$10,000,000	Total Assets

First, is the account a ''securities portfolio?'' The account is a securities portfolio because securities as well as cash and cash equivalents (which the applicant has chosen to include as securities) ($6,000,000+$1,000,000=$7,000,000) comprise at least 50% of the value of the account (here, 70%). (See Instruction 7(a))

Second, does the account receive ''continuous and regular supervisory or management services?'' The entire account is managed on a discretionary basis and is provided ongoing supervisory and management services, and therefore receives continuous and regular supervisory or management services. (See Instruction 7(c))

Third, what is the entire value of the account? The entire value of the account ($10,000,000) is included in the calculation of the investment adviser's total assets under management.

[FR Doc. 97–30296 Filed 11–18–97; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA–1682, File No. S7–29–97]

RIN 3235–AH25

Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is proposing amendments to the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge certain clients performance or incentive fees. The amendments would modify the rule's criteria for clients eligible to enter into a contract under which a performance fee is charged and eliminate provisions specifying required contract terms and disclosures. The amendments would provide investment advisers greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding the terms of these arrangements.

DATES: Comments must be received on or before January 20, 1998.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6–9, Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–29–97; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Kathy D. Ireland, Attorney, or Jennifer S. Choi, Special Counsel, at (202) 942–0716, Task Force on Investment Adviser Regulation, Division of Investment Management, Stop 10–6, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to rule 205–3 [17 CFR 275.205–3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b–1 *et seq.*] (''Advisers Act'').

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Executive Summary

Rule 205–3 under the Advisers Act permits investment advisers to charge performance fees to clients with at least $500,000 under the adviser's management or with a net worth of more than $1,000,000. The rule requires certain terms to be included in contracts providing for performance fees and specific disclosures to be made to clients entering into these contracts. The Commission is proposing to eliminate the provisions of the rule that prescribe contractual terms and require specific disclosures. In addition, the Commission is proposing to revise the threshold levels for determining client eligibility to reflect the effects of inflation on the levels set in 1985 when the rule was adopted and to add a third criterion for eligibility. Under the proposed amendments, eligible clients must have assets under management with the adviser of at least $750,000, net worth of more than $1,500,000, or be ''qualified purchasers'' under section 2(a)(51)(A) of the Investment Company Act of 1940 (''Investment Company Act'').[1]

I. Background

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds or any portion of the funds of the client.[2] Congress enacted the prohibition against performance fees in 1940 to protect advisory clients from compensation arrangements that it believed might encourage advisers to take undue risks with client funds to increase advisory fees.[3]

In 1970, Congress provided an exception from the prohibition in section 205(a)(1) for advisory contracts relating to the investment of assets in excess of $1,000,000,[4] so long as an appropriate ''fulcrum fee'' is used.[5] This

[1] 15 U.S.C. 80a–2(a)(51)(A).

[2] 15 U.S.C. 80b–5(a)(1).

[3] H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). Performance fees were characterized as ''heads I win, tails you lose'' arrangements in which the adviser had everything to gain if successful and little, if anything, to lose if not. S. **Rep. No.** 1775, 76th Cong., 3d Sess. 22 (1940). *See also* SEC, **Investment Trusts and Investment Companies,** H.R. Doc. No. 477, 76th Cong., 3d Sess. 30 (1939). Congress, however, recognized that performance fees may not be harmful in every context and initially excluded from the prohibition contracts between investment advisers and investment companies. Investment Advisers Act of 1940, ch. 686, § 205(1), 54 Stat. 847, 852 (1940) (amended 1970).

[4] Trusts, governmental plans, collective trust funds, and separate accounts referred to in section 3(c)(11) of the Investment Company Act [15 U.S.C. 80a–3(c)(11)] are not eligible for this exception from the performance fee prohibition under section 205(b)(2)(B) of the Advisers Act [15 U.S.C. 80b–5(b)(2)(B)].

[5] 15 U.S.C. 80b–5(b). A fulcrum fee generally involves averaging the adviser's fee over a specified period and increasing and decreasing the fee proportionately with the investment performance of the company or fund in relation to the investment record of an appropriate index of securities prices. *See* Adoption of Rule 205–2 Under the Investment Advisers Act of 1940, as Amended, Defining ''Specified Period'' Over Which the Asset Value of the Company or Fund Under Management is Averaged, Investment Advisers Act Release No. 347 (Nov. 10, 1972) (37 FR 24895 (Nov. 23, 1972)); Adoption of Rule 205–1 Under the Investment Advisers Act of 1940 Defining ''Investment Performance'' of an Investment Company and

statutory exception was the only provision under which advisers could enter into performance fee contracts with so-called ''high net worth'' clients until 1985 when the Commission adopted rule 205–3.[6]

Under rule 205–3, an adviser may charge performance fees to a client that has $500,000 under management with the adviser or has a net worth of $1,000,000. Because of their wealth, financial knowledge, and experience, the Commission presumed that these clients are less dependent on the protections provided by the Advisers Act's restrictions on performance fee arrangements.[7] The rule, however, imposes a number of required provisions on performance fee contracts and obligates the adviser to provide certain disclosures to clients. These provisions were included as ''alternative safeguards to the statutory prohibition.''[8]

In 1992, the Commission's Division of Investment Management issued a report concluding that the existing exemptions from the performance fee prohibition should be expanded to permit certain sophisticated clients of investment advisers to enter into arrangements without the restrictions in the statutory or administrative exemptions.[9] The Division expressed the view that ''where a client appreciates the risk of performance fees and is in a position to protect itself from overreaching by the adviser, the determination of whether such fees provide value is best left to the client.''[10] The Division recommended that Congress enact legislation specifically authorizing the Commission to provide exemptions from the performance fee prohibition for advisory contracts with any person whom the Commission determined did not need the protections of the prohibition.[11] Four years later, Congress included in the National Securities Markets Improvement Act of 1996 (''1996 Act'')[12] two additional statutory exceptions from the performance fee prohibition[13] and new section 205(e) of the Advisers Act, which authorizes the Commission to exempt conditionally or unconditionally from the performance fee prohibition advisory contracts with persons that the Commission determines do not need its protections.[14]

II. Discussion

A. Elimination of Specific Contractual and Disclosure Requirements

As noted above, rule 205–3 contains several conditions on advisers entering into performance fee contracts in addition to those related to the eligibility of clients.[15] First, the compensation provided to the adviser under the contract must be based on the performance of securities that is calculated pursuant to two different methodologies specified in the rule, depending upon the nature of the securities under management.[16] In addition, the performance fee must be based on the gains less the losses in the client's account for a period of not less than one year.[17] Second, the investment adviser must disclose to the client, or to the client's independent agent, prior to entering into the contract, all material information concerning the proposed advisory arrangement, including: (1) the possibility that the arrangement may create an incentive for the adviser to make riskier or more speculative investments; (2) the fact (if applicable) that the adviser may receive increased compensation based on unrealized appreciation as well as realized gains; (3) the periods that will be used to measure investment performance and their significance in the computation of the fee; (4) the nature and significance of any index that will be used as a comparative measure of investment performance, and why the index is appropriate; and (5) if the fee is based on unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued and the extent to which the value will be determined independently.[18] Finally, the adviser must reasonably believe that the contract represents an arm's-length arrangement and that the client, alone or together with an independent agent, understands the proposed compensation arrangement and its risks.[19]

Whether these provisions are necessary to protect sophisticated clients of the type contemplated by rule 205–3 was examined by the Division of Investment Management in 1992. The Commission agrees with the Division's conclusion that if a client appreciates the risk of performance fees and is in a position to protect itself from overreaching by the adviser, then the terms of the arrangement are best left to

''Investment Record'' of an Appropriate Index of Securities Prices, Investment Advisers Release No. 327 (Aug. 8, 1972) (37 FR 17467 (Aug. 29, 1972)).

In 1980, Congress added an exception for contracts involving business development companies under conditions set forth in section 205(b)(3) of the Advisers Act (15 U.S.C. 80b–5(b)(3)).

[6] Rule 205–3 was adopted under section 206A of the Advisers Act (15 U.S.C. 80b–6a), which grants the Commission general exemptive authority. In providing this authority, Congress noted that the Commission would be able to ''exempt persons . . . from the bar on performance-based advisory compensation'' in appropriate cases. H.R. Rep. No. 1382, 91st Cong., 2d Sess. 42 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 46 (1969).

[7] Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 996 (Nov. 14, 1985) (50 FR 48556 (Nov. 26, 1985)).

[8] *Id.* at Section I.C.

[9] *See* Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation 237–49 (1992) (''Protecting Investors'').

[10] *Id.* at 245.

[11] *Id.* at 245, 247–48.

[12] Pub. L. No. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the U.S. Code).

[13] Section 210 of the 1996 Act added to section 205 of the Advisers Act exceptions for contracts with companies excepted from the definition of investment company by section 3(c)(7) of the Investment Company Act [15 U.S.C. 80a–3(c)(7)] and contracts with persons who are not residents of the United States. The definition of ''person'' under section 202 of the Advisers Act includes companies, which in turn includes corporations, partnerships, associations, joint-stock companies, trusts and organized groups of persons [15 U.S.C. 80b–2(a)(5), (16)]; therefore, the exception for foreign residents includes foreign investment companies.

[14] 15 U.S.C. 80b–5(e). Section 205(e) provides that the Commission may determine that persons may not need the protections of section 205(a)(1) on the basis of such factors as ''financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with [section 205].''

[15] Before the enactment of the 1996 Act, rule 205–3 was available only to Commission-registered investment advisers. Title III of the 1996 Act, the Coordination Act, which became effective on July 8, 1997, generally limited Commission registration to larger investment advisers but continued the application of the prohibition of section 205(a)(1) of the Advisers Act to all advisers (other than those exempt from registration pursuant to section 203(b) of the Act [15 U.S.C. 80b–3(b)]), regardless of whether they are prohibited from registering with the Commission pursuant to the Coordination Act. 1996 Act, *supra* note 12. In light of this provision, the Commission amended rule 205–3 earlier this year to permit all advisers to take advantage of the limited exemption in the rule. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)] (''Implementing Release''). The proposed amendments herein also include conforming changes to the May 1997 rule amendments.

[16] If market quotations for the securities involved are readily available, then the formula must include realized capital losses and unrealized capital depreciation of the securities. If market quotations are not readily available, then the formula still must include realized capital losses, but need not include unrealized capital depreciation unless it also includes unrealized capital appreciation. Rule 205–3(c)(1), (2) [17 CFR 275.205–3(c)(1), (2)].

[17] Rule 205–3(c)(3) [17 CFR 275.205–3(c)(3)].

[18] Rule 205–3(d) [17 CFR 275.205–3(d)].

[19] Rule 205–3(e) [17 CFR 275.205–3(e)]. The rule also contains a number of definitions of terms necessitated by these conditions, including ''affiliated person,'' ''client's independent agent,'' ''interested person,'' ''securities for which market quotations are readily available,'' and ''securities for which market quotations are not readily available.'' Rule 205–3(g)(3)–(6) [17 CFR 275.205–3(g)(3)–(6)].

the client.[20] While the conditions of rule 205–3 are intended to protect clients, the Commission's experience with the rule suggests they also may inhibit flexibility of advisers and their clients in establishing performance fee arrangements beneficial to both parties. Moreover, in light of the other protections provided by the Advisers Act, the Commission believes that these clients may not need the protections of the rule.[21] Therefore, the Commission believes that the conditions may not be necessary to protect these types of clients and proposes, pursuant to its exemptive authority under new section 205(e) of the Advisers Act, to eliminate all of the contractual and disclosure provisions in rule 205–3 other than the client eligibility tests.

Under the proposed rule amendments, performance fee contracts would no longer be subject to the prescribed contract terms and disclosures. Thus, an adviser would be free to negotiate all of the terms of a performance fee contract with a client. The Commission emphasizes, however, that an adviser charging a performance fee would continue to be subject to the Advisers Act's prohibitions against fraud.[22] As a result, an adviser could not enter into a performance fee arrangement that was inconsistent with the adviser's fiduciary duties and could not fail to disclose material information about the performance fee to the client.[23]

Comment is requested on whether rule 205–3 should be amended to eliminate all of the contractual and disclosure requirements for sophisticated clients. Should the ''arm's-length contract'' or any of the other provisions be retained? Are certain conditions on performance fee contracts necessary to protect even clients the Commission presumes are able to protect themselves? Are there alternative conditions that should be considered?

B. Qualified Clients

As noted above, in adopting rule 205–3 in 1985, the Commission concluded that clients having a net worth in excess of $1,000,000, or assets under management of at least $500,000, do not need the full protections provided by the Advisers Act's restrictions on performance fee arrangements.[24] The Commission believes that a similar finding by the Commission would support the proposed expansion of the exemption under the new authority granted the Commission last year in section 205(e) of the Advisers Act.[25]

The Commission recognizes that, since 1985, the net worth and assets under management thresholds have been affected by inflation: $1,000,000 in 1985 dollars is now worth approximately $1,521,000; and $500,000 in 1985 dollars is now worth approximately $760,000. The Commission therefore proposes to increase the amounts of the net worth and assets under management tests from $1,000,000 and $500,000 to $1,500,000 and $750,000, respectively. This increase is not intended to reduce the number or to alter the types of clients with which an adviser may enter into a performance fee arrangement, but to reflect the effects of inflation on the rule.

The Commission also is proposing to permit advisers to enter into performance fee contracts with clients who are ''qualified purchaser[s]'' under section 2(a)(51)(A) of the Investment Company Act.[26] The 1996 Act amended the Investment Company Act, among other things, to add new section 3(c)(7), which exempts from regulation under the Investment Company Act certain investment pools whose interests are not offered to the public and whose shareholders consist primarily of ''qualified purchasers,'' including individuals with at least $5,000,000 of investments.[27] Although, in most cases, persons who would be qualified purchasers under section 2(a)(51)(A) would be eligible to enter into a performance fee contract with advisers under rule 205–3, even as proposed to be amended, in some cases, such persons would not.[28] Therefore, the Commission proposes to add ''qualified purchasers'' as eligible clients under the rule so that an investor who meets the eligibility requirements of section 3(c)(7) also could enter into a performance fee arrangement outside the context of a section 3(c)(7) company.[29]

Under the proposed amendments, clients who satisfy the new eligibility criteria contained in rule 205–3 would be referred to as ''qualified client[s].''[30] Comment is requested on the revised criteria for entering into a performance fee contract and whether the Commission should consider alternative criteria for qualified clients. Are the criteria sufficient for the Commission to make the required finding under section 205(e) that qualified clients do not need the protections of the statutory prohibition on performance fee arrangements? Rather than including the qualified purchaser as the third alternative criterion, should the Commission use the qualified purchaser threshold in lieu of the other two tests?

In addition to criteria such as financial sophistication and knowledge and experience in financial matters, section 205(e) permits the Commission

[20] *See* Protecting Investors, *supra* note 9, at 245.

[21] Advisers are regarded as fiduciaries who are required to deal fairly with their clients and to make full and fair disclosure of, among other things, their compensation agreements. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963). In addition, advisers registered with the Commission are required to provide their clients with a brochure describing their fee arrangements. *See* Part II of Form ADV.

[22] Section 206 of the Advisers Act [15 U.S.C. 80b-6].

[23] The proposed amendments also would eliminate paragraph (h) of the current rule, which states that ''[a]n investment adviser entering into or performing an investment advisory contract under this rule is not relieved of any obligations under section 206 of the Advisers Act or of any other applicable provisions of the federal securities laws.'' The Commission believes that the proposed rule amendments by their terms provide an exemption only from section 205(a)(1), and that separate reference to section 206 and other provisions of the federal securities laws is unnecessary. By proposing to eliminate this reference, the Commission does not intend in any way to suggest that compliance with the amended rule would relieve advisers of any obligations under section 206 of the Advisers Act or of any other applicable provisions of the federal securities laws.

The Commission further notes that advisers entering into performance fee arrangements with employee benefit plans covered by the Employee Retirement Income Security Act of 1974 (''ERISA'') are subject to the fiduciary responsibility and prohibited transaction provisions of ERISA. 29 U.S.C. 1001–1461. The proposed amendments to rule 205–3 would not affect an adviser's obligation to comply with ERISA. Issues involving performance fee arrangements under ERISA are within the jurisdiction of the Department of Labor, which is responsible for administering ERISA's fiduciary provisions and has addressed performance fee arrangements in a number of advisory opinions under ERISA. U.S. Department of Labor Advisory Opinion No. 89–28A (Sept. 25, 1989); U.S. Department of Labor Advisory Opinion 86–21A (Aug. 29, 1986); U.S. Department of Labor Advisory Opinion 86–20A (Aug. 29, 1986).

[24] *See supra* note 7 and accompanying text.

[25] *See supra* note 14 and accompanying text.

[26] *See supra* note 1.

[27] 15 U.S.C. 80a–3(c)(7).

[28] For example, in determining the amount of investments for purposes of the definition of qualified purchaser, only outstanding indebtedness incurred to acquire or for the purpose of acquiring the investments must be deducted. Rule 2a51–1(e) of the Investment Company Act (17 CFR 270.2a51–1(e)). *See also* Privately Offered Investment Companies, Investment Company Act Release No. 22597 (Apr. 3, 1997) (62 FR 17512 (Apr. 9, 1997)). Thus, a person with less than $750,000 in assets under management could have over $5,000,000 of investments, but a net worth of less than $1,500,000 because of other debt. Under the proposed rule amendments, such a person would be eligible to enter into a performance fee contract under rule 205–3.

[29] Under section 205(b)(4)] of the Advisers Act [15 U.S.C. 80b–5(b)(4)], section 3(c)(7) companies may enter into performance fee contracts without relying on rule 205–3. Each investor in a section 3(c)(7) company need not satisfy the eligibility criteria for an adviser to charge performance fees to the section 3(c)(7) company. *See infra* note 36.

[30] Proposed rule 205–3(d)(1).

to consider whether a client may not need the protections of the Advisers Act by virtue of its relationship with the adviser.[31] Should the Commission exempt advisers that have a pre-existing relationship with clients that suggests that the abuses Congress sought to prevent by prohibiting performance fee arrangements are unlikely to occur? If so, what should be the nature of those relationships?[32]

Should the Commission revise the criteria to prevent the net worth and assets under management criteria from becoming less meaningful as a result of inflation? Should the criteria be indexed to prevent future effective lowering of the amounts? Should the Commission adopt more detailed criteria to assure the financial sophistication of qualified clients if the objective thresholds are effectively decreased as result of inflation?

C. Identification of the Client[33]

Rule 205–3 provides that with respect to certain clients entering into performance fee contracts with an adviser—private investment companies,[34] registered investment companies, and business development companies—the adviser must ''look through'' the legal entity to determine whether each equity owner of the company would be a qualified client.[35] The proposed amendments would retain the ''look through'' provision[36] and clarify that any equity owners that are not charged a performance fee would not be required to meet the qualified client test.[37]

Comment is requested whether this ''look through'' provision should continue to be included in rule 205–3. The Commission also requests comment concerning whether the rule should specifically address the application of the ''look through'' provision to other entities.

D. Transition Rule

The proposed amendments would add a transition rule permitting investment advisers and their clients to maintain their existing performance fee arrangements notwithstanding the clients' failure to meet the eligibility criteria after the thresholds increase to $750,000 and $1,500,000.[38] Such arrangements could continue under the transition rule if they were entered into before the effective date of the amendments to the rule and they satisfied the requirements of the rule as in effect on the date that they were entered into. A new party to an existing arrangement, however, would be required to satisfy the new qualified client test.

E. General Request for Comment

Any interested persons wishing to submit written comments on the proposed rule amendments that are the subject of this Release, to suggest additional changes (including changes to the provisions of the rule that the Commission is not proposing to amend), or to submit comments on other matters that might have an effect on the proposals described above, are requested to do so. Commenters suggesting alternative approaches are encouraged to submit their proposed rule text.

III. Cost-benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. The Commission notes that the proposed rule amendments are pursuant to new authority granted to it by Congress in the 1996 Act.

The proposed amendments would benefit investment advisers and their qualified clients by providing more flexibility to enter into performance fee arrangements. Specifically, investment advisers and their qualified clients could enter into such arrangements without being subject to prescribed compensation calculations and client disclosures. Thus, the total number of performance fee arrangements may increase. On the other hand, the proposed increase in the thresholds for determining eligibility under the rule may cause the number of eligible clients to decrease,[39] and, as a result, reduce the total number of performance fee arrangements.[40] The Commission, however, does not have information from which to analyze the precise effect of the proposed amendments on the number of performance fee arrangements. Comment is requested on whether the proposed amendments would increase or decrease the number of performance fee arrangements.

To the extent that the proposed rule amendments increase the number of performance fee arrangements, advisers and clients may benefit overall.[41] For example, proponents of performance fees have argued that these arrangements may benefit both parties to the advisory contract because linking advisory compensation to performance may result in a closer alignment of the goals of the adviser and the client.[42] If the goals of both parties coincide, then

[31] *See supra* note 14.

[32] In the context of the definition of investment adviser representative, the Commission has proposed that natural persons with certain business or familial relationships with the supervised person would not need the protection of state qualification requirements. Exemption for Investment Advisers Operating in Multiple States; Revisions to Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1681 (Nov. 13, 1997).

[33] The following discussion of the identity of the ''client'' is relevant only for purposes of this rule and not for purposes of section 206 of the Advisers Act (15 U.S.C. 80b–6).

[34] The definition of ''private investment company'' included in paragraph (g)(1) of the current rule [17 CFR 275.205–3(g)(1)] would continue in the amended rule to refer solely to those companies excepted from the definition of investment company under section 3(c)(1) of the Investment Company Act [15 U.S.C. 80a–3(c)(1)]. Reference to section 3(c)(7) is unnecessary because, as noted above, companies excepted from the definition of investment company under this provision also are excepted from the performance fee prohibition pursuant to section 205(b)(4) of the Advisers Act (15 U.S.C. 80b–5(b)(4)).

[35] Rule 205–3(b)(2) [17 CFR 275.205–3(b)(2)].

[36] Proposed rule 205–3(b). The Commission is not proposing to extend the ''look through'' provision of rule 205–3 to section 3(c)(7) companies. In the 1996 Act, Congress explicitly excepted section 3(c)(7) companies from the prohibition on performance fees having concluded that ''investors in a qualified purchaser pool are sophisticated enough to be allowed to enter into a fee arrangement that is not a fulcrum fee.'' *See* S. REP. NO. 293, 104th Cong., 2d Sess. 11 (1996).

[37] Proposed rule 205–3(b). *See, e.g.,* Hellmold Associates, Inc. (pub. avail. Dec. 18, 1992) (adviser may receive performance fee from certain limited partners when the fee would be based solely on a limited partner's capital account and not based on the overall performance of the partnership). *See also* Compass Investors (pub. avail. Dec. 18, 1996).

The proposed amendments would retain the provision in rule 205–3 that an equity owner who is the investment adviser entering into the performance fee contract need not be a qualified client.

[38] Proposed rule 205–3(c).

[39] According to data from the 1995 Survey of Consumer Finances conducted by the Federal Reserve Board, approximately 1,100,000 households have net worth between $1,000,000 and $1,500,000. This figure, however, represents the net worth of households and not the individual persons who might be clients. Furthermore, the survey results do not address clients that are not natural persons.

[40] The Commission knows of no information concerning the incidence of performance fee arrangements in the United States, and requests the submission of data concerning such incidence. Performance fee arrangements, however, appear to be accepted practices in many other countries. *See* International Survey of Investment Adviser Regulation 15 (Marcia L. MacHarg & Roberta R. W. Kameda eds., 1994) (noting that performance fees generally are permitted in Australia, Brazil, Canada (Ontario, with client's written consent), France, Germany, Italy, Japan, Spain, Switzerland (up to 20% of net capital gain), the United Kingdom and Venezuela).

[41] The Commission's Division of Investment Management discussed the advantages and disadvantages of performance fees in more detail in its 1992 study. Protecting Investors, *supra* note , at 239–40.

[42] Richard Grinold & Andrew Rudd, *Incentive Fees: Who Wins? Who Loses?*, 43 Fin. Analysts J. 27, 37 (Jan.–Feb. 1987); Harvey E. Bines, The Law of Investment Management ¶ 5.03[2][b], at 5–43 (1978 & Supp. 1986) (observing that the principal justification for performance fees is that they permit the uncertainty in the quality of the product—the management of the portfolio—to be shared between the adviser and the client).

the benefits of performance fee arrangements would include fewer conflicts of interest in advisory relationships. Better alignment of the goals of the adviser and the client might also result in more efficient investing and allocation of capital.

Proponents also claim that performance fees may encourage better performance by rewarding good performance rather than linking compensation and assets under management as in more traditional arrangements.[43] Thus, such arrangements may produce more cost-effective results than arrangements with more traditional fee structures.

In addition, advocates of the increased use of performance fees assert that they may encourage the establishment of new advisory firms.[44] Performance fees could result in greater competition and produce a wider array of investment advisers and services and lower overall advisory costs. Proponents also state that performance fees provide an incentive for investment advisers to service smaller accounts that otherwise might be less attractive to the advisers.[45] Furthermore, supporters argue that performance fees permit advisers to focus on a smaller number of clients than they otherwise would under traditional compensation arrangements by allowing them to generate sufficient income without the necessity for a large asset base.[46] Such results also could increase the variety of services provided to a wider array of clients, and decrease advisory costs overall.

The increased use of performance fees, however, also may produce some costs to advisory clients and the economy in general. Opponents of advisory fees have cited the potential for the adviser under a performance fee arrangement to engage in excessive risk taking with respect to the client's account.[47] Excessive risk taking may result in unexpected losses to the clients, which may prompt investors to withdraw from the market and discourage capital formation. Critics also challenge whether there is any basis, theoretical or analytical, for believing that performance fees will improve performance.[48] In addition, some detractors have expressed concern that performance fees might result in discrimination against clients that do not pay performance fees. One form of such discrimination may be advisers devoting more of their time and resources to clients that pay such fees.[49] Such an argument relies on an assumption, which may not be necessarily correct, that an adviser cannot increase the amount of its advisory resources. Nonetheless, this argument notes the potential for an increase in conflicts of interest on the part of advisers.[50]

The arguments for and against performance fee arrangements provide no definitive answers concerning their effect on advisers, clients and the markets in general. The costs and benefits of performance fee arrangements in general are difficult to quantify because of their theoretical nature. Comment is requested on whether the benefits and costs could be quantified.

The Commission has determined to permit clients who are financially sophisticated or have the resources to obtain sophisticated financial advice to weigh the costs and benefits of entering into such arrangements and to determine for themselves whether to enter into such contracts. Although an increase in the use of performance fees may impose some overall costs, such costs could result from the existing rule 205–3 even if the Commission did not adopt the proposed amendments.

With respect to the rule amendments at issue, the Commission believes that the proposed amendments would not impose any additional costs on investment advisers or their clients. Once the adviser determines that a client is qualified, the rule does not prescribe detailed contractual requirements or require specific disclosures to clients. The Commission has observed over the years that the detailed conditions of the current rule raise numerous interpretive issues.[51] The proposed rule should reduce the costs of establishing and monitoring compliance with the current rule.

Comment is requested on this cost-benefit analysis. Commentators are requested to provide views and empirical data relating to any costs and benefits associated with the proposed rules and performance fees in general.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also is requesting information regarding the potential effect of the proposed rule amendments on the economy on an annual basis. Commentators should provide empirical data to support their views.

IV. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding proposed amendments to rule 205–3 under the Advisers Act. The following summarizes the IRFA.

As set forth in greater detail in the IRFA, the 1996 Act added section 205(e) to the Advisers Act, which authorizes the Commission to exempt conditionally or unconditionally from the performance fee prohibition contained in section 205(a)(1) of the Advisers Act advisory contracts with persons that the Commission determines do not need the protections of the prohibition. The IRFA states that the proposed rule amendments would liberalize rule 205–3, which permits performance fees to be charged to sophisticated clients by eliminating required contract terms and disclosures, update the current criteria for determining eligible clients to reflect the effects of inflation on the current assets under management and net worth tests, and add a new category of eligible clients based upon the definition of ''qualified purchaser'' in section 2(a)(51)(A) of the Investment Company Act.

The IRFA sets forth the statutory authority for the proposed rule amendments. The IRFA also discusses the effect of the proposed rule amendments on small entities. For the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity (i) if it manages assets of $50 million or less, in discretionary or non-

[43] *See, e.g.*, Stephen Lofthouse, *A Fair Day's Wages for a Fair Day's Work*, 4 Journal of Investing 74, 76 (Winter 1995); Grinold & Rudd, *supra* note 42, at 37; Bines, *supra* note 42, at 5–36 to 5–37.

[44] Julie Roher, *The Great Debate Over Performance Fees*, 17 Institutional Investor 123, 124 (Nov. 1983) (stating that new firms can begin generating profits before attracting a large asset base).

[45] *See, e.g., id.*

[46] *See, e.g., id.*

[47] Lofthouse, *supra* note 43, at 77; Roher, *supra* note 44, at 127.

[48] Lofthouse, *supra* note 43, at 79 (citing the lack of empirical data); Roher, *supra* note 44, at 128 (noting that incentives for good performance already exist because advisers are compensated on the basis of account size and must perform well to retain their clients); Bines, *supra* note 42, at 5–36 (indicating that there is no demonstrable connection between performance fees and superior performance).

[49] *See, e.g.*, Lofthouse, *supra* note 43, at 77.

[50] *See* In re McKenzie Walker Investment Management, Inc., Investment Advisers Act Release No. 1571 (July 16, 1996) (investment adviser favoring its performance-fee clients in the allocation of hot initial public offerings).

[51] *See, e.g.*, Valuemark Capital Management, Inc. (pub. avail. June 4, 1997) (limited partners purchasing or redeeming mid-year immaterial if performance fee based on performance of partnership over a period of at least one year); Securities Industry Association (pub. avail. Nov. 18, 1986) (use of rolling one-year periods after initial one-year period); P.E. Becker, Inc. (pub. avail. July 21, 1986) (individual limited partners may be considered the ''client'' for purposes of the ''arm's-length'' negotiation requirement).

discretionary accounts, as of the end of its most recent fiscal year or (ii) if it renders other advisory services, has $50,000 or less in assets related to its advisory business.[52] The Commission estimates that approximately 17,650 investment advisers are small entities.[53] The Commission does not have information, however, from which to estimate either the number of clients of small entities who would satisfy the tests of sophistication or the number of such clients who would enter into performance fee arrangements under the rule. The Commission, however, believes that it would be reasonable to estimate that the overall effect of the proposed amendments to the rule would be to increase the use of the exemption by small entities, and that the economic effect on small entities may be significant.

The IRFA states that the proposed rule amendments would not impose any new reporting, recordkeeping or compliance requirements, and that the Commission believes that no rules duplicate, overlap or conflict with the proposed rule amendments.

The IRFA discusses the various alternatives considered by the Commission in connection with the proposed rule amendments that might minimize the effect on small entities, including (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities; (b) the clarification, consolidation or simplification of compliance and reporting requirements under the rule amendments for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule or any portion of the rule, for small entities. As discussed in more detail in the IRFA, the Commission believes that it would be inconsistent with the purposes of the Advisers Act to exempt small entities from the proposed rule amendments or to use performance standards to specify different requirements for small entities. Different compliance or reporting requirements for small entities are not necessary because the proposed rule amendments do not establish any new reporting, recordkeeping or compliance requirements. The Commission has determined that it is not feasible to further clarify, consolidate or simplify the proposed rule amendments for small entities.

The IRFA includes information concerning the solicitation of comments with respect to the IRFA generally, and in particular, the number of small entities that would be affected by the proposed rule amendments. A copy of the IRFA may be obtained by contacting Kathy D. Ireland, Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop 10–6, Washington, DC 20549.

V. Statutory Authority

The Commission is proposing amendments to rule 205–3 pursuant to the authority set forth in section 205(e) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-5(e)].

List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule Amendments

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 is revised to read as follows:

Authority: 15 U.S.C. 80b-2(a)(17), 80b-3, 80b-4, 80b-6(4), 80b-6a, 80b-11, unless otherwise noted.

Section 275.203A–1 is also issued under 15 U.S.C. 80b-3a.

Section 275.203A–2 is also issued under 15 U.S.C. 80b-3a.

Section 275.204–2 is also issued under 15 U.S.C. 80b-6.

Section 275.205–3 is also issued under 15 U.S.C. 80b-5(e).

2. Section 275.205–3 is revised to read as follows:

§ 275.205–3 Exemption from the compensation prohibition of section 205(a)(1) for investment advisers.

(a) *General.* The provisions of section 205(a)(1) of the Act (15 U.S.C. 80b-5(a)(1)) will not be deemed to prohibit any investment adviser from entering into, performing, renewing or extending an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client, *Provided,* That the client entering into the contract subject to this section is a qualified client, as defined in paragraph (d)(1) of this section.

(b) *Identification of the client.* In the case of a private investment company, as defined in paragraph (d)(3) of this section, an investment company registered under the Investment Company Act of 1940, or a business development company, as defined in section 202(a)(22) of the Act (15 U.S.C. 80b-2(a)(22)), each equity owner of any such company (except for the investment adviser entering into the contract and any other equity owners not charged a fee on the basis of a share of capital gains or capital appreciation) will be considered a client for purposes of paragraph (a) of this section.

(c) *Transition rule.* An investment adviser that entered into a contract before [insert the effective date of the final rule] and satisfied the conditions of this section as in effect on the date that the contract was entered into will be deemed to satisfy the conditions of this section; *Provided, however,* that this section will apply with respect to any natural person or company who is not a party to the contract prior to and becomes a party to the contract after [insert the effective date of the final rule].

(d) *Definitions.* For the purposes of this section:

(1) The term *qualified client* means a natural person who or a company that:

(i) Immediately after entering into the contract has at least $750,000 under the management of the investment adviser; or

(ii) The investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

[52] Rule 275.0–7 [17 CFR 275.0–7]. In January 1997, the Commission proposed to revise this definition of ''small entity.'' *See* Definitions of ''Small Business'' or ''Small Organization'' Under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933, Release Nos. 33–7383, 34–38190, IC–22478, and IA–1609 (Jan. 22, 1997) (62 FR 4106 (Jan. 28, 1997)). The Commission expects to adopt a revised definition of small investment adviser for Regulatory Flexibility Act purposes to reflect the Coordination Act.

[53] This estimate of the number of small entities was made for purposes of the Final Regulatory Flexibility Analysis for the rules implementing the Coordination Act. *See* Implementing Release, *supra* note 15, at nn.189–190 and accompanying text. Under rule 203A–5 of the Advisers Act, all investment advisers registered with the Commission were required to file a completed Form ADV–T with the Commission by July 8, 1997, indicating whether they remain eligible for Commission registration. Of the 23,350 Commission-registered investment advisers, approximately 7,200 advisers indicated that they remain eligible for Commission registration, 10,600 advisers withdrew their registrations, and 5,800 advisers did not file their Form ADV–T. The Commission believes that most of the investment advisers that did not file the Form ADV–T are either no longer in the advisory business or no longer eligible to register with the Commission. The Commission expects to cancel the registrations of most of these investment advisers. The Commission also expects to adopt a revised definition of small entity for purposes of the Regulatory Flexibility Act. *See supra* note 52. Therefore, the Commission plans to revise its estimate of the number of advisers that are small entities after the transition is complete so that the Commission would have more accurate information to determine the number of small entities under the new definition of that term.

(A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or

(B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(51)(A)) at the time the contract is entered into.

(2) The term *company* has the same meaning as in section 202(a)(5) of the Act (15 U.S.C. 80b-2(a)(5)), but does not include a company that is required to be registered under the Investment Company Act of 1940 but is not registered.

(3) The term *private investment company* means a company that would be defined as an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exception provided from that definition by section 3(c)(1) of such Act (15 U.S.C. 80a-3(c)(1)).

Dated: November 13, 1997.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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