

Investment Management

September 27, 2017

Common Pitfalls in Investment Adviser Advertising: Balancing Marketing Goals with Compliance Obligations

By **Scott H. Moss, Esq.**, **David Lifshitz, Esq.**, and **Ted McBride, Esq.**

On Sept. 14, 2017, the Securities and Exchange Commission's (the SEC) Office of Compliance Inspections and Examinations (OCIE) published a risk alert (the Risk Alert) highlighting the most common compliance issues identified (i) in deficiency letters sent to SEC-registered investment advisers (Advisers) (based on more than 1,000 Adviser examinations) relating to Rule 206(4)-1 (the Advertising Rule) of the Investment Advisers Act of 1940, as amended (the Advisers Act), and (ii) in connection with the OCIE's recent examination initiative that focused on the use of accolades in Advisers' marketing materials (the Touting Initiative).¹ The Risk Alert is a useful reminder of where the proper balance between compliance and marketing lies, and it also reinforces the notion that the SEC remains focused on the Advertising Rule and the compliance issues it presents.

This alert provides a brief summary of the Risk Alert and key takeaways that Advisers can implement in their practices going forward.

Background

The Advertising Rule prohibits an Adviser from disseminating any "advertisement" that contains any untrue statement of material fact, or that is otherwise false or misleading.² The Advertising Rule defines advertisements broadly, and an advertisement generally encompasses nearly all Adviser communications with investors and prospective investors.³ Accordingly, the purview of the Advertising Rule is very broad, and the deficiencies identified in the Risk Alert, summarized below, are applicable to every single Adviser.

Advertising Rule Compliance Issues

The Risk Alert identifies the following six categories of the most frequent Advertising Rule deficiencies in the marketing materials of Advisers:

- i. Misleading performance results, including performance that is not presented on a net basis (i.e., net of all applicable fees and expenses, including advisory fees)⁴ and performance that is presented without appropriate disclosures (e.g., disclosing the inherent limitations of comparisons to benchmarks or disclosing material information and assumptions used to calculate hypothetical back-tested performance results).⁵
- ii. Misleading one-on-one presentations (which are typically treated more leniently than other advertisements), including not providing proper disclosures when discussing gross performance.⁶
- iii. Misleading claims of compliance with voluntary performance standards, including where advertisements may have complied with such standards, but such advertisements did not clearly disclose or implicate how they adhered to such standards.
- iv. Cherry-picked profitable stock selections, including advertisements that discuss "past specific recommendations" without meeting the specific requirements set forth in Subsection (a)(2) of the Advertising Rule.⁷
- v. Misleading selection of recommendations, including (in addition to the issues identified in the above "cherry-picked profitable stock selections" category) not adhering to the specific assurances provided by the SEC in certain no-action letters regarding the use of past specific recommendations (both where performance results of such recommendations are discussed and where performance results of such recommendations are not discussed).⁸

¹ National Exam Program Risk Alert, The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers (Sept. 14, 2017).

² Advisers Act Rule 206(4)-1(a)(5).

³ Advisers Act Rule 206(4)-1(b).

⁴ See Association for Investment Management and Research, SEC Staff No-Action Letter (Dec. 18, 1996) (gross performance results may be presented when net performance results are provided with equal prominence and certain disclosures about such performance are provided).

⁵ See Clover Capital Mgmt., Inc., SEC Staff No-Action Letter (Oct. 28, 1986).

⁶ See Investment Co. Institute, SEC Staff No-Action Letter (Sept. 23, 1988) (performance results presented on a gross basis in a one-on-one presentation with certain disclosures may not be misleading).

⁷ Advisers Act Rule 206(4)-1(a)(2) (advertisement containing past specific recommendations, which sets out or offers to furnish a list of all recommendations made by such adviser during the preceding year, and which also contains certain specific disclosures about the recommendations, is not prohibited).

⁸ See The TCW Group, SEC Staff No-Action Letter (Nov. 7, 2008) and Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998).

- vi. Compliance policies and procedures, including a lack of compliance policies and procedures that are reasonably designed to prevent deficient advertising practices (including those described herein).

The Touting Initiative

In 2016, the OCIE conducted nearly 70 Adviser examinations under the Touting Initiative, which was established in response to the seemingly frequent misleading use of accolades in the marketing materials of Advisers without properly disclosing material facts about those accolades. The Risk Alert identifies various deficiencies the OCIE observed in such marketing materials, which include the following:

- i. Misleading use of third party rankings or awards, including advertising (a) accolades that were obtained by submitting false or misleading information in the application for such accolades, (b) stale ranking or evaluation information, or (c) accolades without disclosing relevant information about such accolades (e.g., selection criteria, conductor of the survey, fees paid to participate in the survey).
- ii. Misleading use of professional designations, including references to professional designations that are no longer applicable and, where applicable, not disclosing the qualifications required to attain such designations.
- iii. Testimonials, as set forth in the Advertising Rule.⁹

Key Takeaways

It is clear from the Risk Alert that the Advertising Rule, and the potential pitfalls arising from it, is very much a current issue that continues to command the SEC's attention. Fortunately for Advisers, none of the compliance issues identified in the Risk Alert should come as a surprise, and the issues identified can essentially be boiled down into one singular principle: don't be misleading. That being said, the head of investor

relations at any given Adviser may have an opinion different from that of an SEC staff attorney as to what constitutes a misleading advertisement. What constitutes a misleading advertisement also takes into account the context surrounding the advertisement as well as the content of the advertisement itself. In addition, varying industry norms in Adviser advertising can inform the content and context of a particular advertisement, as industry norms in Adviser advertising can vary based on, among other things, the type of strategy and product at issue as well as the sophistication of the intended audience and the means of communication.

One purpose of the Advertising Rule is to provide the reader of an advertisement with as much information as is necessary to assist in making an informed investment decision. To ensure compliance, Advisers should confirm that they have appropriate policies and procedures in place for reviewing marketing materials before they are distributed to investors and prospective investors. In addition, when reviewing their marketing materials, Advisers should put themselves in the readers' shoes and focus on the knowledge base of the readers as well as information available to the readers, not the Adviser.

There is often give-and-take between business-focused Adviser personnel and compliance-focused Adviser personnel as to the proper content and context of an advertisement. The ways in which an Adviser may wish to present past or future activities may be limited only by the Adviser's imagination, and the laws, rules, regulations, no-action letters, and risk alerts governing advertisements do not (and could not) directly address all possible permutations in advertising. On certain issues in particular, including selected recommendations, there can be a great deal of uncertainty as to what meets the letter and spirit of the Advertising Rule even with the best of intentions. In these cases, experienced counsel or consultants can help bridge any gaps between business and compliance and develop practical solutions in line with industry norms that meet marketing goals without putting an Adviser at undue risk for compliance violations.

⁹ Advisers Act Rule 206(4)-1(a)(1).

Contacts

Please contact any of the authors of this article or any other member of Lowenstein Sandler's Investment Management Group for further information on the matters discussed in this alert. Similarly, we are available to assist you in developing best-in-class policies and compliance programs (including advertising reviews) for your firm in accordance with all applicable rules and regulations and industry standards.

Scott H. Moss, Esq.

Partner, Co-chair, Regulatory and Compliance
T 646.414.6874 | smoss@lowenstein.com

David Lifshitz, Esq.

Associate
T 646.414.6923 | dflifshitz@lowenstein.com

Ted McBride, Esq.

Associate
T 646.414.6951 | tmcbride@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

This Alert has been prepared by Lowenstein Sandler LLP to provide information on recent legal developments of interest to our readers. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship. Lowenstein Sandler assumes no responsibility to update the Alert based upon events subsequent to the date of its publication, such as new legislation, regulations and judicial decisions. You should consult with counsel to determine applicable legal requirements in a specific fact situation.