

INVESTMENT FUNDS ALERT

SEC STAFF EXPANDS ABILITY TO USE PAST RECOMMENDATIONS IN ADVERTISEMENTS

In a no-action letter publicly released on November 7, 2008, to The TCW Group, Inc. (the “TCW Letter”)¹, the staff of the Securities and Exchange Commission’s Division of Investment Management (the “Staff”) significantly expanded the information that a registered investment adviser may include concerning past specific recommendations in its advertisements without being in violation of Rule 206(4)-1(a) (the “Advertising Rule”) under the Investment Advisers Act of 1940, as amended. In the TCW Letter, the Staff permitted The TCW Group, Inc. and its affiliated advisers to identify in an advertisement the five most profitable positions in a portfolio representative of a particular investment strategy, so long as it also identified the positions that most negatively impacted the performance of that portfolio, and it presented the positions and maintained records in accordance with the disclosure requirements set forth in the letter.

ADVERTISING RULE AND PREVIOUS STAFF GUIDANCE

The Advertising Rule, among other things, generally prohibits an adviser from specifically mentioning any of its past profitable recommendations in an “advertisement.” However, the Advertising Rule allows an exception if the advertisement also includes, or if it contains an offer to provide, a list of **all** past specific recommendations for a period of at least a year. As stated in the TCW Letter, the purpose of the Advertising Rule is to prohibit the “cherry-picking” of profitable positions for presentation in an advertisement, thus presenting a misleading picture of a client’s account.

The Staff expanded the ability to use past specific recommendations notwithstanding the Advertising Rule in previous no-action letters. In 1998, the Staff published a no-action letter² that allowed an adviser to include a discussion of

¹ The TCW Group, Inc., SEC No-Action Letter, WSB File No. 1110200806 (Nov. 7, 2008).

² Franklin Management, Inc., SEC No-Action Letter, WSB File No. 121498005 (Dec. 10, 1998).

certain of its past recommendations in an advertisement without providing all of its positions so long as the adviser used objective, non-performance based criteria (such as the relative size of the position in the client's account) and did not discuss whether the positions were profitable. In 2004, the Staff published an additional no-action letter³ that interpreted responses to unsolicited requests for information from prospective clients and information provided to existing clients generally not to be "advertisements" and, therefore, outside of the Advertising Rule.

TCW LETTER

In the TCW Letter, the Staff allowed TCW to distribute advertisements to prospective clients that include charts containing the best and worst performing positions in a representative account for a particular investment strategy, because the objective criteria for choosing such positions and the proposed balanced manner of presenting the positions would be consistent with the policy underlying the Advertising Rule. The charts would describe the strategy implemented by the representative account, the average weight of each of the holdings during the relevant measurement period and the impact of each such holding on the performance of the representative account.⁴

In allowing an adviser to use these charts, the Staff relied on the following representations from TCW—

- Each position included in the charts will be chosen by multiplying the percentage of the total account consisting of each position by the rate of return over the relevant measurement period.
- The above calculation and the weighing of positions will be applied consistently during the appropriate measurement period.
- The presentation of the information (including the above calculation) and number of holdings in the charts will be consistent from measurement period to measurement period.
- The charts will show no fewer than 10 holdings, with an equal number of positive and negative holdings.
- The charts will disclose how to obtain the formula and methodology for computing which positions are included in the charts.
- The charts will disclose how to obtain a list showing the contribution of each holding in a client's account to the account's performance.

³ Investment Counsel Ass'n of America, Inc. SEC No-Action Letter, WSB File No. 0310200448 (March 1, 2004).

⁴ TCW stated in its no-action request letter that it intended to provide the contribution of each position to the representative account gross of fees, because of the difficulty in apportioning fees amongst the positions disclosed, but the Staff did not specifically endorse TCW's method of presenting performance information in its response.

- The charts will present all information in the proper form necessary so as not to make the charts misleading, including but not limited to (i) the presentation of the best and the worst holdings on the same page with equal prominence in close proximity to required disclosure and account performance information, (ii) disclosure that the chart does not include all securities bought, sold or recommended to clients and (iii) disclosure that past performance does not guarantee future results.
- The adviser will maintain appropriate records consisting of (i) the calculation used to select securities included in the chart, (ii) a list showing the contribution of each holding to the account's overall performance during the relevant measurement period and (iii) all supporting data related thereto.

The Staff's guidance in the TCW Letter provides advisers with additional flexibility in presenting past performance information to clients and prospects. Advisers should keep in mind that the ability to use the charts does not obviate the need to comply with the Staff's guidance in its no-action letter to Clover Capital Management, Inc.⁵ and other relevant no-action letters regarding including the use of past performance in advertisements. Also, it should be noted that the Staff allowed the inclusion of only limited information in the charts. Advisers should not discuss the performance of specific securities in advertisements outside of the charts without complying with the Advertising Rule and the Staff's previous guidance.

⁵ Clover Capital Management, Inc., SEC No-Action Letter, WSB File No. 111086012 (Oct. 26, 1998).

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