

BY ORDER OF THE  
ALABAMA SECURITIES COMMISSION

PROVISIONS FOR THE IMPLEMENTATION OF CERTAIN PERFORMANCE FEES

WHEREAS, Code of Alabama, 1975, Section 8-6-17(d)(1) prohibits an investment adviser from entering into, extending or renewing a contract which does not expressly prohibit compensation based on a share of the capital gains or appreciation of the funds or a portion of the funds of the client otherwise known as “performance fees,” and

WHEREAS, Code of Alabama, 1975, Section 8-6-17(g) provides that the Alabama Securities Commission (the “Commission”) may by Order adopt an exemption from the prohibition against the charging of performance fees contained at Code of Alabama, 1975, Section 8-6-17(d)(1), provided such exemption is consistent with the purposes fairly intended by the policies and provisions of the Alabama Securities Act (the “Act”) and consistent with the interests of the investing public, and

WHEREAS, the Commission staff has researched this issue and based on current industry standards has determined that performance fees may be allowed as such contracts are applied to “Qualified Investors”, that term being defined by United States Securities Exchange Commission (the “SEC”) Rule 205-3(d)(1) and subject to the restrictive provisions herein stated.

*Historical Context*

In adopting the Investment Advisors Act of 1940, the UNITED States Congress generally prohibited performance fee compensation arrangements believing that such arrangements could encourage advisers to take undue risks with client funds to increase advisory fees. (Section 205(a)(1)). Congress provided the SEC rule making authority to conditionally exempt these prohibitions for persons who did not need the protections based on factors such as financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered adviser, and such other factors as the SEC determines are consistent with (Section 205). As such, in 1985 the SEC used their rule making authority to

implement rule 205-3 allowing the payment of performance fees under specific conditions and to persons who meet the definition of a “qualified investor”.

The Alabama Securities Act was implemented and adopted based primarily on the Uniform Securities Act of 1956, which correlated to provisions prohibiting the charging of performance fees, as well as the power of the Commission to grant broad exemptive relief from such prohibitions.

In 1996, Congress passed the National Securities Markets Improvement Act, in which, among other issues, Congress bifurcated the regulation of investment advisers between the SEC for large advisers (those with assets under management [“AUM”] of \$25,000,000 or more) and the states (those with less than \$25,000,000 of AUM). Pursuant to the Dodd-Frank Act of 2010 the division of regulatory responsibility for investment advisers was reallocated between the Federal Government and States with all investment advisers having AUM of less than \$100,000,000 reverting to state regulation and the SEC retaining regulation of those investment advisers with AUM of \$100,000,000 or more. *With this change, many advisers previously subject to the SEC rules relating to performance fees are now subject to regulation under the Alabama Securities Act.*<sup>1</sup>

Historically, prior to the reallocation of regulatory responsibilities under Dodd-Frank, the SEC has found little abuse relating to these fees as charged to Qualified Investors, that such arrangements can be beneficial to the client under the right circumstances and that the imposition of such fees is consistent with current industry practice. In fact, the failure to allow such fees as it related to investment advisers transitioning from SEC to state regulation may prejudice the investor by effectively denying access to advisers with whom the investor has maintained long term relationships.

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<sup>1</sup> Due to the restrictions relating to the type of client who may participate in such fee arrangements, very few investment advisers charging performance fees were regulated by the states prior to the reallocation of regulatory responsibilities under Dodd-Frank.

**THEREFORE, IT IS ORDERED:**

**Notwithstanding the provisions of Code of Alabama, 1975, Section 8-6-17(d)(1) prohibiting the payment of performance fees and pursuant to the exemptive authority granted the Commission at Code of Alabama, 1975, Section 8-6-17(g), an investment adviser may enter into, extend or renew an investment advisory contract which provides for compensation to the investment adviser on the basis of a share of capital gains upon or appreciation of the funds, or any portion of the funds, of the client if the following conditions of this Order are met;**

1. The client entering such contract must be a “Qualified Investor” meeting the following standards:
  - a. A natural person who, or a company that, immediately after entering into the contract has at least \$1,000,000 under the management of the investment adviser;
  - b. 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:
    - i. Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$2,000,000. For purposes of calculating a natural person’s net worth:
      1. The person’s primary residence must not be included as an asset;
      2. Indebtedness secured by the person’s primary residence, up to the estimated fair market value of the primary residence at the time the investment advisory contract is entered into may not be included as a liability (except that if the amount of such indebtedness outstanding at the time of calculation exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess must be included as a liability); and
      3. Indebtedness that is secured by the person’s primary residence in excess of the estimated fair market value of the residence must be included as a liability, or
    - c. A natural person who immediately prior to entering into the contract is:

- i. An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser.
      - ii. 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.
    - d. Inflation Adjustments will be made to these standards consistent with SEC Rule 205(a)(1)(e).
2. The compensation paid to the investment adviser with respect to performance fees must be based upon the following:
  - a. In the case of securities for which market quotations are readily available within the meaning of Rule 2a-4(a)(1) under the investment Company Act of 1940, the formula must include:
    - i. The realized capital losses of securities over the period; and
    - ii. If the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and
    - iii. The formula must provide that any compensation paid to the investment adviser is based on the gains less the losses in the client's account for a period of not less than one year.
3. All investment advisors charging performance fees pursuant to this exemptive order are subject to an annual independent audit requirement which shall include, but not be limited to, a verification of performance fee calculations and asset valuations.
4. The Commission reserves the right to impose additional restriction, requirements, or provide additional exemptive relief upon any investment adviser charging performance fees based on the specific circumstances by which such investment adviser will offer services subject to performance fees, provided such restrictions, requirements or relief are in the public interest and consistent with the purposes fairly intended by the policies and provisions of the Act.