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

DIVISION OF
INVESTMENT MANAGEMENT

June 1, 1995

ACT IAA-40
SECTION 205(a)(1)
RULE
PUBLIC AVAILABILITY 6/1/95

Mr. James R. Waters
1900 West Loop South
Suite 300
Houston, TX 77027

Dear Mr. Waters:

Your letter to Robert E. Plaze has been referred to this office for response. You ask whether you may use the Consumer Price Index ("CPI") to measure the performance of accounts you advise, for the purpose of charging those accounts a performance-based advisory fee.

Section 205(a)(1) of the Investment Advisers Act of 1940 ("Advisers Act") generally prohibits advisory contracts that provide for compensation based on a share of the capital gains in or capital appreciation of a client's account. 1/ Section 205(b) provides a limited exception to this prohibition, however, and permits an adviser to a registered investment company and certain other entities with assets in excess of $1 million to impose a "fulcrum fee." A fulcrum fee arrangement is one which provides for a fee averaged over a specified period of time that increases or decreases proportionately with the investment performance of the client's account in relation to the investment record of an "appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify."

Your proposal conflicts with the requirements of Section 205(b) in two ways. First, the CPI is not an index of securities prices, and the Commission has not deemed the CPI to be a measure of investment performance. Second, the proposed fee schedule, as set forth in the attachment to your letter, does not increase or

1/ We note that the Section 205(a)(1) prohibition applies only to fees based on a share of capital gains or capital appreciation, and does not prohibit a fee based on a share of other types of asset components. Thus, a performance fee based on, for example, interest, ordinary income, or dividends is permissible, so long as it otherwise is in compliance with the Advisers Act.

decrease proportionately with the investment performance of the client's account in relation to the index.

Rule 205-3 under the Advisers Act provides an exemption from Section 205(a)(1)'s performance fee prohibition. Rule 205-3 permits a registered investment adviser to receive performance fees if the following conditions are met:

(1) the client has a least $500,000 under the adviser's management or has a net worth exceeding $1,000,000;

(2) the performance fee is based on a formula that includes, in the case of securities for which market quotations are readily available, realized capital losses and unrealized capital depreciation; and in the case of securities for which market quotations are not readily available, realized capital losses and, if unrealized capital appreciation is included, unrealized capital depreciation;

(3) the fee is based on the performance of a client's account for a period not less than a year;

(4) the adviser discloses certain material information about the performance fee to the client; and

(5) the adviser reasonably believes that the contract represents an arm's-length arrangement between the parties.

With the exception of the minimum one year period and the inclusion of realized capital losses and unrealized capital depreciation in the formula, Rule 205-3 does not prescribe a method for calculating performance fees. Pursuant to paragraph (d)(4) of the rule, however, if an adviser uses an index to measure investment performance, the adviser must disclose to the client the nature of the index, its significance, and the reason the adviser believes the index is appropriate.

I hope this information is helpful. If you have any questions regarding this letter, please call me at (202) 942-0660.

Sincerely,

John O'Hanlon

John O'Hanlon
Special Counsel

JAMES R. WATERS, CFP
A FEE-FOR-SERVICE FINANCIAL ADVISOR

February 24, 1995

Mr. Robert E. Plaze, Assistant Director
Office of Disclosure and Investment Advisor Regulation
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

RE: James R. Waters, CFP; SEC File Number 801-42352

Dear Mr. Plaze:

I am writing to request approval to use inflation (as measured by the Consumer Price Index (CPI)) as the index to measure performance under my performance-based investment management service. While I am aware the CPI may not be viewed by some as being a direct index of securities prices, in the context of what my clients are trying to achieve and how I manage their money, it is a more suitable index than any of the more traditionally used indexes. Attached is the schedule of compensation, relative to the performance of inflation, I intend to use. Performance will be measured over a rolling three year period. (I am aware of the elements that must go into a performance based contract and that is why this letter focuses on only one of them.)

Before I explain why the CPI is the most suitable index to use, I think it relevant to note that my clients' money is managed in the context of a long-term financial plan. Consequently, money is managed with the intent to achieve long-term financial goals such as college education for children and retirement. Before the money is actually invested, the client has become well-versed in terms of how much money must be invested and how fast that money must grow relative to inflation to achieve the stated goals.

Inflation is the most suitable index to measure performance in this context for two very important reasons:

First, aside from the assets I choose for a client's portfolio (generally U.S. Treasuries and no-load mutual funds) the client often requests that I also manage other assets he or she acquired before obtaining my services. This may include investments such as annuities and Certificates of Deposit (CDs) that do not lend themselves to comparison against equity or debt-based indexes. In this situation, a more meaningful way to report to the client on the performance of his or her investments is to compare the portfolio's performance relative to inflation.

Second, in the final analysis clients are only concerned with

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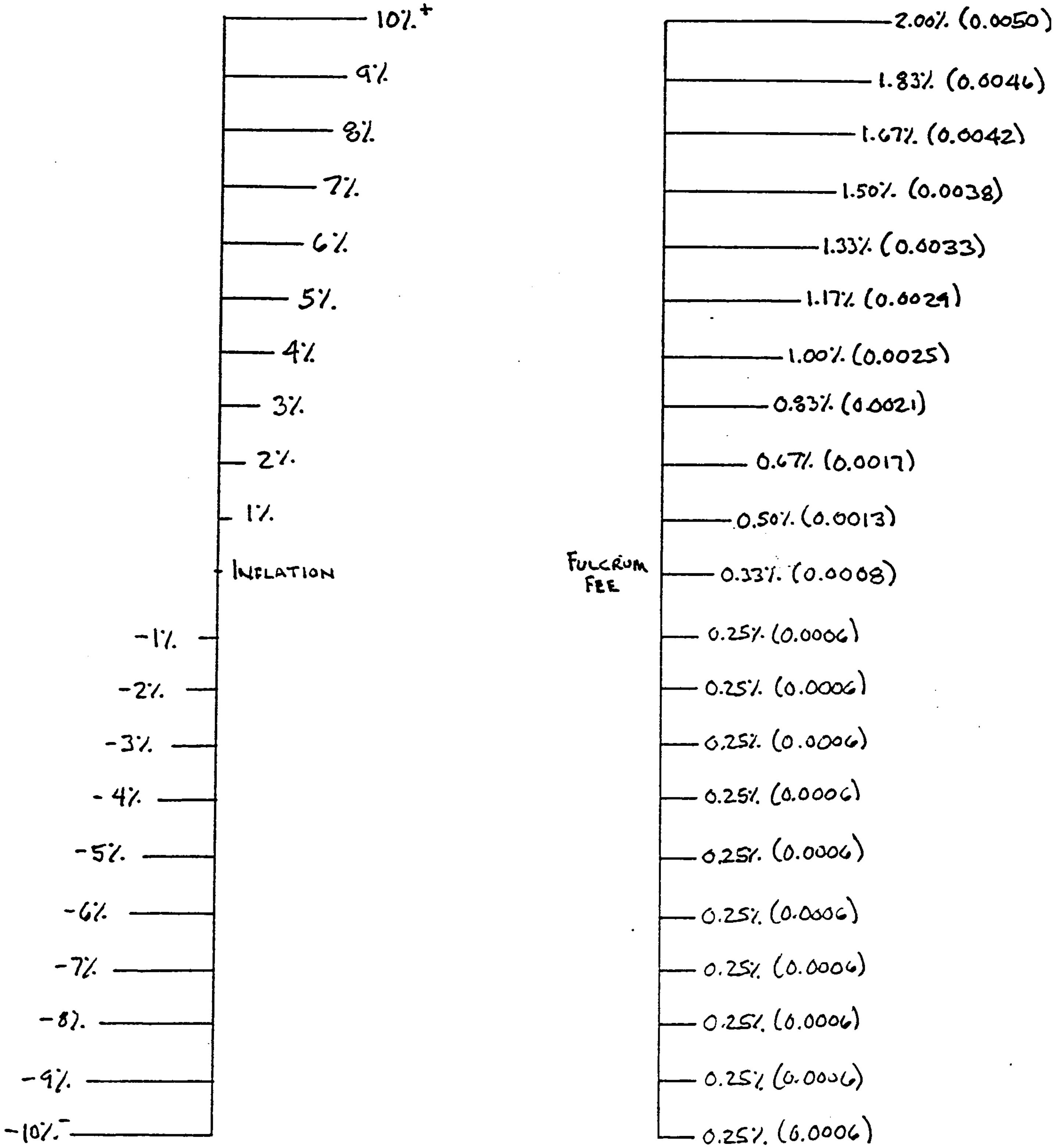
making their investments grow at least as fast as the purpose for which they intend to use the money. For example, if the advisor is managing the assets of a client who is retired, one of the most important goals of the client may be to make his or her assets avoid the ravages of inflation. Using an index other than inflation, say the Standard and Poors 500 (S&P 500), may in fact prove counterproductive and even deceitful if that index does not grow faster than the cost of the goods and services the retired client consumes. Consider that, over a given time the S&P 500's annual return may be three percent, yet inflation may be growing at five percent. In effect, the client is losing what he or she cherishes most - purchasing power. The same may be said about a younger couple saving for a child's college education. While the Consumer Price Index may not directly indicate whether their money is growing faster than college costs, it provides, far and away, the most suitable measurement.

In conclusion, I have historical information on 125 widely quoted indexes at my disposal. In reviewing the historical performance of each index and even combinations of the indexes, I found none, other than inflation, that is suitable for performance evaluation over an extended period of time. Perhaps just as important, my clients are most interested in making their investments grow faster than the goods and services for which the proceeds from the investments are earmarked. The most suitable measure of whether they are achieving this goal is how their investment performance compares to inflation.

Respectfully submitted,

James R. Waters, CFP

James R. Waters, CFP



INVESTMENT MANAGEMENT PERFORMANCE RELATIVE TO INFLATION (C.P.I.)

TOTAL MGMT. FEE
( ) = QUARTERLY MULTIPLIER