JACKO LAW GROUP, PC

Legal Risk Management Tip
September 2017

7 Essential Takeaways from the September SEC Risk Alert

Introduction

On September 14, 2017, the Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examination ("OCIE") released its latest Risk Alert titled "The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers" which is based on the results of over 1,000 examinations of registered investment advisers, including examinations in connection with the SEC's "Touting Initiative" focused on accolades used by advisers in marketing materials.[1]

This month's Legal Risk Management Tip highlights 7 important performance advertising issues identified in the Risk Alert that advisers should consider reviewing in light of the Risk Alert and in order to be more prepared for their next regulatory examination.

1. Does your Firm Clearly Explain Fees when Discussing Performance?

It has long been a focus of the financial services regulators to ensure that advisers describe investment performance in a manner that is accurate and not misleading. One area where the regulators continue to focus is an adviser's explanation of advisory fees and the effect those fees have on investment performance. Applicable rules and regulatory guidance on this topic requires an adviser to include in its marketing materials investment results that reflect the deduction of advisory fees.[2] While an adviser may also choose to set forth performance on a "gross of fees" basis, such gross performance needs to be supplemental to the adviser's net performance.[3]

2. Does your Firm Compare Performance Only to Relevant Benchmarks?

Whether an adviser works to meet or exceed benchmark performance, for purposes of performance advertising, and adviser needs to explain the relevance of any benchmark compared to an adviser's investments, including how benchmarks are different from the adviser's strategy.[4] For example, if an adviser specializes in non-United States, emerging markets investments, any comparison of that adviser's returns to domestic indexes (e.g. NASDAQ-100 Index) would not be directly related, and the regulators expect appropriate disclosures to accompany performance results. For a subtler example, if an adviser manages private equity investments and wants to compare a major U.S. benchmark, such as the S&P 500 Index, in its marketing documents, the

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[1] The Risk Alert is available here: https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf.
[2] *See, e.g., Clover Capital Mgmt., Inc.*, SEC Staff No-Action Letter (Oct. 28, 1986).
[3] Note that there may be limited situations where gross fee reporting is permissible, discussion of which is outside the scope of this article.
[4] *See, e.g., The TCW Group*, SEC Staff No-Action Letter (Nov. 7, 2008).

adviser needs to clearly explain the limitation in such a comparison and whether the index relates to private investing in order to comply with the advertising rules.

3. Does your Firm Use Synthetic or Back-tested Performance in Marketing Materials?

Synthetic performance (also called hypothetical performance) and back-tested performance may be the most difficult areas of adviser advertising to describe clearly. Neither synthetic nor back-tested performance reporting describe an adviser's actual investment activities. Rather, they identify returns an adviser would have experienced under a certain set of conditions and assumptions. Because these types of performance did not really happen, the level of detail required to explain relevant information clearly and in a manner that is not potentially misleading to a client or prospect is significant.

Disclaimers relating to synthetic and back-tested results tend to be lengthy (sometimes longer than the performance reporting data itself), and are often criticized as ruining the appearance of a marketing slide or presentation. While aesthetic considerations are important in many regards to an advisory business, they should not outweigh regulatory considerations for full and fair disclosure to clients and investors. SEC and state regulators will focus on whether the hypothetical or back-tested returns are described in a manner so that the material information is accurately conveyed to clients and prospects. If your company utilizes this type of performance reporting, you should work closely with your compliance team and external advisers when preparing your marketing materials.

4. Do you Claim GIPS Compliance?

Compliance with a voluntary performance standard, such as the Global Investment Performance Standards (GIPS®)[5] set forth by the CFA Institute, helps investment firms to follow rigorous standardized performance measurement standards which may set them apart from competitors. The process to achieve GIPS compliance requires consistent adherence to specific protocols and ethical behaviors. Many advisers opt to have the manager's performance track record verified by an independent third party, which adds an additional layer of integrity. To conform with the standards, performance must be reported in accordance with the detailed GIPS advertising guidelines.[6] In addition, an adviser whose claims GIPS compliance will need detailed policies and procedures tailored to the firm's processes designed to ensure such compliance and to remain current with changes to the applicable requirements. Satisfying these standards requires significant time, effort and discipline, and an adviser will incur substantial costs along the way, with the goal of bringing an additional level of credibility to the reported performance of the firm.

Based on this summary, it should be apparent that, in order to claim adherence to GIPS (or any voluntary standard) in advertising, an adviser needs to undertake and complete its verification process before claiming that its performance is complaint. Similarly, an adviser must follow the standards on a go-forward basis so long as claims of GIPS compliance are made.[7]

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[5] There are other voluntary performance standards, and this article uses GIPS as an example for illustrative purposes.
[6] *See* What Are the GIPS Standards? *available at* http://www.gipsstandards.org/about/documents/factsheet.pdf.
[7] The Risk Alert cites an enforcement action where the adviser fell short of such requirements. *See, ZPR Investment Mgmt., Inc.*, Advisers Act Rel. No. 4249 (Oct. 30, 2015).

Generally, advisers should consider hiring professionals to assist in this endeavor.

5. Do your Materials List Only Certain of your "Best Performing" Investments?

If you answered "yes" to the question above, your firm needs to be concerned about the prohibition against using only past specific recommendations (also known as "cherry-picking") contained in the Advertising Rule.[8] Specifically, the Advertising Rule does not allow references to past specific profitable recommendations in marketing materials, unless they are fair and balanced in accordance with SEC no-action letters[9] and the anti-fraud provisions.
While this particular rule is familiar to many, advisers should review all materials where performance is discussed, including client and prospect materials, the adviser's website, as well as social media sites to ensure that proper disclosures are included along with performance information.

6. Do your Materials Refer to Awards or Rankings?

The Risk Alert focuses in part on the Touting Initiative launched by the SEC in 2016 to examine advisers who include awards, rankings on lists and/or professional designations in their marketing documents and information. Without a full explanation detailing eligibility requirements for achieving such an award or ranking, the regulators may conclude that your advertisements are materially inaccurate and potentially misleading. Consider the following:

- Is the award or raking based on submission of false, misleading or incomplete information?[10]
- Did you have to pay to qualify for the award or accolade?
- Did you have to pay to continue to be considered for the award or accolade?
- Is the ranking based on information that currently applies to your firm (or is the ranking and/or its basis outdated)?
- Do you discuss professional designations held by your personnel in Form ADV Part 2B?

Answers to these questions must be disclosed in order to comply with the testimonial rule. As always, do not forget to save backup of relevant information in your compliance files.

7. Do you Have Controls in Place for Appropriate Recordkeeping and Maintenance?

As part of recent amendments to Form ADV requirements[11], which go into effect on October 1, 2017, the SEC modified Rule 204-2 of the Advisers Act (sometimes called the books and records

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[8] *See* Rule 206(4)-1 of the Investment Advisers Act of 1940.
[9] *See, e.g. The TCW Group*, SEC Staff No-Action Letter (Nov. 7, 2008); *Franklin Management Inc.*, SEC Staff No-Action Letter (Dec. 10, 1998).
[10] This scenario is expressly mentioned in the Risk Alert, and included here to emphasize a point – it should be obvious that an accolade or award based on false, incomplete or incorrect information should not appear anywhere in an adviser's advertising or marketing materials.
[11] JLG issued a Legal Tip discussing the certain aspects of the ADV amendments which is available at: http://www.jackolg.com/Legal-Tip-May-2017.pdf.

rule) such that advisers will be required to maintain additional documents related to the calculation and distribution of performance information, as follows:[12]

- Advisers will be required to keep records supporting performance claims in communications to any person, and not just communications to 10 or more recipients; and

- Advisers will be required to maintain originals of written communications received and copies of written communications sent that relate to the performance or rate of return of any or all managed accounts or securities recommendations. E-mails that contain performance information are covered by this amendment.

These new requirements apply to communications and documents circulated or distributed after October 1, 2017, regardless of whether those documents were created prior to that date.

Conclusion

The Risk Alert serves as a reminder that the regulators will review a large number of factors when examining an adviser's advertising and marketing materials. Advisers should have tailored and effective policies and procedures in place to govern the creation, review and distribution of such information. If you are concerned that your marketing materials or related processes and procedures will not hold up under regulatory scrutiny or if you just want to revisit your current practices considering the recent Risk Alert, now is the time to act.

For more information on these and other considerations relating to performance advertising issues, please contact us at info@jackolg.com, or (619) 298-2880.

Author: Robert Conca, Partner; Editor: Michelle L. Jacko, Esq., Managing Partner, Jacko Law Group, PC. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds, banks and corporate clients on securities and corporate counsel matters.

[12] *See* SEC Adopting Release No. IA-4509 (Aug. 25, 2016), available at https://www.sec.gov/rules/final/2016/ia-4509.pdf.