

Investment Advisers Act of 1940 Rule 206(4)-1(a)(1)

Investment Adviser Association

December 2, 2005

**Karen L. Barr
General Counsel
Investment Adviser Association
1050 17th Street, NW
Suite 725
Washington, DC 20036-5503**

Dear Ms. Barr:

We request that you share with your members the following guidance concerning investment advisers' advertisements of their inclusion in third-party ratings.¹ As you may know, we have taken the position that a third-party rating that relies primarily on client evaluations of an adviser would be a testimonial for purposes of the prohibitions of section 206(4) of, and rule 206(4)-1(a)(1) under, the Investment Advisers Act of 1940 (the "Advisers Act").² Some investment advisers have questioned, however, whether a third-party rating that relies on client evaluations, as one among many other factors (and not primarily), is a testimonial under the Advisers Act.

We believe that third-party ratings that rely in part on client evaluations are not necessarily testimonials for purposes of rule 206(4)-1(a)(1). Whether a third-party rating is a testimonial depends upon all of the facts and circumstances relating to the rating.

The term "testimonial" is not defined in the rule, but we have consistently interpreted that term to include a statement of a client's experience with, or endorsement of, an investment adviser.³ A third-party rating would be a testimonial if it is an implicit statement of a client's or clients' experience with an investment adviser or investment advisory representative (an "IAR"). As stated earlier, a third-party rating that relies primarily on client evaluations of an investment adviser would be a testimonial.⁴ In contrast, if a third party consults an adviser's clients about their evaluation of the adviser when formulating the rating, but the client responses, relative to other criteria, are an insignificant factor in the rating's formulation, the rating would not be a testimonial.

An investment adviser that is considering whether to use a third-party rating in an advertisement should determine whether the third-party rating is a testimonial by evaluating, among other things, (1) the criteria used by the third party when formulating the rating, and (2) the significance to the rating's formulation of criteria relating to client evaluations of the investment adviser.⁵ An investment adviser may find it necessary to contact the third party to obtain the information necessary to make a proper determination.

We note, however, that the use of a third-party rating in an investment adviser's advertisement would be subject to section 206(4) of, and rule 206(4)-1(a)(5) under, the Advisers Act, regardless of whether the rating is deemed a testimonial. Rule 206(4)-1(a)(5) makes it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to publish, circulate, or distribute, directly or indirectly, any advertisement that contains any untrue statement of a material fact or that is otherwise false or misleading. Whether a particular advertisement is false or misleading depends upon all of the relevant facts and circumstances.⁶ Generally, an advertisement may be considered false or misleading if it implies, or would lead a prospective client to infer, something about the investment adviser or its clients' experiences that is not true, and that the prospective client would not have inferred had all material facts been disclosed.⁷

We would like to reiterate guidance, presented in DALBAR, regarding some factors that investment advisers should consider when determining whether any advertisement containing a third-party rating (including one that is a testimonial) is false or misleading:

- Whether the advertisement discloses the criteria on which the rating was based;
- Whether an investment adviser advertises any favorable rating without disclosing any 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 knows that it has been the subject of numerous client complaints relating to the rating category or in areas not included in the survey);
- Whether an investment adviser advertises any favorable rating without also disclosing any unfavorable rating of the adviser;
- Whether the advertisement states or implies that an investment adviser was the top-rated adviser in a category when it was not rated first in that category;
- Whether, in disclosing an investment 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;
- 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 investment adviser's clients;
- Whether the advertisement discloses that the rating is not indicative of the investment adviser's future performance; and
- Whether the advertisement discloses prominently who created and conducted the survey, and that investment advisers paid a fee to participate in the survey.

We hope that this letter will clarify our views on the application of section 206(4) of, and rule 206(4)-1(a)(1) under, the Advisers Act for you and your members. Please share this letter with your members. If you have any additional questions, you may contact John L. Sullivan at (202) 551-6825.

Very truly yours,

Douglas Scheidt
Associate Director and Chief Counsel

Endnotes

1 Certain entities that are not affiliated with investment advisers periodically list, rank or rate investment advisers according to particular criteria ("third-party rating").

2 See, e.g., DALBAR, Inc. (pub. avail. March 24, 1998) ("DALBAR"). Section 206(4) generally prohibits any investment adviser from engaging in any act, practice or course of business that the Commission, by rule, defines as fraudulent, deceptive or manipulative. In particular, rule 206(4)-1(a)(1) states that:

[i]t shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business . . . for any investment adviser registered or required to be registered under [the Advisers Act], directly or indirectly, to publish, circulate, or distribute any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any

advice, analysis, report or other service rendered by such investment adviser.

3 DALBAR; Cambiar Investors, Inc. (pub. avail. Aug. 28, 1997).

4 See, e.g., DALBAR. The third-party rating in DALBAR was based entirely on responses to a questionnaire that were completed by certain clients of investment advisers. The questionnaire in DALBAR focused on the clients' evaluation of the IAR, although DALBAR also requested other information from the clients. The questionnaire requested information about: (1) the client's overall rating of the IAR; (2) the client's satisfaction rating regarding eight different types of advisory services; (3) the client's rating of the IAR's financial results to date for the client; (4) the extent to which the IAR puts the client's interests ahead of the IAR's own interest; (5) the client's satisfaction levels with various aspects of the IAR's services; (6) the length of time that the IAR had provided services to the client; and (7) client information. The last two categories do not appear to relate to client evaluations of the IAR.

5 We previously have agreed not to recommend enforcement action to the Commission under section 206(4) of, and rule 206(4)-1(a)(1) under, the Advisers Act against an investment adviser that advertised its inclusion in a third-party rating that was based primarily on client evaluations of the adviser if, among other things, (1) the rating did not emphasize favorable client responses or ignore unfavorable client responses, and (2) the rating represented all, or a statistically valid sample, of the responses of the adviser's clients. See, e.g., DALBAR.

6 See, e.g., Anametrics Investment Management (pub. avail. May 5, 1977) (whether a communication is misleading will depend upon all of the particular facts, including the form and content of the communication, the implications or inferences arising out of the context of the communication, and the sophistication of the prospective client). See also *In the Matter of LBS Capital Management, Inc.*, Advisers Act Release No. 1644 (July 18, 1997), and *In the Matter of Spear & Staff, Inc.*, Advisers Act Release No. 188 (March 25, 1965) ("In appraising advertisements . . . we do not look only to the effect that they might have had on careful analytical persons. We look also to their possible impact on those unskilled and unsophisticated in investment matters.").

7 See, e.g., New York Investors Group, Inc. (Sept. 7, 1982).