Investment Advisers Act of 1940 Rule 206(4)-1(a)(5)

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
JUL 24 1987

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 87-233-CC
Investment Company Institute
File No. 132-3

Your letter of April 3, 1987 requests the staff, in effect, to modify one of the positions in Clover Capital Management, Inc. (pub. avail. Oct. 28, 1986) ("Clover") concerning paragraph (a)(5) of Rule 206(4)-1 under the Investment Advisers Act of 1940 ("Advisers Act"). That paragraph makes it 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, the staff stated its view that an advertisement that includes actual or model results without reflecting the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid is prohibited by Rule 206(4)-1(a)(5) under the Advisers Act.

You request our assurance that we would not recommend enforcement action to the Commission if members of the Investment Company Institute ("ICI") present performance figures for actual accounts on a "gross basis," i.e., without deducting advisory fees or other expenses paid by clients, rather than on a "net basis" as required by Clover. Because you assert that adviser performance figures generally deduct brokerage commissions, your letter discusses only whether advisory fees and custodian fees should be reflected in actual performance figures and our response is limited to these issues. We cannot assure you that we would not recommend enforcement action to the Commission if ICI members advertise actual performance without reflecting advisory fees in performance figures. However, in our view, adviser performance figures may be presented without reflecting custodian fees paid to a bank or other organization for safekeeping clients' funds and securities.

Your letter states that an advertisement containing actual results on a net basis may be misleading and not meaningful because what is more relevant to a prospective client reviewing an advertisement that contains actual results, which are derived from a sample of the adviser's clients, is not the fees and expenses actually incurred by the clients in the sample, but what the prospective client's fees and expenses will be if he becomes a client. You also argue that because fees and expenses vary among advisers, and among the clients of an adviser, the calculation of actual fees and expenses is, in effect, impossible. You state that an adviser could meet this requirement by averaging fees and expenses paid by clients but that actual results reduced by average fees and expenses would be misleading. Thus, you assert that the only "realistic way" to advertise actual results is to present the results on a gross basis with disclosure about the types of fees and expenses one can expect to incur, and that the fees and expenses have not been deducted from the actual results.

The staff believes that the primary purpose of advertising actual results derived from a sample of client accounts is to show prospective clients the kind of investment experience they might have had as clients of that adviser and to permit them to evaluate the adviser's competence and ability to manage accounts. See, e.g., Anametrics Investment Management (pub. avail. May 5, 1977). As discussed in Clover, the staff also believes that an advertisement containing model or actual results would be false or misleading if it implies, or a reader would infer from it, something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts. Information about the fees the adviser charged clients in the sample is material to evaluating the investment experience of those clients and the adviser's competence, particularly because, as you state, fees vary among advisers. Accordingly, advertising actual results on a gross basis may imply, or may lead a prospective client to infer, something about the investment experience of those clients or the adviser's competence that would not be true if the advertisement included information about actual advisory fees and expenses.

Moreover, because advertisements typically present adviser performance results over a number of years, narrative disclosure of the existence and range of advisory fees, in our view, would not be an adequate substitute for deducting advisory fees because of the compounding effect on performance figures that occurs if advisory fees are not deducted. In our view it is inappropriate to require a reader to calculate the compounding effect of the undeducted expenses on the advertised performance figures. For example, assume that a client places $ 1000 under the management of an adviser and the adviser achieves performance on a gross basis of 10% per year for a period of ten years. If the adviser were to advertise performance solely on a gross basis it would represent that the client's $ 1000 investment would have resulted in a dollar balance of $ 2,593.74, which is the equivalent of an annual compounded rate of 10%. However, if an advisory fee of 1.5% of average assets under management per year for the 100 year period were charged and deducted, the resulting dollar balance would be $ 2,245.82 or an annual compounded rate of 8.43%. If the fee were 3.0% over the same period, the net dollar balance would be $ 1,939.75 or an annual compounded rate of 6.85%. (We understand that some clients request advisers to provide performance data for periods shorter than 10 years, such as for most recent five years. In the example above if only five years of performance data were presented, the compounded rates of return (10%, 8.43% and 6.85%) would not change and the resulting dollar balances would be $ 1,610.51, $ 1,498.61 and $ 1,392.75, respectively.)

With respect to your arguments, we make the following observations. First, we believe that it is inconsistent to argue that because actual fees vary among advisers and among clients of an adviser, the actual expenses of client accounts in the sample would be misleading, but that the performance of the sample of accounts on a gross basis would be representative of the results a prospective client might have achieved. In our view, to the extent the gross performance of a sample of advisory accounts provides useful non misleading information to prospective clients, information about the expenses incurred by those clients is also useful and non misleading. Second, we do not understand, and your letter does not explain, why an adviser would be required to deduct average fees and expenses rather than deduct the actual fees and expenses associated with the advisory accounts that make up the sample. It seems to us, especially in the case of a registered investment adviser required to keep and maintain accurate books and records under Rule 204 2, that information on the fees and expenses of the sample accounts should be readily available. We note in this regard that
closed end investment companies presenting performance information about the adviser's private accounts as permitted by Growth Stock Outlook Trust, Inc. (pub. avail. April 15, 1986) have been able to deduct the actual fees and expenses associated with those accounts.

In light of the foregoing, the staff continues to believe that an advertisement, which includes model or actual results, and which does not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client paid would be misleading under Rule 206(4)-1(a)(5). However, fees charged by a custodian to safekeep the assets of a client's account need not be included in this category of fees and expenses. The staff did not intend to imply in Clover that the costs charged by custodians, which ordinarily are selected by clients and frequently are paid directly by the clients, would have to be deducted in adviser performance figures.

Mary S. Podesta
Chief Counsel

INVESTMENT COMPANY INSTITUTE
April 13, 1987

Mary C. Podesta
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20449

Re: No Action Request Concerning Performance Data by Investment Advisers

Dear Ms. Podesta:

On behalf of the investment adviser and investment adviser associate members of the Investment Company Institute n*, we request assurance that the Division of Investment Management will not recommend to the Commission that enforcement action be taken against our members if performance figures for actual accounts are provided to clients or others without reducing the figures by the amount of fees and other expenses (i.e., on a gross basis) rather than attempting to reduce performance figures by an average fee or other cost (i.e., on a net basis) as seems to be required in the Clover Capital no action letter (publicly available on October 28, 1986), provided adequate disclosure is made that the figures presented are not reduced by the amount of fees or other expenses that the client might incur and provided adequate disclosure of the types of fees and other expenses that a client might actually incur is made.

> n* The Institute is the national association of the American mutual fund industry. Its membership includes 1,862 open end investment companies ("mutual funds"), their investment advisers and principal underwriters. Many of the Institute's investment adviser members also render investment advice to clients other than investment companies. In addition, the Institute's membership includes 454 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

Background

The Clover Capital letter sets forth the staff of the Division of Investment Management's most recent position on advertising by investment advisers. In the letter the staff states that the use of model or actual results in an advertisement is no longer per se fraudulent under Section 206(4) and Rule 206(4)-1(a)(5) of the Investment Advisers Act of 1940. Eleven specific prohibitions under Rule 206(4)-1(a)(5) for both model and actual performance results are also described. One prohibition would prevent an advertisement from including model or actual results if those results do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid. The application of this prohibition to advertisements of actual results is the focus of our no action request. However, since performance figures generally reflect investment results net of brokerage commissions, our no-action request will not discuss brokerage commissions.

History of Investment Adviser Performance Figures

Historically, investment advisers have shown their performance figures on a gross basis without the deduction of fees and other expenses incurred in the maintenance of an advisory account but net of commissions paid on the purchase or sale of portfolio securities. The standard institutional and retail performance data presentation has been on this gross basis. The reasons for this method of presentation are twofold.

First, investment advisory fees often differ depending on the asset size of an account, the type of advisory fee used, whether an account is discretionary or non-discretionary, whether an account is taxable or tax exempt, the type of relationship established between an adviser and its client and occasionally, depending on the length of time the client has retained the adviser.

Second, expenses incurred in maintaining an investment account with an adviser may differ depending on fees charged by a custodian (usually selected by the client) to safekeep the assets of the account.

These two matters are discussed below.

1. Investment Advisory Fees

Advisory fees generally are charged to clients as a function of one primary factor: asset size of the account. Fees typically are based on a sliding scale where, for example, a fee of 1% may be charged an account of under $ 500,000 while a fee of only .5% may be charged on account of over $ 2 million. Large institutions frequently negotiate special fee arrangements with their advisers.

Pursuant to recently adopted Rule 205 3 under the Investment Advisers Act of 1940, performance based fees may be charged a client if certain conditions are met. Such a fee can be agreed to between the client and the adviser and, if so agreed, may result in a fee which is different than the fee the client would have paid if a more typical fee arrangement (e.g. fee based on a percentage of assets) had been agreed to.

A third important factor in assessing a fee turns on whether the account is discretionary or non-discretionary. A discretionary account usually requires less client contact and therefore, a lower fee than a non-discretionary account which often involves frequent discussions about strategies, goals and individual market decisions and thus, may be more time consuming and costly.

A fourth feature that may affect the amount of an advisory fee relates to the taxable or tax exempt status of an account. Taxable portfolio performance results may be inappropriate for tax exempt account holders. If an account is taxable, a money manager must generally be aware of this fact in determining how often and in what magnitude to take gains or losses. Additionally, bookkeeping and accounting functions are usually more extensive for taxable accounts.

Although the above described factors are usually the major determinants in setting an advisory fee, the length and quality of the relationship between an adviser and its client may also affect the fee. For example, if an advisory client attracts additional assets to the advisory firm, he may be rewarded with a lower percentage fee. And, an adviser over time may adjust fees charged to new clients without fully incorporating such adjustments in its fee arrangements with existing clients.

2. Other Expenses Incurred in Maintaining an Advisory Account

The primary expense in maintaining an advisory account, other than the advisory fee, is a custodial fee required by a bank or other organization to maintain safekeeping or custody of a client's securities. Custodian costs vary widely depending on the size and type of account and the level of actual or expected transaction activity. As a percentage of assets under management, custodial costs typically are lower for a large account than for a smaller account. Clients ordinarily select their own custodians and, accordingly, the fee arrangement between the client and its custodian is not subject to the control of the adviser. Moreover, these custodial fees are frequently paid directly by the client and, therefore, an adviser may have no knowledge of the amount by which an account's performance has been affected. Of course, a client may elect to retain securities in his home or office and consequently, incur no custodial costs.

Problem

If performance figures are required to be presented on a net basis, each adviser would need to average its fees and other costs in order to produce such a number. However, performance figures reduced by average fees and costs and based on an aggregate of all accounts would be misleading to almost all potential client accounts. Why? Because there is not likely to be a "normal" account unless an adviser has only one kind of client, with each client having the same characteristics, such figures would be misleading and not reflective of what a specific client's actual experience would be.

Moreover, if performance figures are shown net of fees and costs, it may be misleading and not meaningful to clients with regard to future performance. Indeed, it can be easily argued that what is relevant to the prospective client reviewing an adviser's sample performance is not what fees and expenses have been incurred by clients in the sample but what fees and expenses he may incur. The adviser's fees charged new clients are fully described in Part II of Form ADV or a separate brochure delivered by the adviser to the prospective client pursuant to Rule 204 3 under the Investment Advisers Act of 1940. On the other hand, a client may find very useful a presentation of gross performance figures with a discussion of the range of fees and other expenses that the client might actually incur. Although a performance figure net of "average" fees and costs is possible to derive, it would not generally be as relevant to any given client as presentation of a gross figure with appropriate disclosures.

Conclusion

In requesting that the Division not recommend enforcement action by the Commission, we believe that providing adviser performance data without the deduction of fees or other costs but with relevant disclosure, reflects the only realistic way of accurately presenting such data for actual advisory accounts and is actually much more useful to (and less likely to mislead) the client than the method that appears to be required under Clover Capital. For model accounts, presenting net figures with the necessary deductions is not problematic.

The simplest method to insure that all investment advisers' performance figures for actual accounts are on equal footing is to require gross results without the deduction of fees or other costs but still require disclosure of the type of fees and other costs a client might actually incur together with disclosure of the fact of these fees and costs have not been deducted from the figures presented.

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We would be happy to provide any additional information or discuss the issues in this letter.

Sincerely,

Robert L. Bunnen, Jr.
Assistant General Counsel