floor to fulcrum fees to limit the downside for the adviser, but not proportionally limit the adviser's upside, are impermissible because the incentive adjustments must be symmetrical).

24 See SEC Form N-1A, Instruction 1 to Item 19(a)(3), 17 C.F.R. 274.11A; and SEC Form N-2, Instruction 1 to Item 20(1)(c), 17 C.F.R. 274.11a-1.

25 To require investment advisers to pay negative advisory fees to a fund, the SEC Staff has argued that the proportionality principle embedded in Section 205 of the Advisers Act requires a strict application of the fulcrum fee arrangement calculation formula. If a calculation results in negative fees, then negative fees should be paid to the fund. Conversely, if a calculation results in an extreme positive adjustment, then an extreme positive advisory fee would be required to be paid by the fund. The SEC Staff maintains that its position on payment of negative performance adjustments was documented in Redmond Growth Fund, Inc., SEC No-Action Letter (pub. avail. Apr. 30, 1974) (Redmond Letter), in which a fund requested no-action relief in relation to a transition to a fulcrum fee arrangement and stated in the incoming

letter, while describing their fee arrangement, that if the performance adjustment resulted in a total advisory fee of less than zero, the adviser would not receive any advisory fee and would pay monies to the fund. While this position was the stated basis for the SEC enforcement actions in the early 2000s, the SEC Staff's response to the Redmond Letter does not address this specific aspect of the fee arrangement.

It is questionable whether the current Staff position is consistent with statements from the SEC Staff that "fulcrum fee contracts do not subject advisers' capital to risk" and that "it is only the advisers' fees that are subject to risk, and then only to the degree that they are also subject to increase." First Horizons Unlimited Inc., SEC No-Action Letter (pub. avail. Jan. 4, 1985). In this regard, it is worthy of note that the Redmond Growth Fund was liquidated less than three years after it described its fulcrum fee methodology to the SEC Staff, stating as a reason for the liquidation that "the amount of advisory fees payable to it under the terms of the investment advisory agreement did not make it economically feasible for it to continue to act as investment adviser to the fund." *In the Matter of Redmond Growth Fund, Inc.,* Release No. IC-i0080 (Jan. 4, 1978) at p.1.

26 *See* Andrew J. Donohue, *Speech by SEC Staff: Keynote Address at the Independent Directors Council Investment Company Directors Conference* (Nov. 12, 2009) ("What advisers sometimes fail to realize, however, is that when the base fee is calculated on current level net assets, the adviser runs the risk of having to reimburse the fund when there is a significant decline in assets coupled with poor performance.").

27 This fee limit also appears in the 1972 Interpretative Release. *See id*. at n.1.

28 *See* Franklin Templeton Group of Funds, SEC No-Action Letter (pub. avail. July 23, 1997).

29 *See* Gartmore Mutual Fund, *et al.*, SEC No-Action Letter (pub. avail. March 19, 2004). The Staff's response noted, among other things, the representation that "the rate of the advisory fee that will be paid by a Fund will never exceed the current rate of the advisory fee that is paid by that Fund." The SEC Staff's response does not discuss how a fund might comply with this representation. Perhaps the fund would calculate the fee for each period using both the new performance fee and the previous fixed rate fee and pay the lesser of the two amounts.

30 Rule 18f-3(a)(1)(iii) under the 1940 Act.

31 Of course, one should carefully consider tax matters related to such differing fees.

32 In making this argument in the release, the SEC referred to the following statement included in a report of the House Committee on Interstate and Foreign Commerce: "[T]he fiduciary duty with respect to management compensation contained in . . . new section 36(b) of the [1940 Act] would apply to compensation received pursuant to a performance-related contract permitted by Section 205 to the same extent as it does to other types of investment advisory contracts."

33 *See Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans*, Release No. IC-20915 (Feb. 23, 1995) at n.12.

34 *Id*.

35 *See* Gartenberg, 694 F.2d at 928.

36 In examinations of mutual funds that have fulcrum fee arrangements, in the case of mutual funds computing the performance adjustment based on the performance of a class of shares with a lower level of expenses and higher performance, the SEC Staff has scrutinized closely the boards' considerations of the arrangements in light of the factors listed in the Rule 18f-3 release and reviewed in detail materials provided to the boards.

37 *See e.g.*, *Goldman Sachs Asset Management, et al.*, Release Nos. IA-1806 (June 25, 1999) (notice) and IA-1809 (July 21, 1999) (order); *Sterling Johnston Capital Management, L.P.*, Release Nos. IA-1993 (Nov. 1, 2001) (notice) and IA-1998 (Nov. 27, 2001) (order).

38 It should be noted that, in the past, some funds calculated performance fees on this basis without formal exemptive relief, apparently relying on informal understandings worked out with the SEC Staff during the disclosure review process. Given the SEC

enforcement activity in this area, this practice presents obvious risks.

39 Based on the authors' experience, it appears that the SEC Staff often comments upon fulcrum fee disclosures and frequently requests disclosure that goes beyond the requirements of the Form.

40 *See* John Rekenthaler, "Give Performance Fees a Chance," *Morningstar* (Oct. 31, 2018), available at *https://www.morningstar.com/articles/889886/give-performance-fees-a-chance.html*; Jeffrey Ptak, CFA, "Performance Fees: An Idea Whose Time Has Come," *Morningstar* (Aug. 17, 2017), available at *https://www.morningstar.com/articles/821796/performance-fees-an-idea-whose-time-has-come.html*.

41 *See* "Fulcrum Fees Pop Up in an ETF," *Ignites* (Sept. 23, 2016).

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