

Letter on NASDR Request for Comment on Related Performance Information, September 1997

September 29, 1997

Ms. Joan C. Conley
Office of Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500

**Re: Presentation of Related Performance Information
(NASD Regulation Request for Comment 97-47)**

Dear Ms. Conley:

The Investment Company Institute¹ appreciates the opportunity to respond to NASD Regulation, Inc.'s request for comment on the potential benefits and concerns associated with the presentation of related performance information in mutual fund sales material.² As more fully discussed below, the Institute supports permitting the presentation of certain types of related performance information, but believes that it is important to maintain certain standards and limitations with regard to such information in order to ensure that it is presented in a fair and balanced manner.

I. Background

In the past two years, the Division of Investment Management of the Securities and Exchange Commission has issued a series of no-action letters that permit mutual funds to present a range of performance information in their sales material and prospectuses in specific factual situations and subject to certain conditions. These letters can be categorized as allowing the performance of: (1) an unregistered private account or fund that is converted into a registered mutual fund to be included as part of the registered fund's track record (the MassMutual no-action letter);³ (2) a substantially similar mutual fund managed by the same portfolio manager to be included in a newer, unaffiliated mutual fund's prospectus (the Bramwell no-action letter);⁴ and (3) a substantially similar unregistered private account or registered mutual fund to be included in the prospectus and sales material of a mutual fund managed by the same investment adviser (the Nicholas-Applegate I & II, ITT-Hartford, and GE Funds no-action letters).⁵ The Request for Comment refers to these types of performance information as "Related Performance Information."

Although these no-action letters indicate that the SEC staff will not recommend enforcement action for presentation of Related Performance Information in mutual fund sales material in appropriate circumstances, to date NASDR generally has not permitted Related Performance Information in mutual fund sales material.⁶ The Request for Comment seeks comment on the potential benefits and concerns associated with the presentation of Related Performance Information.

For purposes of these comments, the registered mutual fund whose shares are being advertised is referred to as the "Advertised Fund." An unregistered private account whose performance is included for purposes of promoting the Advertised Fund's shares is referred to as a "Private Account." A registered investment company whose performance is included for purposes of promoting the Advertised Fund's shares is referred to as a "Comparison Fund."

II. Summary of Position

NASDR should permit mutual fund sponsors to include as part of an Advertised Fund's performance record the performance of an unregistered predecessor entity (as permitted in the MassMutual no-action letter), but only under narrow circumstances. In particular, NASDR should permit sponsors of such Advertised Funds to include in the fund's track record only the performance of bona fide entities (1) that were not created for the purpose of establishing a track record and (2) that were managed in all material respects

equivalent to the manner in which the Advertised Fund is managed. In addition, any such performance record should be accompanied by information reflecting the performance of the Advertised Fund after its conversion, once the fund has been in existence for at least one year.

NASDR should not permit in sales material the presentation of performance of another mutual fund previously managed by the Advertised Fund's portfolio manager while he or she was with an unaffiliated investment advisory firm (the fact pattern in the Bramwell no-action letter). Such performance information would be confusing to investors, would create situations where different funds would be advertising the same track record, and would allow outdated performance of the previous fund to be advertised.

NASDR should allow mutual fund sponsors to include in an Advertised Fund's sales material the performance of substantially similar Private Accounts and Comparison Funds managed by the same investment adviser, or under certain circumstances, an affiliate of the investment adviser, subject to a number of conditions. In addition to requiring the conditions and representations contained in the Nicholas Applegate II, ITT-Hartford Mutual Funds, and GE Funds no-action letters, NASDR should: (1) require any such Related Performance Information to be presented less prominently than the Advertised Fund's own performance; (2) prohibit references to Related Performance Information in headlines; (3) prohibit rankings based on Related Performance Information; (4) require disclosures of significant differences between the Advertised Fund and the Private Accounts and Comparison Funds, including significant differences in advisory personnel; (5) generally require all Private Account performance to be computed on a composite basis, adjusted for the Advertised Fund's current fees, and otherwise in accordance with the standards established by the Association for Investment Management and Research; (6) require any Related Performance Information to be as current as the Advertised Fund's performance; and (7) require all Private Accounts with investment objectives, policies, and strategies that are substantially similar to those of the Advertised Fund to be included in the composite (to avoid "cherry-picking").

Each of these recommendations, as well as other matters, are discussed in detail below.

III. Potential Concerns with Related Performance Information

The purpose of presenting Related Performance Information is to provide additional information regarding the past performance of similar Private Accounts or Comparison Funds that have been managed by the same investment adviser (or under certain circumstances, an affiliate of the adviser) or portfolio manager that manages the Advertised Fund. Under certain circumstances and with appropriate disclosures, Related Performance Information can be of benefit to potential investors and provide a "sound basis" for making an investment decision for purposes of NASD Conduct Rule 2210. Nevertheless, Related Performance Information should not be misused and any presentation of such information should be fair and balanced. Additionally, while investors may find Related Performance Information useful in making an investment decision, investors do not need this information to do so, and mutual funds should not be required to provide it.

Accordingly, NASDR should establish appropriate conditions and standards governing the use of Related Performance Information which take into account these concerns. Set forth below are our views on which conditions and standards should apply to particular types of Related Performance Information to adequately address these concerns.

A. Conversion of a Prior Unregistered Account into a New Mutual Fund

The Institute generally concurs with the standards adopted by the SEC staff in the MassMutual no-action letter with respect to a newly created mutual fund assuming the past performance of a predecessor unregistered account. In the MassMutual no-action letter, the staff permitted newly created mutual funds to include the performance records of corresponding predecessor unregistered accounts based in part on the representations that: (i) each registered fund was managed in a manner that was in all material respects equivalent to the manner in which the corresponding predecessor unregistered account was managed; and (ii) the predecessor unregistered accounts were created for purposes entirely unrelated to the establishment of a performance track record.⁷ However, under no circumstances should a mutual fund be required to report the pre-inception performance of an unregistered account. A prospective investor does not need this performance to make an informed decision. Additionally, a fund may have good reasons to exclude predecessor performance. For example, it may be difficult or impossible to adjust the predecessor fund's performance to replicate the Advertised Fund's deduction of expenses, or the predecessor fund may be too small to provide a meaningful performance figure.

We share NASDR's concern that the MassMutual no-action letter could be misinterpreted to encourage mutual fund sponsors to create "incubator" private funds or accounts and convert only those funds or accounts that have successful performance records into registered mutual funds. In the MassMutual no-action letter, the requester represented that the unregistered accounts that were converted to mutual funds were created for reasons wholly unrelated to the establishment of a performance track record. NASDR should only allow the Related Performance Information of a predecessor entity to be included in the Advertised Fund's track record if the predecessor entity meets this standard. NASDR should not permit sales material under any circumstances to include Related Performance Information of "incubator" predecessor entities.

To further prevent over-emphasis of the predecessor entity's performance, NASDR should require a mutual fund that has been in existence for at least one year to disclose the fund's performance record since the conversion date in addition to its performance which includes the predecessor entity's performance. This requirement will provide a prospective investor with helpful information on how the fund has performed since it has become a registered mutual fund as well as how its predecessor entity performed. In addition, NASDR should not permit rankings of an Advertised Fund that take into account the predecessor's performance. Although many ranking entities already do not take into account predecessor entity performance when ranking mutual funds, establishing this policy as a uniform rule will help lead to more consistent industry-wide rankings.

B. Portability of Individual Portfolio Manager's Track Record

In *Bramwell Growth Fund* (pub. avail. Aug. 7, 1996), the SEC staff granted no-action relief to permit the *Bramwell Growth Fund* to disclose in its prospectus the prior performance of an unaffiliated mutual fund with substantially similar investment objectives and policies for which the *Bramwell Growth Fund's* portfolio manager previously served as portfolio manager. The *Bramwell* letter raises many troubling issues, and for the following reasons, NASDR should not permit mutual fund sales material to include this type of Related Performance Information.

In almost all cases, a fund's performance is not only the result of an individual portfolio manager's investment decisions, but also the result of the other factors involving the human, technological and financial resources of the investment advisory firm that employed the portfolio manager. These factors include research performed by the adviser's stock market analysts, favorable execution by stock traders, and various efforts of other investment adviser personnel and technology involved in the portfolio management process. Thus, it seems highly unlikely that this no-action relief would be available in circumstances other than those described in *Bramwell*, because it is extremely rare that there are situations where no factor other than the portfolio manager's own investment decisions is responsible for a mutual fund's performance.⁸

Indeed, in analogous contexts, the SEC staff has considered a fund's track record to reflect the efforts of an entire advisory firm's personnel rather than the efforts of a single individual. For example, the staff has permitted a mutual fund to exclude fund performance prior to the date a new investment adviser began managing the fund only where all of the new adviser's investment advisory and portfolio management services were provided and supervised exclusively by officers and employees who had no prior affiliation with the previous adviser or any of its affiliates, i.e., where there has been a complete change in the advisory organization.⁹ In contrast, where an officer of a new adviser had previously worked for the old adviser, the SEC staff did not allow a mutual fund to exclude performance prior to the date that the new adviser took over.¹⁰ Under this standard, it seems clear that a fund could not exclude past performance simply because of a change in the portfolio manager. It would be inconsistent to, at the same time, permit a fund to advertise the track record of the fund that the portfolio manager previously worked for. In addition to being inconsistent, allowing funds to present this type of Related Performance Information would create circumstances under which two mutual funds (the Advertised Fund and the previous fund managed by the portfolio manager) would be advertising the same performance record. This will undoubtedly lead to customer confusion.

Moreover, in most cases where a portfolio manager changes investment advisory firms, any Related Performance Information on another mutual fund previously managed by that portfolio manager at his or her old firm will not be current. This is often the case because, typically, a period of time will have passed since the Advertised Fund's portfolio manager ceased managing the assets of the other fund. The usefulness of such Related Performance Information will diminish with time. Accordingly, NASDR should not permit fund sponsors to include in mutual fund sales material Related Performance Information of the type that was permitted to be included in prospectuses in *Bramwell*.

C. Performance Records of Comparison Funds and Private Accounts

In the *Nicholas-Applegate II*, *ITT Hartford Mutual Funds*, and *GE Funds* no-action letters, the SEC staff permitted, subject to a number of conditions, mutual fund advertising and sales literature to include performance information of other registered investment companies and certain private accounts. While presentation of this type of Related Performance Information can provide useful supplemental information in certain circumstances, care must be taken to ensure that it is presented in a manner that minimizes potential customer confusion and misuse. Set forth below are our specific recommendations for standards and conditions that NASDR should apply in this area.

In a number of instances below, we recommend that different standards be adopted for Related Performance Information of Private Accounts than for Related Performance Information of Comparison Funds.¹¹ This is because the performance of registered mutual funds is standardized and strictly regulated pursuant to SEC rules and guidelines under the Investment Company Act of 1940 and the Securities Act of 1933. In contrast, Private Account performance is not subject to uniform federal standards. Accordingly, Private Account performance requires closer scrutiny.

1. Disclosure Standards

The Nicholas-Applegate II, ITT Hartford, and GE Funds no-action letters impose various disclosure requirements. While we support these conditions, there also should be additional specific disclosure requirements to prevent over-emphasis of Related Performance Information. First, those letters included the representation that the Private Account performance information would be presented "no more prominently" than the Advertised Fund's performance. NASDR should go further and require that any such Related Performance Information of Private Accounts should be less prominent than the Advertised Fund's performance information. Second, headlines that are contained in advertising that includes Private Account Related Performance Information should not refer to the Private Account performance information. Third, no ranking information concerning Comparison Funds or Private Accounts should be permitted in sales material for the Advertised Fund. Fourth, material differences between the Advertised Fund and any Comparison Fund or Private Account, such as significant differences in advisory personnel, should be disclosed.

NASDR should not however, establish a uniform, mandatory disclosure in all cases where Related Performance Information is presented. Often the context of the presentation will dictate different disclosures. NASDR also should require that disclosures be kept as simple and non-technical as possible to further the goal of investor understanding.

There may be situations where it will not be feasible (for example, due to space limitations) to provide the disclosures that should accompany Related Performance Information (e.g., a small newspaper advertisement). In such situations, the presentation of Related Performance Information may not be appropriate. In addition, if Related Performance Information is presented in sales material that is not accompanied or preceded by a prospectus (i.e., a Rule 482 omitting prospectus), presumably this performance information, as well as a description of how it is calculated, should also appear in the Advertised Fund's prospectus or statement of additional information.

Graphs or charts showing Private Account Related Performance Information should be permitted only if they are fair and balanced and are used under appropriate circumstances. In situations where an Advertised Fund has at least one year of performance, NASDR should permit the use of a "mountain chart" or other similar chart or graph that suggests that a particular dollar investment in a Private Account composite would have yielded a particular dollar return only if it is accompanied by a similar, more prominent chart or graph showing the Advertised Fund's performance.

2. Standards for Calculating Related Performance Information

a. AIMR Standards for Private Account Composites

Most investment advisory firms compute Private Account performance in accordance with standards established by the Association for Investment Management and Research. Based on an informal survey of our members, we understand that in many cases it would be impossible to recalculate Private Account performance in accordance with the procedures established for mutual funds under Form N-1A. Nevertheless, Private Account performance should be computed in a uniform manner to improve comparability among fund advisers.

Accordingly, NASDR should require that Related Performance Information of Private Accounts be computed in accordance with AIMR standards. In order to allow some flexibility for investment advisers that may have utilized different AIMR-approved methodology for calculating Private Account performance, NASDR should permit fund sponsors to calculate performance of Private Accounts based on either the Daily Valuation, Modified Dietz, or Modified BAI methods. In all cases, however, performance should be calculated on at least a monthly basis.

Performance of all Private Accounts should be presented as a composite figure that is asset-weighted in accordance with AIMR standards. To more closely reflect the performance of the Advertised Fund, Private Account performance should be adjusted to reflect the fees and expenses of the Advertised Fund. In recalculating the performance of the Private Account composite, generally a gross composite performance figure should be calculated for each performance period and the Advertised Fund's expenses should be deducted for that period. The frequency of deduction of expenses by the Advertised Fund should be approximated as closely as practicable to take into account the effects of compounding. Thus, for example, if the Advertised Fund deducts expenses on a daily basis, expenses should be deducted from the Private Account composite's gross returns on a daily basis if practicable, and if not practicable, no less frequently than monthly. In addition, the Private Account performance should reflect any front-end or back-end sales charge imposed by the Advertised Fund.¹²

b. Independent Verification of Performance

NASDR requested comment on whether it should permit the presentation of composite Private Account Related Performance Information only if it has been verified by a qualified, independent third party. Although there may be certain situations where review by an independent third party would be helpful in verifying the accuracy and comparability of performance information of such Private Accounts and Comparison Funds to that of the Advertised Fund, this verification should not be required in the ordinary course. As a practical matter, such verification would be extremely time-consuming and expensive and largely would prevent the use of Related Performance Information in sales material. As discussed above, however, mutual fund sponsors should be required to compute all Private Account Related Performance Information in accordance with AIMR standards except as otherwise noted.

c. Compliance with Rule 482 Requirements

To help prospective investors compare Private Account performance with the performance of other advisers' mutual funds, Related Performance Information should be presented in a manner that is similar to the presentation of standardized mutual fund performance. Accordingly, NASDR should impose requirements on the use of Private Account Related Performance Information that are similar to those required by the SEC for mutual fund performance under SEC Rule 482. Thus, for example, mutual fund sponsors should present Private Account composite returns over one-, five- and ten-year periods (as applicable) and (if the accounts have been in existence for less than ten years) since the inception of the composite. "Distribution rates" for Private Account composites should not be permitted.¹³

d. Presentation of Comparison Fund Performance

Comparison Funds' returns should be calculated in accordance with the standards established under Form N-1A and presented in accordance with the provisions of SEC Rule 482. Comparison Fund performance should not be recalculated to reflect the expenses of the Advertised Fund. However, if a Comparison Fund has different fees and expenses than the Advertised Fund, this fact should be disclosed. Sales material need not identify the name of the Comparison Fund so long as it identifies the investment adviser of the Comparison Fund.

e. Timeliness of Performance Information

Private Account composite and Comparison Fund performance information should be continually updated so that it is current with the Advertised Fund's performance information. If current Related Performance Information is no longer available for a composite of Private Accounts or a Comparison Fund (due to, for example, the closing or termination of all substantially similar Private Accounts that make up a composite or the termination of a Comparison Fund), Related Performance Information on such Private Accounts or Comparison Funds should not be included. In accordance with AIMR standards, a Private Account composite should include performance of a Private Account for each full period that it meets the "substantially similar" comparability test. The composite should not include performance of a Private Account for any period during some or all of which the Private Account had investment objectives which were not substantially similar to those of the Advertised Fund.

Related Performance Information can be useful to a prospective investor beyond the initial period before a mutual fund has established its own performance record. For example, even after a fund has one-year total return information, Related Performance Information on similarly managed Private Accounts may provide prospective investors with an idea of how the fund's investment strategy has performed over a longer period of time. Accordingly, there should not be any cut-off point after the inception of the Advertised Fund at which Private Account composite performance information may not be used to promote the Advertised Fund's shares.

3. Standard for Comparison

The performance of Comparison Funds and Private Accounts should be presented only if they reflect the same investment strategies used by the Advertised Fund, so that an investor is comparing "apples to apples." Accordingly, in determining whether the performance record of a Comparison Fund or Private Account should be included in an Advertised Fund's sales material, the Comparison Fund or Private Account should be managed in accordance with investment objectives, policies and strategies that are substantially similar in all material respects.

AIMR does allow, under certain circumstances, the inclusion in a private account composite of the performance of a single asset segment of a multiple asset portfolio.¹⁴ A multiple asset account, however, often will be managed differently than an account that focuses on a single category of assets. Thus, the inclusion of the performance of a single asset segment of a multiple asset account in a Private Account composite could be misleading. Accordingly, NASDR should not allow Private Account composites to include the performance of a single asset segment of a multiple asset private account.

4. Money Market Mutual Funds

NASDR should not permit the presentation of Related Performance Information in sales material for money market mutual funds. Given the unique requirements imposed on registered money market mutual funds under SEC Rule 2a-7, the presentation of such Private Account Related Performance Information would be inappropriate.

5. Advisory Personnel, Sub-Investment Advisers and Affiliated Entities

As discussed above, often the performance of an investment advisory firm reflects not only the efforts of a single portfolio manager or team of managers, but also the efforts of numerous other investment advisory personnel and the financial, technological and investment resources of the entire firm. Thus, the inclusion of the performance records of Comparison Funds and Private Accounts in sales material should not necessarily be limited to funds or accounts whose advisory personnel are substantially the same as those who manage the Advertised Fund; however, the extent to which there are common advisory personnel should be a factor in determining whether to allow the performance records of Comparison Funds or Private Accounts. If the advisory personnel for the

Advertised Fund are not substantially the same as those who managed the Comparison Funds or Private Accounts, disclosure to this effect should be required.

If the Advertised Fund employs a sub-investment adviser as well as an investment adviser, this factor is important in determining the performance of which other Private Accounts and Comparison Funds should be included in sales material for the Advertised Fund. Generally, under such circumstances, only Related Performance Information of Comparison Funds and Private Accounts managed by the sub-investment adviser should be presented. If the investment adviser retains substantially all portfolio management responsibility for the Advertised Fund's assets, however, only Related Performance Information of Comparison Funds and Private Accounts managed by the investment adviser should be presented. If both the adviser and sub-adviser retain substantial portfolio management responsibility, only Related Performance Information of Comparison Funds and Private Accounts that employ both the investment adviser and sub-investment adviser should be presented.

Under certain circumstances, it may be appropriate for an Advertised Fund to use the Related Performance Information of a Comparison Fund or a Private Account advised by an affiliated entity of the Advertised Fund's adviser or sub-adviser. Whether the use of such performance information is appropriate would depend on the factors applicable to the use of Related Performance Information of a Comparison Fund or Private Account advised by the Advertised Fund's adviser or sub-adviser, including the extent to which there are common advisory personnel and financial, technological and financial resources.¹⁵

6. "Cherry Picking"

To prevent a skewed presentation of the investment adviser's prior performance with respect to similarly managed Private Accounts, "cherry picking" of Private Accounts should not be permitted in determining which accounts are included in composites whose performance is presented in mutual fund advertising or sales literature. In accordance with AIMR standards, Related Performance Information on all Private Accounts managed by the Advertised Fund's investment adviser which have investment objectives, policies and strategies that are substantially similar in all material respects should be included in any such composites.

* * *

We appreciate the opportunity to comment on this important issue. If you have any questions about this matter, please contact the undersigned (202/326-5815).

Sincerely,

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Vice President and Senior Counsel

cc: R. Clark Hooper
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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,629 open-ended investment companies ("mutual funds"), 439 closed-end investment companies, and 11 sponsors of unit investment trust. Its mutual fund members have assets of about \$3.974 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

² NASD Notice to Members 97-47 (August 1997).

³ See MassMutual Institutional Funds (pub. avail. Sept. 28, 1995).

⁴ See Bramwell Growth Fund (pub. avail. Aug. 7, 1996).

⁵ See Nicholas-Applegate Mutual Funds (pub. avail. Aug. 6, 1996 and Feb. 7, 1997), ITT-Hartford Mutual Funds (pub. avail. Feb. 7, 1997) and GE Funds (pub. avail. Feb. 7, 1997).

⁶ Since the SEC staff's issuance of the MassMutual no-action letter, NASDR has permitted NASD members to include in sales material the performance of an unregistered predecessor fund as part of a registered mutual fund's track record under appropriate conditions. We understand that NASDR is currently reviewing its position concerning the presentation of predecessor performance as part of its comprehensive consideration of the presentation of all types of Related Performance Information.

⁷ The MassMutual no-action letter was also based on a representation that any quotation of the registered mutual funds' performance that included the performance of the predecessor unregistered accounts would be accompanied by disclosure that: (i) the quoted performance includes the performance of the predecessor unregistered accounts for periods before the registered funds' registration statement became effective; (ii) the predecessor accounts were not registered under the Investment Company Act of 1940 and therefore were not subject to certain investment restrictions that are imposed by the Act; and (iii) if the predecessor accounts had been registered under the 1940 Act, their performance may have been adversely affected. We concur with these disclosure requirements.

⁸ If the Bramwell letter is read more broadly so as to permit the disclosure of Related Performance Information whenever, for example, the same portfolio manager was responsible for both funds (notwithstanding other differences in the personnel and resources of the advisory firms), substantial doubt exists whether investors would be able to appreciate the context in which such performance information is presented. At the very least, it would seem that extensive disclosures would be needed regarding the various differences between the two advisers. The length and complexity of the disclosures required to prevent this type of misunderstanding would not be practical for many types of sales material (such as newspaper advertisements), and probably would not be read or understood by many investors.

⁹ See, e.g., Investment Trust of Boston Funds (pub. avail. Apr. 13, 1989) and Philadelphia Funds (pub. avail. Oct. 17, 1989).

¹⁰ See Zweig Series Trust (Jan. 10, 1990).

¹¹ For example, we recommend that Private Account performance should be adjusted to reflect the Advertised Fund's expense ratio, while Comparison Fund performance should not be so adjusted.

¹² Sales material should be permitted to include performance figures that do not reflect a sales charge in addition to figures that reflect the deduction of a sales charge.

¹³ AIMR standards also require that private account composite performance be shown on a year-by-year basis. We do not believe that Private Account composite Related Performance Information should be required to be presented on a year-by-year basis so long as it meets the Rule 482 duration standards.

¹⁴ For example, if a multiple-asset portfolio includes both equity and fixed income components which are separately managed, the performance of the equity segment may be broken out and included in the performance of an equity account composite under certain circumstances. See Association for Investment Management and Research, Performance Presentation Standards (1993) 9-10.

¹⁵ For example, if all or substantially all of the same advisory personnel that currently advise the Advertised Fund also advise substantially similar Comparison Funds or Private Accounts on behalf of an entity affiliated with the Advertised Fund's adviser or sub-

adviser, Related Performance Information for those funds or accounts may be appropriate for use in sales material for the Advertised Fund. However, if there are no common advisory personnel between the Advertised Fund's adviser and the affiliated entity that advises Comparison Funds or Private Accounts, use of such funds' or accounts' Related Performance Information may not be appropriate for use in sales material for the Advertised Fund. Fact patterns which fall somewhere in between these examples would be analyzed to determine whether there are sufficiently common advisory personnel and financial, technological and investment resources employed by the Advertised Fund's adviser and affiliated entity. Even if there is sufficient commonality, disclosure of the differences may be required.

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