FILED
SECURITIES DIVISION
AUG 29 2011
INDIANA
SECRETARY OF STATE

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SECURITIES DIVISION

IN THE MATTER OF:)
)
PERFORMANCE MANAGEMENT) 11-0266 AO
FEES FOR INVESTMENT ADVISERS)
TO CERTAIN PRIVATE COMPANIES)
)
)

ADMINISTRATIVE ORDER

The Indiana Secretary of State and the Securities Commissioner ("Commissioner") have determined that it is appropriate and in the public interest to issue an Administrative Order regarding performance management fees for investment advisers to certain private companies.

Regulatory Context

Ind. Code § 23-19-5-2(c) provides that a rule adopted under the Indiana Uniform Securities Act ("Act")can specify the contents of an investment advisory contract entered into, extended or renewed by an investment adviser. The Indiana Administrative Code expressly prohibits performance management fees under 710 IAC 4-9-18(b)(1), which states that except as provided by Rule or Administrative Order it is unlawful for an investment adviser to enter into, extend or renew an investment advisory agreement unless it provides in writing that the investment adviser shall not be compensated on the basis of a share of capital gains upon, or of capital appreciation of the funds, or of a portion of the funds of the client. Under 710 IAC 4-9-10, the Rules describe situations where an investment adviser is permitted to charge compensation on the basis of capital gains or capital appreciation.

Background

Managers of a type of private fund, often referred to as a hedge fund, are typically compensated through a performance management fee. Currently, the Rules under the Act prohibit investment advisers from entering into contracts that provide them with a performance management fee. Rather than prohibiting hedge funds in Indiana, the Commissioner has determined to issue this Administrative Order to resolve the issue until more permanent rules are promulgated.

Certain investment advisers to private funds, specifically partnerships that would be defined as investment companies under Section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exemption provided by Section 3(c)(1) of that Act (15 U.S.C. 80a-3(c)(1)) (heretofore known as "Private 3(c)(1) Advisers") are in the practice of charging fees on the basis of a share of capital gains upon or a capital appreciation of the funds, namely performance management fees. This activity is prohibited under 710 IAC 4-9-18 unless the investment

adviser qualifies for an exemption under the Performance Management Fee Rule in 710 IAC 4-9-10, which permits performance management fees so long as six (6) criteria are met. The six criteria include: (1) the client is a company or natural person who has at least five hundred thousand dollars ($500,000) under management of the investment adviser or a net worth of one million dollars ($1,000,000); (2) the compensation is calculated according to accepted formulas; (3) proper disclosure of all material aspects of the advisory arrangement are disclosed; (4) the investment adviser reasonably believes that the contract is an arms-length arrangement; (5) the contract does not relieve any obligations to the client under the Indiana Uniform Securities Act; and (6) the contract does not relieve any obligations under other applicable law. The Rule in 710 4-9-10(c) defines "company" for the purposes of this Rule to not include a company that would be defined as an investment company under Section 3(a) of the Investment Company Act of 1940 but for the exception provided by Section 3(c)(1).

Private 3(c)(1) Adviser contracts clearly meet qualifications (2)-(6), but cannot satisfy the first requirement. Private 3(c)(1) Advisers are general partners of a limited partnership where the limited partners contribute funds into a central Fund, which is then managed by the Private Adviser. For the purposes of the IUSA, the client is considered to be the Fund and not the natural persons or companies contributing to the Fund. Since the definition of "company" in 710 IAC 4-9-10 clearly does not include the Fund, Private 3(c)(1) Advisers cannot meet the first requirement. Since Private 3(c)(1) Advisers cannot meet that first qualification, Private 3(c)(1) Advisers are prohibited by this Rule from charging performance management fees under current Indiana law.

The Securities and Exchange Commission ("SEC") faced a similar issue with its treatment of these Private 3(c)(1) Advisers. The SEC Regulation concerning performance management fees is similar in that it also prohibits the payment of performance management fees unless the fees are from a client, who is a natural person or company. The SEC also has a similar interpretation of "client" under Rule 203(b)(3)-1(a)(2) in that the client of Private 3(c)(1) Advisers is considered to be the Fund and not the investors in the Fund. However, in the SEC's Rule concerning performance management fees (Rule 205-3(b)), the SEC included a different definition of "client." For the purposes of its performance management fee rule, the SEC defines client to be the equity owners of the Fund and not the Fund itself. This allows the Private Adviser to meet the requirements of the performance management fee rule in that performance management fees may only be paid by natural persons or companies with accounts in excess of five hundred thousand dollars ($500,000) or net worth of one million dollars ($1,000,000). The SEC looks through the Fund and considers the investors to be clients but only for the purposes of the Performance Management Fee Rule.

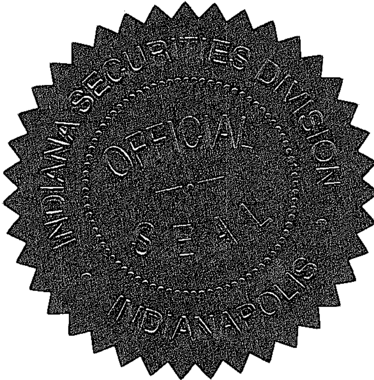
The Indiana Secretary of State, Securities Division ("Division") is applying a similar interpretation in the determination of the client under its Performance Management Fee Rule. In interpreting 710 IAC 4-9-10, the Division will look through the Fund and consider the client to be the individual equity owners of the Fund and not the Fund itself. Therefore, Private 3(c)(1) Advisers will be able to meet all requirements of 710 IAC 4-9-10, which will allow them to charge performance management fees. As a result, Private 3(c)(1) Advisers will not be prohibited from entering into or extending contracts providing for performance management fees under 710 IAC 4-9-18.

IT IS THEREFORE ORDERED that:

For the purposes of 710 IAC 4-9-10 only, the Indiana Secretary of State, Securities Division shall consider the client of a company that would be defined as an investment company under Section 3(a) of the federal Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), but for the exception from that definition provided by Section 3(c)(1) of that Act (15 U.S.C. 80a-3(c)(1)), to be the limited partner or other equity owner of that company.

DATED at Indianapolis, Indiana, this 29TH day of AUGUST, 2011.

CHARLES P. WHITE
SECRETARY OF STATE



CHRIS NAYLOR
SECURITIES COMMISSIONER