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1993 WL 313090
(S.E.C. No - Action Letter)

(SEC No-Action Letter)

Denver Investment Advisors, Inc.
Publicly Available July 30, 1993

LETTER TO SEC

April 22, 1993

Division of Investment Management
Attn: Office of the Chief Counsel
Securities & Exchange Commission
450 Fifth St., N.W.
Washington, DC 20549Re: Denver Investment Advisors, Inc.

Ladies and Gentlemen:

On behalf of **Denver Investment Advisors, Inc.** ("DIA"), we hereby request the concurrence of the staff of the Securities & Exchange Commission (the "Commission") with our opinion that the distribution of client lists as further described below does not constitute an advertisement under Rule 206(4)-1 of the Investment Advisors Act of 1940 ("Act").¹ Alternatively, we ask the staff's concurrence that the list does not constitute a testimonial within the meaning of the Rule.²

I. BACKGROUND

DIA is a registered investment adviser under the Act and manages portfolios for a wide variety of clients, including pension and profit sharing plans, multi-employer plans, foundations, endowments, public retirement systems, insurance companies and individuals. As of December 31, 1992, DIA had \$6.13 billion in total assets under management.

As part of its operations, DIA is regularly evaluated and monitored by consultants and other in-

¹ 17 C.F.R. § 275.206(4)-1.

² 17 C.F.R. § 275.206(4)-1(a)(1).

intermediaries. These consultants provide services in connection with retirement plan operations, including information to enable trustees to meet their fiduciary obligations, advice on asset allocation strategies, and compliance with ERISA.

In addition, consultants are, on occasion, asked to conduct a search for money managers.³ In conducting the search, as well as performing their ongoing monitoring on behalf of trustees, consultants engage in considerable due diligence to locate managers meeting client specifications. While these specifications vary, they often require an examination of an adviser's investment styles, performance, years of operation, expertise of employees, and clients using the services.

To facilitate the process, consultants often maintain an extensive data base, updated at least annually, on various advisers. They typically obtain information for the database through questionnaires to advisers. Information may also be obtained from other forms of contact, including interviews.

In accordance with this process, DIA routinely receives requests for information from consultants. While sometimes oral, the requests usually arrive by letter or fax, with a questionnaire attached. In addition to filling out and returning the questionnaire, DIA also provides consultants with additional, more complete information in the form of a booklet containing a company profile ("Profile").

The Profile describes the company, the investment styles of DIA, includes biographies of the relevant professionals, and provides a list of clients.⁴ Nothing in the Profile specifically solicits business or otherwise seeks clients. A copy of the Profile is attached to this letter.

DIA distributes the Profile to consultants that have expressed an interest in acquiring information about DIA. The profile is not distributed on an unsolicited basis or to the general public. Consultants generally receive one copy⁵ and are not expected to pass the materials on to

³ In some instances, clients may identify a specific manager and ask the consultant to conduct due diligence on the adviser's qualifications.

⁴ DIA also distributes on an annual basis an updated Profile to some consultants receiving earlier versions. DIA does so in large part to obviate the need to respond to questionnaires from the consultants seeking more current information.

⁵ Some consultants may receive multiple copies. This occurs where more than one person related to the consultant has expressed an interest in the Profile. DIA, however, has a practice of sending only one copy to each interested person.

clients.⁶

In compiling the list of clients contained in the Profile, DIA uses objective criteria. Ordinarily, the Profile includes all clients with an account size over a designated threshold. The Profile may also include lists based upon other objective criteria such as geographic location and client classification.⁷ DIA does not use any performance based criteria in determining which clients to include in the list.

For the following reasons set forth more completely below, DIA takes the position that the Profile does not fall within the definition of advertisement and is therefore not subject to the restriction on testimonials. The Profile merely provides consultants with background information necessary to conduct due diligence investigations. Alternatively, to the extent that the staff disagrees with this reasoning, DIA takes the position that the listing of the customers within the Profile does not fall within the definition of “testimonial” as set forth in Rule 206(4)–1.

II. ANALYSIS

Section 206 under the Act contains a broad prohibition on fraud by investment advisers.⁸ Pursuant to rulemaking authority under the provision, the Commission in 1961 adopted Rule 206(4)–1.⁹ The Rule provides specific guidance on the applicability of the antifraud provisions to adviser advertising practices.

A. Advertisement

The Rule applies only to advertisements. Advertisements have been broadly defined to include: any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) 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

⁶ DIA views the materials as inappropriate for distribution to prospective clients. Clients generally have specific needs or specific questions. They require far more focused responses, rather than the broad overview of DIA contained in the Profile.

⁷ Generally, the list includes all clients meeting the designated criteria. DIA, however, reserves the right to delete the name of a client objecting to inclusion.

⁸ See [15 U.S.C. § 80b–6](#)

⁹ 17 C.F.R. § 275.206(4)–1; see also Investment Advisors Act Release No. 121 (Nov. 2, 1961) (adopting release)

to buy or sell, or (2) any 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 (3) any other investment advisory service with regard to securities.¹⁰

The Rule excludes face-to-face conversations with a prospective client and a letter sent to a single person.¹¹

The Profile does not fit within this definition. The document neither contains securities analysis nor formulas and other devices that can be used in purchasing shares. Nor does it offer any other investment advisory service. Other than a brief description of the investment philosophy for each style, the Profile consists largely of performance related data.

More critically, however, the Profile is not intended to solicit additional clients. The definition of advertisement in the Rule was intended to apply only to communications designed to obtain clients. No action letters in the area have emphasized the importance of this factor¹² as have the courts.¹³

The Profile does not go to prospective clients. It is sent to consultants, particularly those having requested information from DIA. Most are distributed on an annual basis to consultants with whom DIA has had long standing relationships. They are not distributed to the general public and are not distributed on an indiscriminate basis.

Moreover, the Profile is not designed to “advertise” DIA’s services but instead to perform a specific and necessary function. It provides background information on DIA to facilitate the due diligence process conducted by consultants. By sending the Profile on an annual basis, DIA avoids the laborious process of filling out large numbers of questionnaires from consultants designed to update their data base.

¹⁰ Rule 206(4)–1(b), 17 C.F.R. § 275.206(4)–1(b).

¹¹ [Investment Advisors Act Release No. 119 \(Aug. 8, 1961\)](#).

¹² See, e.g., Joseph W. Quarles (Feb. 14, 1980) (materials used for “inducing potential clients to subscribe” to adviser’s services constituted an advertisement); John W. Uher (Aug. 5, 1977) (“If copies of your market report are distributed to solicit new subscribers, the publication itself would probably be regarded as an ‘advertisement’ ...”); Charles L. Hatfield (Jan. 29, 1975) (materials disseminated “to potential as well as existing clients” constituted advertisements).

¹³ The term “advertisement” has been held to include any “investment advisory material which promotes advisory services for the purpose of inducing potential clients to subscribe to those services.” SEC v. C.R. Richmond & Co., 565 F.2d 1101, 1105 (9th Cir.1977) [emphasis added].

The Profiles are not designed for, or expected to be passed on to, investors in need of advisory services. To the extent clients of a consultant contact DIA directly, they will receive materials that conform with all legal requirements, including, if necessary, the regulations concerning advertisements.

A finding that the Profile constitutes an advertisement will have important, adverse consequences. It would sweep into the definition communications initiated by consultants and other market professionals. The effect would be a dampening of the communication process, ultimately working to the detriment of managers and fiduciaries of retirement plans.

Moreover, a conclusion by the staff that the Profile falls outside the definition of advertisement does not amount to *carte blanche*. The antifraud provisions contained in Section 206 would still apply with vigor. These antifraud provisions are sufficient to alleviate any residual concerns held by the staff.

B. Testimonials

As an alternative position, we are of the view that the client lists contained in the Profile are not testimonials as defined in the Rule. In adopting the Rule, the Commission recognized the often unsophisticated nature of investment adviser clients.¹⁴ The Rule, therefore sought to balance the protection of potential clients against the need of advisers to legitimately market their services.

In striking the balance, the Rule took two different approaches toward the regulation of advertisements. Certain kinds of disclosure could occur, but only if complete and only if surrounded by prophylactic safeguards such as legends. Stock recommendations represented an example of this approach. Other practices were, however, banned outright. Testimonials fell into this latter category.

The Commission viewed testimonials as inherently misleading.¹⁵ As the staff indicated, testimo-

¹⁴ In justifying the Rule, the Commission noted that advertisements went to prospective clients that were “frequently unskilled and unsophisticated in investment matters.” Investment Advisors Act Release No. 119 (Aug. 8, 1961). The Commission also indicated that investment advisers, as market professionals, were to be held to “a stricter standard of conduct ...” Investment Advisors Act Release No. 121 (Nov. 2, 1961).

¹⁵ See Investment Advisors Act Release No. 121 (Nov. 2, 1961) (“The Commission finds that such advertisements are misleading; by their very nature they emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable. This is true even when the testimonials are unsolicited and are printed in full.”).

nials were likely “to give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients.”¹⁶

Given the inherently misleading nature of the technique, the Commission completely prohibited its use. Specifically, the Rule banned the distribution of any advertisement “[w]hich 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 advisers.”¹⁷

The absolute nature of the Rule, however, had significant implications. Once characterized as a testimonial, the practice had to cease. Too broad an interpretation, therefore, threatened to impede legitimate advertising techniques. This consequence dictated caution in interpreting the term.

Subsequent staff interpretations have been sensitive to this concern. The small number of no action letters on the subject have only applied the term to statements “of a customer's experience or endorsement,”¹⁸ particularly express representations by customers about the adviser's services.¹⁹ The staff, therefore, has not expanded the term beyond its plain and limited meaning.

The staff's narrow construction is most clearly illustrated in connection with no action letters addressing the right of advisers to distribute articles and reports written by third parties. Similar to a testimonial, these articles often contain conclusions about an adviser's ability and performance. The staff, however, has declined to construe them as testimonials unless containing a statement of “a customer's experience or endorsement.”²⁰ The staff declined to extend the de-

¹⁶ New York Investors Group, Inc. (Sept. 7, 1982); see also CIGNA Securities, Inc. (Sept. 10, 1991); J.Y. Barry Arbitrage Management Inc. (Oct. 18, 1989).

¹⁷ 17 C.F.R. 275.206(4)–1(a)(1).

¹⁸ CIGNA Securities, Inc. (Sept. 10, 1991); J.Y. Barry Arbitrage Management, Inc. (Oct. 18, 1989).

¹⁹ See e.g., CIGNA Securities, Inc. (Sept. 10, 1991) (concluding that written statements from satisfied financial planning clients constitute a testimonial); Investor Intelligence (John Anthony) (April 18, 1975) (advertisement describing adviser as a “recognized” powerful psychic medium constituted a testimonial); Analytic Investment Management, Inc. (March 22, 1971) (distribution of a letter indicating that a mutual acquaintance of the advisor would be willing to inform a prospective customer about the investment experience of his fund constituted an offer to provide a testimonial).

²⁰ Richard Silverman (March 27, 1985); New York Investors Group, Inc. (Sept. 7, 1982).

definition apparently out of the belief that unbiased third party statements were not inherently misleading and therefore did not raise the types of concerns that led to the ban on testimonials.

The same can be said about lists of clients. They are not inherently misleading or unrepresentative and do not, “by their very nature” emphasize only the positive.²¹ Indeed, properly assembled through objective criteria, client lists provide information of considerable importance.²²

Client lists can help illustrate the expertise, credibility, and sophistication of the relevant adviser, in much the same way as data about the expertise of employees or number of years of operation. This is particularly true when client data is examined in conjunction with other material about the adviser, such as the information appearing in the Profile. The data aids both prospective clients and consultants engaging in due diligence.²³

Admittedly, issues may arise over the criteria used to assemble a list. DIA does not use selective or biased criteria in listing clients in its Profile. To the extent others do, however, subsection (a)(5) of the Rule addresses the problem by prohibiting advertisements that are “otherwise false and misleading.”²⁴ This would seem to require disclosure of any selective or biased criteria used to compile a list. The staff has aggressively used this subsection to regulate other practices that, while not inherently misleading, may sometimes be abused. Model accounts represent an obvious example.²⁵

Characterizing all client lists as testimonials would ban their use. This represents a far too Draconian approach to a legitimate practice. Client lists represent an appropriate mechanism for differentiation among advisers. Moreover, placing them outside the definition of testimonial

²¹ Nor do they contain any “implicit or explicit representations or recommendations” concerning the performance of these clients. General Statistics, Inc. (Aug. 15, 1976).

²² The value of the information can be seen from the existence of commercial publications that provide this type of data. The data is typically obtained through direct contact with the adviser's client, although the money manager may be asked to verify the information. Often, however, the data is out of date when published.

²³ While the possibility exists that a client on the list may be contacted for a reference, this is not tantamount to a testimonial. The adviser does not screen or control the conversations and cannot ensure that only the positive will be emphasized.

²⁴ 15 U.S.C. § 275.206(4)–1(a)(5).

²⁵ This has been true, for example, in connection with the use of model portfolios. At one time the staff prohibited their use. More recent pronouncements, however, allow their use as long as accompanied by complete disclosure. See, e.g., Clover Capital Management (Oct. 28, 1986).

does not open Pandora's box. The prohibition on false and misleading advertisements ensures that lists will not be improperly manipulated.

III. CONCLUSION

We therefore respectfully request that you advise that you would not recommend enforcement action by the Commission if DIA were to proceed with its proposed distribution as described above.

We would be happy to discuss this matter further at your convenience. Should you have any questions, please feel free to call David Butler at (303) 295-8172 or the undersigned at (303) 295-8304.

Very truly yours,

J. Robert Brown, Jr.
HOLLAND & HART
Suite 2900
555 Seventeenth Street
Denver, Colorado 80202
MAILING ADDRESS
P.O. Box 8749
Denver, Colorado 80201

IAA 1940 Act / s -- / Rule 206(4)-1

July 30, 1993
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Your letter of April 22, 1993, requests our assurance that we would not recommend that the Commission take any enforcement action under Rule 206(4)–1 of the Investment Advisers Act of 1940 (the “Advisers Act”) if Denver Investment Advisors, Inc. (“DIA”), a registered investment adviser, includes a partial list of clients in a booklet containing information about DIA (“Profile”).²⁶

DIA manages portfolios for pension and profit sharing plans, foundations, endowments, public retirement systems, insurance companies, and individuals. Consultants and other intermediaries regularly evaluate and monitor DIA as part of their services to their own clients. In connection with this evaluation, the consultants examine DIA's investment style, performance, years of operation, expertise of employees, and clients. Consultants typically obtain information about DIA through questionnaires or other contacts, such as interviews.

DIA also provides consultants with the Profile which describes DIA's investment style and includes biographies of its professionals. The Profile also includes a partial list of DIA clients. Each client list in the Profile is accompanied by a disclaimer stating that “[i]t is not known whether the listed clients approve or disapprove of Denver Investment Advisors or the advisory services provided.” You state that DIA uses “objective criteria” in compiling the client list, such as account size, geographic location, and client classification. It does not use any performance based criteria. DIA distributes the Profile to consultants or clients that have expressed an interest in acquiring information about DIA. The Profile is not distributed on an unsolicited basis, except that DIA distributes updated Profiles on an annual basis to consultants receiving earlier versions.

DIA does not believe that the Profile falls within the definition of “advertisement” in Rule 206(4)–1 and, therefore, that it is not subject to the rule's prohibition against testimonials. We disagree. The rule broadly defines the term “advertisement” to include any communication addressed to more than one person that offers any investment advisory service with regard to securities. The Profile clearly is a communication addressed to more than one person. Further, the Profile offers advisory services with regard to securities because it describes DIA's invest-

²⁶ Rule 206(4)–1 deems certain investment adviser advertising practices to be fraudulent, deceptive, or manipulative. In particular, the rule prohibits an investment adviser from publishing, circulating, or distributing any advertisement which refers to any testimonial concerning the adviser or any service that the adviser provides

ment advisory services and is distributed to consultants for the ultimate purpose of maintaining existing clients and soliciting new ones.²⁷ Consequently, we believe that the Profile is an advertisement.

Alternatively, you state that the client lists in the Profile are not testimonials within the meaning of the rule. The rule prohibits testimonials (i.e., a statement of a customer's experience or endorsement) in investment adviser advertising because they are likely to give rise to a fraudulent or deceptive implication or mistaken inference that the experience of the person providing the testimonial is typical of the experience of the adviser's clients.²⁸

On the basis of the facts and representations in your letter, and without necessarily agreeing with your assertion that the client lists are not testimonials, we would not recommend enforcement action to the Commission under Rule 206(4)–1 of the Advisers Act if DIA includes a partial list of clients in the Profile. Our position is based, in particular, on the following conditions: (1) DIA will not use performance based criteria in determining which clients to include in the list, (2) each client list will carry the disclaimer described above, and (3) each client list will include a statement disclosing the objective criteria used to determine which clients to include in the list. We note that the Profile, including the presentation of the client list, may not otherwise be false or misleading under Rule 206(4)–1(a)(5). This response expresses the Division's position on enforcement action only and does not purport to express any legal conclusion on the issues presented.

Barbara Chretien–Dar
Attorney

Fed. Sec. L. Rep. P 76,689, 1993 WL 313090 (S.E.C. No - Action Letter)

²⁷ See *S.E.C. v. C.R. Richmond & Co.*, 565 F.2d 1101 (9th Cir.1977); and *Spear & Staff*, 42 S.E.C. 549 (1965) for cases finding that investment advisory material designed to maintain existing clients or solicit new clients constitutes an advertisement.

²⁸ See *Cigna Securities, Inc.* (pub. avail. Sept. 10, 1991); *J.Y. Barry Arbitrage Management Inc.* (pub. avail. Oct. 18, 1989); *New York Investors Group, Inc.* (pub. avail. Sept. 7, 1982).