ADMINISTRATIVE PROCEEDING
FILE NO. 3-8213

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	)
	)
JOHN HARVEY EARLY	)
	)

INITIAL DECISION

Washington, D.C.
June 15, 1994

Glenn Robert Lawrence
Administrative Law Judge

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APPEARANCES: Barry D. Miller, Esq., Susan Ferris Wyderko, Esq., and H.R. Hallock, Jr., Esq., for the Division of Investment Management

John Harvey Early, pro se

BEFORE: Glenn Robert Lawrence, Administrative Law Judge

On July 8, 1992, John Harvey Early filed an application for registration as an investment adviser. Amended and restated applications were filed on October 23, 1992, and February 3, May 5, and July 26, 1993. The Commission subsequently instituted proceedings pursuant to §211(c) of the Investment Advisers Act of 1940, and Rule 0-5(c) thereunder to determine whether the exemption requested by Mr. Early in the applications should be granted under §206A for relief from §205(a)(1) of the Advisers Act, 15 U.S.C. 80b-6a. Section 205(a)(1) bars registered investment advisers, with some exceptions not relevant here, from using performance-based advisory fees to charge clients.

Mr. Early proposes to charge his clients an annual fee for management of their funds that would be based on the performance of his clients' accounts in relation to the return on United States Treasury bills over the same period. It is his contention that the arrangement provides adequate investor safeguards and that it penalizes the investment adviser for failing to show an appropriate return on the investments. In addition, Mr. Early seeks to collect these fees retroactively.

The Division of Investment Management opposes issuance of the order arguing that the proposed arrangement does not fit within the exceptions and that investors are not sufficiently protected by the provisions of Mr. Early's proposal. The Division argues generally that performance-based fees, which link an adviser's compensation to the performance of the client's account, create the possibility for conflicts of interest between the adviser and the client and that such arrangements inherently encourage undue risk-taking in a client's account so as to maximize the adviser's compensation. The Division indicates that §205 of the Adviser Act and the Commission (under authority of §206A) have allowed performance fees only in limited circumstances, where objective criteria

show that investors are either financially sophisticated or wealthy enough to obtain adequate financial advice.

The Division argues that Mr. Early plans to offer his fee arrangement to clients who do not meet any of the objective tests that Congress and the Commission have established. It is the Division's view that the fee arrangement is therefore prohibited by the plain language of §205 as well as Commission precedent. The Division further argues that Mr. Early has the burden of showing that the exemption he seeks from §205 is consistent with the purposes of the Advisers Act, investor protection, and the public interest. The Division argues that Mr. Early has not met this burden because he proposes no test of financial sophistication or other alternative to the statutory requirements. Additionally, the Division argues that Mr. Early's proposed fee schedule presents some of the same concerns inherent in all performance fees -- including conflicts of interest between the adviser and client and undue risk of speculation -- that led to the enactment of §205. Finally, the Division argues that because Mr. Early's fee proposal exemption has not been justified, his retroactivity request is rendered moot.

The findings and conclusions herein are based upon the preponderance of the evidence as determined from the record and upon my observation of the witness that testified at the hearing that was held in Washington, D.C., on April 5, 1994, as well as the arguments and proposals of facts and law of the parties and the relevant statutes and regulations.

FINDINGS OF FACT

After graduating from Vanderbilt University in 1982, Mr. Early sold books for a few months with a publishing company. (Administrative Law Judge Exhibit (ALJ Ex.)) 1, Schedule D of Form ADV at 2; Hearing Transcript page (Tr. 16) He then worked for a

local company in Amarillo selling computers, a period of employment which lasted approximately six months. (Id.) Thereafter, he assisted his mother in her investments and, for a five-year period, published a financial newsletter called "Economic Leads." (Id.) Mr. Early was last employed in 1986, when he worked for his mother as an "administrative assistant." (ALJ Ex. 1, Schedule D of Form ADV at 2; see also Tr. 18)

Mr. Early acknowledges his formal training in making securities investment decisions is "somewhat limited." (Tr. 23) He majored in economics at college and later attended a one-term course in forecasting at West Texas State University. (Tr. 23) Most of Mr. Early's education and training in securities investments has consisted of doing quantitative economic research on his own. (Tr. 16, 23-24)

Mr. Early is presently a sole proprietor located in Amarillo, Texas. He registered as an investment adviser under the Advisers Act on August 28, 1991. (ALJ Ex. 1; Division Exhibit (Div. Ex.) 1 at 3) In 1991 Mr. Early approached the Division with a proposal for a "discretionary" fee for his advisory services that would be based on a performance formula. (Div. Ex. 1 at 3-4) The Division responded that his proposal was a contingent advisory fee prohibited by §205(a)(1) of the Advisers Act. (Div. Ex. 1 at 4; Div. Ex. 4)

Mr. Early then filed an application on July 8, 1992, seeking an exemption from §205(a)(1)[1] that would allow him to enter into a general form of contract using a schedule of fees based largely on the performance of each client's account. (Div. Ex. 1) In response to the Division's comments on the terms of the contract and other matters, Mr. Early filed amendments to the application on October 23, 1992, and February 3, May 5,

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[1]The application seeks an exemption from §205(1) of the Advisers Act. That section was renumbered §205(a)(1) in 1987 by the Securities and Exchange Commission Authorization Act of 1987, Pub. L. No. 100-181, 101 Stat. 1263.

and July 26, 1993.[2] On October 25, 1993, the Commission issued a notice and order for a hearing on the application. (55 SEC Docket 0917)

Under the proposed contract,[3] Mr. Early's performance fee will be calculated yearly. (Hearing Transcript page (Tr.) 13; Early Init. Br. at A-1) He will earn 20% of the amount by which the client's return on the managed funds exceeds the return on three month United States Treasury bills plus an amount initially to be set at three percent, but which may range from two to six percent. (Tr. 10; Early Init. Br. at A-3, A-7) If the client has a net loss for the year, the contract requires Mr. Early to reimburse the client for 20% of that loss. (Tr. 10; Early Init. Br. at A-3; see also Early Res. Br. at 4) If the client's return exceeds $300, the contract has a minimum fee of $100. (Id.) No fee is due if the client's return is less than $300. (Id.)

Mr. Early's investment approach is to identify various market and other variables that he believes "consistently precede major moves in the markets." (Div. Ex. 3 at 6-7) After collecting and testing this data, Mr. Early constructs what he terms "multi-linear regression" or "neural network" models for the market in order to try to predict its future direction. (Div. Ex. 3 at 7) He makes his investment decisions based on his analysis of these forecasts and has tended so far to hold positions for about two years. (Id.) Because his system is not a good predictor of short-term market fluctuations, which may

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[2]The fourth and final amendment to the application was filed on July 26, 1993 and was received in evidence as the Division Exhibit 2.

[3]The current version of the proposed contract is contained in Exhibit A of Mr. Early's Initial Brief dated January 13, 1994. This version of the contract rewords some of the language of the preceding version of the proposed contract that had been set forth in the last formal amendment to the application on July 26, 1993. (Div. Ex. 2)

go to extremes, his investment strategy may cause significant loss positions. (Id.; see also Tr. 43)

Because of one year market fluctuations, Mr. Early could be forced to pay substantial loss reimbursements to his clients. (Early Init. Br. at 27; see also Tr. 43)

As of November 30, 1993, Mr. Early had total assets of almost $600,000 and a net worth of about $450,000. (Early Ex. 8 at 3, 4) Most of Mr. Early's assets are in cash (about $207,000) and real estate (about $187,000). (Tr. 17-18, 25-26; Early Ex. 8 at 4) His residence, which carries a mortgage of about $135,000, accounts for most of his real estate assets and a substantial part of his total assets. (Tr. 25-26; Early Ex. 8 at 4)

Mr. Early's other major assets include listed securities (about $49,000), unlisted securities (about $29,000), business interests ($13,000), and an IRA (about $82,000). (Early Ex. 8 at 4; see also Tr. 17, 24-26) It would be difficult for him to liquidate his real estate assets and his IRA. (Tr. 26) There may be some overlap in the amounts listed for his business interests and unlisted securities, which may have caused him to overstate his net worth by about $10,000. (Tr. 24-25)

Mr. Early's financial situation has not changed significantly since November 1993. (Tr. 17-18) He believes that his net worth will change by more than a nominal amount in the future. (Early Ex. 8) It is difficult to predict how it will change, however, since predicting the stock market is easier than predicting his own net worth. (Id.; Tr. 29) Because Texas is a community property state, Mr. Early expects his wife would be entitled to slightly less than half of any such assets if they were divorced. (Tr. 27-28)

Mr. Early recently invested about $11,000 to acquire a 1/32nd working interest in an oil drilling venture. (Tr. 28; see also Early Ex. 8) The first of the wells to be drilled is currently in production and is expected to generate up to about $6,000 a year in income.

(Tr. 28) Mr. Early concedes he could have lost his entire investment, however, and agreed that such investments are certainly speculative. (Tr. 28-29)

Except for his investment income, Mr. Early's only source of income is from two trusts of which he is a beneficiary. (Tr. 18, 26) In 1993, Mr. Early's trust income amounted to about $26,000. (Id. at 18.) Mr. Early's wife, who is employed by a local company, earns about $50,000. (Id.)

While Mr. Early initially expects his clients will establish their accounts with the Vanguard organization, they may maintain accounts at other mutual fund organizations or brokerage firms. (Tr. 11; Early Init. Br. at A-1) Under the terms of the contract, Mr. Early will be granted trading authority over his clients' accounts, but he will not have custody of their funds. (Id.) He will be compensated only by his clients, who will pay him directly. (Tr. 11; Early Init. Br. at A-2) He will not receive any compensation from any brokerage firm, mutual fund, money manager or dealer. (Id.)

The contract will allow Mr. Early to invest client funds among different mutual funds in the Vanguard Group and any other security that could be acquired through the "Vanguard Discount Brokerage." (Tr. 11, 40; Early Init. Br. at A-1) Vanguard Brokerage Services makes available "anything publicly traded except futures, commodities and currencies." (Div. Ex. 3 at 6) With the written approval of his clients, Mr. Early also may invest through other brokerage firms in any other security. (Early Init. Br. at A-1) The contract prohibits him from using margin to buy or sell securities. (Early Init. Br. at A-1)

Mr. Early intends to limit his investments to those areas where he believes he has a "specialized understanding of a particular aspect of a market." (Div. Ex. 3 at 7) At the present time, he believes he has such an understanding of "the general direction of the broad stock market and interest rate vehicles like long-term stripped bonds." (Id.) In the

future, he intends to develop his expertise in "picking which countries' will have the best performing markets," and he expects he will "be moving to a number of different investments." (Id.; Tr. 15) He does not presently intend to develop his skill in picking individual stocks, however. (Div. Ex. 3 at 7)

Mr. Early will determine what level of investment risk will be appropriate for his clients. (Tr. 36) Mr. Early will place all his clients into essentially the same investments. (Id.; see also Div. Ex. 3) He will treat his clients as if they all had the same risk tolerance for the funds that they have invested. (Tr. 36-38) The investments Mr. Early intends to make for his clients conceivably could be subject to extreme market fluctuations and, for that reason, might cause significant loss positions. (Tr. 43) Mr. Early "assumes" he will invest a substantial part of his own net worth in the same investments as his clients. (Early Init. Br. at 16, 19)

The minimum initial account size will be $20,000. (Tr. 11-12; Early Init. Br. at A-1) Clients will have to represent that they have a net worth of at least $200,000 (which may include their principal residence) and that they would not need the funds placed under Mr. Early's management for at least five years. (Tr. 11, 34; Early Init. Br. at A-2, A-5) The contract also will require clients to warrant that the investment in their account represents no more than one-fifth of their net worth, unless their net worth is at least $1 million. (Tr. 11; Early Init. Br. at A-2)

The contract also provides that when Mr. Early has contracts with 50 or more clients or his clients have given him $5 million or more to manage, he will establish a trust fund to help assure reimbursement of client losses. (Tr. 54-55; Early Init. Br. at A-3 to A-4) The contract says that the trust amount will equal at least five percent of an amount

that the contract refers to as "the aggregate of all client funds with respect to which [Mr. Early] may be responsible for reimbursing a portion of losses." (Early Init. Br. at A-4)

The trustee, which will be a financial institution with assets of at least $500 million, will evaluate these percentage requirements at least annually. (Early Init. Br. at A-4) At five year intervals the trustee will notify Mr. Early's clients of the amount maintained in the trust fund expressed as a percentage of the total amount under Mr. Early's management that is subject to the proposed fee arrangement. (Id.; Early Res. Br. at 5) Additionally, the trustee will be required to notify Mr. Early's clients if at any time the percentage amount in the trust fund falls below the required five percent level. (Id.) The trustee also will be required to verify the amount of each client's assets under management every five years. (Early Init. Br. at A-4)

Until Mr. Early has $5 million under management or 50 clients, the responsibility for reimbursing losses would depend on his own net worth. (Tr. 54-55) Mr. Early's application does not limit the number of clients he may enter into advisory contracts with or limit the amount of funds he may have under management. (Tr. 35-36) If he were to unwisely accept more clients or funds than he should given his net worth, he would logically have to stop when he was no longer able to maintain the reserves required by his contract. (Tr. 35) He also would logically have to stop if he ran out of money with which to reimburse client losses. (Tr. 35-36) Nothing in the application, however, would require him to stop. (Tr. 36)

Mr. Early charted the results of three fee arrangements based upon the returns of the Dow Jones Industrial Average from 1963 to 1992. (Tr. 43-44; Early Init. Br. at B-4; Div. Ex. 6; Div. Ex. 7) Mr. Early believes his analysis indicates that over a 30 year period his fee structure yields better results for clients than two other fee structures - one where

the adviser takes one percent of total assets as his fee and the other where the adviser takes 10 percent of the gains as his fee. (Id.)

The Division submitted a chart showing the results of different fee arrangements using the same assumptions used by Mr. Early, except that the chart covered just the ten-year period from 1983-1992. (Tr. 47-51; Div. Ex. 8) The Division's chart indicated that from 1983 to 1992 Mr. Early's fee proposal would have resulted in lower returns and higher advisory fees for his clients than under the other two fee arrangements. (Id.) Different assumptions lead to different conclusions as to which fee arrangement is better. (Id.)

Mr. Early also has submitted another proposed formula for calculating his performance fee that would pay him 12.5% of any returns he made for his clients and would require him to reimburse 12.5% of client losses. (Tr. 38-39; Early Ex. 9) Under the proposed alternative formula, Mr. Early would not be required to outperform any comparative indicator of investment performance. (Id.) Thus, Mr. Early would earn a fee even if he were to invest his clients in money market funds. (Tr. 39) Such an investment, however, might not be in his clients' long term interest. (Id.)

Continuously since 1991, Mr. Early has managed four accounts without compensation. (Div. Ex. 1 at 4) One of the accounts is held by Mr. Early's mother, who placed about $23,000 with him to manage. (Tr. 12) The other three accounts are held by three related adults, a husband and wife together with a sibling of one of them, all of whom received their money from their father/father-in-law. (Tr. 12; Div. Ex. 1 at 2-3) The husband and wife opened separate accounts with $25,000 each, and the sibling deposited $50,000 in another account. (Tr. 12)

Mr. Early submitted an unsigned document purporting to give the "household net worth" of his mother. (Early Ex. 6) This document states that she has a "household net worth" of more than $500,000. (Id.)[4] Mr. Early also submitted three other unsigned documents purporting to give the "household net worth" of three other clients. (Early Exs. 4, 5 and 7) Each of those exhibits contains unattributed handwriting, with the writing on Early Exhibits 5 and 7 apparently done by the same person. These documents state that the husband and wife have a "household net worth" of more than $650,000, and that the sibling has a "household net worth" of more than $500,000. (Id.)

Two additional clients recently opened accounts with Mr. Early, one in the amount of $50,000 and the other in the amount of $25,000. (Tr. 12) Mr. Early testified that both of these clients have represented to him that their "worth" is more than $1 million. (Id.) There is no other evidence in the record concerning the net worth of these two clients.

Mr. Early testified that his mother has invested extensively in the stock market, the bond market, limited partnerships, and oil and gas working interests. (Tr. 21, 22) While Mr. Early does not know the full extent of his other clients' experience in making securities investments, he is certain they have "some experience." (Tr. 22) He testified to his understanding that the husband and wife had an "overall" income of $180,000 in 1993.[5] (Tr. 21; see also Early Exs. 5 and 7) Out of that amount, Mr. Early thinks that

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[4]Mr. Early "assumes" the term "household net worth" applies to all members of a household. (Tr. 83) Mr. Early testified that he understood the term to include the net worth of his mother together with that of her husband. (Id.) There is no evidence in the record as to how the subject of the exhibit, Virginia Ratliff Early, understands that term.

[5]Early Exhibits 5 and 7 indicate that the husband and wife have an "annual household income" in excess of $180,000. Mr. Early "assumes" that the term "household income" applies to all members of a household. (Tr. 83) There is no evidence in the record as to how the subjects of Early Exhibits 5 and 7 understand that term.

$50,000 represented "investment" income. (Id.) Mr. Early does not know, however, whether this income came from stocks, real estate, certificates of deposit, or interest bearing accounts - although some of it came from the couple's accounts with him. (Tr. 21) There is no other evidence in the record substantiating Mr. Early's understanding of the nature of the couple's income.

With one exception where he has a document stating he is not seeking compensation at this time, Mr. Early has not entered into a written contract with any of his existing clients. (Tr. 31-32, 56-57) Mr. Early believes that his clients understand his services are being provided with the idea of obtaining exemptive relief from the Commission. (Tr. 31-32) He further believes that, if he does not obtain the requested relief, his clients also understand "something else" will be done. (Tr. 31-32)

Mr. Early has never invested more than half of his clients' funds in the stock market. (Tr. 15) A majority of those funds initially were invested in long-term zero coupon United States Treasury bonds. (Tr. 15, 41) He does not recall whether or not he told his clients in advance that half their money was being invested in zero coupon bonds, although his mother and the father/father-in-law of his other clients knew about the investment. (Tr. 41) Mr. Early thinks that within a week after the investment was made, however, the children would have received a brokerage statement reflecting the investment. (Tr. 41)

During the last three weeks of 1991, the value of his clients' accounts went from a ten percent loss position to a six and one half percent gain, most of which was caused by an increase in value of the zero coupon bonds. (Tr. 41-42) These bonds are volatile in price and, at least over the short-term, may be considered very speculative. (Tr. 42)

Mr. Early did not disclose to his clients how volatile the market was for these securities. (Tr. 41)

Mr. Early has not informed his clients that his proposed performance fee arrangement may create an incentive for him to make investments that are risky or more speculative than would be the case in the absence of a performance fee. (Tr. 32-33) Mr. Early does not believe that the type of disclosure that is required by paragraph (d)(1) of Rule 205-3 under the Advisers Act should apply to him because he does not believe his contract creates an incentive to take undue risk. (Tr. 32-33)

For the second half of 1991, the combined value of the accounts managed by Mr. Early increased 11.6%. (Tr. 19; Early Init. Br. at 8.) In 1992 and 1993, they increased 8.7% and 15.9%, respectively. (Id.) For the period from their inception until the end of 1993, the accounts held by the husband and wife each increased from $25,000 to $36,131; the value of their sibling's account increased from $50,000 to $68,994; and the value of the account of Mr. Early's mother increased from $22,888 to $31,506. (Tr. 19; Early Init. Br. at 5-6, 9-10)

Mr. Early seeks exemptive relief retroactively to January 1, 1992. (Div. Ex. 2 at 4, 9, 25) If he is granted relief on a retroactive basis, his clients will not be obligated to pay for his services, but will have the discretion to do so. (Early Init. Br. at 8) Based on the performance of their accounts for 1992 and 1993, the husband and wife would each owe $809, the sibling would owe $1,506, and his mother would owe $695. (Id. at 8-10)

Mr. Early believes he has reasonably good judgment. (Tr. 40) He testified that he assumes his good judgment would not be overcome by emotions of fear or greed. (Id.)

Mr. Early submitted three character affidavits that were accepted into evidence. (Early Exs. 1, 2, 3) Mr. Early prepared the affidavits himself and asked the signatories if they would be willing to sign them. (Tr. 31) None of those three individuals is familiar with his proposed fee arrangement. (Tr. 30)

CONCLUSIONS OF LAW

The basic question is whether the Respondent's proposed performance-based fee arrangement meets the statutory criteria for an exemption from the statutory prohibition of performance-based fees.

Section 205(a)(1) of the Advisers Act provides that no investment adviser may be compensated "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." In 1970, Congress added §205(b)(2) which permits certain performance fees where the client has over $1 million in assets under management or where the client is a registered investment company. In 1970, Congress also added §206A which grants the Commission authority to grant exemptions from the Advisers Act so long as the exemption is: (1) consistent with the purposes of the Act; (2) consistent with the protection of investors; and (3) necessary or appropriate in the public interest. In Roman S. Gorski, 43 S.E.C. 618 (1967), the Commission spelled out the rationale for the prohibition on performance based arrangements:

> 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 his client's funds, since he also 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 interests of his client since his fee would be received only in the event of realized gains.[6]

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[6]It is appreciated that Early's proposal differs from the Gorski case inasmuch as Early would lose if the client loses. However, as discussed infra in Harbine Financial Corp., 36

43 S.E.C. at 620 (footnote omitted).

In 1985, the Commission adopted Rule 205-3 which codified exemptions from §205(a)(1) granted by the Commission since the adoption of §206A. This rule provides two alternative tests for determining a client's eligibility to enter into a performance fee contract. The client must either have (a) a minimum account of $500,000 or (b) net worth over $1 million. In addition, the client must meet a subjective test of financial sophistication.

Analogous to the present case is Harbine Financial Corp., 46 S.E.C. 1328 (1978). In Harbine, the applicant proposed a similar performance fee contract which the Division of Investment Management opposed. The initial decision of the administrative law judge (In the Matter of Harbine Financial Services, Admin. Proc. File No. 3-6150, April 11, 1983) noted that the sole proprietor of Harbine Financial Services, Mr. Jesse Rosenblum, devoted only evenings and weekends to the investment adviser service. Further, he began by managing small sums of money for relatives. At the time of the proceedings, he managed accounts for relatives and other individuals known to him on a personal basis. He had approximately 12 accounts worth a total of $170,000. Mr. Rosenblum had complete discretionary control over the accounts and claimed to be very successful with average earnings on capital of about 12 percent.

Since Harbine was seeking to be relieved from the statutory prohibitions against performance fees, it had the burden of establishing that it met the statutory criteria for an exemption: consistent with the purposes of the Advisers Act, investor protection, and the public interest. The administrative law judge concluded that Harbine failed to meet this

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S.E.C. 1328 (1978), this is not critical to the issue.

burden. Applicant's basic argument was that the public is best served by an adviser who is compensated for his services only when he succeeds in making more money for his client that could be earned in a savings account.

This argument, however, failed to overcome the contention of the Division of Investment Management that performance fees create the possibility of conflicts of interest between adviser and client and encourage undue risk-taking in a client's account so as to maximize the adviser's compensation.

In the initial decision it was noted that "the statutory prohibition against charges 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." (Initial Decision at 10)

In Harbine Financial Corp., the appeal from the initial decision, the Commission stated:

> Section 205(1) was enacted by Congress to prevent investment advisers from entering into profit-sharing agreements with their clients, arrangements which encourage advisers to take undue risks with their clients' funds. We have previously pointed out that such arrangements engender conflicts of interest between adviser and client and, because advisory fees are dependent on the realization of gains in a client's account, tempt advisers to time transactions on the basis of their own compensation rather than their client's best interests.
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> * * *
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> We are unable to conclude that any exemption from the Act is warranted. We do not question Rosenblum's honesty in past dealings, or his good intentions. However, Section 205(1) is a prophylactic measure designed to *ensure* that an investment adviser's decisions to buy, sell or hold a security are based on the best interests of his client and not on his own compensation.

46 S.E.C. at 1330 (footnotes omitted).

In reaching its decision, the Commission also noted that assurances by the applicant that his own funds would be invested similarly "does not accord clients the kind of protection that we deem necessary to justify an exemption from the Act's prohibition," 46 S.E.C. at 1331 (footnote omitted). Similarly, Mr. Early argues that the arrangement he proposes puts at risk his own funds and that this would assure that he invest the clients funds properly.[7] The argument is short sighted. It fails to take in to account the frequent occurrence of compulsive risk takers who find the pain of losing everything an insufficient deterrent and they continue to risk everything whether it be in the market or at the track.

The Commission has approved exemptions to §205(a)(1) on several occasions. There were 21 orders granting the requested exemption prior to 1985 when Rule 205-3 was adopted (Appendix C of Division's Prehearing Brief) and six orders since that time (Appendix D of Division's Prehearing Brief).

The six later-issued orders are not applicable to this proceeding. However, the circumstances in Rockefeller and Co., Inc. (35 SEC Docket 435 (application); 35 SEC Docket 788 (order)) and PaineWebber T.C., Inc. (51 SEC Docket 1094 (application); 51 SEC Docket 1523 (order)) bare some similarity to the instant case.

The proposal at issue in PaineWebber, unlike Mr. Early's proposal, concerned investments in low and moderate-income housing with a 15 year holding period.

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[7]Mr. Early states in his proposed findings of fact: "applicant has sufficient net worth that he would suffer material harm if clients had material losses while operating under the proposed contract (Early Ex. 8, Early Int. Br. at A-2, A-3; Early Res. Br. at 30)"; and "applicant has dealt with real world conditions including fear and greed, and compiled a two and a half year record of beating the overall stock market (Early Int. Br. at 8)." (Early Proposed Findings of Fact at 1, 2)

Consequently, the particular circumstances in Painewebber limited the possibilities for excessive speculation and overtrading. The Commission found the exemption necessary and appropriate in the public interest to provide a vehicle for investment in low and moderate-income housing.

In Rockefeller, the requested exemption was granted with the following limitations: the adviser served exclusively the descendants of John D. Rockefeller, their spouses, trusts, charities, and key employees, and the key employees would have a college or professional degree or substantial experience in financial matters and a minimum income of $50,000. The proposed arrangement by Mr. Early does not set such limits. Neither does the proposed financial eligibility standards assure the client financial sophistication or wealth deemed necessary by Congress to protect against the inherent risks of any performance fee arrangement.

Mr. Early testified that he invested client funds in zero coupon bonds which he admits is a volatile investment. A performance based arrangement encourages such speculation with the resulting conflict of interest. Further, he personally invests in oil and gas ventures which are clearly speculative, which indicates his proclivity toward that type investment. Accordingly, it is considered that the requested exemption is not consistent with the protection of investors.

The requested exemption also is not consistent with the protection of investors because the proposed arrangement does not provide sufficient disclosure of those risks. Mr. Early testified at the hearing that he bought his clients zero coupon bonds without disclosing the substantial risks. It is expected that he would make similar investments without proper disclosure if the proposed arrangement were approved.

Section 206A of the Advisers Act requires any exemption granted thereunder to be in the public interest. The requested exemption is not in the public interest because Mr. Early's proposal does not provide sufficient alternative investor protections to compensate for the subjective and objective tests of client sophistication Congress deemed necessary for this type of fee arrangement. Further, lack of investor protection is reflected in Mr. Early's proposal to place all of the investors in the same investments without regard to the individual investors risk tolerance.

The requested exemption is inconsistent with the views of the Commission expressed in rulemaking proceedings pursuant to §206A of the Advisers Act. The Commission adopted Rule 205-3 under the Advisers Act to allow investment advisers to charge performance fees to individual clients only when the clients are both financially experienced and able to bear the risk of loss associated with such fee arrangements. (34 SEC Docket 913) Mr. Early's proposed arrangement does not require his clients to meet the objective financial standards established by paragraph (b) of Rule 205-3.[8]

Mr. Early's proposal also does not require him to have a reasonable belief that the client, or a representative of the client, understands both the proposed method of compensation and its risks as required by Rule 205-3(e). His proposed arrangement also is inconsistent with the policy underlying Rule 205-3(d) in that it does not disclose to clients the conflicts of interest or other risks involved in the arrangement.

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[8]Mr. Early's use of the term "household net worth" is inconsistent with the concept of net worth in Rule 205-3(b). Rule 205-3(b) does allow assets held jointly with a spouse to be included in determining net worth. The Commission stated in the release adopting the rule, however, that it had considered and rejected suggestions that assets of all family members should be aggregated or that assets owned individually by a single spouse should be counted in determining the other spouse's net worth. (34 SEC Docket 913)

In light of the finding that the requested exemption is unwarranted, Mr. Early's request for authorization to collect the fees retroactively is moot. Even were this not the case, there are no compelling and exigent circumstances in this matter that would justify issuance of an order on a retroactive basis. See Hugh B. Baker, 24 S.E.C. 202, 206 (1946).

ORDER

Accordingly, it is ordered that the application by John Harvey Early for exemption from the provisions of 205(a)(1) of the Investment Advisers Act is hereby denied,

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

Pursuant to Rule 17(f) of the Rules of Practice, 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 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.

Glenn Robert Lawrence
Administrative Law Judge

Washington, D.C.
June 15, 1994