

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

Oct 28, 1986

Clover Capital Management, Inc.

TOTAL NUMBER OF LETTERS:

2

SEC-REPLY-1:  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
OCT 28 1986  
RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT  
Our Ref. No. 86-264-CC  
Clover Capital Management, Inc.  
File No. 801-27041

Your letter of June 3, 1986, requests our assurance that we would not recommend any enforcement action to the Commission under Rule 206(4)-1(a)(5) of the Investment Advisers Act of 1940 ("Act") if Clover Capital Management, Inc. ("Clover"), a registered investment adviser, uses investment results derived from a "model" portfolio in advertisements (hereinafter "model results"). As described more fully in your letter, the model portfolio was established by Clover on January 1, 1985, and consists of the same securities that Clover recommended to clients during that time period. As your letter notes, Clover's investment approach incorporates the philosophy that all of its clients should invest in the same securities, with variances in specific client objectives being addressed via the asset allocation process (i.e., the relative weighting of stocks, bonds, and cash equivalents in each account). Thus, while the model results do not correspond directly to the results achieved by any actual client account, Clover has managed the model portfolio with the same investment philosophy it uses for client accounts. Because of the significant degree of interest in this issue, and in the related issue of advisers using actual investment results of client accounts under management in advertisements (hereinafter "actual results"), we wish to take this opportunity to set forth the staff's views on these issues.

Section 206 of the Act prohibits certain transactions by any investment adviser, whether registered or exempt from registration pursuant to Section 203(b) of the Act. Under paragraph (4) of Section 206, the Commission has authority to adopt rules defining acts, practices, and courses of business that are fraudulent, deceptive, or manipulative. Pursuant to this authority, the Commission adopted Rule 206(4)-1, which defines the use of certain specific types of advertisements n1 by advisers as fraudulent, deceptive, or manipulative. n2 Although the rule does not specifically prohibit an adviser from using model or actual results, or prescribe the manner of advertising these results, paragraph (5) of the rule 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. n3 Accordingly, 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. n4

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

n1 Rule 206(4)-1(b) generally defines an "advertisement" to include any communication addressed to more than one person that offers any investment advisory service with regard to securities.

n2 For example, Rule 206(4)-1 prohibits an adviser from using advertisements that include testimonials (paragraph (a)) or that refer to past specific recommendations unless certain information is provided (paragraph (b)). The staff is currently reviewing Rule 206(4)-1 to determine whether it needs to be revised or updated. See Investment Advisers Act Rel. No. 1033 (Aug. 6, 1986).

n3 As a general matter, whether any advertisement is false or misleading will depend on the particular facts and circumstances surrounding its use, including (1) the form as well as the content of the advertisement, (2) the implications or inferences arising out of the advertisement in its total context, and (3) the sophistication of the prospective client. See, e.g., Covato/Lipsitz, Inc. (pub. avail. Oct. 23, 1981)("Covato"); Edward F. O'Keefe (pub. avail. Apr. 13, 1978)("O'Keefe"); Anametrics Investment Management (pub. avail. May 5, 1977)("Anametrics").

n4 Of course, if an advertisement containing model or actual results also includes any of the specific advertising practices addressed by paragraphs (a)(1)-(a)(4) of the Rule 206(4)-1, the advertisement would have to comply with the requirements of these paragraphs.

The staff no longer takes the position, as it did a number of years ago, that the use of model or actual results in an advertisement is per se fraudulent under Section 206(4) and the rules thereunder, particularly Rule 206(4)-1(a)(5). n5 Rather, this determination is one of fact, and we believe the use of model or actual results in an advertisement would be false or misleading under Rule 206(4)-1(a)(5) 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. n6 Any adviser using such an advertisement must ensure that the advertisement discloses all material facts concerning the model or actual results so as to avoid these unwarranted implications or inferences. n7 Because of the factual nature of the determination, the staff, as a matter of policy, does not review any specific advertisements. n8 Therefore, we express no opinion regarding your proposed advertisements.

n5 See, e.g., A. R. Schmeidler & Co. (pub. avail. June 1, 1976); Schield Stock Services, Inc. (pub. avail. Feb. 26, 1972).

n6 See, e.g., Anametrics, Covato, and O'Keefe, supra noted 3.

n7 Id.

n8 See, e.g., Anametrics, supra note 3.

In order to assist advisers who advertise model or actual results, we wish to take this opportunity to set forth certain advertising practices the staff believes are inappropriate under Rule 206(4)-1(a)(5). The list is not intended to address all advertising practices prohibited by Rule 206(4)-1(a)(5) and does not create a "safe harbor" that may be relied upon by an adviser as an exclusive list of the factors that must be considered in determining the type of disclosure necessary when advertising model or actual results. Items (1)-(6)

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

below apply to both model and actual results; Items (7)-(10) apply to model results; and Item (11) applies to actual results.

In the staff's view, Rule 206(4)-1(a)(5) prohibits an advertisement that:

Model and Actual Results

(1) Fails to disclose the effect of material market or economic conditions on the results portrayed (e.g., an advertisement stating that the accounts of the adviser's clients appreciated in the value 25% without disclosing that the market generally appreciated 40% during the same period); n9

(2) 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 would have paid or actually paid;

(3) Fails to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;

(4) Suggests or makes claims about the potential for profit without also disclosing the possibility of loss; n10

(5) Compares model or actual results to an index without disclosing all material facts relevant to the comparison (e.g. an advertisement that compares model results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio); n11

(6) Fails to disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed (e.g., the model portfolio contains equity stocks that are managed with a view towards capital appreciation);

(7) Fails to disclose prominently the limitations inherent in model results, n12 particularly the fact that such results do not represent actual trading and that they may not reflect the impact that material economic and market factors might have had on the adviser's decision-making if the adviser were actually managing clients' money;

(8) Fails to disclose, 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;

(9) 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 (e.g., the model includes some types of securities that the adviser no longer recommends for its clients); n13

(10) Fails to disclose, if applicable, that the adviser's clients had investment results materially different from the results portrayed in the model;

Actual Results

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

(11) 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. n14

n9 Id.

n10 See F. Eberstadt & Co., Inc. (pub. avail. July 2, 1978).

n11 See, e.g., Anametrics, supra note 3; Multinational Investments, Inc. (pub. avail. Sept. 17, 1977).

n12 With respect to model results, the staff recognizes that advisers may wish to advertise model results derived from model portfolios that differ in form and structure from that presented by your letter. We believe that to the extent it is more difficult to verify or objectively test the criteria underlying the model portfolio in question, the disclosure obligation of the adviser would correspondingly increase.

n13 See, e.g., Covato, supra note 3.

n14 See, e.g., O'Keefe, supra note 3.

We wish to emphasize that: (1) it is the responsibility of every adviser using model or actual results to ensure that the advertisement is not false or misleading; (2) the list set forth above of advertising practices the staff believes are prohibited by Rule 206(4)-1(a)(5) is not intended to be all-inclusive or to provide a safe harbor; and (3) the staff, as a matter of policy, will not review specific advertisements.

As we agreed, this response will be made public immediately.

Thomas P. Lemke  
Chief Counsel

INQUIRY-1:

Clover Capital Management, Inc.  
5 Tobey Village Office Park  
Pittsford, New York 14531  
(716) 385-6000  
June 3, 1986

Mr. Thomas P. Lemke  
Chief Counsel  
Division of Investment Management  
Securities & Exchange Commission  
450 5th Street N.W.  
Washington, D.C. 20549

Dear Mr. Lemke:

Clover Capital Management, Inc. is an investment counseling firm registered with the S.E.C. under the Investment Advisers Act of 1940. I have enclosed a copy of a letter we recently received from Mr. Frank Morrison of the S.E.C.'s New York City office informing us that our use of a Model Portfolio for

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

tracking the firm's investment record violates Rule 206 (4)-1(a)(5). In a subsequent telephone conversation with Mr. Dolan, an associate of Mr. Morrison's, we were made aware that your office has the authority to rule on such matters on a case-by-case basis and to issue "No Action Letters", where warranted. Please consider our case based on the following information:

1. Clover Capital Management, Inc. is an investment management firm founded in October, 1984 by Michael E. Jones, CFA and Geoffrey Rosenberger, CFA. We had several very successful years experience as investment analysts and portfolio managers at the firm of Manning and Napier Advisors, Inc.. In starting our new firm, we were faced with the dilemma of providing prospective clients with an understanding of our prior and current investment results and style of management. In dealing with this problem, we aspired to maintain the highest possible ethical standards. Thus, we have not represented our previous firm's record as our own or as an indication of Clover Capital Management's ability. We have chosen to forego discussion of our specific results on clients prior to forming Clover Capital.

However, as you know, the issue of demonstrating the firm's competence and style of management is important in presenting our service to prospective clients. Our problem is to find a way to show what we are doing in our research and management effort at Clover Capital Management, Inc., without violating client confidentiality and without misrepresenting our performance to the public.

One approach to this problem involves presenting the performance achieved among our account base. However, the securities markets have been quite volatile in the past 18 months and our client based has grown consistently each month. As a result, a portfolio that started in January, 1985 has different results than one we began in September, 1985. To take an arithmetic average of each client's actual results and present that as the firm's track record would be misleading due to the significant standard deviation from client to client based on date of entry to our firm's management.

On the other hand, to just pick one or two client portfolios would be equally misleading because of differences in the timing of cash flows, specific client objectives and other considerations which may be unique to a small sample of accounts. We recognized at the outset that this would be the case. We also recognized this presentation of results would not satisfy questions on portfolio construction and investment style with respect to diversification, portfolio beta, asset allocation and related items. The raw results would also be impossible to verify without violating client confidentiality.

The most accurate, verifiable reflection of our true investment product, in light of these circumstances, was to establish a Model Portfolio as of January 1, 1985, which we would manage exactly as we would a tax-exempt client portfolio with no restrictions as to income and without any cash flow into or out of the fund.

2. The securities purchased and sold in the Model Portfolio are also purchased and sold in our client accounts under management at the time of the transaction. It is important to note that our investment approach incorporates the philosophy that all of our clients should own the same stock selections, with variances in specific client objectives being addressed via the asset allocation process (the relative weightings of stocks, bonds and cash equivalents in each account). For example, when we make a decision to invest in a common stock, we also decide

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

what percentage of each client's assets we wish to commit to that particular equity. Differences in client objectives are reflected in the weightings placed for each account. Most of our accounts are tax exempt retirement funds with conservative objectives and therefore receive similar weightings. However some clients have differing objectives due to current income requirements, moral considerations, tax considerations, "equities only" restrictions, and other factors which may alter the weightings in specific investments. The Model Portfolio weightings are determined according to it's stated hypothetical structure as a conservative pension fund.

3. We have taken extensive steps to insure that the reporting format is an objective one. The independent accounting firm of Davie, Kaplan & Braverman was hired to audit our efforts in this effort. To place a purchase or sale transaction, we call Davie, Kaplan & Braverman prior to the 9:30 a.m. market opening. All transactions are assumed to occur at the prior day's closing price as listed in the Wall Street Journal, which Davie Kaplan & Braverman can easily verify. Commissions are charged against each transaction based on a 35% discount from the Cowen & Co. commission schedule, which is roughly the same commission expense level we incur in our client accounts. Investment management fees are also charged against the portfolio in line with our standard client fee schedule.

4. In addition to monitoring the purchase and sale transactions in the Model Portfolio, Davie, Kaplan & Braverman also accounts for the dividend and interest income, commission charges and investment management fee reimbursement in the portfolio. The quarterly investment performance reports are also compiled and issued by Davie Kaplan & Braverman, not by Clover Capital Management, Inc. There is a measure of independence and objectivity to our Model Portfolio Report and its calculations which may be lacking in the investment performance figures reported by other investment management firms.

5. We feel it is important that prospective clients see how the investment returns being presented to them were achieved. Use of the Model Portfolio allows people to see what stocks we hold and what the recent transaction activity in the account has been. They can develop a feel for our investment style that would otherwise be difficult to achieve prior to entering into a relationship with our firm.

6. The only reference the report makes to investment results is on an absolute return basis. The report only records a percentage increase in asset value. It makes no comparisons to any stock or bond market indexes.

We believe that, for the above reasons, our Model Portfolio report provides an excellent proxy for our investment approach and track record. However, we also understand the Commission's concern about the potential for misunderstanding of the Model's purpose on the part of the public. Therefore, we are willing to incorporate the following statement (or a similar version which you may prefer) into our report:

"The Clover Capital Management, Inc. Model Portfolio represents a fictional account which Clover Capital Management, Inc. ("CCM") attempts to manage in a manner similar to that of a tax-exempt client fund with no need for special portfolio considerations. The investment objective for this portfolio over a four year time period is to exceed, by at least 3%, the compound annual rate of return available on a Treasury Note with a four year maturity and at the same

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

time to limit volatility in such a way as to avoid the incurrance of a negative return during any calendar year.

It is CCM's intention to own the same securities in each client portfolio with similar objectives. Securities transactions will not be undertaken in the Model Portfolio until at least half the existing accounts under management have completed the contemplated transaction. However, circumstances such as market fluctuations may exist which may prevent an individual CCM client from owning one or more of the specific securities held in the Model Portfolio.

Since the account is fictional, there can be no assurance that a CCM client would have achieved similar rates of return over the same time frame. In addition, since the time period in question is a historical one, there can be no assurance that future results achieved by the firm's clients will in any way resemble those represented by the Model Portfolio."

We believe that use of the Model Portfolio is the most valid approximation we can provide a prospective client as to what our investment activity has been since January 1, 1985. While no form of investment performance measurement is entirely without fault, of all those available to us this approach is the one which provides the least amount of bias. We therefore respectfully request that you confirm that you will not recommend enforcement action if we continue to use the Model Portfolio in the manner stated in this letter and with the explanatory and disclaimer language found in the enclosed Model Portfolio copy.

Your assistance in this matter is most appreciated. If you have any questions, please call either me or Michael E. Jones, at 716-385-6090.

Sincerely,  
Clover Capital Management, Inc.  
by Geoffrey Rosenberger, President