

The Evolution of Past Specific Recommendations in Investment Adviser Advertisements

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Investment advisers have long struggled with how to provide clients with meaningful information about the performance of particular holdings given the limitations on the use of past specific recommendations contained in the Investment Advisers Act of 1940 (Advisers Act). This is particularly so when an investment adviser wishes to highlight the performance of particular portfolio holdings or “partial lists” of recommendations recently purchased or sold for client accounts. Although the no-action letters issued in recent years provide investment advisers with additional flexibility in this area,¹ the Securities and Exchange Commission (SEC) Staff had not, until recently, directly addressed the policy considerations underlying the use of past specific recommendations.

On November 7, 2008, the SEC Staff issued a no-action letter to The TCW Group, Inc.

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(TCW)² that arguably shifts the paradigm in this area by permitting TCW to refer to partial lists of recommendations selected using performance-based criteria, if the investment adviser objectively selects the holdings and presents them in a fair and balanced manner. Specifically, the TCW no-action letter allows the presentation of a contribution analysis that shows the relative impact of an equal number of “best and worst performers” that most positively and negatively impacted the

performance of a representative account over the relevant measurement period. The TCW no-action letter also is significant because it allows investment advisers to include these types of presentations in advertisements that are distributed to a wider audience than previously permitted. Perhaps more importantly, however, the TCW letter appears to validate the long-standing industry view that investment advisers should be able to show partial lists of portfolio holdings if they select and present those holdings in a manner that is consistent with the underlying policy considerations of Advisers Act Rule 206(4)-1(a)(2), which governs the use of past specific recommendations (the Rule).³

Background and Policy Considerations

Advisers Act Rule 206(4)-1(a)(2) makes it unlawful for an investment adviser to “publish, circulate, or distribute any advertisement which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person,” subject to certain exceptions. Specifically, the Rule does not prohibit an advertisement that “sets out or offers to furnish” a list of all recommendations made by the investment adviser over the prior 12 months if the advertisement or list complies with two conditions. First, the advertisement or list must state the name of each security recommended during the 12 month period, the nature of the recommendation (for example, buy, sell, or hold) and certain information about the market price of each such security. Second, the advertisement or list must disclose that “it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list.”

The concern underlying the prohibition against referring to past specific recommendations is commonly referred to as “cherry picking.” In its release proposing Rule 206(4)-1, the SEC stated that references to past specific recommendations intrinsically are misleading.⁴ According to the SEC Staff, “Rule 206(4)-1(a)(2) was intended to prohibit advertisements by an investment adviser that would give existing or prospective clients a misleading impression of an adviser’s performance by selectively referring to profitable past recommendations of the investment adviser while ignoring the unprofitable.”⁵ However, “Rule 206(4)-1(a)(2) does not prohibit an investment adviser from distributing advertisements that identify and discuss the adviser’s unprofitable recommendations.”⁶

These policy considerations have prompted the SEC Staff to broadly interpret the prohibition on the use of past specific recommendations with the result that it often is difficult for an investment adviser to discuss the performance of specific portfolio holdings in advertisements. Guidance in this area also is complicated by the fact that the Rule does not define “past specific recommendations.” The SEC Staff takes the view that an advertisement that contains only current recommendations would not be subject to the Rule.⁷ However, whether something is a “current” or a “past” recommendation depends on the facts and circumstances at the time the advertisement is distributed. For example, a recommendation that is current as of the date of publication would be considered a past recommendation if the advertisement is distributed after the investment adviser stops investing in the position on behalf of its client accounts. Because of the practical difficulties distinguishing current and past recommendations, the limitations on the use of past specific recommendations generally are applied broadly to any discussion of portfolio holdings that recently were purchased or sold for client accounts.

TCW No-Action Letter

The TCW no-action letter attempted to address the cherry picking concern by creating a presentation that, in TCW’s words, was “performance-based,” but not “performance-biased.” Specifically, TCW developed an analytical tool called the “Best/Worst Performers Charts” designed to show the effect of the performance of individual holdings on a representative account over a particular period of time or measurement period. The charts show at least five holdings that contributed most positively to the representative account, and an equal number of holdings that detracted the most from the performance of the representative account.

TCW identified these best and worst performers by calculating the weight of each holding compared to the total representative account, multiplied by the rate of return for that particular holding, over the measurement period. Based on these calculations, it created a “master” contribution list that showed the amount of return attributable to each holding in the representative account. TCW included the five holdings that contributed most to performance, the five holdings that detracted most from performance in charts, that also reflected the average weight of each position in the representative account and the amount (positive or negative) that each holding contributed to performance.

TCW proposed to include these charts in advertisements and communications directed to current and prospective clients and consultants. The charts were designed to supplement TCW's performance composites by providing additional information "about how an adviser's investment decisions affected that performance."

In granting the no-action relief, the SEC Staff agreed that the presentation of the charts did not implicate the cherry picking concerns underlying the Rule because, among other things, the specific holdings are selected based on an "objective, non-discretionary, unbiased, and mechanical methodology" that is consistently applied to all holdings in the representative account. The result is that the TCW no-action letter permits investment advisers to distribute advertisements that include a contribution analysis showing those positions that most positively and most negatively impacted the performance of a representative account, subject to the following conditions:

- The calculation methodology must be applied to all holdings in the representative account that contributed to the account's performance during the measurement period.
- The charts must show no fewer than ten (10) total holdings, including an equal number of positive and negative holdings.
- The calculation methodology, the presentation of information, and the number of holdings must be consistent from measurement period to measurement period.
- The charts must disclose how to obtain: (i) the calculation methodology; and (ii) a list showing the contribution of each holding in the representative account to the account's performance during the measurement period.
- The charts must include all information necessary to make the presentation not misleading, including, for example, disclosure that: (i) the holdings identified do not represent all of the securities purchased, sold, or recommended for advisory clients; and (ii) past performance does not guarantee future results.
- The best and worst performers must be presented: (i) on the same page; (ii) with equal prominence; and (iii) with appropriate disclosure (which also must be in close proximity to the performance information).
- The investment adviser must maintain and make available to SEC Staff, on request, records evidencing: (i) the criteria used to select the specific securities listed in the

charts (that is, the calculation methodology); (ii) a list showing the contribution of each holding in the representative account to the account's performance during the measurement period; and (iii) all supporting data necessary to demonstrate the calculation of the contribution of each holding and the appropriateness of the holdings included in each chart.

Use of Performance-Based Criteria

Although the TCW no-action letter does not go so far as to allow investment advisers to show the actual performance of the best and worst performers, it does expand the prior guidance in this area by permitting investment advisers to select partial lists of holdings using performance-based criteria.

Prior to the issuance of the TCW no-action letter, the predominant guidance in the area of past specific recommendations was based on a 1998 no-action letter to Franklin Management, Inc. (Franklin). In Franklin, the investment adviser requested the flexibility to identify and discuss a limited number or "partial list" of securities that were bought, sold, or held for client accounts during the relevant quarter in a quarterly "Investment Outlook" report that was distributed to existing and prospective clients. Because of the large volume of securities transactions and accounts under management, Franklin maintained that it would be impractical to provide clients with a list of all securities recommendations over the prior 12 month period or to provide individualized investment reports listing all client holdings. Instead, Franklin proposed to select the securities that would be discussed based on objective, non-performance based criteria, such as the holdings with the largest dollar amount of purchases or sales during the quarter. In addition, Franklin agreed that the investment reports would not discuss the profits or losses generated by any particular securities holding. The SEC Staff permitted Franklin to include a partial list of recommendations in its quarterly investment reports, if the investment adviser:

- Used objective, non-performance based criteria to select the specific securities it discussed;
- Used the same selection criteria for each quarter or each particular investment category;
- Did not discuss, directly or indirectly, the amount of the profits or losses, realized or unrealized, of any specific security; and

- Maintained, and made available to SEC Staff, on request, records showing: (i) the complete list of all securities recommended in the preceding year for the specific investment category covered by each report; (ii) the information set forth in Rule 206(4)-1(a)(2)(A) (that is, the name of each security recommended during the 12-month period, the nature of the recommendation (for example, buy, sell, or hold) and certain information about the market price of each such security) for each recommendation; and (iii) the criteria used to select the specific securities listed in each report.

The TCW no-action letter maintains the requirement that investment advisers objectivity select particular holdings for discussion, but expands the Franklin standard by allowing investment advisers to use a performance-based calculation to select those holdings. Specifically, the so-called best and worst performers that were highlighted in the TCW charts were selected based on the amount of their relative impact on the performance of a representative account. In this regard, the TCW no-action letter gives investment advisers the flexibility to provide clients with more information as to the specific portfolio holdings that contributed to or detracted from the performance of their accounts. This is particularly helpful given current market conditions in which investment advisers may feel that they have a fiduciary duty,⁸ as well as a business imperative, to provide more meaningful and detailed information about the performance of client accounts.

Broader Distribution of Advertisements

The TCW no-action letter also builds on prior guidance that permitted investment advisers to refer to past specific recommendations in communications to existing clients (with respect to their particular investment strategies) and to prospective clients and consultants that request such information from the adviser. Specifically, in a 2004 no-action letter to the Investment Counsel Association of America, Inc. (ICAA), the SEC Staff took the position that written communications directed to existing clients that discuss the performance of their accounts generally would not constitute “advertisements” under Rule 206(4)-1(b), unless such communications have the purpose of offering advisory services.⁹ Thus, the SEC Staff distinguished between written communications to existing clients that are “part of the adviser’s advisory services,” and those

that, based on the context, are more in the nature of advertisements. Under this approach, written communications directed to existing clients that discuss specific holdings that are or were recently held in the accounts of such clients would not be considered advertisements. However, written communications sent to prospective clients or existing clients who invested in other strategies or that do not hold the positions discussed in the communications, would be considered advertisements that would be subject to the limitations on the use of past specific recommendations set forth in the Rule.

The ICAA no-action letter also stated that written communications sent in response to unsolicited requests from clients, prospective clients, or consultants would not be considered advertisements and would not be subject to the Rule, so long as the adviser did not, directly or indirectly, solicit the request. This approach acknowledges that clients, prospective clients, and consultants routinely ask for information regarding the identity and performance of an investment adviser’s past specific recommendations.

Prior to its request for no-action relief, TCW was including the charts only in communications that were not considered advertisements under the ICAA no-action letter. The TCW no-action letter preserves this existing guidance, but also confirms that investment advisers may send written communications that refer to past specific recommendations to “prospective clients and consultants who do not specifically request the information, and to current clients who are not invested currently in the investment strategy represented in the chart[s],” subject to the conditions set forth in the TCW no-action letter.

Represents an Alternative Approach to Addressing Policy Considerations

Although the flexibility incorporated into the Franklin and ICAA no-action letters was helpful, the TCW no-action letter provides a perhaps more direct approach to addressing the underlying policy considerations of the Rule. In the Franklin no-action letter, the SEC Staff addressed the cherry picking concerns by eliminating references to performance entirely. The Franklin conditions prohibited an investment adviser from using performance as a criterion for selecting particular holdings and from referring to the profitability of any particular holding. In the ICAA no-action letter, the SEC Staff concluded that the communications at issue were not “advertisements” within the meaning of Advisers Act Rule 206(4)-1 and, therefore, never

addressed the policy considerations underlying the use of past specific recommendations.

We caution that the TCW no-action letter does not go so far as to permit investment advisers to show the actual performance or discuss the absolute profitability of particular holdings. However, the TCW no-action letter does seem to validate, or at least move closer than the prior SEC Staff interpretive guidance, to the long-standing industry view that the identification and discussion of partial lists of portfolio holdings should not be prohibited if the holdings are selected on an objective basis (whether or not based on performance) and are presented in a fair and balanced manner.¹⁰ This approach recognizes that it is not the use of performance-based criteria or the reference to a partial list of securities that is *per se* fraudulent, but rather that cherry picking can and should be addressed through processes and disclosure designed to mitigate the risk that investment advisers would highlight only their profitable recommendations.

Policies and Procedures for the Use of Past Specific Recommendations

Investment advisers that wish to avail themselves of the additional flexibility set forth in the TCW no-action letter should consider amending their policies and procedures and testing under Advisers Act Rule 206(4)-7 to address the following issues:

Objective Criteria—Investment advisers that highlight the performance of certain past specific recommendations in advertisements must develop an objective, quantitative methodology for selecting holdings and should document this methodology in their policies and procedures. The TCW no-action letter leaves open the question of whether a different performance-based methodology (other than a contribution analysis) would be permissible, but any such approach would, at a minimum, need to meet the conditions of the TCW no-action letter, including that it is a quantitative methodology designed to take into consideration all holdings, it is applied on a consistent basis and is not subject to manipulation.

As a practical matter, advisers should consider whether the calculation methodology should be designed by personnel distinct from the investment professionals responsible for managing or marketing the particular strategy to which the calculation methodology relates. Further, investment advisers should test the operation of the calculation methodology on an annual or more frequent basis to ensure

that it is objectively and consistently applied each quarter.

Representative Accounts—The TCW no-action letter contemplates that the calculation methodology would be applied to a representative account that reflects the particular investment strategy the investment adviser wishes to discuss.¹¹ The use of a representative account is not *per se* fraudulent or misleading; however, it does raise the question of whether the representative account is, in fact, representative of the accounts managed pursuant to a particular investment strategy.

Accordingly, the investment advisers should consider defining in their policies and procedures the criteria used to select a representative account. On an ongoing basis, investment advisers should monitor the performance and characteristics of their representative accounts relative to the other accounts in the relevant strategy and disclose any dispersion or other factors that may affect whether the account is truly representative of the strategy.

Content of Past Specific Recommendation Presentations—As with any policies and procedures relating to the use of advertisements, investment advisers should have a process for developing and reviewing the content of advertisements or other communications that refer to past specific recommendations. Marketing personnel should be responsible for developing the content in a manner consistent with the requirements of the TCW no-action letter. Specifically, the presentation of the information and the number of holdings discussed should be consistent from quarter to quarter.

Further, the presentation must show an equal number of positive and negative holdings (or best and worst performers), with no fewer than five of each. Importantly, the best and worst performers must be shown with equal prominence on the same page. Thus, investment advisers must resist the temptation to refer to the worst performers in a footnote or in a supplemental information section that appears at the end of a presentation. This also is true of the disclosures that relate to the use of past specific recommendations, which is required to appear in “close proximity” to the past specific recommendation presentation. Compliance or legal personnel, as appropriate, should review the past specific recommendation presentations prior to distribution.

Appropriate Disclosures—Policies and procedures relating to the use of past specific recommendations should describe the relevant disclosures that are required. Under the terms

of the TCW no-action letter, the past specific recommendation presentations should disclose:

- That the holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients;
- That past performance does not guarantee future results;
- How to obtain the relevant calculation methodology; and
- How to obtain a list showing every holding's contribution to the representative account's performance during the measurement period.

Investment advisers also may wish to provide more detailed disclosure that explains the criteria used to select the holdings that are referenced in the advertisement, along with any performance dispersion or other differentiating characteristics relevant to the selection of a representative account. Additional disclosure items might include the fact that portfolio holdings change over time and an explanation that references to specific securities are presented to illustrate the application of a particular investment strategy and should not be considered to be a recommendation of any particular security.

Recordkeeping Requirements—Investment advisers should incorporate the recordkeeping requirements set forth in the TCW no-action letter into their policies and procedures. Among other things, these conditions require investment advisers to maintain all “supporting data necessary to demonstrate the calculation” of the contribution analysis and to demonstrate the appropriateness of the holdings reflected in each chart. This language, which is similar to that contained in Advisers Act Rule 204-2(a)(16),¹² reflects the importance of maintaining appropriate records that SEC Staff can use to verify compliance with the conditions of the TCW no-action letter. Investment advisers can expect past specific recommendations to be an area of focus during SEC examinations and, accordingly, should institute testing procedures to make sure they both maintain and are able to produce the applicable records.

Other Considerations—Although the TCW no-action letter permits investment advisers to distribute advertisements that contain past specific recommendations more broadly to existing and prospective clients and consultants, investment advisers may wish to consider whether a more limited distribution may be appropriate given concerns about the selective disclosure and confidentiality of portfolio holdings.

In addition, investment advisers should keep in mind that they are not required to comply with the terms of the TCW no-action letter or the limitations of the Rule if they refer to past specific recommendations in communications directed to existing clients that discuss specific holdings that are or were recently held in the accounts of such clients or to prospective clients and consultants in response to an unsolicited request for such materials. As a result, investment advisers may wish to distinguish in their policies and procedures between “communications” and “advertisements” based on the context and the audience, as described in the ICAA no-action letter. Even communications that are not technically considered “advertisements,” however, are still subject the general antifraud provisions of Advisers Act Sections 206(1) and 206(2).¹³ Thus, policies and procedures should still include provisions reasonably designed to ensure that those communications are presented in an accurate and balanced manner.

Conclusion

The TCW no-action letter reflects the most recent SEC Staff guidance relating to the use of past specific recommendations and provides investment advisers with increased flexibility, including, for the first time, the ability to select partial lists of portfolio holdings using performance-based criteria. This increased flexibility should be reflected in applicable policies and procedures and implemented in a manner consistent both with SEC Staff guidance and the underlying policy considerations of the Rule.

NOTES

1. See Investment Counsel Association of America, Inc., SEC No-Action Letter (pub. avail. Mar. 1, 2004) [hereinafter, Investment Counsel Association of America]; Franklin Management, Inc., SEC No-Action letter (pub. avail. Dec. 10, 1998) [hereinafter, Franklin].
2. The TCW Group, Inc., SEC No-Action Letter (pub. avail. Nov. 7, 2008) [hereinafter, TCW].
3. We note that there has been an ongoing dialog between the investment adviser industry and the SEC Staff over the need to modernize Advisers Act Rule 206(4)-1 to eliminate the restrictions on the use of past specific recommendations. See Lawrence Stadulis, “Past Specific Recommendations in Investment Adviser Advertisements,” *The Investment Lawyer*, Vol. 13, No. 6 (June 1996) (urging the industry and the SEC to repeal or limit the prohibitions on the use of past specific recommendations and instead rely on the general anti-fraud provisions of Advisers Act Rule 206(4)-1(a)(5)); Paul F. Roye, Director, Division of Investment Management, US Securities and Exchange Commission, Keynote Address

at the Glasser LegalWorks Fifth Annual Investment Advisors Compliance Conference (May 4, 2001), available at <http://www.sec.gov/news/speech/spch488.htm> (expressing desire to eliminate a “laundry list” of practices, such as testimonials and partial lists of recommendations, that currently are *per se* fraudulent and adopt general antifraud standard); see also, Letter from Karen L. Barr, General Counsel, ICAA, to Paul F. Roye, Director, Division of Investment Management, US Securities and Exchange Commission (Aug. 21, 2001), available at http://www.investmentadviser.org/web/docs/Publications_News/Comments_and_Statements/Archived_Comments_Statements/letterscompendium-2001.pdf (proposing changes to Rule 206(4)-1 that would, among other things, eliminate current restrictions on use of past specific recommendations); Letter from Karen L. Barr, General Counsel, ICAA, to Jonathan G. Katz, Secretary, US Securities and Exchange Commission (July 31, 2002), available at <http://www.404.gov/rules/proposed/71702/klbarr1.htm> (responding to SEC request for comments to proposed rule amendments and urging SEC to adopt prior recommendations of ICAA).

4. Regulation of Advertisements by Investment Advisers, Advisers Act Release No. 121 (Nov. 2, 1961).

5. Starr & Kuehl, Inc., SEC No-Action Letter (pub. avail. Apr. 17, 1976).

6. Franklin, *supra* n.1, at n.11.

7. *Id.* at n.9.

8. See Restatement (third) of Trusts § 82 (2007) (detailing trustee’s duty to furnish information to beneficiaries); Restatement (third) of Agency § 8.11 (2006) (stating agent’s duty to provide information to principal).

9. See Investment Counsel Association of America, *supra* n.1.

10. This approach is consistent with that proposed in 1961, which would have allowed an investment adviser “to furnish either (A) a list of all recommendations made by the investment adviser within the preceding period of not less than one year, or (B) a truly representative list of all such recommendations which shows those which were or would have been unprofitable as well as those which would have been profitable, and which is not otherwise misleading.” See *Revised Proposal to Prohibit Deceptive Advertising by Investment Advisers*, Advisers Act Release No. 119 (Aug. 8, 1961).

11. TCW, *supra* n.2, at n.3 (noting that TCW did not ask, and the SEC Staff did not take a position on, whether TCW’s selection of a representative account complies with the federal securities laws).

12. Advisers Act Rule 204-2(a)(16) requires investment advisers to maintain any records or documents “necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations” contained in any advertisement or other communication distributed to more than ten (10) people.

13. See Investment Counsel Association of America, *supra* n.1.

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