

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2547 / September 7, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12411

In the Matter of

**PUTNAM INVESTMENT
MANAGEMENT, LLC,**

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, MAKING
FINDINGS, AND IMPOSING REMEDIAL
SANCTIONS AND A CEASE-AND-
DESIST ORDER PURSUANT TO
SECTIONS 203(e) AND 203(k) OF THE
INVESTMENT ADVISERS ACT OF 1940**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against Putnam Investment Management, LLC (“Putnam” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent’s Offer, the Commission finds that:

RESPONDENT

1. Putnam, a Delaware limited liability company, headquartered in Boston, Massachusetts, has been registered as an adviser with the Commission since November 19, 1971. Putnam provides investment advisory services to the Putnam Research Fund (“Research Fund” or “the fund”), a series of Putnam Investment Funds, a Massachusetts business trust. As of June 30, 2005, the fund had net assets of approximately \$1.1 billion.

SUMMARY

2. In April 1997, Putnam entered into an investment advisory contract with Putnam Investment Funds on behalf of the Research Fund that provided for compensation to Putnam on the basis of a share of the capital gains upon or capital appreciation of the assets of the Research Fund. From April 1997 through September 27, 2004 (the “relevant period”), Putnam collected compensation based on the Research Fund’s average net asset value for the quarter following the performance period in violation of Section 205 of the Advisers Act, as discussed below. Putnam charged the Research Fund approximately \$1.3 million more than it would have if it had complied with Section 205 of the Advisers Act.

Performance-Based Compensation under Section 205 of the Advisers Act

3. Section 205 of the Advisers Act generally prohibits investment advisers, unless exempt from registration under Section 203(b) of the Advisers Act, from entering into advisory contracts that provide for compensation based on a share of capital gains upon, or capital appreciation of, the assets (or any portion of the assets) of a client (“performance-based compensation” or “total fee”), except as provided in Section 205(b) of the Advisers Act.

4. Under Section 205(b)(2) of the Advisers Act, an investment adviser may enter into an advisory contract with a registered investment company that provides for performance-based compensation that: (i) increases and decreases proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices; and (ii) is based on the asset value of the company or fund, “averaged over a specified period.”

5. Rule 205-2(b) under the Advisers Act defines the “specified period” over which the asset value of the company or fund under management is averaged as the “period over which the investment performance of the company or fund and the investment record of an appropriate index of securities prices . . . are computed.”¹ For example, if an advisory contract specifies that the fund’s performance will be measured against the performance of the S&P 500 index over a 36-month period, then the adviser’s performance-based compensation must be assessed against the asset value of the fund averaged over the same 36-month period.

¹ Advisers Act Rule 205-2(b); *see* Adoption of Rule 205-2 under the Investment Advisers Act of 1940, As Amended, Definition of “Specified Period” Over Which Asset Value of the Company or Fund Under Management is Averaged, Advisers Act Release No. 347 (Nov. 10, 1972) (stating that the performance-related portion of the fee must be assessed against the assets averaged over the same period over which performance was computed).

6. Rule 205-2(c) provides a conditioned exemption from Rule 205-2(b). Under this exemption, an advisory contract providing for performance-based compensation may use a “fulcrum fee,”² for which the “specified period” over which the asset value of the company or fund under management is averaged may differ from the period over which the asset value is averaged for computing the performance-related portion of the fee, only if:

- (a) the performance-related portion of the fee is computed over a rolling period³ and the total fee is payable at the end of each subperiod of the rolling period; and
- (b) the fulcrum fee is computed based on the asset value averaged over the most recent subperiod or subperiods of the rolling period.⁴

For the purposes of Rule 205-2(c), the rolling period must be the same as the period over which performance is measured. Thus, for example, under the exemption provided by Rule 205-2(c), an advisory contract could provide for performance-based compensation that uses a fulcrum fee (calculated by applying a fulcrum-fee rate to the asset value averaged over the most recent subperiod or subperiods of a 36-month rolling period (*e.g.*, the most recent month or three months (a quarter)), as adjusted by the performance-related portion of the fee (calculated by applying a performance-adjustment rate to the asset value of the fund averaged over the entire 36-month rolling period).

7. These provisions are designed to link an adviser’s performance-based compensation to the fund’s investment performance and thereby prevent performance-based compensation from being influenced unduly by the amount of sales or redemptions in the fund over a shorter period.⁵

FACTS

Putnam’s Method for Computing Its Total Fee

8. During the relevant period, Putnam charged the Research Fund performance-based compensation. Specifically, the fund’s advisory contract provided that the total fee would equal the sum of a fulcrum fee and a performance-related portion of the fee. The contract further specified that the total fee would be calculated by applying the fund’s fulcrum-fee rate and performance-adjustment rate against the fund’s average net asset value. The advisory contract

² Rule 205-2(a)(1) defines fulcrum fee to be the “fee which is paid or earned when the investment company’s performance is equivalent to that of the index or other measure of performance.”

³ Rule 205-2(a)(2) defines rolling period to be “a period consisting of a specified number of subperiods of definite length in which the most recent subperiod is substituted for the earliest subperiod as time passes.” Thus, an advisory contract providing for a 36-month rolling period would be based on a rolling period consisting of 36 one-month subperiods.

⁴ Rule 205-2(c).

⁵ *See* Factors To Be Considered in Connection With Investment Company Advisory Contracts Containing Incentive Fee Arrangements, Investment Company Act Release No. 7113 (April 6, 1972).

defined average net asset value to mean the average of all determinations of such net asset value of the fund on each business day during the quarter. Under the contract, the fulcrum-fee rate began at 0.65% and declined to a marginal rate of 0.38%, depending on asset levels in the fund during the relevant period. Depending on the fund's performance against the index, the performance-adjustment rate could range from plus or minus 0.07% in 0.01% steps. The advisory contract, which was proposed in a proxy statement, approved by the fund's shareholders and disclosed in the fund's public filings, provided that the fund's performance would be measured against the performance of an external index, the Standard & Poor's 500 Composite Stock Price Index, over a rolling 36-month period ("performance period"). As provided in the contract, Putnam computed the fund's total fee by applying the fulcrum-fee rate and the performance-adjustment rate against the fund's net asset value averaged over the quarter following the performance period. Consequently, although Putnam adhered to the terms of its contract, Putnam did not calculate its total fee consistent with either Rule 205-2(b) or 205-2(c).

9. From 1997 through mid-2002, the Research Fund's asset value generally increased so that the fund's net asset value averaged over the quarter following the performance period was generally higher than the value of its assets averaged over the performance period, and the fund's performance generally exceeded the performance of the external benchmark index. From mid-2002 through September 2004, the Research Fund's asset value generally decreased so that the fund's net asset value averaged over the quarter following the performance period was generally lower than the value of its assets averaged over the performance period and the fund's performance generally lagged the performance of the external benchmark index. As a result of the fund's average assets and performance over the entire seven-year period, Putnam's assessment of its total fee resulted in higher fees than if Putnam had calculated the total fee in accordance with Section 205 and Rule 205-2 of the Advisers Act. Consequently, Putnam overcharged the Research Fund by \$1,307,482 during the relevant period. When the staff of the Commission brought the improper calculation to Putnam's attention in late September 2004, Putnam promptly took remedial steps to bring its performance-based compensation into compliance with the law.

10. Upon notification by the Commission staff that Putnam was charging the Research Fund a total fee based on a method that did not comply with Section 205 of the Advisers Act, Putnam's management discontinued the method and subsequently reimbursed the fund plus interest of \$343,119, for a total payment of \$1,650,601.

Violation

11. As a result of the conduct described above, Respondent willfully⁶ violated Section 205(a) of the Advisers Act, which prohibits an investment adviser from entering into or performing an advisory contract with a registered investment company that provides for performance-based compensation unless pursuant to Section 205(b) of the Advisers Act, the contract provides for performance-based compensation based on the asset value of the fund averaged over a specified period and increasing and decreasing proportionately with the

⁶ "Willfully" as used in this Order means intentionally committing the act which constitutes the violation, *see Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.

investment performance of the fund over a specified period in relation to the investment record of an appropriate index of securities prices.

Respondent's Remedial Efforts

12. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in the Respondent's Offer of Settlement. Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

- A. Respondent is censured.
- B. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 205(a) of the Advisers Act.

By the Commission.

Nancy M. Morris
Secretary