

ACT 1777
SECTION § 206(4)
RULE Rule 206(4)-1(a)(2)
PUBLIC
AVAILABILITY 12-10-98

PUBLIC

Effective November 4, 2022, This Letter is Withdrawn. Please consult the following web page for more information: <https://www.sec.gov/divisions/investment/im-modified-withdrawn-staff-statements>

December 10, 1998
Our Ref No. 98-11-CC
Franklin Management, Inc.
File No. 801-13802

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter of December 7, 1998 seeks assurance that the staff would not recommend enforcement action to the Commission under Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 206(4)-1(a)(2) thereunder if, as described more fully below, Franklin Management, Inc. ("Franklin"), a registered investment adviser, distributes to existing and prospective advisory clients a quarterly report which identifies and discusses some, but not all, of the specific securities bought, sold, or held by the adviser for investment advisory accounts.

Facts

Franklin Management, Inc. ("Franklin") is an investment adviser registered under the Advisers Act. You represent that Franklin provides investment advice and management services to individuals, institutions and non-profit organizations (the "advisory clients"). Each of the advisory client accounts managed by Franklin (the "managed accounts") typically falls within a specific investment category (e.g., growth, fixed-income) that reflects the advisory client's investment objectives. Currently, Franklin prepares a quarterly report for each separate investment category that discusses recent market developments and the adviser's market outlook (the "Reports"). Franklin sends these Reports to existing advisory clients with managed accounts, and to prospective advisory clients.

Franklin proposes to include in the Reports information about some of the specific portfolio management decisions made during the preceding quarter, and some of the reasons for those decisions. Specifically, Franklin wants to identify and discuss specific securities that were bought, sold, or held for managed accounts within an investment category, some of the reasons for the management decisions affecting managed accounts in a specific category, or a brief analysis of the issuer of the security. You believe that this information could be useful to existing and prospective clients because it could help them to better understand the adviser's actions, and the reasons underlying the adviser's investment decisions. You also state that some existing and prospective clients specifically have requested that this type of information be included in the Reports.

You represent that Franklin will use objective, non-performance based criteria to select the securities that it will list and discuss in a Report. For example, Franklin might select securities based upon the largest dollar amount of purchases or sales of securities made for managed accounts in a category, the largest positions held during the quarter by managed accounts in a category, or some other objective criteria. You represent that Franklin will use the same selection criteria for each quarter for a particular investment category. You also represent that the Reports will not discuss, directly or indirectly, the amount of any profits or losses, realized or unrealized, of any of the specific securities. You represent that each Report will contain disclosure that generally states that the specific securities identified and described

do not represent all of the securities purchased, sold, or recommended for advisory clients, and that the reader should not assume that investments in the securities identified and discussed were or will be profitable. You further represent that you will maintain, and make available to the Commission staff upon request, records that evidence: (1) the complete list of all securities recommended by Franklin in the preceding year for the specific investment category covered by each Report; (2) the information set forth in Rule 206(4)-1(a)(2)(A) for each recommendation;¹ and (3) the criteria used to select the specific securities listed in each Report.²

You state that it would not be practical to prepare and distribute Reports that list all of the securities, with all of the information contemplated by Rule 206(4)-1(a)(2), that Franklin has purchased, sold, or recommended to advisory clients during the preceding year (*e.g.*, Franklin has recommended over 500 specific securities within the preceding year period). You also state that it would not be feasible for Franklin to prepare an individualized written report for each advisory client because of the large number of accounts under management. You further contend that it is not necessary to prepare individualized written reports for each client because most managed accounts in the same investment category will be invested in similar proportions in substantially the same securities.³

Analysis

Section 206(4) of the Advisers Act prohibits investment advisers 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)(2) under the Advisers Act generally provides that

¹Rule 206(4)-1(a)(2)(A) provides that the rule's prohibition against including past specific recommendations that were or would have been profitable in an advertisement does not apply if the advertisement includes or offers to furnish a list of all recommendations made by the adviser that includes the following information: (1) the name of each security recommended; (2) the date and nature of each recommendation (*e.g.*, whether to buy, sell or hold); (3) the market price at the time of the recommendation; (4) the price of the security when the recommendation was to be acted upon; (5) the market price of each such security at the most recent practicable date, and (6) a disclaimer regarding the profitability of recommendations in the future.

²Telephone conversation on December 9, 1998 between Lawrence Stadulis, counsel for Franklin, and Mercer Bullard of the Commission staff.

³You represent that Franklin operates the managed accounts in accordance with Rule 3a-4 under the Investment Company Act of 1940. Rule 3a-4 provides a non-exclusive safe harbor from the definition of "investment company" for certain investment advisory programs that are designed to provide the same or similar portfolio management services on a discretionary basis to a large number of clients. You do not seek our views, and we provide none, regarding the operation of Franklin's investment advisory programs under Rule 3a-4.

it is a fraudulent, deceptive or manipulative act, practice, or course of business for any investment adviser to publish, circulate, or distribute any advertisement⁴ “[w]hich refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person” Rule 206(4)-1(a)(2), however, does not prohibit an advertisement “which sets out or offers to furnish a list of all recommendations made by such investment adviser” during the preceding year, provided that the advertisement or the list contains certain specific disclosure about the recommendations.⁵

When the Commission adopted Rule 206(4)-1, it stated that advertisements containing past specific recommendations were inherently misleading because “by their very nature they emphasize the comments and the activities favorable to the investment adviser and ignore those which were unfavorable.”⁶ The primary concern underlying the prohibition against advertisements containing past specific recommendations is that an adviser could “cherry-pick” its profitable recommendations and omit the unprofitable ones.⁷ Under those circumstances, an advertisement could fraudulently or deceptively imply that the recommendations listed, and their profitability, are representative of the experience of the adviser’s clients. Thus, the staff consistently has interpreted Rule 206(4)-1(a)(2) as prohibiting advertisements containing only a selected list of past specific recommendations, even if accompanied by an offer to furnish the remainder in a separate list.⁸

By its terms, Rule 206(4)-1(a)(2) prohibits advisers from distributing advertisements containing only “past specific recommendations.” Thus, an advertisement that lists only the

⁴Franklin’s Reports would be “advertisements” as that term is defined in Rule 206(4)-1(b) under the Advisers Act because they would be communications addressed to existing and prospective clients that offer advisory services regarding securities. See Munder Capital Management (pub. avail. May 17, 1996) (“[m]aterials designed to maintain existing clients or solicit new clients for the adviser are considered to be advertisements within Rule 206(4)-1.”).

⁵See n.1, supra.

⁶Advisers Act Release No. 121 (Nov. 2, 1961) (“Adopting Release”).

⁷See Starr and Kuehl, Inc. (pub. avail. Apr. 17, 1976) (providing prospective clients with selected past issues of an adviser’s newsletter in order to solicit new subscribers could violate Rule 206(4)-1(a)(2)).

⁸See Dow Theory Forecasts, Inc. (pub. avail. Aug. 26, 1983) (“Rule 206(4)-1(a)(2) does not permit an advertisement which refers, directly or indirectly, to past specific recommendations of an investment adviser which were or would have been profitable to any person even if the advertisement offers to provide a full list of all recommendations made during the preceding period of not less than one year with all the details specified in the rule.”). See also James B. Peeke & Co. (pub. avail. Sep. 13, 1982); J.D. Minnick & Co. (pub. avail. Apr. 30, 1975).

current recommendations⁹ of an adviser would not be subject to Rule 206(4)-1(a)(2).¹⁰ The Reports would not contain only current recommendations, however, because you propose that the Reports include discussion and analysis of specific securities that Franklin may no longer be recommending.

Rule 206(4)-1(a)(2) prohibits advertisements that contain past specific recommendations which “were or would have been profitable to any person.”¹¹ You contend that the Reports do not fall within the literal prohibition of Rule 206(4)-1(a)(2) because they will not state, directly or indirectly, whether any of the specific securities identified and discussed in the Reports were or would have been profitable. You also contend that, because the specific securities that would be discussed in the Reports would be selected based upon objective, non-performance based criteria that would be consistently applied, the Reports would not emphasize the favorable recommendations and ignore the unfavorable, and thus should not be prohibited by Rule 206(4)-1(a)(2).

We disagree. The express wording of Rule 206(4)-1(a)(2)¹² prohibits any advertisement that contains selected past specific recommendations that were or would have been profitable regardless of whether the advertisement directly or indirectly states whether the recommendations were or would have been profitable. Rule 206(4)-1(a)(2) was intended to prohibit advertisements by an investment adviser that would give existing or prospective clients a misleading impression of an adviser’s performance by selectively referring to profitable past recommendations of the adviser while ignoring the unprofitable.¹² To prevent such misleading advertisements, the Commission adopted a broad prohibition against advertisements containing selected past specific recommendations that were or would have been profitable.

⁹Whether a specific recommendation is a past recommendation or a current recommendation will depend largely on the facts and circumstances as of the time that the advertisement is distributed to a recipient. For example, an advertisement containing only an adviser’s current recommendations, and thus was not subject to Rule 206(4)-1(a)(2), could fall within the prohibition of the rule if the advertisement were distributed after the adviser ceases recommending any of the particular securities listed, or if the advertisement indicated that any of the current recommendations listed were recommended by the adviser in the past. See, e.g., Starr and Kuehl, supra n.7 (once current recommendations that had become stale).

¹⁰Advertisements that contain an adviser’s current recommendations, however, are subject to Rule 206(4)-1(a)(5) under the Advisers Act. Rule 206(4)-1(a)(5) generally prohibits advisers from distributing advertisements that contain any untrue statement of material fact or are otherwise false or misleading.

¹¹Rule 206(4)-1(a)(2) does not prohibit an adviser from distributing advertisements that identify and discuss the adviser’s unprofitable recommendations.

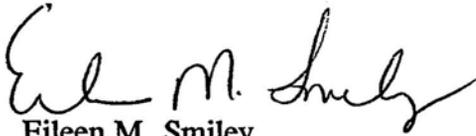
¹²See Adopting Release, supra n.6; Starr and Kuehl, supra n.7.

Nonetheless, we would not recommend enforcement action to the Commission under Section 206(4) pursuant to Rule 206(4)-1(a)(2) if Franklin distributes the Reports, prepared and presented in the manner described in your letter, to existing or prospective clients. As discussed above, Rule 206(4)-1(a)(2) was intended to prevent an adviser from distributing advertisements that would give clients a misleading impression of the adviser's performance by emphasizing its profitable recommendations while ignoring its unprofitable ones. We believe that Reports prepared and presented in the manner described in your letter could be useful information to existing and prospective clients, and do not raise the dangers that Rule 206(4)-1(a)(2) was designed to prevent. The use of objective, non-performance based selection criteria should limit an adviser's ability to cherry-pick its profitable recommendations to the exclusion of its unprofitable ones, and this, coupled with the requirement that the Reports will not discuss the amount of profit or loss of any particular security recommended by the adviser, should prevent an advertisement from misleading clients about an adviser's performance based solely upon the inclusion of past specific recommendations. Thus, in taking this position, we rely in particular on your representations that: (1) Franklin will use objective, non-performance based criteria to select the specific securities that it will list and discuss in the Reports; (2) Franklin will use the same selection criteria for each quarter for each particular investment category; (3) the Reports will not discuss, directly or indirectly, the amount of the profits or losses, realized or unrealized, of any of the specific securities; and (4) Franklin will maintain the records described above, and, upon request, make them available for inspection by the staff of the Commission.

This letter addresses only an adviser's responsibilities with respect to Section 206(4) of the Advisers Act as defined solely by Rule 206(4)-1(a)(2) thereunder. Advisers that distribute advertisements containing selected past recommendations must ensure that the advertisements comply with Rule 206(4)-1(a)(5) under the Advisers Act.¹³ Advisers that distribute

¹³Rule 206(4)-1(a)(5) provides that it is a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for any adviser to distribute, directly or indirectly, any advertisement that contains any untrue statement of material fact or that is otherwise false or misleading. Whether a particular advertisement is false or misleading depends upon all the relevant facts and circumstances. *See, e.g.,* Anametrics Investment Management (pub. avail. May 5, 1977) (whether an advertisement is misleading will depend upon all of the particular facts, including the form and content of the advertisement, the implications or inferences arising out of the context of the advertisement, and the sophistication of the recipient of the advertisement).

advertisements containing past specific recommendations also remain subject to the prohibitions of Sections 206(1) and (2) of the Advisers Act.¹⁴



Eileen M. Smiley
Senior Counsel

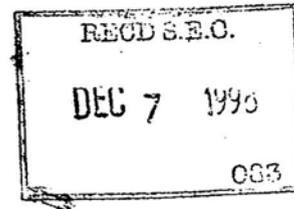
¹⁴See *Cambiar Investors, Inc.* (pub. avail. Aug. 28, 1997) (staff concurred with the view that an advertisement containing a partial client list was not a testimonial within the meaning of Rule 206(4)-1(a)(1), and agreed not to recommend enforcement action under Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) if an adviser distributed an advertisement that contained a partial client list if the selection criteria were objective and unrelated to the performance of the clients' accounts, and the advertisement contained certain disclosure and a disclaimer).

1800 M Street, N.W.
Washington, D.C. 20036-5869
202-467-7000
Fax: 202-467-7176

**Morgan, Lewis
& Bockius LLP**
C O U N S E L O R S A T L A W

December 7, 1998

Douglas J. Scheidt, Esq.
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549



Re: Rule 206(4)-1 Under the Investment Advisers Act of 1940

Dear Mr. Scheidt:

The purpose of this letter is to request that the staff of the Division of Investment Management concur with our view that Rule 206(4)-1(a)(2) under the Investment Advisers Act of 1940 ("Advisers Act") would not prohibit Franklin Management Inc. ("FMI") from providing to existing or prospective clients advisory reports which identify and discuss some, but not all, of the specific securities bought, sold or held for accounts that FMI managed during the last calendar quarter, under the circumstances described below. In the alternative, this letter requests assurance that the staff will not recommend enforcement action to the Securities and Exchange Commission ("SEC") under Rule 206(4)-1(a)(2) if FMI distributes such reports to existing or prospective clients.

Background

The Franklin Templeton Group includes a number of advisers (the "Franklin Templeton Advisers") that are registered with the SEC under the Advisers Act. Franklin Templeton Advisers have been engaged in the investment management business for many years and serve a large number and variety of clients throughout the world. In addition to providing investment advice to investment companies organized in the United States and abroad,

WA05/36675.4

Philadelphia Washington New York Los Angeles Miami Harrisburg Pittsburgh Princeton
London Brussels Frankfurt Tokyo Singapore Jakarta

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Franklin Templeton Advisers offer private account management services to individuals, institutions and non-profit organizations. As of September 30, 1998, Franklin Templeton Advisers managed approximately \$208 billion in private account assets.

Certain Franklin Templeton Advisers, including FMI, provide private account clients and prospective clients with quarterly or other periodic reports discussing recent market developments and their market outlook, investment strategies and any changes in strategies since the prior quarter. Because managed accounts typically fall into separate investment categories, a separate "Investment Outlook" report may be written for each investment category and sent to all clients with accounts in that category.

Given the large number of accounts under management by each Franklin Templeton Adviser, it is not feasible to write a separate "Investment Outlook" report for each client, nor is it necessary since most accounts in a given category are generally invested in substantially the same securities and in similar proportions, in accordance with the conditions of Rule 3a-4 under the Investment Company Act of 1940.

FMI would like to be able to include in its "Investment Outlook" reports information about some of its specific portfolio management decisions during the most recent calendar quarter, and the reasons for these decisions. Specifically, FMI wishes to be able to identify, by name, and to discuss in the reports several specific securities that were bought, sold or held for managed accounts during a given quarter, and explain the reasons for each such buy, sell or hold decision or provide a brief analysis and review of the issuer of the securities. FMI believes that this information would be useful to current and prospective clients and would help them better understand and appreciate the actions taken and the thinking behind FMI's investment approaches. Some existing and prospective clients have specifically asked that this type of information be included in the "Investment Outlook" reports.

It would not be practical to prepare a report which attempted to discuss or even to list all securities which FMI has purchased, sold or recommended to its clients over the past full year. FMI typically recommends more than 500 securities during the course of a single year to its clients. As a result, it would not be practical to include in each "Investment Outlook" report even a simple listing of these securities, let alone a detailed report concerning them. Also, the utility of such a comprehensive listing or detailed report would be extremely limited given the fact that FMI manages at least six separate categories of client investment accounts, each of which invests in different types of securities. For example, a client following a tax exempt investment strategy is not likely to be interested in small cap or real estate securities recommended by FMI.

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Therefore, FMI proposes to discuss in each "Investment Outlook" or similar report a limited number of specific securities drawn from the portfolio holdings of accounts in the particular investment category covered by the report. These securities will be selected on the basis of objective, non-performance based criteria consistently applied. For example, FMI may discuss the three largest purchases and the three largest sales by dollar size made for the accounts in a category during the quarter or the three largest account holdings during a quarter. Other non-performance related selection criteria could include selections made on an alphabetical or other rotational basis among portfolio holdings. The selection criteria will be consistently applied from quarter to quarter for each investment category for which a report is written. There will be no mention of the amount of profits or losses, realized, unrealized or expected, on any of the securities identified and discussed.

Each "Investment Outlook" report will include cautionary statements along the following lines:

The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings.

It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

Applicable Law

Rule 206(4)-1(a)(2) under the Advisers Act makes it a fraudulent, deceptive or manipulative act, practice or course of business for any investment adviser to use any advertisement:

Which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person; *provided, however*, that this shall not prohibit an advertisement which sets out or offers to furnish a list of all recommendations made by such investment adviser within the immediately preceding period of not less than one year if such advertisement, and such list if it is furnished separately: (A) state the

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name of each such security recommended, the date and nature of each such recommendation (e.g., whether to buy, sell or hold), the market price at that time, the price at which the recommendation was to be acted upon, and the market price of each such security as of the most recent practicable date, and (B) contain the following cautionary legend on the first page thereof in print or type as large as the largest print or type used in the body or text thereof: "It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list."

Paragraph (a)(2) of Rule 206(4)-1 is intended to prohibit advertisements by an investment adviser which would give prospective advisory clients a misleading impression of the adviser's investment performance by referring only to past specific recommendations of the adviser which were or would have been profitable while ignoring those recommendations which were unprofitable, a practice also known as "cherry picking." See, e.g., *Foster & Marshall Inc.* (avail. Feb. 18, 1977).

As noted above, specific securities discussed in the reports will be selected on the basis of non-performance based objective criteria that are consistently applied. We believe our proposal is consistent with prior staff interpretations under Rule 206(4)-1(a)(1), which prohibits client testimonials in investment advertisements. Under these interpretations, the staff did not object to the inclusion of a partial client list in adviser advertisements where the clients included in the list were selected on the basis of criteria that were not performance-based.

We are aware that the staff has interpreted paragraph (a)(2) of Rule 206(4)-1 to prohibit references to selected past recommendations of an investment adviser which were or would have been profitable, unless all recommendations made within the immediately preceding year also are set forth in the advertisement with all the necessary details and disclosure statement. See, e.g., *Dow Theory Forecasts, Inc.* (available Aug. 26, 1983).

We believe, however, that the use of materials that do not "cherry pick" profitable recommendations, that use objective, non-performance based criteria to identify certain holdings or transactions, and that do not discuss the amount of profits would not violate paragraph (a)(2). Further, we believe that the type of reports described in this letter would not be inherently fraudulent or misleading.

Recent actions suggest that the SEC may be willing to reevaluate its past interpretation of the past specific recommendation rule. In *the Matter of Stellar Management, Inc.*, Advisers Act Release No. 1416 (June 6, 1994), the SEC found that an adviser had violated Rule 206(4)-1 by

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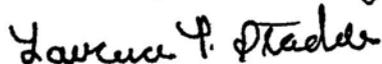
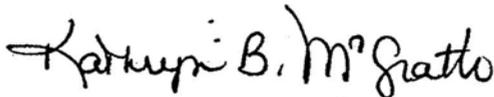
using an advertisement for its investment newsletter "which advertisement referred, directly or indirectly, to past specific recommendations . . . which were or would have been profitable to any person but did not set out or offer to furnish a list of all recommendations made."

It is clear that clients appreciate and want the type of explanations of actual purchase and sale decisions that FMI proposes to provide. We believe that, as long as the information is not provided in a misleading manner, FMI should be permitted to provide factual information regarding recent portfolio activity. Where, as we propose, objective, non-performance related criteria are used to select certain securities out of those recommended by FMI over the course of a year, we believe that the policies and purposes, as well as the literal language of Rule 206(4)-1, permit FMI to identify and discuss those securities. Use of such criteria will ensure that FMI is not portraying "selected past recommendations which were or would have been profitable." In addition, as stated above, there will be no reference to specific profits made with respect to any security.

Conclusion

We believe that the plain meaning of Rule 206(4)-1 permits the use of selected past specific recommendations selected without regard to profitability, in FMI's advertisements, particularly where the other terms and conditions described herein are met. We ask that the staff concur with our view. Please contact Kathryn B. McGrath at (202) 467-7149 or Lawrence P. Stadulis at (202) 467-7405 if you have any questions or comments pertaining to this matter.

Very truly yours,



Kathryn B. McGrath
Lawrence P. Stadulis