

Investment Adviser Regulation An A to Z Workshop

Investment Adviser Advertising
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Overview

- » Definition of advertisement
- » Performance presentation guidelines
- » Record keeping requirements
- » SEC examination focus
- » Best practices

Regulation of Advertising

- » Little specific guidance
 - Section 206, Rule 206(4)-1 and no-action letters
- » No pre-clearance or filing requirements
- » Policed through SEC inspections and enforcement actions
- » Focus on disclosure, not methodology
- » Higher standard of objectivity and clarity than commercial advertising

Definition of Advertisement

- » Basically, any written communication addressed to more than one person (or used more than once) that offers investment advisory services with regard to securities
- » Materials designed to maintain existing clients or solicit new clients
- » Performance is not required
- » When in doubt: it's advertising

Definition of Advertisement

- » Advertisements about mutual funds may be fund – not adviser – advertisements
- » Communications not considered advertising:
 - Oral communications (in-person, telephone)
 - Responses to unsolicited requests by a client, prospective client or consultant for specific information about the adviser or its past specific recommendations
 - *In general*, written communications to existing clients about the performance of the securities in their accounts (customized communications such as account statements)
- » Communications that are not advertisements may still violate Section 206

Specific Prohibitions

Using an ad that . . .

- » Refers to any *testimonial* concerning the adviser or any advice, analysis, report, or other service rendered by such adviser
- » Refers to *past specific recommendations* of the adviser that were or would have been profitable unless the adviser complies with certain conditions
- » Represents that any graph, chart, formula or other device offered can *in and of itself* be used to make trading decisions without prominently disclosing any limitations or difficulties in use
- » Contains any statement to the effect that any report, analysis or service is *free* unless it really is

The Catchall Prohibition

» Using an ad that “contains any untrue statement of a material fact” or that is “*otherwise false or misleading*”

- » **Misleading?** General factors considered:
- Form & content of the ad
 - Adviser’s ability to perform what is advertised
 - Implications or inferences arising from the context
 - Sophistication of the readers

Performance Advertising

» Use of performance results is false or misleading if:

- it implies, or a reader would infer
- something about the adviser's competence or about future investment results
- that would not be true had the advertisement included all material facts



» General Performance Presentation Guidelines –
Clover Capital

Model & Actual Performance

- » Failing to disclose the effect of material market or economic conditions
- » Failing to reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid (net of fees requirement)
- » Failing to disclose whether (and to what extent) the results reflect reinvestment of dividends and other earnings
- » Suggesting or making claims about the potential for profit without also disclosing the possibility of loss
- » Comparing results to an index without disclosing material factors relevant to the comparison
- » Failing to disclose material conditions, objectives or investment strategies used to obtain the performance

Model Performance

- » Failing to disclose prominently the inherent limitations in model results
- » Failing to disclose material changes in the conditions, objectives or strategies of the model portfolio during the period and the effect of the changes
- » Failing to disclose that some of the securities or strategies in the model do not relate (or relate only partly) to services offered by the adviser
- » Failing to disclose, if true, that the adviser's clients actually had results *materially different* from the model results

Actual Performance Results

- » Failing to disclose:
 - that the results relate only to a *select group* of the adviser's clients,
 - the *basis* on which the selection was made, and
 - the *effect* of this practice on the results portrayed, if material.

Specific Performance Issues

- » Exceptions to the “Net of Fees” Requirement
- » “Portability” of Performance
- » “Backtesting”

- » FINRA members
 - Projections and target returns
 - Related performance

Exceptions to Net of Fees

- » Performance NET of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid
 - Custodial fee exception (ICI-I)
 - One-on-One presentation exception (ICI-II)
 - Model advisory fees (SIA/J.P. Morgan)
 - Side-by-side gross and net (AIMR)

“One-on-One” Disclosures

Gross performance is allowed in one-on-one presentations to wealthy prospects and consultants:

- » Performance doesn't reflect the deduction of advisory fees
- » Client's return will be reduced by advisory fees and other expenses
- » Advisory fees are described in the adviser's Form ADV
- » A representative example showing the effect advisory fees, compounded over years

“Portability” of Performance

- » Portability – Any use by one advisory firm of performance data generated by another
- » Horizon’s Refined Test
 - Persons managing accounts at the successor were *primarily responsible* for the past performance
 - Predecessor’s accounts are so similar to currently-managed accounts that the performance is *relevant* to prospects of the successor
 - No cherry picking - all prior accounts managed in a substantially similar manner are shown, unless their exclusion would not result in materially higher performance
 - Ad has relevant disclosures (including that the performance results were from accounts managed elsewhere)
 - New adviser has records

Implications of Portability

» Not just a regulatory issue

- Increases influence and mobility of portfolio managers (corresponding reliance on non-competition agreements)
- Upward pressure on compensation
- Enhances ability of start ups to compete effectively with more established and larger firms
- May impact marketability of advisory firms

Backtesting

“oddball strategies concocted out of tortured historical data”

- » Hypothetical performance developed by applying a particular methodology (typically quantitative or formula-based) to historical data
- » Backtesting does *not* involve market risk (in contrast to model or actual performance)
- » The SEC staff regards backtesting as highly suspect

Backtesting Disclosure

- » Performance does not represent the results of actual trading, but was achieved by means of retroactive application of a model designed with the benefit of hindsight
- » Results may not reflect the impact that material economic and market factors might have had on adviser's decision-making if adviser were actually managing client assets
- » Adviser began offering the service after the performance period referenced in the advertisements
- » Model changed materially during the time period
- » Actual trading results were materially lower

Testimonials

- » Any statement of a client's experience or an endorsement by a client
- » Testimonials tend
 - “to give rise to a fraudulent or deceptive implication or mistaken inference that the experience of the person giving the testimonial is typical of the experience of the adviser's clients.”
 - to emphasize the positive

Testimonials

» Article Reprints

- Prepared by an unbiased third party and do not include a statement of a client's experience

» Client Lists

- Objective criteria, plus disclosure (it is not known whether the clients approve)

» Third-party ratings

- Not based primarily on client evaluations, plus *DALBAR* conditions

Past Specific Recommendations

» Cherry picking

- “misleading impression of the adviser’s performance by referring only to past recommendations of the adviser which are or would have been profitable while ignoring those recommendations which were unprofitable”

Past Specific Recommendations

» Partial List vs. All or Nothing

- “Which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person; provided, however, that this shall not prohibit an advertisement *which sets out or offers to furnish a list of all recommendations* made by such investment adviser within the immediately preceding period of not less than one year . . .”

Past Specific Recommendations

» *Franklin Management, Inc. (1998)*

- Objective, non-performance based criteria
- Applied consistently
- Don't discuss profitability
- Maintain records

» *Investment Counsel Association of America (2004)*

- Written communication sent to existing clients that discusses securities held by those clients – not an advertisement

Recordkeeping (Rule 204-2)

» Ads and Distribution Lists

- written communication (recommendations, handling of funds, transactions)
- no record of names if sent to more than 10 (unless list)

» Ads and Recommendations

- all ads sent to more than 10
- document basis of recommendation

Recordkeeping (Rule 204-2)

» Records to Support Performance Calculations

- “necessary to form the basis for or demonstrate the calculation of the performance”
- internal account statements and worksheets
- prepared contemporaneously
- third party records to substantiate claims

» Retention Periods

SEC Examinations

- » Missing *Clover* disclosures
- » Partial lists of past specific recommendations
- » Adequate policies and procedures for marketing and performance advertising
- » Consultant materials
- » Portability
- » Carve outs (of equity and fixed income performance from balanced accounts)
- » Inaccurate claims of compliance with CFA Institute's performance
- » Selection of benchmarks
- » Accurate composite construction and descriptions

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Best Practices

- » Written policies
- » Separate functions
 - number crunching
 - composite construction
 - ad preparation
 - review and approval
- » Date versions of advertisements
- » Use a checklist for each advertisement
 - Track SEC requirements
 - Document signoff by all involved in preparation & review
 - Attach support to verify factual claims
 - Attach approved advertisement

Reviewing Advertisements

- » Review each ad with a critical eye as to any inferences, implications, predictions
- » Describe dates, benchmarks, sources
- » Consider facts and circumstances
- » Consider sophistication of audience
- » If you can't substantiate it - don't say it
- » Regular review process

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