ADVERTISING BY INVESTMENT ADVISERS

Michael S. Caccese and Christina H. Lim

This article was originally published as Investment Adviser Regulation, A Step-by-Step Guide to Compliance and the Law, Chapter 7, Practical Considerations for Performance Advertising by Advisers, Second Edition, Nov. 2006

§ 6.1 Introduction

§ 6.2 Rule 206(4)-1

§ 6.2.1 Definition of Advertisement
§ 6.2.2 Testimonials
  [A] Partial Client Lists
  [B] Ratings
  [C] Article Reprints
§ 6.2.3 Past Specific Recommendations
  [A] Performance-Based Recommendations
    [1] Partial List of Recommendations
    [2] Article Reprints
  [B] Non-Performance Based Recommendations
§ 6.2.4 Charts and Formulas
§ 6.2.5 Free Reports or Services
§ 6.2.6 Anti-Fraud Catchall Provision

§ 6.3 Performance Advertising

§ 6.3.1 General Requirements
§ 6.3.2 Model Performance
§ 6.3.3 Hypothetical Backtested Performance
§ 6.3.4 Gross-of-Fee and Net-of-Fee Performance
  [A] Net-of-Fee Performance
  [B] Gross-of-Fee Performance
    [i] One-on-One Presentations
    [ii] Consultants
    [iii] Side-by-Side Gross and Net of Fee Performance
§ 6.3.5 Model Fees

1 Michael S. Caccese is a partner in the Boston office of Kirkpatrick & Lockhart Nicholson Graham LLP. He works extensively with investment firms on compliance issues, including all of the GIPS and AIMR standards. He was previously the General Counsel to CFA Institute and was responsible for overseeing the development of the AIMR-PPS, GIPS and other standards governing the investment management profession and investment firms. He can be reached at 617.261.3133 and mcaccese@klng.com. Christina H. Lim is an associate with Kirkpatrick & Lockhart Nicholson Graham LLP in the Boston office and may be reached at 617.261.3243 and clim@klng.com.

© 2006 Kirkpatrick & Lockhart Nicholson Graham LLP

This article is for information purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.
§ 6.3.6 Portability
§ 6.3.7 Recordkeeping

§ 6.4 Global Investment Performance Standards (GIPS®)

§ 6.4.1 General Background
[A] Overview of the Standards
[B] Interpretation of the Standards
[C] Enforcement of the Standards

§ 6.4.2 Fundamentals of Compliance
[A] Definition of the Firm
[2] Redefinition of the Firm
[4] Sub-Advisors
[B] GIPS Policies and Procedures
[C] Claim of Compliance
[D] Firm Fundamental Responsibilities

§ 6.4.3 Input Data
§ 6.4.4 Calculation Methodology
§ 6.4.5 Constructing Composites
[A] Carve-Outs

§ 6.4.6 Disclosures
§ 6.4.7 Presentation and Reporting
[A] Performance Record Portability
[B] Supplemental Information

§ 6.4.8 Advertising Guidelines
§ 6.4.9 Verification
§ 6.1 Introduction

Deficiencies in presenting investment adviser performance continues to be one of the top five problem areas identified by the Securities and Exchange Commission (“SEC” or “Commission”) for investment advisers.2 As investment advisers continue to expand their efforts in asset gathering, adviser advertisements are becoming more prominent and important to the success of investment firms. Although neither the Investment Advisers Act of 1940, as amended (the “Advisers Act”) nor the rules thereunder require advisers to submit or file advertisements with the SEC prior to use, advisers should expect a request by the SEC staff during any SEC examination for any and all advertising materials distributed by the adviser during the examination period and all necessary documentation that supports the calculation of the advertised performance. As a matter of policy, the SEC staff will not review advertisements on a pre-use basis to determine whether they comport with the advertising rules under the Advisers Act.3 Therefore, advisers must decipher the regulatory scheme governing adviser advertising themselves by piecing together the SEC and its staff’s positions as set forth in sometimes conflicting SEC staff no-action letters, speeches by the SEC’s staff, and SEC enforcement actions against investment advisers.

§ 6.2 Rule 206(4)-1

Section 206(4) of the Advisers Act and Rule 206(4)-1 thereunder govern the advertisements of investment advisers. Section 206 applies to all advisers, whether registered or unregistered, whereas Rule 206(4)-1 only applies to those advisers that are registered or required to be registered with the Commission.4 Section 206(4) of the Advisers Act makes it unlawful for any investment adviser, whether registered or unregistered, to directly or indirectly engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.5 Rule 206(4)-1 promulgated thereunder speaks specifically to four advertising practices, but also contains a “catchall” provision for any additional practices deemed to be false and misleading. Specifically, the Rule deems it to be a “fraudulent, deceptive, or manipulative act, practice, or

---

2 Lori A. Richards, “Fiduciary Duty: Return to First Principles,” Speech before the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006). One of the five most common deficiencies discovered through examinations by the Office of Compliance Inspections and Examinations in 2005 included deficiencies in performance calculations including overstating performance results, comparing results to inappropriate benchmarks, failing to disclose material information regarding the calculation methods behind performance returns, and advertising returns in a misleading manner.


4 Section 206 was amended in September 1960 to subject all advisers, whether registered or unregistered, to Section 206 and grant the SEC the power, through rules and regulations, to “define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative” within the meaning of Section 206(4). Prior to this amendment, the SEC did not have the power to define the specific activities that were deemed to be fraudulent or deceptive within the meaning of Section 206 of the Advisers Act. See Investment Advisers Notice of Proposed Rule Making, SEC Release No. IA-113 (Apr. 4, 1961).

5 Section 206 of the Advisers Act.
course of business” for any registered adviser to, directly or indirectly, publish, circulate or
distribute an advertisement that:

- makes any direct or indirect references to a testimonial concerning the adviser or
  its advice, analysis, report or other service it has rendered;  
- makes any direct or indirect references to the adviser’s past specific
  recommendations that were or would have been profitable, unless the
  advertisement sets out or offers to provide a list of all recommendations made
  within the immediately preceding period of not less than 1 year, accompanied by
  certain disclosures;
- makes any direct or indirect representation that a graph, chart, formula or other
  device: (a) can in and of itself determine which securities to buy or sell or when to
  buy or sell securities; or (b) can assist an individual in making such
  determinations, without prominently disclosing the limitations thereof and the
  difficulties regarding its use;
- states that any report, analysis or other service is for free, unless such materials or
  services are entirely free and without any direct or indirect condition; or
- that contains any untrue statement of a material fact, or is otherwise false or
  misleading.

Rule 206(4)-1 was originally adopted in 1961 under the consideration that “advisers are
professionals and should adhere to a stricter standard of conduct than that applicable to
merchants, securities are ‘intricate merchandise’, and clients or prospective clients of investment
advisers are frequently unskilled and unsophisticated in investment matters.” The SEC staff
continues to impose a standard of conduct for investment adviser advertisements that is stricter
than that for other vendors of products or services. Each investment adviser is accountable for
all of the information that is included in an advertising piece that it creates and/or distributes. If
information is obtained from external sources, those sources are required to be identified, the
information must be truthful and supportable, and if it includes any performance, the investment
adviser must have documentation supporting the calculation of that performance.

§ 6.2.1 Definition of Advertisement

---

6 Rule 206(4)-1(a)(1).
7 Rule 206(4)-1(a)(2).
8 Rule 206(4)-1(a)(3).
9 Rule 206(4)-1(a)(4).
10 Rule 206(4)-1(a)(5).
11 Advertisements by Investment Advisers, SEC Release No. IA-121 (Nov. 1, 1961) (adopting release to Rule
206(4)-1).
12 See discussion infra, § 6.3.7 Recordkeeping.
Whether any material, either in written or in oral form, is subject to Rule 206(4)-1 depends upon whether it constitutes as an “advertisement” within the meaning of Rule 206(4)-1(b) under the Advisers Act. Rule 206(4)-1(b) defines an “advertisement” to include:

- any notice, circular, letter or other written communication addressed to more than one person, or
- any notice or announcement in any publication or by radio or television which offers 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
  - 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
  - other investment advisory service with regard to securities.

In general, “whether any particular communication – or series of communications – constitutes an advertisement under rule 206(4)-1(b) under the [Advisers] Act depends upon all of the facts and circumstances.”13 Although Rule 206(4)-1 does not set forth a specific list of communications that are considered advertisements under the Rule, the SEC has applied a broad view of what constitutes an advertisement, which generally includes materials designed to maintain existing clients or solicit new clients14 including form letters, presentation booklets, requests for proposals, a brochure delivered pursuant to Rule 204-3 under the Advisers Act, radio and television broadcasts, magazine or newspaper pieces, and certain electronic communications such as internet postings.15 Some examples of communications that are generally not considered advertisements within the meaning of Rule 206(4)-1 include oral communications other than those in radio or television broadcasts,16 and written communications that do no more than respond to an unsolicited request by a client, prospective client or consultant for specific information about the adviser.17 In addition, the SEC staff has clarified that documents that

---

14 Munder Capital Management, SEC No-Action Letter (pub. avail. May 17, 1996) (“Materials designed to maintain existing clients or solicit new clients for the adviser are considered to be advertisements within Rule 206(4)-1.”).
15 See also SEC v. Yun Soo Oh Park a/k/a Tokyo Joe and Tokyo Joe’s Societe Anonyme Corp., N.D. IL, Case No. 00C 0049 (complaint filed Jan. 5, 2000).
17 Id. An adviser that induces an existing or prospective client, or a consultant to request the adviser to provide information on its past specific recommendations or distributes an advertisement indicating that the adviser may provide past specific recommendations upon request is deemed to have solicited such a request. See id. The SEC staff clarified that a response to an unsolicited client request would not be deemed to be an advertisement under Rule 206(4)-1 even if the information was provided to one consultant who submits the request on behalf of several clients, or several consultants, so long as the information was provided “in response to a specific, unsolicited request” for information. See id.
relate specifically to investment companies (e.g., prospectuses, advertisements or sales literature) will not be treated as materials “designed to maintain existing clients or solicit new clients for the adviser unless the documents are directed to such persons or refer to advisory services that are offered to such persons.”\(^{18}\) Written communications to existing advisory clients about the performance of their accounts are also generally not considered advertisements under Rule 206(4)-1.\(^{19}\) However, if the purpose of the communication is to offer advisory services or maintain the existing client, the communication will likely be deemed to be an advertisement under Rule 206(4)-1.\(^{20}\)

§ 6.2.2 Testimonials

Rule 206(4)-1(a)(1) under the Advisers Act prohibits an adviser from referring, directly or indirectly, to a testimonial of any kind regarding the adviser, its advice or any other services the adviser offers.\(^{21}\) The prohibition against testimonials is premised on the concern that the testimonial may give the misleading impression that the experience of the individual giving the testimonial is typical of the experience of all of the adviser’s clients.\(^{22}\) In adopting the prohibition, the SEC characterized advertisements containing testimonials as innately misleading since advisers will always present testimonials in an unbalanced manner by publishing only those that are favorable to the adviser and/or its activities.\(^{23}\) Although Rule 206(4)-1(a)(1) does not define the term “testimonial,” the SEC staff has interpreted the term through a number of no-action letters. A testimonial generally includes statements of an experience with, or endorsement of an adviser made by any former, existing or prospective client, and is not restricted to statements about the adviser’s performance.\(^{24}\) For instance, in Gallagher and Associates, Ltd., the SEC staff refused to grant a no-action position with respect to client endorsements that were restricted to the adviser’s character.\(^{25}\)


\(^{20}\) Id. For instance, if an adviser distributes a communication to an existing client that discusses the profitability of past specific recommendations that were not held or recently held by the existing client, this would suggest that the purpose of the communication was to promote the adviser’s services and may therefore constitute an advertisement that contains past specific recommendations in contravention of Rule 206(4)-1(a)(2). See id.

\(^{21}\) Rule 206(4)-1(a)(1) under the Advisers Act.


\(^{23}\) Advertisements by Investment Advisers, SEC Release No. IA-121 (Nov. 1, 1961). The SEC added that “[t]his is true even when the testimonials are unsolicited and are printed in full.” Id.

\(^{24}\) See DALBAR, Inc., SEC No-Action Letter (pub. avail. Mar. 24, 1998) (“Although the term ‘testimonial’ is not defined in Rule 206(4)-1, we consistently have interpreted that term to include a statement of a client’s experience with, or endorsement of, an investment adviser.”).

\(^{25}\) Gallagher and Associates, Ltd., SEC No-Action Letter (pub. avail. July 10, 1995). The proposed endorsements were restricted to statements about the adviser’s religious affiliation or moral character, his community service, trustworthiness and ethical character, diligence and attention to details, ability to listen and be sensitive to client needs, knowledge of investing, insurance and tax strategies (but without referencing performance), and prudence and judgment. See id.
Partial Client Lists

In Denver Investment Advisors, Inc., the SEC staff’s first no-action letter to address client lists as testimonials under Rule 206(4)-1(a)(1), an adviser sought permission to provide consultants with partial client lists assembled using objective criteria (e.g., account size, geographic location, client classification) on an unsolicited basis, except with respect to updates to consultants who originally received the information pursuant to their request. The SEC staff declined to take the position that the client lists were not testimonials under Rule 206(4)-1(a)(1), but stated that it would not recommend enforcement action to the Commission if the adviser included a partial client list in its advertisements so long as: (i) the adviser did not use performance-based criteria in determining which clients to include in the list; (ii) each client list contained a disclaimer that it was not known whether the listed clients approved or disapproved of the adviser or the advisory services provided; and (iii) each client list included a statement disclosing the objective criteria used to determine which clients to include in the list.

Approximately four years later, in Cambiar Investors, Inc., the SEC staff pronounced that a partial client list that does no more than identify certain clients of the adviser (i.e., neither emphasizes comments or activities favorable to the adviser nor ignores those that are unfavorable) is not a statement of a client’s experience with or endorsement of the adviser and is therefore not a testimonial under Rule 206(4)-1(a)(1). The SEC staff clarified:

Our position is not conditioned on the adviser’s use of nonperformance-related criteria to select clients that appear on the partial list or the presence of any particular disclosure or disclaimer. Our position also is not conditioned on who receives the advertisement (consultant or client) or whether the recipient requested the information. In our view, these factors are not relevant to determining whether the content of an advertisement constitutes a statement of a client’s experience with, or endorsement of, a particular investment adviser.

Although an advertisement that does no more than identify select advisory clients is not a testimonial within the meaning of Rule 206(4)-1(a)(1), the SEC staff emphasized that such advertisements are nonetheless subject to the general prohibition against false or misleading advertisements under Rule 206(4)-1(a)(5). For instance, in an action against Reservoir Capital Management, Inc., the SEC admonished the adviser for providing prospective clients with a “representative” client list which contained eight institutional investors. Since institutional clients comprised no more than 15% of the adviser’s assets under management and at least 2 of

---

27 Id.
29 Id. But see Franklin Management, Inc., SEC No-Action Letter, at n. 14 (pub. avail. Dec. 10, 1998) (stating that the SEC staff agreed not to recommend enforcement action against Cambiar Investors, Inc. so long as the selection criteria for the partial client list were objective and unrelated to the performance of clients’ accounts, and the advertisement contained disclosure and the disclaimer set forth in Denver Investment Advisors, Inc.).
the 8 investors were not clients of the adviser, the SEC found that the adviser violated Section 206(4) and Rule 206(4)-1(a)(5) thereunder.

The SEC staff has indicated that a partial client list that is not distributed in the manner described in Denver Investment Advisors, Inc. is not necessarily false or misleading under Section 206(4) and Rule 206(4)-1(a)(5). However, the SEC staff stated that “an adviser’s deviation from one or more of the [Denver Investment Advisors, Inc.] representations could be relevant, but would not necessarily be determinative” in the analysis of whether the advertisement containing a partial client list is false or misleading. In addition, the SEC staff stated that a list that includes only advisory clients who were selected on the basis of performance and the selection bias was not adequately disclosed may be potentially misleading in violation of Rule 206(4)-1(a)(5).

[B] Ratings

Third party ratings that are based solely on performance, regardless of whether an adviser compensates the third party to verify and rank its performance, do not constitute as testimonials under Rule 206(4)-1. However, a third party rating that contains an implicit statement of a client’s experience with an adviser is a testimonial within the meaning of Rule 206(4)-1(a)(1). In Investment Advisers Association, the SEC staff clarified that the term “testimonial” includes a third-party rating that “relies primarily” on client evaluations of an adviser, but does not include a third-party rating where client responses about the adviser are considered but deemed to be an insignificant factor in formulating the rating. When determining whether a third-party rating constitutes a testimonial, the adviser should consider (1) the criteria used by the third party in formulating its rating, and (2) the significance of client evaluations in the rating’s formulation. In making these considerations, the SEC staff indicated that an adviser may need to contact the third party to make this determination.

In a no-action letter issued to DALBAR, Inc., the SEC staff stated that a rating that solicits client views about their experience with an adviser is a testimonial under the Rule since the rating “is an implicit statement of clients’ experiences with an adviser . . . and because the rating purports to convey the experience of a hypothetical average, or typical client with an adviser.” Nonetheless, the SEC staff believed that the advertising of such ratings would not raise the dangers that Rule 206(4)-1(a)(1) was designed to prevent so long as:

33 Id. at n. 8.
36 Id.
37 Id.
38 Id.
(1) the rating does not emphasize favorable client responses or ignore unfavorable client responses;

(2) the rating represents all, or a statistically valid sample, of the responses of the adviser’s clients;

(3) the questionnaire sent to clients was not prepared to produce any pre-determined results that could benefit any adviser;

(4) the questionnaire is structured to make it equally easy for a client to provide a negative or positive response; and

(5) the research firm does not perform any subjective analysis of the survey results, but instead assigns numerical ratings after averaging the client responses for each adviser.

In taking this position, the SEC staff relied upon the factors above and DALBAR, Inc.’s representations that: (i) participating advisers have met certain eligibility criteria reasonably designed to ensure that a participating adviser has an established and significant history and record free from regulatory sanctions; (ii) the research firm is not affiliated with any participating adviser; (iii) the research firm surveys all or a statistically valid sample of a participating adviser’s clients; (iv) all participating advisers are charged a uniform fee, paid in advance; (v) the research firm does not issue ratings to an adviser unless the ratings are statistically valid with respect to that adviser; and (vi) any survey results published by the research firm contains information that clearly identifies the percentage of survey participants who have received such designation and the total number of survey participants.

Even if a third-party rating does not constitute as a “testimonial” within the meaning of the Rule 206(4)-1, the advertisement is still subject to Rule 206(4)-1(a)(5), the general “catchall” fraud provision under the advertising rule. In order to determine whether an advertisement containing a third-party rating is false or misleading under Rule 206(4)-1(a)(5), the SEC staff has provided the following eight factors that should be considered:

(1) whether the advertisement discloses the criteria on which the rating was based;

(2) whether an adviser advertising any favorable rating without disclosing facts that the adviser knows would call into question the validity of the rating or the appropriateness of advertising the rating (e.g., the adviser has received numerous complaints relating to the rating category or in areas not included in the survey);

(3) whether the adviser advertises a favorable rating without disclosing any unfavorable ratings;

(4) whether the advertisement states or implies that the adviser was a top-rated adviser in a category when it was not rated first in that category;

(5) whether, in disclosing an adviser’s rating, the advertisement clearly and prominently discloses the category for which the rating was calculated or
determined, the number of advisers surveyed in that category, and the percentage of advisers that received that rating;

(6) whether the advertisement discloses that the rating may not be representative of any one client’s experience because the rating reflects an average of all, or a sample of all, of the experiences of the adviser’s clients;

(7) whether the advertisement discloses that the rating is not indicative of future performance; and

(8) whether the advertisement discloses prominently who created and conducted the survey, and that the adviser paid a fee to participate in the survey.  

[C] Article Reprints

An article drafted by an unbiased third party that discusses an adviser’s performance is not a testimonial within the meaning of Rule 206(4)-1(a)(1) unless it includes a statement of a customer’s experience or endorsement. However, the advertisements of such reprints will continue to be subject to Rule 206(4)-1(a)(5). The SEC staff has indicated that an advertisement that reprints articles by an independent financial publication may be prohibited pursuant to Rule 206(4)-1(a)(5) if the reprint, together with the advertisement, implied something about or caused a reader to make an inference regarding: (i) the experience of the adviser’s clients; (ii) the possibility of a prospective client having a similar investment experience to that of prior clients; or (iii) the adviser’s competence, when there are additional facts that if disclosed would imply different results.

§ 6.2.3 Past Specific Recommendations

[A] Performance-Based Recommendations

In adopting Rule 206(4)-1, the SEC emphasized its belief that advertisements that refer only to profitable recommendations and ignore unprofitable ones are “inherently misleading and deceptive” in absence of a list containing all recommendations made within the immediately preceding period of at least one year. In the adopting release to Rule 206(4)-1, the Commission stated that the underlying concern of the Rule was the act of misleading prospective clients regarding the adviser’s investment performance by emphasizing profitable recommendations

---

41 Richard Silverman, SEC No-Action Letter (pub. avail. Mar. 27, 1985); New York Investors Group, Inc., SEC No-Action Letter (pub. avail. Sept. 7, 1982). See also Kurtz Capital Management, SEC No-Action Letter (pub. avail. Jan. 18, 1988) (stating that bona-fide unbiased third party reports are generally not subject to the prohibition against testimonials and the distribution of a bona-fide article drafted by an unbiased third party is not subject to the requirements of Rule 206(4)-1(a)(2) where past specific recommendations happen to be referred to within the article).
while ignoring unprofitable ones, a practice commonly referred to as “cherry picking.”44 Rule 206(4)-1(a)(2) makes it a fraudulent, deceptive, or manipulative act, practice or course of business for any registered investment adviser to publish, circulate or distribute any advertisement that makes a direct or indirect reference to past specific recommendations of the adviser that were or would have been profitable unless: (i) the advertisement sets out or offers to furnish free of charge a list of all recommendations made within the immediately preceding period of not less than one year;45 and (ii) the advertisement (or list if furnished separately) contains the following pieces of information:

- the name of each security recommended;
- the date and nature of each recommendation (e.g., buy, hold or sell);
- the market price at that time;
- the price at which the recommendation was to be acted upon;
- the market price of each listed security as of the most recent practicable date; and
- the following legend on the first page in print or type as large as the largest print or type used: “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.”

In *Scientific Market Analysis*, the SEC staff clarified that the earliest recommendation referred to in an advertisement would establish the beginning period from which the list of all recommendations must be presented.46 For instance, if an adviser wanted to refer to profitable securities recommendations made for the period from 2002 to the present, it must include in its list every recommendation made from 2002 to the present.47

[1] Partial List of Recommendations

Although contrary to the plain language of the Rule, the Commission staff interprets Rule 206(4)-1(a)(2) strictly to preclude any references in advertisements to past specific recommendations that were or would have been profitable without setting out all past recommendations during the preceding year, even when accompanied by an offer to provide such

44 See id. See also Franklin Management, Inc. (pub. avail. Dec. 10, 1998) (stating that use of objective, non-performance based selection criteria of past specific recommendations in reports issued by an adviser will not raise the dangers of cherry-picking, which the Rule was designed to prevent); National Corporate Sciences, Inc. (pub. avail. July 24, 1976) (rule serves to protect against misleading clients about the adviser’s performance by referring only to profitable recommendations while ignoring unprofitable ones); Starr and Kuehl, Inc. (pub. avail. Apr. 17, 1976) (same).

45 In *Scientific Market Analysis*, the SEC staff stated that Rule 206(4)-1(a)(2) “could be interpreted to require that such list be furnished free of charge to prospective clients, since an adviser might be able to avoid the rule’s requirements by charging a fee for a list of recommendations for which prospective clients might be unwilling to pay.” Scientific Market Analysis, SEC No-Action Letter (pub. avail. Mar. 24, 1976).

46 Id. (“[T]he earliest recommendation referred to establishes the pertinent time period.”).

47 See id.
information separately.\textsuperscript{48} Therefore, an adviser may not refer to select recommendations in its advertisements with an offer to furnish the remainder. Rather, Rule 206(4)-1(a)(2) permits advertisements that either: (i) contain a full list of recommendations made during the preceding period of not less than one year with certain disclosures; or (ii) an advertisement with an offer to provide such a list.\textsuperscript{49}

\[2] \textbf{Article Reprints}\n
In \textit{New York Investors Group, Inc.} and \textit{Dow Theory Forecasts, Incorporated}, the SEC staff took the position that the inclusion in an advertisement of an article that commends an adviser for its ability to select stocks that perform well in favorable and unfavorable market conditions is an indirect reference to the adviser’s past specific recommendations and violates Rule 206(4)-1(a)(2) unless it contains all the recommendations made by the adviser within the preceding year.\textsuperscript{50} However, the SEC staff seemingly reversed its position in \textit{Kurtz Capital Management} when it stated that the distribution of an article drafted by an unbiased third party that “happens” to refer to past specific recommendations made by the adviser is not subject to the requirements of Rule 206(4)-1(a)(2), but is still subject to the prohibition against misleading and fraudulent advertisements under Rule 206(4)-1(a)(5).\textsuperscript{51}

\[B] \textbf{Non-Performance Based Recommendations}\n
In \textit{Franklin Management, Inc.}, the staff broadened its interpretation of the Rule 206(4)-1(a)(2) to permit discussions of past specific securities bought, sold or held for the adviser’s accounts in quarterly reports to existing and prospective clients so long as:

\begin{enumerate}
\item the securities discussed are selected on objective, non-performance based criteria;
\item the same selection criteria will be consistently applied each quarter;
\end{enumerate}

\textsuperscript{48} See Mr. Norman L. Yu & Company, Inc. (pub. avail. Apr. 12, 1971) (“Any advertisement by an investment adviser which contains a partial list of recommendations and an offer to furnish a list of all recommendations made during the previous 12 month period would be viewed by us as an attempt to ‘wet the appetite’ of the general public and would clearly be in violation of Rule 206(4)-1 and be deemed to be a misleading and fraudulent advertisement.”). See also Dow Theory Forecasts, Inc., SEC No-Action Letter (pub. avail. Nov. 7, 1985) (“Rule 206(4)-1(a)(2) under the [Advisers] Act does not permit an advertisement which refers to selected past recommendations of an investment adviser which were or would have been profitable to any person, even if the advertisement offers to provide a list of all recommendations made by the adviser within the past year.”); James B. Peeke & Company, Inc., SEC No-Action Letter (pub. avail. Sept. 13, 1982); Scientific Market Analysis (pub. avail. Mar. 24, 1976); J. D. Minnick & Company, SEC No-Action Letter (pub. avail. Apr. 30, 1975); Mr. Charles Swanson, SEC No-Action Letter (pub. avail. Apr. 10, 1972).


\textsuperscript{50} Dow Theory Forecasts, Incorporated, SEC No-Action Letter (pub. avail. Nov. 7, 1985) (advertisement of a New York Post article that contains references to past specific recommendations made by an adviser must satisfy the requirements in Rule 206(4)-1(a)(2)); New York Investors Group, Inc., SEC No-Action Letter (pub. avail. Sept. 7, 1982) (finding that quoting an article that lauds the Company or its officer’s success in selecting stocks is an indirect reference to past specific recommendations in violation of Rule 206(4)-1(a)(2) without referencing all past recommendations within the preceding year).

(3) the advertisement does not discuss, directly or indirectly, realized or unrealized profits or losses of the named securities;

(4) the advertisements include cautionary disclosures; and

(5) the adviser maintains, and makes available to the SEC staff upon request, records that evidence: (i) the complete list of all securities recommended by the adviser in the preceding year for the specific investment category covered by the advertisement; (ii) the information set forth in Rule 206(4)-1(a)(2) for each recommendation; and (iii) the criteria used to select the specific securities listed in each advertisement.52

The SEC staff believed that the use of objective, non-performance selection criteria and the omission of any discussion on the profitability of any security would limit the ability of the adviser to cherry-pick profitable recommendations and mislead prospective clients about the adviser’s performance.53 In Franklin Management, Inc., the staff also clarified that advertisements that identify and discuss current or unprofitable recommendations of the adviser are not within the prohibitions of the Rule.54 However, while current or unprofitable recommendations are not prohibited under the Rule, it is difficult, if not impossible, to predict whether, at the time such recommendations are written, the listed securities held in the portfolio will subsequently be sold or whether the unprofitable holdings will subsequently become profitable.

§ 6.2.4 Charts and Formulas

Rule 206(4)-1(a)(3) under the Advisers Act prohibits an adviser from making any claim in its advertisements that a graph, chart, formula or other device being offered: (i) can be used to determine which securities to buy or sell, when to buy or sell the securities, or (ii) will assist persons in making such decisions, unless the limitations and difficulties regarding the use of the device are prominently disclosed.55 The SEC staff has clarified that the former restriction is absolute; that is, an advertisement may never make a claim that a device can be used to make decisions on which securities to buy or sell, or the timing of such decisions, irrespective of what limitations and difficulties are discussed.56

§ 6.2.5 Free Reports or Services

53 Id.
54 See id. at note 11.
55 Rule 206(4)-1(a)(3) under the Advisers Act.
Rule 206(4)-1(a)(4) prohibits the distribution of an advertisement that states that any report, analysis or other service will be furnished for free or without charge if there are any conditions or obligations connected with the receipt of such report, analysis or service.\textsuperscript{57}

\section*{§ 6.2.6 Anti-Fraud Catchall Provision}

Rule 206(4)-1(a)(5) deems it to be a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for any adviser to distribute, directly or indirectly, any advertisement that contains an untrue statement of material fact or that is otherwise false or misleading.\textsuperscript{58} This is a catchall provision that is used by the SEC to sanction investment adviser firms for advertising violations that do not fit within the specific prohibitions listed in subparagraphs (a)(1) through (a)(4) of Rule 206(4)-1. Whether an advertisement is false or misleading under Rule 206(4)-1(a)(5) largely depends upon the particular facts and circumstances.\textsuperscript{59} An adviser should consider the following three factors when conducting an analysis under Rule 206(4)-1(a)(5):

\begin{itemize}
\item \textit{the form and content of the advertisement:} An adviser should make sure that all relevant information is included in the advertisement so that its audience receives a clear and unbiased picture of the adviser’s investment skills;\textsuperscript{60}
\item \textit{the implications that arise out of the context of the communication:} An adviser should examine its advertisement to determine whether the audience may infer something about the adviser’s competence or future investment results that would not be true had the advertisement included all material facts;\textsuperscript{61} and
\item \textit{the prospective client’s sophistication:} An adviser should determine whether the advertisement is being presented to a sophisticated client in a one-on-one presentation, to a retail investor, or distributed broadly through a newspaper, magazine, radio or on the internet.\textsuperscript{62}
\end{itemize}

\textsuperscript{57} Rule 206(4)-1(a)(4) under the Advisers Act. See, e.g., Dow Theory Forecasts, Inc., SEC No-Action Letter (pub. avail. May 21, 1986) (stating that an advertisement’s offer of a free subscription to an investment newsletter on the condition that the Dow Jones Industrial Average not rise 10 points during the subscription period violates Rule 206(4)-1(a)(5)).

\textsuperscript{58} Rule 206(40-1(a)(5) under the Advisers Act.


\textsuperscript{60} For example, an adviser that directs his clients’ investments in mutual fund shares has a duty to disclose that in addition to the adviser’s fees, additional fees and expenses associated with an investment in mutual fund shares will be incurred. See James B. Peeke & Company, Incorporated, SEC No-Action Letter (pub. avail. Sept. 13, 1982).

\textsuperscript{61} See, e.g., In re Valicenti Advisory Services, Inc., SEC Release No. IA-1774 (Nov. 18, 1998) (concluding that an adviser willfully violated Section 206(1) and Rule 206(4)-1(a)(5) thereunder for, among other things, presenting performance of a “composite” that failed to disclose that the performance reflected was achieved only by a small sampling of accounts chosen by the adviser’s principal).

An advertisement may be deemed to be misleading even if each individual statement in an advertisement is factually correct. In *In re Spear & Staff, Incorporated*, the SEC found that the advertisements at issue “were deceptive and misleading in their over-all effect even though it might be argued that when narrowly and literally read, no single statement of a material fact was false.” Generally, an advertisement may be considered false or misleading if it implies something about the adviser or its client’s experiences that is not true, or that the client would not have inferred if the adviser had disclosed all material facts.

§ 6.3 Performance Advertising

§ 6.3.1 General Requirements

Although the SEC does not prescribe the method by which investment advisers must calculate or present their past performance, it does rely upon Rule 206(4)-1(a)(5) to police what it deems to be fraudulent or misleading advertising of performance.

In one of the most seminal advertising no-action letters issued by the SEC staff, *Clover Capital Management, Inc.*, the SEC staff took the opportunity to set forth the advertising practices in connection with the presentation of either model or actual returns that it believed were prohibited under Rule 206(4)-1(a)(5):

- Failure to disclose the effect of material market or economic conditions on the results portrayed;

- Presentation of model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses a client would have paid or actually paid, unless an exemption applies;

- Failure to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;

- Failure to disclose the possibility of loss when the advertisement suggests or makes claims about the potential for profit;

- Failure to disclose all material facts relevant to any comparison made between model or actual results and an index (e.g., disclose, if applicable, that the volatility of an index materially differs from a model portfolio).
• Failure to disclose any material conditions, objectives, or strategies used to obtain the results portrayed (e.g., failure to disclose that certain investment practices or instruments contributed overwhelmingly to performance, especially when it is doubtful that the performance could be expected to continue including IPO investments or other material events that may not repeat themselves), and

• Failure to disclose, if applicable, that actual results portrayed relate only to a select group of the adviser’s clients, the basis on which the selection was made, and any material effect of this practice on the results portrayed.

Advisers should not rely on the Clover Capital no-action letter as a safe harbor when presenting actual and model returns, nor should advisers consider the Clover Capital list to be an exhaustive list of all factors to be considered. Moreover, the SEC staff has clearly stated that a disclaimer to the effect of “Past performance is not a guarantee of future returns” may not, in and of itself, be sufficient to cure a misleading presentation. Each communication of the adviser should be reviewed in its totality to determine whether its audience may imply something about the adviser or its competence that would not be true if all material facts were presented.

§ 6.3.2 Model Performance

Neither Section 206 nor Rule 206(4)-1 thereunder speaks to the use of model performance results. However, the SEC staff has explicitly stated that “the applicable legal standard governing the advertising of model or actual results is that contained in paragraph (5) of the rule, i.e., whether the particular advertisement is false or misleading.” At least thirty years ago, the SEC staff took the position that the advertisement of model performance was per se misleading, and could not be cured by any amount of disclosure. The SEC staff eventually
abandoned this position and currently permits model disclosure so long as it is not false or misleading in contravention of Rule 206(4)-1(a)(5). In Clover Capital, the SEC staff clarified that advisers who present model returns must equip prospective investors with additional information in light of the heightened chance that model returns may give rise to an erroneous inference about future investment returns. In addition to the presentation and disclosure requirements applicable to both model and actual returns, the SEC staff opined that the failure to make the following disclosures would be prohibited by Rule 206(4)-1(a)(5):

- the limitations inherent in model results, particularly that model returns do not reflect actual trading and may not reflect the impact that material economic and market factors may have had on the adviser’s decision-making had the adviser actually managed client funds;
- if applicable, that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period portrayed in the advertisement and, if so, the effect of any such change on the results portrayed;
- if applicable, that any of the securities contained in, or the strategies followed with respect to, the model portfolio do not relate, or only partially relate, to the type of advisory services currently offered by the adviser (e.g., the model reflects securities that are no longer recommended for clients); and
- if applicable, that the adviser’s clients had investment results materially different from the results portrayed in the model.

§ 6.3.3 Hypothetical Backtested Performance

Unlike model performance, backtested performance presents hypothetical performance based upon the retroactive application of an adviser’s investment strategy over a select market period. Great care should be taken when presenting backtested performance, which is regarded as highly suspect by the SEC. Backtested returns should only be presented to sophisticated (i.e., non-retail) clients. Through enforcement actions addressing this practice, the SEC has admonished advisers for failing to disclose the following in connection with the presentation of hypothetical backtested returns:

---

75 The SEC has admonished an investment adviser for advertising hypothetical returns based upon a timing system that was no longer in use by the adviser. See In re Bond Timing Services, Inc. and Vilis Pasts, SEC Release No. IA-920 (July 23, 1984).
76 In re LBS Capital Management, Inc., SEC Release No. IA-1644 (July 18, 1997) (stating that in concluding that an advertisement containing backtested performance was misleading, the SEC considered that the advertisement was distributed to existing and prospective retail clients.).
that backtested performance was derived from the retroactive application of a model developed with the benefit of hindsight (e.g., disclosure that the adviser began to offer its strategy after the period depicted);77

the inherent limitations of data derived from the retroactive application of a model developed with the benefit of hindsight and the reasons why actual results may differ;78

whether the trading strategies retroactively applied were not available during the periods presented;79

that actual performance with client accounts was materially less than the advertised hypothetical results for the same period;80

all material economic and market factors that may have impacted the adviser’s decision-making when using the model to actually manage client funds;81

whether the advertised performance reflects the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid;82

all material facts relevant to any comparison between backtested performance and its benchmark;83 and

the potential for loss.84


78 In re Market Timing Systems, Inc. et al., SEC Release No. IA-2047 (Aug. 28, 2002); In re Schield Management Company et al., SEC Release No. IA-1872 (May 31, 2000). For instance, in In re Schield Management Company, the SEC admonished an adviser for failing to disclose that the hypothetical strategy, when actually executed, underperformed its benchmark even though the backtested performance presented showed that the hypothetical strategy consistently outperformed the benchmark each year.

79 See, e.g., In re Leeb Investment Advisors et al., SEC Release No. IA-1545 (Jan. 16, 1996) (admonishing an adviser under Section 17(a)(2) of the Securities Act and Section 34(b) of the 1940 Act for stating that an investor could turn an investment made in 1980 into millions by the 1990s without disclosing that this result would depend on using trading strategies that were not available in 1980).

80 In re Market Timing Systems, Inc. et al., SEC Release No. IA-2047 (Aug. 28, 2002). See also In re Profitek, Inc. and Edward G. Smith, SEC Release No. IA-1764 (Sept. 29, 1998) (finding a violation of Section 206(4) and Rule 206(4)-1(a)(5) thereunder, among other violations, for failing to disclose that performance data of model portfolios were based on hypothetical stock transactions that bore no resemblance to the actual performance of its client accounts).


82 Id.

83 Id.
With respect to the requirement that advisers disclose that backtested performance was derived from the retroactive application of a model developed with the benefit of hindsight, the SEC has indicated that labeling backtested returns as “pro forma” or “hypothetical,” in and of itself, is insufficient to satisfy this requirement. Moreover, the SEC has stated that the inclusion of general disclaimers to the effect of, “Future results based upon past performance, including hypothetical returns, cannot be guaranteed” is also insufficient to remove the erroneous suggestion that the performance was achieved through actual trading. In In re LBS Capital Management, Inc., the SEC noted that disclosure that backtested returns were “pro-forma” and that “actual results were available upon request” was insufficient to convey that the advertised performance were achieved by retroactive application of a model, or otherwise dispel the misleading suggestion that the advertised performance represented actual trading.

§ 6.3.4 Gross-of-Fee and Net-of-Fee Performance

[A] Net-of-Fee Performance

As a general matter, investment adviser performance must be advertised after the deduction of advisory fees, brokerage or other commissions, and any expenses that a client paid or would have paid. The SEC staff has clarified that custodial fees do not have to be reflected in net-of-fee returns since custodians are ordinarily selected and paid directly by advisory clients. Except under limited circumstances, the SEC staff deems the presentation of gross-of-fee performance alone to be misleading under Rule 206(4)-1(a)(5) since an average investor would make an inference about the future returns of the adviser or its competence that would not be true if the adviser had presented returns on a net-of-fee basis. This is largely due to the fact that gross-of-fee returns fail to reflect the impact that fees have on performance or the compounded effect on performance of not deducting fees.

[B] Gross-of-Fee Performance

[i] One-on-One Presentations

84 Id.
90 See discussion infra, § 6.3.4[B].
91 See Investment Company Institute, SEC No-Action Letter (pub avail. Sept. 23, 1988). See also In re Bond Timing Services, Inc. and Vilis Pasts, SEC Release No. IA-920 (July 23, 1984) (finding an adviser to have fully violated Section 206(4) and Rule 206(4)-1(a)(5) thereunder for distributing advertisements of annualized returns that did not reflect advisory fees, sales loads, and transfer fees).
92 See id.
In a no-action letter issued to the Investment Company Institute (the “ICI II no-action letter”), the SEC staff permitted the presentation of gross-of-fee performance returns in a one-on-one presentation to certain prospective clients that are in a position to negotiate their advisory fees (e.g., wealthy individuals, pension funds, universities and other institutional investors) so long as the adviser provides the following disclosures to the client in writing:

- performance disclosures do not reflect the deduction of advisory fees;
- the client’s return will be reduced by the advisory fees and any other expenses it may incur in the management of its advisory account;
- the adviser’s fees are described in Part II of its Form ADV; and
- a representative example (e.g., table, chart, graph, or narrative) that shows the effect an advisory fee, compounded over a period of years, could have on the total value of a client’s portfolio.

To constitute as a “one-on-one presentation,” the presentation must be private and confidential in nature and the prospective client must have ample opportunity to discuss the type of advisory fees that may be paid. In addition, the presentation must not be publicly available through any print, electronic or other medium.

[ii] Consultants

An adviser may present performance information to a consultant on a gross-of-fee basis in a one-on-one presentation so long as the adviser instructs the consultant to present such performance data to prospective clients only on a one-on-one basis with the disclosures set forth in the ICI II no-action letter.

[iii] Side-by-Side Gross and Net of Fee Performance

In a no-action letter issued to the Association for Investment Management and Research, the SEC staff stated that an adviser may distribute an advertisement that presents composite performance on a gross and net-of-fee basis, so long as: (i) the gross and net performance is

---

93 The SEC staff has acknowledged that “a client’s ability to negotiate fees with an adviser is directly related to the amount of client assets subject to the adviser’s management.” Investment Company Institute, SEC No-Action Letter (pub. avail. Sept. 23, 1988). The SEC staff acknowledged that information on the fees and expenses associated with performance of other advisory clients is not as material to a client that has bargaining power over its advisory fees. See id.


95 See id.

96 See id.

presented with equal prominence; (ii) the presentation is in a format designed to facilitate the ease of comparison between the gross and net performance; and (iii) the advertisement contains sufficient disclosure (e.g., that gross-of-fee performance does not reflect the payment of advisory fees and other expenses) that would ensure that the presentation is not otherwise misleading.98

§ 6.3.5 Model Fees

An adviser may advertise performance reflecting the deduction of a model fee so long as the resulting performance is no higher than the performance that would have resulted if actual fees were deducted, and the performance data is accompanied by disclosure that: (i) the performance reflects the deduction of the highest fee charged to an advisory customer employing that particular strategy during the period under consideration; (ii) actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size; and (iii) the advisory fees are available upon request and may be found in Part II of the adviser’s Form ADV.99 There are two other situations in which the SEC staff has permitted “model” advisory fees to be used in lieu of the actual fee. These include:

- **Composites containing wrap and non-wrap accounts.** Advertisements that present composites containing both wrap and non-wrap fee accounts may calculate net-of-fee performance using the actual fees from wrap accounts and a model fee from non-wrap accounts, which is equal to the highest fee charged to a wrap fee account, so long as the advertisement contains sufficient disclosure to ensure that the information presented is not misleading.100

- **Multi-manager accounts.** A composite that includes advisory accounts that consist of a portion of the assets of a multi-manager account101 can be presented on a net-of-fee basis after deducting only those fees and costs related to the assets managed by the adviser, including transaction costs and all fees and charges paid by the account to the adviser or its affiliate, provided that it is accompanied with a statement that identifies those fees and costs that have been deducted.102

§ 6.3.6 Portability

“Portability” of performance refers to the ability of one adviser to reference in its own performance presentation the historical performance record of either a predecessor firm or that of the adviser’s portfolio managers achieved while at another firm. A number of SEC staff no-action letters considered whether an adviser’s advertisement of performance results of accounts managed by a predecessor would be misleading and therefore deemed fraudulent for purposes of Section 206(4) and Rule 206(4)-1. These no-action letters take the position that an advertisement that includes prior performance of accounts managed by portfolio managers at

101 In a multi-manager account, different investment firms manage a discrete portion of the account’s assets.
their prior place of employment will not, in and of itself, be misleading under Section 206(4) and Rule 206(4)-1 thereunder so long as:

1. the person(s) managing accounts at the adviser are also those primarily responsible for achieving the prior performance results;\(^{103}\)

2. the accounts managed at the prior adviser are so similar to the accounts currently under management that the performance would provide relevant information to prospective clients;\(^{104}\)

3. all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance;\(^{105}\)

4. the advertisement is consistent with SEC staff interpretations with respect to the advertisement of performance results;\(^{106}\)

\(^{103}\) Fiduciary Management Associates, Inc., SEC No-Action Letter (pub. avail. Mar. 5, 1984) (stating that it is not misleading for a new adviser to use the performance of another adviser when, among other things, the investment personnel are the same). See also Bramwell Growth Fund, SEC No-Action Letter (pub. avail. Aug. 7, 1996) (finding that Section 206 does not prohibit the inclusion in a mutual fund’s prospectus performance of another registered investment company previously managed by the fund’s portfolio manager provided that (1) no other individuals played a significant part in achieving the prior performance, and (2) the performance is not presented in a misleading manner and does not obscure or impede understanding of information required to be in the prospectus); Great Lakes Advisors, SEC No-Action Letter (pub. avail. Apr. 3, 1992) (finding that it may be misleading for an adviser to advertise the performance results of accounts managed at an employee’s prior place of employment when the employee was one of several persons responsible for selecting the securities for those accounts). The SEC staff has clarified that whether this requirement is satisfied requires a review of the investment team both at the prior firm and the new firm. That is, the individuals primarily responsible for achieving the prior performance results must also be those individuals primarily responsible for the accounts at the new firm. See Horizon Asset Management, LLC, SEC No-Action Letter (pub. avail. Sept. 13, 1996). In Horizon Asset Management, the SEC staff found that although the sole portfolio manager who was responsible for achieving the prior performance was now a member of an advisory committee at his new firm, this in and of itself would not bar the portability of the prior performance so long as the portfolio manager was actually responsible for making investment decisions without the need for consensus from the other committee members. See id.


\(^{105}\) See id; Conway Asset Management Incorporated, SEC No-Action Letter (pub. avail. Jan. 27, 1989) (allowing newly registered adviser solely owned by an employee to use performance data of several accounts managed by employee prior to registration); Fiduciary Management Association, Incorporated, SEC No-Action Letter (pub. avail. Mar. 5, 1984). Although the advertisement of performance of a prior adviser’s select accounts is not per se prohibited so long as such performance is not materially higher than the composite performance, the Global Investment Performance Standards (“GIPS”) prohibits a firm from linking select accounts of the composite’s performance history. See Guidance Statement on Performance Record Portability (Revised), Application No. 2 (effective Jan. 1, 2006) (hereinafter, “Portability Guidance Statement”) (“In addition to meeting all the elements of the Guidance Statement, in order for a firm to be able to link the composite from the old firm to the on-going performance of the new firm, the entire composite performance history, including all portfolios, must be used.”)

\(^{106}\) See, e.g., Clover Capital Management, Inc., SEC No-Action Letter (pub. avail. Oct. 28, 1986) (stating that Rule 206(4)-1(a)(5) prohibits an advertisement that (i) fails to disclose the effect of material market or economic conditions on the results portrayed; (ii) includes model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client paid or would have paid; (iii) fails to disclose whether and to what extent returns reflect the reinvestment of dividends and other earnings; (iv) suggests the potential for profit without disclosing the possibility of loss; (v) compares model or actual results to an index
(5) the advertisement includes all relevant disclosures, including that the performance results were from accounts managed at another entity. ¹⁰⁷

Through no-action letters and administrative proceedings, the SEC and its staff has emphasized that an investment adviser who advertises the prior performance of another adviser may not do so unless it can comply fully with the recordkeeping requirements of Rule 204-2(a)(16). ¹⁰⁸

§ 6.3.7 Recordkeeping

Rules 204-2(a)(11) and 204-2(a)(16) under the Advisers Act govern the maintenance of records associated with investment adviser advertising. Rule 204-2(a)(11) requires generally that every registered investment adviser “make and keep true, accurate and current . . . a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly to 10 or more persons.” ¹⁰⁹ Rule 204-2(a)(16) generally requires that each federally registered investment adviser maintain:

all accounts, books, internal working papers, and any other records or documents that are 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 in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with the investment adviser). ¹¹⁰

without disclosing all material facts relevant to the comparison; (vi) fails to disclose any material conditions, objectives or investment strategies used to obtain the results portrayed; (vii) fails to disclose prominently the limitations inherent in model results, if applicable; (viii) fails to disclose, if applicable, that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period portrayed and, if so, the effect of any such change on the results portrayed; (ix) fails to disclose, if applicable, that any of the securities contained in, or the investment strategies followed with respect to, the model portfolio do not relate, or only partially relate, to the type of advisory services currently offered by the adviser; (x) fails to disclose, if applicable, that the adviser’s clients had investment results materially different from the results portrayed in the model; (xi) fails to disclose prominently, if applicable, that the results portrayed relate only to a select group of the adviser’s clients, the basis on which the selection was made, and the effect of this practice on the results portrayed if material).


¹⁰⁹ Rule 204-2(a)(11).

¹¹⁰ Rule 204-2(a)(16) under the Advisers Act. Rule 204-2(e)(3)(i) generally requires such books and records to be maintained and preserved in an easily accessible place for a period of not less than 5 years, the first 2 years in an appropriate office of the adviser, from the end of the fiscal year during which the adviser last published or otherwise
Rule 204-2(a)(16) applies to any advertised performance, both actual and model.\textsuperscript{111} Rule 204-2(a)(16) also provides that an adviser is deemed to satisfy the requirements of the Rule if, with respect to the performance of its managed accounts, the adviser retains: (i) all account statements so long as they reflect all debits, credits, and other transactions in the client’s account for the period of the statement; and (ii) all worksheets that are necessary to demonstrate the calculation of the performance or rate of return of the managed accounts.\textsuperscript{112} In the adopting release to Rule 204-2, the SEC emphasized that these account statements must be prepared contemporaneously with the period reported, and that all account statements for the period for which performance is calculated be kept, irrespective of whether a particular account is included in the computation of an advertised performance figure.\textsuperscript{113} The SEC staff has acknowledged that neither the Rule nor the releases proposing or adopting the Rule states that this safe harbor for managed accounts is the exclusive method of satisfying the requirements of Rule 204-2(a)(16).\textsuperscript{114} However, as a matter of policy, the SEC staff will not provide no-action assurances under the Rule regarding whether an adviser’s particular records are sufficient to form the basis of, or demonstrate the calculation of, the investment performance of an adviser’s managed accounts.\textsuperscript{115} The SEC’s purpose in adopting the Rule was to assist SEC examiners in their efforts to substantiate performance claims made by advisers in their advertisements.\textsuperscript{116}

Although Rule 204-2(a)(16) may be satisfied through the reliance on internally generated records, the SEC staff has noted that advisers can facilitate the SEC’s examination of advertised performance by maintaining: (i) records prepared by a third party (e.g., custodial and brokerage statements) that confirm the accuracy of client account statements and other performance-related records maintained by the adviser; and (ii) reports prepared by an independent auditor that verify

---


\textsuperscript{112} Rule 204-2(a)(16).


\textsuperscript{114} Salomon Brothers Asset Management Inc., SEC No-Action Letter (pub. avail. July 23, 1999). Rule 204-2(a)(16) may also be satisfied by retaining published materials listing the net asset values of an account together with worksheets demonstrating the performance calculations based on the net asset values, provided the net asset values were accumulated contemporaneously with the management of the account. See Solomon Brothers Asset Management Inc., SEC No-Action Letter (pub. avail. July 23, 1999).


\textsuperscript{116} Recordkeeping by Investment Advisers, SEC Release No. IA-1135, at fn. 3 (Aug. 17, 1988) (Adopting Release); Recordkeeping by Investment Advisers, SEC Release No. IA-1093 (Nov. 5, 1987) (Proposing Release). See also Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000) (“The purpose of Rule 204-2(a)(16) was to deter the use of false or misleading performance advertisements by advisers by requiring advisers to make and keep for inspection by the Commission’s examination staff all records necessary to substantiate the performance information in their advertisements.”).
performance. On at least one occasion, the SEC staff has indicated a preference for independent records to substantiate advertised returns. Lori Richards, the Director of the SEC Office of Compliance Inspections and Examinations has questioned the reliability of internally generated documents, stating that advisers may easily manipulate their internal statements to support false performance and advisers are therefore encouraged to support their performance claims with third party records (e.g., brokerage or custodial records and statements). The SEC staff has acknowledged the value of third party records for not only assisting in the verification of performance claims, but also for enabling SEC examiners to confirm client assets and review for the misappropriation of client funds and securities.

The records required to be made under paragraphs (a)(11) and (a)(16) of Rule 204-2 must be maintained in an easily accessible place for at least five years, the first two years in an appropriate office of the adviser, beginning from the end of the fiscal year during which the adviser last disseminated the advertisement.

§ 6.4 Global Investment Performance Standards (GIPS®)

§ 6.4.1 General Background

[A] Overview of the Standards

The Global Investment Performance Standards (“GIPS” or “Standards”) are performance presentation standards that are created, sponsored and interpreted by the CFA Institute (“CFAI,” which was formerly known as the Association for Investment Management and Research or “AIMR”). The objectives of the Standards are to: (i) establish a global standard for the

---

117 Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000). When reviewing auditor reports, the SEC indicated that it will consider all the facts and circumstances relating to the quality of the audit, including whether: (i) the auditor is appropriately independent from the adviser; (ii) the auditor reports are based on the review of data that were accumulated contemporaneously with the management of the relevant accounts; (iii) the auditor reviews sufficient information to afford a reasonable basis for its conclusions (e.g., by reviewing custodian and brokerage statements and confirming data directly with custodians and brokers) and prepares the auditor reports in accordance with appropriate auditing standards); (iv) the adviser or the auditor maintains records underlying the auditor reports (i.e., audit work papers) and the SEC staff has access to such records; (v) the performance verified by the auditor is consistent with the performance derived from other records maintained by the adviser; and (vi) whether the auditor reports include a clear and specific description of the standard used by the adviser to calculate performance. Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000).

118 Lori A. Richards, “Compliance Priorities for Investment Advisers,” Remarks at the Investment Adviser Compliance Summit (May 1, 2000) (“Because of the possibility of fraud, internal documentation prepared by the adviser may not be adequate alone to substantiate performance claims. In today’s technologically sophisticated world, it’s relatively easy for an adviser to artificially create internal statements supporting false performance returns. We have seen this scenario too often.”).

119 Id.


121 Rule 204-2(e)(3)(i) under the Advisers Act. For instance, if an advertisement contains performance over the last ten years, the documents that form the basis for the adviser’s performance for each of the ten years must be kept for five years, the first two years in an appropriate office of the adviser, after the end of the fiscal year in which the advertisement was last published or disseminated. See Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000).
calculation and presentation of investment performance in a fair, comparable format with full
disclosure, (ii) ensure the accuracy and consistency of performance data for reporting,
recordkeeping, marketing and presentations; (iii) promote competition among investment firms
without barring entry of new investment firms; and (iv) foster industry self-regulation on a global
basis. Although firms must always adhere to the fundamental principles of fair representation
and full disclosure, the Standards primarily address the presentation of performance to
prospective clients. Presentations to existing clients do not have to adhere to the GIPS standards
since “[p]erformance reporting to existing clients is something that should be agreed upon
between the firm and the client.”

The Standards are comprised of eight sections that reflect what the CFAI perceives to be
the basic components involved in presenting performance: fundamentals of compliance; input
data; calculation methodology; composite construction; disclosures; presentation and reporting;
real estate; and private equity. Within each section, the Standards are divided into required
provisions and recommended provisions. Each firm that claims compliance with the Standards
must adhere to the required provisions and is “strongly encouraged” to adhere to the
recommended provisions under the Standards. Failure to adhere to the recommended
provisions will not in any way bar a firm’s claim of GIPS compliance.

[B] Interpretation of the Standards

Each firm that claims compliance with the Standards is required to comply with all
reports, Guidance Statements, interpretations, or clarifications published by the CFAI and the
IPC, which is posted on the CFAI website (www.cfainstitute.org) and in the GIPS Handbook. The
Standards are interpreted by the Investment Performance Council (“IPC”) of the CFAI,
which consists of 36 members from 15 countries. Under this framework, the IPC delegates
interpretation of the Standards to the Interpretations Subcommittee that “has the responsibility of
ensuring the integrity, consistency, and applicability of the GIPS standards by providing
guidance to the public on practical issues and clarifying areas of confusion.” Interpretations of
the Standards occur in one of three ways: through the “Standards Helpdesk” which provides brief
responses to questions submitted by CFAI members individually; through Guidance Statements,
which are in-depth responses to novel questions that the Standards may not directly address or

123 GIPS Interpretations on Client Reporting (Q: “Do I violate the GIPS standards if I report money-weighted rates
of return for a single portfolio to an existing client?”).
124 GIPS Standard 0.A.15 (“Firms are encouraged to comply with the recommendations and must comply with all
applicable requirements of the GIPS standards ….”); GIPS Introduction to the Provisions of the Global Investment
Performance Standards, II.
125 GIPS Standard 0.A.15.
126 GIPS Background of the GIPS Standards. CFAI has indicated that a new GIPS Executive Committee will replace
the IPC and “will operate as a ‘think tank’ for performance measurement, presentation, research, and will develop
new performance standards as needed by the industry.” IPC Meeting Information, at
http://www.cfainstitute.org/cfacentre/ips/ipc/meetings.html. As of the date of this publication, the GIPS Executive
Committee has not assumed the function of the IPC.
127 GLOBAL INVESTMENT PERFORMANCE STANDARDS HANDBOOK §1-4, p. 2 (1st ed. 2002) (hereinafter, “GIPS
HANDBOOK”).
require additional interpretation or clarification; or through members of the IPC, CFAI staff and others active in CFAI activities as volunteers, who publicly and privately speak on the Standards and various approaches to GIPS compliance, including interpretations of various provisions of the Standards. Guidance Statements, which are subject to the most formalized finalization process of these three interpretive sources, are intended to consolidate and incorporate all existing interpretations by the IPC Interpretations Subcommittee. Before new GIPS provisions or Guidance Statements are finalized, CFAI publishes its proposals for public comment on its website for a period of approximately 60-90 days, depending upon the complexity of the issue. At the conclusion of this period, the Interpretations Subcommittee presents a modified provision or Guidance Statement to the IPC for approval. Unlike Guidance Statements, interpretive responses electronically posted by the Standards Helpdesk are not submitted for public comment. The primary purpose of the Standards Helpdesk is to assist firms in complying with the Standards by responding to specific questions.

[C] Enforcement of the Standards

Compliance with the Standards is voluntary. However, once a firm claims compliance, it must comply at all times on a firmwide basis. GIPS are ethical standards, not legally required, enforced or interpreted. Laws and regulations override GIPS when in conflict. However, if the Standards impose a higher standard than law and regulation, the Standards control. CFAI’s enforcement of the Standards is limited to individuals that are members of CFAI and involved in the preparation or presentation of historical performance by a firm claiming GIPS compliance. CFAI does not have any authority over a firm that does not claim compliance with the Standards. Firms that choose to claim compliance with GIPS are expressly required to comply with all “updates, reports, guidance statements, interpretations or clarifications published by the CFA Institute and the Investment Performance Council . . .”

The SEC takes an active role in enforcing the Standards. As part of its investment adviser inspection program, the SEC Staff will determine whether a firm’s claim of compliance with GIPS is accurate. The SEC Staff will examine in detail all aspects of a firm’s compliance

129 See id.
130 GIPS HANDBOOK §1-2, p. 1.
132 GIPS Introduction, I.D.10(i) (“In cases where applicable local or country-specific law or regulation conflicts with the GIPS standards, the Standards require firms to comply with the local law or regulation and make full disclosure of the conflict.”)
133 GIPS Standard 0.A.15
135 See Lori A. Richards, Director of the SEC Office of Compliance Inspections and Examinations, Division of Investment Management: SEC Roundtable on Investment Adviser Regulatory Issues (May 23, 2000) (“[T]he most common type of area where I think there probably are misunderstandings by advisers is what it takes to constitute
with the Standards, including firm definition, discretion definition, composite creation and maintenance, calculation methodology, recordkeeping, and presentations. The SEC’s jurisdiction with respect to the Standards is based on whether a firm claims compliance with GIPS.\(^\text{136}\) The SEC cannot impose the Standards on any firm that does not claim compliance with the Standards.

\section*{ § 6.4.2 Fundamentals of Compliance}

The “Fundamentals of Compliance” section of the GIPS standards address the critical issues that a firm is required to consider when claiming GIPS compliance, including firm definition, documenting firm policies and procedures, maintaining compliance with interpretations and updates of the standards, and properly using the claim of compliance and references to GIPS verification.\(^\text{137}\)

\textbf{[A] Definition of the Firm}

\textbf{[1] General Guidelines}

Defining the firm is both the responsibility of the entity in question and the “foundation for firm-wide compliance,”\(^\text{138}\) and creates defined boundaries for determining total firm assets.\(^\text{139}\) The firm definition must be fairly and appropriately defined and also be “meaningful, rational, and fair.”\(^\text{140}\) Firm definitions may not be defined too narrowly such that they serve as a substitute for defining composites.\(^\text{141}\) The GIPS standards recommend that a compliant firm adopt the broadest, most meaningful definition of the firm, and consider how it is viewed by the public.\(^\text{142}\) For instance, the scope of this definition should include all geographic offices operating under the same company regardless of the actual name of the individual investment compliance with AIMR standards … In many of our exams of advisers that claim that they’re AIMR compliant we find that in fact that they’re not appropriately applying the AIMR guidelines . . . . Whether it’s because of misunderstandings of the law or more intentional misconduct, the consequences can be very serious if it results in a performance claim or an advertisement that misstates actual performance results.”)

\(^\text{136}\) Lori A. Richards, Director of the SEC Office of Compliance Inspections and Examinations, “Compliance Priorities for Investment Advisers,” Remarks at the Investment Adviser Compliance Summit (May 1, 2000) (“[T]he Commission does not require advisers to comply with AIMR standards but if an adviser claims AIMR compliance and has in fact not complied with the standards, the adviser may have made a material misrepresentation.”). The Director of the SEC’s Office of Compliance Inspections and Examinations has explicitly stated that due to the importance of the GIPS standards to potential clients, an erroneous claims of GIPS compliance will be cited in a deficiency letter and the adviser may be referred to the enforcement staff of the SEC. See id.

\(^\text{137}\) See GIPS Standards 0.A.1 – 0.A.15, Standards 0.B.1 – 0.B.3.


\(^\text{139}\) Id. at 4.

\(^\text{140}\) Id. at 2.

\(^\text{141}\) Id.

\(^\text{142}\) Firm Definition Guidance Statement, p. 2; GIPS Standard 0.B.1.
management companies. The GIPS standards require that each firm disclose its firm definition in its composite presentations and verifiers are also required to verify that the firm’s definition is appropriate.

Prior to January 1, 2006, firms were permitted to define themselves in one of two primary ways: (1) an entity registered with the appropriate national regulatory authority overseeing the entity’s investment management activities; or (2) an investment firm, subsidiary or division held out to existing or potential clients as a distinct business unit. Beginning January 1, 2006, firms may only be defined “as an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business entity.” In order to be defined appropriately under the standards, a firm must: (1) be a unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices; (2) retain discretion over the assets it manages and should have autonomy over the investment decision-making process; and (3) hold itself out to existing and potential clients as a separate firm.

Whether a business entity is “separate and distinct,” and deemed to be held out to the public as a separate firm is a factual determination that may be affected by factors such as whether the business entity is a legal entity, has a distinct market or client type, or whether it uses a separate and distinct investment process. However, whether the firm is a legal entity or utilizes a separate investment process is not necessarily dispositive of the issue of whether the firm is appropriately defined. The Guidance Statement on Definition of the Firm explicitly states that the scope of the definition of the firm may include “[f]inancial service holding companies defined as one global firm with multiple brands, several legal entities, multiple offices, investment teams, and investment strategies.”

[2] Redefinition of the Firm

143 Firm Definition Guidance Statement, p. 2; GIPS Standard 0.B.1.
145 GIPS Verification, III.B.2.a.
146 Introduction, AIMR-PPS Paragraph 12. See also IPC Firm Definition Guidance Statement, p. 1. Prior to January 1, 2005, firms that managed global assets were also permitted to define themselves as all assets managed to one or more base currencies.
147 GIPS Standard 0.A.2.
149 Id.
150 The IPC ultimately rejected the notion that a firm that holds itself as a separate entity yet does not maintain its own distinct investment process may not be defined as a firm. The proposed Firm Definition Guidance Statement initially had a guiding principle that required the firm to be a “distinct entity with its own distinct investment process.” See Firm Definition Guidance Statement (Adopting Release), p. 4. The IPC ultimately removed this principle in response to commenters’ opposition to the principle.
151 Firm Definition Guidance Statement, p. 2. Other examples of permissible firm definitions include: offices operating under a single brand name, other names resulting from mergers, acquisitions, etc., trading under a different name for branding purposes, a firm with one brand but employing multiple strategies and investment teams, or all offices trading under a globally recognizable trading name with regional/country specific additions. See id.
Changes in a firm’s organization may not result in the modification of the firm’s historical composite returns.\textsuperscript{152} If an entity redefines its firm definition, it should disclose the date and rationale behind the redefinition.\textsuperscript{153} Changes in investment style, investment personnel, or a firm name change are not sufficient justifications for firm redefinitions unless the change has resulted in the firm being held out to the public in a significantly different way.\textsuperscript{154} Consistent with GIPS’ recommendation for expansive firm definitions, the Standards recognize the need for a multiple defined firm to clearly disclose the firms included within a parent company.\textsuperscript{155} Accordingly, GIPS recommends that each firm: (i) disclose a list of the other firms within the parent company; and (ii) clearly state which firm claims GIPS compliance.\textsuperscript{156} In addition, when jointly marketing with other firms, whether within an organization or externally, “the firm claiming compliance must be sure that it is clearly defined and separate relative to any other firms being marketed and that it is clear which firm is claiming compliance.”\textsuperscript{157}

### [3] Total Firm Assets

How a firm is ultimately defined will affect the boundaries for determining total firm assets.\textsuperscript{158} Total firm assets should include all assets for which the firm has investment management responsibility, including assets managed by sub-advisers that the firm has discretionary authority to hire or fire.\textsuperscript{159} Total firm assets are determined by aggregating the market value of all discretionary and non-discretionary assets under management, including both fee-paying and non-fee-paying accounts.\textsuperscript{160} Assets to which GIPS cannot be applied (e.g., investment vehicles based on cost or book values) must not be included in a firm’s total firm assets.\textsuperscript{161}

### [4] Sub-Advisors

If a firm has discretionary authority to hire and/or fire a sub-advisor, the firm must include the sub-advisor’s performance in its performance history and include those assets in the firm’s total firm assets.\textsuperscript{162} Only the performance history attached to the assets assigned by the

\textsuperscript{152} GIPS Standard 0.A.5; Firm Definition Guidance Statement, p. 3.

\textsuperscript{153} GIPS Standard 4.A.21; Firm Definition Guidance Statement, p.3.

\textsuperscript{154} Firm Definition Guidance Statement, p. 3. It is important to note that a firm that redefines itself must examine whether its performance history may be preserved. See Guidance Statement on Performance Record Portability.

\textsuperscript{155} \textit{id.} at 3.

\textsuperscript{156} \textit{id.} (“When jointly marketing with other firms, the firm should be sure that it is clearly defined relative to the other firms being marketed and apparent which firm is claiming compliance . . . . If a parent company contains multiple defined firms, it is recommended that each firm within the parent company disclose a list of the other firms contained within the parent company.”).

\textsuperscript{157} Firm Definition Guidance Statement (Adopting Release), p. 2. See also GIPS Standard 0.A.14.

\textsuperscript{158} Firm Definition Guidance Statement, p. 3.

\textsuperscript{159} Firm Definition Guidance Statement, p. 3.

\textsuperscript{160} GIPS Standard 0.A.3.

\textsuperscript{161} Firm Definition Guidance Statement, p. 3.

\textsuperscript{162} GIPS Standard 0.A.4; Firm Definition Guidance Statement, p.4.
firm to the sub-advisor may be included in the firm’s performance history. In addition, beginning January 1, 2006, firms must disclose the use of a sub-advisor and the period during which the sub-advisor was used in their performance presentations.

[B] GIPS Policies and Procedures

One of the fundamentals of compliance under GIPS is the requirement that firms “document, in writing, their policies and procedures used in establishing and maintaining compliance with all the applicable requirements of the GIPS standards.” Such policies and procedures may include the following:

- criteria used to define the firm;
- criteria used to define discretion;
- valuation policies;
- calculation methodologies;
- how large cash flows are handled;
- how new and terminated portfolios are handled; and
- policies for using a minimum portfolio size.

Firms that are registered under the Advisers Act are also required by that Act to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons.

[C] Claim of Compliance

A firm that satisfies the required provisions of the GIPS standards must use the following compliance statement in its presentations to its prospective clients: “[Firm name] has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).” The following claims of compliance are deemed to be inappropriate under the Standards:

---

163 Firm Definition Guidance Statement, p. 4.
165 GIPS Standard 0.A.6.
166 For additional information on dealing with large external cash flows, see the Guidance Statement on the Treatment of Significant Cash Flows (Revised) (effective Jan. 1, 2006).
167 CFA Institute, “Questions and Answers on the Revised GIPS Standards,” p. 4.; see also GIPS Interpretations on Fundamentals of Compliance (Q: “What information must we include in our GIPS-compliance policies and procedures?”).
168 Rule 206(4)-7 under the Advisers Act.
claims of partial compliance with the Standards (e.g., claims compliance with GIPS “except for ….”)\(^\text{169}\)

- claims that a calculation methodology is “in accordance” or “in compliance” with GIPS;\(^\text{170}\) and

- claims that refer to the performance of a single, existing client as being calculated in accordance with GIPS, unless such claim is made in the course of reporting performance to that existing client.\(^\text{171}\)

[D] Firm Fundamental Responsibilities

Once a firm claims compliance with the GIPS standards, it must make every reasonable effort to provide a GIPS-compliant performance to each of its prospective clients unless the client has received a compliant presentation within the previous 12 months.\(^\text{172}\) If a firm has provided a compliant presentation to a prospective client within the past 12 months, the firm may present additional information that does not meet the requirements of the GIPS standards.\(^\text{173}\) Under such circumstances, a reference should be included that a composite presentation in compliance with the GIPS standards is available upon request.\(^\text{174}\) Every firm must provide a list\(^\text{175}\) and description\(^\text{176}\) of its composites and/or a compliant presentation for any composite listed on such list upon request by a prospective client.\(^\text{177}\)

§ 6.4.3 Input Data\(^\text{178}\)

\(^{169}\) GIPS Standard 0.A.8.

\(^{170}\) GIPS Standard 0.A.9.

\(^{171}\) GIPS Standard 0.A.10.

\(^{172}\) GIPS Standard 0.A.11.

\(^{173}\) See Interpretations on Client Updates (Q: “We provide a compliant presentation to all prospective clients when we first meet with them. However, we often are in discussions with large prospective clients for many months, if not years. We send them updated composite information quarterly. Must the quarterly updates include all required disclosures?”).

\(^{174}\) See id.

\(^{175}\) The composite list must reflect discontinued composites for 5 years at minimum since discontinuation. GIPS Standard 0.A.12.

\(^{176}\) A composite description is defined by the Standards as “General information regarding the strategy of the composite. A description may be more abbreviated than the composite definition but includes all salient features of the composite.” GIPS Glossary, “Composite Description.” The full composite definition, which must be made available to clients upon request, includes the “detailed criteria that determine the allocation of portfolios to composites.” GIPS Glossary, “Composite Definition”; GIPS Standard 3.A.2. Composite definitions must be documented in the firm’s GIPS policies and procedures.

\(^{177}\) GIPS Standards 0.A.12, 0.A.13.

\(^{178}\) For additional information regarding valuation principles, see the Guidance Statement on Calculation Methodology (Revised) (effective Jan. 1, 2006) (hereinafter, “Calculation Methodology Guidance Statement”).
Standard 1.A.1 requires that all data and information that supports a firm’s performance presentation and is necessary to perform the required calculations be captured and maintained.\textsuperscript{179} The Standards also require that portfolios be valued at their market value, and not their cost or book value.\textsuperscript{180} “Market value” is defined under the Standards as the “current price at which investors buy or sell securities at a given time.”\textsuperscript{181} The frequency of which portfolios must be valued depends upon the relevant period; for periods prior to January 1, 2001, portfolios must be valued at least quarterly.\textsuperscript{182} From January 1, 2001 to January 1, 2010, portfolios must be valued at least monthly.\textsuperscript{183} After January 1, 2010, portfolios must be valued: (a) on the date of all large external cash flows;\textsuperscript{184} and (b) as of the calendar month-end or the last business day of the month.\textsuperscript{185}

All firms must use trade date accounting for periods beginning January 1, 2005.\textsuperscript{186} Firms must use accrual accounting for fixed income securities and all other assets that accrue interest income.\textsuperscript{187} Market values of fixed-income securities must include accrued income.\textsuperscript{188} Beginning on January 1, 2006, the beginning and ending valuation dates of composites must be consistent and must be at calendar year-end or the last business day of the year, unless the composite is reported on a non-calendar fiscal year.\textsuperscript{189}

\section*{§ 6.4.4 Calculation Methodology}\textsuperscript{190}

In order to facilitate the comparison between various investment firms’ returns, the uniformity of method by which returns are calculated is integral.\textsuperscript{191} Therefore, GIPS requires that the following principles be followed by a GIPS-compliant firm when calculating \textit{portfolio} returns:

\textsuperscript{179} GIPS Standard 1.A.1.
\textsuperscript{180} GIPS Standard 1.A.2.
\textsuperscript{181} GIPS Glossary, “Market Value.”
\textsuperscript{182} GIPS Standard 1.A.3.
\textsuperscript{183} GIPS Standard 1.A.3.
\textsuperscript{184} The term “external cash flow” is defined as “cash, securities, or assets that enter or exit a portfolio.” GIPS Glossary, “External Cash Flow.” For additional information on dealing with large external cash flows, see the Guidance Statement on the Treatment of Significant Cash Flows (Revised) (effective Jan. 1, 2006).
\textsuperscript{185} GIPS Standard 1.A.4.
\textsuperscript{186} GIPS Standard 1.A.5. A firm that recognizes the asset or liability within at least 3 days of the date the transaction is entered into (\textit{i.e.}, trade date, T+1, T+2 or T+3) will satisfy this requirement. GIPS Glossary, “Trade Date Accounting.”
\textsuperscript{187} GIPS Standard 1.A.6.
\textsuperscript{188} GIPS Standard 1.A.6.
\textsuperscript{189} GIPS Standard 1.A.7.
\textsuperscript{190} For additional information on the GIPS requirements on guiding principles on calculation methodology, see the Calculation Methodology Guidance Statement.
\textsuperscript{191} See Calculation Methodology Guidance Statement, p. 1 (“Achieving comparability among investment management firms’ performance presentations requires as much uniformity as possible in the methodology used to calculate portfolio and composite returns.”)
• The calculation method employed must represent returns in a fair manner, not be misleading, and be applied consistently;\textsuperscript{192}

• Total return must be used, which must include realized and unrealized gains and losses plus income;\textsuperscript{193}

• Time-weighted rates of return\textsuperscript{194} that adjust for external cash flows must be used and periodic returns must be geometrically linked;\textsuperscript{195}

• External cash flows must be treated pursuant to the firm’s documented composite-specific policy;\textsuperscript{196}

• For periods beginning January 1, 2005, the firm must, at a minimum, use approximated rates of return that adjust for daily-weighted external cash flows.\textsuperscript{197} For periods beginning January 1, 2010, firm must, at a minimum, value portfolios on the date of all large external cash flows;\textsuperscript{198}

• Returns from cash and cash equivalents must be included in total returns;\textsuperscript{199}

• Actual trading expenses must be reflected in all returns; estimated trading expenses must not be used;\textsuperscript{200} and

• In the case of a bundled fee,\textsuperscript{201} if actual direct trading expenses cannot be identified and segregated, then returns must be reduced as follows:

(a) \textit{Gross-of-fee returns}. Returns must be reduced by the entire bundled fee or the portion that includes actual direct trading expenses.\textsuperscript{202}

\textsuperscript{192} Calculation Methodology Guidance Statement, p. 2.

\textsuperscript{193} GIPS Standard 2.A.1.

\textsuperscript{194} The term “time-weighted rate of return” is defined as the “[c]alculat[ion] that computes period-by-period returns on an investment and removes the effects of external cash flows, which are generally client-driven, and best reflects the firm’s ability to manage assets according to a specified strategy or objective. GIPS Glossary, “Time-Weighted Rate of Return.”

\textsuperscript{195} GIPS Standard 2.A.2.

\textsuperscript{196} GIPS Standard 2.A.2. For additional information on dealing with large external cash flows, see the Guidance Statement on the Treatment of Significant Cash Flows (Revised) (effective Jan. 1, 2006).

\textsuperscript{197} GIPS Standard 2.A.2.a.

\textsuperscript{198} GIPS Standard 2.A.2.b.

\textsuperscript{199} GIPS Standard 2.A.4.

\textsuperscript{200} GIPS Standard 2.A.5.

\textsuperscript{201} A “bundled fee” is defined under the Standards as a fee that combines multiple fees into one fee, which may include any combination of management, transaction, custody and other administrative fees. GIPS Glossary, “Bundled Fee.”

\textsuperscript{202} GIPS Standard 2.A.7.a.
Net-of-fee returns. Returns must be reduced by the entire bundled fee or the portion that includes direct trading expenses and the investment management fee.\textsuperscript{203}

The following principles apply to the calculation of composite returns:

- Individual portfolio returns must be asset weighted to calculate composite returns, using beginning-of-period values or a method reflecting both beginning-of-period values and external cash flows.\textsuperscript{204}

- For periods beginning January 1, 2006, composite returns must be calculated by asset weighting individual portfolio returns at least quarterly and for periods beginning January 1, 2010, monthly,\textsuperscript{205} and

- Periodic returns must be geometrically linked.

\section*{§ 6.4.5 Constructing Composites}

How a firm defines its composites is one of the three most fundamental issues when claiming compliance with the Standards.\textsuperscript{206} Once the other two issues have been resolved, the firm definition and definition of discretion, a firm may construct composites based upon the strategies that it implements.\textsuperscript{207}

A composite is defined under the Standards as an “[a]ggregation of individual portfolios representing a similar investment mandate, objective, or strategy.”\textsuperscript{208} In order to prevent firms from cherry-picking performance, firms must include all actual, fee-paying, discretionary portfolios in at least one composite, irrespective of whether the firm ever plans to market the strategy employed.\textsuperscript{209} Although neither model nor non-discretionary portfolios may be included in the firm’s composites, non-fee paying discretionary portfolios may be included in a composite so long as the firm discloses percentage of composite assets represented by non-fee-paying portfolios as of the end of each annual period.\textsuperscript{210} Assuming that it qualifies for inclusion in a

\begin{footnotesize}
\textsuperscript{203} GIPS Standard 2.A.7.b.
\textsuperscript{204} GIPS Standard 2.A.2.3.
\textsuperscript{205} GIPS Standard 2.A.6.
\textsuperscript{207} Composite Definition Guidance Statement, p. 1.
\textsuperscript{208} GIPS Glossary, “Composite.”
\textsuperscript{209} See GIPS Standard 3.A.1; Composite Definition Guidance Statement, p. 1. See also GIPS Interpretations on Composite Construction (Q: “Firm B manages several portfolios according to a particular strategy; however, the firm does not ever plan to market the strategy. Do these portfolios have to be included in a composite?”).
\textsuperscript{210} See GIPS Standard 3.A.1; Composite Definition Guidance Statement, p. 1; GIPS Interpretations on Model Results (Q: “Will a model portfolio, compiled by an adviser who does not have discretion to invest assets in accordance with the model, qualify for a composite?”) (“Model, or advisory-only assets are not considered assets of the firm, and are not included in total firm or composite assets.”). Moreover, if the firm decides to include non-fee-paying portfolios in its composites, it must treat the non-fee-paying portfolios to the same standards as its fee-paying
\end{footnotesize}
composite, a portfolio may be included in more than one composite. Each composite must only reflect actual assets under management within the defined firm; simulated or model portfolios may not be linked with actual performance. For instance, a firm may not substitute missing performance with the composite’s benchmark return, irrespective of whether the missing performance is for a brief period (e.g., quarter). Composites must be defined according to similar investment objectives and/or strategies and the full composite definition must be provided to clients upon request. The CFAI suggests, but does not require, the following hierarchy for defining composites: investment mandate; asset classes; style or strategy; benchmarks; risk/return characteristics. Composites may be further defined by relevant client constraints or guidelines, such as the extent of derivatives, hedging and/or leverage use; treatment of taxes; client type; instruments used; portfolio sizes; client characteristics; portfolio types; and base currency.

Each firm’s composite definitions must provide detailed criteria on how the firm allocates its portfolios among its composites. The criteria for defining composites must be applied consistently, and composites must be representative of the firm’s products and be consistent with its marketing strategy. If the firm sets a minimum asset level for inclusion in a composite, the firm must disclose the minimum asset level and consistently apply this requirement for inclusion in the composite by excluding all portfolios that fall below that asset level. Any changes to the minimum asset level must not be applied retroactively. In addition, the Standards recommend that firms refrain from marketing a composite with a minimum asset level to a prospective client that is unable to satisfy the minimum. Each firm that establishes a minimum asset level must document its policies on how portfolios are treated if they fall below minimum asset level. Such actions, such as refraining from moving the portfolio in and out of the composite without documented changes in client guidelines or a composite redefinition makes it appropriate to do so. See Composite Definition Guidance Statement, p. 1.

213 GIPS Interpretations on Model Results (Q: “Our firm had a composite which lost all of its constituent portfolios for one quarter. May we continue our track record without interruption by using the benchmark return for the missing quarter of performance?”).
216 Composite Definition Guidance Statement, p. 6.
217 Composite Definition Guidance Statement, pp. 6-7.
218 Composite Definition Guidance Statement, p. 4.
219 Composite Definition Guidance Statement, p. 2.
223 GIPS Standard 3.B.3.
the minimum, and apply this policy consistently. If all of the portfolios in a composite fall below the minimum and are removed from the composite pursuant to the firm’s policies, the performance record of the composite would terminate. If, subsequently, the portfolios meet the minimum asset level or new portfolios are added to the composite, the prior performance may be presented but not linked to the ongoing performance results of the composite.

The redefinition of a composite should occur only rarely, and should not result from a modification of an existing strategy. Rather, changes in investment strategies should result in the construction of a new composite. In the event that the firm determines to redefine a composite, it must not apply the change retroactively and must disclose the nature and date of the change. Changes to a composite’s name must also be disclosed. Composites that are discontinued must remain on the firm’s list of composites for five years from the date of discontinuation.

Firms are prohibited from including its non-discretionary portfolios in its discretionary composites. Each firm is responsible for creating its own definition of discretion, applying this definition on a consistent basis, and documenting the definition of discretion in its GIPS policies and procedures. Whether a portfolio is non-discretionary depends upon whether the firm is unable to implement its intended strategy. If a client-driven investment restriction prevents the firm from fully implementing its strategy to the extent that the portfolio would no longer be representative of the strategy, a firm may either (i) characterize the portfolio as non-discretionary, or (ii) create a composite with portfolios carrying similar restrictions. Examples of client-imposed restrictions that may render a portfolio to be non-discretionary include: restriction of trading subject to client approval; firm restrictions on asset allocation; tax considerations; limiting sale of certain securities; restriction on purchase of types of securities;

224 Composite Definition Guidance Statement, p. 4.
225 Composite Definition Guidance Statement, p. 4.
226 Composite Definition Guidance Statement, p. 4.
227 Composite Definition Guidance Statement, p. 4.
228 GIPS Statement 4.A.22; Composite Definition Guidance Statement, p. 4.
230 Composite Definition Guidance Statement, p. 4.
231 Composite Definition Guidance Statement, p. 2.
232 See Composite Definition Guidance Statement, p. 2; GIPS Interpretation on Discretion (Q: “Firm C manages a portfolio that recently had new investment restrictions placed on it by the client, rendering it non-discretionary. Should the firm retroactively remove that portfolio from its composite?”).
233 Composite Definition Guidance Statement, p. 2.
234 Composite Definition Guidance Statement, p. 2.
cash flow requirements; or legal restrictions. If a firm classifies a portfolio as non-discretionary, it should document its reasons for doing so.

New portfolios must be added to composites on a timely and consistent basis after the portfolio has come under the firm’s management, unless otherwise directed by the client. Portfolios that have been terminated must be reflected in the historical returns of the composite up to the last full measurement period that the portfolio was managed. Portfolios may not be moved from one composite into another, except where there are documented changes by the client or in the rare case in which a composite has been redefined. The portfolio’s historical record must remain with the appropriate composite.

[A] Carve-Outs

General Requirements

A carve-out is defined under the Standards as “a single or multiple asset segment of a multiple asset class portfolio.” Carve-outs are “used to create a track record for a narrower mandate from a portfolio managed to a broader mandate” and are usually based upon characteristics such as asset class, geographic region, or industry sector. The use of carve-out returns raises two concerns: (1) the presentation of carve-out returns may be misleading if it does not represent what would have been achieved in a portfolio that was dedicated to that strategy; and (2) if cash is not accounted for separately and not allocated to the carve-out returns, the accuracy of the calculation of the carve-out returns is jeopardized. To address the former concern, the Standards require that the carved-out segment “be discretionary and structured materially the same as a portfolio dedicated to that strategy and have a risk profile that is substantially similar.” A firm may not combine different carve-outs to construct a composite that represents a simulated strategy for purposes of complying with GIPS, but may

---

235 See Composite Definition Guidance Statement, pp. 2-3. The CFAI warns, however, that “[f]ew of these restrictions are reasons to automatically classify a portfolio as non-discretionary, as the firm must determine if the restriction will significantly hinder the implementation of the intended strategy.” See id. at 3.

236 Composite Definition Guidance Statement, p. 2.


239 Documentation may include letters, faxes, e-mails and/or written memoranda documenting oral conversations with the client. See Composite Definition Guidance Statement, pp. 4-5.


242 GIPS Glossary, “Carve-Out.”


246 Carve-Out Guidance Statement, p. 2.
present such information as supplemental information.\textsuperscript{247} The firm is responsible for establishing a policy for creating, using and calculating carve-out returns and applying this policy on a consistent basis.\textsuperscript{248}

If the segment is carved-out of a particular strategy, the firm must carve-out all similar portfolio segments that are managed to that strategy and include such performance results in the composite.\textsuperscript{249} Firms are prohibited from cherry-picking specific portfolios to include in the stand-alone composite, and must include all portfolios that satisfy the criteria for inclusion in the composite.\textsuperscript{250} In addition, when presenting net-of-fees performance of composites that contain carve-outs, the carve-out returns must reflect the deduction of fees, which must be representative of the fees charged for a separately managed portfolio for the asset class carved-out considering the fee schedule for the composite containing the carve-outs.\textsuperscript{251}

\textit{Cash Allocation Requirements}

Carve-out segments that exclude cash must not be used to represent a discretionary portfolio and therefore may not be included in composite returns.\textsuperscript{252} Prior to January 1, 2010, if a single asset class is carved out of a multiple asset class portfolio to be presented as part of a single asset composite, a firm must allocate cash to the carve-out returns in a timely and consistent manner.\textsuperscript{253} The Standards do not require that a specific cash allocation methodology be employed, but the method that the firm selects must be documented and applied consistently.\textsuperscript{254} The Guidance Statement on the Treatment of Carve-Outs specify two acceptable allocation methods for use prior to January 1, 2010: (i) \textit{Beginning of Period Allocation}, in which the cash allocation for each portfolio segment is identified at the beginning of the period; and (ii) \textit{Strategic Asset Allocation}, in which the cash allocation is based directly upon the target strategic asset allocation (\textit{i.e.}, the cash position will constitute the difference between the actual asset allocation and strategic asset allocation).\textsuperscript{255} Until 2010, the Standards recommend, but do not require, that the carve-out be managed separately with its own cash balance (\textit{i.e.}, the segment should be managed as if it were a separate portfolio rather than a segment of a larger portfolio).\textsuperscript{256} However, beginning January 1, 2010, this recommendation will become a

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{247} Carve-Out Guidance Statement, p. 4. For example, a firm may not carve-out an equity and fixed income portion from its composites to create a simulated balanced composite and link it to the actual results of the firm. \textit{See id.}
\item \textsuperscript{248} Carve-Out Guidance Statement, p. 2.
\item \textsuperscript{249} Carve-Out Guidance Statement, p. 2. However, if a firm decides to carve-out a particular segment of a portfolio, it does not have to carve-out the remaining portions of the portfolio to form a stand-alone composite. \textit{See id.}
\item \textsuperscript{250} Composite Definition Guidance Statement, p. 2.
\item \textsuperscript{251} Carve-Out Guidance Statement, p. 2.
\item \textsuperscript{252} GIPS Standard 3.A.7.
\item \textsuperscript{253} GIPS Standard 3.A.7.
\item \textsuperscript{254} Carve-Out Guidance Statement, p. 2; GIPS Interpretations on Carve-Outs (Q: “Our firm has a balanced portfolio with a defined asset allocation ….”)\textsuperscript{254}
\item \textsuperscript{255} Carve-Out Guidance Statement, pp. 2-3.
\item \textsuperscript{256} GIPS Standard 3.B.1.
\end{itemize}
\end{footnotesize}
requirement in order for a carve-out to be included in single asset class composite returns.\textsuperscript{257} Acceptable methods of accounting for cash positions include: (i) \textit{Separate Portfolios}, where cash and securities are actually segregated into a separate portfolio at the custodian; (ii) \textit{Multiple Cash Accounts}, where each segment’s cash is accounted for separately; and (iii) \textit{Sub-Portfolios}, where each portfolio segment is accounted for as if it were a separate portfolio.\textsuperscript{258} If a firm creates carve-outs and allocates cash to the carve-out prior to January 1, 2010, but does not choose to apply any method for accounting for the cash position to the carve-out (thereby discontinuing the carve-out for periods after January 1, 2010): (1) the performance record of the carve-out using a cash allocation method must not be changed; (2) the firm must disclose the historical inclusion of the carve-out and the period of inclusion in its presentation; and (3) if the composite consists only of carve-outs using cash allocation methods and does not apply any method of accounting for the cash position to any of the carve-outs in the composite for periods after January 1, 2010, the firm must treat the composite as discontinued but maintain the composite on its list of composites for five years after discontinuation.\textsuperscript{259}

\textit{Required Disclosures}

Beginning January 1, 2006, if a composite includes or is formed using single-asset class carve-outs, the firm must disclose the percentage of the composite that is composed of carve-outs prospectively for each period.\textsuperscript{260} In addition, firms must disclose the cash allocation method employed for periods prior to January 1, 2010 and are encouraged to disclose changes to such methods, if any.\textsuperscript{261}

Net of fee performance results must disclose the fee that was applied to the carved-out portion of the composite. For periods prior to January 1, 2010, Standard 4.A.15 requires that firms disclose the cash allocation method when a single asset class is carved out of a multiple asset portfolio and the returns are presented as part of a single asset composite.\textsuperscript{262} The firm should also disclose any modification to the cash allocation method.\textsuperscript{263} If a composite is formed using single-asset carve-outs from multiple asset composites, Standard 5.A.6 requires that the presentation include: (i) a list of the underlying composites from which the carve-out was drawn; and (ii) the percentage of each composite the carve-out represents. Beginning on January 1, 2006, if a composite includes or is formed using single asset class carve-outs from multiple asset class portfolios, the presentation must include just the percentage of the composite that is composed of carve-outs prospectively for each period.\textsuperscript{264}

\textsuperscript{257} GIPS Standard 3.A.7.
\textsuperscript{258} Carve-Out Guidance Statement, p. 3.
\textsuperscript{259} Carve-Out Guidance Statement, pp. 3-4.
\textsuperscript{260} GIPS Standard 5.A.5; Carve-Out Guidance Statement, p. 4.
\textsuperscript{261} GIPS Standard 4.A.11; Carve-Out Guidance Statement, p. 4.
\textsuperscript{262} AIMR-PPS Standard 4.A.15.
\textsuperscript{263} Guidance Statement on the Treatment of Carve-Outs, p. 5.
\textsuperscript{264} See GIPS Standard 5.A.5.
§ 6.4.6 Disclosures

A firm that claims compliance with GIPS must disclose the following information in its GIPS-compliant presentations:265

- firm definition used to determine total firm assets and firm-wide compliance;266
- availability of a complete list and description of the firm’s composites;267
- minimum asset level (if any), and any changes thereto, below which portfolios are excluded from the composite;268
- currency used to express performance;269
- presence, use and extent of leverage or derivatives (if material), and description of the use, frequency and characteristics of the instruments to identify risks;270
- whether returns are gross or net-of-fees;271
- details of the treatment of withholding tax on dividends, interest income, and capital gains. If indexes are net-of-taxes, the firm must disclose the tax basis of the benchmark versus that of the composite;272
- known inconsistencies in the exchange rate used among portfolios within a composite and between the composite and the benchmark;273
- fee schedule appropriate to the presentation;274
- if a composite contains portfolios with bundled fees, the firm must disclose: (i) for each annual period shown the percentage of composite assets that is bundled fee portfolios;275 and (ii) the various types of fees included in the bundled fee;276

265 Firms are not required to give negative assurance for disclosures that are not applicable to the firm. See CFA Institute, “Questions and Answers on the Revised GIPS Standards,” p. 4 (“If a situation described in a disclosure requirement does not exist at a firm, or is not applicable to a specific composite, no disclosure is required.”).
when presenting gross-of-fee returns, whether any other fees are deducted in addition to direct trading expenses;\(^{277}\)

when presenting net-of-fee returns, whether any other fees are deducted in addition to the advisory fee and direct trading expenses;\(^{278}\)

that additional information regarding policies for calculating and reporting returns is available upon request;\(^{279}\)

the composite description\(^{280}\) and composite creation date,\(^{281}\) and

the dispersion measure presented.\(^{282}\)

The following disclosures must be made only if applicable to the firm and/or the particular composite presentation:

the date and reason for any firm redefinition;\(^{283}\)

beginning January 1, 2006, the use of a subadviser and the periods of use;\(^{284}\)

that the presentation adheres to law that conflicts with the GIPS requirements, and the manner in which it conflicts;\(^{285}\)

for performance presented for non-compliant periods prior to January 1, 2000, the period of non-compliance and how the presentation is not compliant with the Standards;\(^{286}\)

for periods prior to January 1, 2010, when a single asset class is carved out of a multiple asset portfolio and returns are presented as part of a single asset composite, the policy used to allocate cash to the carve-out returns.\(^{287}\)


\(^{278}\) GIPS Standard 4.A.16.

\(^{279}\) GIPS Standard 4.A.17.


\(^{281}\) GIPS Standard 4.A.24. The composite creation date is the date that the firm first groups the portfolios to create the composite. See Composite Definition Guidance Statement, p. 4. The composite creation date is not the same as its inception date, which is the earliest date that performance is reported for the composite. See id.


the date and nature of a composite redefinition;\(^{288}\)
changes to the name of a composite;\(^{289}\) and
that prior to January 1, 2010, the firm does not use calendar month-end portfolio valuations or valuations on the last business day of the month.\(^ {290}\)

§ 6.4.7 Presentation and Reporting

A firm that claims compliance with the Standards must include in its presentations the following required items:

- for each composite presented, at least 5 years\(^ {291}\) of performance that meets the Standards (or since firm or composite inception if the firm or composite has existed for less than 5 years), which must be increased annually until 10 years of performance is presented.\(^ {292}\) Performance of less than one year may not be annualized;\(^ {293}\)
- annual returns for each year presented;\(^ {294}\)
- number of portfolios and amount of assets in the composite at the end of each annual period, unless the composite contains 5 portfolios or less in which case the number of portfolios is not required;\(^ {295}\)


\(^{291}\) A firm that has been in existence for less than 1 year is not prohibited from claiming compliance with the Standards. A firm may be GIPS compliant so long as it meets the requirements of the Standards and has any performance to report. See GIPS Interpretations on Partial Period Returns (Q: “Provision 5.A.1.b requires the presentation of annual returns for all years ….”).

\(^{292}\) A firm that has claimed compliance with an IPC-endorsed Country Version of GIPS (“CVG”) prior to the effective date of the revised GIPS standards, such as the AIMR-PPS Standards, may not eliminate previously reported CVG-compliant periods. The CFA Institute has clarified, “Since the GIPS Standards require firms to show five year of compliant track record building to ten years, the firm that previously complied with a CVG must continue to show their historical performance, building up to ten years, or since composite inception.” CFA Institute, “Questions and Answers on the Revised GIPS Standards,” p. 2. Therefore, an AIMR-PPS compliant firm that previously reported 10 years of performance may not present only 5 years of history and claim compliance with the GIPS standards. Rather, the firm must present all 10 years of performance results.

\(^{293}\) GIPS Standard 5.A.3; see also GIPS Interpretations on Partial Period Returns (Q: “Firm A was established on 1 March 1998 and claims compliance with the GIPS standards ….”) (stating that firms are prohibited from annualizing partial year returns, and that firms must clearly state that any returns of less than 1 year is for a partial period).

\(^{294}\) GIPS Standard 5.A.1.b.

\(^{295}\) GIPS Standard 5.A.1.c.
either the percentage of total firm assets represented by the composite or the amount of total firm assets at the end of each annual period;\(^{296}\)

- measure of dispersion of the individual portfolio returns for each annual period, unless the composite contains 5 portfolios or less for the full year;\(^{297}\)

- beginning January 1, 2006, if a composite includes or is formed using single asset class carve-outs from multiple asset class portfolios, the percentage of the composite comprised of carve-outs prospectively for each period;

- total return for the benchmark(s) that reflects the investment strategy of the composite for each annual period, or if none then an explanation why no benchmark is disclosed;\(^{298}\)

- if applicable, the date and reasons for changes to a composite’s benchmark;\(^{299}\)

- if applicable, a description of the creation and re-balancing process of a custom benchmark or combination of multiple benchmarks;\(^{300}\) and

- if applicable, the percentage of the composite assets represented by non-fee-paying portfolios as of the end of each annual period.\(^{301}\)

Returns that are not GIPS compliant may be linked to compliant returns if the non-compliant returns are for periods prior to January 1, 2000 and the firm discloses the non-compliant periods and explains how the presentation is not in compliance with the Standards.\(^{302}\)

[A] Performance Record Portability

In situations where an existing firm acquires an investment team or another firm, the performance achieved at the prior firm may be substantially relevant to potential clients of the new affiliation. Under the GIPS portability standards, the historical performance record of an investment firm belongs to that firm. A firm’s performance record is the product of many factors beyond personnel, including processes, discipline and strategy.\(^{303}\) If specific GIPS requirements are met, a firm claiming GIPS compliance is required under the Standards to “link” the historical

---

\(^{296}\) GIPS Standard 5.A.1.c.

\(^{297}\) GIPS Standard 5.A.1.d.

\(^{298}\) GIPS Standard 5.A.6.


\(^{300}\) GIPS Standard 5.A.6.

\(^{301}\) GIPS Standard 5.A.7.

\(^{302}\) GIPS Standard 5.A.2.; GIPS Introduction, I.E.12.c (“Firms may link a non-GIPS-compliant performance record to their compliant history so long as no noncompliant performance is presented after 1 January 2000 and the firm discloses the periods of noncompliance and explains how the presentation is not in compliance with the GIPS standards.”).

performance record of the prior firm to its ongoing performance record, thus creating the appearance of a continuous performance history.\textsuperscript{304} Where such linking is required under the Standards, multiple firms may claim the same performance history as their own.\textsuperscript{305} However, an SEC-registered adviser that claims compliance with GIPS must also satisfy the regulatory requirements that govern the advertisement of a prior firm’s performance records.\textsuperscript{306} If the GIPS requirements are not met, non-portable performance is \textit{per se} prohibited from being linked to the ongoing performance of a firm claiming GIPS compliance.\textsuperscript{307} However, a firm may present the performance of the prior firm as supplemental information so long as the presentation is consistent with the Standards’ ethical principles, contains appropriate disclosures, and is otherwise compliant with the IPC Guidance Statement on the Use of Supplemental Information.\textsuperscript{308}

A portability analysis under the Standards involves an evaluation of a number of issues and the presence or lack of a particular fact is not necessarily determinative of whether investment performance is portable. Rather, “[d]ue to the unique circumstances surrounding the use of prior performance results, portability of performance must be addressed on a case-by-case basis.” Standard 5.A.4 and the Portability Guidance Statement each state that when a portfolio manager, group of managers, or an entire firm joins a new firm, a composite’s past performance must be linked to the ongoing results of the new firm if all of the following conditions are true for that composite:

- substantially all the investment decision-makers are employed by the new firm (\textit{i.e.}, research department, portfolio managers, and other relevant staff);

\textsuperscript{304} See Portability Guidance Statement, p. 2. Performance that is not portable may be presented as “supplemental information” attached to a fully compliant GIPS report, but such non-portable performance may not be linked to the ongoing performance record. Supplemental information is defined as “any performance-related information included as part of a compliant performance presentation that supplements or enhances the required and/or recommended disclosure and presentation provisions of the GIPS standards. Supplemental information should provide users of the composite presentation with the proper context in which to better understand the performance results.” IPC Guidance Statement on the Use of Supplemental Information, p. 1 (effective Jan. 1, 2006) (hereinafter, “Supplemental Information Guidance Statement”). A new firm may represent the historical record of the prior firm as supplemental information to a fully compliant performance presentation so long as (i) the performance is clearly identified as the past record of a prior firm, (ii) the performance is not linked to the performance of the new affiliation, (iii) the performance is supported with appropriate records, and (iv) the use of the past performance record is relevant. See Portability Guidance Statement, p. 1.

\textsuperscript{305} See Portability Guidance Statement, p. 1.

\textsuperscript{306} See discussion supra § 6.3 Performance Advertising.

\textsuperscript{307} See Supplemental Information Guidance Statement, p. 2 and discussion infra § 6.4.7 Supplemental Information. The only exception to this prohibition is when the performance is specifically requested by a prospective or currently client in a one on one presentation. See Supplemental Information Guidance Statement, p. 2 (“This Guidance Statement does not prohibit firms from preparing and presenting information according to specific request from prospective clients.”).

\textsuperscript{308} See Supplemental Information Guidance Statement.

\textsuperscript{309} AIMR-PPS Interpretation on Portability (Q: “With regard to portability, if 11 of the 13 investment professionals left their old firm to join a new firm (along with all of the support staff), can the new firm meet the criteria for linking performance history?”).
the staff and investment decision-making process remain intact and independent within
the new firm;

- the new firm has records that document and support the reported performance; and

- the new firm discloses that the performance results from the old firm are linked to the
performance record of the new firm.\footnote{See Standard 5.A.4; Portability Guidance Statement, p. 2.}

In the context of one firm joining an existing firm, the foregoing factors must be satisfied and
substantially all of the assets from the former firm’s composite must transfer to the new firm in
order to link the former firm’s performance to the ongoing record of the new firm.\footnote{Standard 5.A.4.c.} If the
acquired or acquiring firm is not GIPS-compliant, the combined firm has one year to bring non-
compliant assets into compliance with the Standards.\footnote{GIPS Standard 5.A.4.d.}

In essence, the crux of the determination of whether portability of a prior firm’s
performance is required is whether the historical records “still warrant having the same label as
the old entity.”\footnote{Portability Guidance Statement, p. 1.} Ultimately, the “applicability and integrity of the performance record is only
as good as the ongoing integrity of the strategy and all the contributing factors.”\footnote{Portability Guidance Statement, p. 1.} If the
portability requirements are satisfied, the Portability Guidance Statement requires that the entire
composite history from the old firm, including all portfolios included in the composite, must be
used by the new firm and supported by the records necessary to substantiate the performance
history of that composite.\footnote{See Portability Guidance Statement, Application No. 2 (“In addition to meeting all the elements of the Guidance
Statement, in order for a firm to be able to link the composite from the old firm to the on-going performance of the
new firm, the entire composite performance history, including all portfolios, must be used.”).}

In addition to requiring the transfer of substantially the same investment decision-making
processes and personnel, both the Standards and the Portability Guidance Statement require that
the presentation of linked performance be supported by records that document and support that
performance.\footnote{Standard 5.A.4(a)(iii); Portability Guidance Statement, p. 2.} The Standards explicitly require that each firm claiming GIPS compliance
maintains sufficient records to permit, if needed, the recalculation of account-level and
composite-level returns.\footnote{See Standard 1.A.1 (“All data and information necessary to support a firm’s performance presentation and to
perform the required calculations must be captured and maintained.”). The IPC has proposed, but has not yet
adopted, a Guidance Statement on Portfolio Recordkeeping Requirements. See IPC Proposed Guidance Statement
on Portfolio Recordkeeping Requirements (proposed effective date Jan. 1, 2006) (“Proposed Recordkeeping
Guidance Statement”).} A fundamental principle of the Standards is the need for firms to be
capable of substantiating or recalculating their performance history if questioned by a potential
client, verifier, or regulator. All investment firms are required under the Standards to retain

\begin{itemize}
  \item the staff and investment decision-making process remain intact and independent within
  the new firm;
  \item the new firm has records that document and support the reported performance; and
  \item the new firm discloses that the performance results from the old firm are linked to the
  performance record of the new firm.
\end{itemize}
supporting documentations, such as confirmations and statements “that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return (current and historical performance results) of any or all managed accounts that the advisor uses in advertisements.” 318 Firms must have supporting documentation for each year that the firm shows performance results for all portfolios that are reflected in the performance shown. 319 Therefore, in order for a firm to properly present the previous performance history of prior firm, i.e., in order for the historical performance to be portable, the new firm must have the underlying data necessary to recreate the performance of its composites for those periods, including beginning and ending market values of all portfolio holdings and intra-period cash flows for the composite for each account in the composite. Although the Standards do not identify specific records that will suffice, records that would be needed to meet the GIPS recordkeeping requirement are typically custodian statements that include a list of all holdings and inflows and outflows. 320 If records are not readily available, the new firm can obtain supporting records in one of two ways: (i) obtain permission of the prior firm to obtain copies of the supporting records; or (ii) attempt to obtain the supporting records from third parties such as clients, custodians, or consultants. 321 If the new firm is unable to acquire or obtain access to the records supporting the prior firm’s performance, the new firm may not properly link to the prior firm’s historical performance. 322

[B] Supplemental Information

Each firm that claims GIPS compliance is encouraged to present relevant additional and supplemental information in order to fully explain performance that is presented in a GIPS-compliant presentation. 323 “Supplemental information” is defined as “[a]ny performance-related information included as part of a compliant performance presentation that supplements or enhances the required and/or recommended disclosure or presentation provisions of the GIPS standards.” 324 The following is excluded from this definition:

---

318 AIMR PERFORMANCE PRESENTATION STANDARD HANDBOOK, at p. 79 (2nd ed. 1997).
319 GIPS HANDBOOK § 4-1.A.1, p. 1; see also GIPS Interpretation on Recordkeeping (Q: “Firm A claims compliance with the GIPS standards. It maintains hard copies of the records supporting compliance for three years and discards all records older than three years in an effort to save office space. The performance reported on all its composite presentations shows five years of history. Is the firm in compliance with the GIPS standards?”) (stating that a firm claiming compliance with GIPS must maintain records that support presented performance and “all other relevant data on the firm’s composite presentations.”).
320 Proposed Recordkeeping Guidance Statement, p. 1 (“Although most firms are looking for a very precise list of the minimum supporting evidence that must be maintained in order to be able to recreate the firm’s performance history, there is not a single list of records that will suffice in all situations.”).
321 See GIPS HANDBOOK § 4-5, p.5 (“If the records are not readily available, [a firm] can seek the permission of the team’s previous firm to obtain copies or try to obtain them from third parties who may have retained the records such as clients, custodians or consultants.”).
322 See Portability Guidance Statement, p. 2.
323 GIPS Introduction, I.D.10(g); Supplemental Information Guidance Statement, p. 1.
324 GIPS Glossary, “Supplemental.”
- Additional information. “Additional information” is defined under the Standards as “[i]nformation that is required or recommended under the GIPS standards and is not considered as ‘supplemental information’ for the purposes of compliance.”

- Non-performance related information. Non-performance information includes, but is not limited to, details about the firm, its investment strategy, or its investment process.

- Misleading information. Misleading information can never be presented under the Standards. Unless specifically requested by a prospective or existing client to be presented in a one-on-one presentation, a firm may not link (1) model, hypothetical, backtested or simulated returns to actual performance; or (2) prior firm non-portable performance to the new firm’s ongoing performance results.

Examples of supplemental information may include: carve-out returns that exclude cash; non-portable returns not linked to the ongoing performance of the new firm; unlinked model, hypothetical, backtested, or simulated returns; representative account information (e.g., portfolio-level country or sector weightings, and portfolio-level risk measures); attribution; peer group comparisons; risk-adjusted performance; and specific holdings information (composite or portfolio-level). Since supplemental information could potentially mislead clients, the CFAI encourages firms to adhere to the guiding principle of GIPS, i.e., fair representation and full disclosure. A firm may not contradict the information contained in its GIPS-compliant presentation through supplemental information.

If a firm chooses to provide supplemental information, a firm must make clear that the information is supplemental to a particular GIPS-compliant presentation, which must be provided prior to or with the supplemental information. The CFAI does not prohibit a firm from presenting supplemental and compliant information on the same page or preceding compliant information with supplemental information so long as the placement does not mislead prospective or existing clients, contradict compliant information, is clearly labeled, and references the appropriate GIPS-compliant presentation. If the presentation of supplemental

---

325 GIPS Glossary, “Additional Information.”
333 See Supplemental Guidance Statement, p. 2; GIPS Interpretations on Supplemental Information (Q: “Can supplemental information be presented on the same page as the compliant presentation?”). See also GIPS Interpretations on Supplemental Information (“XYZ created a presentation booklet that primarily highlights performance information that is considered supplemental. The booklet shows an appropriate compliant presentation in the back of the book as an appendix. Is it acceptable for the supplemental information to precede the compliant presentation?”).
§ 6.4.8 Advertising Guidelines

Firms that advertise their claim of compliance with the GIPS standards in any advertisement (i.e., written material distributed to maintain existing clients or solicit new clients other than a one-on-one presentation or individual client reporting) must adhere to the GIPS Advertising Guidelines or the full GIPS standards. For purposes of the GIPS Advertising Guidelines, “an advertisement includes any materials that are distributed to or designed for use in newspapers, magazines, firm brochures, letters, media, or any other written or electronic material addressed to more than one prospective client.” Although the full GIPS standards must be followed in one-on-one presentations, advertisements that include a claim of GIPS compliance may adhere to either the GIPS Advertising Guidelines or the full GIPS standards. Under no circumstance do the GIPS Advertising Guidelines alter the SEC’s regulatory requirements that govern investment adviser advertising; firms that advertise performance returns must also satisfy any and all applicable regulatory requirements that govern their advertising activities. In the event that applicable law conflicts with the GIPS Advertising Guidelines, the law must control and the firm must disclose the conflict between the legal requirement and the GIPS Advertising Guidelines.

All advertisements that include a claim of GIPS compliance must include: (1) a firm description; (2) how to obtain a GIPS-compliant presentation and/or a list and description of the firm’s composites; and (3) the GIPS Advertising Guidelines compliance statement (“[Firm name] claims compliance with the Global Investment Performance Standards (GIPS®).”). If performance of the firm is also advertised, the following information must also be presented, which must be taken or derived from a GIPS-compliance presentation:

- a description of the investment strategy of the advertised composite;
- period-to-date composite performance, and either: (a) 1, 3, and 5-year cumulative annualized composite returns with the end-of-period date clearly identified (or since composite inception if inception is greater than 1 and less than 5 years); or (b) 5 years of annual composite returns with the end-of-period date clearly identified (or since composite inception if inception is less than 5 years). Periods of less than 1 year may not be annualized. The annualized or annual returns, as applicable, must be calculated through the same period as presented in the corresponding GIPS compliant presentation;
- whether performance is gross or net of advisory fees;

---

334 See Supplemental Guidance Statement, p. 3.
335 GIPS Advertising Guidelines, Introduction.
336 GIPS Advertising Guidelines, Introduction.
337 GIPS Advertising Guidelines, Introduction.
• total return of the benchmark for the same periods that composite returns are presented and a benchmark description, and if no benchmark is presented, an explanation why no benchmark is presented; 338

• currency used to express returns;

• description of the use and extent of leverage and derivatives if used as an active part of the strategy and has a material effect on returns; and

• if performance or supplemental information is presented for non-compliant periods prior to January 1, 2000, disclosure of the period(s) of non-compliance, which information is non-compliant, and the reason(s) the information is non-compliant with the GIPS standards.

In addition to the information required under the GIPS Advertising Guidelines, firms may present supplemental or additional information so long as the supplemental information is clearly labeled as supplemental and is presented with equal or less prominence than the required information. 339

§ 6.4.9 Verification

Firms that claim GIPS compliance are encouraged, but are not required under the Standards, to undergo the verification process. 340 Verification is the process by which an independent third party confirms that the firm’s claim of compliance is appropriate. Specifically, GIPS verification confirms that: (i) the firm has complied with the composite construction requirements on a firm-wide basis; and (ii) the firm’s processes and procedures are designed to calculate and present performance results in compliance with the Standards. 341 The verification process is not confirmation that a particular performance claim is appropriate. 342

Verification is conducted on a firm-wide basis, and not on a composite basis. 343 Although a firm may arrange for a performance audit of a specific composite presentation, firms are prohibited from claiming that it a particular composite presentation has undergone the

338 The appropriate benchmark return that should be advertised is the same benchmark total return presented in the GIPS compliant presentation for the composite. See GIPS Advertising Guidelines, B.7.

339 GIPS Advertising Guidelines.

340 The CFAI will reevaluate in 2010 whether verification should be mandatory under the Standards. See Verification Guidance Statement, p. 3.


342 Verification Guidance Statement, p.3.

343 GIPS Verification, III.A.1.
verification process.\textsuperscript{344} Moreover, a firm may not claim that it has been verified until the verification process has concluded and a verification report has been issued.\textsuperscript{345}

Section III of the Standards outlines the minimum procedures that a verifier must follow when verifying a firm’s compliance with the GIPS standards. These procedures generally include verification that:

\begin{enumerate}
\item the firm definition is, and has been appropriately defined,\textsuperscript{347}
\item the firm has defined and maintained composites according to GIPS standards and the firm’s guidelines, that the discretionary fee-paying portfolios are included in the composite, that no accounts have been excluded from a particular composite, that composite benchmarks are consistent with composite definitions, and the firm’s list of composites is complete,\textsuperscript{348}
\item the firm’s classification of accounts as discretionary or nondiscretionary is appropriate,\textsuperscript{349}
\item the firm’s open and closed accounts are in compliance with the Standards, which may be accomplished through a selected sample of the firm’s accounts;\textsuperscript{350}
\item the timing of initial inclusion in and exclusion from the composite is consistent with the firm’s policies, the manager’s composite definition is consistent with the objectives set forth in the account agreement, portfolio summary and composite definition, portfolios with the same guidelines are included within the same composite, and that transfers from one composite to another are appropriate;
\item the firm has calculated performance consistent with its policies and disclosures,\textsuperscript{351} and
\item the information and disclosures required by GIPS are included in the sample of composite presentations reviewed by the verifier.\textsuperscript{352}
\end{enumerate}

A firm that has been verified should disclose in its composite presentations or advertisements that it has been verified and state the periods of verification if the presentation

\textsuperscript{344} GIPS Verification, III.C.
\textsuperscript{345} GIPS Verification, III.C; Verification Guidance Statement, p. 3.
\textsuperscript{346} GIPS Verification, III.B.
\textsuperscript{347} GIPS Verification, III.B.2.a.
\textsuperscript{348} GIPS Verification, III.B.2.b(i-vii).
\textsuperscript{349} GIPS Verification, III.B.2.c.
\textsuperscript{350} GIPS Verification, III.B.2.d.
\textsuperscript{351} GIPS Verification, III.B.2.f(i-11).
\textsuperscript{352} GIPS Verification, III.B.2.g.
includes results for periods that were not subject to a firm-wide verification. The Standards recommend the following disclosure: “[Insert name of firm] has been verified for the periods [insert dates] by [name of verifier]. A copy of the verification report is available upon request.” Although verifications do not necessarily “expire,” references to verifications that cover periods of more than 24 months ago may be deemed to misleading.

353 GIPS Standard 0.B.3.
354 GIPS Standard 0.B.3.
355 Verification Guidance Statement, p. 5. (Applications: “Our firm has been in compliance with the GIPS standards since 2000. We obtained a verification from an independent verifier which covered the periods from 1995 through December 31, 2002. At what point does our verification ‘expire?’”).