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## SEC Expands Scope of Permissible Past Specific Recommendation Advertising for Investment Advisers

In a recent letter to the TCW Group, Inc.,<sup>1</sup> the SEC staff granted no-action relief to TCW's wholly-owned investment adviser subsidiaries for distributing marketing materials that include performance-based past specific recommendations to prospective clients.<sup>2</sup> Specifically, the SEC staff permitted the distribution of so-called best performers/worst performers charts to prospective clients, so long as certain conditions were met.

The TCW letter is significant because it extends the current boundaries relating to marketing past specific recommendations established by Rule 206(4)-1 (the "Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and prior SEC staff no-action relief. Specifically, it extends the past specific recommendation guidance to permit an advertisement to include references to specific securities that were selected for inclusion based on an objective, mathematical calculation of best and worst performance. Importantly, the TCW letter does not permit an adviser to show the actual performance of the best and worst performing securities. Instead, it permits the adviser to show only (i) the average weight of the best and worst performing holdings in a representative account during a specified period; and (ii) the impact of those holdings on the representative account's return overall.

The Rule was established under Section 206(4) of the Advisers Act, which prohibits advisers from engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Rule provides that it is a fraudulent, deceptive, or manipulative act, practice, or course of business for any registered 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," unless the advertisement sets out or offers to furnish a list (with certain detailed information) of all recommendations made by the adviser during a specified period of at least one year. The Rule was designed to address the concern that an adviser could "cherry pick" its profitable recommendations and omit unprofitable ones—thereby deceptively implying that the recommendations shown, and their profitability, were representative of the experience of the adviser's clients.

While the Rule's requirement to furnish a list of all recommendations made by the adviser during the time period was found by most advisers to be too onerous for practical use, the SEC staff provided some limited relief in the Franklin Management Inc.<sup>3</sup> and Investment Counsel Association of America, Inc.<sup>4</sup> no-action letters. Franklin permitted past specific recommendations to be used in advertisements so long as they: were selected based on objective, non-performance based criteria; did not refer, directly or indirectly, to performance of the securities; and included certain disclosures. ICAA permitted performance-based past specific recommendation

information to be presented to a prospective client if the prospective client made an unsolicited request for the information. However, the adviser was constrained by Franklin in that it could not use performance in selecting which securities to highlight; and by ICAA in only providing the information if it was specifically requested by the prospective client. The TCW letter relaxes these limitations, but continues the prohibition against referencing the actual performance of a specific holding.

With the publication of the TCW letter, registered investment advisers may now show certain information about past specific recommendations that were selected based on objective, mathematical performance-based criteria, so long as the following rules are observed:

- the best and worst holdings are selected by taking into account consistently the weighting of every holding in a representative account that contributed to the account's performance during a period of time (the "Measurement Period");
- the Measurement Period consists of at least a full calendar month, as computed as of the most recent calendar month's last trading day;
- the presentation of information and number of holdings is consistent from period to period;
- the presentation shows no fewer than a total of ten holdings, including an equal number of the best and worst performing holdings during the Measurement Period;
- the presentation includes all information necessary to make the information not misleading, including showing the best and worst performing holdings on the same page with equal prominence;
- the presentation includes the following disclosures in close proximity to (i.e., on the same page as) the performance information: (i) how to obtain the calculation methodology; (ii) how to obtain a list showing the contribution of each holding in the representative account to the overall account's performance during the Measurement Period; (iii) that the holdings identified do not represent all of the securities purchased, sold or recommended for the adviser's clients; and (iv) that past performance does not guarantee future results; and
- the adviser maintains, and makes available to the SEC staff upon request, records that evidence: (i) the criteria used to select the specific holdings listed; (ii) a list showing the contribution of each holding in the representative account to the overall account's performance during the Measurement Period; and (iii) all supporting data necessary to demonstrate the calculation of the contribution analysis and the appropriateness of the holdings included in each presentation.

<sup>1</sup> See <http://www.sec.gov/divisions/investment/noaction/2008/tcwgroup110708.htm>.

<sup>2</sup> "Prospective clients" means those potential clients with no current ties to the advisory firm, as well as consultants and clients of the advisory firm currently invested in unrelated strategies.

<sup>3</sup> See Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998) ("Franklin").

<sup>4</sup> See Investment Counsel Association of America, Inc., SEC Staff No-Action Letter (March 1, 2004).

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