

**PUBLIC**

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RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 96-217-CC  
John W. Henry & Co., Inc.  
File No. 132-3

By letter dated September 6, 1996, you request assurance that the staff would not recommend that the Commission take enforcement action against

- (i) John W. Henry & Co., Inc. ("JWH & Co.") for failure to register as an investment adviser under Section 203 of the Investment Advisers Act of 1940 ("Advisers Act") 1/ or to comply with the provisions of the Advisers Act and the rules thereunder, if JWH Risk Management, Inc. ("RMI"), a newly formed affiliate of JWH & Co. which proposes to register under the Advisers Act, or any other JWH & Co. affiliates which may in the future register under the Advisers Act (collectively with RMI, the "Advisory Affiliates"), engage in an investment advisory business, as more fully described in your letter; or
- (ii) any Advisory Affiliate under Section 205 of the Advisers Act 2/ if the Advisory Affiliate charges fees that are based on capital appreciation in the value of non-securities assets held in an account, for providing advice relating to the trading of commodity futures and related options.

Facts

JWH & Co. engages in the commodity trading advisory business and is registered with the Commodity Futures Trading Commission ("CFTC") as a commodity trading advisor ("CTA") and as a commodity pool operator ("CPO"). JWH & Co. is also a member of the National Futures Association ("NFA"). RMI, a newly formed affiliate of JWH & Co., will engage initially in the business of providing commodity trading advice, but expects thereafter also to provide investment advice regarding securities. Other Advisory Affiliates will provide investment advice regarding securities and, possibly, commodities. RMI (and, as applicable, the other Advisory Affiliates) will register with the CFTC as CTAs and CPOs and be member firms of the NFA. You represent that all of the Advisory Affiliates will

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1/ Section 203(a) of the Advisers Act requires a person or entity that meets the definition of "investment adviser," and that makes use of the U.S. mails or any other means or instrumentality of interstate commerce in connection with its business as an investment adviser, to register under the Advisers Act, unless an exemption from registration is available.

2/ Section 205 of the Advisers Act prohibits a registered investment adviser from charging an advisory fee on the basis of a share of capital gains or capital appreciation of the funds or any portion of the funds of a client ("performance fee"), except in certain limited circumstances.

register as investment advisers under the Advisers Act prior to engaging in the business of providing investment advice regarding securities.

John W. Henry ("John Henry") controls JWH & Co. and also will control the Advisory Affiliates. In managing the assets of its clients, JWH & Co. uses proprietary trading systems developed by John Henry to formulate trading decisions. The Advisory Affiliates also may utilize the technical trading systems developed by John Henry in making investment decisions for their clients.

One or more of the Advisory Affiliates may offer an asset allocation service to commodity pools and individual client accounts to determine the portion of assets in a client's account to invest in securities, and the portion of assets to invest in commodities. That portion of a client's assets invested in securities will be managed by the Advisory Affiliate, while the portion invested in commodities will be managed by JWH & Co. Clients who subscribe to this asset allocation service will enter into separate agreements with the Advisory Affiliate (for allocation and securities trading advice) and with JWH & Co. (for futures trading advice).

#### Discussion

##### *Registration of JWH & Co. under the Advisers Act*

You represent that JWH & Co. does not, and will not, provide investment advice regarding securities, 3/ other than with respect to certain U.S. government obligations used as margin for futures trading. You believe, therefore, that JWH & Co. is excluded from the definition of "investment adviser" and need not register under the Advisers Act or rely on any exemption from registration. 4/ Because John Henry will be involved in the investment advisory activities of the Advisory Affiliates, and the Advisory Affiliates will utilize JWH & Co. personnel in connection with their advisory activities, however, the contemplated registration and activities of the Advisory Affiliates raise the question whether JWH & Co.

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3/ You state that JWH & Co. provides advice on foreign currency forward contracts. You believe that such advice does not constitute advice concerning securities so as to bring JWH & Co. within the definition of "investment adviser." You have not requested, and we do not express, our views regarding whether such forward contracts are securities under Section 202(a)(18) of the Advisers Act.

4/ Section 202(a)(11)(E) of the Advisers Act excludes from the definition of "investment adviser" any person whose investment advice is limited to certain types of U.S. government securities. You represent that any advice provided by JWH & Co. regarding securities is limited to the types of obligations specified by Section 202(a)(11)(E). You have not requested, and we do not express, our views regarding whether JWH & Co. qualifies for this exclusion.

could be viewed as doing indirectly that which it could not do directly, in violation of Section 208(d) of the Advisers Act. 5/

You represent that JWH & Co. and each of the Advisory Affiliates will be operated as separate companies, will be separately capitalized and will make investment decisions independently of each other. You also represent that JWH & Co. and the Advisory Affiliates will take appropriate steps to assure that sales materials, disclosure documents (including Forms ADV and brochures of the Advisory Affiliates), and other public communications make clear that the companies are separate entities having separate registrations under different bodies of law, and distinguish clearly the services provided by each company.

In Thomson, the staff concluded that the concerns underlying Section 208(d) of the Advisers Act are adequately addressed when (i) an unregistered affiliate of a registered investment adviser does not provide investment advice; (ii) the unregistered affiliate and each of its employees are deemed "associated persons" of the registered investment adviser when they have access to investment recommendations made by the registered adviser or information concerning the recommendations prior to the effective dissemination of those recommendations to the clients of the registered adviser; and (iii) the Commission has access to the unregistered affiliate's books and records to the extent necessary to examine the business of the registered adviser.

You represent that John Henry, as the controlling person of JWH & Co. and the Advisory Affiliates, and each JWH & Co. officer, director or employee who has access to the investment recommendations of an Advisory Affiliate or information concerning such recommendations prior to their effective dissemination ("Associated Employee"), 6/ will be

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5/ Section 208(d) of the Advisers Act provides that it shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing that it would be unlawful for such person to do directly under the Advisers Act. In the past, the Commission has expressed concern about structural arrangements in which a registered investment adviser is merely a conduit for advisory services provided by personnel of an unregistered affiliate. See Thomson Advisory Group L.P. (pub. avail. Sept. 26, 1995) ("Thomson"), citing Investment Advisers Act Release No. 353 (Dec. 18, 1972) (proposing Rule 202-1 under the Advisers Act, which would have exempted affiliates of a registered adviser from registration if certain conditions, designed to ensure that the registered adviser was operated separately from and independently of its unregistered affiliates, were met).

6/ You represent that any individual who, as officer, director, or employee of JWH & Co. (other than an employee whose duties are solely ministerial or clerical and who is not involved in the investment process and does not have access to investment decisions or recommendations of any Advisory Affiliate) engages in the business or  
(continued...)

deemed by that Advisory Affiliate to be a "person associated with an investment adviser" (an "Associated Person"). Although the unregistered affiliate in Thomson also was deemed to be an Associated Person, however, you maintain that JWH & Co. should not be deemed an Associated Person because (i) JWH & Co. does not meet the definition of Associated Person, 7/ and (ii) no meaningful regulatory purpose would be served by requiring JWH & Co. to be treated as an Associated Person. 8/ You further represent that the Commission will be given access to JWH & Co.'s books and records to the extent necessary to examine the businesses of the Advisory Affiliates, and that JWH & Co. will instruct Associated Employees to cooperate fully with the staff in connection with such examinations.

### *Performance Fees for Futures Trading Advice*

For its advice regarding futures trading, JWH & Co. charges its clients a performance fee that is computed as a percentage of the appreciation in the value of the clients' accounts, and which includes net gains from trading, as well as any appreciation in the value of client holdings of U.S. government obligations used as margin for futures trading. 9/ You

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6/(...continued)

affairs of any Advisory Affiliate will be deemed to be an Associated Employee of that Advisory Affiliate. You further represent that each Associated Employee will be subject to the supervision, direction and control of that Advisory Affiliate to the same extent as would be required by the Advisers Act if such individual engaged therein as an officer, director, or employee of the Advisory Affiliate.

7/ You note that JWH & Co. is under common control with an investment adviser but is not a person controlling or controlled by an investment adviser. Section 202(a)(17) of the Advisers Act defines a "person associated with an investment adviser" as including a partner, officer, or director of the adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by the adviser, including the adviser's employees.

8/ You note in this regard, among other things, that JWH & Co. will be deemed to be an "advisory representative" under Rule 204-2(a)(12)(A), which defines "advisory representative" as including, among others, controlling persons of the investment adviser and affiliates of such controlling persons who obtain information concerning securities recommendations made by the adviser prior to the effective dissemination of those recommendations. Therefore, to the extent that JWH & Co. engages in proprietary securities trading or trades securities for an account in which John Henry has a beneficial interest, such trading would be subject to reporting under Rule 204-2 regardless of whether JWH & Co. is deemed to be an Associated Person.

9/ You state that the imposition of this type of performance fee is standard practice in the managed futures industry. You maintain that the fees charged by JWH & Co.

(continued...)

represent that the fees that the Advisory Affiliates charge for investment advice regarding securities, including asset allocation advice, will comply with Section 205 of the Advisers Act and Rule 205-3 thereunder. You state, however, that fees charged by the Advisory Affiliates for advisory services relating solely to futures trading may not necessarily comply with those provisions of the Advisers Act. You maintain that performance fees of the type proposed to be charged by the Advisory Affiliates for advice relating solely to the trading of commodity futures and related options should not be subject to the requirements of Section 205 of the Advisers Act or Rule 205-3 thereunder. You represent that performance fees charged by the Advisory Affiliates for advice relating to futures trading will be computed in a manner that excludes from the fee calculations any realized or unrealized gains or losses on securities held in clients' accounts, and that the Advisory Affiliate will disclose to the client, prior to entering into any such performance fee arrangement, that the fee is not computed in accordance with the provisions of Rule 205-3.

Section 205 of the Advisers Act, in relevant part, provides that a registered investment adviser may not enter into any investment advisory contract that 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 the client. The staff has recognized that Section 205 regulates only performance fees based on the value of *securities*, and does not prohibit other types of performance fees. 10/

#### Representations

In connection with your request regarding the status of JWH & Co. under the Advisers Act, you make the following representations:

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9/(...continued)

need not comply with Section 205(a)(1) of the Advisers Act or Rule 205-3 thereunder because JWH & Co. is not an investment adviser and, therefore, is not required to be registered under the Advisers Act, in reliance on Section 202(a)(11)(E). Rule 205-3 under the Advisers Act permits an investment adviser to charge a performance fee under certain specified conditions.

10/ EQK Partners (pub. avail. July 13, 1988) (registered investment adviser may charge fees based on capital appreciation in the value of real estate without complying with Section 205 or Rule 205-3). In Wallace G. Wagner (pub. avail. June 28, 1990), however, the staff indicated that a registered investment adviser providing commodity trading advice to a commodity pool must comply with Section 205 and Rule 205-3. Upon reconsideration, we believe that EQK Partners accurately reflects the views of the staff on this issue. Therefore, this letter should be read to supersede that aspect of the position taken in Wallace Wagner.

- (1) each Associated Employee of an Advisory Affiliate will be subject to the supervision, direction and control of such Advisory Affiliate to the same extent as would be required under the Advisers Act if such individual engaged therein as an officer, director or employee of the Advisory Affiliate;
- (2) each Advisory Affiliate will deem as an Associated Person each Associated Employee who has access to the investment recommendations of that Advisory Affiliate or information concerning such recommendations prior to their effective dissemination;
- (3) pursuant to Rule 204-2(a)(12) under the Advisers Act, each Advisory Affiliate will obtain and maintain on-site personal securities transaction records and records of personal transactions in futures and related options for each of its "advisory representatives;" 11/
- (4) each Advisory Affiliate will identify each Associated Employee in its Form ADV to the same extent as would be required under the Advisers Act if the Associated Employee were an officer, director or employee of such Advisory Affiliate;
- (5) each Associated Employee of an Advisory Affiliate will be subject to the conflict of interest, insider trading and personal securities transaction reporting requirements established by such Advisory Affiliate to the same extent as would be required under the Advisers Act if such individual were an officer, director or employee of the Advisory Affiliate;
- (6) JWH & Co. will not provide investment advice concerning securities without registering under the Advisers Act, except as described in your letter; and
- (7) JWH & Co. will provide the Commission staff access to any books and records of JWH & Co. which relate to services rendered by JWH & Co. to clients of any Advisory Affiliate (including any documents and records relating to the accounts of such clients) or which are required to be maintained by JWH & Co. pursuant to the Commodity Exchange Act and the rules thereunder, 12/ will instruct Associated Employees to cooperate fully with the

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11/ You represent in this regard that all persons deemed to be Associated Persons of an Advisory Affiliate, as well as JWH & Co. itself, will be advisory representatives of such Advisory Affiliate.

12/ You state that, pursuant to CFTC regulations, a CPO or CTA must make and retain for a five-year period books and records of all trading activity for client accounts and proprietary accounts.

staff in connection with such examinations, and will promptly produce such books and records to the staff upon request.

In connection with your request regarding the imposition of performance-based fees, you represent that:

- (1) any performance fee charged by an Advisory Affiliate for advice relating to futures trading will not be based on the capital gains or capital appreciation of securities of any type;
- (2) all fees charged by an Advisory Affiliate for investment advice relating to securities will comply with Section 205 of the Advisers Act or Rule 205-3 thereunder; and
- (3) prior to entering into any performance fee arrangement for advice relating to futures trading that does not comply with Section 205 or Rule 205-3 under the Advisers Act, an Advisory Affiliate will disclose to the client the fact that the fee is not computed in accordance with the requirements under the Advisers Act.

Based on the facts and representations set forth in your letter and summarized above, we would not recommend enforcement action to the Commission (i) under Sections 203 or 208(d) of the Advisers Act if JWH & Co. does not register under the Advisers Act or comply with the provisions of the Act or the rules thereunder, or (ii) under Section 205 of the Advisers Act if an Advisory Affiliate charges fees based on capital appreciation in the value of non-securities assets held in an account which do not meet the conditions of Section 205 or Rule 205-3 under the Advisers Act, for providing advice relating to the trading of commodity futures and related options. Different facts or representations may require a different conclusion.

  
Natalie S. Bej  
Attorney

IAA

Section 203

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9-20-96

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September 6, 1996

IAA/§§ 205, 208(d)  
and Rule 205-3

Jack W. Murphy, Esq.  
Chief Counsel  
Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W. Mail Stop # 10-6  
Washington, D.C. 20549

Re: John W. Henry & Co., Inc.

Dear Mr. Murphy:

On behalf of our clients, John W. Henry & Co., Inc. ("JWH & Co.") and certain of its affiliates, we are writing to request confirmation that the Staff of the Securities and Exchange Commission (the "Commission") will not recommend that the Commission take enforcement action: (1) against JWH & Co. for failure to register under the Investment Advisers Act of 1940 (the "Advisers Act") or to comply with the provisions of the Advisers Act and the rules thereunder, including Section 205 and Rule 205-3, if JWH Risk Management, Inc. ("RMI"), a newly formed affiliate of JWH & Co. which proposes to register under the Advisers Act, or any other JWH & Co. affiliate which may in the future register under the Advisers Act (collectively with RMI, the "Advisory Affiliates"), engages in an investment advisory business, as described in this letter and subject to the representations hereinafter set forth; or (2) against any Advisory Affiliate for failure to comply with Section 205 and Rule 205-3, if the Advisory Affiliate charges performance fees for advice relating



solely to the trading of commodity futures and options thereon, which fees do not meet the conditions of Rule 205-3.

### BACKGROUND

JWH & Co., a California corporation controlled by John W. Henry ("JWH"), was incorporated in 1982 to conduct a commodity trading advisory business. It is registered with the Commodity Futures Trading Commission (the "CFTC") as a commodity trading advisor (a "CTA") and as a commodity pool operator (a "CPO") under the Commodity Exchange Act (the "CEA"), and is a member of the National Futures Association (the "NFA"), a self-regulatory organization for the futures industry. JWH & Co. serves as the trading advisor of publicly and privately offered commodity pools and as trading advisor to various individual client accounts. Currently, JWH & Co. has over \$1.3 billion of assets under management and is one of the largest trading advisors in the managed futures industry. In managing the assets of its clients, JWH & Co. employs proprietary trading systems developed by JWH.<sup>1</sup> These systems use technical, trend-following analyses to formulate trading decisions.

As is standard practice in the managed futures industry, JWH & Co. charges its clients performance fees for its advice regarding futures trading. These fees, as is typical, are computed as a percentage of the appreciation in the value of the clients' accounts, which would include net gains from trading, as well as any appreciation in the value of client holdings of U.S. government obligations used as margin for futures trading. JWH & Co.'s performance fees need not comply with Rule 205(a)(1) of the Advisers Act and Rule 205-3 thereunder, given that JWH & Co. is not registered under the Advisers Act or required to be so registered.

JWH & Co. does not, and will not, provide investment advice regarding securities, other than with respect to certain U.S. government obligations used as margin for futures trading.<sup>2</sup> Thus, JWH & Co. is not an "investment adviser" as defined by Section

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<sup>1</sup> The trading systems are licensed by JWH to Elysian Licensing Corporation ("ELC"), another company controlled by JWH, and sub-licensed by ELC to JWH & Co.

<sup>2</sup> The U.S. government obligations with respect to which JWH & Co. provides investment advice are limited to U.S. Treasury bills which are used by its clients as futures margin. However, certain clients of JWH & Co. make their own investment decisions as to the securities in which futures margin is invested or have delegated the authority to make such decisions to a person other than JWH & Co. In such cases, futures margin may be invested in securities other than those set forth herein, including securities which are not U.S. government obligations, to the extent permissible under applicable commodities exchange rules and under requirements that may be imposed by futures commission merchants on their customers.

202(a)(11) of the Advisers Act,<sup>3</sup> and does not rely upon Section 203(b)(3) of the Advisers Act, which provides an exemption from registration for any investment adviser that during the past twelve months has had fewer than fifteen clients and does not hold itself out generally to the public as an investment adviser.

An affiliate of JWH & Co., Westport Capital Management Corporation, is registered with the CFTC as a CPO and serves as the general partner of two commodity pools that are privately offered in the U.S. Another affiliate, Global Capital Management Limited, which is also registered as a CPO, serves as the CPO of two offshore funds.<sup>4</sup> These affiliates are each controlled by JWH.<sup>5</sup>

RMI, a newly formed Florida corporation, is also controlled by JWH. It will initially engage in the business of providing commodity trading advice and expects thereafter also to provide investment advice regarding securities. In making securities investment decisions for its clients, RMI will use technical trading systems developed by JWH. These systems will differ substantially from those used by JWH & Co., but will utilize trend-following analyses.<sup>6</sup> The systems used by RMI in formulating commodity trading decisions will be similar to those used by JWH & Co.

RMI intends to register with the CFTC as a CPO and CTA and to become a member firm of the NFA because RMI will provide advice regarding futures trading to commodity pools and possibly to individual client accounts. Such advice would involve the use of futures contracts for investment and yield enhancement purposes, or for hedging or other risk management purposes, such as synthetically altering the investment exposures of client accounts. RMI will register as an investment adviser under the Advisers Act prior to engaging in the business of providing investment advice regarding securities.

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<sup>3</sup> JWH & Co. also provides advice on foreign currency forward contracts ("FX Forwards"). However, we believe that such advice does not constitute advice concerning securities so as to bring JWH & Co. within the definition of the term "investment adviser." In this regard, we note that JWH & Co. is not requesting that the Staff provide any assurances regarding whether FX Forwards are "securities" as defined by Section 202(a)(18) of the Advisers Act or whether JWH & Co. is an "investment adviser" as defined by Section 202(a)(11) of the Advisers Act.

<sup>4</sup> Neither Westport Capital Management Corporation nor Global Capital Management Limited provides advice concerning securities or commodities. Their activities are in each case strictly limited to serving as CPO of commodity pools.

<sup>5</sup> JWH also controls JWH Investments, Inc., a company that is registered under the Advisers Act. However, such company is inactive.

<sup>6</sup> The trading systems used by RMI will be sub-licensed to it by an affiliate of JWH & Co. other than ELC.

Like RMI, the other Advisory Affiliates will be controlled by JWH. Such affiliates will be registered under the Advisers Act and would provide investment advice regarding securities and possibly, commodities, subject to obtaining appropriate CFTC registrations and NFA membership. They may also use trading systems developed by JWH; however, those systems may or may not be similar to those used by RMI. It is presently contemplated that one or more of the Advisory Affiliates would offer asset allocation services involving recommendations as to the portion of client assets to be allocated from time to time to JWH & Co. or to another affiliated or unaffiliated commodity trading advisor for futures trading.

The fees that RMI and the other Advisory Affiliates will charge their clients for investment advice regarding securities, including any asset allocation advice, will comply with Section 205 of the Advisers Act and Rule 205-3 thereunder. The fees that the Advisory Affiliates propose to charge clients for advisory services relating solely to futures trading will not necessarily be computed in a manner that complies with Section 205 and Rule 205-3. However, in such cases, performance fees will be computed in a manner that excludes realized and unrealized gains and losses on securities from the fee calculations, and the Advisory Affiliate will disclose to the client, prior to entering into any such performance fee arrangement, that the fee is not computed in accordance with the provisions of Rule 205-3.

JWH & Co., RMI and the other Advisory Affiliates (collectively, the JWH Companies") will each be operated as a separate company. Each Advisory Affiliate will be separately capitalized, and through its employees, will make investment decisions independently of those made by other JWH Companies. In addition, the JWH Companies will take appropriate steps to assure that sales materials, disclosure documents, including the Form ADVs of the Advisory Affiliates, and other public communications make clear that the JWH Companies are separate entities having separate registrations under different bodies of law, and to distinguish clearly the services provided by each company.

One or more Advisory Affiliates may furnish to certain clients a service that will coordinate the securities trading strategies of that particular Advisory Affiliate with the commodity trading strategies of JWH & Co. The service will involve use of an allocation strategy by the Advisory Affiliate to determine the portion of the assets of client accounts to invest in securities and the portion of the assets to invest in commodities. The Advisory Affiliate will manage the securities investments of these clients and make asset allocation decisions, and JWH & Co. will manage their investments in commodities.<sup>7</sup> Clients that wish to avail themselves of this service, which could include both pools and individual accounts, would each enter into one agreement with the Advisory Affiliate to obtain allocation and securities trading advice and a second, separate agreement with JWH & Co. for futures trading advice.

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<sup>7</sup> Under no circumstances, however, will JWH & Co. be providing advice regarding securities, except as discussed at n. 2, *supra*.

It is anticipated that JWH will be involved in the investment advisory activities of the Advisory Affiliates to the extent that the Advisory Affiliates will generally utilize the personnel of JWH & Co. in connection with their operations and advisory activities. However, JWH and each other individual who, as officer, director, or employee of JWH & Co. (other than an individual whose duties are solely ministerial or clerical in nature and who is not involved in the investment process and does not have access to the investment decisions or recommendations of any Advisory Affiliate) engages in the business or affairs of any Advisory Affiliate (an "Associated Employee") will do so subject to the supervision, direction and control of that Advisory Affiliate to the same extent as would be required by the Advisers Act, if such individual engaged therein as an officer, director, or employee of the Advisory Affiliate. Thus, for example, each Associated Employee of an Advisory Affiliate will be subject to the conflict of interest, insider trading and personal securities transaction reporting requirements established by that Advisory Affiliate to the same extent as would be required under the Advisers Act if such individual were an officer, director, or employee of the Advisory Affiliate.

In this regard, JWH, as the controlling person of the JWH Companies, and each Associated Employee who has access to the investment recommendations of an Advisory Affiliate, or information concerning such recommendations of that Advisory Affiliate prior to their effective dissemination, will be deemed by the Advisory Affiliate to be a "person associated with an investment adviser," as that term is defined in Section 202(a)(17) of the Advisers Act (an "Associated Person").<sup>8</sup> Pursuant to Rule 204-2(a)(12) under the Advisers Act, each Advisory Affiliate will obtain and maintain on-site personal securities transaction records for each of its "advisory representatives."<sup>9</sup> Each Advisory Affiliate will also identify each Associated Employee in its Form ADV to the same extent as would be required under the Advisers Act if the Associated Employee were an officer, director, or employee of the Advisory Affiliate. Finally, JWH & Co. will allow the Staff access to its books and records as hereinafter set forth and will instruct Associated Employees to cooperate fully with the Staff.

We note that under the relevant definitional provision of the Advisers Act, Section 202(a)(17), JWH & Co. would not, in our view, be an Associated Person. That Section explicitly defines the term to include any person controlling or controlled by an

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<sup>8</sup> Section 202(a)(17) of the Advisers Act defines a "person associated with an investment adviser" to include any partner, officer, or director of the adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by the adviser, including the adviser's employees. A registered investment adviser is obligated reasonably to supervise the activities of its associated persons. *See, e.g.*, Sections 203(e)(5) and 204A of the Advisers Act.

<sup>9</sup> Rule 204-2(a)(12) under the Advisers Act defines an "advisory representative" as including, among others, any partner, officer or director of the adviser, and certain employees and certain other persons who obtain information concerning securities recommendations made by the adviser prior to the effective dissemination of the recommendations.

investment adviser. Thus, we believe it to be implicit that persons under common control with an investment adviser are not Associated Persons, absent some other basis for finding Associated Person status. Cf., Section 202(a)(20) (defining the term "issuer" to include "any person under direct or indirect common control with the issuer") and the definitions of the term "related person" in Rule 203(b)(3)-1 under the Advisers Act and in the Instructions to Form ADV (each defining the term "related person" to include, among others, any person under common control).

In addition, as already noted, JWH and all natural persons affiliated with JWH & Co. having information regarding the trading activities of an investment adviser affiliate would be subject to the personal trade reporting requirements of Rule 204-2 under the Advisers Act and would also be subject to supervision by the affiliate, as required by the first representation of this letter and consistent with the standard set forth in Section 203(e)(5) of the Advisers Act. We believe that, in view of the foregoing, no meaningful regulatory purpose would be served by requiring JWH & Co. to be treated as an Associated Person.<sup>10</sup>

### DISCUSSION

As discussed below, we are of the view that the proposed activities of RMI and the other Advisory Affiliates will not require JWH & Co. to register under the Advisers Act as an investment adviser or to comply with the provisions of the Advisers Act and the rules thereunder, including Section 205 and Rule 205-3. We are also of the view that performance fees charged by the Advisory Affiliates for advice relating solely to the trading of commodity futures and related options should not be deemed subject to the requirements of Section 205 of the Advisers Act and Rule 205-3 thereunder.

#### I. Legal Framework

##### A. Section 208(d)

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<sup>10</sup> For example, to the extent JWH & Co. engages in proprietary securities trading or trades securities for an account in which JWH has a beneficial interest, such trading will be subject to reporting under Rule 204-2 regardless of whether JWH & Co. is deemed to be an Associated Person. See, paragraphs (a)(12) and (a)(13) of Rule 204-2 (requiring investment advisers to maintain records of securities transactions in which any "advisory representative" has a beneficial interest, and defining such term to include controlling persons of the investment adviser and affiliates of such controlling persons which have information regarding the adviser's trading activities). In addition, in the event of any violation of law committed by an Associated Person who is an officer, director or employee of JWH & Co., the Commission would have the same basis to commence an enforcement action against and impose sanctions on JWH or an investment adviser affiliate as it would if JWH & Co. were an Associated Person because JWH, as the controlling person of each affiliate, and the relevant affiliate, would have the same duties to supervise the Associated Person committing the violation regardless of whether JWH & Co. itself is treated as an Associated Person.

Section 203(a), of the Advisers Act makes it "unlawful for any investment adviser, unless registered [under the Advisers Act], to make use of the mails or any means or instrumentality of interstate commerce in connection with . . . its business as an investment adviser." Section 202(a)(11) of the Advisers Act defines an investment adviser to include:

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . . .

However, clause (E) of Section 202(a)(11) excludes from this definition any person whose investment advice concerning securities is limited to advice regarding certain types of U.S. government securities. Any advice given by JWH & Co. regarding securities is limited to the types of obligations specified by Section 202(a)(11)(E).<sup>11</sup> Consequently, JWH & Co. is currently excluded from the definition of the term "investment adviser" and thus need not register under the Advisers Act.

Under Section 208(d) of the Advisers Act, it is unlawful for "any person indirectly, through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of the [Advisers] Act." Among the provisions regulating the conduct of registered investment advisers is Section 205, which provides that a registered investment adviser is generally prohibited from charging a fee "on the basis of a share of capital gains upon or appreciation of the funds or any portion of the funds of the client." Such fees are permissible only if certain conditions specified by Rule 205-3 are satisfied. Thus, one question raised by the contemplated registration and activities of RMI and the other Advisory Affiliates is whether JWH & Co., a company not registered as an investment adviser under the Advisers Act and thus not complying with the provisions of the Advisers Act regulating such entities, including Section 205 and Rule 205-3 thereunder, could be viewed as doing indirectly that which RMI and the other Advisory Affiliates could not do directly, in violation of Section 208(d).

In *Richard Ellis, Inc.* (pub. avail. September 17, 1981), the Staff considered the applicability of Section 208(d) to a situation where an unregistered foreign company involved in furnishing investment advice proposed to create a registered subsidiary to provide investment advice on securities to U.S. persons. The Staff stated that an unregistered foreign adviser would not be doing indirectly that which it could not do directly, in violation of Section 208(d), if it provided advice to U.S. persons through a subsidiary registered under the Advisers Act that had an existence sufficiently independent of its parent and functioned independently of the parent. We are of the view that RMI and the other Advisory Affiliates will exist and operate sufficiently independently and separately from JWH & Co. so that JWH & Co. need not register under the Advisers Act.

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<sup>11</sup> As discussed at n. 3, *supra*, we do not believe that advice concerning FX Forwards should be deemed to constitute investment advice regarding securities.

In *Ellis*, the Staff identified circumstances in which a registered affiliate of an unregistered foreign adviser would be regarded as having a separate, independent existence and independent functions so as not to require registration of the unregistered foreign affiliate. In this regard, the Staff stated that registration would not be necessary where the registered investment adviser subsidiary: (a) is adequately capitalized; (b) has a buffer between the subsidiary's personnel and the parent, such as a board of directors a majority of whose members are independent of the parent; (c) has officers, directors, and employees who, if engaged in providing advice on behalf of the subsidiary, are not otherwise engaged in the investment advisory business of the parent; (d) makes the decisions as to what investment advice is to be communicated to, or used on behalf of its clients, and uses sources of investment information not limited to its parent; and (e) keeps investment advice confidential until communicated to its clients. These standards have also been applied to registered investment advisers and their affiliates in the domestic context.<sup>12</sup>

However, in the report of the Division of Investment Management, entitled *Protecting Investors: A Half Century of Investment Company Regulation*, 240 (May 1992) ("Division Report"), the Staff relaxed the *Ellis* standards in certain respects and expressed its view that a registered investment adviser should be regarded as sufficiently separate and independent from its foreign affiliate if the two companies are separately organized and the registered investment adviser is staffed with personnel capable of providing investment advice, subject to certain conditions. This approach was first applied in *Uniao de Bancos de Brasileiros, S.A.* (pub. avail. July 18, 1992) and has generally been followed in other subsequent no-action letters.<sup>13</sup>

More recently, the Staff further clarified its position as to whether an affiliate of a registered investment adviser must itself register. *Thomson Advisory Group L.P.* (pub. avail. September 26, 1995). In *Thomson*, a registered investment adviser and its affiliates sought confirmation that a planned merger and subsequent reorganization of the companies with another registered investment adviser would not result in a Staff recommendation of enforcement action based upon the failure of the general partners of the affiliated investment advisers to register under the Advisers Act. It was represented that the general partners of each investment adviser would not be directly involved in giving investment advice, but under the proposed structure, management and control of each investment adviser partnership would technically reside with their respective unregistered general partners.<sup>14</sup> The employees of the

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<sup>12</sup> See, e.g., *Sentinel Real Estate Corporation* (pub. avail. November 22, 1988); *United Asset Management Corporation* (pub. avail. November 2, 1981).

<sup>13</sup> See, e.g., *Murray Johnstone Holdings Limited, et. al.* (pub. avail. October 7 1994); *Kleinwort Benson Investment Management Limited* (pub. avail. December 15, 1993).

<sup>14</sup> Actual management and control of each investment adviser was to be delegated to management boards composed primarily of representatives from other affiliated investment advisers.

unregistered general partners would not be prohibited from engaging in the investment advisory activities of the affiliated investment advisers. However, they would conduct such activities, if at all, only through their respective registered affiliates and only as Associated Persons of the affiliates.

The Staff provided the requested no-action relief in *Thomson* even though the specific criteria identified in *Richard Ellis* were not satisfied in all respects. In this regard, the Staff concluded that the concerns underlying the criteria in *Ellis* and Section 208(d) of the Advisers Act are adequately addressed when:

- (i) the unregistered affiliate of a registered adviser does not provide investment advice;
- (ii) the unregistered affiliate and each of its employees are deemed Associated Persons of the registered adviser when they have access to the investment recommendations of the registered adviser or information concerning investment recommendations prior to the effective dissemination of the recommendations; and
- (iii) the Commission has access to the unregistered affiliate's books and records to the extent necessary to examine the business of the registered adviser.

B. Rule 205-3

As noted above, Section 205 of the Advisers Act and Rule 205-3 thereunder, taken together, prohibit an investment adviser from charging of a fee on the basis of a share of capital gains or appreciation of the funds or any portion of the funds of a client unless certain conditions of the rule are met. These conditions generally require that: (1) performance fee arrangements are entered into only with clients deemed eligible under the rule; (2) such fees are computed in accordance with specified requirements; (3) all material information concerning the arrangement, including certain specified matters, are disclosed to the client; and (4) the adviser reasonably believes that the agreement providing for a performance fee represents an "arm's-length arrangement" and the client (or the client together with the client's independent agent) understands the proposed method of compensation and its risks.

The question raised under these provisions is whether the Advisory Affiliates, as registered investment advisers, are required to comply with Section 205 and Rule 205-3 thereunder with respect to the fees they charge for advice relating solely to futures trading.

In *Wallace G. Wagner* (pub. avail. June 28, 1990), the Staff took the position that, where a registered investment adviser not registered as a CTA would solely provide futures trading advice to a particular client, the terms of the advisory agreement with that client would nonetheless have to comply with Section 205 of the Advisers Act and Rule 205-3 thereunder.



## II. Application of Section 208(d) to JWH & Co.

### A. Satisfaction of Thomson Criteria

We are of the view that in the case of JWH & Co., as in *Thomson*, the concerns underlying Section 208(d), as articulated by the Staff in *Ellis* and subsequent no-action letters, will be adequately addressed without requiring JWH & Co. to register as an investment adviser. As an initial matter, we note that each of the three representations set forth in *Thomson* will be satisfied by JWH & Co. First, as represented below, JWH & Co. will not be giving advice regarding any securities other than certain U.S. government securities. JWH & Co. will thus not be an investment adviser as defined by Section 202(a)(11) of the Advisers Act. While it is true that in *Thomson* each unregistered affiliate was essentially a "shell entity," we believe that this fact was not essential to the Staff in reaching its conclusion. Indeed, the Staff did not include such a representation as one of the specific conditions upon which no-action relief was based, but only required that the unregistered affiliates not be engaged in rendering investment advice.<sup>15</sup> Moreover, to the extent that JWH & Co. engages in an active business, it is fully regulated by the CFTC and subject to the comprehensive regulatory scheme applicable to CTAs and CPOs under the CEA, including the rules of the NFA.

Second, JWH and any officer, director, or employee of JWH & Co. having access to the investment recommendations of RMI or any other Advisory Affiliate, or information concerning those recommendations prior to their effective dissemination, will be deemed an Associated Person of RMI or the Advisory Affiliate, as the case may be. Since these Associated Persons will not engage in investment advisory activities in their capacities as officers, directors, or employees of JWH & Co., those activities should not trigger any requirement that JWH & Co. register as an investment adviser.

Third, the Commission will be given access to JWH & Co.'s books and records to the extent necessary to examine the businesses of RMI and the other Advisory Affiliates.

### B. Underlying Concerns Not Implicated

In addition to satisfying the conditions set forth by the Staff in *Thomson*, the arrangements proposed by JWH & Co. do not, in our view, give rise to the concerns

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<sup>15</sup> In its discussion of the required representations, the Staff clearly contemplated circumstances where unregistered affiliates of registered investment advisers are actively engaged in a business:

[W]hen an unregistered affiliate of a registered adviser is engaged in some other business, the [Staff] would need access only to those books and records regarding transactions relating to the business of the registered adviser. . . .

underlying Section 208(d) of the Advisers Act. As discussed above, JWH & Co. is not an investment adviser as defined by Section 202(a)(11) of the Advisers Act. Thus, because the activities in which JWH & Co. engages do not constitute acting as an investment adviser, RMI and the other Advisory Affiliates will not be serving as means by which JWH & Co. can circumvent any requirements of the Advisers Act, or the rules and regulations thereunder, in contravention of Section 208(d).

We have considered the Staff's position in *Wagner* in reaching this conclusion in view of the possibility that such position could serve as the basis for an argument that JWH & Co. is violating Rule 208(d) by establishing RMI and the other Advisory Affiliates as separate entities from JWH & Co. to avoid the requirement that might be deemed to exist under *Wagner* that JWH & Co. not charge performance fees except under the conditions specified in Rule 205-3. For a number of reasons, however, we believe that *Wagner* is not applicable to the circumstances presented here.

Under *Ellis* and as clarified by *Thomson*, the JWH Companies are sufficiently independent and separate to justify separate legal treatment of JWH & Co. and the other Advisory Affiliates. The argument that the Staff's position in *Wagner* should apply to JWH & Co., however, presupposes that the affiliates are not sufficiently independent and separate to deserve separate legal treatment. In this regard, JWH & Co.'s affiliation with the Advisory Affiliates cannot be viewed as an indirect means for JWH & Co. to charge performance fees to investment advisory clients that otherwise would be impermissible because, under the *Thomson* criteria, JWH & Co. will not be providing investment advisory services.<sup>16</sup>

In addition, the proposed arrangements involving the JWH Companies are materially different from those considered in *Wagner*. JWH & Co., as a CTA, follows accepted industry practice by charging its clients performance fees for futures trading advice. This practice is of long standing and antedates the formation of RMI or any other Advisory Affiliate. In contrast, *Wagner* involved an existing registered investment adviser that was subject to Section 205 and Rule 205-3 at the time the investment adviser proposed to provide futures trading advice.

### III. Application of Section 205 and Rule 205-3 to Advisory Affiliates

In our view, the Advisory Affiliates should not be deemed subject to the requirements of Section 205 and Rule 205-3 with respect to performance fees they charge for advice relating solely to futures trading.

Unlike the case in *Wagner*, the Advisory Affiliates will be registered CTAs. Thus, to the extent the Advisory Affiliates provide advisory services relating to futures

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<sup>16</sup> The Staff's position in *Wagner* related to the activities of a *single* investment adviser. In our view, there is no regulatory concern that would warrant the application of this Staff position to the activities of an affiliate of an investment adviser where the *Thomson* criteria are satisfied.

trading, their activities will be fully regulated by the provisions of the CEA and the rules and regulations thereunder. Moreover, in view of the fact that the Advisers Act was not intended to regulate these services, because they do not involve advice concerning securities, we do not believe that Section 205 should be broadly applied so as to regulate fees charged by dually registered CTAs and investment advisers for futures-related services.

It is relevant in this regard that the performance fees charged by the Advisory Affiliates for commodity trading advice will, as noted above, be computed in a manner to assure that any gains or losses from securities held in clients' accounts as futures margin are not considered in determining the fees payable by clients. Indeed, in an analogous context the Staff did not require compliance with Section 205 and Rule 205-3 by a registered investment adviser that proposed to charge performance fees for real estate related advice. *EQK Partners* (pub. Avail. July 13, 1988). In *EQK*, although securities would be held in clients' accounts, it was represented that the performance fees charged for real estate related advice would not be based on the capital gains or capital appreciation of any securities.

In the case of the Advisory Affiliates, it would in our view be more appropriate to follow the position taken by the Staff in *EQK*, rather than that taken in *Wagner*. Such an approach would be consistent with the intended investor protection goals of the Advisers Act and would give due recognition to the CEA as the regulatory framework applicable to the CTA activities of the Advisory Affiliates.

#### IV. Public Policy Considerations

In our view, no public policy concern or regulatory purpose would be served by requiring JWH & Co. to register as an investment adviser or by requiring the Advisory Affiliates to adhere to Rule 205-3 when charging performance fees for commodity trading advice. As represented above, to the extent investment advisory services are provided to clients, they will all be provided by RMI or another Advisory Affiliate in full compliance with all applicable requirements of the Advisers Act and the rules thereunder, including Section 205 and Rule 205-3 thereunder. To the extent that RMI or another Advisory Affiliate provides advice regarding futures trading, their activities will be subject to the regulatory scheme of the CEA and the rules and regulations thereunder, as applicable to CPOs and CTAs, which includes regulation by the NFA. The services provided by JWH & Co. will also continue to be subject to such rules and regulations. Accordingly, all activities engaged in by the JWH Companies will be fully regulated and governed by the appropriate agencies and bodies of law. Thus, clients of each of the JWH Companies will receive the full benefits provided by the federal regulatory schemes applicable to investment advice and commodity trading advice with respect to all the services they receive from any of the JWH Companies. No regulatory purpose would, therefore, be served by requiring JWH & Co. to register as an investment adviser or by requiring the performance fees of the Advisory Affiliates to comply with Rule 205-3 when they are providing advisory services that relate solely to futures trading.

In this regard, we note that clients of the JWH Companies will be fully apprised of the separate identities and businesses of those companies because JWH & Co., RMI and the

other Advisory Affiliates will each take appropriate steps to assure that communications and disclosures to their respective clients and prospective clients will clearly distinguish the services provided by each company. In addition, prior to entering into a performance fee arrangement relating to futures trading that does not comply with Rule 205-3, the client of the Advisory Affiliate will be apprised of that fact. Thus, any potential for client confusion about which regulatory schemes and protections apply to services provided by JWH & Co., and which apply to RMI and the other Advisory Affiliates and the various services they render, will be avoided.

### REPRESENTATIONS

In connection with the request set forth in this letter, JWH & Co., RMI and the other Advisory Affiliates will comply with the following representations:

- (1) Each Associated Employee of an Advisory Affiliate will be subject to the supervision, direction and control of such Advisory Affiliate to the same extent as would be required under the Advisers Act if such individual engaged therein as an officer, director or employee of the Advisory Affiliate.
- (2) Each Advisory Affiliate will deem as an "associated person" each Associated Employee who has access to the investment recommendations of that Advisory Affiliate or information concerning such recommendations prior to their effective dissemination.
- (3) Each Advisory Affiliate will, in accordance with Rule 204-2(a)(12) under the Advisers Act, obtain and maintain on-site personal securities transaction records for each of its "advisory representatives" as such term is defined by such rule, and will also obtain and maintain on site records of the personal transactions of such persons in futures and related options.<sup>17</sup>
- (4) Each Advisory Affiliate will identify each Associated Employee in its Form ADV to the same extent as would be required under the Advisers Act if the Associated Employee were an officer, director, or employee of such Advisory Affiliate.
- (5) Each Associated Employee of an Advisory Affiliate will be subject to the conflict of interest, insider trading and personal securities transaction reporting requirements established by such Advisory Affiliate to the same extent as would be required under the Advisers Act if such individual were an officer, director, or employee of that Advisory Affiliate.

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<sup>17</sup> In this regard, all persons deemed to be "associated persons" of an Advisory Affiliate under the representation set forth in paragraph 2 above also will be "advisory representatives" of such Advisory Affiliate.

(6) JWH & Co. will not provide investment advice concerning securities except as described herein.

(7) JWH & Co. will: (a) provide the Staff access to any books and records of JWH & Co. which relate to services rendered by JWH & Co. to clients of any Advisory Affiliate (including any documents and records relating to the accounts of such clients) or which are required to be maintained by JWH & Co. pursuant to the provisions of the CEA and the rules thereunder;<sup>18</sup> and (b) instruct Associated Employees to cooperate fully with the Staff. (Such books and records of JWH & Co. will promptly be produced to the Staff upon request.)

(8) Any performance fee charged by an Advisory Affiliate for advice relating to futures trading that does not comply with Rule 205-3, will not be based upon the capital gains or capital appreciation of any securities.

(9) All fees charged by an Advisory Affiliate for investment advice relating to securities will comply with Section 205 of the Advisers Act and Rule 205-3 thereunder.

(10) Prior to an Advisory Affiliate entering into a performance fee arrangement with a client that does not comply with Rule 205-3, it will disclose to the client the fact that the fee is not computed in accordance with the rule.

#### CONCLUSION

For the reasons described above, and subject to the representations set forth above, we respectfully request confirmation that the Staff will not recommend that the Commission take enforcement action: (1) against JWH & Co. for failure to register under the Advisers Act or to comply with the provisions of the Advisers Act and the rules thereunder, including Section 205 and Rule 205-3, if RMI or any other Advisory Affiliate engages in an investment advisory business as described above; or (2) against any Advisory Affiliate for failure to comply with Section 205 and Rule 205-3, if the Advisory Affiliate charges performance fees for advice relating solely to the trading of commodity futures and options thereon, which fees do not meet the conditions of Rule 205-3.

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<sup>18</sup> Pursuant to CFTC regulations, a CPO or CTA must make and retain for a five year period books and records of all trading activity for client accounts and proprietary accounts. See, CFTC Rules 1.31, 4.23 and 4.33.

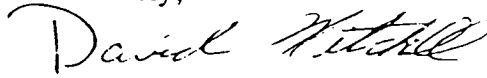
Jack W. Murphy, Esq.

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September 6, 1996

Please call me at the telephone number noted above, if you have any questions concerning this request or if you need any further information. We appreciate your consideration of this matter.

Sincerely,

A handwritten signature in cursive script that reads "David Mitchell". The signature is written in dark ink and is positioned above the printed name.

David S. Mitchell