The SEC's advertising and marketing rules

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Most communication to clients and prospects by investment advisers is considered advertising. Section 206 of the Investment Advisers Act prohibits a deceit or manipulation on any client, and Rule 206(4)-1 is known as the Advertising Rule. The advertising rule has been interpreted through a series of enforcement actions and no-action letters and the advertising rule and its application continues to evolve with new types of communication, and new **SEC** rulemaking, enforcement and issuance of no-action letters (**IA Watch**, April 18, 2011). Many attorneys refer to SEC regulation as more "lore" than "law."

In 2017, the OCIE published a risk alert regarding the most frequent advertising rule compliance issues identified in examinations of investment advisers. The most frequent issues were:

1. Misleading performance results
2. Misleading one-on-one presentations
3. Misleading claims of compliance with voluntary performance standards, such as GIPS®
4. Cherry-picked profitable stock selections
5. Misleading selections of recommendations
6. Lack of compliance policies and procedures designed to detect deficient advertising practices.[1]

As means of communication have increased, so has the application of the advertising rule. Not only does it apply to print and broadcast advertisements, its scope extends to all types of communications to clients and prospective clients.

(1) Definition of "advertisement" for purposes of SEC Rules

(a) Rule 206(4)-1, the advertising rule, defines an advertisement as follows:

> "*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 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.*"

The definition has been interpreted to cover broadcasts and electronic communications, such as social media postings, tweets, e-mails and statements made on an adviser's website. Other examples would include firm newsletters, press releases, web postings and more. More importantly, regular reporting to clients, even if customized, can still be viewed as advertising.

[1] National Exam Program Risk Alert, Volume VI, Issue 6, September 14, 2017, by the *Office of Compliance Inspections and Examinations* ("OCIE").

Finally, marketing collateral, whether customized or general can always be viewed as advertising, regardless of the audience or potential audience.

(b) Section 206 of the Investment Advisers Act prohibits an adviser from perpetrating fraud, deceit or manipulation on any client or prospective client through any means of interstate commerce and *specifically prohibits*:

(1) Testimonials;
(2) Past specific recommendations;
(3) Claims that any graph, chart, formula or device can by itself determine whether to buy or sell a security, or which security to buy or sell; or
(4) Offering free reports, analyses or services.[2]

(2) **Material presented to an institutional investor in a one-on-one meeting**. Just because it may be a communication to only one person, don't expect a customized proposal or RFP to be exempt from the advertising rule. The anti-fraud provisions in section 206 of the Act always apply. Further, marketing to institutional investors is not exempt from the advertising rule. In 1988, the SEC staff issued a no-action letter stating that an institutional investor may not need to see net-of-fee performance returns, if the performance presented is accompanied by a footnote that includes an example of how the adviser's fees will impact performance (See *Investment Company Institute*, SEC Staff No-Action Letter, Sept. 23, 1988). This letter is sometimes *incorrectly* interpreted to mean that net-of-fee disclosures are not necessary when performance data are presented to an institutional client. Such disclosures are necessary.

(3) **Compliance P&Ps**. As the SEC has stated, at its base, compliance entails avoiding use of "any untrue statement of a material fact or that is otherwise false or misleading." There is no requirement for intent, and "false and misleading" is not associated with any specific prohibition. Any advertisement is evaluated in its totality, based upon the specific facts and circumstances, so your compliance reviews must be comprehensive and thoughtful – not a formulaic checklist of requirements. Compliance staff are expected to have a deep understanding of their firm's products and services, the performance data presented, and the SEC Rules, regulations and "lore" to empower them to effectively review their firm's advertising. Further, firms are expected to have written P&Ps (that are followed) describing their specific requirements for advertising reviews that are reasonably designed to detect potential violations of the advertising rule.

Complying with the Advertising Rule – Presenting Investment Performance

Although past performance is no guarantee of future results, all advisers want to present a successful performance record. There are different ways to measure performance and it can be confusing to prospective investors to evaluate different advisers based on their respective track records. Performance returns can be presented for a group of accounts with the same investments, or individually for specific clients. The SEC rules impose a myriad of requirements for presentations of investment performance, the intent of which is to prevent any performance

[2] These topics will be covered in additional articles.

presentation from being false or misleading. Issues relating to presentation of investment performance include the:

(1) Substantiation;
(2) Impact of investment advisory fees;
(3) Benchmarking;
(4) Cherry-picking;
(5) Validity of back-tested or hypothetical returns;
(6) Using returns from third party sources, such as **Morningstar**; and
(7) GIPS®.

(4) **Performance Returns: Be able to support the calculations**. The SEC reviews all performance advertising closely, including the returns presented, which advisers must be able to substantiate. SEC will eye closely all disclosures, too. Note that Advisers Act rule 204-2(a)(16) (books and records rule) requires that advisers retain documentation of the calculation of any and all performance returns that are presented. This means that performance records substantiating returns must be kept for as long as the returns are presented. If your firm has a long-term performance record, make sure that you can substantiate all performance information from inception. The firm's compliance P&Ps should have a mechanism to review and/or test the calculations, or, in the case of advisers that claim GIPS® compliance, the requirement that the returns are reviewed by an outside firm.

(5) **Gross of Fee vs. Net of Fee Returns**: A common misconception is that net-of-fee returns ***do not*** need to be presented in a one-on-one meeting, and/or to a qualified or institutional client. Not true. It's generally considered false and misleading to present performance returns without deducting investment advisory fees. However, as per the ICI no-action letter, the impact of fees can be presented in a footnote in one-on-one presentations to qualified/institutional clients if certain disclosures are made, including a disclosure that investment returns will be reduced by the impact of investment advisory fees. In general, performance returns should include net-of-fee returns. Proper calculations will reflect the fees being deducted from the returns with the same frequency as the firm's billing cycle.

(6) **Benchmarks:** In the ***Clover*** no-action letter, the SEC lays out what would be considered false and misleading in presenting either model or actual results:

> "*an advertisement that (1) Fails to disclose the effect of material market or economic conditions on the results portrayed (e.g., an advertisement stating that the accounts of the adviser's clients appreciated in value 25% without disclosing that the market generally appreciated 40% during the same period)….(Compares model or actual results to an index without disclosing all material facts relevant to the comparison (e.g. an advertisement that compares model results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio)." Clover Capital Management,* SEC Staff No-Action letter, October 28, 1986.

Although the SEC does not explicitly instruct on the right way to choose a benchmark, it seems clear that in doing so, an adviser should (a) use an index that is appropriate to the investment strategy presented and (b) explain the differences between the index and the relevant strategy. Disclosures with a performance record should point out relevant differences, such as

- That index returns are not impacted by trading or investment advisory fees;
- comparison of the number of securities in the index vs. the investment strategy; and
- comparison of volatility and turnover of the index vs the investment strategy.

Explaining why the index is appropriate should also be useful to investors and help to create advertisements that are *not* false and misleading.

(7) **Cherry-picking**: The advertising rule prohibits an advertisement "*which refers directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person*" but does not prohibit providing a comprehensive list of all recommendations within the past 12-month period (or longer). The idea is that you can't show a client a handful of securities that were purchased or sold with positive returns because this would be false and misleading as you cherry-picked the results. The **Franklin** no–action letter refines the rule to allow an adviser to present less than all securities' recommendations, if the recommendations presented are chosen on the basis of objective, non-performance-based criteria consistently applied, for example, the top 10 holdings or the three largest sales by dollar size. The Franklin letter also provides disclosure language that is typically used in similar situations – that the information is not a recommendation, that the securities listed may or may not be or remain in an account and that the securities mentioned are only a part of a portfolio, plus disclaimers about the profitability of the securities discussed or any transactions in the future. In short, be cautious in using specific investment decisions that were profitable in client presentations. If they are being used to illustrate something other than performance, be sure to comply with the restrictions described in the Franklin letter and provide adequate disclosures. (See *Franklin Management Inc.,* SEC Staff No-Action Letter, Dec.10, 1998). The **TCW** no-action letter from 2008 accepts an adviser showing an equal number of winning and losing securities' selections. (See *The TCW Group Inc.*, SEC Staff No-Action Letter, Nov. 7, 2008).

(8) **Back-tested or hypothetical performance returns**. Using back-tested results is another confusing issue – the SEC does not outright prohibit using them, however, making a compliant presentation of back-tested returns presents challenges. The famous ***Clover*** no-action letter presents basic guidelines for presenting model portfolio returns. In general, the back-tested returns must be clearly explained, calculated correctly and be supportable with documented calculations. Recently, an action was brought against an adviser for using back-tested results with institutional clients. The adviser was cited for inadequate compliance P&Ps because its compliance staff didn't detect the potential violations. OCIE examiners scrutinized the back-tested record as well as the adviser's claims and representations made about the record, some of which could not be validated. The opinion in this SEC action indicate that the agency will review claims and information in advertisements carefully and require evidence that any statement (or performance) is accurate. (See, *In the Matter of Massachusetts Financial Services Company*, Release # 4999, Aug. 31, 2018). Accordingly, RIAs need compliance reviewers who understand every part of their firm's marketing presentations and can confirm that such presentations (including performance data, claims and descriptions, and disclosures) do not create an advertisement that can be viewed as "false and misleading."

(9) **My firm just uses other firms as subadvisers**. What about using their performance? **F-Squared** was a sub-adviser whose strategies were distributed by several RIAs. The adviser was fined $35 million for publishing misleading performance data and ultimately closed down. Advisers that used F-Squared as a sub-adviser published F-Squared's performance

data in their own advertisements and were censured and fined. The SEC's language in the administrative actions against those advisers indicated that they were responsible for all data presented – including performance data supplied by another adviser. In 2016, 13 advisers were found to have violated the Advisers Act by "publishing, circulating, and distributing advertisements that contained untrue statements of material fact." Because each firm did not "make and keep true, accurate and current records or documents necessary to form the basis for or demonstrate the calculation of the performance or rate of returns that it circulated and distributed, as required by Section 204(a) of the Advisers Act and Rule 204-2(a)(16) thereunder," those advisers were fined and sanctioned by the SEC for violating the Advisers Act. (See, *e.g.*, *In the Matter of Shamrock Asset Management*, File no. 3-17492, Release No. 4496, Aug. 25, 2016). Using a disclosure, such as *"Performance returns calculated or provided by X"* in marketing your firm's services will not relieve you of these advertising rule requirements. Your firm is responsible for all numbers presented, including those computed by a third party. If they turn out to be inaccurate, your firm will be responsible to your clients or prospects that relied on the inaccurate data (**IA Watch**, March 2, 2017).

(10) **Claims that your firm's performance ads are presented in compliance with GIPS® Standards**. If your firm's performance presentations claim GIPS® compliance, the SEC may review them to confirm that they comply with GIPS®. Although the SEC doesn't create or enforce GIPS® requirements, claims that an adviser complies with GIPS® standards must be accurate or they're false and misleading. Further, simply presenting performance in compliance with GIPS® may not be enough, as GIPS® standards are different from the standards set out by the SEC.

GIPS® standards are administered by the **CFA Institute** and are an ethical set of standardized, industry-wide principles that provide investment firms with guidance on how to report investment performance to prospective clients. Firms that claim GIPS® compliance generally engage a firm to perform a "verification" annually, which is basically an audit of a firm's procedures for calculating performance and an opinion of whether these procedures comply with the GIPS® standards. Verification also includes a review of composite presentations for appropriate disclosures and review of returns, statistics and calculations. A composite is a group of accounts in the same investment strategy that must comply with certain standards for being included.)

Final points: As you can see, compliance reviews of investment performance presentations included in advertisements and marketing collateral have many components. Compliance staff need to be trained to identify the relevant issues and to draft disclosures that fit the needs of the particular presentation and comply with SEC expectations. Drafting appropriate and sufficient disclosure requires judgment and a thorough understanding of these rules.

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