

**SEC Regulation of Advertising  
by Investment Advisers**

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SEC Regulation of Advertising  
by Investment Advisers<sup>1</sup>

The Securities and Exchange Commission (“SEC”) and its staff have devoted considerable attention to the issue of how and under what circumstances investment advisers may advertise their services and performance to customers. As discussed below, the SEC and its staff have articulated guidelines for advertising through a rule, a series of “no-action” and interpretive letters under the rule, and numerous enforcement actions.

Part I of this Outline provides an overview of the SEC’s regulation of advertising under the Investment Advisers Act of 1940 (the “Advisers Act”). Part II discusses specific advertising prohibitions under the Advisers Act and current SEC staff positions concerning the prohibitions, including those pertaining to performance advertising. Part III highlights certain recent SEC enforcement actions dealing with investment adviser advertising. Part IV reviews the Advisers Act’s record keeping requirements as they apply to advertising, including performance advertising. Finally, Part V briefly reviews the SEC staff’s focus on advertising in the course of its field examinations.

**I. Overview of the Regulation of Advertising Under the Advisers Act**

Investment adviser advertising, including performance advertising, is principally regulated at the federal level under the general antifraud provision of the Advisers Act – Section 206 – and Rule 206(4)-1 thereunder.

**A. The Antifraud Provision**

Sections 206(1) and (2) of the Advisers Act make it unlawful for any investment adviser using the mails or interstate commerce “to employ any device, scheme or artifice to deceive, or manipulate any client or prospective client” or to “engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” These provisions apply to all investment advisers (as defined in Section 202(a)(11) of the Advisers Act) even if they are exempt from registration under Section 203(b) of the Advisers Act. A person

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can be found to have violated Section 206 even if the person engaged in the proscribed acts unintentionally.<sup>2</sup>

Section 206(4) of the Advisers Act also gives the SEC rulemaking authority to define acts, practices, and courses of business that are fraudulent, deceptive, or manipulative and to establish rules reasonably designed to prevent fraud. The SEC adopted Rule 206(4)-1 (the “SEC Advertising Rule”) under this authority. The SEC Advertising Rule applies to all investment advisers registered (or required to be registered) with the SEC.

## **B. Overview of the SEC Advertising Rule – The Definition of “Advertisement”**

The SEC Advertising Rule sets forth four specific prohibitions (discussed in the next section of this outline) and a general or “catch-all” prohibition relating to the use and content of investment adviser “advertisements.” The SEC Advertising Rule defines “advertisement” broadly to include (1) any “notice, circular, letter or other written communication addressed to *more than one* person” or (2) “any notice or other announcement in any publication or by radio or television, which offers . . . any . . . investment advisory service with regard to securities.” Rule 206(4)-1(b) (emphasis added). The definition of “advertisement” does not include oral communications between an investment adviser and a client or prospective client, as the initially-proposed Rule 206(4)-1 would have done.<sup>3</sup> In addition, it does not include communications tailored to meet the individual needs or circumstances of a person, such as statements containing account information pertaining to a single client. Moreover, the definition of advertisement does not include a written communication by an adviser that does no more than respond to an unsolicited request by a client, prospective client or consultant for specific information about the adviser’s past specific recommendations.<sup>4</sup>

Finally, the SEC staff does not view investment company advertisements as “advertisements” of the investment company’s adviser for purposes of the SEC Advertising Rule so long as such advertisements neither are directed to existing or prospective advisory clients nor refer to advisory services offered to such persons. According to the SEC staff

Materials designed to maintain existing clients and solicit new clients for [an] adviser are considered to be advertisements within Rule 206(4)-1. Generally, we would not view documents relating specifically to one or more investment companies, such as prospectuses, advertisements or sales literature, as designed to maintain existing clients or solicit new clients for the adviser unless the

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<sup>2</sup> Specifically, scienter (or intent) is not required to establish a violation of Section 206(2). *See SEC v. Capital Gains Research, Inc.*, 375 U.S. 180, 191-92 (1963); *SEC v. Blavin*, 557 F. Supp. 1304, 1315 (E.D. Mich. 1983); *aff’d*, 760 F.2d 706 (6th Cir. 1985).

<sup>3</sup> *See* Advisers Act Release No. 119 (August 8, 1961) (re-proposing the SEC Advertising Rule).

<sup>4</sup> *See Investment Counsel Association of America, Inc.* (March 1, 2004) (discussed in more detail below in Section II.D)

documents are directed to such persons or refer to advisory services that are offered to such persons.

On this basis, the SEC staff advised that information regarding portfolio transactions of specific investment companies advised by an investment adviser should not be viewed as “advertisements” for the investment adviser’s other advisory services, provided that the information does not refer to such other services. *See Munder Capital Management* (available May 17, 1996). Similarly, the SEC staff has commented that it generally would not view a mutual fund prospectus containing performance for the investment adviser’s private accounts to be an “advertisement” for purposes of the SEC Advertising Rule. *See Nicholas-Applegate Mutual Funds* (available August 6, 1996).

Aside from the few exceptions discussed above, the SEC and its staff historically have given a broad interpretation to the definition of “advertisement” under the SEC Advertising Rule. For instance, the SEC stated in *In re Paul K. Peers, Inc.*, 42 SEC Docket 539, 540-4 (1965), that “advertisement” for purposes of the Rule means any “investment advisory material which promotes advisory services for the purpose of inducing potential clients to subscribe to those services.” This broad reading of the term “advertisement” was endorsed by the U.S. Court of Appeals for the Ninth Circuit in a 1977 case in which the court found that a book published by an investment adviser was an “advertisement” for purposes of the SEC Advertising Rule. *See SEC v. C.R. Richmond & Co.*, 565 F.2d 1101 (9th Cir. 1977). The book in that case discussed the services provided by the investment adviser, its investment methods, and its performance.

A broad reading of the term “advertisement” is also reflected in the SEC staff’s no-action positions. For example, in *Denver Investment Advisors, Inc.* (available July 30, 1993), the staff took the position that a booklet containing a partial list of an investment adviser’s clients and other information concerning the investment adviser was an “advertisement” even though it was to be distributed on request only to consultants and existing clients. In the staff’s view, the booklet was addressed to more than one person and was to be distributed “for the ultimate purpose of maintaining existing clients and soliciting new ones” indirectly through consultants.

## **II. Specific Prohibitions**

### **A. Background**

The SEC Advertising Rule specifically prohibits an investment adviser from publishing, circulating or distributing any advertisement that:

- ♦ Refers to any *testimonial* concerning the investment adviser or any advice, analysis, report, or other service rendered by such investment adviser (Rule 206(4)-1(a)(1)); *see* discussion in Section II.C below);
- ♦ Refers to *past specific recommendations* of the investment adviser that were or would have been profitable unless the investment adviser complies with certain conditions (Rule 206(4)-1(a)(2)); *see* discussion in Section II.D below);

- ◆ Represents that any graph, chart, formula or other device offered can *in and of itself* be used to make trading decisions without prominently disclosing in the advertisement any limitations or difficulties in its use (Rule 206(4)-1(a)(3));<sup>5</sup> or
- ◆ Contains any statement to the effect that any report, analysis, or service is *free* unless it really is (Rule 206(4)-1(a)(4)).

In addition to the foregoing, the SEC Advertising Rule prohibits an investment adviser from publishing, circulating, or distributing any advertisement that “contains any untrue statement of a material fact” or that is “otherwise *false or misleading*.” Rule 206(4)-1(a)(5) (emphasis added). The significance of this general standard is demonstrated in the SEC’s 1965 administrative proceeding against *Spear & Staff, Inc.*, Advisers Act Release No. 188 (March 25, 1965). In that proceeding, the SEC found that statements made in an investment adviser’s advertisements “were deceptive and misleading in their over-all effect even though it might be argued that when narrowly and literally read, no single statement of a material fact was false.”

The “false or misleading” standard has often been troublesome to investment advisers and their legal counsel because the determination of whether a given communication is “misleading” is intrinsically subjective. The SEC staff has recognized the subjective nature of this determination and, for that reason, generally refuses to provide advice on whether a given advertisement should be viewed as misleading. *See, e.g., Anametrics Investment Management* (available May 5, 1977). Instead, the SEC staff routinely cautions in its no-action letters that whether a specific advertisement is misleading depends on the particular facts relating to the advertisement and the statements contained in it, including the:

- ◆ Form and content of the advertisement;
- ◆ Investment adviser’s ability to perform what is advertised;
- ◆ Implications or inferences arising from the context of the communication; and
- ◆ Sophistication of the prospective clients.<sup>6</sup>

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<sup>5</sup> *See The Mottin Forecast* (available November 29, 1975).

<sup>6</sup> *See, e.g., Triad Asset Management, Inc.* (available April 22, 1993); *Mills-Price & Associates, Inc.* (available July 15, 1992); *Bypass Wall Street, Inc.* (available January 7, 1992); *Clover Capital Management, Inc.* (available July 19, 1991); *Investment Company Institute* (available September 23, 1988); *Covato/Lipsitz, Inc.* (available October 23, 1981); *Edward F. O’Keefe* (available April 13, 1978); *Anametrics Investment Management* (available May 5, 1977).



## **B. Performance Advertising**

### **1. Background**

The SEC Advertising Rule does not contain any express prohibition concerning the use of performance in investment adviser advertisements. Instead, performance, whether based on actual results or trading in a “model” portfolio, is subject to that Rule’s general prohibition against advertisements that are “false or misleading,” and the SEC staff interpretations under the prohibition.

At the outset, it is important to note that the SEC staff’s positions concerning the use of performance in advertisements have evolved dramatically over the past 25 years. Until the late 1970s, the SEC staff took the position that the use of actual or model results in advertisements was inherently “false or misleading.” For instance, in *Ferris & Company, Inc.* (available May 23, 1972), the staff flatly stated in connection with a request to use model portfolio performance that, “[i]n our view, no amount of disclosure would remove the potential for deception which is inherent in such a practice” of using accounts that are “entirely hypothetical in nature.” Similarly, in *Executive Analysts, Inc.* (available August 6, 1972), the SEC staff stated that the use in advertisements of average performance figures for advised accounts would require “a high degree of disclosure” not to be considered misleading.<sup>7</sup>

This strict position has been largely abandoned in favor of a facts-and-circumstances test. Under this test, the determination of whether the use of performance results is false or misleading turns on whether “it implies, or a reader would infer from it, something about the adviser’s competence or about future investment results that would not be true had the advertisement included all material facts.”<sup>8</sup> Performance advertisements must disclose all material facts to avoid any unwarranted implications or inferences.

### **2. General Performance Presentation Guidelines**

In *Clover Capital Management, Inc.* (available October 28, 1986), one of the most important SEC no-action letters in the advertising area, the SEC staff attempted to present a comprehensive set of guidelines for advertising actual and model performance results.

#### **a. Model and Actual Performance Results**

*Clover* indicates that the following practices would be misleading in connection with the use of model or actual performance results:

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<sup>7</sup> See also, e.g., *A.R. Schmeidler & Co.* (available June 1, 1976); *Schild Stock Services, Inc.* (available February 26, 1972).

<sup>8</sup> *Clover Capital Management, Inc.* (available October 28, 1986); see also *Edward F. O’Keefe* (available March 14, 1978); *Anametrics Investment Management* (available May 5, 1977).

- ♦ Failing to disclose the effect of material market or economic conditions on the results portrayed (*e.g.*, an advertisement stating that the accounts of the investment adviser’s clients appreciated in value 25% without disclosing that the market generally appreciated 40% during the same period);
- ♦ Failing, except under certain circumstances (discussed in Part II.B.3.a. below), to reflect the deduction of investment advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid (the so-called “net of fees requirement”);
- ♦ Failing to disclose whether and to what extent the results portrayed reflect the 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 all material factors relevant to the comparison (*e.g.*, an advertisement that compares model results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio); and
- ♦ Failing to disclose any material conditions, objectives, or investment strategies used to obtain the performance advertised.<sup>9</sup>

**b. Model Performance Results**

*Clover* also indicates that the following practices would be misleading in connection with the use of model performance results:

- ♦ Failing to disclose prominently the limitations inherent in model results;
- ♦ Failing to disclose, if applicable, material changes in the conditions, objectives, or investment strategies of the model portfolio during the period portrayed and the effect of those changes;
- ♦ Failing to disclose, if applicable, that some of the securities or strategies reflected in the model portfolio do not relate, or relate only partially, to the services currently offered by the investment adviser; and

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<sup>9</sup> See, *e.g.*, *In Re Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker*, Advisers Act Release No. 2154 (July 31, 2003); *In re The Dreyfus Corporation and Michael L. Schonberg*, Advisers Act Release No. 1870 (May 10, 2000); *In re Van Kampen Investment Advisory Corp. and Alan Sachtleben*, Advisers Act Release No. 1819 (September 8, 1999).

- ♦ Failing to disclose, if applicable, that the investment adviser’s clients actually had investment results that were materially different from those portrayed in the model.

**c. Actual Performance Results**

Finally, *Clover* indicates that the following practices would be misleading in connection with the use of actual performance results:

- ♦ Failing to disclose, if applicable, that the results portrayed relate only to a select group of the investment adviser’s clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.

**3. Specific Performance Presentation Issues**

**a. Exceptions to the Net of Fees Requirement**

As noted above, the staff stated in *Clover* that performance for actual and model accounts must be shown on a “net” basis after first deducting all investment advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid. Although the net of fees requirement has long been the most controversial aspect of *Clover* in the investment management industry, the staff has reaffirmed the requirement on numerous occasions. For example, it stated in *Investment Company Institute* (available August 24, 1987) (“*ICI-I*”) that

[B]ecause advertisements typically present adviser performance results over a number of years, narrative disclosure of the existence and range of advisory fees, in our view, would not be an adequate substitute for deducting advisory fees because of the compounding effect on performance figures that occurs if advisory fees are not deducted. In our view it is inappropriate to require a reader to calculate the compounding effect of the undeducted expenses on the advertised performance figures.

Despite this reaffirmation, the SEC staff has relaxed the net of fees requirement in a number of significant respects, as discussed below.

**(i) Side-by-Side Gross and Net of Fees Presentation**

First, the SEC staff stated in *Association for Investment Management and Research* (available December 18, 1996) (“*AIMR*”) that an investment adviser may distribute advertisements containing performance figures both gross and net of fees so long as both sets of fees are presented in an equally prominent manner. In addition, the advertisements must contain sufficient disclosure to ensure that the performance figures are not misleading. For example, the disclosure accompanying performance figures shown gross of fees should specifically state that the figures do not reflect the payment of investment advisory fees and other expenses.

**(ii) Multi-Manager Account Performance**

The SEC staff also concluded in *AIMR* that an investment adviser that manages only a portion of a client’s account may advertise performance figures relating only to that portion of the account so long as the performance is shown net of all transaction costs and advisory fees or charges paid to the adviser or its affiliates.

**(iii) Custodial Fees Exception**

The SEC staff has taken the position since *ICI-I* that investment adviser performance may be presented without reflecting custodial fees paid to a bank or other organization for safekeeping client funds and securities. The rationale for this position is that the client usually selects and pays the custodian.

**(iv) “One-on-One” Presentation Exception**

Finally, in a second letter to the Investment Company Institute – *Investment Company Institute* (available September 23, 1988) (“*ICI-II*”) – the SEC staff further relaxed its position regarding the presentation of performance net of investment advisory fees. Specifically, the SEC staff stated that it would not recommend enforcement action if an investment adviser uses gross performance results in one-on-one presentations to wealthy prospective clients and consultants, provided that the investment adviser furnishes the following information in writing at the time of the presentation:

- ♦ Disclosure that the performance figures do not reflect the deduction of investment advisory fees;
- ♦ Disclosure that the client’s return will be reduced by the investment advisory fees and any other expenses the client may incur in the management of its investment advisory account;
- ♦ Disclosure that the investment advisory fees are described in Part II of the investment adviser’s Form ADV; and
- ♦ A representative example (in the form of a table, chart, graph, or narrative) which shows the effect that an investment advisory fee, compounded over a period of years, could have on the total value of a client’s portfolio.

For purposes of *ICI-II*, wealthy prospective clients include wealthy individuals, pension funds, universities and other institutions that have sufficient assets to justify the investment adviser incurring the costs of a one-on-one presentation. As to what constitutes a one-on-one presentation, *ICI-II* seems to permit a presentation to be made to more than one individual. To be “one-on-one,” a presentation must be of a “private and confidential nature” and made in a setting that affords each prospective client with “the opportunity to discuss with the adviser the types of fees that the client might pay.” The SEC also advised that it could not recommend enforcement action if an investment adviser provides gross performance data to consultants so

long as the adviser instructs the consultant to give the performance data to prospective clients of the adviser only on a one-on-one basis and the consultant provides the disclosures referred to above.

**b. Deduction of Model Advisory Fees**

In *Clover* the SEC staff required that performance figures be presented net of investment advisory fees charged to managed accounts. In a letter to *The Security Industry Association* (available November 27, 1989) (“*SIA Letter*”) the staff clarified that the net of fees requirement means that performance must be presented net of all advisory fees actually charged to customers, and may not be presented net of a model advisory fee (except for a six-month grace period after issuance of the letter). However, the SEC staff subsequently issued a no-action letter to *J.P. Morgan Investment Management, Inc.* (available May 7, 1996), overturning its position in *SIA*. Specifically, the staff concluded in *J.P. Morgan* that it would not object if an investment adviser advertises the composite performance of accounts for which it employs a particular investment strategy by deducting model fees equal to the highest fee charged to any such account during the performance period. In giving this advice, the SEC staff stated

[W]hen an adviser advertises performance that is no higher than that which reflects the deduction of actual fees, there appears to be little chance that an investor would be misled. In our view, therefore, assuming appropriate accompanying disclosure, Rule 206(4)-1(a)(5) does not prohibit an adviser from advertising performance that reflects the deduction of a model fee when doing so would result in performance figures that are no higher than those that would have resulted if actual fees had been deducted.<sup>10</sup>

**c. “Portability” of Performance**

“Portability” of performance – or the ability of an investment adviser to cite as its own performance the performance of a predecessor firm or a firm at which the investment adviser’s portfolio managers previously managed accounts – is an issue of considerable importance to many investment advisers. The SEC staff has issued a number of no-action and interpretive letters providing guidance on this issue.<sup>11</sup> These letters are discussed below in the chronological order in which they were issued. This discussion ends with the SEC staff’s most recent no-

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<sup>10</sup> In this regard, the staff also concluded in the *AIMR* letter that an adviser may advertise the composite performance of both wrap and non-wrap fee client accounts after deducting a model wrap fee equal to the highest fee charged to any wrap or non-wrap fee client. Of course, the advertisement must contain sufficient disclosure to ensure it is not misleading.

<sup>11</sup> The SEC staff has also issued a no-action letter providing guidance on “portability” issues in the investment company context. *See, e.g., Bramwell Growth Fund* (available August 7, 1996) (permitting the inclusion in an investment company’s prospectus of performance information relating to another similar investment company *managed* by the same portfolio manager).

action letter to *Horizon Asset Management LLC* (available September 13, 1996), in which the staff introduced a reformulated test for portability.

**(i) Performance of Portfolio Managers at Prior Firm**

In *Fiduciary Management Associates, Inc.* (available March 5, 1984), an investment adviser led by a portfolio manager who was previously an officer of another firm sought assurances that the SEC staff would not object if the investment adviser included in its performance the results of accounts managed by the portfolio manager while at the old firm. The SEC staff replied that, with appropriate disclosure, the investment adviser could use the performance of the portfolio manager's accounts that followed him from the old firm if (i) "no person other" than the portfolio manager "played a significant part in the performance of accounts of clients" of the old firm that were under his management; and (ii) the performance of those accounts that became accounts of the portfolio manager at the new firm was not "materially different from the performance" of those accounts at the old firm that did not follow him to the new firm.

**(ii) Performance of Portfolio Manager's Own Personal Accounts**

In *Conway Asset Management, Inc.* (available January 27, 1989), an investment adviser sought permission to use – in private presentations (not in advertisements or seminars) – the performance results of three personal accounts managed under sole discretion of the investment adviser's portfolio manager (and only employee) prior to the investment adviser's organization. Echoing its earlier no-action position in *Fiduciary Management Associates, Inc.*, the SEC staff replied that:

While the use of prior performance results by a subsequent investment adviser may raise an issue under Rule 206(4)-1, we do not believe that the Adviser's use of [the portfolio manager's] performance results would in and of itself be misleading provided: (1) that no individual or entity, other than [the portfolio manager] played a significant part in the performance of the accounts of [the portfolio manager] and (2) the results of [the portfolio manager's] accounts whose performance you seek to advertise were not materially different from the performance of [the portfolio manager's] accounts which did not become accounts of the Adviser.

**(iii) Performance of Accounts "Purchased" From Predecessor Firm**

In *Great Lakes Advisors, Inc.* (available April 3, 1992), Great Lakes Advisors, Inc. ("Great Lakes") sought SEC staff permission to use certain performance data of its predecessor, Continental Capital Management Corporation ("Old CCMC") from January 1, 1985 until July 31, 1990. Great Lakes began business on August 1, 1990 when it acquired 84% of the dollar value of the Old CCMC accounts. Great Lakes' portfolio manager for equity and convertible securities had been responsible for developing Old CCMC's investment philosophy for equity

and convertible security portfolio selections, but Old CCMC selected equity securities by consensus among this portfolio manager and two or three others who played a significant role in the process. Great Lakes' portfolio manager for fixed-income securities had been responsible for selecting and managing Old CCMC's fixed income portfolio securities using an investment philosophy Old CCMC applied prior to his joining that firm in November 1988.

Great Lakes argued that, with appropriate disclosure, Great Lakes' use of Old CCMC's equity and fixed income performance data from January 1, 1985 until July 31, 1990, would not violate rule 206(4)-1(a)(5) under the Advisers Act. In its reply, the SEC staff noted its prior no-action positions that it may not be misleading for an investment adviser to use performance data of a predecessor if (1) no individual other than the successor's portfolio manager played a significant part in the performance of the predecessor's accounts that were transferred to the successor investment adviser; and (2) the performance of the predecessor's accounts that were not transferred to the successor investment adviser did not differ materially from the performance of the transferred accounts. The SEC staff then went on to deny Great Lakes' no-action request, explaining that "[b]ecause individuals other than [Great Lakes' equities portfolio manager] played a significant role in managing Old CCMC's equity accounts . . . , Great Lakes' use of Old CCMC's performance data . . . would be misleading under rule 206(4)-1(a)(5)." The staff added that, because Great Lakes' fixed income manager "played no role in managing Old CCMC's fixed income accounts" before his employment with that firm in 1988, Great Lakes' use of Old CCMC's fixed income performance data for the period from January 1, 1985 to November 1988 would be misleading. The staff concluded by rejecting the argument that "disclosure alone would be sufficient to make the proposed use of Old CCMC's equity and fixed income performance data not misleading."

Great Lakes is significant in a number of respects. First, it is the first no-action letter dealing with portability of performance to emphasize that a successor investment adviser cannot use the performance of a predecessor firm unless it can comply fully with the record keeping requirements of Rule 204-2(a)(16), discussed in Part III below. Specifically, the staff noted that Rule 204-2(a)(16) generally requires an investment adviser to keep all documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts that the investment adviser uses in advertisements or other communications distributed to 10 or more persons. The staff went on to say that "[t]his requirement applies also to a successor's use of a predecessor's performance data."

Second, although the SEC staff turned down Great Lakes' no-action request because persons other than Great Lakes' portfolio managers were involved in security selection at the predecessor firm, the SEC staff offered guidance on the portability problems posed by investment committee decision making. Specifically, the staff noted that "[w]here an adviser selects portfolio securities by consensus or committee decision making, it may be difficult to attach relative significance to the role played by each group member." The staff suggested, however, that "[u]nder certain circumstances, it may not be misleading for a successor adviser, composed of less than 100% of the predecessor's committee, to use the performance data of the predecessor's committee. We believe, however, that, at a minimum, there would have to be a substantial identity of personnel among the predecessor's and successor's committees."

**(iv) Performance of Joint Venture Partner**

In *Taurus Advisory Group, Inc.* (available July 15, 1993), Taurus Advisory Group, Inc. (“TAG”) sought no-action assurances from the SEC staff in connection with a proposal that Taurus Advisory Group Joint Venture (“TAG-JV”), a joint venture of TAG and Sector Management, Inc. (“Sector”), be permitted to provide privately to prospective clients past performance data of TAG. Although TAG-JV was to become registered itself as an investment adviser, the joint venture arrangements contemplated that TAG would perform all of TAG-JV’s investment advisory services and, specifically, that the same individuals responsible for investment decisions for TAG’s clients also would be responsible for investment decisions for TAG-JV’s clients. Sector would only market TAG-JV’s services, and provide certain other services to TAG-JV (such as administrative services, office management, and financial controls). It was contemplated that none of TAG’s existing advisory clients would become clients of TAG-JV, and that any new advisory clients would be clients of TAG-JV, not TAG. TAG-JV and Sector proposed to provide prospective TAG-JV clients – in “private and confidential, one-on-one or very small group presentations” – with TAG’s investment performance data for a maximum of five years. TAG-JV would not, however, use TAG’s past performance in public advertisements.

The SEC staff granted TAG’s no-action request. As in *Great Lakes*, the staff reiterated its position that it may not be misleading for an investment adviser to use a predecessor’s performance data if (1) no person other than the successor’s portfolio manager played a significant part in the performance of the predecessor’s accounts, and (2) the performance of the predecessor’s accounts that were not transferred to the successor did not differ materially from the performance of the predecessor’s accounts that were transferred to the successor. The staff impliedly agreed with TAG that, “[a]lthough TAG and [TAG-JV] are not in the position of predecessor and successor, . . . the arrangement meets the intent of these conditions.” Following *Great Lakes*, the SEC staff also noted that Rule 204-2(a)(16), which requires that investment advisers keep documents necessary to form the basis for or demonstrate the calculation of the performance of managed accounts used in advertisements, applied to TAG-JV’s use of TAG’s performance data.

**(v) Continuing Primary Role of Portfolio Managers  
Responsible for “Ported” Performance – A Refined  
Test**

In *Horizon Asset Management LLC* (available September 13, 1996), Horizon Asset Management LLC (“Horizon”) requested permission to include in its advertisements performance data reflecting the performance of an advisory firm previously owned and operated by the controlling member of Horizon’s investment committee. Horizon manages accounts using a three-person advisory committee, the controlling member of which has final decision-making authority and the remaining two members play an advisory role. The controlling member also was principally responsible for all investment decisions made by the predecessor firm.

The *Horizon* no-action letter is significant in three respects. First, more than prior “portability” letters it stressed *the portfolio manager’s continuing role at the investment adviser* claiming the



portfolio manager's past performance. Most prior letters focused only on the primacy of the portfolio manager's role at the predecessor firm but paid no attention to whether the portfolio manager played the same role at the new firm. In *Horizon*, the staff declared that "it may be misleading for an employee's new firm to use the performance results of an account he previously managed if at the new firm the [employee] is one of several persons responsible for managing accounts." As noted above, *Horizon* represented that the portfolio manager (whose past performance it proposed to use) was principally responsible for the decisions of *Horizon*'s investment committee and that the remaining two members played an ostensibly advisory role.

Second, *Horizon* provides, at least by analogy, another illustration of circumstances in which the performance of a predecessor firm's investment committee could be used by a successor firm that employed some of the members of the predecessor's investment committee. As discussed above, in *Great Lakes Advisors, Inc.* the SEC staff said that "[u]nder certain circumstances, it may not be misleading for a successor adviser, composed of less than 100% of the predecessor's committee, to use the performance data of the predecessor's committee." The SEC staff went on to say that "at a minimum, there would have to be a substantial identity of personnel among the predecessor's and successor's committees." In *Horizon*, the staff suggested that it would be sufficient if, notwithstanding the composition of investment committees, the predecessor and successor firms' investment decisions were in fact made or controlled by the same person. Specifically, the SEC staff said that "the fact that the Controlling Manager will be a member of an advisory committee does not necessarily mean that including the Predecessor Firm's performance results in an advertisement would be misleading, if the Controlling Manager is the person actually responsible for making the investment decisions, and those decisions need not be made with the consensus of the other members of the committee."

Third, the SEC staff in *Horizon* presented a reformulated standard for portability of performance that not only incorporates the concepts discussed above, but also requires disclosure of the use of "ported" performance and comparability of accounts managed at the predecessor and successor firms. Specifically, the staff said that an advertisement that includes prior performance results of accounts managed by a predecessor would not, in and of itself, be misleading under Rule 206(4)-1(A)(5) if the following conditions were satisfied:

- ♦ The person or persons who manage accounts at the successor adviser were also primarily responsible for achieving the prior performance results;
- ♦ The accounts managed at the predecessor are so similar to the accounts currently under management that the performance results would provide relevant information to prospective clients of the successor adviser;
- ♦ All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance;
- ♦ The advertisement is consistent with staff interpretations with respect to the advertisement of performance results; and

- ♦ The advertisement includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

**d. “Backtesting”**

Although the specific performance presentation issues discussed above were developed through SEC staff no-action and interpretive letters, the law in the area of “backtesting” has emerged in the less subtle context of SEC enforcement actions. Backtesting involves the use of theoretical performance developed by applying a particular investment strategy (typically, a quantitative or formula-based strategy) to historical financial data. The backtested results show investment decisions that theoretically would have been made had the given strategy been employed during the particular past period of time. Unlike traditional forward-looking models, backtesting does not involve market risk. The SEC staff regards backtesting as highly suspect because the adviser can run the backtested model again and again until it gets the results it wants.

The SEC has brought several enforcement cases against investment advisers relating to the use of backtested results. Although the SEC has stopped short of saying the use of backtested results is *per se* or intrinsically misleading, the SEC’s enforcement cases place a heavy burden on advisers using backtested performance to ensure that clients are not misled.

**(i) *In re Leeb Investment Advisers***

The first enforcement case brought by the SEC in the backtesting area was *In re Leeb Investment Advisers*, Advisers Act Release 1545 (January 16, 1996). In *In re Leeb Investment Advisers*, the SEC agreed to settle an enforcement action brought in May 1995 against Stephen Leeb (“Leeb”) and others for, among other things, publishing false and misleading advertisements regarding the performance of a market-timing program Leeb developed. Although the action centered on the use of advertisements in the mutual fund context (and did not find violations of Section 206 of the Advisers Act), it illustrates the SEC’s enforcement focus in the performance area. The advertisements related to Leeb’s “Master Key,” a market-timing program that purportedly analyzed historical market data and trends to generate buy and sell signals. The advertisements, according to the SEC, falsely claimed that an investor could have turned a \$10,000 investment in 1980 into \$39,160,394 by 1992 using Leeb’s “Master Key.”

The SEC cited two principal reasons for finding that the advertisements were false and misleading. First, Leeb’s “Master Key” had not remained the same since its inception. Rather, Leeb had constantly adjusted and revised the “Master Key” to account for new market data. The claimed “earnings” were simulated or backtested results that could only be obtained, if at all, by retroactively applying the continually updated version of Leeb’s “Master Key.” Second, the representation that an investor could turn a \$10,000 investment into \$39 million in twelve years depended on using trading strategies that only became available long after 1980. In finding violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 17(a)(2) of the Securities Act of 1933, and Section 34(b) of the Investment Company Act by certain of the respondents, the SEC stated that the newsletter advertisements failed adequately to disclose the above facts concerning the nature and performance of the “Master Key.”

**(ii) *In re Patricia Owen-Michael***

The second enforcement case in the backtesting area was *In re Patricia Owen-Michael*, Advisers Act Release No. 1584 (September 27, 1996). In this enforcement case, the SEC sanctioned the president of an investment adviser for allegedly circulating misleading advertisements. According to the SEC order, the adviser was a quantitative money management firm that used a computer-based statistical model to select stocks and mutual funds and to generate trading signals. The adviser advertised its services through, among other things, various charts and graphs depicting hypothetical performance of an investment model applied retroactively. The SEC found that the adviser's president caused violations of Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) in that she aided and abetted and caused the adviser to distribute advertisements that contained an untrue statement of a material fact or otherwise was false or misleading. In this regard, the SEC alleged that the various charts and graphs depicting hypothetical performance of the adviser's model failed to disclose:

- ♦ That the adviser only began offering the given service after the performance period depicted by the advertisement;
- ♦ That the advertised performance results do not represent the results of actual trading but were achieved by means of the retroactive application of a model designed with the benefit of hindsight;
- ♦ All material economic and market factors that might have had an impact on the adviser's decision-making when using the model to manage actual client accounts;
- ♦ Whether the advertised performance reflects the deduction of advisory fees, brokerage or other commissions, mutual fund exchange fees, and any other expenses that a client would have paid; and
- ♦ The potential for loss as well as for-profit.

**(iii) *In re LBS Capital Management, Inc.***

Another example of SEC enforcement cases in the backtesting area is *In re LBS Capital Management, Inc.*, Advisers Act Release No. 1644 (July 18, 1997). In this action, the SEC sanctioned an investment adviser in connection with its use of an advertisement that contained performance results achieved by means of backtesting. According to the SEC's order, the adviser violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) by distributing an advertisement containing simulated performance results for a quantitative mutual fund timing and selection service. Specifically, the adviser had developed a mutual fund timing and selection service by using historical financial data from 1983 through 1986. The adviser then tested the quantitative validity of the model by applying it retroactively to a different period of time – 1987 through 1993 – and, thereby, derived simulated performance results for the model for those years – a process known as “out-of-sample” testing. The advertisement disclosed in a footnote that the performance results were “pro-forma,” that “model” performance was “no guarantee of future results,” that the timing service “went live” in January 1994, and that “actual results” were

“available upon request.”

The SEC found that the advertisement was materially misleading because it failed to disclose “with sufficient prominence or detail” that the advertised performance results did not represent the results of actual trading but were achieved by means of the retroactive application of a model. The SEC found that the footnote disclosure was inadequate under the circumstances, and cited another case for the proposition that a misleading statement in an advertisement cannot be “cured by the disclaimers buried in the [smaller print] text [of the advertisement].”<sup>12</sup> The SEC also focused on the fact that the advertisement was distributed by the adviser to existing and prospective *retail* clients “without regard for their investment sophistication or acumen.”

(iv) *In re Schield Management Company*

In this case, *In re Schield Management Company et al.*, Advisers Act Release No. 1871 ( May 31, 2000),<sup>13</sup> the SEC alleged that the firm distributed materially false and misleading advertisements relating to its asset allocation and risk management strategies through brochures, newsletters, written performance updates, oral presentations, Internet postings and information submitted to the *Money Manager Review* ratings publication. Specifically, the adviser published advertisements containing performance figures for up to five years prior to implementing its asset allocation and risk management strategies while failing to disclose or inadequately disclosing that the performance was derived from the retroactive application of a model developed with the benefit of hindsight. The adviser also failed to convey fully the inherent limitations associated with the use of backtested performance. For example, its advertisements frequently included tables and graphs that combined the pre-implementation data with performance data from periods following Schield’s implementation of the relevant trading strategies. One such chart showed that the Sector Allocation Investment Plan (“SAIP”) model consistently outperformed the S&P 500 index without disclosing that Schield’s actual implementation of the strategy actually underperformed the S&P 500 index. The adviser also failed to disclose that it applied materially different trading rules in calculating the performance of the SAIP strategy before and after the actual implementation of the strategy.

According to the SEC, the firm also published and distributed advertisements that were false and misleading because they materially overstated the performance of their asset allocation and risk management strategies by failing to deduct the full management fee and other fees earned by the firm. In some cases, the adviser deducted only one twelfth to one half of its management fee each year. On a cumulative basis, this had the effect of overstating the performance of the SAIP strategy by more than thirteen percent. The firm also included performance numbers that were calculated erroneously, the firm allowed the *Money Manger Review* to publish information suggesting that the firm complied with the AIMR performance presentation standards when, in fact, it did not.

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<sup>12</sup> *In re Jesse Rosenblum*, Advisers Act Release No. 913 (May 17, 1984).

<sup>13</sup> *See also In re Schield Management Company, et al.*, Advisers Act Release No. 1872 (May 31, 2000).

(v) *In re Market Timing Systems, Inc.*

In this case, *In re Market Timing Systems, Inc. et al.*, Advisers Act Release No. 2047 (August 28, 2002),<sup>14</sup> the SEC alleged that Market Timing Systems, Inc. (“MTS”) distributed materially false and misleading advertisements that featured the performance of its “MASTERTIMER model,” a computerized model that consisted of two commercially available market-timing software programs. The advertisements, which were distributed through the adviser’s website, newsletters and direct mailings to actual and potential clients, promoted returns for the MASTERTIMER model of over 70% for a 13 year time period. However, the advertisements did not disclose that the performance results were hypothetical and were generated by the retroactive application of the model (MTS did not actually begin managing money until 1998).

The SEC also claimed that MTS overstated the role the model played in its market timing program. The performance reflected in the advertisements was generated by the MASTERTIMER model. However, in making investment decisions for client accounts the adviser relied on, and in fact attached greater weight to a number of other factors. Finally, MTS failed to disclose that the actual performance of client accounts during its first quarter of operations was materially less than the model’s hypothetical results for the same period.

**C. Testimonials**

As noted above, the SEC Advertising Rule prohibits an investment adviser from using any advertisement that refers to any testimonial concerning the investment adviser or any advice, analysis, report, or other service rendered by such investment adviser.<sup>15</sup> As written, this prohibition appears to apply to testimonials relating to an investment adviser’s non-investment advisory activities. The SEC staff has generally viewed the word “testimonial” broadly to mean any statement of a client’s experience or an endorsement by a client.<sup>16</sup>

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<sup>14</sup> See also *In re Market Timing Systems, Inc., et al.*, Advisers Act Release No. 2048 (August 28, 2002).

<sup>15</sup> For a more thorough discussion and commentary concerning the prohibition against using testimonials, see Lawrence Stadulis, “*Unequal Treatment Under the Law; The Regulation of Client Testimonials in Investment Adviser, Investment Company and Broker-Dealer Ads*,” *Investment Lawyer* (Nov. 1996), at 10. If an investment adviser is also registered as a broker-dealer, its use of testimonials is subject to various self-regulatory organization rules relating to testimonials. See, e.g., FINRA Conduct Rule 2210(d)(2)(D) and NYSE Rule 472.40(8).

<sup>16</sup> See, e.g., *Richard Silverman* (available March 27, 1985). Consistent with this broad view, the SEC staff has regarded a wide variety of communications as testimonials. See, e.g., *In re Louis Corujo*, Advisers Act Release No. 1490 (May 11, 1995) (involving signed quotes from satisfied financial seminar participants that described how the seminar benefited the participants); *Gallagher and Associates, Ltd.* (available July 10, 1995) (involving limited testimonials related to the investment adviser’s civic-mindedness and other traits relating indirectly to investment advice); *CIGNA Securities, Inc.* (available September 10, 1991) (involving written statements from satisfied financial planning clients); *Investor Intelligence* (available April 18, 1975) (involving a proposed advertisement that described the investment

The SEC adopted the prohibition against the use of testimonials based on the view that testimonials are intrinsically misleading because of their conclusory nature. Testimonials “by their very nature[,] emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable.” Advisers Act Release 121 (November 2, 1961). The SEC’s concerns about the misleading nature of testimonials have been echoed by the SEC staff. In replying to a number of no-action requests, the SEC staff has made clear its concern that 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.” *Denver Investment Advisors, Inc.* (available July 30, 1993); *New York Investors Group, Inc.* (available September 7, 1982); see also *CIGNA Securities, Inc.* (available September 10, 1991); *J.Y. Barry Arbitrage Management, Inc.* (available October 18, 1989).

More recently, the SEC staff has addressed the use of testimonials in social media. In a National Examination Risk Alert that was issued on January 4, 2012,<sup>17</sup> the SEC staff reiterated the broad definition of a testimonial and reminded investment advisers that, depending on the facts and circumstances, the use of a “like” or similar feature on a social media website could be viewed as a testimonial. The SEC staff explained that

Third-party use of the “like” feature on an investment adviser’s social media site could be deemed to be a testimonial if it is an explicit or implicit statement of a client’s or clients’ experience with an investment adviser or [investment adviser representative]. If, for example, the public is invited to “like” an [investment adviser representative’s] biography posted on a social media site, that election could be viewed as a type of testimonial prohibited by rule 206(4)-1(a)(1).

Despite the concerns surrounding the use of testimonials, the SEC staff has given no-action relief in connection with proposals to disseminate reprints of articles that refer to an investment adviser and its performance and to disseminate partial lists of clients. These no-action positions are discussed below.

## 1. Article Reprints

Given the SEC staff’s broad view of “testimonial,” the question arose whether Rule 206(4)-1(a)(1)’s prohibition against the use of testimonials applied to the dissemination of articles that feature or speak favorably of an investment adviser’s abilities or performance. Like pure client testimonials, such articles may contain conclusions about an investment adviser’s abilities or performance and, at least indirectly, may reflect the experiences of the investment adviser’s clients. Nevertheless, in a series of no-action letters, the SEC staff has permitted the distribution

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adviser “recognized”); *Analytic Investment Management, Inc.* (available March 22, 1971) (involving the written offer to provide references from a mutual acquaintance).

<sup>17</sup> *Investment Adviser Use of Social Media*, National Examination Risk Alert, Volume II, Issue 1, published by the office of Compliance Inspections and Examinations (January 4, 2012), available at <http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf> (the “Risk Alert”).

of articles concerning an investment adviser where the articles are prepared by an unbiased third party and do not include a statement of a client's experience or a client endorsement. *See, e.g., Stalker Advisory Services* (available January 18, 1994); *Kurtz Capital Management* (available January 18, 1988); *Richard Silverman* (available March 27, 1985); *New York Investors Group, Inc.* (available September 7, 1982).

In one of the more recent of these letters, *Stalker Advisory Services* (available January 18, 1994), the investment adviser in question proposed to distribute copies of articles from various independent financial publications that ranked various firms, including the investment adviser. The rankings and related performance information published in these articles were prepared by an independent company with which the investment adviser contracted (and paid money) to be included in the rankings.

In giving its no-action advice, the SEC staff (as it had in its other no-action letters in this area) cautioned that the use of these articles would still be subject to the general prohibition against advertisements that are false or misleading. According to the SEC staff

Use of a reprint containing this performance information and rankings . . . would be prohibited if it implied something about or caused a reader to draw an inference concerning (i) the experience of advisory clients, (ii) the possibility of a prospective client having an investment experience similar to that of prior clients, or (iii) the adviser's competence, when there are additional facts that, if disclosed, would imply different results from those suggested in the article.

Because the distribution of article reprints remain subject to the general prohibition against false or misleading advertising, an investment adviser proposing to distribute article reprints should consider if any additional information or disclosures should accompany the article reprints.

## 2. Investment Adviser Rankings

Despite the SEC staff's positions (discussed above) concerning article reprints, the SEC staff concluded in *DALBAR, Inc.* (available March 24, 1998) that the distribution by investment advisers of advertising materials containing reprints of a research firm's investment adviser ratings would constitute "testimonials" within the meaning of Advisers Act Rule 206(4)-1(a)(1). The staff based its conclusion on the fact that the ratings would be derived from responses to client questionnaires that the research firm would distribute to clients of advisers participating in the ratings process. Thus, each rating would constitute a "testimonial by an adviser's clients, made indirectly through" the research firm.

Nonetheless, in *DALBAR* the SEC staff agreed not to recommend enforcement action under Rule 206(4)-1(a)(1) if investment advisers distributed advertisements containing reprints of the ratings, based on the view that such materials do not raise the types of concerns that the provision was designed to prevent. The SEC staff noted the following factors in support of this conclusion:

- ♦ The ratings would not emphasize favorable client responses or ignore unfavorable ones;

- ♦ The ratings would represent all, or a statistically valid sample, of the responses of an adviser's clients;
- ♦ The questionnaire distributed to clients would not be prepared to produce any pre-determined favorable results; and
- ♦ The research firm would not provide any subjective analysis of the questionnaire results but merely assign numerical ratings after averaging the client responses for each adviser.

In addition to noting the above factors, the SEC staff's response was conditioned on the following representations: (1) participating advisers would meet certain eligibility criteria reasonably designed to ensure that a participating adviser has an established and significant history and a record free from regulatory sanctions; (2) the research firm would not be affiliated with any participating adviser; (3) the research firm would survey all or, as appropriate, a statistically valid sample, of a participating adviser's clients; (4) all participating advisers would be charged a uniform fee, paid in advance; (5) the research firm would not issue ratings to an adviser unless the ratings are statistically valid with respect to that adviser; and (6) any survey results published by the research firm would contain information that clearly identified the percentage of survey participants who have received each designation and the total number of survey participants.

Finally, the SEC staff took the opportunity to provide guidance regarding some factors that investment advisers should themselves consider when determining whether any advertisement containing a research firm rating is otherwise false or misleading under Rule 206(4)-1(a)(5). Specifically, the SEC staff commented that investment advisers proposing to distribute ratings should consider whether:

- ♦ The advertisement discloses the criteria on which the rating was based;
- ♦ The adviser knows of undisclosed facts that would call into question the validity of the rating or the appropriateness of advertising the rating (*e.g.*, the adviser knows that it had been the subject of numerous client complaints relating to the rating category or in areas not included in the survey);
- ♦ The adviser advertises a favorable rating without also disclosing any unfavorable rating;
- ♦ The advertisement states or implies that an adviser was the top-rated adviser in a category when it was not rated first in that category;
- ♦ In disclosing an adviser's rating or designation, the advertisement clearly and prominently discloses the category for which the rating was calculated or designation determined, the number of advisers surveyed in that category, and the percentage of advisers that received that rating or designation;



- ♦ The advertisement discloses that the rating may not be representative of any one client’s experience because the rating reflects an average of all, or a sample of all, of the experiences of the adviser’s clients;
- ♦ The advertisement discloses that the rating is not indicative of the adviser’s future performance; and
- ♦ The advertisement discloses prominently who created and conducted the survey, and that the adviser paid a fee to participate in the survey.

The SEC staff later clarified its position in the DALBAR letter that a third-party rating that relies primarily on client evaluations of that an investment adviser would be a testimonial. A third-party rating that relies *in part* on client evaluations would not be a testimonial, if the rater consults clients about their views of an adviser, but client responses are an “insignificant factor” in determining the rating.<sup>18</sup>

### 3. Client Lists

The SEC staff’s broad reading of “testimonial” as including client endorsements has also led firms to question whether, consistent with the prohibition against testimonials, an investment adviser could disseminate whole or partial lists of clients. In the first no-action letter on the matter, *Denver Investment Advisors, Inc.* (available July 30, 1993), an investment adviser sought permission to distribute to clients and consultants on request<sup>19</sup> a booklet containing information, including a partial list of the investment adviser’s clients. The SEC staff disagreed with the investment adviser’s view that the booklet and partial client list included in it were not “advertisements” as defined in Rule 206(4)-1(b) and stated that it did not necessarily agree with the investment adviser’s contention that the client lists were not testimonials. Nevertheless, the SEC staff said that it would not object if the investment adviser distributed the partial client list if the following three conditions were satisfied:

- ♦ The investment adviser could not use performance-based criteria (but would use some other objective criteria, *e.g.*, account size, geographic location and client classification) in choosing which clients to include in the list;
- ♦ Each client list would have to bear a disclaimer stating that “it is not known whether the listed clients approve of [investment adviser] or the advisory services provided”; and
- ♦ Each client list would include a statement describing the objective criteria used to determine which clients to include in the list.

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<sup>18</sup> See *Investment Advisers Association* (Dec. 2, 2005).

<sup>19</sup> Updated information would be sent on an unsolicited basis to consultants that requested earlier lists.

Although the SEC staff declined to take a stance on whether a partial client list was a testimonial in *Denver Investment Advisors*, the SEC staff subsequently broke ground on the subject in its no-action letter to *Cambiar Investors, Inc.* (available August 28, 1997). In *Cambiar*, the SEC staff flatly said

We agree that a partial client list that does no more than identify certain clients of the adviser cannot be viewed either as a statement of a client’s experience with, or endorsement of, the investment adviser, and therefore is not a testimonial. Our position is not conditioned on the adviser’s use of nonperformance-related criteria to select clients that appear on the partial client list or the presence of any particular disclosure or disclaimer. Our position also is not conditioned on who receives the advertisement (consultant or client) or whether the recipient requested the information. In our view, these factors are not relevant to determining whether the content of an advertisement constitutes a statement of a client’s experience with, or endorsement of, a particular investment adviser.

As with article reprints, the SEC staff in both *Denver Investment Advisors* and *Cambiar* cautioned that the dissemination of partial client lists is still subject to the general prohibition against false or misleading advertisements. The SEC staff commented in *Cambiar* that an advertisement presenting a partial client list in a way that deviates from *Denver Investment Advisors* “would not necessarily be false or misleading,” but warned that such deviations would be “relevant” (though not determinative) in determining whether the advertisement is false or misleading. Accordingly, investment advisers proposing to distribute partial client lists should consider doing so in the manner described in *Denver Investment Advisors*. Even then, the investment adviser should consider if any additional information or disclosures should accompany the lists. In addition, the investment advisers should make sure to get client consent before including a client’s name on a list. Many states prohibit an investment adviser from disclosing a client’s identity without client consent.<sup>20</sup> Although Regulation S-P generally does not apply to institutional clients, the fact that a particular “customer or consumer” is a client of an investment adviser constitutes “nonpublic personal information” and the disclosure of this information is prohibited, except in accordance with the provisions of Regulation S-P.<sup>21</sup>

#### **D. Past Specific Recommendations**

The use of past specific recommendations in investment adviser advertisements is prohibited by the SEC Advertising Rule.<sup>22</sup> Specifically, that Rule prohibits an investment adviser from

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<sup>20</sup> See, e.g., California Blue Sky Regulations Section 260.238(m); Montana Blue Sky Regulations Section 6.10.127(1)(n); North Carolina Blue Sky Regulations Section 1801(a)(14).

<sup>21</sup> Section 248.3(u)(2)(i)(C) of Regulation S-P.

<sup>22</sup> For a more thorough discussion and commentary concerning the prohibition against using past recommendations, see Lawrence Stadulis, *Past Specific Recommendations in Investment Adviser Advertisements*, *The Investment Lawyer* (June 1996), at 3. If an investment adviser is also registered as a broker-dealer, its use of past recommendations is subject to various self-regulatory organization rules

disseminating any advertisement that refers “directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person.” (Rule 206(4)-1(a)(2)).

The Rule excludes from the prohibition any advertisement that complies with three conditions. First, the advertisement must “set[] out or offer[] to furnish<sup>23</sup> a list of all recommendations made by such investment adviser within the immediately preceding period of not less than one year.” Second, the advertisement or list must state (i) the name of each security recommended; (ii) the date and nature of each recommendation (*e.g.*, buy, sell or hold); (iii) the market price of the security at the time of the recommendation; (iv) the price at which the recommendation was to be acted on; and (v) the market price of each security as of the most recent practicable date. Third, the advertisement or list must include the following legend on the first page (in print or type as large as the largest print or type used in the text of the advertisement or list): “It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities in this list.”

The concern underlying the prohibition against referring to past specific recommendations is “cherry picking.” The SEC stated in its release proposing the SEC Advertising Rule that references to past specific recommendations are intrinsically misleading. This concern has subsequently been echoed in SEC staff no-action letters. According to the SEC staff, the prohibition “is intended to prohibit advertisements by an investment adviser which would give prospective advisory clients a 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.” *Starr & Kuehl, Inc.* (available April 17, 1976).

The Rule does not define “past specific recommendations.” Although the term would clearly include formal “buy,” “sell” and “hold” recommendations issued by an investment adviser, the term’s coverage of other types of advice is less clear. For example, in a rather curious no-action letter from the early 1980s, the SEC staff stated that reference to hypothetical or model recommendations would be inconsistent with the Rule. *See A.R. Schmeidler & Co., Inc.* (available June 1, 1976); *S.H. Dike & Co., Inc.* (Available April 20, 1975). However, this position pre-dated the SEC staff’s position in *Clover Capital Management, Inc.* (available October 28, 1986), discussed above, in which the SEC staff reversed its prior view that using model performance was intrinsically misleading.

Another, perhaps more common example of “past specific recommendations” might be lists of holdings and recent transactions. In its release proposing a suitability rule for investment

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relating to use of past recommendations. *See, e.g.*, FINRA Conduct Rule 2210(d)(2)(B)(iii) & (iv) and NYSE Rule 472.40(3).

<sup>23</sup> The SEC staff has indicated that an investment adviser may not charge money for a copy of the full list. *See Scientific Market Analysis* (available March 24, 1976); *BullBear Indicator Inc.* (available April 14, 1973).

advisers (not adopted), the SEC stated that each trade made by an investment adviser constitutes “advice” from the investment adviser. *See* Advisers Act Release No. 1406 (March 16, 1994), at n.12. Neither the SEC nor its staff have addressed whether trades by investment advisers would be viewed as “recommendations” for purposes of Rule 206(4)-1(a)(2)’s restrictions on referring to past specific recommendations, especially in the context of lists of holdings or recent transactions. The SEC staff was asked to address this matter when an investment adviser inquired about the applicability of Rule 206(4)-1(a)(2) to investment company advertisements showing “top ten” holdings and recent transactions. As discussed above, the SEC staff never addressed the issue because it first concluded that such investment company advertisements were not “advertisements” subject to the SEC Advertising Rule. *See Munder Capital Management* (available May 17, 1996). Individual members of the SEC staff have, from time to time, advanced the view that “top ten” holdings lists should not be viewed as violating the Rule 206(4)-1(a)(2) because such lists are typically not offered as an indication of an investment adviser’s performance.<sup>24</sup> Although the guidance does not focus specifically on “top ten” holdings lists, the ability to identify and discuss specific securities that were bought, sold or held for client accounts has been addressed in a series of no-action letters discussed in more detail below.

Investment advisers are also often confronted with the issue of past specific recommendations in the context of “requests for proposals” in which prospective clients or consultants may request attribution analyses, holdings lists or other information that discusses past specific recommendations. The SEC staff has provided some flexibility in this regard by taking the position that a written communication by an adviser that merely responds to an unsolicited request by a client, prospect client or consultant for specific information about the adviser’s past specific recommendations is not, by itself, an “advertisement” and would not, therefore, violate Rule 206(4)-1(a)(2). *See Investment Counsel Association of America, Inc.* (available March 1, 2004). The SEC staff position applies even if the same information is requested by and provided to more than one client, prospective client or consultant, so long as the investment adviser did not directly or indirectly solicit the client, prospective client or consultant to make the request.

Since the adoption of Rule 206(4)-1, the SEC staff has issued a number of no-action letters interpreting the scope of the prohibition against using past specific recommendations in advertisements. Unfortunately, it is sometimes difficult to reconcile the SEC staff’s positions in some of these no-action letters with the plain wording of the Rule.

## **1. List of Partial Recommendations**

The plain wording of the SEC Advertising Rule would allow an investment adviser to refer in an advertisement to its past specific recommendations so long as, among other things, the

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<sup>24</sup> *See IA Week*, April 1998 (“[L]ess worrisome than previously, said [Bill] Meck [Senior Assistant District Administrator for the SEC’s Philadelphia District Office], are so-called “top ten lists,” where investment advisers provide lists of the actual stocks and investments the firm has placed its client in. The SEC had once prohibited the practice, but is now taking a gentler if still skeptical view, said Meck.”)

advertisement “sets out *or offers to furnish* a list of all recommendations” during the applicable period. (Emphasis added.) However, in a series of no-action letters, the SEC staff has said that an investment adviser may *not* “refer to selected recommendations in [an] advertisement and offer to furnish the remainder.”<sup>25</sup> Under the SEC staff’s interpretation, the Rule only permits an investment adviser to distribute an advertisement that either (i) contains a list of all the investment adviser’s recommendations during the applicable period; or (ii) does not reference any particular recommendation but instead offers to provide a complete list of all such recommendations. As noted above, this narrow interpretation does not fit with the plain wording of the Rule (or even seemingly comport with the SEC’s own enforcement of the Rule<sup>26</sup>). Indeed, in 1968 the SEC considered – but did not adopt – an amendment to the SEC Advertising Rule that would have codified the SEC staff’s reading of the rule.<sup>27</sup>

Nor has the SEC staff been inclined to give added flexibility to investment advisers that manage different types of accounts. For example, in response to an inquiry, the SEC staff said that an investment adviser that provides advice with respect to different types of accounts (*e.g.*, equity balanced and fixed income) may not provide prospective clients with a complete list of recommendations relating only to a single account type, even if it offered to provide on request a complete list of recommendations for all account types. Instead, the investment adviser would have to include all of its recommendations on an aggregate basis. *See S.H. Dike & Co., Inc.* (available April 20, 1975). In contrast, the SEC staff has stated that it would not object if a foreign-based division of a U.S. registered investment adviser distributed to prospective foreign clients a list of recommendations made by that division and offered to provide on request a full listing of all recommendations by the investment adviser (both U.S. and foreign-based divisions and affiliates). *See, e.g., Donaldson, Lufkin & Jenrette Securities Corp.* (available March 2, 1977).

## 2. The One-Year Requirement

As discussed above, Rule 206(4)-1(a)(2) permits reference in advertisements to past specific recommendations if, among other things, the advertisement sets forth or offers to furnish a list of all recommendations made during the “immediately preceding period of not less than one year.” The SEC staff takes the position that an investment adviser may not distribute a list of recommendations made over a period of less than one year, even if the investment adviser has

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<sup>25</sup> *J.D. Minnick & Co.* (available April 30, 1975); *see also Franklin Management, Inc.* (available December 10, 1998); *Dow Theory Forecasts, Inc.* (available November 7, 1985); *Dow Theory Forecasts, Inc.* (available August 26, 1983); *New York Investors Group, Inc.* (available September 7, 1982); *James B. Peeke & Co., Inc.* (available September 13, 1982).

<sup>26</sup> *See, e.g., In Re Stellar Management, Inc.*, Advisers Act Release No. 1416 (June 6, 1994) (finding that an investment adviser violated Rule 206(4)-1 by distributing an advertisement that “referred, directly or indirectly, to past specific recommendations . . . but did not set out an offer to furnish a list of all recommendations.”)

<sup>27</sup> *See* Advisers Act Release No. 231 (October 10, 1968).

not been engaged in the investment advisory business for a full year. *See, e.g., Cubitt-Nichols* (available December 22, 1971). However, if the investment adviser has, prior to its SEC registration, been engaged in the investment advisory business in reliance on an exemption from registration it should be permitted to include, for purposes of meeting the one-year requirement, recommendations made while relying on an exemption from registration. *See Eaton, Mark* (available June 9, 1977).

In addition, the SEC staff takes the position that, where an investment adviser includes recommendations made over the course of several years, “the earliest recommendation referred to establishes the pertinent time period.” *Scientific Market Analysis* (available March 24, 1976). That is, if an investment adviser wishes to show past specific recommendations starting with a recommendation made, for example, in October 1995, it would also have to show all recommendations made from that date to the present.

### **3. Non-Specific Reference to Performance of Recommendations**

Because the Rule prohibits reference in advertisements to “past specific recommendations,” the prohibition does not apply to references in advertisements to the performance of the investment adviser’s recommendations, so long as the advertisement does not state the specific securities recommended. *See, e.g., Dow Theory Forecasts, Inc.* (available August 26, 1983); *Oberweis Securities, Inc.* (available July 25, 1983).

### **4. Discussions of Specific Recommendations**

In December 1998, Franklin Management, Inc. requested interpretive guidance from the SEC staff to permit it to send quarterly reports to existing and prospective clients that identified some, but not all, of the securities that were bought, sold or held for advisory accounts within a particular investment category, the reasons for those decisions and a brief analysis of the issuer of the security. *See Franklin Management, Inc.* (available December 10, 1998). The staff stated that the proposed reports would not raise the concerns underlying the Rule 206(4)-1(a)(2) prohibition on the use of past specific recommendations, so long as the adviser satisfied various conditions relating to the selection of the particular securities and the presentation of the information in the reports. The staff emphasized that (i) the securities to be described in the reports must be selected using objective, non-performance based criteria; (ii) the adviser must use the same selection criteria for each quarter for each investment category; (iii) the reports should not discuss the extent to which the investments were, or were not, profitable; and (iv) the adviser must maintain certain records.

The quarterly reports that were at issue in the Franklin letter we distributed to both existing and prospective clients. The SEC staff subsequently provided more flexibility in the case of written communications that are offered only to existing clients. *See Investment Counsel Association of America, Inc.* (available March 1, 2004). In the Investment Counsel Association of America, Inc. letter, the SEC staff took the position that an adviser’s written communication to its clients generally would not be an advertisement within the meaning of Rule 206(4)-1(b) solely because it contains the adviser’s past specific recommendations about securities each client holds or held.

The staff went on to state that “in general, written communications by advisers to their existing clients about the performance of the securities in their accounts are not offers of investment advisory services but are part of the adviser’s advisory services. If, however, the context in which the past specific recommendations are presented by the investment adviser to an existing client suggests that a purpose of the communication is to offer advisory services, we would conclude that the communication was an advertisement.” If the content and context of the written communication suggested that it was an advertisement, the investment adviser would have to comply with the conditions of the Franklin no-action letter or otherwise comply with the terms of Rule 204-1(a)(2).

## 5. Contribution Analysis

In 2008, The TCW Group, Inc. sought relief to show the presentation of a contribution analysis that shows the relative impact of an equal number of “best and worst performers” that most positively and negatively impacted the performance of a representative account over the relevant measurement period. *See The TCW Group, Inc.* (available Nov. 7, 2008). The TCW letter maintains the requirement that investment advisers use an objective standard to select particular holdings for discussion, but expands the Franklin standard by allowing a performance-based calculation to select those holdings. Specifically, TCW developed an analytical tool called the “Best/Worst Performers Charts” designed to show the effect of the performance of individual holdings on a representative account over a particular period of time or measurement period. The charts show at least five holdings that contributed most positively to the representative account, and an equal number of holdings that detracted the most from the performance of the representative account. TCW proposed to include these charts in advertisements and communications directed to current and prospective clients and consultants.

In granting the no-action relief, the SEC staff agreed that the presentation of the charts did not implicate the cherry picking concerns underlying the Rule because, among other things, the specific holdings are selected based on an “objective, non-discretionary, unbiased, and mechanical methodology” that is consistently applied to all holdings in the representative account. The use of the contribution analysis was subject to the following conditions:

- ♦ The calculation methodology must be applied to all holdings in the representative account that contributed to the account’s performance during the measurement period.
- ♦ The charts must show no fewer than ten (10) total holdings, including an equal number of positive and negative holdings.
- ♦ The calculation methodology, the presentation of information, and the number of holdings must be consistent from measurement period to measurement period.
- ♦ The charts must disclose how to obtain: (i) the calculation methodology; and (ii) a list showing the contribution of each holding in the representative account to the account’s performance during the measurement period.

- ♦ The charts must include all information necessary to make the presentation not misleading, including, for example, disclosure that: (i) the holdings identified do not represent all of the securities purchased, sold, or recommended for advisory clients; and (ii) past performance does not guarantee future results.
- ♦ The best and worst performers must be presented: (i) on the same page; (ii) with equal prominence; and (iii) with appropriate disclosure (which also must be in close proximity to the performance information).
- ♦ The investment adviser must maintain and make available to SEC Staff, on request, records evidencing: (i) the criteria used to select the specific securities listed in the charts (that is, the calculation methodology); (ii) a list showing the contribution of each holding in the representative account to the account's performance during the measurement period; and (iii) all supporting data necessary to demonstrate the calculation of the contribution each holding and the appropriateness of the holdings included in each chart.

The TCW letter does not go so far as to permit investment advisers to show the actual performance or discuss the absolute profitability of particular holdings. However, it does seem to validate, or at least move closer than prior SEC staff interpretive guidance, to the long-standing industry view that the identification and discussion of partial lists of portfolio holdings should not be prohibited if the holdings are selected on an objective basis (whether or not based on performance) and are presented in a fair and balanced manner.

## **6. Article Reprints**

Consistent with its position in the testimonials area, the SEC staff takes the position that the distribution of copies of *bona fide* articles written by unbiased third parties are not subject to the prohibition against using past specific recommendations, even if the articles refer to past specific recommendations. The use of such reprints would still, of course, be subject to the general prohibition against false or misleading advertisements. Accordingly, the use of a reprint that referred to an investment adviser's past specific recommendations would violate Rule 206(4)-1(a)(5) if the reprint implied something about, or caused a reader to have an inference regarding, the experience of advisory clients, the possibility of a prospective client having an experience similar to that of prior clients, or the investment adviser's competence when there are additional facts that, if disclosed, would imply different results from those suggested in the reprint. *See Kurtz Capital Management* (available January 18, 1988).

## **III. Selected SEC Enforcement Actions Relating to Advertising**

The SEC has over the years imposed remedial sanctions on investment advisers for advertisements that, among other things, did not reflect the deduction of investment advisory



fees.<sup>28</sup> As seen in the examples below, advertising violations, especially those involving performance advertising, continue to be an area of focus.

**A. *In re Jason A. D’Amato***

In *In re Jason A. D’Amato*, Advisers Act Release No. 3455 (Aug. 31, 2012) the SEC instituted administrative and cease-and-desist proceedings against Jason A. D’Amato (“D’Amato”), alleging that he fraudulently misrepresented the performance of a mutual fund allocation program run by his employer, Stanford Group Company (“SGC”), a dually registered broker-dealer and investment adviser, in pitchbooks that were distributed to potential clients. In particular, D’Amato used unverified performance data from 2000 through 2004 in conjunction with actual audited returns from 2005 forward to represent the mutual fund allocation program’s performance data in the pitchbooks. The performance data was labeled “historical performance,” and did not mention that the data from 2000 to 2004 was actually backtested data while the later performance data was properly audited. The pitchbook reported year-to-date, 1-year, 3-year, 5-year, 7-year, and since inception performance information, but did not disclose that some of the information was actually a blend of hypothetical performance data with actual data. In addition, D’Amato allegedly misrepresented to his employer and to clients that he was a Chartered Financial Analyst (“CFA”) when in fact he was not.

As a result of the above alleged conduct, the SEC alleged that D’Amato willfully violated and willfully aided and abetted SGC’s violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, willfully aided and abetted and caused SGC’s violations of Sections 206(1) and 206(2) of the Advisers Act, and willfully aided and abetted and caused SCM’s violation of Section 207 of the Advisers Act. The administrative proceeding is currently pending.

**B. *In re Anthony Fields, CPA, d/b/a Anthony Fields & Associates and d/b/a Platinum Securities Brokers***

In *In re Anthony Fields, CPA, d/b/a Anthony Fields & Associates and d/b/a Platinum Securities Brokers*, Advisers Act Release No. 3348 (Jan. 4, 2012) the SEC instituted administrative and cease-and-desist proceedings against Anthony Fields (“Fields”), alleging that he made fraudulent offers of fictitious securities by using social media to solicit investors. The SEC also alleged that Fields, as sole proprietor of Anthony Fields and Associates (“AFA”), reported false and materially misleading information to the SEC on AFA’s Form ADV by falsely representing that AFA had \$400 million in assets under management. In addition, the SEC alleged that Fields failed to maintain required books and records and failed to implement adequate compliance

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<sup>28</sup> See, e.g., *In re Hazel B. Canham d/b/a Canham & Canham Associates*, Advisers Act Release No. 1386 (September 30, 1993); *In re Lynn Elgert, Inc.*, Advisers Act Release No. 1339 (September 21, 1992); *Eric S. Emory & Renaissance Advisors, Inc.*, Advisers Act Release No. 1283 (July 22, 1991); *In re Makrod Investment Associates, Inc.*, Advisers Act Release No. 1176 (July 3, 1989); *In re Harvest Financial Group, Inc.*, Advisers Act Release No. 1155 (February 21, 1989); *In re Managed Advisory Services, Inc.*, Advisers Act Release No. 1148 (December 27, 1988).

policies and procedures. The SEC alleged that Fields also published false and materially misleading information regarding registration and assets under management on the websites of AFA and Platinum Securities Brokers (“Platinum”), an entity controlled by Fields that holds itself out to be a broker-dealer. Finally, the SEC alleged that Fields used social media platforms, including LinkedIn to offer and sell fraudulent bank guarantees and medium term notes in exchange for transaction-based compensation without being registered with the SEC as a broker-dealer.

As a result of the above alleged conduct, the SEC alleged that Fields violated Sections 17(a)(1) and 17(a)(3) of the Securities Act, Section 15(a) of the Exchange Act, Sections 203A, 204, 204A-1, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2(a)(11), 204-2(e)(3)(i), 204A-1, 206(4)-1(a)(5) and 206(4)-7 thereunder. The administrative proceeding is currently pending.

**C. *In re Delta Global Advisors, Inc. and Charles P. Hanlon***

In *In re Delta Global Advisors, Inc. and Charles P. Hanlon*, Advisers Act Release No. 3282 (September 20, 2011), the SEC instituted an order making findings and imposing remedial sanctions and a cease and desist order against an investment advisor for numerous violations of federal securities laws, including violations of Section 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-4(a)(1) and (2) thereunder. Delta’s misrepresentations allegedly included stating that it served as an investment adviser to a registered investment company and that it managed more than \$1.5 billion, when in fact it did not advise any such client and had at times no more than \$9 million under management. Delta also allegedly failed to disclose its poor financial condition, a default judgment entered against it in a breach for fiduciary duty lawsuit brought by a client, and that Hanlon had been the subject of disciplinary action by the Financial Industry Regulatory Authority (“FINRA”). According to the SEC, as a result of these misleading statements and omissions, Delta appeared to be operationally sound and much larger and more established than it really was.

Hanlon submitted an offer of settlement, which the Commission chose to accept, where he agreed to cease and desist from any from any future violations of the Advisers Act, to be prohibited from associating with or participating in numerous facets of investment advising for a period of five years with the right to apply for reentry thereafter, and to pay civil penalties of \$50,000.

**D. *In re Groh Asset Management, Inc.***

In *In re Groh Asset Management, Inc. and Roger O. Groh*, Advisers Act Release No. 2308 (September 30, 2004), the SEC instituted public administrative and cease-and-desist proceedings against an investment adviser and its president for false and misleading advertising practices concerning assets under management and inadequate recordkeeping. The SEC alleged that Groh Asset Management overstated its assets under management to certain entities in the business of, among other things, gathering, publishing and distributing information about investment advisers, which in turn disseminated the false information to the public. The entities included

various third-party ranking publications and databases, including *Nelson Information*, *Callan Associates, Inc.*, *Money Manager Review*, *Effron-PSN* and *Checkfree Investment Services*. Since 1997, Groh Asset Management had managed five different portfolios. At various times, Groh overstated the assets under management of the portfolios and the total assets under management of Groh Asset Management in amounts ranging from \$8 million to \$96 million. The SEC alleged that these actions took place despite the fact that Groh Asset Management and Groh received deficiency letters following a 1997 SEC compliance examination citing them for overstating assets under management and requiring corrective action.

Groh Asset Management and Groh were ordered to cease and desist from any future violations of the Advisers Act and together were required to pay a civil monetary penalty of \$45,000. Groh Asset Management was also required to retain, for a period of five years, an independent consultant to conduct a review of its policies and procedures relating to the reporting of assets under management, annually review all advertising and marketing materials containing assets under management information and verify compliance with the Advisers Act recordkeeping requirements. Groh Asset Management was also required to deliver a copy of the order to each of its existing clients within thirty days and to prospective clients in connection with any contract entered into for twelve months from the date of the SEC order.

**E. *In re Nevis Capital Management, LLC***

In *In re Nevis Capital Management, LLC*, David R. Wilmerding, III, and Jon C. Baker, Advisers Act Release No. 2214 (February 9, 2004), the SEC brought an action against an investment adviser, its president and its executive vice-president for making misrepresentations and omitting material information regarding the role of initial public offerings in the performance of two funds managed by Nevis Capital. From approximately December 1998 through July 2000, the SEC alleged that Wilmerding and Baker inequitably allocated all shares of IPOs acquired by Nevis Capital to only two of its clients, Snowdon Limited Partnership, an unregistered investment company, and Nevis Fund, an open-end management investment company. By allocating IPOs to Nevis Fund when it had a small asset base, it achieved returns ranging from 90.1% on May 31, 1999 to 286.1% on December 31, 1999. The investment in IPO shares was primarily responsible for Nevis Fund's outstanding performance. Without the impact of first-day gains from IPOs, Nevis Fund's returns through May 31, 1999, September 30, 1999 and December 31, 1999 would have been approximately -8.7%, -5.3% and 38.7%, respectively, rather than the fund's reported returns of 90.1%, 154.6% and 286.1%. The SEC alleged that Wilmerding and Baker did not analyze the contributions of IPO shares to Nevis Fund's overall performance and did not disclose this information to the fund's board of directors or to investors.

These returns were reported in the Fund's 1999 Annual Report and on Nevis Capital's website, in addition to appearing in various media reports, without an explanation of the impact of IPOs on the returns. In particular, the SEC alleged that Wilmerding made false and misleading statements in three reports for *SmartMoney.com*, which were subsequently linked to Nevis Capital's website. Nevis Capital's website also contained links to Nevis Fund's prospectus, periodic reports, a press release and advertisements, all of which contained performance information that did not disclose that the fund's performance was primarily attributable to IPO

investments. After these returns were publicized, the net flow of investment dollars into Nevis Fund increased from approximately \$9,000,000 during its first year to approximately \$70,000,000 during the six-month period from July through December 1999. By March 31, 2000, Nevis Fund's net assets increased to approximately \$317,000,000. The increase in fund assets resulted in a corresponding increase in the management fees paid by Nevis Fund to Nevis Capital.

Nevis Capital, Wilmerding and Baker were ordered to cease and desist from any future violations of the Advisers Act. Nevis Capital was required to pay disgorgement and prejudgment interest of \$10,000 and a civil money penalty of \$1,690,000. Wilmerding and Baker were each required to pay disgorgement and prejudgment interest of \$10,000 and a civil money penalty of \$140,000. Nevis Capital was also required to retain an independent consultant to conduct a review of its policies and procedures relating to the allocation of IPO shares, performance advertising, communications with the press and interactions with the Nevis Fund board of directors, fund counsel and administrator and to verify compliance with federal securities laws. In addition, Nevis Capital was required to deliver a copy of the order to each of its existing clients within thirty days, including investors in Nevis Fund, and to prospective clients in connection with any contract entered into or any fund investment for one year from the date of the SEC order.

**F. *In re Oxford Capital Management, Inc.***

In *In re Oxford Capital Management, Inc. and John G. Danz, Jr.*, Advisers Act Release No. 2138 (June 24, 2003), the SEC instituted public administrative and cease-and-desist proceedings against the investment adviser, its president and majority shareholder alleging that between approximately June 1998 and May 2001 the Oxford Capital Management, Inc. ("Oxford") repeatedly submitted false and inflated performance results and assets under management to various third parties, including clients and prospective clients, reporting services, brokers and consultants. According to the SEC, Oxford inflated its performance figures for its enhanced equity composite for the period between 1991 and 1997. This had the effect of raising the composites long-term returns and causing the *Nelson Investment Manager Database* to rank Oxford as one of its "Top 20 Money Managers" for the periods ending December 31, 1998, December 31, 1999, June 30, 2000 and September 30, 2001. Similarly, based on information provided by the firm, *The Mobius Group* published reports stating that Oxford's Equity composite had a 34.5% return with \$51 million in management in 1996. The actual composite returned 23.03% and had \$10 million in assets during the period.

Oxford had at various times retained an independent accountant that audited the firm's performance numbers and assets under management. The most recent audit, completed in February 2001, was a 5-year audit for the years 1996 through 2000. The SEC alleged that given the fact that it had audited data in its possession, Oxford knew, or was reckless in not knowing, that the composite performance figures and statements of assets under management it provided to *Nelson* and *Mobius* and various other reporting firms, were materially false and misleading. In addition, the SEC claimed that Oxford was unable to demonstrate how the performance figures contained in its advertisements were calculated and failed to maintain a variety of

required books and records, including internal working papers and other records necessary to substantiate its advertised performance claims.

Without agreeing with or denying the SEC's allegations, Oxford and Danz agreed to an order under which Danz was suspended from association with any investment adviser for a period of three months and was prohibited for a period of twelve months from participating in any activity related to the calculation of investment performance or disseminating performance results for Oxford's Enhanced Equity composite to reporting services, consultants, newspapers or brokers. Oxford and Danz were ordered to cease and desist from causing future violations of the Advisers Act and were jointly order to pay a civil money penalty of \$35,000. In addition, Oxford was required to retain an independent consultant to conduct a comprehensive review of the adviser's policies and procedures relating to investment performance recordkeeping, calculation and verification and the calculation and verification of its assets under management. The SEC order required an initial, final and follow-up report from the consultant, as well as a compliance audit to be performed annually for a period of five years. Oxford was also required to retain a certified public accountant to perform an annual review of Oxford's Enhanced Equity composite for a period of five years.

**G. *In re Independent Financial Group***

In *In re Independent Financial Group and Gregory Duplessis*, Advisers Act Release No. 1891 (August 8, 2000), the SEC brought an action against the investment adviser and its managing partner for fabricating and disseminating false advertisements and information regarding the firm's performance and services. According to the SEC, Independent Financial Group ("IFG") inflated the size and assets under management reflected in advertising, regulatory filings and records maintained by the firm (*e.g.*, an account actually consisting of 350 clients and \$115 million under management was presented as containing 462 clients and over \$500 million under management). In addition, IFG's advertising materials and Form ADV claimed that IFG had been in existence since 1980, but it was not founded until 1987 and did not have any clients until 1992. The SEC also claimed that details about the size and experience of IFG that were submitted to various reporting services and included in certain copies of the firm's Form ADV included figures that were higher than those contained in copies of the same documentation that was filed with the SEC on Form ADV and retained by IFG for purposes of complying with its record keeping obligations. In addition to maintaining inflated records, the SEC also suggested that for the period of time between 1987 and 1998 IFG failed to retain copies of all advertisements and the necessary supporting documentation.

Finally, the SEC claimed that advertisements containing the performance of IFG's MidCap account either stated or implied that it was actual performance based on a comprehensive composite of client accounts. In fact, it was backtested, hypothetical performance that was neither based on, nor bore any relation to, any client portfolio. Moreover, the portion of the performance presentation that was based on the performance of actual accounts overstated the performance numbers by including only selected client accounts in the composite.

Without agreeing with or denying the SEC’s allegations, IFG and its managing partner agreed to an order requiring that they cease and desist from violating certain provisions of the Advisers Act, barring the managing partner from association with an investment adviser for one year and suspending him from association with a broker or dealer for 60 days, and imposing a fine of \$50,000 on IFG and \$25,000 on its managing partner.

#### **IV. Record keeping Requirements for Advertisements**

Rule 204-2 under the Advisers Act (the “Records Rule”) lists the types of books and records that investment advisers are required to “make and keep true, accurate and current” and the applicable retention periods. Three of the Rule’s provisions deal directly with advertisements.

##### **A. Advertisements and Distribution Lists**

Paragraph (a)(7) of the Records Rule requires that an investment adviser keep copies of all written communications sent by the investment adviser relating to its recommendations, handling of customer funds or securities, and transactions. If the investment adviser sends an advertisement to more than 10 persons, the investment adviser is not required to keep a record of the recipients’ names and addresses, *unless* the advertisement is sent to persons named on a list (in which case, the investment adviser is required to retain the list along with a copy of the advertisement and a memorandum describing the list or its source).

##### **B. Advertisements and Recommendations**

Paragraph (a)(11) of the Records Rule requires that an investment adviser keep copies of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser sends to 10 or more persons (other than its associated personnel). If the communication recommends the purchase or sale of a specific security and does not state the reasons for the recommendation, the investment adviser must retain along with the copy of the communication a memorandum stating the basis of the recommendation.

##### **C. Records to Support Performance Calculations**

Paragraph (a)(16) of the Record Rule requires that investment advisers keep all working papers and other records “necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations” in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser sends to 10 or more persons (other than its associated personnel). For performance of managed accounts, these record retention requirements may be satisfied if the investment advisers retain account statements that show all debits, credits and other client transactions for the applicable period and all worksheets necessary to demonstrate the performance calculations. The SEC requires that these account statements be prepared *contemporaneously* with the period reported and that all account statements for the periods for which performance is calculated be kept, not just for accounts included in the computation of the performance figures advertised. To satisfy the record keeping requirements of Paragraph (a)(16), an investment adviser has to keep records reflecting the manner in which it calculated any model

fees used in advertisements, *see J.P. Morgan Investment Management, Inc.* (available May 7, 1996), and appropriate records reflecting the performance of advised accounts of a predecessor if the performance of such accounts is included in the investment adviser's performance, *see Great Lakes Advisers, Inc.* (available April 3, 1992); *Taurus Advisory Group, Inc.* (July 15, 1993).

As noted above, the Record Rule provides that an investment adviser may satisfy the requirements of paragraph (a)(16) with regard to its managed accounts if the investment adviser retains account statements that show all debits, credits and other client transactions for the applicable period and all worksheets necessary to demonstrate the performance calculations. This method was set out as an alternative to requiring investment advisers to maintain all documentation relating to the calculation of their performance numbers. However, this method is not the exclusive means of satisfying the requirements of the Record Rule. The SEC staff reaffirmed this position in a no-action letter to *Salomon Brothers Asset Management Inc and Salomon Brothers Asset Management Asia Pacific Limited* (available July 23, 1999) in which it permitted the investment adviser to substantiate the performance of an unregistered investment company managed by a portfolio manager at another firm who subsequently joined Salomon by relying on published materials that contained the net asset values of the fund during the relevant period along with corresponding worksheets of the independent public accountants. In granting relief the SEC staff emphasized the fact that the net asset value calculations were published by an independent third party and were accumulated contemporaneously with the management of the account.

Although paragraph (a)(16) of the Record Rule allows investment advisers to satisfy their performance record keeping requirements by relying on internally generated records, the SEC staff has recommended that investment advisers maintain third-party records such as custodial or brokerage statements and reports prepared by independent auditors that confirm the accuracy of the internally generated records. *See Jennison Associates LLC* (available July 6, 2000). In taking this position the SEC staff noted an increasing number of enforcement actions in which investment advisers were inflating performance in both their advertising and their account statements. As a result, the SEC was unable to use the internally generated account statements to substantiate the investment adviser's performance claims. Based on this experience, and the availability of electronic storage technology that allows investment advisers to retain information in an electronic format, the SEC staff urged investment advisers to maintain third-party documentation to facilitate the inspection staff's review of performance claims.

#### **D. Retention Periods**

Advertisements and other communications required to be maintained under paragraph (a)(7) of the Records Rule must be maintained for not less than five years from the end of the fiscal year during which the last entry was made on such records. Rule 204-2(e)(1). Advertisements and other communications required to be maintained under paragraphs (a)(11) and (a)(16) must be maintained for not less than five years from the end of the fiscal year during which the investment adviser last published or distributed the advertisement or other communication. Rule 204-2(e)(3). Records supporting the entire measuring period of an advertised performance figure must be kept (*i.e.*, if an investment adviser advertises a 10 year performance number, supporting

documentation for each of the 10 years would have to be retained for a period of 5 years after the end of the fiscal year in which the advertisement was last published).

#### **E. Transition Rule for Private Fund Advisers**

Under Rule 204-2(e)(3)(ii), investment advisers that were previously exempt from registration under Section 203(b)(3) of the Advisers Act, which was eliminated on July 21, 2011, are not obligated to maintain and preserve certain the books and records that would otherwise be required under the provisions of paragraph (a)(16) in order to substantiate the performance or rate of return of private funds or other accounts for any period ended prior to such adviser's registration with the SEC. However, an adviser is required to continue to preserve and retain any books and records that it has in its possession that relate to performance or rate of return for periods prior to registration if it has such records.

#### **V. SEC Staff Focus on Advertising in Examinations**

As reflected in the enforcement actions discussed in Part III, advertising has long been a major focus in SEC examinations and a priority for the SEC's Office of Compliance Inspections and Examinations ("OCIE"). More recently, OCIE's focus on advertising has included aberrational performance and certain related issues associated with the use of social media by investment advisers.

##### **A. SEC Examination Priorities**

In an open letter to investment advisers (the "Open Letter") Lori Richards, then director of OCIE, identified advertising violations and inaccurate performance claims as two primary areas where the SEC inspection staff find repeated violations and compliance weaknesses during the course of examinations.<sup>29</sup> In a companion speech delivered on the same day the Open Letter was released, Ms. Richards took the opportunity to "sound an alarm about performance claims." She noted that fraudulent advertising is both the most common type of serious problem found in examinations and the leading type of enforcement case brought against investment advisers.<sup>30</sup>

The Open Letter set out a number of specific examples of performance claims that may be fraudulent. These examples include:

- ♦ Inaccurate claims about compliance with AIMR (now GIPS) performance presentation standards;

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<sup>29</sup> See Letter from the Office of Compliance Inspections and Examinations: To Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections (May 1, 2000), available at <http://www.sec.gov/offices/ocie/advltr.htm>.

<sup>30</sup> See Lori Richards, "Compliance Priorities for Investment Advisers" (May 1, 2000), available at <http://www.sec.gov/news/speeches/spch367.htm>.



- ♦ Creating distorted performance results by constructing composites that include only selected profitable accounts, or are for selected profitable periods;
- ♦ Comparing the investment adviser's performance to inappropriate indices (*e.g.*, stating or implying that a dissimilar index is comparable to the adviser's investment strategies);
- ♦ Representing or implying that model or backtested performance is actual performance;
- ♦ Failing to deduct the investment adviser's fees from performance calculations, without disclosure;
- ♦ Falsely representing the investment adviser's total assets under management, credentials, or length of time in business; and
- ♦ Incorporating a predecessor adviser's performance into the investment adviser's advertised performance returns in a misleading manner, or when it is otherwise inappropriate.

More than a decade later, performance and advertising continue to be a high priority for OCIE. In its National Exam Program Review dated February 2011, OCIE identifies "performance characteristics and marketing practices that have been associated with an increased risk of misrepresentations and investor harm" as an ongoing focus for investment adviser and investment company examinations. This focus includes the use of risk analytics to identify aberrational performance (*i.e.*, performance that may be inconsistent with an account's investment strategy or other benchmarks) that may be indicative of inaccurate or exaggerated performance numbers or abusive valuation.<sup>31</sup>

## **B. Social Media**

An additional area of regulatory focus that is related to advertising is the use of social media by investment advisers. In its January 4, 2012 Risk Alert on the use of social media by investment advisers, the SEC staff described social media as converting "the traditional two-party, adviser-to-client communication into an interactive, multi-party dialogue among advisers, clients, and prospects, within an open architecture accessible to third-party observers. It also converts a static medium, such as a website, where viewers passively receive content, into a medium where users actively create content." The use of social media expands the types of communications that may be deemed to be advertisements and presents a number of challenges both in the way

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<sup>31</sup> Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (February 2011), available at <http://www.sec.gov/about/offices/ocie/ocieoverview.pdf>. See also, Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (March 21, 2011), available at <http://www.sec.gov/news/speech/2011/spch032111cvd.htm> (identifying performance and advertising issues as one of the areas of focus for investment adviser examinations and noting that OCIE will review "both performance calculation and the presentation of that performance in offering materials" and stating that aberrational performance is used as a risk indicator for OCIE's risk assessment and surveillance models).

that investment advisers structure their compliance controls and satisfy their record keeping requirements.

The Risk Alert sets forth SEC staff observations relating to a number of factors that investment advisers may wish to consider in reviewing the adequacy of their compliance controls relating to the use of social media. These considerations apply equally to the use of social media by investment advisers and their employees (or investment adviser representatives) and solicitors.

- ♦ Usage Guidelines. The SEC staff noted that many firms may have overlapping policies and procedures that apply to advertisements, client communications and electronic communications generally, and that those policies and procedures may not specifically address social media. The Risk Alert suggests that investment advisers should develop policies and procedures that relate specifically to social media, including whether to restrict or prohibit the use of social media for business purposes or whether to limit the use of social media only to approved social media networking sites.
- ♦ Content Standards. Investment advisers may wish to limit or restrict content that may raise specific regulatory issues (*e.g.*, content that contains investment recommendations, information on specific investment services or investment performance).
- ♦ Monitoring. Investment advisers should consider how to monitor the firm's social media sites or use of third-party sites, and the frequency with which they monitor activity.
- ♦ Approval of Content. Investment advisers should consider the appropriateness of pre-approval requirements, as opposed to after-the-fact review, given the fluid nature of the medium.
- ♦ Firm Resources. Investment advisers should consider whether they have dedicated sufficient compliance resources to adequately monitor their activity on social media sites, or whether they should engage outside vendors to monitor conversations. The Risk Alert also provides examples of various types of monitoring, including sampling, spot checking, lexicon or other search methodologies, or a combination of methodologies, to monitor social media use and content.
- ♦ Criteria for Approving Participation. In determining whether to allow the use of a particular social networking site, an investment adviser may consider the reputation of the site, the site's privacy policy, the ability to remove third-party posts, controls on anonymous posting and the advertising practices of the social media site. The functionality of each social media site, including the ability to address any upgrades or modifications that affect the risk exposure for the firm or its clients is also important.
- ♦ Training and Certification. Investment advisers should consider implementing training relating to the use of electronic media and certifications that its employees understand and are complying with the firm's social media policies and procedures.

- ♦ **Personal/Professional Sites.** Investment advisers should consider whether to permit its employees to conduct business on personal (non-business) or third-party social media sites – that is sites that are not operated, supervised or sponsored by the firm.
- ♦ **Information Security.** Investment advisers should consider the information security risks that may be presented by the use of social media sites, including the need to create firewalls between sensitive customer information, the firm’s own proprietary information and the social media site.
- ♦ **Enterprise Wide Sites.** An investment adviser that is part of a larger financial services organization may wish to consider creating usage guidelines reasonably designed to prevent the advertising practices of a firm-wide social media site from violations of the Advisers Act.

The Risk Alert also discusses the use of third-party content and whether it is appropriate to allow third-parties, for example, to post messages, forward links, and post articles on an investment adviser’s social media sites, or whether it is more appropriate to limit or prohibit third-party use. For example, an adviser may decide only to allow “one way postings” where employees are permitted to post on the firm’s social media sites, but may not interact with third parties or respond to third-party postings. Alternatively, firms may limit third-party postings to authorized users and prohibit postings by the general public. Firms that do permit third-party postings have to consider the implications of such content under the Advisers Act advertising rules, including whether third-party postings may be considered testimonials under Rule 206(4)-1(a)(1).

The SEC staff also reminded investment advisers that the recordkeeping requirements set forth in Advisers Act Rule 204-2 do not differentiate between different types of media, rather they focus on the content of the communications. Investment advisers that communicate through social media must retain records of those communications if they contain advice, recommendations or other information that is subject to the record keeping requirements and must be able to maintain and access them for the time periods specified in Rule 204-2.

### **C. SEC Examination Process**

In the course of an examination, the SEC staff requests a variety of information concerning advertising. Traditionally, the SEC staff provides the investment adviser with a list of books and records that the investment adviser is expected to produce for SEC staff review. Although the requested books and records may vary somewhat among the SEC’s Regional Offices, the following are the sorts of books and records commonly requested in the area of advertising:<sup>32</sup>

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<sup>32</sup> In 2008, OCIE published a “core list” of the types of books and records it typically requests during an examination. See Office of Compliance Inspections and Examinations Investment Adviser Examinations: Core Initial Request for Information (November 2008), available at <http://www.sec.gov/info/cco/requestlistcore1108.htm>

- ♦ A copy of any pitch books, one-on-one presentations, pamphlets, brochures and other promotional and/or marketing materials used for each investment strategy or mandate;
- ♦ A copy of any advertisements (*e.g.*, newspaper or magazine ads, radio scripts, etc.) used to inform or solicit clients during the past 2 years;
- ♦ A copy of performance figures or charts used in general advertising or in one-on-one presentations;
- ♦ Access to records and work papers supporting the performance calculations;
- ♦ Composite performance returns, including a statement of the account inclusion criteria the investment adviser employs in the construction of any composite performance, accounts included in each composite and specific client account performance and supporting documentation for such clients, accounts not included in a composite and terminated composites;
- ♦ A copy of any article reprints disseminated to clients or prospective clients during the period;
- ♦ Requests for proposal;
- ♦ A list of all third party consultants for whom the investment adviser completed questionnaires or otherwise corresponded with during the period;
- ♦ Copies of third-party consultant questionnaires;
- ♦ Global Investment Performance Standards (“GIPS”) compliance documentation, if applicable; and
- ♦ Website access, if restricted.

As a general technique, the SEC staff often reviews first for disclosure violations using the *Clover* no-action letter as a checklist. The staff also looks to see if an adviser’s performance looks “too good.” Examination “red flags” include the following:

- ♦ An adviser consistently beating the indices (most do not);
- ♦ Composites that change year-to-year (signals possible “cherry picking”);
- ♦ Terminating clients being dropped from past performance (so-called “survivor bias”); and
- ♦ Backtested results (not *per se* fraudulent, but highly suspect).

From there, the staff may perform a “top down” review from the adviser’s own records to determine whether it is able to substantiate its performance.

As reflected in the list of commonly-requested books and records, the SEC staff focuses on information given to consultants – specifically information on an adviser’s performance, assets under management, number of years in business and GIPS compliance. Although the SEC staff may ask the adviser for this information, the SEC staff also frequently gets copies of the adviser’s questionnaires from the consultants directly.