

AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

ASSET MANAGEMENT **INSIGHTS**

OCIE ISSUES RISK ALERT SUMMARIZING FREQUENT "ADVERTISING RULE" COMPLIANCE ISSUES IDENTIFIED FROM ADVISOR EXAMINATIONS

The Office of Compliance Inspections and Examinations ("OCIE") of the Securities and Exchange Commission ("SEC") issued a [risk alert](#) that summarized observations of Rule 206(4)-1 of the Investment Advisers Act (the "Advertising Rule")¹ compliance issues identified during recent examinations, including through OCIE's examination initiative that focused on advisers use of accolades (e.g., touting awards, promoting list rankings, boasting about assets under management) in advertisements (in print or in media). This examination initiative alone covered nearly 70 examinations that were conducted in 2016.

The OCIE found compliance issues with the use of third-party rankings, performance representations using both gross and net of fees, use of professional designations, and specific trade selections, among other areas found at issue. In nearly all cases where a compliance issue was found, the central takeaway was the adviser's lack of adequate disclosures.

Learn more about the most common Advertising Rule compliance issues identified by OCIE's recent examinations and things to consider to ensure your firm can promote its successes and attract investors, while at the same time comply with regulatory requirements and expectations.

SUMMARY

From time to time, OCIE, which manages the examination program for the SEC, publishes "risk alerts" to summarize observations of compliance issues found during recent examinations. These observations aim to promote transparency and the implementation of effective compliance programs.

In the most recent SEC Risk Alert (issued on September 14, 2017), OCIE highlighted common deficiencies and, in some cases, clear violations with the Advertising Rule. As expressed in this SEC Risk Alert, "[t]he Advertising Rule prohibits [SEC-registered investment advisers ("advisers")], directly or indirectly, from publishing, circulating, or distributing any advertisement that contains any untrue statement of material fact, or that is otherwise false or misleading." The central theme to all the compliance issues identified by the OCIE is *the failure to make adequate disclosures*.



BDO's Risk & Regulatory Advisory practice provides wide-ranging regulatory compliance services. In particular with advisers, our professionals have extensive experiences with advising, developing and enhancing the firm's 206(4)-7 Compliance Program to ensure compliance with the Advertising Rule, among other securities laws and requirements. With our well-versed knowledge and expertise with the Investment Advisers Act and having a "pulse" on regulatory trends, our professionals are well-equipped to help you meet your organization's specific needs.

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¹ <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm>

The common compliance issues identified in recent examinations that conflicted with or otherwise violated the Advertising Rule were as follows:

- ▶ **Misleading Performance Results** – The OCIE observed that advisers presented performance results without deducting advisory fees, one of several observations.
- ▶ **Misleading One-on-One Presentations** – The OCIE observed that advisers that advertised performance results did not include relevant disclosures such as client returns would be reduced by advisory fees and other expenses.
- ▶ **Misleading Claim of Compliance with Voluntary Performance Standards** – The OCIE observed that advisers claimed advertised performance results complied with a certain voluntary performance standard, such as the Global Investment Performance Standards (“GIPS”), when this could not be validated by the OCIE staff.
- ▶ **Cherry-Picked Profitable Stock Selections** – The OCIE observed that advisers' cherry-picked stock selections in their advertisements, including instances where the advisers only included only profitable stock selections in the advertisements.
- ▶ **Misleading Selection of Recommendations** – The OCIE observed that advisers only disclosed specific investment recommendations, which is misleading as it does not provide all recommendations to meet the conditions set form in Subsection (a)(2) of the Advertising Rule.
- ▶ **Misleading Use of Third-Party Rankings or Awards** – The OCIE observed advertisements that contained potentially misleading use of third-party rankings or awards, such as stale rankings or evaluation information.
- ▶ **Misleading Use of Professional Designations** – The OCIE observed disclosures made by advisers that contained false or misleading references to employee professional designations.
- ▶ **Testimonials** – The OCIE observed that advisers published statements of clients endorsing the adviser, which is prohibited by Subsection (a)(1) of the Advertising Rule.

Not surprisingly, due to the foregoing compliance issues identified, the OCIE also found advisers non-compliant with Rule 206(4)-7(a), which requires advisers to maintain policies and procedures that are reasonably designed to prevent violations of securities laws and other applicable requirements; in this case, adequate policies and procedures to comply with advertising practices.

WHY DOES THIS MATTER?

What is an advertisement? Rule 206(4) – 1 provides a broad definition of what is considered an “advertisement”. It can be any notice, circular, letter, or other written communication addressed to more than one person that offers any investment advisory service. It is important to understand what can be considered an advertisement if an adviser is to be compliant with the Advertisement Rule.

As evidenced by this risk alert, advertisement has, and will always be, a major focus during an OCIE examination. It is one area that is commonly subject to compliance failures and carry serious penalties.

For example, in August of 2016, the SEC fined 13 advisers for advertising false performance claims. These advisers made recommendations to their investors for a strategy (called “AlphaSector”) offered by F-Squared Investments, Inc. (“F-Squared”) by repeating the claims made by F-Squared that AlphaSector outperformed relative to the S&P 500 index. The SEC found that the advisers did not perform adequate due diligence of the claims made by F-Squared. What makes this case interesting is the fact that even though a third-party made the false and misleading representations, an adviser is still liable if such adviser adopts the representations in its advertisements without performing adequate due diligence. As the former Director of the SEC Enforcement Division, Andrew J. Ceresney, shared in this matter, “[w]hen an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact”; otherwise, the adviser is negligently passing along false and misleading representations to their own clients.

This matter brought penalties to each of the advisers ranging between \$100,000 and \$500,000.²

THINGS TO CONSIDER

- ▶ Do you want to highlight past recommendations / performance? If so, please ensure compliance with Rule 206(4)-1(a)(2), which makes it fraudulent, deceptive or manipulative act, practice, or course of business if an advertisement refers to past specific recommendations. However, the adviser may furnish a list of all recommendations made during the preceding year, provided that such advertisement includes the necessary disclosures.
- ▶ Do you want to highlight specific recommendations, including some of your most profitable trades? This may be permitted, so long as the adviser includes “an equal number of worst performers” to balance the best performing recommendations. See *TCW Group* SEC Staff No-Action Letter (Nov. 7. 2008).

² <https://www.sec.gov/news/pressrelease/2016-167.html>

Otherwise, such representations violate Rule 206-1(a)(2) and is considered cherry-picking.

- ▶ Advisors must highlight performance after deducting advisory fees (*i.e.*, net of fees), but there are exceptions to highlighting such performances gross of fees. While such exceptions exist, this does not remove the adviser's obligation to ensure appropriate disclosures are included so that the representations made in the advertisement false or otherwise misleading.
- ▶ If you are comparing your performance to a benchmark, or anything else, such benchmark needs to be comparable. For

example, comparing performance with focus in small cap growth strategy should not be compared to a benchmark that focuses on large cap blue chip securities.

- ▶ *Disclosures, disclosures, disclosures.* You can follow all the rules above, but without adequate and appropriate disclosures, you run the risk of potentially making an untrue statement of material fact, thereby making the advertisement false or otherwise misleading.

HOW DO I GET MORE INFORMATION?

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