ADMINISTRATIVE PROCEEDING
FILE NO. 3-5232

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :
:
HARBINE FINANCIAL SERVICE
:
(803-3) :
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FILED
OCT 6 1977
SECURITIES & EXCHANGE COMMISSION

INITIAL DECISION

Washington, D.C.
October 6, 1977

Jerome K. Soffer
Administrative Law Judge

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APPEARANCES: Michael Berenson and Gerald Osheroff, for the Division of Investment Management.

Jesse Rosenblum, *pro se*, for applicant.

BEFORE: Jerome K. Soffer, Administrative Law Judge

By order adopted May 24, 1977 the Commission directed that a hearing be held pursuant to Section 206A of the Investment Advisers Act of 1940 (Act) with respect to an application filed on July 13, 1976 by Harbine Financial Service, a registered investment adviser, seeking an exemption from the provisions of Section 205(1) of the Act and the rules thereunder in connection with a proposed fee schedule desired to be charged by applicant for its services.[1/]

The Order directed that a determination be made as to whether the requested exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. Although the Order invited participation by interested parties,[2/] the Commission received no requests to participate in the proceedings.

The evidentiary hearing was held in Washington, D.C. on June 29, 1977, at which applicant's proprietor appeared *pro se*. He was its only witness. The Division of Investment Management (Division) produced no witnesses but did offer some exhibits. Applicant waived its right to submit proposed findings of fact and conclusions of law and a supporting brief. The Division did submit such a filing, to which applicant

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1/ Jesse Rosenblum, of Closter, New Jersey, is the applicant's sole proprietor who operates under the "Harbine" name. He has no employees.

2/ Investment Advisers Act Release No. 588, May 24, 1977, 12 SEC Docket 499.

replied.

The findings and conclusions herein are based upon a preponderance of the evidence determined from the record and upon observing the demeanor of the only witness.

The Applicant

Mr. Jesse Rosenblum works full time as a machinery buyer, only devoting evenings and weekends to applicant's affairs. His activities as an investment adviser (he prefers to consider himself to be a "personal manager") began some time in 1949 with respect to the securities investments of members of his family. Specifically, they had entrusted to him small sums of money, between $25 and $50, with the right on his part to make investments for them based upon his own judgment and skill. Over the years the services have been extended to other individuals known to him either as relatives or on some other personal basis so that at the present time he is handling about a dozen accounts involving total funds of some $170,000. The average account is worth about $13,500; the median account is worth about $6,200; and the average individual stock purchase on their behalf amounts to $432.

Rosenblum is given complete discretionary control over the funds of clients. He makes all the purchases and sales of registered securities on their behalf through registered brokers without consulting with clients or in any way informing

them of his activities. The brokers are entrusted with the securities, and cash balances are kept in a bank account for each client. Applicant has been charging clients a fee based upon 15 percent of net earnings from securities transactions and dividends. Rosenblum, because of his unrelated full-time employment, does not depend upon the earnings from his securities activities for his livelihood. This fact is not disclosed either to existing or potential customers.

Applicant claims, without contradiction, a very high ratio of successful transactions. Specifically, he claims that since 1949, he has shown a profit in some 90 percent of transactions for clients, and, since 1960, to have been successful in almost 98% percent thereof. These are translated into average earnings on capital of about 12 percent on all managed portfolios or about 10.3 percent annually after deducting his commissions.

Feeling that he should extend his successful operation beyond his immediate circle of family and friends, Rosenblum began to advertise applicant's services inviting public participation which, in turn, bought him to the attention of the Commission's staff. This resulted in applicant's eventual filing as an investment adviser on May 28, 1976.[3/]

3/ It would appear that but for the commencement of advertising for outside clients, applicant's activities were exempt from registration requirements of the Act under the provisions of Section 203(b)(3) pertaining to:

(3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act." (Continued)

Proposed Fee Schedule

Applicant submitted with its application for registration as an investment adviser a proposed fee schedule (copy of which is hereto attached as an Appendix) containing charges for its services varying from 15 to 50 percent of a client's net earnings comprised of capital gains and dividends. This schedule is broken down into 8 separate plans designated "A" through "H", respectively, to be elected by a client in advance.

Plan "A" is the basic one and calls for the payment of 15 percent of net earnings, with an offset for unearned fees resulting from any trading losses, provided the account is maintained for 8 years. Plans "B" through "F" call for higher fees ranging from 20 to 45 percent of net earnings, in return for a limited guarantee of protection ranging from 20 to 100 percent against losses on the original investment. Thus, Plan "B" which requires a fee payment of 25 percent of net income, guarantees the investor to the extent of 20 percent of any losses on his portfolio. Plan "G" is somewhat different from the others in that it merely provides for a fee of 1.2 percent of the managed assets per year. Under Plan "H", the client would be liable for a fee of 50 percent of net earnings but only on those trades earning over 20 percent.

3/ (continued)
In fact, Rosenblum urges that by requiring him to register as an investment adviser merely because he began to engage in media advertising, the Commission unconstitutionally infringed upon his right of free speech. This argument is totally without substance.

There are additional features of the plans. Thus, the fees to be charged are subject to reduction or elimination if a minimum yield of 5 1/2 percent per annum, compounded, is not achieved in the period that the account is required to be maintained actively (eight years under Plan "A" and five years under Plans "B" through "H"). Applicant's fee is earned upon completion of a profitable transaction, and he has the sole discretion as to when a security held for a client should be sold. Billing for fees is deferred for a period of time to allow for the event whereby the amount of fee might be reduced as the result of an unprofitable transaction. In fact, even after a fee is paid there would be a return to the client of offsetting unearned fees from later trading losses. However, in order for this feature to be available, the account would have to remain under applicant's control for the period of years specified. Thus, although a client has the right to close his account and withdraw his monies at any time, he does not get any offset in fees arising from losses prior to the periods stated. Moreover, should there be an over-all loss in the value of the portfolio after the expiration of these periods, applicant is not responsible for such losses, except to the extent that the guarantee is contained in the proposed Plans "B" through "H", nor does he incur any "negative" liability for unearned fees greater than those he might have earned from profitable trades against portfolio losses.

The guarantees under the plans other than "A" and "G" also are conditioned on the maintenance of the account for the required periods. In order to assure that funds would be available to meet such losses, applicant proposes to set up for each account electing one of these plans an escrow fund equal to 25 percent of the potential loss at any given time commencing with the initial deposit. As the total value of the fund might decline, applicant expects to deposit additional funds into the escrow account proportionate to the percent of guarantee. Should applicant fail to make such a deficiency deposit for a period of 25 days, the client would have the right to cancel the account and to receive whatever funds there may then be in the escrow. In order that the guarantees for these accounts not exceed applicant's available resources, Rosenblum promises that he would not open accounts under these plans which would call for greater potential liability than his resources would permit him to cover.

It should be noted that prior to his registration as an adviser, all of applicant's clients paid fees on the basis of Plan "A" only, and hence, he can show no experience with respect to the so-called guarantee features and escrow accounts pertaining to the other plans. However, applicant would like to be in a position to offer, as an inducement to obtain new clients, that he earns no fee unless his advice is

profitable, as well as the guarantee and escrow commitments.

Upon being advised by Commission's staff that the foregoing proposed fee schedule was in purported violation of Section 205 of the Act, applicant filed an amendment to the schedule calling for a fee payment of a fixed amount per share sold, plus additional specified charges for servicing bank accounts, preparing tax summaries, and preparing account handling charges.[4/]

Although this schedule is the one under which applicant is now operating, Rosenblum has not advised any of his client's thereof since he feels that the net costs to them would be the same under the original 15 percent of net earnings basis, and that he would succeed in this application before any of his customers would become aware of the change. He does not expect that any of his present clients, who comprise members of his family and close friends, would be lost to him no matter what was the basis for his charges. Were his proposed fee schedule disallowed, he would continue his best performance for them under the fee schedule as now filed. He does not know what effect this might have on new customers since he has not as yet obtained any.[5/] However, as seen, applicant would like to have

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4/ In addition, the schedule contains additional charges per share sold under Plans designated "B" through "G", and a "research charge" under Plan "H", in return for which applicant would rebate varying percentages of the fees if the yield to the customer amounted to less than 5 1/2 percent per annum, compounded over a five-year period, and for a return of all fees in any account not showing a gain.

5/ He has obtained one "public" client since he began to offer his services beyond the circle of family and friends. This individual has been (continued)

the proposed schedule as a selling point to prospective clients.

The Statute

Section 205(1) of the Act prohibits an investment adviser from in any way performing his services under a contract which provides for compensation on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the fund of the client.[6/] It is conceded herein that the net earnings upon which the proposed fees are to be based include capital gains.

In order to be relieved of the provisions of Section 205(1) as they may prohibit the proposed fee schedule, applicant is proceeding pursuant to Section 206A of the Act which permits the Commission, upon application, to conditionally or unconditionally exempt any person or transaction from any provision of the Act to the extent that "such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

5/ (continued)
operating under Plan "A", in effect the same 15 percent of net earnings basis applicable to all prior accounts. The remaining "Plans" have never been involved with any account.

6/ Section 205(1) is not applicable to investment advisory contracts with a registered investment company, or to a contract with any other person relating to investment of assets in excess of $1,000,000, where such contract "provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices ***."

DISCUSSION AND CONCLUSIONS

I.

Since the applicant is seeking to be relieved from the statutory prohibitions against the features of the proposed schedule calling for fees based on a percentage of a client's net earnings including capital gains, it has the burden of establishing the tests set down in Section 206A relating to the public interest, protection of investors, and consistency with the policy of the Act.

Applicant attempts to meet this burden by advancing the basic argument that the public is best protected and served when one who functions as an investment adviser is compensated for his services only when he succeeds in making more money for his client than could be earned in a savings account. Otherwise, the public would be paying for worthless advice. Moreover, he argues that when an adviser is rewarded solely upon the basis of profits earned, he has an incentive to ensure successful management and devotion to the clients' best interests which he would not have if he were paid on a fee basis. Thus, contends applicant, a percentage fee basis protects investors from money-losing advice and careless management of his funds.

Moreover, Rosenblum believes that concepts of "free enterprise", "freedom of choice", "free speech" and "free competition" require that he be permitted to make his services available to new customers under the proposed fee schedule. He

feels that his past performance demonstrates that he is not the type of individual who would commit any of the abuses against which the statutory prohibition is directed. He urges that he never has nor ever would abuse his relationships with his clients in order to generate commissions, and that he has demonstrated utmost devotion to making money for his accounts.

Finally, he assserts that although he would perform equally as well under any system of compensation, to ask potential clients to pay fixed charges for his services in addition to brokerage fees for which they would become responsible might deter them from availing themselves of a service such as his. 7/ He avers further that not only does his track record of successful investments over the years for his family and friends demonstrate his ability to faithfully serve the public, but future clients would be protected by the "guarantee" provisions of his Plans (other than Plan "A", the only one heretofore used), and which are claimed to be similar to insurance against losses offered by mutual funds through policies issued by licensed insurance companies to investors in such funds.

II.

Since the statutory prohibition against charging fees

7/ However, he would afford the right to charge on a percentage fee basis to any investment adviser choosing to do so.

on the basis proposed is quite clear, the discretionary authority afforded the Commission to provide exemptions from this provision should be exercised only in unusual or unanticipated circumstances of a particular case where compliance with such provisions is not necessary to accomplish the objectives and policies of the Act. Compare Variable Annuity Life Ins. Co. of America, 43 S.E.C. 61, 64 (1966); and The Prudential Insurance Co. of America, 41 S.E.C. 335, 349-350 (1963). The authority conferred must be exercised with circumspection; and the propriety of granting an exemption largely depends upon the purposes of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish. Transit Investment Corporation, 28 S.E.C. 10, 15-16 (1948).

The Supreme Court, in commenting upon the purposes of the Investment Advisers Act in S.E.C. v. Capital Gains Bureau, 375 U.S. 180, 191, observed that the Act reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate all conflicts of interest which might incline an investment adviser -- consciously or unconsciously-- to render advice which was not disinterested. Finally, the Court points out, it is the potential for abuse and not merely actual proof of abuse that is basic to carrying out the purposes of the Act.

The Commission had occasion to pass upon the particular

section involved here, 205(1) in Roman S. Gorski, 43 S.E.C. 618 (1967). At page 620, the Commission appraises the section's prohibitions against compensation to the adviser on the basis of a share of capital gains or appreciation as being reflective of the awareness of Congress of the delicate fiduciary nature of an investment advisory relationship, and stated:

> "Under an arrangement for compensation based on and payable upon the realization of profits, . . . the adviser is likely to be in a position of conflict with his client in that he may be inclined to take undue risks with the client's funds, since he participates in gains and has no chance of loss. He would also be tempted to time transactions on the basis of considerations relating to his compensation rather than the best interest of the client since his fee would be received only in the event of realized gains." 8/

III.

There is nothing in the applicant's proof of argument which justifies the grant of an exception from the legislative mandate as expressed in Section 205(1) of the Act. Rosenblum's services are not so unique, and his relationship with his clients not so unusual, as to warrant that he alone should be afforded a plan of compensation denied to other investment advisers. On the contrary, the statutory intent to forestall potential abuse requires that the statutory prohibitions be

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8/ In a footnote to this quotation, the Commission refers to its Report on investment trust and investment companies which points out that arrangements for contingent compensation to investment counselors were strongly condemned by industry representatives as inimical to the interest of the client since, apart from the "heads I win, tails you lose" aspect of such arrangements, such a basis of compensation encourages the advisor to recommend a degree of risk that the investor himself would not knowingly undertake and may also be a strong temptation to take unusual risk and to speculate or overtrade.

maintained in this case, especially because of the total discretion retained by applicant in the management of the funds of customers. They have no say in the investment of their funds, are given no knowledge of the transactions to be executed on their behalf, have no opportunity to act on the advice promulgated by applicant, and have no control over when and to what extent fees will be earned by him.

Rosenblum insists he is an honorable man, whose record of overwhelmingly successful investments demonstrates how well he has served his clients. That being so, there is all the more reason that he should be content with being compensated on a fee basis. Otherwise the temptation will always be present (and a conflict of interest continue to exist) which might cause this investment adviser -- consciously or unconsciously -- to render advice which is not disinterested. Assuming his confidence of continued positive performance is well placed, it follows that his clients should likewise not object to paying him a fee for his advice. In the last analysis, it is his performance that should determine the usefulness of his advisory services.

It becomes apparent that the prime motivation of applicant in seeking the proposed fee schedule is to attract new customers with an appeal of "no profits, no fee", who might otherwise be reluctant to use his services if they were required to pay for services whose quality were unknown to them. Yet,

this is the situation faced by all other registered advisers, and the mere desire by applicant for an advertising advantage over the others is hardly a reason for an exercise of discretion contradictory to the clear statutory mandate. Nor is this conclusion altered because of a claimed series of past investment successes.

Rosenblum has repeatedly asserted that he is not truly an "investment adviser", since he neither publishes nor dispenses advice, as such. However, in his performance as a claimed "personal manager of investments", advisory functions are implicit. He merely carries the rendering of advice one step further by buying or selling the recommended securities on behalf of his clients under the discretion afforded him.

IV.

Under all the circumstances, it is found that the proposed fee schedule is not permitted by Section 205(1) of the Act and the rules thereunder and that applicant has failed to sustain the burden of showing that the claimed exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. If anything, the facts herein warrant the conclusion that the public and other interests require that the prohibition be enforced. If Rosenblum has a quarrel, it is with the Congress and the

expression of its desires in Section 205(1), and not with "the Staff" who merely attempts to carry out the law.[9/]

ORDER

Accordingly, IT IS ORDERED that the application by Harbine Financial Service for exemption from the provisions of Section 205(1) of the Investment Advisers Act of 1940 is hereby denied.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a

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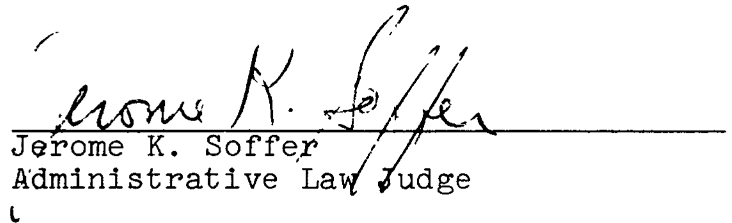
9/ In their briefs and arguments, the parties have requested the Administrative Law Judge to make findings of fact and have advanced arguments in support of their respective positions other than those heretofore set forth. All such arguments and expressions of position not specifically discussed herein have been fully considered and the Judge concludes that they are without merit, or that further discussion is unnecessary in view of the findings herein.

party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.



Jerome K. Soffer
Administrative Law Judge

Washington, D.C.
October 6, 1977

APPENDIX

Schedule E of Form ADV

(Continuation Sheet)

1. Full name of Applicant or Registrant exactly as stated in Item 2 of Form ADV.

Jesse Rosenblum

Item of Form (identify)	Answer
18(b)	I invest my clients' surplus funds, under limited power of attorney, in common stocks, achieving a higher yield than available at banks or elsewhere. My clients never interfere in my method of operation; I do not seek their comments or advice on the portfolio. There is no formal agreement with the client. Either party can terminate the service at any time. Service fee is based on growth of portfolio valuation. As profitable trades are completed, the fee would be charged the client per his Plan. If the value of the portfolio should drop below the fee level previously billed, the service would continue without charge, until the account had generated sufficient income to normalize. Plan "A" fee is 15% of net earnings(capital gains & dividends), with unearned fees returned to active accounts after eight(8) year period. Plans "B" to "H" fees are subject to reduction or elimination, if a minimum yield of at least 5½% per annum compounded is not achieved in a five (5) year period. In addition, Plans "B" to "F" offer a limited guaranty of protection against loss on original investment, secured by distinct escrow type bank accounts from me, having 25% of my potential liability under the Plan (10% for Plans D, E, and F). Additional funds would be added on a dollar-for-dollar basis to cover loss in portfolio value. If such additional monies are not available within 25 business days, the client can request the escrow monies. Any removal of funds by me in the escrow accounts, as may be required to satisfy the Plan at such time of withdrawal, would be a fraudulent act.

Plan/	__% fee on net earnings/	__% loss protection/	investment
B	25	20	$10M - $50M
C	30	40	10M - 25M
D	35	100	10M - 15M
E	45	100	10M - 15M
F	20	100	10M minimum

Plan "G" fee is 1.2% of managed assets per year.
Plan "H" fee is 50% of excess gain only on those trades earning over 20% net.

24(e)

Upon choosing a stock for purchase and the limit price we wish to pay for that stock, an order is given to our Broker. The order will, in most cases, include all clients and/or Rosenblum accounts having free funds in their respective accounts. Our Broker gives first preference to my clients in most instances; other times it may be a mix of random selection and/or combination of odd lot orders. All purchases in that time period, one day or one week, in most cases, are made at the same limit price or lower, and no account is ever at a disadvantage or benefits at the expense of another account. The above operating principle also applies to the sale of securities.

Date as given in SEC FORM ADV according to this rule.
RECD. S.E.C.
APR 19 1976

April 16, 1976

If any item on this page is amended, you must answer in full all other items on this page and file with a completed and executed page one.

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