

Association for Investment Management and Research

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

File No. 132-3

Your letter of December 3, 1996 requests our assurance that we would not recommend enforcement action to the Commission if, in presenting performance information, an investment adviser ("Presenting Adviser") that seeks to comply with certain minimum performance presentation standards ("PPS") developed by the Association for Investment Management and Research ("AIMR") advertises performance as follows:⁵

- (1) The Presenting Adviser provides gross and net-of-fee performance for composites of the Presenting Adviser's accounts that include mutual fund accounts, provided that the gross and net performance are both presented with equal prominence in a format designed to facilitate ease of comparison and are accompanied by appropriate disclosure explaining how the performance figures were calculated and not identifying any specific mutual fund included within the composite.
- (2) The Presenting Adviser includes the performance of both its non-wrap fee accounts and wrap fee accounts in the same composite, and calculates the composite performance by deducting from the performance of non-wrap fee accounts a "model fee" equal to the highest fee charged to a wrap fee account in the composite.
- (3) The Presenting Adviser calculates net-of-fee performance for an account managed by a number of advisers including the Presenting Adviser ("multi-manager accounts"), by deducting from the performance of that portion of the account managed by the Presenting Adviser those fees related to the management of that portion by the Presenting Adviser, such as transaction costs and all fees paid to the Presenting Adviser or any of its affiliates.

⁵ AIMR is a global non-profit membership organization consisting of investment analysts, portfolio managers and other investment decision makers. The staff views expressed in this letter are not conditioned in any way on an adviser complying with AIMR's PPS. In addition, the staff views included in this letter are in no way intended to indicate any position with respect to AIMR's PPS generally .

1. The Presentation of Composites Including Mutual Fund and Non-Mutual Fund Accounts

You first inquire whether a Presenting Adviser may provide, in advertisements and one-on-one presentations, both gross- and net-of-fee performance results for composites⁶ that include both mutual funds and non-mutual fund accounts. Specifically, you represent that a Presenting Adviser would display both gross and net performance results with equal prominence and in a format designed to facilitate ease of comparison of the gross and net results. You also represent that these results would be accompanied by disclosure explaining how the performance figures were calculated.⁷ Finally, to avoid any inference that the presentation is a promotion or advertisement for a particular mutual fund, you state that this disclosure will not identify any specific mutual fund included within the composite.

Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") prohibits any act, practice or course of business that the Commission, by rule, defines as fraudulent, deceptive or manipulative. Rule 206(4)-1(a)(5) under the Advisers Act provides that it is a fraudulent, deceptive or manipulative act for any investment adviser to distribute, directly or indirectly, any advertisement that contains any untrue statement of a material fact or that is otherwise false or misleading. In Clover Capital Management, Inc. (pub. avail. Oct. 28, 1986) ("Clover Capital"), the staff interpreted Rule 206(4)-1(a)(5) to prohibit advertisements that include performance results that do not reflect the deduction of advisory fees, brokerage commissions, and any other expenses that a client would have paid or actually paid.⁸

⁶You state that a basic component of AIMR's PPS is the use of composites in investment performance presentations. You define a composite as an aggregation into a single performance presentation of portfolios or asset classes that are managed with a similar strategy or investment objective. You represent that, under the AIMR standards, all fee-paying discretionary portfolios must be included in one or more of an adviser's composites. We note that the staff has taken the position that an adviser may choose to exclude from a composite certain similarly managed accounts, so long as doing so would not cause the composite performance to be misleading. Nicholas-Applegate Mutual Funds (pub. avail. Aug. 6, 1996).

⁷The disclosure accompanying gross-of-fee performance would specifically state that the performance does not reflect the payment of investment advisory fees and other expenses that would be incurred in the management of an account.

⁸The staff took the position that the presentation of gross performance data alone may be false and misleading because it could imply, or cause a potential advisory client receiving the data to infer, something about the adviser's competence or about future investment results that was not true. The Commission subsequently commenced several enforcement actions against investment advisers that advertised only gross-of-fee performance. See In the Matter of Hazel B. Canham, Advisers Act Rel. No. 1386 (Admin. Proc. File No. 3-8067) (Sep. 30, 1993); In the Matter of Eric S. Emory and Renaissance Advisors, Inc., Advisers Act Rel. No. 1283 (Admin. Proc. File No. 3-7530) (July 22, 1991); In the Matter of Makrod Investment Associates Inc., John Thomas O'Donnell, Advisers Act Rel. No. 1176 (Admin. Proc. File No. 3-7220) (July 3, 1989); In the Matter of Harvest Financial Group, Inc. and Stephen S. Duklewski, Jr., Advisers Act Rel. No. 1155 (Admin.

The first issue presented by your letter is whether an investment adviser may distribute an advertisement that presents both gross- and net-of-fee performance information for a composite of the adviser's accounts. You maintain that an adviser would not violate Rule 206(4)-1(a)(5) if it distributes an advertisement presenting gross and net performance with equal prominence and in a format designed to facilitate ease of comparison, provided that the advertisement contains sufficient disclosure to ensure that the material presented is not misleading. The staff agrees that such an advertisement would not be prohibited by the Rule.⁹

The second issue raised by your letter is whether the presentation of a gross-of-fee composite that includes the performance of one or more mutual funds managed by the adviser would be subject to the requirements governing investment company advertisements and sales literature. Under the Securities Act of 1933 (Rule 482(e)(3)) and the Investment Company Act (Rule 34b-1)¹⁰, any performance information in mutual fund advertisements or sales literature must include standardized total return calculated under a formula that requires the deduction of all fees and expenses paid by the fund. You represent, however, that the disclosure accompanying the composite would not identify any specific mutual fund that is included in the composite. In our view, as long as an advertisement for investment advisory services does not include an explicit or implicit reference to a particular fund, it would not be an advertisement for a fund.¹¹ Therefore, in our view the standardized performance requirements of Rule 482 and Rule 34b-1 referenced above would not apply to such an advertisement.

Proc. File No. 3-7146) (Feb. 21, 1989); In the Matter of Managed Advisory Services, Inc. and Henry L. Chisea, Advisers Act Rel. No. 1148 (Admin. Proc. File No. 3-7107) (Dec. 27, 1988) .

⁹We note that the staff has previously taken the position that an adviser's presentation of gross-of-fee performance results without net-of-fee results would not be misleading if made only in one-on-one presentations to sophisticated investors, provided that sufficient disclosures are made and the investors are given the opportunity to inquire about fees. Investment Company Institute (pub. avail. Sept. 23, 1988) .

¹⁰Rule 34b-1 under the Investment Company Act provides that sales literature for open-end funds other than money market funds, containing performance information is deemed to be misleading unless it includes, among other things, the total return calculations required under Rule 482(e)(3). See also Form N-1A, Item 22(b). Rule 34b-1 was adopted pursuant to Section 34(b) of the Investment Company Act, which prohibits persons from making any untrue statement of material fact in documents relating to investment companies that are required to be filed with the Commission. Advertisements and sales literature used by an open-end investment company or its underwriter must be filed, or be deemed filed, with the Commission pursuant to Section 24(b) of, or Rule 24b-3 under, the Investment Company Act .

¹¹Cf. Rule 135a under the Securities Act of 1933, which provides that generic advertisements that do not specifically refer by name to the securities of a particular investment company or to the investment company itself will not be deemed offers of those investment company securities if certain other conditions are met.

2. The Presentation of Performance of a Composite Including Wrap Fee and Non-Wrap Fee Accounts

You propose that Presenting Advisers deduct from non-wrap fee accounts that are included with wrap fee accounts in a composite, a "model fee" equal to the highest fee charged to a wrap fee account in the composite. You represent that the highest fee charged to a wrap fee account would be higher than any fee charged to a non-wrap fee account included in the composite.¹²

In such a case, the staff would not consider it a fraudulent or deceptive practice under Rule 206(4)-1 if an adviser presents net performance that reflects the deduction of actual fees from wrap fee accounts and the deduction of a model fee, equal to the highest fee charged to a wrap fee account, from non-wrap fee accounts, provided that the advertisement contains sufficient disclosure to ensure that the information presented is not misleading.¹³

3. The Calculation of Net Performance Results

You request our views regarding which fees a Presenting Adviser must deduct in calculating the net-of-fee performance of a "multi-manager" account.¹⁴ You propose that, for purposes of calculating the net-of-fee performance of an adviser's portion of a multi-manager account included in a composite, a Presenting Adviser should be required to deduct only those fees related to its management of the account. You represent that performance results would be accompanied by disclosure that specifically identifies the types of fees deducted.

In Clover Capital, the staff took the position that performance information in an advertisement should reflect the deduction of "advisory fees, brokerage or other commissions, and any other expense that a client would have paid or actually paid". In Investment Company Institute (pub. avail. July 24, 1987), the staff took the position that custodial fees need not be deducted from net performance, and stated that "[i]nformation about the fees the adviser charged clients in the sample is material to

¹²You also represent that the performance results would be accompanied by a schedule detailing the actual fees applicable to wrap fee accounts .

¹³The staff addressed a similar issue in J.P. Morgan Investment Management, Inc. (pub. avail. May 7, 1996). In that letter, the staff took the position that an adviser may advertise performance reflecting the deduction of a model fee when doing so would result in performance figures that are no higher than those reflecting the deduction of actual fees.

¹⁴For this discussion, we define a multi-manager account as a single account in which different advisory firms each manage a separate portion of the account's assets.

evaluating the investment experience of those clients and the adviser's competence. . .
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In the staff's view the fees relevant to an evaluation of the investment experience of the adviser's clients and of the adviser's competence are those fees or charges related to the adviser's management of the account. The staff believes that, at a minimum, these fees and charges include: 1) all transaction costs; and 2) all fees or charges paid to the adviser or an affiliate of the adviser.

Our position with respect to the calculation of net performance is not limited to the performance of multi-manager accounts. The net-of-fee performance of any investment advisory account may be calculated by deducting only the fees described above.

4. Conclusion

We would not recommend enforcement action to the Commission if an adviser includes performance information in advertisements and one-on-one presentations calculated and set forth in the manner described above. This position is based on the facts and representations set forth in your letter and described above. You should note that any different facts or representations might require a different conclusion.

Eileen M. Smiley
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