The future of the performance fee in '40 Act mutual funds

One of the big hang-ups investors with '40 Act mutual funds is whether the quality of managers is as high as in hedge funds. Some say manager quality may not be as high because '40 Act mutual funds don't usually have incentive fees.

"Getting around the performance fee issue could open the floodgates for '40 Act mutual funds because most managers that you want to invest with don't manage money unless they get the incentive fee," says Bob Gordon, founder of 21st Securities, speaking at Infovest21's Liquid Hedge Fund Seminar last week.

Gordon explained the long history of the use of "blocker offshore" corporations. If a US pension plan invested in a hedge fund partnership that used leverage, it was then considered unrelated taxable income. Therefore, they eventually went through offshore funds also known as blocker corporations. "By going through a corporation instead of a partnership, tax-exempt investors can have as much leverage as they want," says Gordon.

Gordon says that over time, '40 Act funds started using tax haven offshore corporations where they can pretty much do what they want, not concerned by what would have been the US based fund's limits. Some even ventured to see if they could charge a performance fee in the blocker funds.

The SEC has granted more than 40 no-action letters that allow commodity futures funds to go through a blocker corporation.

Complicating the issue further is that the SEC only requires that the base management fee be shown rather than the fees for the underlying managers, adds Gordon.

Gordon feels the issue is coming to a head. "The government has to pull those rulings i.e. put the genie back in the bottle, or let everyone else do it so there is no competitive advantage."

Gordon points to one disadvantage with this approach - everything is taxed as ordinary income instead of futures favorably taxed nature which means tax efficiency is negatively impacted.

Aisha Hunt, partner at Cole-Frieman Mallon & Hunt, says that over 70 private letter rulings have been issued by the IRS approving these managed futures mutual fund structures. In July 2011, the IRS suspended issuing these private letter rulings pending a review of policy issues. "Managed futures mutual funds are holding tens of billions of dollars, and it would disrupt the stability of the mutual fund industry if this legal structure was disallowed. It is unprecedented for the SEC or other regulators to force mandatory redemptions of this scale."

Hunt says precedent exists for grandfathering existing funds. The SEC established a moratorium a few years ago on issuing exemptive orders for ETFs that use derivatives. The result has been that those who have been grandfathered in, enjoy a competitive advantage.

Hunt says a number of managed futures managers are considering whether to bring a mutual fund to market now in the event they get grandfathered in. "People are conducting cost benefit analysis now to determine whether to bring managed futures mutual funds to market."

Meanwhile those firms that don't have a private letter ruling are screaming to pull the letters or let them do the same. "From a fairness standpoint, the regulators can't let these people have a competitive edge forever just because they were the first ones in the market place," says Gordon.