

Chapman Client Alert

September 19, 2017

Current Issues Relevant to Our Clients

SEC Staff Highlights Investment Adviser Advertising Compliance Issues

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") recently published a Risk Alert that highlights frequently identified investment adviser advertising compliance issues. The Risk Alert identifies the advertising compliance issues most frequently identified in deficiency letters from over 1,000 investment adviser examinations. The Risk Alert also summarizes observations from OCIE's 2016 "Touting Initiative", which focused on disclosures that advisers provided to clients when touting awards, promoting ranking lists and/or identifying professional designations. While the Risk Alert does not address all deficiencies or weaknesses found in examinations, OCIE intends for the Risk Alert to assist advisers in adopting and implementing effective compliance programs. The Risk Alert is available [here](#).

Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 206(4)-1 thereunder prohibit investment adviser advertisements which contain any untrue statement of a material fact, or which is otherwise false or misleading, along with several other specific prohibitions. The rule defines "advertisement" very broadly to include most written communications (including electronic/social media) that an investment adviser might distribute to more than one person. The following highlights the issues that OCIE identifies in the Risk Alert.

Misleading Performance Results—OCIE found various examples of misleading performance presentations, including:

- performance results presented without deducting advisory fees,
- use of benchmarks without disclosures about the limitations inherent in benchmark comparisons,
- failure to disclose that an investment strategy materially differed from the composition of the comparison benchmark, and
- failure to explain how hypothetical and back-tested performance results were derived.

Misleading One-on-One Presentations—OCIE found cases where (i) gross-of-fee performance was shown without potentially relevant disclosures and (ii) advisers failed to disclose that performance did not reflect advisory fees and that client returns would be reduced by those fees and other expenses.

Misleading Claim of Compliance with Voluntary Performance Standards—OCIE found cases where it was not clear to OCIE

staff that performance adhered to the Global Investment Performance Standards ("GIPS") guidelines when the adviser claimed GIPS compliance.

Past Specific Investment Recommendations Issues (Rule 206(4)-1(a)(2))—The Advisers Act advertising rule generally prohibits showing past profitable investment recommendations unless the advertisement also includes or offers a list of all recommendations made by the adviser within the preceding year, among other things. SEC staff no-action letters also allow certain alternatives, such as showing (i) the five or more best performing holdings along with an equal number of worst performing holdings or (ii) past specific recommendations that were selected using consistently applied, objective non-performance based criteria provided that the advertisement does not discuss the amount of profit or loss of any particular security. OCIE observed cases where advertisements:

- cherry-picked only profitable stock selections or recommendations,
- included only certain, and not all, recommendations, to illustrate a particular investment strategy,
- showed the best-performing holdings without an equal number of worst-performing holdings,
- did not disclose that the advertisement did not represent all securities purchased, sold or recommended to clients during the period, and
- discussed the profits realized by the specific recommendations.

Compliance Policies and Procedures. OCIE staff observed issues relating to advisers that did not have, or did not implement, policies and procedures reasonably designed to prevent deficient advertising practices, including issues such as:

- a process for reviewing and approving advertising materials prior to use,
- determining the parameters for which accounts were included or excluded in composites when presenting composite performance information, and
- confirming the accuracy of performance results.

Touting Initiative Observations—OCIE began a “Touting Initiative” in 2016 to review disclosures that advisers provided to clients when touting awards, promoting ranking lists and/or identifying professional designations. Issues that OCIE found included the use of:

- stale rankings,
- accolades which were obtained by submitting false or misleading information,

- advertisements that did not disclose the relevant selection criteria for awards or rankings, the source of a survey and the fact that the adviser paid a fee to participate in or distribute the survey,
- professional designations shown in Form ADV brochure supplements that had lapsed, and
- statements from clients which may have been prohibited testimonials.

Advisers should review their advertising compliance policies and procedures, as well as actual practices, in light of the Risk Alert to ensure that all advertisements are consistent with the Advisers Act advertising requirements and fiduciary obligations.

[For More Information](#)

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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