



October 25, 2017

OCIE RISK ALERT DESCRIBES MOST FREQUENT ADVERTISING RULE COMPLIANCE ISSUES

The SEC's Office of Compliance Inspections and Examinations ("OCIE") published a National Exam Program Risk Alert dated September 13, 2017 (the "Risk Alert") that addresses compliance deficiencies relating to Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the "Advertising Rule").¹ The Risk Alert sets forth the most frequent Advertising Rule compliance deficiencies identified by OCIE in over 1,000 examinations of registered investment advisers and in an examination initiative that focused on advisers' use of accolades in their marketing materials ("Touting Initiative"). Advisers should review OCIE's findings with a view to how best to prepare effective advertising materials and make effective advertising representations that do not run afoul of the Advertising Rule.

The Advertising Rule

By way of background, the Advertising Rule prohibits an adviser, directly or indirectly, from publishing, circulating or distributing advertisements that contain any untrue statement of material fact, or that otherwise is false or misleading. An advertisement includes:

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.

¹ <https://www.sec.gov/ocie/article/risk-alert-advertising.pdf>.

It must be noted that statements made by an adviser through electronic media or other non-traditional styles of presentation may fall within the purview of the Advertising Rule.

Most Frequent Advertising Rule Compliance Issues

The Risk Alert describes the six most frequent deficiencies OCIE identified in connection with failure to comply with the Advertising Rule, as follows:

- **Misleading Performance Results**

Performance results are misleading when, among other things, they present (i) performance results without deducting advisory fees; (ii) advertisements that compare results to a benchmark but do not disclose limitations inherent in such comparisons (for example, not disclosing that the advertising strategy materially differs from the composition of the benchmark); and (iii) advertisements that contain hypothetical and back-tested performance results, but fail to explain how the returns are derived or other material information regarding those results.

- **Misleading One-on-One Presentations**

Misleading one-on-one representations include (i) advisers that advertise performance results (gross of fees) in certain one-on-one presentations that are not subject to the Advertising Rule, but do not include potentially relevant disclosures; and (ii) advisers in certain one-on-one presentations that are subject to the Advertising Rule that do not disclose that the advertised performance results do not reflect the deduction of advisory fees and that client returns would be reduced by such fees and other expenses.

- **Misleading Claims of Compliance with Voluntary Performance Standards**

These include advisers that claim that their advertised performance results comply with a particular voluntary performance standard, when the performance results do not necessarily adhere to the performance standard's guidelines.

- **Cherry-Picked Profitable Stock Selections**

Cherry-picking occurs when advisers include only profitable stock selections or recommendations in presentations, client newsletters, or on their websites, but do not set out or offer to furnish a list of *all* recommendations made by any such adviser during the preceding year, which list includes certain specific disclosures about the recommendations.

- **Misleading Selection of Recommendations**

A misleading selection of recommendations occurs when advisers (i) disclose past specific investment recommendations that may be misleading because they include only certain (not all) recommendations, in order to illustrate a particular investment strategy;

and (ii) do not satisfy the representations upon which the SEC's Division of Investment Management ("IM") staff based certain no-action assurances in the *TCW Group* and *Franklin* no-action letters:

- In the *TCW Group*² no-action letter, IM staff stated that it would not recommend enforcement action against an adviser that advertised to clients who were not currently invested in the relevant investment strategy, the five (or more) best performing holdings, provided the adviser also disclosed an equal number of worst performers.
- In the *Franklin*³ 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.

- Compliance Policies and Procedures

Compliance policies and procedures are deemed not reasonably designed to prevent deficient advertising practices when advisers do not have or do not implement policies and procedures (i) pertaining to the process for reviewing and approving advertising materials prior to publication or dissemination; (ii) when using composites for determining the parameters for which accounts were included or excluded from performance calculations; and (iii) for confirming the accuracy of performance rules in compliance with the Advertising Rule.

Examination Observations from Touting Initiative

The Risk Alert sets forth three deficiencies identified by OCIE in connection with the Touting Initiative it launched to examine the adequacy of disclosures that advisers provide to their clients when touting awards, promoting ranking lists and/or identifying other performance designations ("accolades") in their marketing materials. The deficiencies identified include:

- Misleading Use of Third Party Rankings or Awards

Use of third-party rankings or awards is misleading when advisers publish potentially misleading advertisements that contain references to awards or rankings that (i) fail to disclose that the advertised accolades had been obtained by submitting potentially false or misleading information in the applications for such accolades; (ii) include marketing

² *The TCW Group*, November 7, 2008.

<https://www.sec.gov/divisions/investment/noaction/2008/tcwgroupp110708.htm>

³ *Franklin Management, Inc.* (December 10, 1998).

<https://www.sec.gov/divisions/investment/noaction/franklinmanagement121098.pdf>

materials that reference stale ranking or evaluation information; and (iii) include potentially misleading advertisements that do not disclose the relevant selection criteria for the awards or rankings, or the identity of the person who created and conducted the survey and/or that advisers paid a fee to participate in or distribute the results of the survey.

- Misleading Use of Professional Designations

Use of professional designations is misleading when advisers make disclosures in their Form ADV Part 2B Brochure Supplements that contain potentially false or misleading references to employee professional designations, such as, references that have lapsed or that do not explain the minimum qualifications required to attain such designations.

- Testimonials

Testimonials include published statements of clients attesting to services of the adviser or otherwise endorsing the adviser that may be prohibited, including client endorsements published in firm websites, social medial pages, reprints of third party articles or pitch books.

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If you would like us to review your advertising or marketing materials or if you would like us to make certain your materials are not misleading and otherwise comply with the Advertising Rule, please contact Meryl Wiener, any of the undersigned or your regular Warsaw Burstein attorney.

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