Carew Carswell
1776 Peachtree St. NW
Suite 412 North
Atlanta, GA 30309

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VIA EMAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F. St., NE
Washington, D.C. 20549-1090

Re: Investment Advisor Performance Compensation, Release Number IA-3198 (the "Release")

Dear Ms. Murphy,

I am writing to comment on the Securities and Exchange Commission's (the "SEC") intention to change the allowable ways in which an SEC registered investment advisor (an "advisor") may engage in performance based compensation contracts with investors, as described in the above referenced Release.[1]

My understanding is that, unfortunately, the SEC on July 12, 2011, issued an Order[2] that increased two dollar amount tests that investors must now pass in order to be allowed to engage in performance based compensation contracts with advisors registered under the Investment Advisors Act of 1940 (the "Adviser's Act"). Specifically, as I understand the Release and subsequent Order, Rule 205-3 under the Adviser's Act now allows advisors to engage in performance based compensation contracts only with investors whose assets under the management of the advisor, and whose total net worth, generally, exceed $1 million and $2 million, respectively.

My understanding of the Release today is that two additional areas discussed therein remain open for potential modification by the SEC. These two open areas where comments are sought and will be considered by the SEC in their additional rule making and amendments to Rule 205-3 are briefly summarized as follows: "whether to exclude the value of a person's primary residence from the test of whether a person has sufficient net worth to be considered a 'qualified client;' and [how to] add certain transition provisions to the rule."[3]

With respect to my forthcoming comments, I note and seek to honor the following requests of the SEC as described in the Release:

> Commenters are requested to provide empirical data to support their views. The Commission also requests suggestions for additional changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this release.[4]

It is within these parameters that I aim to present my comments on the aforementioned areas of the Release still open for potential modification. My comments are borne of a desire to foster a level playing field for all our industry's participants, both investors and financial service

providers, and to foster an environment in which mere beliefs and imagination as guides in creating securities industry regulations take a back seat to the sort of empirically derived data the SEC is requesting from commenters seeking to influence SEC rule making. I am also motivated by an idealistic vision that all securities industry participants can collectively create and maintain an excellent sense of confidence in the US securities industry and its professionals; and can foster ongoing full disclosure of potential risks and other material information that investors need to make informed investment decisions.

Along these lines, not only do I back my comments with my own empirically derived arguments relative to the topics highlighted in the Release, but I also look back in history to gain perspective as to where we are today insofar as performance based compensation in the securities industry is in general, including the two areas still open for potential modification by the SEC. In order to build my arguments, I start at the beginning of what appears to be Congress' early imaginings of performance fees being problematic with respect to risk.

In the Beginning, There Was Imagination: **A Presumed Problem with Performance Fees**

In seeking to understand Congress' perception of a risk related problem with performance fees, I note in the Release where the SEC states that "Congress prohibited these compensation arrangements […] in 1940 to protect advisory clients from arrangements it believed might encourage advisors to take undue risks with client funds to increase advisory fees."[5] According to this sentence, Congress merely "believed [performance fees] might encourage advisors to take undue risks with client funds to increase advisory fees. As is known by most reasonable people, believing that something might happen is a far cry from knowing---from experience---that something will happen.

Yet, with regard to empirical evidence, in no part of the Release do I read that the fears and concerns of Congress are based on any empirically derived evidence that advisors' use of performance fees subjects investors to "undue risks" that would not exist in the absence of performance fees.

Paradoxically, however, as I previously noted, the SEC requests that commenters like me present their views with empirically derived information to back their arguments. I find this puzzling: Congress and the SEC implement rules based on their beliefs of what might happen, yet the SEC asks those who may disagree with those rules to back their arguments with "empirical data to support their views." It seems to me that, for all the parties to be on a level playing field, Congress and the SEC would create and implement regulations based on empirically derived knowledge that supports the particular rules being forced on securities industry participants.

In any case, endeavoring to present largely my own empirically derived comments with respect to Rule 205-3 and the Release, I enthusiastically offer comments that point to the weaknesses in what Congress and the SEC originally appear to have sought by placing limitations on the allowance of performance based compensation contracts being offered to investors, that is, increased protections for investors as to the potential risks presented to their investment capital under the management of advisors working under the Advisers Act. From general and broad brush comments, I seek to provide the SEC helpful food for thought as to the two remaining areas of potential additional regulation outlined in the Release, that is, again, whether to exclude the value of a person's primary residence from the test of whether a person has sufficient net worth to be considered a "qualified client;" and how to implement certain transition provisions to the rule.

Performance Based Compensation --- An Empirically Derived Point of View

As a registered investment advisor, a general securities registered representative, a service provider to the hedge fund industry, and as one with over two decades of experience in the securities investment industry,[6] I am pleased to provide my empirically derived views as to the SEC's proposed amendments referenced above, while also providing comments on what I consider to be more constructive ways for the SEC to accomplish the objectives originally envisioned by Congress.[7]

My empirically derived views come from having personally served numerous investors throughout my 20 plus year career, both high net worth investors as well as investors of limited financial means; from having served as consultant and service provider to numerous investment advisors (mostly advisors to hedge funds); and from having observed the behavior of the investor clients of many of these hedge fund advisors. Importantly, almost all of these investor clients fit the definition of accredited investor of Regulation D of the Securities Act of 1933 and the definition of qualified client under the Adviser's Act. From this background, I offer these reflections from my personal experience --

In general, the amount of assets owned by an investor, and similarly, the amount of income generated by an investor, has little to no relationship to that person's financial knowledge and sophistication. In the context of my comments, and reflecting on my past experiences, neither an investor's total net worth nor income is indicative of that person's financial knowledge and sophistication and, thus, using an investor's net worth or income as a means of determining whether an investor has the ability to understand and bear the risks associated with performance fee contracts is fruitless.

Reflecting back on my own experiences and those of others whom I have observed over many years, and while seeking to illustrate my comments through the power of comparison, I do so within the framework of the three basic compensation schemes enjoyed by advisors in the investment advisory industry: (1) brokerage commissions; (2) asset based management fees/advisory fees; and (3) performance based fees such as those focused on in the Release. While advisors generally utilize only one or two of these compensation schemes in their practices, a limited few utilize all three of the above at one time and with each of their advisory clients.

From my experience and observations over the years, when each of the three compensation schemes above is deployed by an advisor in the service of an investor, again, whether as a single, dedicated compensation offering, or perhaps all at once, that is, a combo of brokerage commissions, asset based management fees/advisory fees, and performance fees, all of the advisors will share a common goal: To create the investment performance mutually understood as appropriate for the investor and as reasonably deliverable by the advisor.

With regard to touching on some negatives of each of these compensation schemes, and by focusing my comments momentarily on some of the common arguments often heard against each, I point out that brokerage commissions can be unjustifiably increased ("churned") by a broker who is seeking to generate commissions unfitting for the client account (a risk to the investor). Asset based management fees/advisory fee compensation can breed laziness and complacency on the part of an advisor who, for example, may be focused on raising more client assets, thereby taking time away from dutifully seeking to manage risk and increase returns (a risk to the investor). And performance fees can motivate some advisors to undertake aggressive measures to increase returns or to make up a loss (a risk to the investor).

Moreover, whether in the case of commissions, asset based management fees/advisory fees, or performance fees, each scheme used to serve an investor can potentially reward the advisor with handsome compensation while the investor is left with losses. With this possibility always in play, that is, *You lost money, but I got paid anyway*, as a result of an investor's investment account potentially decreasing in value, an advisor by his human nature may undertake more aggressive strategies to increase the investor account value back up to a point of break-even or, hopefully, profitability.[8]

Indeed, whether in the context of brokerage commission compensation, asset based management fees/advisory fee compensation, or performance based compensation contracts, the above mentioned possibilities exist for an investor to have his investment assets exposed to more risk than was originally expected or originally agreed upon at the outset of an advisor/ investor business relationship.

I make the above points because these are some of the dynamics that truly unfold in the real world of advisory/investor relationships. I have not imagined the above scenarios and imbedded them in my mind as beliefs of what might happen. And the major, overarching point I want to make is this:

Whether in the case of brokerage commissions, asset based management fees/advisory fees, or performance based compensation, each investment advisor using these compensation schemes is prone to create varying degrees of risk to bear on his investor assets---sometimes to devastating levels---and none of these compensation structures discriminates in terms of the possibility of delivering unexpected, disappointing, and devastating losses to investors under the service of an advisor. For the sake of simplicity, the reason for this can be reduced to the fact that humans will deviate from the best laid plans when faced with potential large monetary loss or potential large monetary gain.

So, when reflecting on Congress' belief that performance based fee contracts might motivate advisors to take on excessive risks, I argue from experience and observation that the risks about which Congress was concerned in 1940 are no greater or no less than those risks which exist in brokerage commission or asset based management fees/advisory fee compensation investor relationships. Sadly, again, all three compensation schemes can lead to human influences that deal unwanted surprises of capital loss to investors amid each scheme's structural imperfections, and this is what Congress missed in 1940 when it unfairly singled out performance fees as possibly exposing unexpected risks to investors, and this is what the SEC should focus its attention on today when devising regulations aimed at protecting investors from unexpected risk.

Dismissing Beliefs and Imagination, Leveling the Playing Field, and Doing Something Good

Based on my comments above, I believe that Congress and the SEC have erroneously singled out performance fee contracts as an area in which many investors wanting and qualified to enter into performance fee contracts, and seeking to do so with advisors who may wish to utilize this compensation scheme in serving all investors, may not do so. This is not fair. Moreover, I firmly believe that if the SEC further constrains the provisions of Rule 205-3 through tests related to the net worth or value of a person's primary residence in determining whether a person has sufficient net worth to be considered a "qualified client," and if the SEC implements any transition mechanics that further limit or impede investors' and advisors' freedom to engage in performance compensation advisory contracts, more unnecessary restrictions will have been placed on investors and advisors who should have total freedom to engage with one another via performance fee contracts.

I think it bears repeating that my experience and observations in the securities investment industry tell me that just as much risk exists in brokerage commission compensation schemes and asset based management fees/advisory fees client relationships as there is in performance based compensation contracts. Were the SEC to implement the additional prospective amendments proposed in the Release, performance based compensation would be unfairly penalized when offered as an alternative to brokerage commissions and asset based management fees/advisory fees, and because of this, advisors wishing to deploy the use of performance based compensation would have fewer actual and prospective customers to serve, due to many investors being, in the incorrect view of Congress and the SEC, unqualified to engage in a performance fee contract with advisors. Thus, the SEC's implementation of any additional rules that constrain the free use of performance fee contracts between all investors and advisors would serve only to limit such advisors' and investors' choices as to service providers and compensation possibilities.

Finally, as an antidote to the remaining amendments proposed in the Release, as well as to the constraining requirements of Rule 205-3 currently in effect today, I am pleased to offer a suggestion as to a better means of effectuating the thorough disclosure of risk to investors in the context of advisor relationships. My suggestion involves, again, an effort at further stamping out the use of imagination as a tool to deal with prospective risk; in this case, I focus my attention on advisors who use imagination as a means of determining the amount of risk to which their investor clients will be subjected. For, just as I have observed about Congress' imaginings about risk in the 1940s, I have also observed similar imaginings among many investment advisors in the industry today.

With respect to how much risk an advisor incurs on behalf of an investor assets being managed by an advisor, I have observed that, upon asking numerous advisors over many years just how much of a percentage loss their particular strategy has inherent within it, an ambiguous answer is more often than not forthcoming. In other words, too few advisors, in my opinion, have a specific, defined risk control plan in place, and, as a result, the investors in such a program are left without a complete understanding as to how much risk they are taking on by investing in such a program. In other words, most advisors, from what I have observed, have only vague imaginings as to how much loss can or might occur within a given portfolio; as a consequence, the possibility for an unpleasant surprise on the part of the investor often results.

My view, then, is that the vast majority of advisor/investor relationships exist without the advisor and, thus, the investor, really knowing just how low an investor's account value can go before a "stop loss" trigger is imposed for the purpose of terminating an investment program and preserving what may remain of the investor's investment capital. The absence of such a stop loss mechanism is the origin of significant misunderstandings and problems between many advisors and investors. This uncertainty as to risk is pervasive in the investment advisory industry. But it does not need to be as pervasive and damaging as it is.

In my opinion, the sort of risk that Congress originally sought to alleviate from its imaginings in the 1940s with respect to performance fee contracts -- the same sort of risk that is just as potentially devastating to investment advisor/investor relationships today -- could be substantially mitigated by securities market regulators encouraging advisors to craft in writing the possible sources and specific magnitude of risk inherent in a particular investment program. In turn, investors in these programs would then be apprised of, and will have agreed to, a certain amount of risk—ideally, a specific dollar amount of risk. Upon an investor account reaching this level of agreed upon, acceptable level of capital loss, the program would then be considered a failure, and thus terminated.

I have observed---only rarely, however---such agreements between advisors and investors. Such agreements leave little room for misunderstandings as to risk. Yet, should misunderstandings arise due to an advisor not holding up his end of an agreement, actions to recover undue capital loss can be undertaken against the advisor for deviating from the agreed upon risk plan.

In summary, the imagination deployed by Congress in 1940 is overshadowed by the empirically derived reality of the conflicts and potential extraordinary risks of every advisor compensation structure utilized today, whether brokerage commissions, asset based management fees/advisory fees, or performance compensation contracts. Indeed, each of these compensation structures is fraught with the potential to negatively surprise investors with a level of risk that was unexpected, yet this problem can be addressed by advisors and investors so that the possibility of unexpected, unpleasant loss of capital can be substantially mitigated.

Performance based compensation contracts, therefore, should not be singled out and kept from being a compensation choice for any advisor or investor. The choice of how to compensate one's advisor should be that of the investor---not Congress or the SEC. If Congress or the SEC would like to attempt to alleviate potential negative risk surprises experienced by investors, then heightened disclosures by advisors as to risk should be encouraged; the crafting of specific risk management agreements between advisors and investors should be encouraged; and specific levels of tolerable risk being put into writing by advisors and investors should be encouraged. These two parties---advisors and investors---should be left to independently negotiate their own agreement as to the overall scope and amount of risk that is suitable.

I welcome further dialogue on the above referenced topics and my arguments delineated herein.

Sincerely,

Carew Carswell

Notes

[1] Securities and Exchange Commission, "Investment Advisor Performance Compensation," Release Number IA--3198. May 10, 2011

[2] Investment Advisors Act of 1940, Release Number 3236, July 12, 2011. "Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 Under the Investment Advisors Act of 1940"

[3] p 1 of Release Number IA--3198. May 10, 2011

[4] Ibid p 18

[5] Ibid pp 3,4

[6] You may visit www.carewcarswell.com for more information.

[7] By Congress stating that it did not want investors being subjected to "undue" risk, I perceive this to mean that Congress wanted to help in keeping investors from being surprised by learning the hard way that they signed-up for more risk than they thought they had originally agreed to.

[8] In spite of these forgoing negative points sometimes heard about these compensation schemes used by advisors, each one serves well tens of thousands of investors and thousands of advisors today; which compensation scheme--or combo of them--is best for an advisor and investor, of course, is left to the advisor and investor to decide.