



# NATIONAL EXAM PROGRAM

## RISK ALERT

*By the Office of Compliance Inspections and Examinations<sup>1</sup>*

**Volume VI, Issue 6**

**September 14, 2017**

***In this Alert:***

***Topic:*** Advertising Rule compliance issues identified in deficiency letters sent to SEC-registered investment advisers.

***Key Takeaways:*** Advisers should review their compliance programs and practices in light of the topics noted in this Risk Alert. This information is intended to assist advisers in adopting and implementing effective compliance programs.

### **The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers**

#### **I. Introduction**

The Office of Compliance Inspections and Examinations (“OCIE”) is providing a list of compliance issues relating to Rule 206(4)-1 (the “Advertising Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”).<sup>2</sup> These compliance issues were most frequently identified in deficiency letters recently sent to SEC-registered investment advisers (“advisers”) and as part of an examination initiative that focused on advisers’ use of accolades in their marketing materials (“Touting Initiative”).<sup>3</sup> This Risk Alert includes observations by OCIE staff and is intended to highlight the risks and issues associated with Advertising Rule compliance. This information is intended to assist advisers in adopting and implementing effective compliance programs.<sup>4</sup>

The Advertising Rule prohibits an adviser, directly or indirectly, from publishing, circulating, or distributing any advertisement that contains any untrue statement of material fact, or that is otherwise false or misleading.<sup>5</sup> The Advertising Rule also includes four

<sup>1</sup> The views expressed herein are those of the staff of OCIE. The Securities and Exchange Commission (the “SEC” or the “Commission”) has expressed no view on the contents of this Risk Alert. This document was prepared by SEC staff and is not legal advice.

<sup>2</sup> This Risk Alert reflects issues identified in deficiency letters from over 1,000 adviser examinations. *See also [National Exam Program Risk Alert, The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers](#)*, (Feb. 7, 2017).

<sup>3</sup> OCIE conducted nearly 70 examinations under the Touting Initiative, which took place in 2016.

<sup>4</sup> This Risk Alert does not address all types of deficiencies or weaknesses related to the Advertising Rule. Nor does it address advertising or advertising-related deficiencies or weaknesses related more generally to Advisers Act Sections 206(1), 206(2), Advisers Act Rule 206(4)-8, or to registered investment companies.

<sup>5</sup> Advisers Act Rule 206(4)-1(a)(5).

specific prohibitions.<sup>6</sup> In addition, relevant advertising guidance and principles are often discussed in Commission opinions, court decisions, and Commission orders in settled enforcement proceedings and in no-action letters and guidance updates issued by the SEC’s Division of Investment Management (“IM”).<sup>7</sup>

Advertisements, as defined in the Advertising Rule, can encompass a broad array of statements. The Advertising Rule states that an “advertisement shall include any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security 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.”<sup>8</sup> Adviser statements made through electronic media, or other non-traditional styles of presentation may fall within the purview of the Advertising Rule.<sup>9</sup>

## II. Most Frequent Advertising Rule Compliance Issues

Below are the most frequent deficiencies that OCIE staff has identified in connection with failure to comply with the Advertising Rule:

- *Misleading Performance Results.* OCIE staff has observed advertisements that staff believe contain misleading performance results.<sup>10</sup> For example, staff observed advisers that presented performance results without deducting advisory fees.<sup>11</sup> Staff also observed adviser advertisements that compared results to a benchmark but did not include

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<sup>6</sup> Advisers Act Rule 206(4)-1(a)(1) (prohibiting advertisements that refer, directly or indirectly, to any testimonial concerning the adviser or any advice, analysis, report or other service rendered by the adviser); Advisers Act Rule 206(4)-1(a)(2) (generally prohibiting an adviser from advertising past specific recommendations of the adviser that were or would have been profitable to any person); Advisers Act Rule 206(4)-1(a)(3) (prohibiting advertisements claiming that any graph, chart, formula or other device can by itself determine whether to buy or sell a security); and Advisers Act Rule 206(4)-1(a)(4) (prohibiting advertisements that offer purportedly free reports, analyses, or services).

<sup>7</sup> No-action letters and guidance updates issued by IM staff provide informal interpretive and advisory assistance and represent the views of members of the Commission staff who are continuously working with the provisions of the Advisers Act. Opinions expressed by IM staff, however, are not an official expression of the Commission’s views.

<sup>8</sup> Advisers Act Rule 206(4)-1(b).

<sup>9</sup> *Id.* IM staff has provided guidance on the testimonial provision of the Advertising Rule and social media. See [IM Guidance Update No. 2014-04, Guidance on the Testimonial Rule and Social Media](#), (Mar. 2014); see also [National Exam Program Risk Alert, Investment Adviser Use of Social Media](#), (Jan. 4, 2012); see also [IM Guidance Update 2017-02, Robo-Advisers](#), (Feb. 2017), at note 34 and accompanying text.

<sup>10</sup> See Advisers Act Rule 206(4)-1(a)(5). IM staff has issued several no-action letters that discuss the application of Subsection (a)(5) and advertisements that may be misleading.

<sup>11</sup> See [Clover Capital Mgmt., Inc.](#), SEC Staff No-Action Letter (Oct. 28, 1986) (IM staff indicating that an advertisement that includes results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid may be misleading).

disclosures about the limitations inherent in such comparisons, including instances where, for example, an advertisement did not disclose that the advertised strategy materially differed from the composition of the benchmark to which it was compared.<sup>12</sup>

Additionally, staff observed adviser advertisements that contained hypothetical and back-tested performance results, but did not explain how these returns were derived and did not include other potentially material information regarding the performance results.<sup>13</sup>

- *Misleading One-on-One Presentations.* OCIE staff has observed advertisements that staff believe contain misleading one-on-one presentations.<sup>14</sup> For example, staff observed advisers that advertised performance results (gross of fees) in certain one-on-one presentations, but did not include potentially relevant disclosures.<sup>15</sup> In addition, some one-on-one presentations (that are subject to the Advertising Rule) did not disclose that the advertised performance results did not reflect the deduction of advisory fees and that client returns would be reduced by such fees and other expenses.<sup>16</sup>
- *Misleading Claim of Compliance with Voluntary Performance Standards.* OCIE staff has observed advertisements that staff believe contain misleading claims of compliance with voluntary performance standards.<sup>17</sup> For example, staff observed advisers that claimed that their advertised performance results complied with a certain voluntary performance standard, when it was not clear to staff that the performance results in fact adhered to the performance standard's guidelines.<sup>18</sup>
- *Cherry-Picked Profitable Stock Selections.* OCIE staff has observed advertisements that staff believe contain cherry-picked stock selections.<sup>19</sup> For example, staff observed

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<sup>12</sup> See *id.* (IM staff indicating that an advertisement comparing performance results to a benchmark may be misleading if the advertisement does not disclose the material limitations inherent in such a comparison).

<sup>13</sup> See, e.g., [In the Matter of Jeffrey Slocum & Assocs., Inc. & Jeffrey C. Slocum](#), Respondents, Advisers Act Rel. No. 4647 (Feb. 8, 2017) (use of misleading performance results).

<sup>14</sup> See Advisers Act Rule 206(4)-1(a)(5).

<sup>15</sup> See *Investment Co. Institute*, SEC Staff No-Action Letter (Sept. 23, 1988) (IM staff indicating that performance results presented on a gross basis in a one-on-one presentation with certain disclosures may not be misleading).

<sup>16</sup> See, e.g., [In the Matter of Trust & Inv. Advisors, Inc., Larry K. Pitts, & George M. Prugh](#) Respondents, Advisers Act Rel. No. 4087 (May 18, 2015).

<sup>17</sup> See Advisers Act Rule 206(4)-1(a)(5).

<sup>18</sup> A common example of a voluntary performance standard is the Global Investment Performance Standards ("GIPS®"). The Commission has found a violation of the Advertising Rule when an adviser's advertisement falsely claimed it complied with GIPS®. See, e.g., [ZPR Investment Mgmt., Inc.](#), Advisers Act Rel. No. 4249 (Oct. 30, 2015) (SEC Opinion).

<sup>19</sup> See Advisers Act Rule 206(4)-1(a)(2). Subsection (a)(2) of the Advertising Rule provides that it shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business to, directly or indirectly, publish, circulate, or distribute any advertisement that refers to past specific recommendations of an 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 disclosures about the recommendations.

advisers that included only profitable stock selections or recommendations in presentations, client newsletters, or on their websites, without meeting the conditions set forth in Subsection (a)(2) of the Advertising Rule.<sup>20</sup>

- *Misleading Selection of Recommendations.* OCIE staff has observed advertisements that staff believe contain misleading selections of investment recommendations.<sup>21</sup> For example, staff observed advisers that disclosed past specific investment recommendations that may have been misleading because they included only certain, and not all, recommendations, in order to illustrate a particular investment strategy, and they did not meet the conditions set forth in Subsection (a)(2) of the Advertising Rule. In addition, they did not satisfy the representations upon which IM staff based certain no-action assurances as provided in the *TCW Group* and *Franklin* no-action letters.
  - In the *TCW Group* no-action letter, IM staff stated that it would not recommend enforcement action against an adviser that advertised to consultants, prospective clients, and existing clients who were not currently invested in the relevant investment strategy, the five (or more) best performing holdings along with an equal number of worst performers if several representations were met.<sup>22</sup> OCIE staff has observed advertisements that may not have been consistent with these representations, including the use of advertisements that included the best performing holdings, but did not simultaneously include an equal number of the worst performing holdings.
  - In the *Franklin* no-action letter, IM staff stated that it would not recommend enforcement action against an adviser for advertising past specific recommendations that were selected using consistently applied, objective, non-performance based selection criteria, provided that certain representations were met.<sup>23</sup> OCIE staff has observed advertisements that may have not been consistent with these representations, including, for example, not disclosing that the specific recommendations did not represent all securities purchased, sold, or recommended to clients during that period and discussing in advertisements the profits realized by the specific recommendations.
- *Compliance Policies and Procedures.* OCIE staff observed advisers that did not appear to have compliance policies and procedures reasonably designed to prevent deficient advertising practices.<sup>24</sup> For example, the staff observed advisers that did not have, or did

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<sup>20</sup> See *id.*

<sup>21</sup> See *id.*

<sup>22</sup> [The TCW Group](#), SEC Staff No-Action Letter (Nov. 7, 2008).

<sup>23</sup> [Franklin Management, Inc.](#), SEC Staff No-Action Letter (Dec. 10, 1998); see also [Investment Counsel Ass'n of America, Inc.](#), SEC Staff No-Action Letter (Mar. 1, 2004).

<sup>24</sup> Advisers Act Rule 206(4)-7(a) (requiring advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Act and the rules that the Commission has adopted under the Act).

not implement, policies and procedures pertaining to the following issues: the process for reviewing and approving advertising materials prior to their publication or dissemination; when using composites, determining the parameters for which accounts were included or excluded from performance calculations; and confirming the accuracy of performance results in compliance with the Advertising Rule.

### III. Summary of Examination Observations from Touting Initiative

OCIE launched the Touting Initiative in 2016 to examine the adequacy of disclosures that advisers provided to their clients when touting awards, promoting ranking lists, and/or identifying professional designations (collectively “accolades”) in their marketing materials. OCIE launched its Touting Initiative in response to the regularity with which staff encounters advisers that advertise these accolades without disclosing material facts about them.

- *Misleading Use of Third Party Rankings or Awards.* OCIE staff observed advertisements containing the potentially misleading use of third party rankings or awards.<sup>25</sup> Staff observed advisers that published potentially misleading advertisements containing references to awards or rankings conferred by third parties that failed to disclose facts, which staff believes were material under the circumstances, about such awards or rankings.<sup>26</sup> For example:
  - Advisers advertised accolades that had been obtained by submitting potentially false or misleading information in the applications for such accolades.<sup>27</sup>
  - Advisers published marketing materials that referenced stale ranking or evaluation information, thus potentially misrepresenting the adviser’s current status. For example, OCIE staff observed advertisements that referred to advisers receiving high rankings in various publications, but those publications were issued several years prior, and the rankings were no longer applicable.
  - Advisers published potentially misleading advertisements that did not disclose the relevant selection criteria for the awards or rankings, or who created and conducted the survey and the fact that advisers paid a fee to participate in or distribute the results of the survey.

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<sup>25</sup> See Advisers Act Rule 206(4)-1(a)(5).

<sup>26</sup> See *DALBAR, Inc.*, SEC Staff No-Action Letter (Mar. 24, 1998) (IM staff providing guidance regarding factors advisers should consider when determining whether an advertisement containing a rating is false or misleading); see also *Investment Adviser Ass’n.*, SEC Staff No-Action Letter (Dec. 2, 2005) (IM staff reiterating guidance presented in *DALBAR* regarding factors that advisers should consider when determining whether an advertisement containing a third-party rating is false or misleading).

<sup>27</sup> The Commission has found a violation of the Advertising Rule when an adviser’s advertisement contained a favorable industry ranking that had been obtained through the adviser’s misrepresentations. See, e.g., *In the Matter of Bennett Grp. Fin. Servs., LLC & Dawn J. Bennett*, Advisers Act Rel. No. 4676 (Mar. 30, 2017) (SEC Opinion).

- *Misleading Use of Professional Designations.* OCIE staff observed advertisements and disclosures made in advisers' Form ADV Part 2B Brochure Supplements that contained potentially false or misleading references to employee professional designations, such as, for example, references to professional designations that have lapsed or that did not explain the minimum qualifications required to attain such designations.<sup>28</sup>
- *Testimonials.* OCIE staff observed advisers that had published statements of clients attesting to their services or otherwise endorsing the adviser that may be prohibited testimonials (e.g., client endorsements published in firm websites, social media pages, reprints of third party articles, or pitch books).<sup>29</sup>

#### IV. Conclusion

In response to OCIE staff's observations, advisers elected to either remove misleading language from their advertisements, or to add disclosures designed to prevent the advertisements from being misleading. OCIE's objective in providing this guidance is to encourage advisers to assess the full scope of their advertisements and consider whether those advertisements are consistent with the Advertising Rule, the prohibitions of Section 206, and their fiduciary duties, and review the adequacy and effectiveness of their compliance programs.

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*This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some may not be applicable to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.*

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<sup>28</sup> See Item 2 of Form ADV Part 2B Brochure Supplement (Educational Background and Business Experience), which states that the adviser may list any professional designations held by a *supervised person*, but if the adviser does so, the adviser must provide a sufficient explanation of the minimum qualifications required for each designation to allow *clients* to understand the value of the designation.

<sup>29</sup> Subsection (a)(1) of the Advertising Rule provides that it shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business to, directly or indirectly, publish, circulate or distribute any advertisement that refers, directly or indirectly, to any testimonial of any kind concerning the adviser or concerning any advice, analysis, report or other rendered service.