SEC Publishes Important Guidance on Common Advertising Rule Compliance Issues

This Sidley Update summarizes a Risk Alert that the Securities and Exchange Commission’s (SEC) Office of Compliance Inspections and Examinations (OCIE) staff published on September 14, 2017 and supplements Sidley’s annual summary of developments for investment advisers published on February 17, 2017. The Risk Alert addresses compliance issues related to Rule 206(4)-1 (Advertising Rule) under the Investment Advisers Act of 1940 (Advisers Act).

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

The Risk Alert highlights the Advertising Rule topic areas most frequently associated with deficiencies identified in OCIE examinations of registered investment advisers (RIAs). Those topic areas and a summary of the illustrative deficiencies identified in the Risk Alert include:

- Misleading Performance Results
  - RIAs presented performance results without deducting advisory fees;
  - RIAs compared results to a benchmark but did not include disclosures regarding the limitations of such comparisons, e.g., the advertised strategy materially differed from that of the benchmark;
  - RIAs included hypothetical and back-tested performance results without explaining how these returns were derived; and
  - RIAs did not include potentially material information regarding performance results.


• Misleading One-on-One Presentations
  o RIAs advertised gross performance results in some one-on-one presentations but did not include potentially relevant disclosures as set forth in the SEC’s Division of Investment Management (IM) staff guidance that may make such presentations not misleading; 3 and
  o RIAs conducted one-on-one presentations, subject to the Advertising Rule, and 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.

• Misleading Claim of Compliance With Voluntary Performance Standards
  o RIAs claimed their advertised performance results complied with a certain voluntary performance standard (e.g., Global Investment Performance Standards (GIPS®)), when it was not clear that the performance results adhered to relevant guidelines.

• Cherry-Picked Profitable Stock Selections
  o RIAs included only profitable stock selections or recommendations in presentations, client newsletters or on their websites, and failed to meet the conditions set forth in Subsection (a)(2) of the Advertising Rule. Subsection (a)(2) does not prohibit an advertisement which sets out [or offers to furnish]4 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, e.g., the name of each security recommended, the date and nature of each such recommendation.

• Misleading Selection of Recommendations
  o RIAs 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 failed to meet the conditions set forth in Subsection (a)(2) of the Advertising Rule; and
  o RIAs did not satisfy the representations upon which IM staff based certain no-action assurances as provided in The TCW Group, Inc.,5 and Franklin6 no-action letters.

3 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).

4 Note that, despite the language in Subsection (a)(2) permitting “offers to furnish,” the SEC staff consistently has interpreted this Subsection as “prohibiting advertisements containing only a selected list of past specific recommendations, even if accompanied by an offer to furnish the remainder in a separate list.” Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998) (Franklin), available at: https://www.sec.gov/divisions/investment/noaction/franklinmanagement121098.pdf.

5 The TCW Group, Inc., SEC Staff No-Action Letter (Nov. 7, 2008) (TCW Group), available at: https://www.sec.gov/divisions/investment/noaction/2008/tcwgroup110708.htm. In TCW Group, the staff indicated it would not recommend enforcement against an RIA 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 conditions were met. The Risk Alert noted that, among the common exam deficiencies, RIAs used advertisements that included the best performing holdings but did not simultaneously include an equal number of the worst performing holdings.

6 Note 4 above. In Franklin, the staff indicated it would not recommend enforcement against an RIA for advertising past specific recommendations that were selected using consistently applied, objective, non-performance based selection criteria, provided that certain conditions were met and representations were made (e.g., in selecting and presenting the information and disclosing that the specific securities identified did not represent all of the securities purchased, sold, or recommended), and no profits or losses of any specific securities were discussed. The Risk Alert noted that, among the common exam deficiencies, RIAs did not disclose that the specific recommendations did not represent all securities purchased, sold or recommended to clients during that period and discussed the profits realized by the specific recommendations.
• Compliance Policies and Procedures
  o RIAs did not have, or did not implement, policies and procedures concerning the following issues:
    o the process for reviewing and approving advertising materials prior to their publication or dissemination;
    o when using composites, determining the parameters for which accounts were included or excluded from performance calculations; and
    o confirming the accuracy of performance results in compliance with the Advertising Rule.

Summary of Examination Observations From Touting Initiative
The Risk Alert also summarizes OCIE’s observations regarding the Touting Initiative, which was launched in 2016 to examine the adequacy of an RIA’s disclosures when touting awards, promoting ranking lists, and/or identifying professional designations. Those topic areas and a summary of the illustrative deficiencies identified in the Risk Alert include:

• Misleading Use of Third-Party Rankings or Awards
  o RIAs advertised accolades that had been obtained by submitting potentially false or misleading information in the applications for such accolades;
  o RIAs published marketing materials that referenced outdated rankings, e.g., advertisements that referred to the RIA’s high rankings in various publications, where the publications were issued several years prior and the rankings were no longer applicable;
  o RIAs published potentially misleading advertisements that did not disclose the relevant selection criteria for the awards or rankings, or who conducted the survey; and
  o RIAs failed to disclose the fact that they had paid a fee to participate in or distribute the results of the survey.

• Misleading Use of Professional Designations
  o RIAs referred to professional designations in advertising and in Form ADV Part 2B that have lapsed or failed to explain the minimum qualifications required to attain such designations.

• Testimonials
  o RIAs presented statements of clients attesting to the RIA’s services or endorsing the RIA that may be prohibited testimonials, e.g., client endorsements published in firm websites, social media pages, reprints of third-party articles or pitch books.
If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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