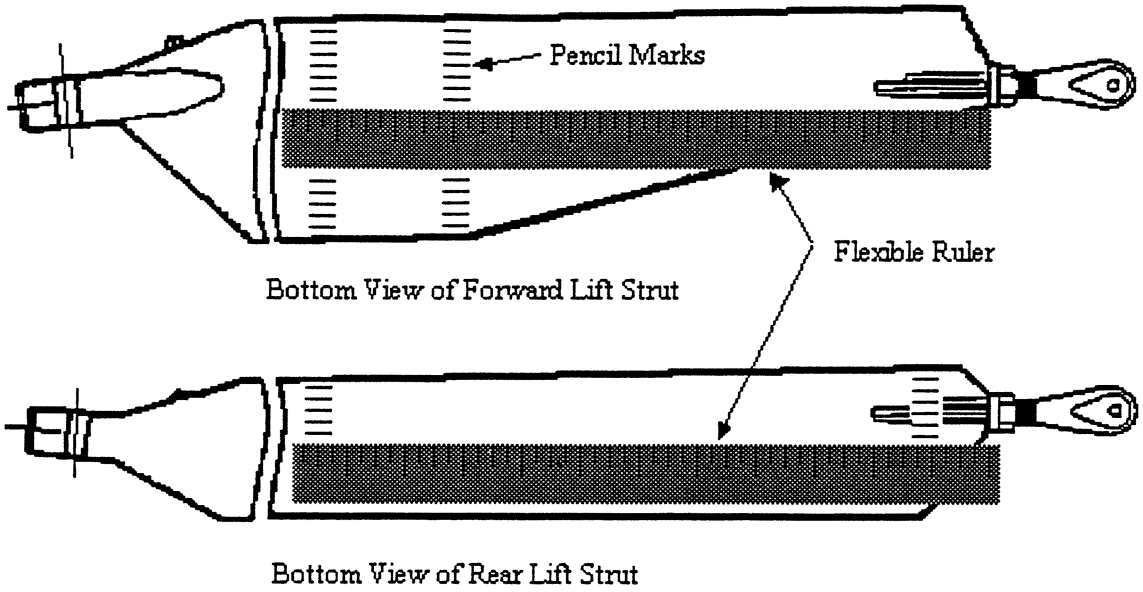

Figure 1

Issued in Kansas City, Missouri, on July 14, 1998.

Marvin R. Nuss,

Acting Manager, Small Airplane Directorate, Aircraft Certification Service.

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA–1731, 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: Final rule.

SUMMARY: The Commission is adopting 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 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 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.

EFFECTIVE DATE: The rule amendments will become effective August 20, 1998.

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, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 5–6, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission today is adopting amendments to rule 205–3 [17 CFR 275.205–3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (''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 adopting rule amendments to eliminate the provisions of the rule that prescribe contractual terms and require specific disclosures. In addition, the amendments change the client eligibility criteria to permit the following clients to enter into performance fee arrangements with their investment advisers: (1) clients with at least $750,000 under management with the adviser or more than $1,500,000 of net worth; (2) clients who are ''qualified purchasers'' under section 2(a)(51)(A) of the Investment Company Act of 1940

(''Investment Company Act''); [1] and (3) knowledgeable employees of the investment adviser.

I. Background

A. Introduction

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] 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,[3] so long as an appropriate ''fulcrum fee'' is used.[4] This 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.[5]

Under current rule 205–3, an adviser may charge performance fees to a client who has at least $500,000 under management with the adviser or has a net worth of more than $1,000,000. The Commission presumed that these clients, because of their wealth, financial knowledge, and experience, are less dependent on the protections provided by the Advisers Act's restrictions on performance fee arrangements.[6] The rule, however, imposes several conditions on advisers entering into performance fee contracts in addition to those related to the eligibility of clients.

In 1992, the Commission's Division of Investment Management issued a report recommending, among other things, that Congress enact legislation clarifying the authority of the Commission to provide exemptions from the performance fee prohibition for advisory contracts with any persons whom the Commission determined did not need the protections of the prohibition.[7] Four years later, Congress included in the National Securities Markets Improvement Act of 1996 (''1996 Act'') [8] two additional statutory exceptions from the performance fee prohibition [9] 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.[10]

B. Proposed Amendments to Rule 205–3

On November 13, 1997, the Commission issued a release proposing amendments to rule 205–3 (''Proposing Release'').[11] The proposed amendments were intended to provide increased flexibility to investment advisers and their clients in entering into performance fee arrangements and to revise the client eligibility criteria under the rule.

The Commission received 22 comment letters on the proposed amendments to rule 205–3. Commenters supported the proposed amendments; many urged the Commission to expand further the types of clients eligible to enter into such arrangements. The Commission is adopting amendments to rule 205–3 with one change from the amendments as proposed, in view of the issues raised by commenters. As suggested by commenters, the Commission is adding certain knowledgeable employees of investment advisers as another category of clients eligible to enter into performance fee arrangements under rule 205–3.

II. Discussion

A. Elimination of Specific Contractual and Disclosure Requirements

Current rule 205–3 imposes a number of required provisions on performance fee contracts, obligates the adviser to provide certain disclosures to clients, and requires that the adviser reasonably believe that the contract represents an arm's length arrangement and that the client (or its independent agent) understands the method of compensation and its risks. In the Proposing Release, the Commission explained that, although these conditions were intended to protect clients, they have inhibited the flexibility of advisers and their clients in establishing performance fee arrangements beneficial to both parties.[12] In light of the other protections provided by the Advisers Act, the Commission believed that these clients may not need the protections of the rule. Therefore, the Commission proposed, 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. All but one of the commenters supported these proposed amendments, which the Commission is adopting as proposed.

The Commission emphasizes that the elimination of the contractual and disclosure provisions from rule 205–3 does not alter the obligation of an adviser, as a fiduciary, to deal fairly with its clients and to make full and fair disclosure of its compensation arrangements.[13] This obligation includes full client disclosure of all material information regarding a proposed performance fee arrangement

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[1] 15 U.S.C. 80a–2(a)(51)(A).

[2] 15 U.S.C. 80b–5(a)(1).

[3] 15 U.S.C. 80b–5(b)(2). 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)].

[4] 15 U.S.C. 80b–5(b)(2). *See* discussion of fulcrum fees in Proposing Release, *infra* note 11, at n.5.

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)].

[5] 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).

[6] 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)].

[7] *See* Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation 245, 247–48 (1992) (''Protecting Investors'').

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

[9] 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.

[10] 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].''

[11] Exemption To Allow 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. 1682 (Nov. 13, 1997) [62 FR 61882 (Nov. 19, 1997)].

[12] *See* Proposing Release, *supra* note 11, at 8.

[13] *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.

as well as any material conflicts posed by the arrangement.[14]

B. Qualified Clients

Currently, rule 205–3 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. As noted above, in adopting rule 205–3 in 1985, the Commission concluded that clients who satisfy these criteria do not need the full protections provided by the Advisers Act's restrictions on performance fee arrangements.[15]

The Commission proposed to raise the net worth and assets-under-management threshold levels and to add a third category of eligible clients, ''qualified purchasers'' under section 2(a)(51)(A) of the Investment Company Act. Under the proposed amendments, clients who satisfied the new eligibility criteria contained in rule 205–3 would be referred to as ''qualified clients.'' The Commission is adopting amendments to the criteria for determining the eligibility of clients with one modification to the proposal in response to suggestions by commenters, as discussed below.[16]

1. Numerical Thresholds

As discussed in the Proposing Release, the Commission recognized 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 $1,500,000; and $500,000 in 1985 dollars is now worth approximately $750,000.[17] The Commission therefore proposed 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. Five commenters supported the increased net worth and assets-under-management thresholds. One commenter noted that increasing the thresholds to reflect inflation would ensure that unsophisticated retail clients continue to receive the protections of the performance fee prohibition.[18]

Nine commenters opposed increasing the thresholds as unnecessary to ensure adequate client sophistication, often citing the lack of a history of abuse and the costs and inconvenience of incorporating new thresholds into existing agreements.[19] None of the commenters, however, suggested any alternative criteria to the objective thresholds, as requested by the Commission in the Proposing Release. Moreover, responding to the Commission's request for comment, the commenters opposed any indexing of the thresholds to take into account automatically the effects of inflation. The Commission has decided to adopt the amendments to the threshold levels as proposed. In light of the expansion of the performance fee exemption and the effects of inflation on the threshold levels, the Commission believes that, in order to continue to determine that clients who satisfy the numerical thresholds do not need the protections of the performance fee prohibition, it should increase the thresholds.

2. Qualified Purchasers

The Commission also proposed 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.[20] New section 3(c)(7) of the Investment Company Act, as added by the 1996 Act, 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.[21] Although, in most cases, persons who would be qualified purchasers under section 2(a)(51)(A) would satisfy the assets-under-management or net worth criterion under rule 205–3, even as amended, in some cases, such persons would not.[22] Therefore, the Commission proposed to add ''qualified purchasers'' as eligible clients under the rule so that an investor who meets the eligibility requirements to invest in a section 3(c)(7) company also could enter into a performance fee arrangement outside the context of a section 3(c)(7) company.[23] The commenters supported this provision, which the Commission is adopting as proposed.

3. Knowledgeable Employees

The Proposing Release requested comment on whether the Commission should exempt from the performance fee prohibition arrangements between advisers and clients who have certain pre-existing relationships. These relationships would be of a type that suggests that the abuses Congress sought to prevent by prohibiting performance fee arrangements are unlikely to occur. Section 205(e) permits the Commission to consider, in addition to criteria such as financial sophistication and knowledge and experience in financial matters, whether a client may not need the protections of the performance fee

[14] The disclosure obligation flows from the Advisers Act's prohibitions against fraud in section 206 of the Advisers Act [15 U.S.C. 80b–6]. The amendments also 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 rule 205–3 by its terms provides an exemption only from section 205(a)(1), and that separate reference to section 206 and other provisions of the federal securities laws in the rule is unnecessary. By eliminating 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 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 amendments to rule 205–3 do 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).

[15] *See supra* note 6 and accompanying text.

[16] One commenter requested that the Commission clarify whether a trust, governmental plan, collective trust fund, or separate account referred to in section 3(c)(11) of the Investment Company Act may be charged a fulcrum fee (or any other kind of performance fee) under rule 205–3. The Commission believes that a trust, governmental plan, collective trust fund, or separate account that satisfies all the conditions of rule 205–3 may enter into a performance fee (including a fulcrum fee) arrangement under the rule.

[17] *See* Proposing Release, *supra* note 11, at 10.

[18] One commenter went further and recommended a substantial increase in the thresholds beyond those set forth in the proposal.

[19] Although the proposed transition rule would ''grandfather'' existing arrangements with existing clients, the new thresholds would apply to new clients to existing arrangements. *See infra* Section II.D.

[20] *See supra* note 1.

[21] 15 U.S.C. 80a–3(c)(7).

[22] For example, in determining the amount of investments for purposes of the definition of qualified purchaser, only outstanding indebtedness incurred to acquire the investments must be deducted. Rule 2a51–1(e) under 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 more than $5,000,000 of investments, but a net worth of less than $1,500,000 because of other debt. Under the rule amendments, such a person would be eligible to enter into a performance fee contract under rule 205–3.

[23] 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 of rule 205–3 for an adviser to charge performance fees to the section 3(c)(7) company.

prohibition by virtue of the client's relationship with the adviser.[24]

Many commenters recommended that the Commission add to the list of qualified clients certain ''knowledgeable employees,'' consistent with the concept of ''knowledgeable employees'' eligible to invest in section 3(c)(1)[25] and section 3(c)(7) companies in accordance with rule 3c–5 under the Investment Company Act.[26] Under rule 3c–5, knowledgeable employees include executive officers, directors, trustees, general partners, and advisory board members of a section 3(c)(1) or a section 3(c)(7) company, and those who serve in similar capacities. The rule also includes certain other employees of the fund or its management affiliate who participate in investment activities and have performed such functions for at least 12 months.

One commenter asserted that such employees are inherently sophisticated because of their knowledge of the day-to-day investment activities of the adviser and are in the best position to evaluate the risks of performance fees and protect themselves from overreaching on the part of the adviser. Another commenter noted that inclusion of knowledgeable employees as qualified clients would allow such employees to invest in section 3(c)(1) companies that enter into performance fee arrangements as well as section 3(c)(7) companies, which are excepted from the performance fee prohibition pursuant to section 205(b)(4) of the Advisers Act.[27]

The Commission agrees that employees who actively participate in the investment activities of the adviser are likely to be sophisticated financially and do not need the protections of the performance fee prohibition. Therefore, the Commission is adding certain knowledgeable employees of the investment adviser as another criterion for ''qualified clients'' under the rule. The new category is similar to the definition of knowledgeable employee in rule 3c–5 under the Investment Company Act, and would include an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser, as well as certain other employees of the adviser who participate in investment activities and have performed such functions for at least 12 months.

[24] *See supra* note 10.

[25] 15 U.S.C. 80a–3(c)(1).

[26] Rule 3c–5 [17 CFR 270.3c–5].

[27] 15 U.S.C. 80b–5(b)(4).

C. Identification of the Client[28]

Rule 205–3 provides that with respect to certain clients entering into performance fee contracts with an adviser—private investment companies, 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.[29] Under this provision, each ''tier'' of such entities must be examined in this manner. Thus, if a private investment company seeking to enter into a performance fee contract (the first tier company) is owned by another private investment company (the second tier company), the look through provision applies to the second (and any other) level private investment company, and thus the adviser must look to the ultimate client to determine whether the arrangement satisfies the requirements of the rule.[30]

The Commission proposed to retain the ''look through'' provision and to clarify that any ''equity owners'' that are not charged a performance fee would not be required to meet the qualified client test.[31] The Commission is adopting this provision as proposed.

Some commenters urged the Commission to eliminate the look through provision with respect to certain entities, such as private investment companies. Others opposed such changes, arguing that it would permit circumvention of the client eligibility requirements of the rule and result in performance fees being charged to groups of unsophisticated investors. The Commission has decided not to eliminate the look through provision of the rule at this time.[32]

[28] 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].

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

[30] Conditional 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. 961 at n.21 (March 15, 1985) [50 FR 11718 (March 25, 1985)].

[31] Amended rule 205–3(b) [17 CFR 275.205–3(b)]. The Commission notes that an adviser charging a performance fee to only certain clients in this context should provide appropriate disclosure concerning the existence of the performance fee to those clients who do not pay a performance fee. In addition, the amendments 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. Furthermore, as stated in the Proposing Release, the look through provision does not apply to section 3(c)(7) companies, which are excepted from the performance fee prohibition by section 205(b)(4) of the Advisers Act.

[32] One commenter urged that the look through provision not apply if the first tier company and the second tier company are independent of each other. This commenter reasoned that where a second tier section 3(c)(1) company is truly independent of the first tier section 3(c)(1) company, the adviser receiving the performance fee could not seek to circumvent the purpose of the look through provision and pool clients to avoid the qualified client requirement. Another commenter urged that the look through provision not apply if the first tier company and the second tier company are section 3(c)(1) companies, unless the adviser to the first tier company also is the adviser to the second tier company. This commenter reasoned that the financial sophistication of the managers of the second tier company would protect the interests of their investors in negotiating a performance fee at arm's length, which is consistent with the rule 205–3 exemption from the performance fee prohibition. The Commission has decided not to amend the rule; it, however, will entertain requests for relief from the application of the look through provision in circumstances where the policies and purposes of section 205 of the Advisers Act would not be served by its application.

D. Transition Rule

The Commission is adopting, as proposed, 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.[33] 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 satisfy 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.

III. Cost-Benefit Analysis

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

As discussed below, although costs and benefits of the rule amendments are difficult to quantify, the Commission believes that these amendments will benefit investment advisers and their clients without imposing any measurable costs.

The rule amendments will likely alter the total number of investment advisers that rely on the performance fee exemption.[34] The number of performance fee contracts may increase

[33] Amended rule 205–3(c) [17 CFR 275.205–3(c)].

[34] The Commission knows of no information concerning the incidence of performance fee arrangements in the United States. 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).

because the performance fee arrangement will no longer be subject to prescribed contract terms. Moreover, the rule amendments will add two new categories of clients eligible to enter into performance fee arrangements—qualified purchasers and knowledgeable employees who may not have been eligible under the numerical thresholds. On the other hand, the increase in the net worth and assets-under-management thresholds for determining eligibility under the rule may reduce the number of eligible clients [35] and, as a result, the total number of performance fee arrangements. Overall, however, the Commission believes it is reasonable to estimate that the amendments to the performance fee rule will increase the number of performance fee arrangements.

To the extent that the rule amendments increase the number of performance fee arrangements, advisers and clients may benefit overall.[36] 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.[37] 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.[38] In addition, advocates of the increased use of performance fees assert that they may encourage the establishment of new advisory firms[39] and may result in greater competition and produce a wider array of investment advisers and services and lower overall advisory costs.

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.[40] In addition, some detractors have expressed concern that performance fees might result in discrimination against clients that do not pay performance fees.[41]

The arguments for and against performance fee arrangements provide no definitive answers concerning their effect on advisers, clients and the markets. The costs and benefits of performance fee arrangements in general are difficult to quantify because of their theoretical nature. Although the Commission requested comment in the Proposing Release on whether the benefits and costs could be quantified, no commenters responded to this request.

Similarly, it is difficult to quantify the effect of the rule amendments on advisers, their clients, or the economy. The Commission has no data from which to measure the total effect of these amendments. For example, the Commission knows of no information concerning the number of advisers that have performance fee contracts or the average number of performance fee contracts per adviser. The Commission requested the submission of data concerning incidence of performance fees in the Proposing Release, but no commenters responded to this request. In addition, the Commission has no information concerning either the number of clients who would no longer qualify under the new criteria or the number of clients who would qualify only under the new criteria.

Although the Commission cannot quantify the effects of the rule amendments, the Commission believes that the amendments will benefit advisers and their qualified clients by providing them with more flexibility in structuring performance fee arrangements that may benefit both parties. The amendments eliminate all the prescribed compensation calculations and other required contract terms, which have raised a number of interpretative issues and technical concerns over the years.[42] Thus, the amendments allow investment advisers and their clients who are financially sophisticated or have the resources to obtain sophisticated financial advice to negotiate the terms of their performance fee contracts. Moreover, the Commission believes that these amendments should reduce the costs of establishing and monitoring compliance with the current rule, and thus benefit both investment advisers and their clients who wish to enter into performance fee arrangements.

IV. Summary of Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis (''IRFA'') was published in the Proposing Release. No comments were received on the IRFA. The Commission has prepared a Final Regulatory Flexibility Analysis (''FRFA'') in accordance with 5 U.S.C. 604 regarding amendments to rule 205–3 under the Advisers Act. The following summarizes the FRFA.

As set forth in greater detail in the FRFA, 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 FRFA states that the rule amendments will 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 new categories of eligible clients—''qualified purchasers'' under section 2(a)(51)(A) of the Investment Company Act, and ''knowledgeable employees'' of the investment adviser.

The FRFA also discusses the effect of the 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

[35] 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.

[36] The Division discussed the advantages and disadvantages of performance fees in more detail in its 1992 study. Protecting Investors, *supra* note 7, at 239–40.

[37] 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).

[38] *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 37; at 37; Bines, *supra* note 37, at 5–36 to 5–37.

[39] 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).

[40] Lofthouse, *supra* note 38, at 77; Roher, *supra* note 39, at 127.

[41] *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).

[42] *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).

million or less, in discretionary or non-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.[43] The Commission estimates that approximately 17,650 investment advisers are small entities.[44]

The Commission does not have information from which to estimate the number of advisers managing assets of $50 million or less whose clients will be able to meet the eligibility tests under the amended rule and thereby will qualify to enter into a performance fee arrangement under the rule. However, the Commission believes that the number may be substantial. The Commission also believes that it would be reasonable to estimate that the overall effect of the 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 FRFA states that the rule amendments will not impose any new reporting, recordkeeping or compliance requirements. The FRFA also discusses the various alternatives considered by the Commission in connection with the 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 FRFA, the amended rule will reduce the regulatory burden on all investment advisers, impose no new compliance or reporting requirements, and include a transition rule allowing existing arrangements to continue. The Commission therefore believes that it would be inappropriate to establish a different timetable for small entities, to further clarify, consolidate or simplify the rule's requirements for small entities, or to provide an even broader exemption for small entities.

The FRFA is available for public inspection in File No. S7–29–87, and a copy may be obtained by contacting Kathy D. Ireland, Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop 5–6, Washington, D.C. 20549.

V. Statutory Authority

The Commission is adopting 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 Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is 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), 0b–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 an 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 August 20, 1998 and satisfied the conditions of this section as in effect on the date that the contract was entered into will be considered 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 August 20, 1998.

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

(1) The term *qualified client* means:

(i) A natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;

(ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

(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; or

(iii) A natural person who immediately prior to entering into the contract is:

(A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or

(B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular

[43] Rule 275.0–7 [17 CFR 275.0–7]. The Commission has revised the definition of ''small entity,'' effective July 30, 1998. *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. 33–7548, 34–40122, IC–23272, and IA–1727 (June 24, 1998) [63 FR 35508 (June 30, 1998)]. Because the IRFA concerning the proposed amendments to rule 205–3 was prepared under the old definition, that definition applies to the Commission's preparation of the FRFA concerning these amendments. *Id.* at n.32.

[44] This estimate of the number of small entities was made for purposes of the Final Regulatory Flexibility Analysis for the rules implementing Title III of the 1996 Act, the Investment Advisers Supervision Coordination Act (the ''Coordination Act''). *See* 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)] at nn.189–190 and accompanying text.

functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

(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)).

(4) The term *executive officer* means the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the investment adviser.

Dated: July 15, 1998.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 98–19373 Filed 7–20–98; 8:45 am]

BILLING CODE 8010–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Part 558

New Animal Drugs for Use in Animal Feeds; Bacitracin Methylene Disalicylate and Nitarsone

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect approval of a new animal drug application (NADA) filed by Alpharma Inc. The NADA provides for using approved bacitracin methylene disalicylate and nitarsone Type A medicated articles to make combination drug Type C medicated turkey feeds used as an aid in the prevention of blackhead, and for increased rate of weight gain and improved feed efficiency.

EFFECTIVE DATE: July 21, 1998.

FOR FURTHER INFORMATION CONTACT: Charles J. Andres, Center for Veterinary Medicine (HFV–128), Food and Drug Administration, 7500 Standish Pl., Rockville, MD 20855, 301–594–1600.

SUPPLEMENTARY INFORMATION: Alpharma Inc., One Executive Dr., P.O. Box 1399, Fort Lee, NJ 07024, is sponsor of NADA 141–088 that provides for combining approved BMD® (10, 25, 30, 40, 50, 60, or 75 grams per pound (g/lb) bacitracin methylene disalicylate) and Histostat® (227 g/lb nitarsone) Type A medicated articles to make Type C medicated feeds for growing turkeys containing 4 to 50 g per ton bacitracin methylene disalicylate and 0.01875 percent nitarsone. The Type C medicated turkey feed is used as an aid in the prevention of blackhead, and for increased rate of weight gain and improved feed efficiency in growing turkeys. The NADA is approved as of June 17, 1998, and §§ 558.76(d)(3) and 558.369(d) (21 CFR 558.76(d)(3) and 558.369(d)) are amended to add new entries to reflect the approval. The basis for approval is discussed in the freedom of information summary.

Also, due to enactment of the Generic Animal Drug and Patent Term Restoration Act in 1988, National Academy of Science/National Research Council (NAS/NRC) NADA's are no longer approved. Therefore, the text of § 558.369(c) *NAS/NRC status* is removed and the paragraph reserved.

In accordance with the freedom of information provisions of 21 CFR part 20 and 514.11(e)(2)(ii), a summary of safety and effectiveness data and information submitted to support approval of this application may be seen in the Dockets Management Branch (HFA–305), Food and Drug Administration, 5630 Fishers Lane, rm. 1061, Rockville, MD 20852, between 9 a.m. and 4 p.m., Monday through Friday.

This approval is for use of single ingredient Type A medicated articles to make combination drug Type C medicated feeds. One ingredient, nitarsone, is a Category II drug as defined in 21 CFR 558.3(b)(1)(ii). Prior to enactment of the Animal Drug Availability Act of 1996 (Pub. L. 104–250) (ADAA), an approved medicated feed application (MFA) was required for feed mills to make Type C medicated feeds from Category II drugs. The ADAA revised the Federal Food, Drug, and Cosmetic Act to replace the requirement for MFA's with that for feed mill licenses. Use of Type A medicated articles to make Type C medicated feeds as in this NADA is limited to licensed feed mills.

FDA has determined under 21 CFR 25.33(a)(2) that this action is of a type that does not individually or cumulatively have a significant effect on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

List of Subjects in 21 CFR Part 558

Animal drugs, Animal feeds.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 558 is amended as follows:

PART 558—NEW ANIMAL DRUGS FOR USE IN ANIMAL FEEDS

1. The authority citation for 21 CFR part 558 continues to read as follows:

Authority: 21 U.S.C. 360b, 371.

2. Section 558.76 is amended by adding paragraph (d)(3)(xvi) to read as follows:

§ 558.76 Bacitracin methylene disalicylate.

* * * * *

(d) * * *

(3) * * *

(xvi) Nitarsone alone or in combination as in § 558.369.

3. Section 558.369 is amended by removing paragraph (c) and reserving it, by revising the introductory text of paragraph (d), by redesignating paragraphs (d)(1), (d)(2), and (d)(3) as paragraphs (d)(1)(i), (d)(1)(ii), and (d)(1)(iii), respectively, by adding a heading to paragraph (d)(1), and by adding new paragraph (d)(2), to read as follows:

§ 558.369 Nitarsone.

* * * * *

(c) [Reserved]

(d) *Conditions of use.* It is used as follows:

(1) *Chickens and turkeys.*

* * * * *

(2) *Turkeys*—(i) *Amount.* Nitarsone 0.01875 percent, plus bacitracin methylene disalicylate 4 to 50 grams per ton.

(ii) *Indications for use.* As an aid in the prevention of blackhead, and for increased rate of weight gain and improved feed efficiency.

(iii) *Limitations.* For growing turkeys. Feed continuously as sole ration. Early medication is essential to prevent spread of disease. Adequate drinking water must be provided near feeders at all times. Overdosage or lack of water may result in leg weakness or paralysis. The drug is not effective in preventing