JOHN C. KINNARD & COMPANY INCORPORATED

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Advisers Act Sec. 206

October 30, 1973

Timothy M. Heaney, Esq.
Fredrikson, Byron, Colburn, Bisbee, Hansen & Perlman
1460 Northwestern Bank Building
Minneapolis, Minnesota 55402

Re: John G. Kinnard & Co., Inc. ('Kinnard')

Dear Mr. Heaney:

I regret the delay in responding to your no-action request of July 20, 1973 on behalf of Kinnard with respect to its proposed operation of the Kinnard Technical Advisory Service (the 'Service').

As I informed you in our telephone conversation of October 24, 1973, the Commission's staff is presently analyzing the recommendations of the Advisory Committee on Investment Services for Individual Investors. Because the matter is presently under review and the Commission may, in the near future, announce its views with respect to the issues raised in your letter, as a matter of administrative discretion we are not currently issuing no-action letters in this area. You may, nevertheless, wish to advise Kinnard to proceed as you have outlined based on your opinion as counsel that its proposed activities would not violate the federal securities laws. Of course, your client might later be required to cease or modify it activities depending on the resolution of the current uncertainties.

We intend to respond to your letter as soon as possible after such resolution. However, we have the following comments on certain features of the Service which you may wish to consider at this time:

> (1) As you appear to recognize, the use of margin accounts and short selling would not be suitable for clients who are not financially able to sustain the risks inherent in their use. However, the proposed minimum account size of $15,000 seems relatively small, and many potential clients willing and able to invest this amount may nevertheless be unsuitable prospects for the Service. This suggests the need for the formulation of adequate suitability standards and very thorough screening procedures in determining the acceptability of potential clients.
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> (2) As you know, an investment adviser is a fiduciary who has a duty of undivided loyalty to his clients and must deal fairly and honestly with them. Therefore, Kinnard will have a duty to the clients of the Service to inform them of their ability to maintain their accounts with broker-dealers other than Kinnard. Moreover, if Kinnard recommends that accounts be maintained with it, applicable antifraud provisions of the federal securities laws require full disclosure, preferably in writing, of the nature and extent of any adverse interests Kinnard may have, including the amount of any compensation it will receive in connection with transactions. These laws, including Section 206 of the Investment Advisers Act of 1940, make it unlawful, in connection with an investment advisory business, to make misstatements or misleading omissions of material facts or to engage in any fraudulent act, practice, or course of business. Similarly, it appears that prior disclosure would be required of the fact that comparable services may be available elsewhere at a fee smaller than the 2 1/2 annual management fee proposed by the Service, since information available to us indicates that the fee imposed by most advisers for similar services does not generally exceed 2% of the assets under management. In view of the complex nature of the necessary disclosures, Kinnard may wish to present prospective clients of the Service with a written statement prior to their entering into an agreement with Kinnard and to receive in return a written acknowledgement of their receipt and their understanding of the matters disclosed.
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> (3) You state that the clients terminating their agreements during the first year with the Service will be required to pay the fees which would have been due during such year. An arrangement

which contemplates payment of advisory fees for advisory services which are not rendered could, in our view, constitute a deceptive practice within the meaning of Section 206 of the Advisers Act. It would appear that the imposition of a fee, whether or not paid in advance, in excess of that earned until the date of termination of an agreement by a client would be justifiable only to the extent necessary to reimburse the adviser for reasonable expenses actually incurred in initiating the client's account. Thus, a more reasonable approach would be to prorate the annual fee after deduction of such expenses and to refund, if already paid, the portion allocable to the period after termination.

I would like to emphasize that the fact that we have made the foregoing comments should not be construed as meaning that there are no other possible problems under the federal securities laws with respect to the proposed operation of the Service, or that the staff concurs in the views expressed in your letter or is taking a no-action position. As indicated above, the recommendations in the Advisory Committee's report express only the views of the committee and not of the Commission or its staff.

Sincerely,

Seymour Spolter
Attorney

INCOMING LETTER

July 20, 1973

Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Securities Act Secs. 2(1), 4(2)
Investment Company Act Sec. 3(a)(1)

Gentlemen:

We are writing to you as counsel for John G. Kinnard & Company, Incorporated ('Kinnard'), a registered broker-dealer and an applicant for registration as an investment adviser, to inquire as to whether the staff of the Commission agrees with our opinion as to the proposed operation by Kinnard of the 'Kinnard Technical Advisory Service'. Details of the service to be offered, a brief analysis of the legal questions presented and our opinion are set forth below.

Operation of the Service

1. Kinnard will be registered as an investment adviser with the Securities and Exchange Commission and with the appropriate ?? of States in which it offers its service and registration is required.

2. The service offered will be the management of discretionary brokerage accounts. Accounts may be maintained at Kinnard or at any other registered broker-dealer which will accept instructions from its clients to follow investment decisions made by the Kinnard Technical Advisory Service. Directions for purchases or sales will be given by personnel of the advisory service to the registered representative maintaining the client's account.

3. The service will be offered to investors able to invest a minimum of $15,000.00 in an account with a technical orientation towards the securities markets. Specific investment decisions for each account will be dependent upon:

a) the degree of risk appropriate for the client as determined by an analysis of his economic status including financial obligations, income, life insurance, and other investments;

b) the tax situation of the client including relative advantages of short-term and long-term capital gains and to losses;

c) the rate of turn-over in investments appropriate for client.

All accounts will be margin accounts and only clients willing and able to engage in short-selling will be accepted. Purchases on margin will not be made unless the client specifically authorizes such purchases.

4. The service will be offered only through personal contacts made by registered representatives of Kinnard. Such contacts will be made only with persons whom Kinnard employees have reasonable grounds to believe possess the financial resources to include as a part of their investment program a margin account with a technical orientation. General solicitation of the public or of present Kinnard customers will not be made.

5. The service will be administered by John E. Silber, Edward W. Brownell and such additional employees of Kinnard as are required Potential clients will meet with Kessrs. Silber and Brownell for an explanation of the technical orientation of the service and a preliminary analysis of the potential client's investment objectives and the suitability of the service.

6. Potential clients will be required to complete a Personal Data Questionnaire to be designed along the lines of the questionnair prepared by the SEC Advisory Committee on Investment Services for Individual Investors. Up-dating of such questionnaire will be required annually and upon the occurrence of material changes in the data provided therein.

7. The management fee will be prepaid quarterly at a 2–1/2% annual rate based on the net equity value of the account during the previous quarter. Clients terminating their agreement during the first year with the service will be required to pay the fees which would have been due during such year calculated on basis of net equip value on the date of termination. Management fees will be charged in addition to regular brokerage commissions and no reduction in fees of commissions will be allowed to clients who maintain their accounts at Kinnard.

8. The orientation of the investment adviser towards the market will be technical analysis of leading and coincident indicators including momentum, volum and popular averages. Analysis of fundamentals will play a secondary role in the adviser's approach to investment. The investment adviser will continually monitor and research number of securities which display characteristics favorable to gained through purchase or short-sale. Approximately 100 such securities at presently being monitored and research by Kinnard. Purchase or sale of specific securities will be made for specific accounts on an individual basis with decisions being based upon the degree of risk in this position and the resources in the account. Accounts will not be placed uniformly in the same securities. Securities purchased or sold will be purchased or sold for designated accounts. Each transaction will be handled by the registered representative maintaining the account.

9. The investment adviser will not direct the purchase or short-sale of any securities in which Kinnard makes a market or in which it is participating in a distribution. Kinnard, its affiliates or employees may have a position or interest in a security in which it orders purchase or sale for clients' accounts, however, orders and sales by such persons will be permitted only after transactions ordered for clients' accounts have been completed. The client may direct the purchases or sale of any security in his account, may add to or withdraw from his account at any time and may terminate his account at any time.

10. Clients will receive copies of confirmations of all transactions in their accounts and monthly statements reflecting all securities positions and cash balances. Duplicate copies of all confirmations will be retained permanently by the advisory service. Both the registered representative maintaining the client's account and personnel associated with the advisory service will be available to the client for consultation.

Analysis of Legal Questions and Opinion

1. 1933 Act/2(1). The Securities Act of 1933 prohibits a public offering of unregistered securities. 'Security' is defined in § 2(1) to include any '. . . investment contract . . ..' Literally applied such definition might be held to encompass an agreement by Kinnard to manage a brokerage account and hence to require registration of the Kinnard advisory service. We suggest that such a literal application would not be justified as it would ignore the common enterprise requirement for the finding of a security and the interrelationship of the definition of security in § 2(1) and the exemption for transactions not involving a public offering in § 4(2). Neither a common enterprise nor a public offering is to be found in the type of individualized management services proposed by Kinnard.

The United States Supreme Court in SEC v. W. J. Howey Co., 328 U.S. 293 at 301, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946), held that: 'The test [for an investment contract] is whether the scheme involves an investment of money in a common enterprise with profits to come sole from the efforts of others.' Though several lower court decisions, see e.g., Johnson v. Espey, 314 F. Supp. 764 (S.D. N.Y. 1972), Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D. N.Y. 1968), and Berman v. Orimex, 291 F. Supp. 701 (S.D. N.Y. 1968), have implied that common enterprise is not an essential element to the finding of a 'security' or 'investment contract' such an interpretation of the Securities Act has been rejected by other courts, see e.g., Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149 (N.D. Ill. 1970), 457 F.2d 274 (7th Cir. 1972), cert. denied, 93 S. Ct. 113 (1972). It should also be noted that the decisions implying that common enterprise is not a necessary element arose from cases involving discretionary commodition accounts. The need to extend the protections of the Securities Act in the largely unregulated area of commodities accounts is far more certain than the need for extension in the area of corporate security accounts.

A 'common enterprise' will not result from the service offered by Kinnard because there will be no common ownership nor sharing of ?? Each client will have full ownership rights in specific securities. Though securities certificates will be maintained in the street name of Kinnard such certificates will be no more commingled than the certificates of general customers of broker-dealers and clients will have all of the protections accorded general customers. Further, the elements of value enhanced by similar investments of others and of mutual dependence of investments found fatal to certain other investment programs (see Continental Marketing v. SEC, 387 F.2d 466 (10th Cir. 1967) will be absent from the service offered by Kinnard. The value which clients will pay for their accounts and which will be realized upon liquidation of their accounts will be net equity value less a minimal service charge related entirely to services extended their individual accounts and not to a value enhanced by the benefit of pooling.

2. The definition of 'security' in § 2(1) should not be read apart from the exemption of transactions not involving a public offering in § 4(2). The concept of individualized service negates both the common enterprise element of a security and the public offering ?? of the registration requirements. The Kinnard service will neither offered to the public nor will the same service offered be to more ?? one individual. In these two critical respects the Kinnard service will differ from services found objectionable by the SEC in SEC v. First National City Bank, et al., CCH Fed. Sec. L. Rptr. ¶92,592 (S.D. N.Y. 1970) and In Finanswer America America/Investments, Inc., CCH Fed. Sec. L. Rptr. ¶78,111 (SEC 1971). Prospective clients will be selected on the basis of present investment activities and will be immediately screened to determine the suitability of the service to their investment capabilities and objectives. The minimum size of the accounts and the requirement that clients have other financial resources are additional protections against public participation.

The service offered by Kinnard will be individualized both in the attention that will be given to each client's economic and tax status and in the method of selection of securities and the timing of transactions for each account. The Kinnard service will have a technical orientation towards the market and in that sense its management of an accounts will be similar. However, such technical analysis will indicate investment opportunities with differing degrees of risk and investment decisions for particular accounts will accordingly differed Accounts will not be uniformly moved in and out of securities position.

3. The Investment Company Act in § 8(a) requires the registration of investment companies not otherwise exempt. We suggest that an 'investment company' as defined in § 3(a) would not be created by Kinnard's management of discretionary accounts for basically the same reasons that offering the service would not constitute the offering of a 'security'. As pointed out by the Third Circuit Court of Appeal in The Prudential Insurance Company of America v. SEC, 326 F.2d 383 (3d Cir. 1964) (cert. denied, 377 U.S. 953 (1954)), finding an investment company depends upon finding '. . . a combination

of distinct individual interests . . .', a '. . . commingling of funds of numerous investors . . .', the management of '. . . large liquid pools of the public's savings . . ..' As pointed out above, the Kinnard service will not result in a combination of interests, rather the success of an account will depend upon the securities individually selected for it. Commingling of clients' securities will occur only to the extent commingling occurs in operation of all brokerage firms and to the extent that Kinnard may act as clients' broker-dealer as well as investment adviser its activities are exempt under § 3(c)(2). Pooling of clients' funds for purchases will not occur. Most importantly, unlike in Prudential, where clients owned '. . . only a pro rata share of what the portfolio of equity interests reflects . . .', the interests of Kinnard's clients will be individual ownership interest in specific securities.

On the basis of the foregoing, we are of the opinion that no registration of the 'Kinnard Technical Advisory Service' is required under either the Securities Act of 1933 or the Investment Company Act of 1940.

Your consideration of this matter is appreciated. If you need additional facts, please call me at your convenience.

Very truly yours,

Timothy M. Heaney