UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
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February 1, 1994

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Mr. Gerald Zuckerman
Service Support Group, Inc.
7655 East Gelding Drive
Suite A-3
Scottsdale, AZ 85260

Dear Mr. Zuckerman:

Your letter to Chairman Levitt has been referred to this Office for response. You state that you are a registered investment adviser and would like to charge clients a fee based upon a percentage of the profits earned. You ask (1) why performance fees are generally prohibited; (2) whether a performance fee arrangement requires that you postpone billing the client for at least one year after the date you begin working on an account; and (3) if there is any way the one year restriction can be amended or appealed.

Section 205(a)(1) of the Investment Advisers Act ("Advisers Act") generally prohibits an investment advisory contract that provides compensation to the adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the client's funds ("performance fee"). Congress included the performance fee prohibition in the Advisers Act because of concern that performance fees create incentives for an adviser to take inappropriate risks in managing a client's account in order to increase advisory fees. 1/ Performance fees in use at the time Congress enacted the Advisers Act typically rewarded an adviser, above and beyond its customary fee, for good performance, without penalizing it for poor performance. Congress concluded that performance fees encouraged an adviser to speculate unduly because it had everything to gain and little to lose.

Rule 205-3 under the Advisers Act provides a limited exemption from the performance fee prohibition for advisory contracts with wealthy clients having at least $500,000 under the adviser's management or a net worth exceeding $1 million. The rule requires, among other things, that the compensation paid to the adviser be based on performance over a period of not less than one year. The Commission believed that a one year period would be of sufficient duration to preclude an adviser from basing an incentive fee on short-term fluctuations in securities

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1/ See H.R. Rep. No. 2639, 76th Cong. 2d Sess. 29 (1940).

prices. 2/ Thus, in response to your second question, an adviser may not bill a client until passage of at least one year from the date the adviser begins providing investment advice to the client. After the initial one-year period elapses, however, the adviser may bill the client on a "rolling" basis. 3/

You also ask whether the one year period can be amended or appealed. The Division of Investment Management believes that further exemptions from the performance fee prohibition are warranted but require Congressional action. The Division has recommended in its Investment Company Act Study that the Commission consider legislation that would authorize the Commission generally to provide exemptions from the performance fee prohibition for advisory contracts with any person whom the Commission determines does not need the protections of the prohibition, based on financial sophistication, net worth, knowledge and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, or any other factors the Commission may determine are relevant. 4/ The Commission has not yet acted on the Division's proposal.

Finally, you allude to Section 205(b)(2) of the Advisers Act, which permits an investment adviser to charge a "fulcrum fee" when advising either a registered investment company or certain persons with whom the adviser has contracted to manage at least $1 million in assets. With a fulcrum fee, an adviser's compensation increases or decreases depending on how an account performs relative to an appropriate index or other measure of performance over a specified period. 5/ If you incorporate a fulcrum fee compensation arrangement, you would not have to adhere to the one year performance period requirement of Rule 205-3.

2/ See Investment Advisers Act Rel. No. 996 (Nov. 14, 1985) ("Release No. 996").

3/ See Release No. 996 (adviser can use any method for receiving payment of a performance fee provided it is consistently applied and fully disclosed to the client).

4/ See Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation Chapter 6 (May, 1992) (copy enclosed).

5/ See Rules 205-1 and 205-2 under the Advisers Act.

I hope this information is helpful. If you have any further questions you may write this Office or call Jana Cayne, Attorney, at (202) 272-2030.

Sincerely,

Thomas S. Harman

Thomas S. Harman
Associate Director
(Chief Counsel)

SSG

Service Support Group, Inc.
7655 East Gelding Drive • Suite A-3
Scottsdale, Arizona 85260
Phone (602) 998-1616

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OFFICE OF THE CHAIRMAN

December 23, 1993

Chairman Arthur Levitt Jr.
Securities and Exchange Commission
450 5th St. NW
Washington, DC 20549

Dear Chairman Levitt,

THE BACKGROUND

I have recently been registered as an Investment Advisor #801-44041. I am developing a business around my proprietary software which I will use to pick stocks. I anticipate offering my services to individuals, pensions and mutual funds. My compensation will be entirely based up a percentage of the profits earned for my clients.

THE RULES

Under the provisions of section 205(1) I would be permitted to base my fees upon a percentage of the profits. There are several restrictions however that apply. My clients are permitted to hire me on a percentage basis **only** if they have a net worth in excess of $1,000,000 at the time they hire me or they must have $500,000 under management with me.

If the client does not meet these two criteria they are, and I am, prohibited from doing business with one another based on this performance formula. ie: if the client does well I do well. This may seem strange given the fact that many vocations that pay commission do so with the understanding that the success or failure of the venture will determine the pay of the worker.

Is this not the premise upon which the capitalistic system is based?

I have been also advised that even meeting these criteria ($500,000 under management or $1,000,000 + net worth) I must then base my income on at least a year's worth of history. My instructions are a little hazy. I don't know if this means I must wait one year from the date I start working an account before I can bill them or if I must wait one year from the end of a period of time before I bill them.

SSG

By way of example: Client "A". If I start advising them on January 1, 1994 does the law require me not to bill them until January 1, 1995 for the year? Or: Client "B". If I start with them January 1, 1994 and I bill them on a monthly basis, does this mean that I can not bill them until February 1, 1995 which would be one complete year after the first month in question?

THE PROBLEM

In any event it certainly puts an incredible hardship on someone trying to make a living if they must wait a full year before they can get paid for work performed simply because they have chosen to work on a commission or percentage of the profits basis.

Is there any way that this restriction can be amended or appealed? After all when we speak of clients having $500,000 under management or having a net worth in excess of $1,000,000 we are not speaking of unsophisticated buyers. If the client is willing to pay and the worker is willing to work on the basis of a percentage of the profits as compensation then why not let them do it?

After all if either party is unhappy with the arrangement it can be canceled by either party at any time. By restricting an investment adviser in such a way that he can only be paid after one year then for many this is the same as saying that even though the law has a provision enabling you to do something, you as a practical matter, will be severely hampered in your right or ability to do so.

THE SOLUTION

Is there one? Can not the period be something more workable than a year? How about monthly or even on a quarterly basis? Something reasonable so that the parties to this arrangement can do business with the ground rules that work for them. I understand that an index may be used but this is such a convoluted formula and is not found in a simple pay for performance contract.

Thank you for your time. I hope I have stated my case clearly.

Respectfully,

Gerald Zukerman

encl: Schedule F of Form ADV