

# STROOCK SPECIAL BULLETIN

## OCIE Issues Risk Alert Highlighting the Most Frequent Advertising Rule Compliance Issues

*October 2, 2017*

On September 14, 2017, the Securities and Exchange Commission's (the "SEC") Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert<sup>1</sup> highlighting compliance issues relating to Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the "Advertising Rule"), which the OCIE staff most frequently identified during the course of over 1,000 examinations of SEC-registered investment advisers. The Risk Alert follows the completion of OCIE's recent "Touting Initiative", which focused on advisers' use of accolades in marketing materials and identified common deficiencies in the advertising practices of advisers.

### Advertising Rule Overview

The Advertising Rule prohibits an adviser, 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.<sup>2</sup> For purposes of the Advertising Rule, an "advertisement" is broadly defined to include any communication

addressed to more than one person which offers any analysis, report or publication concerning securities. Advertisements may be in both written or oral form and include any announcement or publication, including those conveyed over the internet or by radio or television.<sup>3</sup> Four types of advertisements by advisers are expressly prohibited: (i) testimonials<sup>4</sup>; (ii) subject to certain exceptions, those presenting past specific recommendations that were profitable<sup>5</sup>; (iii) those which claim that any graph, chart, formula or other device can in and of itself be used to make buy or sell determinations with respect to securities<sup>6</sup>; and (iv) those which purportedly offer any report, analysis, or service for free, unless it actually is free and without any condition or obligation<sup>7</sup>. The SEC has also issued guidance regarding permissible advertising activity, particularly as it relates to the use of performance information, and advisers should take heed of such

<sup>3</sup> Rule 206(4)-1(b) under the Advisers Act.

<sup>4</sup> Rule 206(4)-1(a)(1) under the Advisers Act.

<sup>5</sup> Rule 206(4)-1(a)(2) under the Advisers Act. For example, presenting past specific recommendations may be permissible if the adviser includes a list of all recommendations made during the past year.

<sup>6</sup> Rule 206(4)-1(a)(3) under the Advisers Act.

<sup>7</sup> Rule 206(4)-1(a)(4) under the Advisers Act.

<sup>1</sup> <https://www.sec.gov/files/risk-alert-advertising.pdf>

<sup>2</sup> Rule 206(4)-1(a)(5) under the Advisers Act.

guidance when preparing and reviewing their advertising materials.

Advertisements also are subject to the general prohibition on fraud and should not imply that the SEC or any other agency has sponsored, recommended, or approved that adviser.

## Common Advertising Rule Compliance Deficiencies

Set forth below are the six most common Advertising Rule compliance deficiencies identified by the OCIE staff.

*Misleading Performance Results.* The OCIE staff noted the following examples of advisers providing misleading performance results: (i) presenting performance results without deducting advisory fees (*i.e.*, providing gross performance results while excluding net performance results); (ii) comparing performance results to a benchmark without including disclosure regarding the limitations of such comparisons or, when the advertised strategy materially differs from the composition of the benchmark, failing to disclose such differences; and (iii) presenting hypothetical and back-tested performance results without explaining how such results were derived and excluding other material disclosures regarding such results.

*Misleading One-on-One Presentations.* While not every Advertising Rule limitation applies to one-on-one presentations, such presentations may result in deficiencies. Common pitfalls include: (i) advertising performance results without including potentially relevant disclosures and (ii) failing to disclose that advertised performance results do not reflect the deduction of advisory fees or that client results would be reduced by such fees and other expenses.

*Misleading Claim of Compliance with Voluntary Performance Standards.* The OCIE staff noted examples of deficient advertisements which claimed that advertised performance results complied with certain voluntary performance standards (*e.g.*, the Global Investment

Performance Standards (“GIPS®”)) when it was unclear whether the advertisements actually adhered to the guidelines of such performance standard.

*Cherry-Picked Profitable Stock Selections.* Certain advisers include only profitable stock selections or recommendations in their marketing materials in violation of the Advertising Rule. In order to disclose past specific investment recommendations, an adviser must comply with certain requirements to ensure that the presentation of such information is not misleading (*e.g.*, furnishing a list of all recommendations made by the adviser during the preceding year and including accompanying disclosures regarding such recommendations).

*Misleading Selection of Recommendations.* The OCIE staff noted that certain advertisements contained misleading selections of investment recommendations, and highlighted advertisements that included only certain, but not all, investment recommendations as an illustration of a particular investment strategy. The SEC previously provided guidance on the presentation of specific past recommendations and the OCIE staff noted that certain advertisements failed to comply with such guidance.<sup>8</sup>

*Compliance Policies and Procedures.* Certain advisers fail to have adequate compliance policies and procedures reasonably designed to prevent

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<sup>8</sup> The Risk Alert references two no-action letters which address the use of past specific recommendations: *The TCW Group* (November 7, 2008) (granting no-action relief to an adviser who used past specific recommendations in an advertisement to investors that were not currently invested in the relevant strategy, if the adviser disclosed at least five of its best performing recommendations, together with an equal number of its worst performing recommendations) and *Franklin Management, Inc.* (December 10, 1998) (granting no action relief to an adviser for presenting past recommendations when the recommendations presented were selected using a consistently applied, objective, non-performance based selection criteria).

deficient advertising practices. In particular, the OCIE staff noted that adviser compliance programs are often deficient in the following areas: (i) the review and approval process prior to their publishing or disseminating advertising materials; (ii) when using composites, the determination of parameters for the inclusion or exclusions of accounts from performance calculations; and (iii) the confirmation of the accuracy of performance results.

### Key Observations from OCIE's Touting Initiative

In addition, the OCIE staff identified three common deficiencies in advisers' advertising materials when advisers tout awards, promote ranking lists, and/or identify professional designations.

*Misleading Use of Third Party Rankings or Awards.* Certain advisers publish potentially misleading advertisements containing references to awards or rankings conferred by third parties without disclosing material facts about such awards or rankings. For example, certain advertisements: (i) reference third party rankings or awards that had been obtained by submitting misleading or false information; (ii) reference stale ranking or evaluation information (*i.e.*, referring to rankings in publications that were issued several years prior or were no longer applicable); or (iii) fail to disclose the relevant selection criteria for the awards or rankings, who created and conducted the survey, and the fact that advisers pay a fee to participate in or distribute the results of the survey.

*Misleading Use of Professional Designations.* Another common deficiency in adviser advertisements and adviser Form ADV Part 2B Brochure Supplements is referencing employee professional designations that have lapsed and/or failing to explain the minimal qualifications required to attain such designations.

*Testimonials.* Certain advisers improperly publish client statements attesting to the adviser's services

or otherwise endorsing the adviser, in particular on the website or social media pages of the adviser, reprints of third-party articles, or in pitch books.

### Our Take

The Risk Alert should serve as a reminder of the risks and issues associated with complying with the Advertising Rule and may be a harbinger of a coming wave of enforcement actions related to the Advertising Rule. As such, advisers should review their compliance programs and existing advertisements in light of the Advertising Rule requirements and update or bolster their compliance programs as needed.

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