Approved April 12, 1986
Date

MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE.

The meeting was called to order by Sen. Neil H. Arasmith at
Chairperson

9:00 a.m./~~p.m.~~ on April 2, 1986 in room 529-S of the Capitol.

All members were present except:

Committee staff present:

Bill Wolff, Legislative Research
Myrta Anderson, Legislative Research
Bruce Kinzie, Revisor of Statutes

Conferees appearing before the committee:
Ken Koger, Reimer and Koger Investment Counselors
John Wurth, Securities Commissioner's Office
Chris Edmonds, representing Ken Koger
Marshall Crowthers, KPERS
Dr. Robert Harder, Secretary, SRS
Bil Pitsenberger, HMO Kansas
Richard Harmon, Health Care Plus and Humana

The minutes of April 1 were approved.

The hearing began on SB 750 regarding securities. Ken Koger of Reimer and Koger Investment Counselors in Shawnee Mission, testified in support of the bill. He told the committee that his is a large investment counseling firm. The bill involves a technical correction in the state law that will allow his firm to compete nationally with other investment firms with regard to fees charged. Committee questions and discussion followed as to how the fees are charged and as to "the investment advisers act of 1940 and the rules and regulations promulgated thereunder" as shown on lines 56-58 of the bill.

John Wurth of the Securities Commissioner's office testified next. As to the questions regarding the Investment Advisers Act of 1940, he said that he feels they still have the authority needed and that this language is included to be consistent with other states. He continued that the bill refers to sophisticated clients who are those who have a net worth of $1 million or a portfolio of $500,000 so it will not apply to every client. It is consistent with the SEC and is being done in other states. The investment protection still remains since it is only going to be applied to sophisticated investors. Sen. Werts asked if the Investment Advisers Act of 1940 had ever been amended, and Mr. Wurth said only a few times. Sen. Werts felt it needed to be looked at more.

Chris Edmonds, representing Ken Koger, testified further in support of the bill. (See Attachment I.)

Next to testify was Marshall Crowthers of KPERS. He said the Board of Trustees is interested in this legislation which would give them the authority to negotiate with the various investment advisers with which they deal. They understand that they need to be careful with the use of this bill, but they want the opportunity it would give them. This concluded the hearing on SB 750.

Next to be heard was SB 751 dealing with health maintenance organizations (HMOs). Dr. Robert Harder of Social and Rehabilitation Services testified first. (See Attachment II.) He noted that an amendment is needed to show that the charge could not be in excess of what is in the HMO policy.

Bill Pitsenberger, HMO Kansas, testified in support of the bill. He said there are seven HMOs in Kansas insuring 100,000. They work well in reducing costs because of control of the primary care physician. He has a conceptual objection to the bill in that there has not been any mandated coverage for HMOs since they began, and all has been working well. The bill may destroy the cost containment accomplished by HMOs. Also, he objects because coverage for pre-existing conditions will affect cost containment.

Last to testify on SB 751 was Richard Harmon for Health Care Plus and Humana. He also expressed conceptual opposition to the bill. He said HMOs operate with the concept of primary care physician, and this bill would circumvent that and hamper HMOs in cost containment.

The chairman related a call from Sylvia Hoagland now in Dallas with Hospital Corporation of America who wanted to register her objectins to the bill. This concluded the hearing on SB 751.

Attention was turned to SB 729 dealing with recording and reporting of loss and expense experience by insurance companies which had been previously heard. Technical amendments had been prepared by staff regarding references to rules and regulations. (See Attachment III.) Staff explained them to the committee.

Sen. Kerr made a motion to accept the amendments, Sen. Strick seconded, motion carried.

Sen. Karr made a motion to report SB 729 favorable for passage as amended. Sen. Gordon seconded, and the motion carried.

Consideration of HB 3097 dealing with auxiliary banking services which had been previously heard began. The chairman recalled the House floor amendment.

Sen. Harder made a motion to amend the bill by striking lines 101-104. Sen. Werts seconded, and the motion carried.

Sen. Werts made a conceptual motion to make technical amendments necessary. Sen. Karr seconded, and the motion carried.

Sen. Werts made a motion to recommend HB 3097 favorable for passage as amended. Sen. Karr seconded, and the motion carried.

Attention was turned to HB 2737 dealing with insurance coverage for alcohol, drug abuse, or mental conditions. The chairman informed the committee that he had talked to AFL-CIO and found that they have no position on subsection (e) which the committee had discussed at the hearing.

Sen. Burke made a motion to strike subsection (e). Sen. Karr seconded, and the motion carried.

A discussion followed regarding striking lines 49 and 50 applying to individual policies which testimony had indicated could cause adverse selection.

Sen. Kerr made a motion to amend HB 2737 to remove the reference to individual policies to remove the possibility of adverse selection. Sen. Warren seconded.

Staff said that these amendments would make these applicable to individual policies. Discussion followed, and Sen. Kerr stated that if it is mandated, the burden should be placed on all equally. Upon a call for a vote on the motion, the motion carried.

The chairman pointed out to the committee that this bill has been around a long time and has been recommended not to be recommended. It will add additional costs to policyholders and goes against the policy already set against mandated insurance.

Sen. Burke said he is persuaded by the argument that although they may be mandating additional costs, employers will reap the benefit by keeping employees on the job. Sen. Karr felt the bill needs to get to the floor for debate and that the insurance framework could handle the problem rather than the state. Sen. Kerr said he has voted against mandates but is disturbed when the burden is placed on employers rather than on the state. He feels this is a more effective way to approach the problem. Also, he feels inpatient care is more expensive and made a motion to conceptually amend HB 2737 by striking the inpatient portion and making a dollar limitation on the second page to apply to inpatient and outpatient care and send the bill to the floor with this conceptual amendment. Sen. Strick seconded, and the motion carried.

CONTINUATION SHEET

MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE,

room 529-S, Statehouse, at 9:00 a.m./~~p.m.~~ on April 2, 1986.

Attention was returned to SB 750. Discussion began with regard to how to deal with the unlawful delegation of legislative authority. The chairman suggested changing it to "investment advisory act of 1940 as amended, and the rules and regulations promulgated thereunder as of the date of this act." Sen. Burke made a motion to put in the wording "no less restrictive than provided by the federal act." Discussion followed, and Sen. Werts seconded the motion. The motion carried.

Sen. Kerr made a motion to recommend SB 750 favorable for passage as amended. Sen. Burke seconded, and the motion carried.

Consideration returned to SB 751. Sen. Gannon made a motion to conceptually amend SB 751 to the effect that coverage under this provision would be no greater than if the patient were committed by an attending physician. Discussion followed, and staff felt this limitation is already in the bill. Sen. Gannon withdrew his motion.

Sen. Gannon made a motion to recommend SB 751 favorable for passage. Sen. Strick seconded. Discussion followed regarding court ordered admissions. On a call for a vote on the motion, the voice vote was not clear. The chairman called for a show of hands, and the motion carried.

The meeting was adjourned.

SENATE COMMITTEE

ON

FINANCIAL INSTITUTIONS AND INSURANCE

OBSERVERS
(Please print)

DATE	NAME	ADDRESS	REPRESENTING
4-2-86	Jim Allen	Topeka	KBA
"	Pete McGill	"	KIBA
"	Chip Wheelen	"	KIBA
"	Chris Edwards	"	Reimer / Koger Assoc.
"	Ken Koger	Mission	Reimer Koger Assoc
"	Bob Edmonds	Topeka	R&K
"	JOHN WURTH	TOPEKA	SECURITIES COMMISSION
"	Richard Harmon	Topeka	Health Care Plus, Inc. Humana, Inc
	Ric Silber		DOB
"	Pamela Patterson	Topeka	Assoc. of CMHC's of KS
"	Pam Klotz	Topeka	Assoc. of CMHC's of Ks.
12	Gerald Hoffman	Topeka	SRS
13	Robert C. Mueller	Topeka	SRS
	Elizabeth E. Taylor	"	KADACA/KAADPD
	Larry Magill	"	IND. INS. AGENTS OF KS.
	Roger h. Walker	Topeka	Securities Commissioner
	Wayne Morris	"	Security Benefit Life
	William Fitzenberger	Topeka	Blue Cross Blue Shield
	JACK ROBERTS	"	" "

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SENATE BILL 750
INVESTMENT ADVISERS ACT

LEGISLATION BRIEF

On November 26, 1985 the Securities and Exchange Commission adopted Rule 205-3 under the Investment Advisers Act of 1940. The rule permits any registered investment adviser to be compensated on the basis of a share of capital gains on or capital appreciation of client assets. Compensation of this type, generally referred to as "performance" or "incentive" fee, is prohibited by Section 205 of the Investment Advisers Act of 1940 with certain limited exceptions. Under the general exemptive authority of Section 206A of the Investment Advisers Act of 1940, however, the Securities and Exchange Commission has issued a number of orders permitting registered investment advisers to charge performance fees. The Commission now has adopted a General Exemptive Rule which will permit investment advisers subject to regulation under the Investment Advisers Act of 1940 to receive performance fees under certain limited circumstances. These circumstances are explained in the attached pages of the November 26, 1985 Federal Register.

Section 17-1253(c) of the Kansas Securities Act provides that, "It is unlawful for any investment adviser to enter into, extend, or renew any investment advisory contract unless the investment adviser provides in writing:

> (1) That the investment adviser shall not be compensated on the basis of a share of the capital gain upon or capital appreciation of the funds or any portion of the funds of the client."

It is clear that fees based upon a share of the capital gains upon or capital appreciation of a client's account now permitted under the federal exemptive rule are prohibited by statute in Kansas.

In the past when changes have been made in federal statutes and rules relating to securities, Kansas law has been amended and corrected to conform with federal statutes and rules. That is the situation in this case.

The legislation has the support of the office of the Securities Commissioner as well as the support of investment advisers across the state of Kansas and the National Association representing investment advisers and counselors.

To make this change, Senate bill 750 has been proposed. The change is simply a technical one, allowing the Kansas law to conform with federal changes in the Investment Advisers Act of 1940.

Attached you will find a copy of the Securities and Exchange Commission rule from the Federal Register, Volume 50, number 228. Also attached is a chart detailing other state activity in this area. Of the states that have a direct prohibtion, it has been

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Attachment I

determined that a majority of the states are considering legislation that would allow such compensation consistent with the new federal rule.

As always, I thank you for your consideration in this matter.

REGISTERED INVESTMENT ADVISERS
INCENTIVE COMPENSATION
STATE SURVEY

March 20, 1986

The following chart sets forth a survey of state statutes and how each statute governs incentive compensation based on a share of capital gains for registered investment advisers.

NO PROHIBITION	PROHIBITION EXCEPT WHAT PERMITTED UNDER INVESTMENT ADVISERS ACT 1940	MISC. (NO PROHIBITION)	DIRECT PROHIBITION
Alabama	Connecticut	California (1)	Alaska
Arizona	Kentucky	Illinois (2)	Arkansas
Colorado	Michigan	Maine (3)	Delaware
Dist. Columbia	Pennsylvania	Massachusetts (3)	Hawaii
Florida		Mississippi (3)	Idaho
Georgia		Oregon (1)	Indiana
Iowa		Tennessee (4)	Kansas
Louisiana			Maryland
Nevada			Minnesota
New York			Missouri
North Carolina			Montana
Ohio			Nebraska
Rhode Island			New Hampshire
South Dakota			New Jersey
Texas			New Mexico
Vermont			North Dakota
Wyoming			Oklahoma
			South Carolina
			Utah
			Virginia
			Washington
			West Virginia
			Wisconsin

(1) Exemptive rule allowed
(2) Fair and reasonableness standard and disclosure
(3) No prohibition except as may be fraudulent or deceptive

N.B. In some manner, 28 states permit incentive compensation based on a share of capital gains

amendments will have no effect on competition. In this regard, the amendments provide all examining authorities with an alternative method of supplying information for which they currently are required to provide the Commission.

V. Regulatory Flexibility Act Consideration

Section 603(a) [8] of the Administrative Procedure Act,[9] as amended by the Regulatory Flexibility Act ("RFA"),[10] generally requires the Commission to undertake a regulatory flexibility analysis of the impact of a rule or amendment on "small entities," unless exempted under Section 605(b) on the basis that the rule or rule amendments would not have a significant impact on a substantial number of small entities. The amendments' primary effect will be to provide the MSRB and the examining authorities a more efficient method of making available to the MSRB information regarding compliance examinations of municipal securities brokers and dealers. Because the MSRB and the examining authorities are not small entities for purposes of the RFA, the Chairman of the Commission has certified that the amendments will not have a significant impact on a substantial number of small entities.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

VI. Statutory Basis and Text of the Amendments

Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read as follows:

Authority: Sec. 23, 48 Stat. 901, as amended, 15 U.S.C. 78w. Section 240.15Bc7–1 issued under Secs. 15B, 17, and 23(a), 15 U.S.C. 78*o*–4, 78q, and 78w(a).

2. Section 240.15Bc7–1 is revised as follows:

§ 240.15Bc7–1 Availability of examination reports.

(a) Upon written request, copies of any report of an examination of a municipal securities dealer made by the Commission or furnished to it by an appropriate regulatory agency pursuant to section 17(c)(3) of the Act or by a registered securities association pursuant to section 15B(c)(7)(B) of the Act shall be made available to the Municipal Securities Rulemaking Board (the "Board") by the Commission subject to the following limitations:

(1) The Board shall establish by rule and shall maintain adequate procedures for ensuring the confidentiality of any information made available to it by the Commission pursuant to section 15B(c)(7)(B) of the Act;

(2) Information made available to the Board shall not identify any municipal securities broker, municipal securities dealer, or associated person that is the subject of a non-public examination report.

(b) If information to be made available to the Board is furnished to the Commission on a separate form prepared by an appropriate regulatory agency other than the Commission or by a registered securities association, that form, rather than a copy of any report of an examination, will be made available to the Board, provided that the conditions set forth in this paragraph are satisfied. Within sixty days of every six month period ending May 31 and November 30, each appropriate regulatory agency or registered securities association making available information on a separate form shall furnish to the Commission two copies of a form containing the information set forth in paragraphs (b)(1) through (b)(8) of this section. The Commission shall make one copy of the form promptly available to the Board. Copies of any forms furnished pursuant to this paragraph shall not identify any municipal securities broker, municipal securities dealer, or associated person that is the subject of an examination from which information was derived for the form; however, the Commission may obtain for its own use, upon request, the identity of any such examinee or the full examination reports. Furnished forms shall include the following information:

(1) The report period.

(2)(i) With respect to a registered securities association, the number of examinations that formed the basis of the report and, of these examinations, the number that were routine, special, and financial/operational. (ii) With respect to an appropriate regulatory agency that is a bank agency, the number of examinations that formed the basis of the report and, of these examinations, the number that were routine, special, and financial/operational. The number of examinations that formed the basis of the report of bank dealers and the number of examinations of separately identifiable departments or divisions of banks effecting municipal securities transactions.

(3) Indications of the violations of each Board rule found in examinations that formed the basis for the report.

(4) Copies of public notices issued during the report period of any formal actions and non-public information regarding any actions taken on violations of Board rules.

(5) Any comments concerning any questionable practices relating to municipal securities activities, whether or not covered by provisions of the Act and the rules and regulations thereunder, including the rules of the Board.

(6) Descriptions of any significant or recurring customer complaints relating to municipal securities activities received by the appropriate regulatory agency or registered securities association during the report period or by municipal securities dealers during the 12 month period preceding the examination.

(7) Description of any novel issues or interpretations arising under the Board's rules.

(8) Description of any changes to existing Board rules or additional rules that would improve the regulatory scheme for municipal securities professionals or assist in the enforcement of the Board's rules.

(c) Copies of any report of an examination of a municipal securities broker or municipal securities dealer made by the Commission or furnished to it pursuant to section 15B(c)(7)(B) or section 17(c)(3) of the Act, or separate forms made available to the Commission pursuant to paragraph (b) of this section, will be maintained in a non-public file.

Dated: November 7, 1985.

By the Commission.

John Wheeler,

Secretary.

[FR Doc. 85–28001 Filed 11–25–85; 8:45 am]

BILLING CODE 8010-01-M

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17 CFR Part 275

[Rel. No. IA 996; File No. S7–11–85]

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

AGENCY: Securities and Exchange Commission.

ACTION: Adoption of Rule.

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[8] 5 U.S.C. 603(a).

[9] 5 U.S.C. 551 *et seq.*

[10] Pub. L. No. 96-354, 94 Stat. 1164, (September 19, 1980).

SUMMARY: The Commission is adopting a rule under the Investment Advisers Act of 1940 to permit registered investment advisers to charge certain clients performance or incentive fees. Under the Advisers Act, registered investment advisers may not enter into performance fee contracts except under the limited circumstances set forth in the Act or under a Commission exemptive order or rule. The rule as adopted, which reflects certain changes made as a result of comments on the proposed rule, will provide registered investment advisers and their clients significantly more flexibility in negotiating their compensation arrangements.

EFFECTIVE DATE: November 26, 1985.

FOR FURTHER INFORMATION CONTACT: Forrest R. Foss, Special Counsel (202–272–2105), or John Banks-Brooks, Attorney Adviser (202–272–7313), Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549. After the effective date, questions should be directed to: Office of the Chief Counsel (202–272–7308), Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is today adopting Rule 205–3 under the Investment Advisers Act of 1940 ("the Advisers Act"). The rule, which was proposed for public comment on March 15, 1985,[1] permits a registered investment adviser to be compensated on the basis of a share of the capital gains on or capital appreciation of client assets. Compensation of this type, generally referred to as a "performance" or "incentive" fee, is prohibited by Section 205 of the Advisers Act with certain limited exceptions. Under the general exemptive authority of Section 206A of the Act, however, the Commission has issued a number of orders permitting registered investment advisers to charge performance fees. The Commission has now determined to adopt a general exemptive rule which will permit investment advisers subject to registration under the Act to receive performance fees under certain limited circumstances.

Under the rule as adopted, a registered investment adviser may enter into an advisory contract calling for a performance fee if: (a) The client (i) has at least $500,000 under the management of the adviser; or (ii) the adviser reasonably believes the client has a net worth of at least $1,000,000; (b) the adviser's compensation is based on a formula which includes realized capital losses and, under certain circumstances, unrealized capital depreciation; (c) the compensation paid to the adviser under the rule is based on performance over a period of not less than one year; (d) the adviser discloses certain information to the client; and (e) the adviser reasonably believes that the contract represents an arm's-length arrangement between the parties and that the client, alone or together with the client's independent agent, understands the performance fee contract and its risks.

Where the client entering into a performance fee contract is a registered investment company, business development company or a certain type of pooled investment vehicle, defined in the rule as a "private investment company," the eligibility requirements of the rule are modified. These entities may enter into contracts under the rule only if each of their equity owners individually satisfies the rule's eligibility conditions. Finally, the rule provides a limited degree of transitional relief for certain performance fee contracts in existence prior to November 14, 1985.

I. Background

A. General

Section 205(1) of the Advisers Act prohibits an investment adviser subject to registration from entering into, extending, renewing or performing any investment advisory contract which provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of a client. The prohibition against performance-based compensation does not apply to: (i) Advisory contracts which provide for compensation based on the total value of the client's account averaged over a definite period, or as of definite dates, or taken as of a definite date; (ii) contracts with investment companies registered under the Investment Company Act of 1940 ("Investment Company Act") provided that an appropriate fulcrum fee is used;[2] (iii) contracts relating to the investment of assets in excess of $1,000,000 with persons other than trusts, collective trust funds, or separate accounts referred to in section 3(c)(11) of the Investment Company Act [15 U.S.C. 80a–3(c)(11)] provided that an appropriate fulcum fee is used; and (iv) advisory contracts involving business development companies provided the conditions set forth in section 205(C) of the Advisers Act [15 U.S.C. 80b–5(C)] are met.

Congress enacted the prohibition of Section 205(1) against performance fees in 1940 to protect clients of investment advisers from fee arrangements which in Congress' view could encourage advisers to engage in speculative trading practices while managing client funds in order to realize or increase an advisory fee.[3] In 1970, Congress enacted Section 206A of the Advisers Act which authorizes the Commission to exempt any person or transaction from any provision of the Act, provided the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Advisers Act. At the time it enacted section 206A, Congress specifically indicated that Commission action would be appropriate in certain cases "to exempt persons . . . from the bar on performance [compensation]."[4] Beginning in 1975, the Commission began granting exemptive orders from the section 205(1) prohibition.[5]

B. The 1983 Proposal

Prompted by criticism from the investment advisory industry that the general ban on performance fees was unnecessary for certain clients, the Commission undertook a review of the propriety of providing more general relief from the prohibition than was possible through the individual exemptive order process. This review resulted in a June, 1983 proposed rule.[6]

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[1] Investment Advisers Act Release No. 961 (50 FR 11718).

[2] A fulcrum fee is one in which the adviser's fee is averaged over a specified period and increases and decreases proportionately with the investment performance of the account in relation to the investment record of an appropriate index of securities prices.

[3] H.R. Rep. No. 2639, 78th Cong. 3d Sess. 29 (1940). Performance fees were characterized as, "heads I win, tails you lose," arrangements in which the adviser had everything to gain if successful and little, if anything to lose, if not. S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940). *See also,* Report of the Securities and Exchange Commission on Investment Counsel Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 3d Sess. 30 (1939).

[4] S. Rep. No. 91–184, 91st Cong., 1st Sess. 46 (1969); H.R. Rep. No. 91–1382, 91st Cong., 2d Sess. 42 (1970).

[5] *See* Investment Advisers Act Release Nos. 459 and 461; May 7, 1975, and June 5, 1975, respectively.

[6] The Commission initially proposed an exemptive rule under Section 205 in 1979 (Investment Advisers Act No. 680, June 19, 1979). The rule, however, was limited to investment advisers to business development companies. Prior to final action by the Commission, Congress enacted section 205(C) which, as noted, permits investment advisers to business development companies to receive performance compensation limited to not more than 20% of net realized capital gains of the business development company. The proposed exemptive rule was withdrawn in Investment Advisers Act Release No. 750 (February 20, 1981).

Subject to certain conditions, the 1983 proposal would have provided general exemptive relief for registered advisers to enter into contracts with persons who, because of their wealth and financial knowledge and experience, were considered to be less dependent on the protections which the performance fee prohibition is intended to provide.[7]

The 1983 proposal generated a varied response from members of the public, and, in May, 1984, it was withdrawn.[8] After withdrawal of the proposal, however, the Commission continued to grant individual orders permitting registered investment advisers to charge certain clients performance fees. Since 1975, the Commission has granted a total of 22 orders, with 13 granted since the 1983 proposal.

C. The 1985 Proposal

The conditions of the 1985 proposal were based on the specific provisions of Section 205 of the Act, a review of the legislative history of that section, Congressional intent with regard to the limitations on performance fees and individual exemptive orders granting relief from the prohibition of Section 205(1).[9] In response to the 1985 proposed rule, the Commission received 49 comment letters. Forty-three commentators either supported the rule as proposed or with certain modifications. Six opposed adoption of a general performance fee exemption.[10]

After considering the comment letters and its reasons for proposing the rule, the Commission has decided to adopt the rule with certain changes. The Commission believes that permitting the use of performance fees in the limited circumstances allowed by the rule is in the public interest and consistent with the protection of investors and the purposes fairly intended by the Advisers Act. The Commission's decision to provide generic relief for performance fees under certain limited circumstances is based on its experience in granting individual exemptive orders, its review of the legislative history of section 205(1) and section 206(A), and the experience of other regulatory authorities in areas where performance fees are allowed. The Commission has concluded that it is consistent with the protection of investors and the purposes of the Act to permit clients who are financially experienced and able to bear the risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate. The Commission believes that the conditions of the rule provide alternative safeguards to the statutory prohibition. The rule should result in more competition among advisers and more flexibility for investors without sacrificing investor protections. As noted, however, the Commission is modifying the proposed rule in certain respects. These changes and the specific provisions of the final rule are discussed in detail below.

II. General Provisions of the Rule

A. Exemption

Paragraph (a) of the rule as adopted is identical to paragraph (a) of the proposed rule. It provides relief from the general prohibition of section 205(1) of the Advisers Act to permit a registered investment adviser to enter into and perform an advisory contract which provides for a performance fee provided all of the conditions of the rule are met.

B. Eligible Clients

Paragraph (b) sets forth alternative objective tests for measuring client eligibility to enter into a performance fee contract under the rule. Commentators expressed widespread support for the proposed tests as appropriate means of determining client capacity to understand and bear the risks associated with performance fee contracts. Several commentators, however, urged the Commission to revise the eligibility standards of the paragraph or clarify their applicability.

A number of commentators, referring to Regulation D under the Securities Act of 1933, urged the Commission to extend client eligibility to any natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 in the current year.[11] Two commentators argued that clients be required to have both $1,000,000 in net worth and at least $500,000 under the adviser's management.

Several commentators addressed the proposal's condition that, in measuring net worth, the net worth of a natural person may include assets held jointly with the person's spouse. One commentator argued that the emphasis on joint ownership is unduly restrictive and that it should be permissible for assets owned individually by a single spouse, that is, not in any joint capacity, to be counted toward the other spouse's net worth for purposes of the rule. Other commentators advocated expanding the net worth standard to permit the aggregation of assets of all family members, whether or not a spousal relationship exists, or to permit the aggregation of assets of employee benefit plans with a common sponsor.

The rule, as adopted, does not incorporate these suggestions. In the Commission's view, the proposed alternative eligibility tests—$500,000 under the adviser's management or $1 million net worth (including assets held jointly with the client's spouse)—will provide sufficient flexibility to advisers and clients while adequately protecting investors within the policies and purposes of the Advisers Act.

In response to concern over how an adviser could verify the net worth of a client so as to be certain that the client was eligible to enter into a performance fee contract under the rule, the rule as adopted provides that an eligible client includes any person who the adviser, immediately prior to entering into the contract, reasonably believes satisfies the net worth test. The Commission emphasizes however, that an adviser would be required to make whatever inquiry is necessary to satisfy this test.

C. Contractual Provisions

1. *Compensation Formula.* Paragraphs (c) (1) and (2) of the rule as adopted are identical to the proposal. These two paragraphs set forth different methods of calculating the compensation paid to

[7] Investment Advisers Act Release No. 865; (48 FR 27771, June 17, 1983). The 1983 proposal set forth a two-part test to determine client eligibility to enter into a performance fee contract. The first part required that the adviser make a finding that the client or his representative was sufficiently knowledgeable about and experienced in financial and business matters to understand the merits and risks of the performance fee contract. The second part required the performance fee contract to relate to a minimum of $150,000 in assets. The proposal also set forth certain information to be disclosed by the adviser to the client.

[8] Investment Advisers Act Release No. 911, May 2, 1984; (49 FR 19524, May 8, 1984).

[9] For a full discussion of the rationale underlying the 1985 proposal, see IA Release No. 991, March 15, 1985 (50 FR 11718). For a similar discussion, see the 1983 proposing release (IA Release No. 865) which also refers to the experience of other regulatory authorities in areas where performance fees are allowed.

[10] Opponents of the rule argued that performance fees would lead to conflicts of interest between advisers and clients and to unnecessary speculation by advisers. They also disagreed that any widespread demand by clients for performance fees exists. Some commentators opposing the rule acknowledged that incentive fees might be appropriate in certain areas where they have been customary (i.e., venture capital and real estate), but argued these fees would not be appropriate for managing a traditional securities portfolio. Opponents also argued that performance compensation would not lead advisers to work or give better advice inasmuch as advisers presumably perform to the best of their ability now under traditional fee arrangements.

[11] Regulation D under the Securities Act of 1933 uses this $200,000 income test in defining one of the categories of persons considered to be accredited investors. *See* 17 CFR 230.501(a)(7).

an adviser for a given period depending on the nature of the securities being managed. With respect to securities for which market quotations are readily available, the compensation formula must include the realized capital losses and unrealized capital depreciation of the securities over the period. For securities for which market quotations are not readily available, the formula must include the realized capital losses of the securities over the period and, if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period must be included.

In response to several comments, the Commission wishes to emphasize that the factors referred to in paragraphs (c)(1) and (2), namely realized *capital* gains and losses and unrealized *capital* appreciation and depreciation, are only the minimum elements which any compensation formula under the rule must contain. Other factors also may be included, as appropriate. For example, paragraphs (c)(1) and (2) do not prohibit a compensation formula which includes income derived from interest and dividends in the determination of an advisory fee under the rule.[12]

In a related manner, in the proposing release, the Commission requested comment on whether a twenty percent (or some other percentage) limitation on the amount of performance fees would be appropriate. Commentators overwhelmingly were opposed to the imposition of a maximum percentage limitation on the amount of a performance fee under the rule. Because the Commission believes that the appropriate level of a performance fee is a matter best decided by the parties to the contract, and because of the various protections of the rule designed to prevent overreaching by the adviser, it has decided not to incorporate a mandatory percentage limitation on fees into the rule.

2. *Cumulative Losses.* Paragraph (c)(3) of the proposed rule required that any compensation paid to the adviser for a given period under the rule be based on the lesser of (i) the gains in the client's account for that period; or (ii) the cumulative gains less the cumulative losses, in the client's account for that period and all prior periods. The conditions of paragraph (c)(3) were modelled largely on prior section 205 exemptive orders to require that performance fees be based on an adviser's over-all performance over the term of a contract.[13]

A sizeable majority of persons commenting on paragraph (c)(3) characterized its cumulative loss provisions as unnecessary or unworkable and urged that the paragraph be modified or eliminated. Many argued that a cumulative loss requirement is inappropriate in light of the other conditions of the rule, especially the eligibility standards which are designed to limit performance fee contracts to persons capable of bearing and understanding their risks. Several claimed that it would increase the likelihood that an adviser would take undue risks in managing an account, particularly if an adviser were in a net loss position because the chance of obtaining a gain would be the only way of earning a fee. Others pointed to possible problems in the mechanical operation of the provision. A suggested alternative proposed by two commentators was the use of a minimum one year measurement period in any performance fee contract.

Upon consideration of these comments, the Commission has decided to revise paragraph (c)(3). As adopted, paragraph (c)(3) requires that any compensation paid to the adviser under the rule be based on the gains less the losses (computed in accordance with paragraphs (c)(1) and (2)) in the client's account for a period of not less than one year.[14] Contracts which measure performance for a period of less than one year would not be exempt under the rule. Performance fee contracts which terminate prior to the expiration of a one year period could provide for compensation to the adviser only if the compensation were not based on the capital gains or appreciation in the client's account.[15]

In the Commission's view, a one year period is sufficiently long generally to achieve the purpose of the proposed cumulative loss provision—precluding an adviser from basing an incentive fee on short term fluctuations in securities prices. At the same time, the flexibility afforded by the one year provision is more appropriate in the context of a general exemptive rule. Finally, use of at least a one year period for measuring performance is common among advisers relying on the statutory exemption for fulcrum fees. Thus, the Commission anticipates that the problems commentators perceived with the proposal's use of an open-ended cumulative loss period will be avoided.[16]

D. Disclosure

The disclosure provisions of the rule as adopted are substantially identical to those of the proposal. Paragraph (d)(3) of the rule regarding disclosure of periods used to measure performance has been amended to reflect the changes made in the cumulative loss provision of the proposal. The amended paragraph now requires disclosure of the periods used throughout the contract as well as the practical effect of these periods on the amount of the performance fee paid to the adviser and the intervals at which the fee is paid.

Several commentators described various factual situations with which advisers might be faced and suggested that the Commission specify in the rule the information which must be disclosed with respect to them. The Commission has decided not to adopt this approach. As stated in the proposing release, the disclosure requirements specifically referred to in paragraph (d) of the rule constitute minimum obligations of the adviser. They have been included because of the broad exemptive nature of the rule and because the Commission believes they reflect matters which may often arise in the context of performance fee contracts. However, the requirements of paragraph (d) should not be read as narrowing, in any manner, the disclosure obligations of

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[12] The traditional position of the staff has been that the Section 205(1) prohibition against performance fees does not prohibit a fee based on income derived from dividends and interest. Investment Advisers Act Release No. 721 at note 5 (May 16, 1980).

[13] *See*, for example, *Show Management Co., Inc.* (Investment Advisers Act Release Nos. 875 and 878, July 29, 1983 and August 24, 1983, respectively); and *Maier & Siebel, Inc.* (Investment Advisers Act Release Nos. 829 and 830, October 20, 1982 and November 10, 1982, respectively).

[14] Advisers could use any method for receiving payment of the performance fee provided it is consistently applied and fully disclosed to the client. For example, the fee could be paid annually after each year's performance, or the fee could be paid on a rolling basis beginning at the end of a year's performance. However, regardless of the method chosen, no part of the performance fee may be paid for any period of less than one year.

[15] Rule 205-3 does not prohibit an adviser from charging a non-performance related fee, for example a fee based on the percentage of assets under management, in addition to the performance fee. However, the anti-fraud provisions of Section 206 of the Advisers Act may be violated where the total advisory fee charged is higher than the total fee normally charged for similar services without disclosure to clients that similar services may be available elsewhere at a lower fee. *See* Alan D. Pekelner (pub. avail. June 6, 1977).

[16] The use of a minimum one year measurement period under the rule does not affect the staff's general position on termination provisions of advisory contracts. In this regard, in *Robert D. Brown Investment Counsel, Inc.* (July 19, 1984) the staff took the position that an adviser would breach "its fiduciary duty and violate section 206(2) of the Act by entering into a contract for the provision of investment supervisory services which purported to bar a client from terminating the relationship except annually." Advisers relying on Rule 205-3 are expected to comply with the position.

investment advisers under the Act or other applicable law. In this regard, advisers are reminded of their duty under Section 206 of the Act of " 'utmost good faith and full and fair' disclosure of all material facts" (*SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 194 (1963)) and of the requirements of Form ADV regarding the disclosure of advisory fees.[17]

E. Arm's-Length Transaction

Paragraph (e) of the proposed rule required that an investment adviser seeking to enter into a performance fee contract under the rule reasonably believe, immediately prior to entering into the contract, that the contract represents an arm's-length arrangement between the parties, and that the client, alone or together with the client's independent agent, fully understand the risks of the proposed method of compensation. One commentator recommended that the language of the proposal requiring that a client "understand the risks of the proposed method of compensation" be amended to state that the client "understand the proposed method of compensation and its risks." The rule as adopted reflects this slight modification. In the Commission's view, the new language better reflects the requirement that the client understand the performance fee arrangement in its totality, not just its risks.

Other commentators were uncertain as to the correct application of the arm's-length standard. They noted many advisers have developed standard contracts and expressed concern that the arm's length requirement may suggest that the terms of each fee arrangement between the adviser and client must be negotiated. The commentators were uncertain whether acceptance by a client of a non-negotiable advisory contract would satisfy the arm's-length requirement. In the Commission's view an arm's length arrangement between the parties is one whose terms correspond to those which independent parties of equal bargaining position would arrive at after negotiation and without overreaching by either party. Use by an adviser of a standard performance fee contract would not preclude the contract from representing "an arm's-length arrangement between the parties" within the meaning of the rule. As noted in the proposing release, paragraph (e) is intended to supplement the disclosure obligations of paragraph (d) of the rule in a manner intended to ensure that the adviser satisfies his affirmative duty of finding that the client thoroughly appreciates the nature of the performance fee contract. In addition, the Commission believes the paragraph (e) provides an important and necessary safeguard in that the effect of this condition is to place on the adviser the burden of demonstrating that its performance fee contracts do not involve overreaching and are limited to clients who can fend for themselves.

G. Transition Rule

Paragraph (f) of the rule as adopted is new. It was added as a result of comments suggesting the need to address the problem created if an adviser not subject to registration, with preexisting performance fee arrangements with clients, later registers with the Commission. Under paragraph (f), paragraphs (b), (c) and (e) of the rule will not apply to an advisory contract between an investment adviser and a client provided the contract was first entered into prior to November 14, 1985 and continues in force after the effective date of the rule. The disclosure provisions of paragraph (d) of the rule, however, would apply with respect to preexisting clients who were parties to any such contract. In addition, the provisions of paragraph (e) would apply to any renewal or extension of such a contract. The transitional relief provided by paragraph (f) would be limited to advisory contracts with advisers who were, at the time the contracts were entered into, not registered or required to be registered as advisers under the Act. Finally, all provisions of the rule would apply to persons who become a party to a performance fee contract with a registered investment adviser after the effective date of the rule.

H. Definitions

Paragraph (g) contains definitions of terms used in the rule. Paragraph (g)(4) defines the term "client's independent agent" to exclude persons whose independence could be comprised because of direct or indirect conflicts of interest.

Several commentators argued that the proposal unnecessarily excluded certain persons from acting as the client's independent agent. It was asserted, for example, that the proposed definition would effectively bar a bank or the trustee of a trust, which held a single share of a publicly held advisory company, from acting as the independent agent of any client who entered into a performance fee contract with the advisory company. A suggested approach was to provide an exception in the rule so that, in the situation referred to above, the bank or trustee would not be prohibited from acting as the client's independent agent if the bank or trust's interest in the adviser was less than a certain *de minimis* amount. The Commission believes that the definition of client's independent agent may be modified in the manner suggested by the comments without compromising investor protections. Paragraph (g)(5)(ii) of the rule as adopted provides that a person may still qualify as an independent agent where his interest in the investment adviser constitutes less than 1/10 of 1% of any class of outstanding securities of the adviser and the interest represents less than 5% of the total assets of the agent.

Another commentator pointed out that the definition would prohibit a relative of a client from acting as the independent agent of the client if the relative were affiliated with the adviser. It was argued that this could be unfair in situations where, for example, the relative was generally responsible for making investments decisions for his parents or children. The Commission is not persuaded that it is appropriate to eliminate the protections provided by the "independent agent" requirement for relatives of person affiliated with the adviser.

Finally, several commentators urged the Commission to amend the definition to allow the limited partner of an investment partnership (or a representative of the limited partner) to act as the independent agent of the partnership. The Commission has decided not to incorporate this suggestion into the rule as adopted. In the Commission's view, a limited partner in a limited partnership may not be in a position to provide the type of objective advice to other potential limited partners that the rule seeks to ensure from client agents.

I. Other Matters

One commentator noted that a number of the individual exemptive orders granted under Section 205 have extended exemptive relief to the books and records requirements of Rules 204-2(b) and (c) under the Advisers Act.[18]

[17] Registered advisers entering into performance fee contracts under the rule would be required to promptly amend Form ADV to reflect their new fee arrangements.

[18] Rule 204-2(b) sets forth specific books and record requirements for registered investment advisers with custody or possession of client securities or funds and Rule 204-2(c) sets forth specific requirements for advisers rendering investment supervisory or management services to clients.

The relief has been provided to the extent the provisions of that rule might require an investment advisor, acting as the general partner of an investment limited partnership, to maintain separate books and records of the underlying interests of each limited partner in the partnership. Advisers obtaining these exemptions have typically represented that they will maintain a capital account for each limited partner which reflects capital contributions, and all income, gains, expenses, losses, withdrawals and distributions.

Upon review of this matter, the Commission has determined that, for purposes of performance fee contracts entered into under Rule 205–3, exemptive relief from the provisions of Rules204–2(b) and (c) is not necessary. Rules 204–2(b) and (c) require that books and records be maintained by advisers on behalf of certain *clients*. Thus, for purposes of this rule, where the client entering into the performance fee contract is an investment limited partnership (or other private investment company), Rules 204–2(b) and (c) would require that the designated books and records be maintained only for the client limited partnership (or other entity) and not the limited partners of the partnership (or equity owners of the private investment company).

A number of commentators pointed out that many states have adopted laws or imposed requirements generally prohibiting advisers from receiving performance fees. The Commission believes that successful operation of a performance fee exemption at the federal level may encourage these states to reexamine their requirements. However, adoption of Rule 205–3 by the Commission does not in any way affect an adviser's obligation to comply with applicable state requirements.

In a related context, a number of commentators expressed concern over the effect of the rule on advisers to employee benefit plans, subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 et seq. The Commission emphasizes that adoption of Rule 205–3 in no way affects 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.

Several commentators suggested that the Commission should amend Rules 205–1 and 205–2, which set forth requirements for fulcrum fee compensation arrangements. The Commission is not adopting changes in these rules at this time. The Commission's staff will consider, however, whether, in light of the comments received, changes in these rules are necessary.

Summary of the Final Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Act Analysis, which the Commission prepared in accordance with 5 U.S.C. 603 regarding proposed Rule 205–3, was published in Investment Advisers Act Release No. 961. No comments were received on the analysis and the Commission has prepared a Final Regulatory Flexibility Analysis.

A copy of the Final Regulatory Flexibility Analysis may be obtained by contacting John Banks-Brooks, Attorney, Division of Investment Management, Securities and Exchange Commission, Room 5130, 450 Fifth Street, NW., Washington, D.C. 20549.

List of Subjects in 17 CFR Part 275

Investment advisers, Reporting and recordkeeping requirements, Securities.

Text of Rule

Part 275 of Chapter II of Title 17 of the Code of Federal Regulations under the Investment Advisers Act of 1940 is amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 is amended by adding the following cite for §§ 275.205–3 to read:

Authority: Secs. 203, 204, 211, 54 Stat. 850, as amended, 852, as amended, 855, as amended; 15 U.S.C. 80b–3, 80b–4, 80b–11 * * *; Section 275.205–3 is also issued under Section 205A (15 U.S.C. 80b–5A).

2. By adding § 275.205–3 as follows:

§ 275.205–3 Exemption from the compensation prohibition of section 205(1) for registered investment advisers.

(a) *General.* The provisions of section 205(1) of the Act shall not prohibit any registered investment adviser from entering into, performing, renewing or extending an investment advisory contract which 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 all the conditions in this rule are satisfied.

(b) *Nature of the client.* (1) The client entering into the contract subject to this rule must be (i) a natural person or a company, as defined in paragraphs (b)(2) and (g)(1) of this rule, who immediately after entering into the contract has at least $500,000 under the management of the investment adviser; or (ii) a person who the registered investment adviser (and any person acting on his behalf) entering into the contract reasonably believes, immediately prior to entering in to the contract, is a natural person or a company, as defined in paragraphs (b)(2) and (g)(1) of this rule, whose net worth at the time the contract is entered into exceeds $1,000,000. (The net worth of a natural person may include assets held jointly with such person's spouse.)

(2) The term "company" as used in paragraph (b)(1) does not include (i) a private investment company, as defined in paragraph (g)(2) of this rule, (ii) an investment company registered under the Investment Company Act of 1940 or (iii) a business development company, as defined in section 202(a)(22) of the Investment Advisers Act of 1940, unless each of the equity owners (other than the investment adviser entering into a contract under the rule) of any such company is a natural person or company described in this paragraph (b).

(c) *Compensation formula.* The compensation paid to the adviser under this rule with respect to the performance of any securities over a given period shall be based on a formula which:

(1) Includes, in the case of securities for which market quotations are readily available, the realized capital losses and unrealized capital depreciation of the securities over the period;

(2) Includes, in the case of securities for which market quotations are not readily available, (i) the realized capital losses of the securities over the period; and (ii) if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

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

(d) *Disclosure.* In addition to the requirements of Form ADV, the adviser shall disclose to the client, or the client's independent agent, prior to entering into an advisory contract under this rule, all material information concerning the proposed advisory arrangement including the following:

(1) That the fee arrangement may create an incentive for the adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

(2) Where relevant, that the adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

(3) The periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

(4) The nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the adviser believes the index is appropriate; and

(5) Where an adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued and the extent to which the valuation will be determined independently.

(e) *Arms-Length contract.* The investment adviser (and any person acting on its behalf) who enters into the contract must reasonably believe, immediately prior to entering into the contract, that the contract represents an arm's-length arrangement between the parties and that the client (or in the case of a client which is a company as defined in paragraph (g)(1), the person representing the company), alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The representative of a company may be a partner, director, officer or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent set forth in paragraph (g) (4).

(f) *Transition rule.* (1) The proviso of paragraph (a) and paragraphs (b), (c) and (e) of this rule do not apply to any advisory contract (or renewal or extension thereof) between an investment adviser and a client where (i) the contract was entered into prior to and continued in force after November 14, 1985; and (ii) the adviser, at the time the contract was entered into, was not registered or required to be registered as an investment adviser under the Act; provided however, that all provisions of this rule shall 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 the effective date of this rule.

(2) Notwithstanding paragraph (f)(1), the renewal or extension of a contract described therein will be subject to paragraph (e).

(g) *Definitions.* For the purposes of this rule:

(1) The term "company" has the same meaning as in section 202(a) (5) of the Act, but does not include a company that is required to be registered under the Investment Company Act of 1940 but is not registered.

(2) The term "private investment company" means a company which would be defined as an investment company under section 3(c) of the Investment Company Act of 1940 but for the exception provided from that definition by section 3(c)(1) of such Act.

(3) The term "affiliated person" has the same meaning as in section 2(a)(3) of the Investment Company Act.

(4) The term "client's independent agent" means any person agreeing to act as the client's agent in connection with the contract other than:

(i) The investment adviser acting in reliance upon this rule, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in paragraph (g)(5);

(ii) A person who receives, directly or indirectly, any compensation in connection with the contract from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser or an interested person of the investment adviser as defined in paragraph (g)(5); or

(iii) A person with any material relationship between himself (or an affiliated person of such person) and the investment adviser (or an affiliated person of the investment adviser) that exists, or has existed at any time during the previous two years.

(5) The term "interested person" as used in paragraph (g)(4) means:

(i) Any member of the immediate family of any natural person who is an affiliated person of the investment adviser;

(ii) Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment adviser or by a controlling person of the investment adviser if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser (A) exceeds one tenth of one percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or (B) exceeds 5% of the total assets of the person (seeking to act as the client's independent agent).

(iii) Any person or partner or employee of any person who at any time since the beginning of the last two years has acted as legal counsel for the investment adviser.

(6)(i) the term "securities for which market quotations are readily available" in paragraph (c) has the same meaning as in Rule 2a-4(a) (1) under the Investment Company Act of 1940 [17 CFR 270.2a-4(a)(1)].

(ii) The term "securities for which market quotations are not readily available" in paragraph (c) means securities not described in paragraph (g) (6) (i) of this rule.

(h) An investment adviser entering into or performing an investment advisory contract under this rule is not relieved of any obligations under section 206 of the Adviser Act or of any other applicable provisions of the federal securities laws.

(i) Nothing in this rule relieves a client's independent agent from any obligations to the client under applicable law.

By the Commission.

John Wheeler,

Secretary.

November 14, 1985.

[FR Doc. 85-28007 Filed 11-25-85; 8:45 am]

BILLING CODE 8010-01-M

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

18 CFR Part 282

[Docket No. RM 79-14]

Natural Gas Policy Act; Order of the Director, OPPR, of Publication of Incremental Pricing Acquisition Cost Thresholds

Issued November 21, 1985.

AGENCY: Federal Energy Regulatory Commission.

ACTION: Order Prescribing Incremental Pricing Thresholds.

SUMMARY: The Director of the Office of Pipeline and Producer Regulation is issuing the incremental pricing acquisition cost thresholds prescribed by Title II of the Natural Gas Policy Act and 18 CFR 282.304. The Act requires the Commission to compute and publish the threshold prices before the beginning of each month for which the figures apply. Any cost of natural gas above the applicable threshold is considered to be an incremental gas cost subject to incremental pricing surcharging.

STATE DEPT. OF SRS
Testimony Regarding Senate Bill No. 751

There is a growing number of our state's population who are being denied coverage of HMO benefits for circumstances over which they have no control. These HMO members are those patients of state mental health hospitals who have been involuntarily committed by the courts. This legislation addresses this exclusion of coverage by HMO's. It provides for HMO coverage of treatment which is given by state mental health hospitals to persons who are involuntarily committed.

Health maintenance organizations are generally organizations of primary care physicians who make assignments of care for their members. The assignments for care are made to participating providers. Persons who are involuntarily committed do not have the benefit of services of primary care physicians. Further, they do not have the benefit of receiving initial care from participating providers because they have been committed to a state facility.

Of the eight health maintenance organizations that operate in the state, none specifically provide for coverage of court directed psychiatric treatment. Six organizations require the prior authorization of a primary care physician and six require care to be given by a participating provider. Seven organizations specifically exclude coverage of involuntary admissions at state hospitals. One organization allows for the grant of waivers under emergency circumstances.

The exclusion by HMO's of coverage for care of involuntarily committed persons resulted in the loss of 154,480 during FY 1985. The projected loss for FY 1986 is 120,603. This loss is expected to increase, as the availability and use of HMO's increases among Kansans.

We encourage the passage of this legislation so that persons who are members of HMO's and who require court directed psychiatric treatment are treated equitably. Further, prohibiting the exclusion by HMO's of care for involuntary commitments would provide the state a means to recover losses that are increasing each year.

Office of the Secretary
Robert C. Harder, Secretary
296-3271

April 2, 1986

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Attachment II

STATE DEPT. OF SRS
STATEMENT REGARDING Senate Bill No. 751

LOSSES OF REIMBURSEMENT
OF STATE PSYCHIATRIC HOSPITALS
DUE TO HMO DENIAL OF COVERAGE

Hospitals	Total FY 85 Loss of HMO Coverage	FY 85 HMO Loss from Involuntary Commitments	Total Projected FY 86 Loss of HMO Coverage	Projected FY 86 HMO Loss from Involuntary Commitments
Larned State Hosp.	$ 45,072	$ 27,043	$ 70,983	$ 63,885
Rainbow Mental Health Facility	20,346	181	19,984	-0-
Osawatomie State Hospital	95,954	83,275	62,080	28,166
Topeka State Hospital	43,981	43,981	28,552	28,552
Total	205,353	154,480	181,599	120,603

STATE DEPARTMENT OF SRS
Statement Regarding Senate Bill No. 751

1. Title - This bill would prohibit certain exclusions of HMO coverage of persons who are involuntarily committed to state psychiatric hospitals.

2. Purpose - HMO's currently do not provide coverage to persons involuntarily committed to state mental health hospitals. This denial of coverage has resulted in increasing financial losses to the state. The bill would require HMO plans to include such coverage.

3. Background - An HMO is an organization which provides comprehensive health care for fixed fee. HMO's vary in structure, but health care is generally determined by primary care physicians who make decisions of assignment of care of patients. Such health care is also furnished by particular providers who are designated by the HMO as participating providers. Persons who are involuntarily committed to state mental health hospitals do not have the benefit of services of their primary care physicians. Neither do these persons have the benefit of receiving care from participating providers because they have been committed to a state facility.

   A summary follows which provides the conditions of coverage of the majority of HMO's operating in the state.

HMO	Coverage
Kaiser Foundation Health Plan of Kansas City	All care assigned by primary care physician and provided at University of Kansas Medical Center. Coverage excluded for care which is required by law to be provided in public facilities.
Total Health Care	All care assigned by primary care physician through specific psychiatric groups. Involuntary admissions not covered.
Health Care Plus of America	All care assigned by primary care physician. Involuntary admissions not covered.

HMO	Coverage
HMO Kansas	All care assigned by primary care physician. Involuntary admissions not covered.
Health Plan of MidAmerica	Care provided by state hospitals is excluded. Psychiatric care which is provided at participating hospitals is covered.
Family Health Plan	All care assigned by primary care physician.
Prime Health	All care assigned by primary care physician. Any care ordered by third party is excluded from coverage. Emergency care covered if referred to primary care physician and participating hospital within 48 hours of admission.
Human Care Plus	Care is not assigned by primary care physician; however, care must be provided by participating provider. A waiver can be granted to cover care given by non-participating provider when emergency circumstances exist.

A chart which provides the losses of reimbursement due to HMO denial of coverage follows.

4. Effect of Passage - Requiring health maintenance organizations to provide coverage to their members who are involuntarily committed at state institutions would result in significant savings of costs to the state.

5. SRS Recommendation - The Department of Social and Rehabilitation Services supports this legislation because it provides state institutions with reimbursement from HMO's that is consistent with traditional insurance. Further, passage of the legislation would result in more equitable treatment of members of HMO's who require court directed psychiatric treatment.

Office of the Secretary
Robert C. Harder, Secretary
296-3271

April 2, 1986

Session of 1986

SENATE BILL No. 729

By Committee on Federal and State Affairs

3-10

AN ACT relating to insurance; concerning recording and reporting of loss and expense experience; amending K.S.A. 40-937 and 40-1118 and repealing the existing sections.

Be it enacted by the Legislature of the State of Kansas:

Section 1. K.S.A. 40-937 is hereby amended to read as follows: 40-937. (a) *Recording and reporting of loss and expense experience.* The commissioner shall ~~promulgate~~ reasonable ~~rules and regulations and~~ statistical plans, ~~reasonably adopted to each of the rating systems on file with, which may be modified from time to time and~~ which shall be used ~~thereafter~~ by each insurer in the recording and reporting of its loss and ~~country-wide~~ expense experience, in order that the experience of all insurers may be made available at least annually in such form and detail as may be necessary to aid ~~him~~ *the commissioner* in determining whether rating systems comply with the standards set forth in K.S.A. 40-927, *and amendments thereto*. Such ~~rules and regulations and~~ plans may also provide for the recording and reporting of expense experience items which are specially applicable to this state ~~and are not susceptible of determination by a prorating of country-wide expense experience~~. In ~~promulgating such rules and regulations and~~ plans, the commissioner shall give due consideration to the rating systems on file with ~~him~~ *the commissioner* and, in order that such ~~rules and regulations and~~ plans may be as uniform as is practicable among the several states, ~~to the rules and regulations and~~ to the form of the plans used for such rating systems in other states. ~~No insurer shall be required to record or report its loss experience on a classification basis that is inconsistent with the rating system filed by it.~~ The commissioner may designate one or more rating organizations or other

Proposed Amendments to SB No. 729

develop

developing such

Attachment III

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agencies to assist ~~him~~ *the commissioner* in gathering such experience and making compilations thereof, and such compilations shall be made available, [~~subject to reasonable rules and regulations promulgated~~] by the commissioner, to insurers and rating organizations: ~~*Provided,* That nothing in this act shall be construed to require, nor shall the commissioner adopt any rule to require, any insurer to record or report its loss or expense experience on any basis or statistical plan not consistent with the rating system filed by it~~.

(b) *Interchange of rating plan data.* Reasonable [~~rules and regulations and~~] plans may be [~~promulgated~~] by the commissioner for the interchange of data necessary for the application of rating plans.

developed

(c) *Consultation with other states.* In order to further uniform administration of rate regulatory laws, the commissioner and every insurer and rating organization may exchange information and experience data with insurance supervisory officials, insurers and rating organizations in other states and may consult with them with respect to rate making and the application of rating systems.

(d) *Rules and regulations.* The commissioner may make reasonable rules and regulations necessary to effect the purposes of this act.

Sec. 2. K.S.A. 40-1118 is hereby amended to read as follows: 40-1118. (a) *Recording and reporting of loss and expense experience.* The commissioner shall [~~promulgate rules and regulations and~~] statistical plans, ~~reasonably adopted to each of the rating systems on file with him, which may be modified from time to time and~~ which shall be used ~~thereafter~~ by each insurer in the recording and reporting of its loss and ~~country wide~~ expense experience, in order that the experience of all insurers may be made available at least annually in such form and detail as may be necessary to aid ~~him~~ *the commissioner* in determining whether rating systems comply with the standards set forth in K.S.A. 40-1112, *and amendments thereto.* Such [~~rules and regulations and~~] plans may also provide for the recording and reporting of expense experience items which are specially applicable

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to this state ~~and are not susceptible of determination by a prorating of country wide expense experience~~. In promulgating such ~~rules and regulations and~~ plans, the commissioner shall give due consideration to the rating systems on file with ~~him~~ *the commissioner* and, in order that such ~~rules and regulations and~~ plans may be as uniform as is practicable among the several states, ~~to the rules and regulations and~~ to the form of the plans used for such rating systems in other states. ~~No insurer shall be required to record or report its loss experience on a classification basis that is inconsistent with the rating system filed by it.~~ The commissioner may designate one or more rating organizations or other agencies to assist ~~him~~ *the commissioner* in gathering such experience and making compilations thereof, and such compilations shall be made available, ~~subject to reasonable rules and regulations promulgated~~ by the commissioner, to insurers and rating organizations: ~~*Provided,* That nothing in this act shall be construed to require, nor shall the commissioner adopt any rule to require, any insurer to record or report its loss or expense experience on any basis or statistical plan not consistent with the rating system filed by it.~~

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(b) *Interchange of rating plan data.* Reasonable ~~rules and regulations and~~ plans may be ~~promulgated~~ by the commissioner for the interchange of data necessary for the application of rating plans.

(c) *Consultation with other states.* In order to further uniform administration of rate regulatory laws, the commissioner and every insurer and rating organization may exchange information and experience data with insurance supervisory officials, insurers and rating organizations in other states and may consult with them with respect to ratemaking and the application of rating systems.

(d) *Rules and regulations.* The commissioner may make reasonable rules and regulations necessary to effect the purposes of this act.

Sec. 3. K.S.A. 40-937 and 40-1118 are hereby repealed.

Sec. 4. This act shall take effect and be in force from and after its publication in the statute book.