

# Financial Services

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## SEC Staff Guidance on “Past Specific Recommendations”

On March 1, 2004, the staff (“Staff”) of the Securities and Exchange Commission’s (“SEC”) Division of Investment Management responded to a request by the Investment Counsel Association of America (“ICAA”) for certain guidance concerning Rule 206(4)-1 (“Advertising Rule”) under the Investment Advisers Act of 1940, as amended (“Advisers Act”).<sup>1</sup> The Staff’s response significantly expands the ability of a registered investment adviser (“Adviser”) to provide information about the Adviser’s past specific recommendations to clients, prospective clients and consultants without such a communication being considered to be an “advertisement”<sup>2</sup> under the Advertising Rule.<sup>3</sup>

This Dechert Client Alert details the Staff’s response and its effect on an Adviser’s communications with its current clients, prospective clients, consultants and investors in private investment vehicles managed by the Adviser.

### Use of “Past Specific Recommendations” under Rule 206(4)-1(a)(2)

The Advertising Rule has severely restricted the ability of Advisers to present the results of past specific recommendations to clients and potential clients in advertisements.<sup>4</sup> Advertisements containing past specific recommendations are required to comply either with subsection (a)(2) of the Advertising Rule or with a series of no-action letters under

<sup>1</sup> *Investment Counsel Association of America*, (pub. avail. Mar. 1, 2004) (“ICAA”). The Staff’s response to the ICAA grew out of an earlier rulemaking proposal regarding the Advertising Rule. The ICAA rulemaking proposal is available at <http://www.icaa.org/public/letters/compendiums/letterscompendium-2001.pdf>.

<sup>2</sup> The term “advertisement” under the Advertising Rule includes:

any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula or other device to be used in making any

determination as to when to buy or sell any security or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

<sup>3</sup> Subsection (a)(2) of the Advertising Rule.

<sup>4</sup> Although by its terms subsection (a)(2) of the Advertising Rule applies to any advertisement which “refers, directly or indirectly, to past specific recommendations of [an Adviser] which were or would have been profitable to any person,” many Advisers avoid discussing any past recommendations (profitable or otherwise) in advertisements.

the Advertising Rule.<sup>5</sup> Under the Advertising Rule, an advertisement that contains any past specific recommendation is required to set forth (or offer to furnish) a list of all of the Adviser's recommendations for the immediately preceding period of not less than one year.<sup>6</sup>

The Staff had previously provided no-action guidance that subsection (a)(2) of the Advertising Rule applies only to "past", not "current", recommendations.<sup>7</sup> Yet, the Staff has provided little insight as to the circumstances under which a recommendation is "current". The Staff observed in the *Franklin* no-action letter that the analysis of what is current would "depend largely on the facts and circumstances as of the time that the advertisement is distributed" and has cautioned Advisers that otherwise "current recommendations" may come within the scope of the prohibition in the

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<sup>5</sup> See, e.g., *Franklin Management, Inc.* (pub. avail. Dec. 10, 1998) ("*Franklin*") (an Adviser may include, in an advertisement, information about selected past specific recommendations provided certain selection, disclosure and recordkeeping requirements are met); *Munder Capital Management*, (pub. avail. May 17, 1996) (documents relating specifically to one or more investment companies, such as prospectuses, advertisements or sales literature, are generally not advertisements for purposes of the Advertising Rule unless used to offer advisory services); *Kurtz Capital Management*, (pub. avail. Jan. 18, 1988) (distribution by an Adviser of a reprint of a *bona fide*, unbiased third-party news article is not subject to the Advertising Rule, even if the article refers to past specific recommendations).

<sup>6</sup> Subsection (a)(2) of the Advertising Rule. If the list is furnished separately, it must:

(A) state the name of each security recommended, the date and nature of each such recommendation (e.g., whether to buy, sell or hold), the market price at that time, the price at which the recommendation was to be acted upon, and the market price of each such security as of the most recent practicable date, and (B) contain the following cautionary legend on the first page thereof in print or type as large as the largest print or type used in the body or text thereof: "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."

<sup>7</sup> See *Franklin*, *supra* n. 5.

Advertising Rule if "the advertisement were distributed after the adviser ceases recommending any of the particular securities listed, or if the advertisement indicated that any of the current recommendations listed were recommended by the adviser in the past."

The Staff had also granted no-action relief that permits Advisers to provide partial lists of past specific recommendations in advertisements.<sup>8</sup> However, the no-action relief previously granted by the Staff did not permit Advisers to respond to informational requests by clients, prospective clients, consultants and investors in private funds managed by the Adviser, including requests for attribution analyses that may include a discussion of an Adviser's securities recommendations that were profitable or unprofitable. Consequently, although, as noted in the Staff's response to the ICAA, "many clients or their consultants request investment advisers to provide [such] attribution analyses," many Advisers avoided responding to such requests with information that could have been viewed as past specific recommendations when providing materials to clients, prospective clients, consultants and other investors.

## Effect of the Staff's Guidance

The Staff's guidance does not change (1) the requirements of the Advertising Rule with respect to an Adviser's burden when presenting "past specific recommendations" within an "advertisement" or (2) the type of information that may be considered to be a "past

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<sup>8</sup> In *Franklin*, for example, the Staff permitted an Adviser to provide, in client newsletters or similar materials, a partial list of holdings provided that: (1) the specific securities included are chosen pursuant to objective, non-performance based criteria; (2) the same selection process is used for each successive period for each investment category; (3) the advertisement does not discuss, directly or indirectly, the amounts of profits or losses, realized or unrealized, of any of the specific securities; and (4) the Adviser maintains certain records relating to the securities and the selection process (including that information required pursuant to subsection (a)(2) of the Advertising Rule for separately furnished lists as well as the criteria used to select the specific securities listed.

specific recommendation” under the Advertising Rule. Rather, the Staff’s guidance to the ICAA carves out of the universe of communications that may be considered to be an “advertisement” for purposes of subsection (a)(2) of the Advertising Rule certain specific communications.<sup>9</sup> Under the Staff’s guidance, the following communications are not generally considered to be “advertisements” within the scope of the relevant portions of the Advertising Rule:<sup>10</sup>

- oral communications other than those in radio or television broadcasts;
- written communications in response to unsolicited requests by a client, prospective client or consultant for specific information about the Adviser’s past specific recommendations provided to: (a) the requesting client, prospective client or consultant; (b) a single consultant on behalf of several clients; or (c) several consultants; and
- written communications to an Adviser’s existing clients; *unless*, “the context in which the past specific recommendations are presented by the investment adviser to an existing client suggests that a purpose of the communication is to offer advisory services.”<sup>11</sup>

One principle condition for the relief provided by the

<sup>9</sup> The Staff also indicated, in its guidance, that a similar analysis would apply with respect to “testimonials” as described by subsection (a)(1) of the Advertising Rule. The Staff did not extend its guidance or relief to subsections (a)(3) through (a)(5) of the Advertising Rule which govern: (1) representations regarding graphs, charts, formulae or other devices; (2) false representations that any report, analysis or service is provided “free or without charge”; and (3) false or misleading statements, respectively.

<sup>10</sup> The Staff noted, however, that “[w]hether any particular communication – or series of communications – constitutes an advertisement under [the Advertising Rule] depends upon all of the facts and circumstances.” *ICAA*.

<sup>11</sup> *Id.*

Staff is that the communication not be “solicited” by the Adviser. The Staff noted that “so long as the [Adviser] did not directly or indirectly solicit the [client or] consultant to make the request” the mere communication in writing of information in response to a request would not by itself cause the communication to be considered to be an advertisement. However, if the request is “the result of, for example, any affirmative effort by an investment adviser that is intended or designed to induce [someone] to request the adviser to provide [the information] or an advertisement indicating that the adviser is willing to provide [the information] upon request” the Staff noted that such a request would not be considered to be “unsolicited”.<sup>12</sup>

Similarly, with respect to communications to existing clients, the Staff noted that a written communication by an Adviser to its existing clients would not be an advertisement under the Advertising Rule “merely because it discusses the [Adviser’s] past specific recommendations concerning securities that are held or were recently held by each of those clients.” However, the Staff cautioned that “a letter written by an adviser that discussed its past specific recommendations concerning securities not held or not recently held by some of the clients to whom the letter was directed . . . may constitute an ‘advertisement’ and be prohibited by [the Advertising Rule].”<sup>13</sup>

In addition, the Staff noted that all communications to existing clients, prospective clients and consultants, whether or not “advertisements” are subject to the general anti-fraud provisions of the Advisers Act and must be “truthful, accurate, balanced and not misleading.”<sup>14</sup>

Consequently, the Staff guidance would now permit Advisers to discuss “past specific recommendations” in

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

communications with parties who either: (1) have made an unsolicited request for such information; or (2) are existing clients of the Adviser. With respect to private investment vehicles, such as hedge funds, the relief granted by the Staff should allow the fund's Adviser to include more detailed portfolio position information in communications with existing investors without concern that the information will be viewed by the SEC as an improper past specific recommendation.

If you have questions regarding the information in this Client Alert, please do not hesitate to contact one of the attorneys listed below or the Dechert LLP attorney with whom you are regularly in contact:

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