INFORMATIONAL

Performance Fees

SEC Approves Proposed Changes To Rule 2330(f)(2) Relating To Performance Fees

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Registered Representatives

KEY TOPICS

- Rule 2330
- Performance Fee Arrangements
- Investment Advisers

Executive Summary

On February 15, 2001, the Securities and Exchange Commission (SEC or Commission) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2330(f)(2), to permit NASD members and associated persons that act as investment advisers to share in the customer account profits and gains, subject to the provisions of Rule 205-3 under the Investment Advisers Act of 1940 ("Advisers Act").[1] The amendments are effective on April 21, 2001.

Questions/Further Information

Questions concerning this *Notice* may be directed to Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation), at (202) 728-8176; or Joseph Savage, Counsel, Advertising/Investment Companies Regulation, NASD Regulation, at (240) 386-4534.

The text of the amendments to Rules 2330 is provided in Attachment A.

Background And Discussion

NASD Rule 2330(f) prohibits members and persons associated with members from sharing in customer account profits and gains except under certain conditions. Subparagraph (f)(1) permits sharing in customer account profits and gains where the firm has authorized it and the sharing is proportionate to the member's or associated person's contributions to the account.

Subparagraph (f)(2) also permits members or registered representatives to charge a performance fee (an advisory fee based on a percentage of the capital gains or capital appreciation of an account), under the conditions provided for in Rule 2330(f)(2). The conditions provided in Rule 2330(f)(2) have always closely tracked the requirements of Rule 205-3 under the Advisers Act. However, effective August 20, 1998, the Commission amended Rule 205-3 to provide greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding these arrangements.[2]

Because the NASD had specifically incorporated the requirements of Rule 205-3 into NASD Rule 2330(f)(2) rather than only referencing the rule generally, upon the amendment of Rule 205-3, NASD Rule 2330(f)(2) and Rule 205-3 were no longer consistent.

To restore consistency under current requirements and ensure consistency in the future if Rule 205-3 is amended, the NASD has amended Rule 2330(f)(2) to permit members and their associated persons that act as investment advisers (whether or not registered as such) to share in customer account profits and gains if the member or person associated with a member seeking such compensation (1) obtains prior written authorization from the member carrying the account; and (2) complies with the provisions of Rule 205-3 under the Advisers Act. Accordingly, Rule 2330(f)(2) is amended to eliminate the specific conditions of Rule 205-3 set forth previously in the rule and to incorporate, by reference, the terms of Rule 205-3, as may be amended from time to time. Thus, in the future, Rule 2330(f)(2) will conform to any subsequent amendments by the Commission to Rule 205-3.

Generally, Rule 205-3 permits an investment adviser to enter into an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains or the capital appreciation of the client's funds, provided that the client entering into the contract is a "qualified client." Under Rule 205-3, a "qualified client" includes:

(1) An individual or company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;

(2) An individual or company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

(A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or

(B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into; or

(3) An individual who immediately prior to entering into the contract is (A) an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

A copy of Rule 205-3 of the Advisers Act is provided in Attachment B.

The staff would like to emphasize that members that share in the profits or gains of an account must comply with the provisions of Rule 2330(f)(1) or (2) to receive such compensation, whether or not that member is required under the Advisers Act to register as an investment adviser. In this regard, the SEC has proposed a new rule under the Advisers Act that, among other things, would not deem a registered broker/dealer to be an investment adviser under the Advisers Act based solely on its receipt of "special compensation," subject to certain conditions.[3] The staff also has received a number of inquiries relating to the possible application of Rule 2330(f) to brokerage fees that are calculated based on the total assets in a customer account. The staff is clarifying that such brokerage fees that are calculated based on a share of the total assets in the account would not be considered sharing in the profits or gains of an account for the purposes of Rule 2330(f).

Endnotes

1 *See* Securities Exchange Act Release No. 43973 (February 15, 2001), 66 FR 11623 (February 26, 2001) (File No. SR-NASD-99-42).

2 *See* Investment Advisers Act Release No. 1731 (July 15, 1998), 63 FR 39022 (July 21, 1998).

3 *See* Securities Exchange Act Release No. 42099, Investment Advisers Act Release No. 1845, 64 FR 61226 (November 10, 1999).

ATTACHMENT A

New language is underlined; deletions are in brackets.

2300. TRANSACTIONS WITH CUSTOMERS

2330. Customers' Securities or Funds

(a) through (e) (No change)

(f) Sharing in Accounts; Extent Permissible

(1)(A) and (B)(No change)

(2) Notwithstanding the prohibition of paragraph (f)(1), a member or person associated with a member that is acting as an investment adviser (whether or not registered as such) may receive compensation based on a share in profits or gains in an account if [all of the following conditions are satisfied:*]

[(A) T]the member or person associated with a member seeking such compensation obtains prior written authorization from the member carrying the account[;], and all of the conditions in Rule 205-3 of the Investment Advisers Act of 1940 (as the same may be amended from time to time) are satisfied.

[(B) The customer has at the time the account is opened either a net worth which the member or person associated with a member reasonably believes to be not less than $1,000,000, or the minimum amount invested in the account is not less than $500,000;]

[(C) The member or person associated with a member reasonably believes the customer is able to understand the proposed method of compensation and its risks prior to entering into the arrangement;]

[(D) The compensation arrangement is set forth in a written agreement executed by the customer and the member;]

[(E) The member or person associated with a member reasonably believes, immediately prior to entering into the arrangement, that the agreement represents an arm's-length arrangement between the parties;]

[(F) The compensation formula takes into account both gains and losses realized or accrued in the account over a period of at least one year; and]

[(G) The member has disclosed to the customer all material information relating to the arrangement including the method of compensation and potential conflicts of interest which may result from the compensation formula.]

[* It is the position of the Division of Investment Management of the Commission that compensation received by a member or person associated with a member under this Rule would constitute "special compensation" for purposes of the broker/dealer exception to the definition of "investment adviser" in Section 202(a)(11)(C) of the Investment Advisers Act of 1940 (Advisers Act). Any member or person associated with a member, required to be registered under the Advisers Act, or state law, who receives compensation based on a share of profits or capital appreciation of a customer's account must comply with Section 205(l) and Rule 205-3 under the Advisers Act, or applicable state law, with respect to such compensation. (SEC Release 34-24355, 52 Fed. Reg. 13778, April 24, 1987).]

ATTACHMENT B

Rule 205-3 of the Investment Advisers Act of 1940 — Exemption from the compensation prohibition of section 205(1) for investment advisers.

(a) General. The provisions of section 205(a)(1) of the Act (15 U.S.C. 80b-5(a)(1)) will not be deemed to prohibit an investment adviser from entering into, performing, renewing or extending an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client, provided, that the client entering into the contract subject to this section is a qualified client, as defined in paragraph (d)(1) of this section.

(b) Identification of the client. In the case of a private investment company, as defined in paragraph (d)(3) of this section, an investment company registered under the Investment Company Act of 1940, or a business development company, as defined in section 202(a)(22) of the Act (15 U.S.C. 80b-2(a)(22)), each equity owner of any such company (except for the investment adviser entering into the contract and any other equity owners not charged a fee on the basis of a share of capital gains or capital appreciation) will be considered a client for purposes of paragraph (a) of this section.

(c) Transition rule. An investment adviser that entered into a contract before August 20, 1998 and satisfied the conditions of this section as in effect on the date that the contract was entered into will be considered to satisfy the conditions of this section; provided, however, that this section will apply with respect to any natural person or company who is not a party to the contract prior to and becomes a party to the contract after August 20, 1998.

(d) Definitions. For the purposes of this section:

(1) The term qualified client means:

(i) A natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;

(ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

(A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or

(B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(51)(A)) at the time the contract is entered into; or

(iii) A natural person who immediately prior to entering into the contract is:

(A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or

(B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

(2) The term company has the same meaning as in section 202(a)(5) of the Act (15 U.S.C. 80b-2(a)(5)), but does not include a company that is required to be registered under the Investment Company Act of 1940 but is not registered.

(3) The term private investment company means a company that would be defined as an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exception provided from that definition by section 3(c)(1) of such Act (15 U.S.C. 80a-3(c)(1)).

(4) The term executive officer means the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the investment adviser.