PUBLIC

1 MAR 1994

Our Ref. No. 93-740-CC
Summit Advisors, Inc.
File No. 801-42184

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

In your letter dated December 7, 1993, you request assurances that we would not recommend enforcement action to the Commission under Section 205(a)(1) of the Investment Advisers Act of 1940 if Summit Advisors, Inc. ("Summit"), a registered investment adviser and general partner of Marlboro Equity Partners, L.P. (the "Partnership"), is allocated profits from the Partnership based on the Partnership's performance for a period of less than one year, as described in your letter.

You state that the Partnership is excepted from the definition of investment company under Section 3(c)(1) of the Investment Company Act of 1940. The Partnership offers and sells limited partnership interests pursuant to Regulation D of the Securities Act of 1933 and Rule 506 thereunder. The Partnership currently has five limited partners and Summit as its sole general partner. Three of the limited partners were admitted to the Partnership in February of 1993, one in March of 1993 and one in September of 1993.[1] Under the Partnership agreement, Summit receives an annual management fee, payable quarterly, of 1% of the net assets of the Partnership. Summit, as general partner, at all times maintains at least a 1% ownership interest in the Partnership, and 1% of the Partnership's realized and unrealized net profits and losses are allocated to Summit's capital account.

In addition, under certain conditions Summit may receive a performance fee.[2] This fee, which you propose to prorate for tax purposes, represents 20% of each limited partner's gains as computed under the rule, less cumulative management fees received by Summit and front end sales charges paid by each limited partner, and less any previous performance allocations paid to Summit as General Partner. The fee is to be calculated at the end of each quarter, beginning with the quarter at or following a limited partner's one year anniversary. For subsequent quarters, the performance period is to be rolled back to the beginning of

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1 You state that this request pertains to four limited partners, the three who were admitted in February of 1993 and the one admitted in March 1993, and does not apply to the limited partner admitted in September 1993.

2 You represent that the performance fee is accounted for on a limited partner-by-limited partner basis. Telephone conversation between Jane Katz Crist and Lawrence B. Stoller (Jan. 26, 1994). See Hellmold Associates, Inc. (pub. avail. June 4, 1993).

each partner's participation.

You state that some of the limited partners, because of tax considerations, have requested that a proportionate amount of the annual performance fee be reflected on the Partnership's records as of December 31, 1993. This would result in Summit receiving a performance fee allocation from the capital accounts of these limited partners based on a period of less than one year. While a performance fee allocation will be reflected on the Partnership's and Summit's books, no limited partner will actually pay a performance fee, nor would a performance fee be finally calculated, until the limited partner's funds have been invested in the Partnership for at least one year.[3] Therefore, with respect to the limited partners admitted in February and March of 1993, Summit will not receive actual payment of a performance fee until March 1994.[4] Moreover, you state that Summit ultimately will not receive any performance fee payment if the cumulative losses in the periods from December 31, 1993 until the limited partners' one year anniversaries exceed any cumulative gains in the prior periods.

Notwithstanding the general prohibition in Section 205(a)(1), Rule 205-3 permits a registered investment adviser to charge a fee based upon a share of capital gains upon or capital appreciation of a client's account, if, among other things, the compensation formula is based on the performance over a period of not less than one year. You represent that, but for the one-

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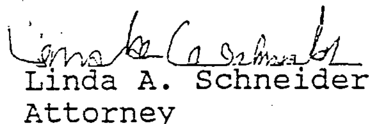
3 Telephone conversations between Jane Katz Crist and Lawrence B. Stoller (Jan. 24 and 26, 1994). You state, for example, that, if a limited partner's capital contribution to the Partnership was received on February 15, 1993, and the performance allocation to Summit for this limited partner for the period ending February 14, 1994 was $10,000, then on February 15, 1994 or shortly thereafter, Summit's capital account would be allocated 10.5/12 of $10,000 or $8,750 from this limited partner's capital account as of December 31, 1993. Summit would not be able to withdraw its performance allocation as of December 31, 1993, but would have to wait to withdraw its performance allocation until February 15, 1994. Furthermore, Summit would not collect any performance fee if the losses in the period from December 31, 1993 until February 15, 1994 exceeded the gains in the prior period.

4 Telephone conversation between Jane Katz Crist and Linda Schneider (Jan. 28, 1994).

year requirement, all of the conditions of Rule 205-3 are met.[5] Despite the fact that a performance fee will be assessed for a period of less than one year, you believe that the proposal is consistent with the purpose of the Rule.

In adopting the Rule, the Commission required a one-year minimum period to preclude an adviser from basing an incentive fee on short-term fluctuations in securities prices.[6] You state that, even if the proposed arrangement is viewed as a performance fee for a period of less than one year, the cumulative gains aspect of the performance allocation formula satisfies the purpose of the Rule's one-year requirement. The Partnership's limited partners are protected from the possibility of short-term, speculative trading by Summit because Summit's compensation in the short period will be reduced by any losses incurred in the full year.

On the basis of the facts and representations in your letter and the telephone conversations, we would not recommend enforcement action to the Commission under Section 205(a)(1) if Summit is allocated profits from the Partnership based on the Partnership's performance for a period of less than one year. We note that our response would be different if the ultimate performance calculations on which this allocation is based were for a period of less than one year. This response expresses the Division's position on enforcement action only and does not express any legal conclusion on the issues presented.



Linda A. Schneider
Attorney

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5 Telephone conversation between Jane Katz Crist and Lawrence B. Stoller (Jan. 26, 1994).

6 Investment Advisers Act Rel. No. 996 (Nov. 14, 1985) (adopting Rule 205-3). The Commission adopted the one-year requirement as an alternative to the cumulative loss provision of proposed Rule 205-3. See Investment Advisers Act Rel. No. 961 (Mar. 15, 1985).

ACT IAA
SECTION 205(a)(1) AND
RULE 205-3
PUBLIC AVAILABILITY 3-1-94

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December 7, 1993

Investment Advisers Act of 1940
Section 205; Rule 205-3

VIA FEDERAL EXPRESS

Thomas S. Harman, Esq.
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Summit Advisors, Inc.
File No. 801-42184

Dear Mr. Harman:

On behalf of my client, Summit Advisors, Inc. ("Summit"), a registered investment adviser and general partner of Marlboro Equity Partners, L.P. (the "Partnership"), I request the staff's advice that it will not recommend that the Commission take enforcement action if Summit is allocated profits from the Partnership based on the Partnership's performance for a period of less than one year in the manner described below.

Summit proposes to receive an allocation of profits from the capital accounts of certain of the Partnership's limited partners based on the performance of such limited partner's capital account for a period of less than one year. However, this allocation with respect to each limited partner would be a portion of the year's profits in such limited partner's capital account and would be made after such limited partner's funds had been invested in the Partnership for at least one year.

Background

Summit, a California corporation, is a registered investment adviser under the Investment Advisers Act of 1940 (the "Act"), is the sole general partner of the Partnership, and in that capacity,

acts as investment adviser of the Partnership.[1] Summit is also registered with the National Futures Association as a commodity trading advisor and commodity pool operator.

The Partnership is a California limited partnership formed in January of 1993 which is engaged in the business of investing in mutual funds and S & P 500 Index Futures contracts. The Partnership is a private fund exempt from investment company status by virtue of Section 3(c)(1) of the Investment Company Act of 1940. The Partnership currently has five limited partners and Summit as its sole general partner. The limited partnership interests were offered and sold in transactions pursuant to Regulation D of the Securities Act of 1933 (the "1933 Act") and Rule 506 promulgated thereunder.[2] Each limited partner has a minimum investment in the Partnership of $1 million.

Pursuant to the Agreement of Limited Partnership (the "Partnership Agreement"), Summit is entitled to receive an annual management fee, payable quarterly, of 1% of the net assets of the Partnership. In addition, Summit, as general partner, at all times maintains at least a 1% ownership interest in the Partnership, and 1% of the Partnership's realized and unrealized net profits and losses are allocated to Summit's capital account. Furthermore, in certain circumstances, as described below, a performance allocation (the "Performance Allocation") will also be allocated from the capital accounts of limited partners to the capital account of Summit.

If there are cumulative net profits in a limited partner's capital account for the time periods described below, a Performance Allocation will be made to Summit's capital account from such limited partner's capital account. Net profits include realized and unrealized capital gains (net of realized and unrealized

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[1] As a result of its responsibilities as general partner, including the disbursement of Partnership funds, Summit has initiated procedures to comply with the provisions of Rule 206(4)-2 under the Act and related recordkeeping requirements.

[2] Pursuant to Section 4.7(a) of Part 4 of the Regulations under the Commodity Exchange Act, Summit claimed an exemption from filing the Partnership's offering memorandum with the Commodity Futures Trading Commission.

losses) before deduction of certain expenses[3] and any front-end load sales charges. Cumulative Net Profits for each limited partner are the total net profits allocated to such limited partner's capital account less total net losses allocated to such limited partner's capital account from the date of admission of such limited partner to the Partnership (the "Admission Date") to the date Cumulative Net Profits are calculated.

The amount of the Performance Allocation with respect to each limited partner will be equal to: (A) 20% of the Cumulative Net Profits allocated to such limited partner's capital account less: (B) the cumulative management fee and cumulative front-end load sales charges charged to such limited partner's capital account since the Admission Date; and less (C) any amounts previously allocated to Summit as a Performance Allocation. The Partnership Agreement provides that Summit will receive the Performance Allocation commencing on the first anniversary of a limited partner's admission to the Partnership (or at the end of the fiscal quarter following such anniversary if the first anniversary occurs on a day other than the end of a fiscal quarter) and continuing as of the end of each fiscal quarter thereafter. A similar allocation calculation will be made upon any partial or complete withdrawal by a limited partner and upon termination of the Partnership as long as such partner has been a limited partner for at least twelve months.

For example, if, at the end of the fiscal quarter following the first anniversary of the Admission Date, there were Cumulative Net Profits of $100,000 allocated to such limited partner's capital account since the Admission Date and there were no additions to, or withdrawals from such limited partner's capital account, Summit's Performance Allocation would be 20% of $100,000 or $20,000 less the management fee charged to such limited partner's capital account since the Admission Date of $1,000, and less the front-end load sales charges charged to such limited partner's capital account since the Admission Date of $9,000,[4] or a Performance Allocation

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[3] The expenses which are not deducted from net profits are the management fee and accounting fees. The management fee and front-end load sales charges are deducted from the Performance Allocation.

[4] The Partnership Agreement provides that the amount of the management fee payable to Summit shall be reduced by the amount of front-end load sales charges paid by the Partnership. Thus, this

of $10,000. If at the end of the second fiscal quarter following the first anniversary of the Admission Date, there were Cumulative Net Profits of $125,000 allocated to such limited partner's capital account from the Admission Date to the end of such quarter, and there were no additions to, or withdrawals from such limited partner's capital account, Summit's Performance Allocation would be 20% of $125,000 or $25,000, less the cumulative management fee charged to such limited partner's capital account since the Admission Date of $3,500, less the cumulative front-end load sales charges charged to such limited partner's capital account since the Admission Date of $9,000, and less the Performance Allocation previously allocated to Summit of $10,000, or a Performance Allocation of $2,500.

Each investor in the Partnership has received a confidential private offering memorandum describing the Partnership and Summit and making the required disclosures regarding the Performance Allocation. In addition, each investor in the Partnership received a copy of the Partnership Agreement and a copy of Part II of Summit's Form ADV. Each limited partner has signed a subscription agreement and completed a questionnaire. These documents enabled Summit to make a good faith determination that each limited partner satisfied the suitability requirements for investing in the Partnership and understood the methods of compensation to Summit and the risks inherent in investing in the Partnership. Each limited partner also signed representations and warranties concerning, among other things, his suitability and understanding of the compensation method and the associated risks. None of the limited partners in the Partnership were clients of Summit prior to acquiring a Partnership interest. As a result of these procedures, Summit assured itself that decisions as to investment in the Partnership were made independently by the limited partners.

Rule 205-3(c)

Paragraph (c)(3) of the Rule provides that:

> "...any compensation paid to the adviser under this rule is based on the gains less the losses (computed in accordance with paragraphs (c)(1) and (2)) in the client's account for a period of not less than one year."

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hypothetical management fee has been reduced by the hypothetical front-end sales charge of $9,000.

The Partnership received initial capital contributions from its limited partners commencing in February of 1993. Thus, the Performance Allocation to Summit's capital account from each limited partner's capital account cannot be made until twelve months after the Partnership's receipt of such limited partners' initial capital contributions, or at various dates in 1994. However, some of the limited partners, because of tax considerations, have requested that a proportionate Performance Allocation be made to Summit's capital account from such partners' capital accounts as of 12/31/93. This proportionate allocation would not be calculated nor entered into the Partnership's records until after such limited partner's funds had been invested in the Partnership for at least twelve months.[5]

Under this proposal, the Partnership's records, as of 12/31/93, would reflect an allocation to Summit's capital account of a fraction of the Performance Allocation, if any, for the required twelve-month period, the numerator of which is the number of months the limited partner's funds had been invested in the Partnership as of 12/31/93 and the denominator of which is 12. For example, if a limited partner's capital contribution to the Partnership was received on February 15, 1993, and the Performance Allocation to Summit for this limited partner for the period ending February 14, 1994 was $10,000, then on February 15, 1994 or shortly thereafter, Summit's capital account would be allocated 10.5/12 of $10,000 or $8,750 from this limited partner's capital account as of 12/31/93. In addition, under this proposal, Summit would not be able to withdraw its Performance Allocation as of 12/31/93, but would have to wait to withdraw its Performance Allocation until twelve months after a limited partner's funds had been invested in the Partnership.

Discussion

Section 205(1) of the Act prohibits an adviser from receiving compensation based upon a share of capital gains or appreciation of the funds of an advisory client.

The Commission has summarized this section's purpose as follows:

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[5] Three of the limited partners were admitted to the Partnership in February of 1993, one in March of 1993 and one in September of 1993. This request would not apply to the limited partner who was admitted in September of 1993.

> "Congress enacted the prohibition of Section [205(a)(1)] against performance fees in 1940 to protect clients of investment advisers from fee arrangements which in Congress' view could encourage advisers to engage in speculative trading practices while managing clients' funds in order to realize or increase an advisory fee. 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." Release No. IA-996, 1985-1986 CCH Fed. Sec. L. Rptr., ¶83,939, at p. 87,901, including n.3; 50 Fed. Reg. 48555, (Nov. 14, 1985) (citations omitted).

Rule 205-3 under the Act was adopted with the same view to protecting advisory clients from fee arrangements not in their best interests and which would encourage advisers to speculate with clients' funds. The Rule's conditions are designed to provide alternative safeguards to the statutory prohibition. In addition, one of the underlying concepts in the adoption of Section 205, and the rules thereunder, is the belief that advisory clients need the protections offered by the Act from arrangements that give investment managers a direct pecuniary interest in pursuing high risk investment policies at the expense of their clients.

In the proposed arrangement discussed above, whereby a portion of the Performance Allocation would be made to Summit as of a date prior to the one year anniversary of a limited partner's investment in the Partnership, the minimum period of one year would already have elapsed before Summit would actually receive any Performance Allocation for any portion of a measurement period less than one year. Moreover, the proposed arrangement satisfies the Rule's condition of requiring a performance fee to be based on an adviser's performance for at least one year. The Performance Allocation would not be calculated until after the one-year anniversary of a limited partner's investment in the Partnership. The Performance Allocation, a portion of which would be allocated to Summit from appropriate limited partners' capital accounts, would be based on the performance of the limited partner's capital account over a one-year period.

Thus, if a limited partner's capital account had net profits for the first 10 1/2 months in the example given above, but in the last 1 1/2 months of the year, the limited partner's capital account suffered net losses in excess of net profits, then under the proposed arrangement, Summit would not receive any Performance Allocation from that limited partner's capital account for the year's period. This method of calculating the Performance

Allocation insures that Summit will not have any incentive to engage in speculative trading over the short-term.

Moreover, the use of cumulative gains less cumulative losses as the basis of calculating the Performance Allocation to Summit also insures that Summit will not have any incentive to engage in short-term speculative trading. When the Commission originally proposed Rule 205-3 in 1985, the proposed Rule did not have any requirement for calculating performance over a one-year period. Rather, paragraph (c)(3) of the Rule, as originally proposed, required that any compensation paid to the adviser for a given period under the Rule be based on cumulative gains less cumulative losses for the period. Release No. IA-961, CCH 1984-1985 Fed. Sec. L. Rptr. ¶83,749, 50 Fed. Reg. 11718, (Mar. 15, 1985). The Commission dropped the requirement of cumulative gains less cumulative losses for the period from the final Rule and gave the following rationale for this change:

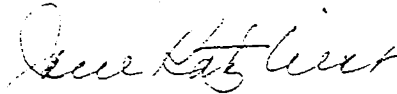
> "In the Commission's view, a one-year period is sufficiently long generally to achieve the purpose of the proposed cumulative loss provision -- precluding an adviser from basing an incentive fee on short term fluctuations in securities prices." Release No. IA-996, 1985-1986 CCH Fed. Sec. Rptr. supra. at 87,903-87,904.

Thus, even if one viewed the proposed arrangement as a performance fee based on performance for a period of less than one year, the cumulative gains aspect of the Performance Allocation formula satisfies the purpose of the Rule's one-year requirement to prohibit advisers from basing incentive fees on short-term fluctuations in securities' prices. The limited partners of the Partnership are protected from the possibility of speculative trading by Summit because its future compensation will be reduced by any losses that it incurs for the Partnership.

For the foregoing reasons, it is my opinion that the proposed allocation arrangement described above is permissible under Rule 205-3 under the Act. I therefore request the staff's advice that it will not recommend that the Commission take enforcement action if Summit receives a proportionate Performance Allocation from each limited partner's capital account in the manner described in this letter. In the event that you disagree with the views expressed in the request, I would ask that you so inform me before you issue a written response.

I have enclosed herewith four additional copies of this no-action request. Please do not hesitate to contact the undersigned at (310) 207-9818 should you have any questions or desire any further information. Thank you for your consideration of this request.

Very truly yours,



Jane Katz Crist

cc: Dennis A. Tito