Risk Management Update
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PITFALLS OF PERFORMANCE ADVERTISING BY INVESTMENT ADVISERS

In this age of technology, advertising and marketing by investment advisers can be very economical and the venues numerous. Advisers utilize websites, social media, blogs and blast messages as their main distribution channels and all of these mediums have far reaching capabilities. While the SEC has issued a multitude of guidance in the way of no-action letters, Risk Alerts, and enforcement cases that pave the landscape of requirements covering advertising and marketing by investment advisers, such guidelines are not contained within the text of Rule 206(4)-1.

This month's Risk Management Update outlines the main prohibitions covering this area, discusses common pitfalls and risks regarding performance advertising, and provides information and practical tips that can help firms ensure compliance with the regulatory requirements governing marketing and advertising.

Overview of Rule 206(4)-1 Prohibitions

Rule 206(4)-1 of the Investment Advisers Act of 1940[1] ("Advisers Act") contains prohibitions applicable to investment advisers' advertising and marketing activities. Below is a summary of each prohibition:

- *No Testimonials* – Advisers cannot advertise or use marketing materials that refer directly or indirectly to a testimonial regarding the advice, analysis, report or any other services the adviser may offer. A testimonial includes, but is not limited to, statements of a client's experience or an endorsement by a client related to the adviser's services or offerings.

- *No Partial List of Past Specific Recommendations* – Advisers cannot reference, directly or indirectly in any advertisement or marketing materials, a partial list of past specific recommendations unless certain disclosures are made. The reference to profitable recommendations which ignore unprofitable recommendations is prohibited.

- *No Stand Alone Graphs, Charts or Formulas* – Advisers advertising and marketing materials cannot solely contain a graph, chart, formula or other device that infers which securities to buy or sell, when to buy or sell, or to otherwise

[1] Rule 206(4)-1 applies to investment advisers registered or required to be registered with the SEC. Notably, certain states, like California that do not have specific regulations covering advertising by state registered investment advisers generally rely on Rule 206(4)-1. State registered advisers should check with their applicable state(s).

- assist persons in making those decisions without discussing the inherent limitations of such graphs or charts and any difficulties of its use.

- *No Offer of Free Reports or Services Unless Entirely Free* - Advisers cannot claim that any type of services or products will be provided free of charge unless it will be entirely free and without any direct or indirect conditions and/or obligations.

- *No False or Misleading Statements* – Advertising and marketing materials cannot contain any untrue, false or misleading statements or information.

Importantly, there are SEC no-action letters that provide relief from some of the above prohibitions, so long as the investment adviser relying on the no-action letter follows all of the outlined requirements[2]. One of the most notable is the Clover Capital Management (October 28, 1986) letter[3], which provides a list of what should and should not be included when presenting model and/or actual performance.

Common Pitfalls and Risks

One of the most common mistakes advisers make when marketing and advertising their services is not including adequate and appropriate disclosures. Required disclosures that often get overlooked include failing to provide: (i) the source of statistical information; (ii) a full description of each index mentioned; (iii) the material differences between a benchmark used for performance comparison and the firm's investment strategy; (iv) whether the performance results include the reinvestment of dividends and other earnings; and (v) a statement that past performance is not a guarantee of future performance.

Other pitfalls include:

- Showing only *gross-of-fee* performance outside of a one-on-one presentation[4];
- Not clearly labeling hypothetical performance;
- Linking hypothetical returns to actual performance returns;
- Not prominently disclosing that hypothetical performance has inherent conflicts and limitations, including the fact that it is not based on actual trading, does not take into consideration the material economic and market factors that might have had an impact on the manager's decision-making;
- Including "since inception" performance, but not disclosing the inception date;
- Providing disclosures in too small of font or providing only at the end and not referenced within a presentation;

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[2] For a list and copies of SEC no-action letters, see https://www.sec.gov/divisions/investment/im-noaction.shtml.
[3] See https://www.sec.gov/divisions/investment/noaction/clovercapital102886.htm.
[4] While showing gross-of-fee only performance is permitted under the Global Investment Performance Standards, the SEC only allows in one-on-one in person presentations as outlined in the SEC's no action letter to the Investment Company Institute dated September 23, 1988.

- Showing performance based on a representative account or select group of accounts and not disclosing the selection criteria;
- Not disclosing that certain performance results are based on accounts that had been managed by a portfolio manager during a time he was employed at a previous firm;
- Not having the required books and records to back-up the performance returns;
- Not providing information about the effect material market or economic conditions had on the reflected performance returns;
- Stating the firm is a "registered investment adviser" without including a statement that such registration does not imply any level of skill or expertise;
- Not maintaining documentation that substantiates the statistical information and factual statements made; and
- Not providing meaningful disclosures regarding applicable risks.

The list above is not all encompassing, but rather reflecting some of the most common problems we see. Perhaps the biggest risk surrounding this area is lack of knowledge; "you don't know what you don't know."

Compliance Tips

Ensuring that a firm's marketing collateral is compliant turns not only on knowing which regulations apply, but also understanding the intended audience and method of distribution. L labeling a presentation "For Financial Professionals Only" or "For Institutional Investors Only" is good practice when that is the only intended audience; however, it should be made clear to the intended receiver and firm personnel that this presentation is not approved for posting on websites, social media sites or other types of general distribution.

To advance your internal controls, consider the following:

1. Provide periodic training to marketing, sales and client servicing staff on applicable rules and firm policies.
2. Prior to compliance review, have materials reviewed by other applicable personnel (*e.g.,* Marketing Director/Supervisor, Chief Investment Officer, and operations team responsible for performance calculations and related backup).
3. Provide marketing and sales staff with a disclosure library that contains disclosure language covering various types of marketing scenarios generally used by the firm.
4. Perform periodic reviews of emails sent and received by marketing and sales staff, client servicing personnel and investment adviser representatives.
5. Monitor social media sites to confirm compliance with applicable rules and firm policies.
6. Test stated performance against backup documentation to confirm accuracy.
7. Utilize a marketing checklist that includes pertinent information to help facilitate the review.
8. Assign a stale date to all marketing collateral and ensure it is retired or updated by such date.

9. Perform periodic reviews of Request for Proposal responses to confirm information is accurate, consistent and compliant.
10. Maintain an "approved for use" file containing all current and approved materials that is accessible to appropriate staff.

Firms also should confirm that any past regulatory deficiencies regarding the adviser's marketing efforts have been corrected.

Conclusion

Advertising and marketing deficiencies of investment advisers continues to be one of the most frequent findings of the SEC staff performing examinations. Implementing strong controls that include review, monitoring, testing and training will go a long way in staying in line with regulations and preventing violations of Rule 206(4)-1 of the Advisers Act.

For more information or assistance, please contact us at info@corecls.com, at (619) 278-0020 or visit us at www.corecls.com.

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