

PUBLIC

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Our Ref. No. 97-453-CC
DALBAR, Inc.
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated March 20, 1998 requests assurance that we would not recommend enforcement action to the Commission under Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-1(a)(1) thereunder if, as described in your letter, DALBAR, Inc. ("DALBAR"), any investment adviser, or any associated person of an adviser, uses certain numerical ratings created by DALBAR in investment adviser advertisements.

FACTS

DALBAR is a research firm that conducts survey research regarding financial institutions and, based on the survey findings, issues ratings of these institutions. DALBAR has conducted a survey to measure the effectiveness of services rendered by investment advisers 1/ and/or their investment advisory representatives ("IARs"). 2/ You state that DALBAR intends to conduct subsequent surveys on a quarterly basis using substantially identical questionnaires; however, an adviser or IAR will be permitted to participate and be rated only once a year. 3/

You represent that DALBAR will not be affiliated with any adviser or IAR participating in the surveys. You state that DALBAR will solicit advisers and IARs to participate in a survey for a \$500 fee, paid in advance, per participating IAR, or if a rating is sought only for an adviser, per adviser. 4/ You represent that to participate in DALBAR's survey, an adviser and any participating IAR must have: (1) at least five years of experience as a financial adviser; (2) a minimum of 100 clients from whom a fee or commission was earned within the prior 12 months, or at least \$15 million in client assets under management; and (3) no record of any regulatory sanctions imposed within the past

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- 1/ You state that DALBAR expects that most of the investment advisers surveyed will be registered with the Commission.
 - 2/ The term "investment advisory representatives" refers to those natural persons employed by investment advisers who render investment advisory services to an adviser's clients.
 - 3/ You state that the description of the DALBAR program applies to activities that already have been conducted as well as activities to be conducted in the future. The no-action assurances provided in this letter, however, apply only to activities relating to the DALBAR program that take place in the future in accordance with the facts and representations in your letter.
 - 4/ As applicable, the discussion in this letter regarding participating IARs also applies to participating Advisers that have no IARs who are being rated.

five years by the Commission, state securities regulators or any self-regulatory organization as that term is defined in Section 3(a)(26) of the Securities Exchange Act of 1934.

You state that DALBAR will send uniform questionnaires to all clients of a participating IAR, except when an IAR has a sufficient number of clients to permit a statistically valid sampling. You represent that if a participating IAR has fewer than 300 clients from whom the IAR has earned a fee within the prior 12 months, DALBAR will send each of these clients a questionnaire prepared by DALBAR. If a participating IAR has 300 or more clients from whom the IAR earned an advisory fee, DALBAR will send questionnaires to a statistically valid sample of these clients that it randomly selects. 5/ You also state that if an adviser wants to receive a firm-wide rating, the adviser must provide DALBAR with a list of all of its IARs, who then provide DALBAR with a list of all their clients from whom the IAR earned a fee within the last 12 months. DALBAR sends all of these clients a questionnaire. If, however, an adviser has 100 or more IARs, DALBAR then randomly will select at least 10% or 100 of the IARs (whichever is higher), and will send a questionnaire to each client, or a statistically valid sample of clients, of these IARs. 6/ Thus, you assert that advisers seeking firm-wide ratings will not be able to pre-determine which clients will participate in the survey or which IARs will be the subject of the survey. 7/

5/ If an IAR earned an advisory fee from 300 to 1,000 clients in the past twelve months, DALBAR will send the questionnaire to 100 of those clients that it randomly will select. If an IAR earned an advisory fee from 1,001 to 2,000 clients in the past twelve months, DALBAR will send the questionnaire to 150 of those clients that it randomly selects. If an IAR earned an advisory fee from more than 2,000 clients in the past twelve months, DALBAR will send the questionnaire to 200 or more of those clients that it randomly selects. In subsequent surveys, DALBAR may adjust these guidelines based on prior response rates, although it always will survey a sufficient number of clients to have a statistically valid sample. If an adviser or IAR participates in subsequent DALBAR surveys, DALBAR will randomly select the clients from a group that includes clients of the adviser or IAR from whom the adviser or IAR earned advisory fees in the past year as well as clients who were listed by the adviser or IAR for any previous DALBAR survey.

6/ DALBAR will follow the same procedures as described in note 5.

7/ You represent that the survey responses will be kept confidential by DALBAR. You state that no adviser or IAR will have access to the responses of any client. Additionally, you state that DALBAR will not disclose to any adviser or IAR which of its clients responded or did not respond to the survey. You represent that DALBAR randomly will contact certain clients to confirm the validity of their responses.

You represent that the questionnaire has not been prepared to produce any pre-determined results that could benefit any adviser or IAR. Rather, you represent that the questionnaire is structured to make it equally easy for a client to give negative or positive responses. 8/ You state that the questionnaire contains a series of questions with four multiple-choice answers. You further represent that DALBAR will not perform any subjective analysis of the survey results, but instead assigns numerical ratings based on the aggregate client responses for each adviser or IAR. Each possible client response corresponds to a number from 1 to 4. You state that for each survey question, DALBAR averages the responses of an adviser's or IAR's clients to obtain a rating for that question. Each adviser or IAR also is rated in three major categories -- performance, trust, and satisfaction -- by averaging the client responses to the questions in those categories. 9/ You represent that DALBAR will not issue ratings to an adviser or IAR unless the ratings are statistically valid with respect to that adviser or IAR.

You state that DALBAR will publicly release the names of the advisers and IARs who satisfy certain minimum rating guidelines and will publish some or all of the survey results in its written directories and on its Internet web site. You represent that, among other information, these published listings will identify clearly the percentage of survey participants who have received each of the designations described in note 9 and the total number of survey participants. In addition, you state that DALBAR expects some advisers and IARs to refer to their ratings and/or to other relevant survey ratings of their services in their own advertisements or sales materials.

ANALYSIS

Section 206(4) of the Advisers Act 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. Rule 206(4)-1(a)(1) under the Advisers Act provides that it is a fraudulent, deceptive or manipulative act, practice or course of business within the

8/ The questionnaire asks about: (1) the length of time that the IAR has provided services to the client; (2) the client's overall rating of the IAR; (3) the client's satisfaction rating regarding eight different types of advisory services; (4) the client's rating of the IAR's financial results to date for the client; (5) the extent to which the IAR puts the client's interests ahead of the IAR's own interests; (6) the client's satisfaction levels with various aspects of the IAR's services; and (7) client information.

9/ IARs and advisers are rated from 1 (poor) to 4 (excellent) in each category. DALBAR assigns those IARs and advisers who are rated from 3.75 to 4.0 an "Excellent" designation, those who are rated from 3.5 to 3.74 a "Very Good" designation, and those who are rated from 3.0 to 3.49 a "Good" designation.

meaning of Section 206(4) for any investment adviser registered or required to be registered as such with the Commission 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 the investment adviser.

When the Commission adopted Rule 206(4)-1, it stated that testimonials were inherently misleading because "by their very nature they emphasize the comments and the activities favorable to the investment adviser and ignore those which are unfavorable." ^{10/} The rule forbids the use of a testimonial "because the testimonial may 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." ^{11/} Although the term "testimonial" is not defined in Rule 206(4)-1, we consistently have interpreted that term to include a statement of a client's experience with, or endorsement of, an investment adviser. ^{12/} We also have taken the position, however, that an article by an unbiased third party concerning an investment adviser's performance is not a testimonial unless it includes a statement of a client's experience with, or endorsement of, the adviser. ^{13/}

You maintain that the ratings produced and used in the manner described in your letter are not testimonials within the meaning of Rule 206(4)-1(a)(1). First, you argue that the ratings assigned by DALBAR are reports by an unbiased third party that do not contain any statement regarding the experience of any particular client with an adviser or IAR. Second, you argue that the ratings themselves do not constitute client testimonials because they do not directly or indirectly emphasize statements by one or more clients that are favorable to the investment adviser or IAR and ignore those that are unfavorable. Finally, you argue that even if the ratings are considered to be indirect testimonials by the clients of advisers and IARs, the "experience" being conveyed is not the experience of a single client or a group of clients selected by the adviser or IAR. You state that a DALBAR rating is, at most, the collective experience of all clients responding to the survey.

We believe that a DALBAR rating is a testimonial because the rating is an implicit statement of clients' experiences with an adviser or IAR and because the rating purports to convey the experience of a hypothetical average, or typical, client with an adviser or IAR.

^{10/} Advisers Act Release No. 121 (Nov. 2, 1961) (adopting Rule 206(4)-1).

^{11/} Richard Silverman (pub. avail. Feb. 25, 1985) ("Silverman").

^{12/} See, e.g., Cambiar Investors, Inc. (pub. avail. Aug. 28, 1997).

^{13/} See Silverman; New York Investors Group, Inc. (pub. avail. Sept. 7, 1982) ("New York Investors").

As a result, we believe that a DALBAR rating would be a testimonial by DALBAR, notwithstanding that it is third-party report. 14/ For the same reasons, we also consider a DALBAR rating to be a testimonial by an adviser's clients, indirectly made through DALBAR.

Nonetheless, we would not recommend enforcement action to the Commission under Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(1) thereunder if DALBAR, any adviser, or any associated person of an adviser publishes, circulates, or distributes advertisements containing DALBAR ratings prepared in the manner described in your letter. We believe that the use of these ratings in advertisements would not raise any of the dangers that Rule 206(4)-1(a)(1) was designed to prevent because, based upon your representations, a DALBAR rating does not emphasize the favorable client responses or ignore the unfavorable responses; 15/ a DALBAR rating represents all, or a statistically valid sample, of the responses of an adviser's or IAR's clients; the questionnaire that is sent to the clients of participating advisers and IARs has not been prepared to produce any pre-determined results that could benefit any adviser or IAR; the questionnaire is structured to make it equally easy for a client to give negative or positive responses; and DALBAR does not perform any subjective analysis of the survey results, but instead assigns numerical ratings after averaging the client responses for each adviser or IAR.

14/ You cite Stalker Advisory Services (pub. avail. Jan. 18, 1994) ("Stalker") in support of your assertion that the mere payment of compensation by an adviser to an unbiased third party does not transform a report by the third party about the adviser's performance into a prohibited testimonial. We note, however, that the third-party report in Stalker was not a testimonial, regardless of the payment of any fee to the third party by the adviser, because the third party merely verified and published the investment performance of certain accounts managed by the adviser, which performance the adviser could have published directly without implicating Rule 206(4)-1(a)(1).

In contrast, DALBAR solicits the views of clients about their experience with an adviser or IAR, thus creating a rating that contains an implicit statement of the experience of a typical client with the adviser or IAR. Because we conclude that a DALBAR rating contains a client testimonial, and that therefore a DALBAR rating is itself a testimonial, we do not need to determine whether DALBAR's receipt of compensation from participating advisers or IARs would transform a DALBAR rating into a testimonial.

15/ Because an adviser or IAR can receive DALBAR ratings in various categories, we note that an advertisement for an adviser or IAR that included one or more favorable ratings while ignoring one or more unfavorable ratings could present the dangers that Rule 206(4)-1(a)(1) was designed to prevent.

In taking this position, we rely in particular on your representations discussed in the previous paragraph and your representations that: (1) participating advisers and IARs will have met the eligibility criteria described above, or similar criteria reasonably designed to ensure that a participating adviser or IAR has an established and significant history and a record free from regulatory sanctions; (2) DALBAR will not be affiliated with any participating adviser or IAR; 16/ (3) DALBAR will survey all or, as appropriate, a statistically valid sample, of a participating adviser's or IAR's clients; (4) all participating advisers and IARs are charged a uniform fee, paid in advance; (5) DALBAR will not issue ratings to an adviser or IAR unless the ratings are statistically valid with respect to that adviser or IAR; and (6) any survey results published by DALBAR will contain information that clearly identifies the percentage of survey participants who have received each designation listed in note 9 and the total number of survey participants. You should note that any different facts or representations may require a different conclusion.

We note that the use of DALBAR ratings in advertisements by investment advisers and IARs would be subject to Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder. 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) of the Advisers Act 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. 17/ Generally, an advertisement may be considered false or misleading if it implies, or would lead a prospective client to infer, something about the adviser or IAR or its clients' experiences that would not be true if all material facts had been disclosed. 18/


16/ We note that if an investment adviser participated in a survey of its clients that was created or conducted by that adviser, or by a person affiliated with the adviser, the advertising, indirectly or directly, of any resulting ratings by that adviser could present the dangers that Rule 206(4)-1(a)(1) was designed to prevent.

17/ 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.").

18/ See, e.g., New York Investors Group.

We express no view on whether a particular presentation of DALBAR ratings in an advertisement by advisers or IARs would violate Section 206(4) and Rule 206(4)-1(a)(5). We are, however, taking the opportunity to provide guidance regarding some factors that advisers and IARs should consider when determining whether any advertisement containing a DALBAR rating is false or misleading:

1. Whether the advertisement discloses the criteria on which the rating was based;
2. Whether an adviser or IAR advertises any favorable rating without disclosing any facts that the adviser or IAR knows would call into question the validity of the rating or the appropriateness of advertising the rating (e.g., the adviser or IAR knows that it has been the subject of numerous client complaints relating to the rating category or in areas not included in the survey);
3. Whether an adviser or IAR advertises any favorable rating without also disclosing any unfavorable rating of the adviser or IAR (or the adviser that employs the IAR);
4. Whether the advertisement states or implies that an adviser or IAR was the top-rated adviser or IAR in a category when it was not rated first in that category;
5. Whether, in disclosing an adviser's or IAR's rating or designation 19/, the advertisement clearly and prominently discloses the category for which the rating was calculated or designation determined, the number of advisers or IARs surveyed in that category, and the percentage of advisers or IARs that received that rating or designation;
6. 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 adviser's or IAR's clients;
7. Whether the advertisement discloses that the rating is not indicative of the adviser's or IAR's future performance; and
8. Whether the advertisement discloses prominently who created and conducted the survey, and that advisers and IARs paid a fee to participate in the survey.


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19/ See note 9.