The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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DEPARTMENT OF LABOR ISSUES OPINION PERMITTING PERFORMANCE FEE ARRANGEMENTS BETWEEN ADVISER AND PENSION FUNDS

11/ The percentage of appreciation fee would simply be a specified percentage to the appreciation in the accounts assets. The base plus fee would provide for a minimum fee plus a fee which increases incrementally to the extent the adviser's performance exceeds a disignated index. The fulcrum fee would increase or decrease with the adviser's performance relative to October 23, 1989 TO: PENSION MEMBERS NO. 48-89 INVESTMENT ADVISER MEMBERS NO. 53-89 INVESTMENT ADVISER ASSOCIATE MEMBERS NO. 54-89 RE: DEPARTMENT OF LABOR ISSUES OPINION PERMITTING PERFORMANCE FEE ARRANGEMENTS BETWEEN ADVISER AND PENSION FUNDS

_____ On September 25, 1989, the Pension and Welfare Benefits Administration of the Department of Labor issued an advisory opinion that the payment of any of three performance-based compensation arrangements to an adviser by employee benefit plans would not, in itself, violate the prohibited transaction provisions of Section 406 of the Employee Retirement Income Security Act of 1974 (ERISA). A copy of the advisory opinion is attached. As you will recall, on August 29, 1986, the DOL issued two advisory opinions which permitted payment by plans of performance-based compensation to investment managers provided the plans had at least fifty million dollars in aggregate assets, the investments were made in securities for which there generally were available market quotations, the adviser's performance included both realized and unrealized gains and losses during a pre-established valuation period, and the incentive fee arrangements complied with Rule 205-3 under the Investment Advisers Act of 1940. (See Institute Memorandum to Pension Members No. 20-86, Investment Adviser Members No. 22-86, and Investment Adviser Associate Members No. 26-86, dated September 10, 1986.) The attached letter generally contains the same conditions, but analyzes performance fee arrangements that differ from the arrangements reviewed in the earlier advisory opinions. As described in the advisory opinion, the adviser proposed to give each client plan with aggregate assets of at least $50 million the option of paying the adviser through one of three basic fee structures: (1) a "percentage of appreciation" fee, (2) a "base plus" fee, or (3) a "fulcrum" fee. 1/1 For purposes the performance of a designated index. of comparing the advisers performance with a relative index under the latter two options, the adviser proposed to use either a generally accepted standardized index (e.g., S&P 500 Index, Salomon Brothers High Grade Long Term Bond Index, etc.) or a customized "asset list normal portfolio" index tailored to the adviser's or client's investment approach.

The adviser would use screening criteria (e.g., historical data, book price, dividend payout ratio, etc.) and, thereafter, portfolio weighting procedures in structuring the adviser's "asset list normal portfolio." Advance approval by the affected client would be required with respect to any changes in the screening criteria and weighting procedures. While concluding that the payment of a performance fee pursuant to the three specific arrangements would not, in itself, constitute a prohibited transaction, the Department stated it is not prepared to rule that these arrangements, in operation, would not violate Section 406. In addition, the Department advised that the plans' fiduciaries must act prudently with respect to the decision to enter into such an arrangement. Robert L. Bunnen, Jr. Assistant General Counsel Attachment

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