

Investment Adviser Advertising

**“BAD AD” CASE STUDY
AND COMMENTARY**

by
Lorna A. Schnase
Attorney at Law

June 2007

SAMPLE "BAD AD"

SHOULD BE READ IN CONJUNCTION WITH THE ACCOMPANYING COMMENTARY
Numbered items in the "bad ad" correspond to the
numbered paragraphs in the commentary.

We're seeing stars!⁽¹⁾

XYZ has been rated a top 5-star ★★★★★ manager by Fill-in-the-Blank Magazine!⁽²⁾

XYZ beat the S&P500 for every period since inception.⁽³⁾

	⁽⁴⁾ 2 nd Quarter	YTD	1-year	5-year	10-year ⁽⁸⁾	Since inception ⁽⁸⁾
XYZ Small Cap ⁽⁵⁾	6.84% ⁽⁶⁾	8.14% ⁽⁶⁾	22.94% ⁽⁶⁾	7.38% ⁽⁶⁾	10.66% ⁽⁶⁾	9.31% ⁽⁶⁾
S&P500 ⁽⁷⁾	-1.02% ⁽⁶⁾	6.01% ⁽⁶⁾	13.01% ⁽⁶⁾	6.12% ⁽⁶⁾	8.21% ⁽⁶⁾	9.02% ⁽⁶⁾

Partial Client List: ⁽¹⁰⁾

On-the-Brink Inc.
Local U Pension Fund
Goodstuff Foundation

"XYZ invested us in Microsoft when it was still \$21. Good call!" ⁽⁹⁾
-- I.M. Friend, Trustee, Goodstuff Foundation

XYZ Investment Management is a recognized investment management firm with a favorable performance track record in a wide variety of markets. Our investment professionals have over 50 years of combined experience. ⁽¹¹⁾

Call us today to set up your free consultation. ⁽¹²⁾

XYZ INVESTMENT MANAGEMENT CO.

Estab. 2001

PAT XYZ, CFA, RIA ⁽¹³⁾

Phone: XXX-XXX-XXXX

SAMPLE “BAD AD” COMMENTARY

Relating to the Accompanying “Bad Ad” for an Investment Adviser

The following commentary relates to the accompanying “bad ad” for the fictitious investment advisory firm XYZ Investment Management Co. The commentary begins with a general discussion of the standards that apply to investment adviser advertising and the concept of “fraud” under the securities laws. It then follows with specific remarks regarding the sample “bad ad.”

First, What is an “Ad”?

The adviser advertising rule -- Rule 206(4)-1 under the Investment Advisers Act of 1940¹ -- defines an “advertisement” for purposes of the rule² as including those items traditionally thought of as advertisements, such as notices or announcements that appear in printed publications or on radio or television.³ However, the definition of “advertisement” also covers items in addition to traditional ads and includes any “notice, circular, letter or other written communication addressed to more than one person” that offers advisory services.⁴ This definition is broad enough to include, for example, the typical adviser’s website and even basic marketing materials that an adviser might use in a meeting with clients or prospective clients.⁵

Standards Applicable to Adviser Advertising

Rule 206(4)-1 contains a list of items that are specifically banned in adviser ads – no testimonials, no past specific recommendations, and so on.⁶ These bans are based on the notion that certain items in an adviser ad are inherently misleading -- or pose too great a risk of being misleading -- and should therefore not be allowed. The rule also contains a general prohibition on any adviser

¹ For convenience of reference, Rule 206(4)-1 is reproduced in its entirety at the end of this commentary.

² Be aware that the definition of “advertisement” for purposes of Rule 206(4)-1 is not completely consistent with the definitions of “advertisement” and similar terms used elsewhere under the federal securities laws, such as:

- the Securities Act of 1933 (see, for example, Rule 156(c) defining investment company “sales literature”);
- the Investment Company Act of 1940 (see, for example, Rule 34b-1 specifying certain required disclosures for investment company “sales literature”); and
- the NASD rules (see, for example, NASD Conduct Rule 2210(a) and (b) defining “advertisement” and “sales literature”).

The “addressed to more than one person” element of the Advisers Act definition is also confusingly at odds with the Advisers Act books and records rule (see Rule 204-2), which calls for advisers to keep copies of any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes to 10 or more persons.

³ In order to fall within the “advertisement” definition under Rule 206(4)-1, the ad must offer (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

⁴ Rule 206(4)-1(b).

⁵ If material is created for and used with only one client or prospective client, an adviser might be able to argue that the material is not an “advertisement” because it is not “addressed” to more than one person. In addition, see Investment Counsel Association of America (SEC No-Action Letter available March 1, 2004), which can be read as carving out of the definition of “advertisement” for purposes of the advertising rule any adviser report sent to existing clients (unless the context indicates that the material is being used to offer advisory services) and any written communications sent in response to unsolicited requests by a client, prospective client or consultant, even if those reports or communications contain content that might otherwise be prohibited under the advertising rule (such as references to past specific recommendations or client lists). Even in those cases, however, the adviser should remain cognizant of the points about “fraud” that are discussed in this commentary.

⁶ These items are prohibited in adviser ads except under the specific conditions defined in the rule. See the rule itself appearing at the end of this commentary for details.

ad which contains “any untrue statement of a material fact, or which is otherwise false or misleading.”⁷ The rule, then, covers the waterfront on “fraud” in adviser ads, banning those specific items that are treated as inherently misleading and more generally prohibiting anything else that is misleading, whether or not it is specifically banned.

However, Rule 206(4)-1 is not the only legal restriction governing adviser ads. All adviser communications -- whether contained in an ad, a letter addressed to one client, an oral communication or whatever -- are subject to legal prohibitions against “fraud.” Even adviser communications that are not “advertisements” within the advertising rule are subject to the general anti-fraud provisions of Section 206 of the Advisers Act, which outlaw any “device, scheme or artifice to defraud” and any “act, practice or course of business which is fraudulent, deceptive or manipulative.”⁸ As a result, wise advisers will focus not only on whether their communications fall within the adviser advertising rule, but also on whether their communications could be considered “fraudulent” regardless of whether they constitute “ads.”

What is “Fraud”?

The concept of “fraud” under the securities laws is very broad. It includes far more than the bald-faced intentional lie that may ground a classic fraud claim.⁹ Rather, the securities laws recognize that clients and investors can be defrauded (i.e., misled) not only by what is said, but what isn’t said as well (or put another way, by what is omitted). Therefore, the anti-fraud provisions of the securities laws require that a communication be both truthful and not omit material facts necessary to make the statements made, in the light of the circumstances under which they were made, not misleading. Communications must be both materially accurate and complete, avoiding both material misstatements as well as material omissions. In short, communications must be accurate, fair and balanced.

How is “materiality” determined for these purposes? Simply put, information is considered “material” if a reasonable client ought to know it in order to evaluate and understand the material provided.¹⁰ The test for materiality is very contextual and depends on the facts and circumstances of each case, but it is a standard that permeates the federal securities laws and one that we have been living with now for decades.

Thus, advisers should prepare and review all their communications with these standards in mind. Advisers should ask themselves, is this an “ad” subject to the specific prohibitions in Rule 206(4)-1, and even if not, is there something stated in the communication – or omitted from the communication – which might render it misleading?

⁷ Rule 206(4)-1(a)(5).

⁸ Moreover, even in-person oral communications that arguably fall outside the scope of the federal securities laws because they do not involve the use of any “means or instrumentality of interstate commerce” (which includes the U.S. mail, telephone and Internet) would almost certainly fall within the scope of state Blue Sky laws prohibiting fraud (which apply whether or not an adviser is SEC-registered) and/or common law principles prohibiting fraud.

⁹ In fact, a violation of the anti-fraud sections of the Advisers Act may not require a showing of intent at all. See Aaron v. SEC, 446 U.S. 680, 696-97 (1980), which cites Capital Gains Research Bureau, Inc. v. SEC, 375 U.S. 180, 200 (1963) for the proposition that a violation under Section 206(2) does not require a showing of intent. Even in cases where intent is an element, the state of mind required to establish a securities fraud claim is usually “scienter,” Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976), which is a mental state embracing an intent to deceive, manipulate or defraud that can usually be satisfied by showing some form of recklessness. See Howard v. Everex Systems, Inc., 228 F.3rd 1057, 1063 (9th Cir. 2000) (knowledge or recklessness is required for a finding of scienter); SEC v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992) (extreme recklessness); Dennis v. General Imagin, Inc., 918 F.2d 496, 567 (5th Cir. 1990) (severe recklessness); and Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044-45 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1977) (common law recklessness).

¹⁰ This is an adaptation of the definition of materiality applied by the U.S. Supreme Court in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (information is material under the SEC’s proxy rules if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”); and in Basic Incorporated v. Levinson, 485 U.S. 224 (1988) (applying the same basic standard of materiality for purposes of Rule 10b-5).

Remarks Regarding the Sample “Bad Ad”

The accompanying “bad ad” for the fictitious advisory firm XYZ Investment Management Co. was created to depict a host of legal and practical issues that can arise in adviser advertising. The issues discussed in this commentary may not be the only issues raised by the ad, but they are among the more common issues faced by advisers in creating compliant advertising and are therefore included here for discussion purposes. The numbered paragraphs contained in the commentary correspond to the similarly numbered text and tabular items depicted in the “bad ad.”

(1) “We’re Seeing Stars!” -- Advertising Fluff

This statement might be viewed as mere advertising “fluff” or “puffery” and therefore not misleading or fraudulent *per se*. However, cautious lawyers often steer their clients away from these types of statements because they are non-factual and therefore impossible to back up with hard facts and figures should the ad ever be called into question. When contemplating whether to include non-factual fluff or puffery in an ad, advisers should pay particular attention to the overall impression that the statements create in the context of the ad – or the implications created by the statements -- and consider whether that impression or implication is any respect misleading (inaccurate or incomplete).

(2) “5-Star Manager” -- Ratings and Rankings

The sample “bad ad” states that XYZ has been rated as a 5-star manager by Fill-in-the-Blank Magazine. Third-party ratings (including rankings) may be viewed as having a “testimonial nature” and, as referenced above, testimonials are generally prohibited in adviser ads under the adviser advertising rule.¹¹

The term “testimonial” is not defined in the advertising rule, but it has consistently been interpreted to include a statement of a client’s experience with, or endorsement of, an investment adviser. This explains the SEC Staff’s “clarification” of its views concerning third-party ratings, which appears in a no-action letter issued to the Investment Adviser Association in 2005.¹² According to that letter, third-party ratings will be considered “testimonial” if they are based primarily on information obtained from client surveys.¹³ However, third-party ratings that rely in part on client evaluations will not necessarily be considered testimonials for purposes of the advertising rule. Whether a third-party rating is a testimonial will depend on all of the facts and circumstances relating to the rating. For example, if a third party consults an adviser’s clients about their evaluation of the adviser when formulating the rating, but the client responses, relative to other criteria, are an insignificant factor in the rating’s formulation, the rating would not be a testimonial.¹⁴ As usual, however, all uses of adviser ratings will be subject to the general prohibition against false and misleading statements, whether or not they are testimonial and whether or not they appear in an ad.

Factors that advisers should consider when determining whether a third-party rating in an advertisement -- including one that is a testimonial -- is false or misleading include:¹⁵

1. Whether the advertisement discloses the criteria on which the rating was based;

¹¹ See Rule 206(4)-1(a)(1).

¹² Investment Adviser Association (SEC No-Action Letter available December 2, 2005).

¹³ Id., citing DALBAR, Inc. (SEC No-Action Letter available March 24, 1998).

¹⁴ Id.

¹⁵ These factors appear in the DALBAR and Investment Adviser Association no-action letters cited above.

2. Whether an investment adviser advertises any favorable rating without disclosing any facts that the adviser knows would call into question the validity of the rating or the appropriateness of advertising the rating (e.g., the adviser knows that it has been the subject of numerous client complaints relating to the rating category or in areas not included in the survey);
3. Whether an investment adviser advertises any favorable rating without also disclosing any unfavorable rating of the adviser;
4. Whether the advertisement states or implies that an investment adviser was the top-rated adviser in a category when it was not rated first in that category;
5. Whether, in disclosing an investment adviser's rating, the advertisement clearly and prominently discloses the category for which the rating was calculated or determined, the number of advisers surveyed in that category, and the percentage of advisers that received that rating;
6. Whether 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 investment adviser's clients;
7. Whether the advertisement discloses that the rating is not indicative of the investment adviser's future performance; and
8. Whether the advertisement discloses prominently who created and conducted the survey, and that investment advisers paid a fee to participate in the survey.

As you can see, the sample "bad ad" fails to disclose even the most basic information about the rating XYZ received from Fill-in-the-Blank Magazine. Accordingly, XYZ should -- at a minimum -- consider substantially enhancing the ad to include information about the rating along the lines suggested by the factors listed above. Of course, XYZ should also consider whether the rating should be referenced in the ad at all, if other factors suggest that its presence alone could be misleading. This might be the case, for example, if the rating is too old to be pertinent or has since been superseded by a lower rating, or if the rating was based on XYZ's performance in a style category where XYZ no longer provides services, or in other circumstances where the rating may no longer be relevant or current.

(3) "XYZ beat the S&P500 for every period" -- Literal Inaccuracy

This statement is an example of imprecise wording that is probably inaccurate as stated. Although the performance table in the ad suggests that XYZ's performance exceeded the S&P500 for all the periods shown, the table does not depict "every period since inception." For example, the table does not show the 3-year performance data, or any calendar year data. What would those data show? Did XYZ beat the S&P500 for all those periods too? What about other time periods, such as during particular bull or bear markets? It is frankly improbable that an adviser beat the S&P500 for "every period" since inception. This illustrates the point that advisers should always ask themselves if their advertising statements are literally true as well as whether the implications of the statements are true.

This statement is also imprecise – and therefore potentially misleading – because XYZ itself would not have beaten the index for any particular period. Rather, more likely, XYZ's composite performance did, or perhaps XYZ's Small Cap Composite, if XYZ has more than one composite.¹⁶ In many cases, problems created by sloppy wording can be easily avoided by simply adding precision to the language. In this case, the problems caused by sloppy wording could be avoided by deleting the entire statement from the ad, without losing any substance. In other words, let the table speak for itself.

¹⁶ Presumably, XYZ is not holding out the performance of any one account – or any small group of accounts – as "its" performance. See the discussion below under heading (5) concerning GIPS.

(4) Time Periods in Headings of Table -- Poor/Misleading Labeling

The performance data in the sample “bad ad” lack clarity and context because nowhere in the table is it stated what year is involved. In other words, the table shows data for the 2nd quarter of what year? The 1-year performance is for the period ending as of what date? It is unwise to assume that the data speak as of the calendar year in which the ad is being used. The data might speak as of the adviser’s fiscal year, if not some other unstated period. Clarification should be added by enhancing the labeling both of the table and in the table.

The “Since Inception” label is also incomplete. In order to fully understand the significance of the “Since Inception” data, the reader needs to know the actual inception date. That information would usually appear in the heading over the “Since Inception” column or in a footnote to the table.

Lastly, performance data should not be used once it is stale. In general, performance data should be kept current within a quarter. So, for example, the “bad ad” showing performance achieved during the 2nd quarter should not be used once the 3rd quarter data is available. Without more context, it is impossible to tell whether XYZ’s “bad ad” performance table is already stale.

(5) “XYZ Small Cap” -- Labeling/Construction of Composite

The “bad ad” reference to “XYZ Small Cap” is another example of potentially misleading unclarity. What does it refer to? Is it a composite that XYZ maintains of actual client accounts? Or is it a hypothetical model portfolio that XYZ manages? Not knowing more raises concerns about cherrypicking. If it is a composite, does it depict all of XYZ’s small cap accounts? If not, why are some being excluded? Advisers using the performance of composites or logical groupings of accounts in their ads would be wise to familiarize themselves with GIPS, the Global Investment Performance Standards established by the CFA Institute.¹⁷ While advisers are not required to present their performance in accordance with GIPS, the GIPS standards are designed to help assure that performance presentations are both complete and fair. Therefore, even advisers that choose not to comply with GIPS can use GIPS as a “gold standard” for their own presentations and ask themselves whether their presentations are likely to be viewed as misleading in the areas where they deviate from GIPS.

Whether the “XYZ Small Cap” is a composite or a model, the ad should also disclose any material investment strategies that were used to create the performance. The name itself suggests that the portfolio is “small cap” oriented, but what else is material and relevant to disclose? How does the adviser define “small cap”? Is the portfolio 100% small cap all the time? Is there any fixed income or cash holdings in the portfolio? Is there any type of security or strategy used to create the performance that may not be used in the future, such as investing in IPOs? These are the types of things that advisers ought to ask and disclose to the extent material. Typically in an ad, these types of disclosures would appear in footnotes to the table. In marketing presentations, they would typically appear in supplementary materials accompanying the performance data.

(6) Performance Numbers in Table – Material Misstatements or Omissions?

Every presentation of actual and model adviser performance is subject to general SEC guidelines articulated in a series of no-action letters sometimes referred to as the “Clover letters,” named after the often-cited letter issued to Clover Capital Management.¹⁸ In those letters, the SEC set out an extensive list of criteria that advisers should consider when determining whether a presentation of actual or model performance would be misleading.¹⁹ Among those criteria is the

¹⁷ See http://www.cfainstitute.org/centre/ips/gips/pdf/GIPS_2006.pdf.

¹⁸ Clover Capital Management, Inc. (SEC No-Action Letter available October 28, 1986).

¹⁹ These criteria were established over time in Clover and other important no-action letters addressing adviser advertising, including Anametrics Investment Management (SEC No-Action Letter available May 5, 1977), Investment Company

“net-of-fees” requirement, which requires that performance be calculated to reflect the deduction investment advisory fees, brokerage or other commissions and any other expenses that a client would have paid or actually paid.²⁰

Thus the sample “bad ad” raises the question of whether the actual performance numbers included in the table were calculated net of fees, or if not, which exception might apply. Best practice would suggest labeling or footnoting the table to describe what fees were taken into account when calculating the performance.

Among other “Clover” criteria that are not referenced in the sample “bad ad” (and should be where applicable and material) are:

- Do the performance data (including those of the index) include reinvested dividends or not?
- Is there anything about the performance data or the conditions under which they were generated that needs to be disclosed in order to adequately explain the numbers? For example, were the 1-year and more recent data materially impacted by in-and-out investing in IPOs that is not expected to continue due to changes in the market or other changes? Or, were the numbers generated using leverage or derivatives to any material extent?

Again, it could be enlightening to look at the GIPS standards for ideas on what an adviser should disclose. Material deviations from GIPS on how the composite was constructed, what methodology was used to calculate the returns, information included about the index, whether the figures are audited or unaudited, etc., all could uncover material information that should be disclosed.

Other relatively “standard” disclosures that are missing from the sample “bad ad” include:

- The table depicts average annual total return (if true).
- Past performance is no guarantee of future results.
- Results for individual accounts and for different time periods may vary.
- Performance for periods of less than one year are not annualized.

(7) S&P500 – Appropriate Benchmark?

While the S&P500 index may be a perfectly acceptable broad-based index for general comparisons of performance with “the market,” it is not normally considered a relevant index for comparing small cap performance like that shown in the “bad ad.” In lieu of -- or in addition to -- the S&P500 as a comparison benchmark, XYZ should compare its small cap performance to another index that allows for a more meaningful comparison, perhaps the Russell 2000 or the S&P Small Cap 600 Index.

Even when an appropriate index is used for comparison purposes, an adviser’s ad should disclose any material factors that are relevant to understanding the comparison. For example, do both the adviser’s data and the index data include the reinvestment of dividends? Were derivatives used to generate the adviser’s performance that would not be used in connection with generating the index performance? Derivatives might affect, for example, the comparative volatility of the composite and the index, which readers ought to know in order to fully appreciate the meaning of the comparison. Also, references to an index typically include a brief explanation of what the index is (for example, “the S&P 500 Index is an unmanaged broadly-based index of

Institute (ICI-I) (SEC No-Action Letter available July 24, 1987), Investment Company Institute (ICI-II) (SEC No-Action Letter available September 23, 1988), Securities Industry Assoc. (SEC No-Action Letter available November 27, 1989), J.P. Morgan Investment Management, Inc. (SEC No-Action Letter available May 7, 1996) and Association for Investment Management and Research (AIMR) (SEC No-Action Letter available December 18, 1996).

²⁰ In other no-action letters, the SEC Staff has carved out a number of exceptions to the net-of-fees requirement, including the side-by-side presentation exception, the multi-manager exception, the custodial fees exception and the one-on-one institutional presentation exception. See the AIMR, ICI-I and ICI-II No-Action Letters cited above for details.

the common stock prices of 500 large U.S. companies”) and an indication that the index does not bear fees and expenses or that investors cannot invest directly in the index.

(8) 10-Year and Since Inception Data -- Ported, Model or Backtested Performance?

According to the “bad ad,” XYZ Investment Management Co. was established in 2001. This raises the question of how XYZ could have a performance track record that stretches all the back to 10 years or more as shown in the table in the ad. Does the 10-year and Since Inception performance data include performance “ported” from Pat XYZ’s prior firm? There are circumstances where the SEC will allow a successor adviser to use performance data “ported” from a predecessor advisory firm, so long as the data and presentation comports with the requirements spelled out by the Staff in a series of no-action letters.²¹ Included among these is the requirement that the person who is currently making the investment decisions at the successor firm also be the person who was primarily responsible for making the investment decisions at the predecessor firm.²² In addition, all accounts that were managed in a substantially similar manner must be advertised unless the exclusion of any particular account would not result in materially higher performance.²³ Even if XYZ’s 10-year and Since Inception data were properly “ported” from a predecessor firm consistent with applicable SEC guidance, the “bad ad” would need to be revised to disclose that those data include results from accounts managed at a predecessor firm.

If XYZ’s long-term data is not “ported” performance information, is it hypothetical model performance? The use of hypothetical model performance in advertisements is permissible, subject to criteria set out in the “Clover” no-action letter.²⁴ In any case, the approach taken in the “bad ad” would certainly be considered misleading, if model performance has been simply melded onto actual performance and does not include any disclosures clarifying whether and what portion of the performance is model versus actual. Moreover, in addition to all the disclosures that an adviser should use for actual performance presentations, use of model performance should include disclosures such as:

- The limitations inherent in model results.
- Any material changes in the conditions, objectives or investment strategies of the model portfolio during the period portrayed and the effect of those changes.
- Any material differences in securities or investment strategies that relate to the model that do not relate or only partially relate to services offered by the adviser for actual accounts.
- The fact that actual clients had performance results that varied materially from the model results (if so).

If XYZ’s long-term data is not “ported” information and is not hypothetical model performance, is it “backtested” performance information? “Backtested” performance data refers to data derived by a backward-looking application of a particular strategy or formula to historical financial data. Backtested performance data is theoretical and does not involve market risk. As a result, it is treated as highly suspect. Although the SEC has never said that backtesting is *per se* misleading, the Staff has addressed backtesting primarily in the context of enforcement actions taken against advisers for misleading uses of backtested data. In any event, XYZ’s approach in the “bad ad” would be inadequate, given that if it includes backtested data, that data has been apparently

²¹ Among the more recent of the key no-action letters defining the “portability” of adviser performance is Horizon Asset Management LLC (SEC No-Action Letter available September 13, 1996).

²² See the Horizon Asset Management No-Action Letter cited in the footnote above for a more complete discussion of the SEC’s requirements.

²³ This can become particularly problematic since the Advisers Act books and records rule (see Rule 204-2(a)(16)) requires that advisers preserve the underlying account records necessary to demonstrate the calculation of any performance used in ads or other communications that the adviser circulates to 10 or more persons. As a practical matter, the underlying account records for “ported” performance information may be unavailable to a successor firm, particularly for those accounts that did not transfer over to the successor.

²⁴ See the Clover Capital Management No-Action Letter referenced in the discussion under heading (6).

melded onto actual performance data and includes no disclosure to clarify that backtested data has been included and to explain what clients or investors ought to know about the backtested data in order to not be misled.

(9) *“Microsoft when it was still \$21” -- Testimonial/Past Specific Recommendation*

The statement about Microsoft appearing in the “bad ad” is a classic testimonial recounting the client’s own experience with the adviser. This kind of classic testimonial is banned under the Advisers Act advertising rule.²⁵ As mentioned previously, testimonials are considered inherently misleading because they tend to focus on the favorable and ignore the unfavorable and they leave the impression that the testimonial is typical of the experience of the adviser’s clients, when indeed it may not be.

While this type of classic testimonial is banned, other statements with a “testimonial nature” are sometimes permissible, such as:

- Third-party ratings and rankings²⁶
- Client lists²⁷ and
- Article reprints, which are permitted under certain circumstances, if they are prepared by an unbiased third party and do not include a statement of a client’s experience or a client endorsement.²⁸

The statement in the sample “bad ad” is not only a testimonial, it also refers to a past specific recommendation that the adviser made (Microsoft when it was still \$21). Referring to past specific recommendations in ads is also specifically prohibited by the Advisers Act advertising rule, unless the ad complies with very onerous conditions spelled out in the rule including, among other things, that the adviser either incorporate into the ad, or offer to furnish, a list of all recommendations made by the adviser for at least the preceding one-year period.²⁹ This makes it impractical if not impossible to include any past specific recommendations in an ad like the sample “bad ad.” Since the past specific recommendation in the “bad ad” does not meet the conditions spelled out in the rule, it should be deleted from the ad.

As is the case with testimonials, the concern with past specific recommendations is cherry-picking, an unbalanced focus on only the good recommendations while overlooking the bad. While the statement in the sample “bad ad” is a blatant reference to a past specific recommendation, more nuanced issues arise if advisers want to discuss (in client reports, for example) buys or sells that they made during the quarter for client accounts, or to furnish lists of holdings (“top ten” lists and so on). Although references of that sort could potentially implicate the ban on past specific recommendations, the SEC has issued a no-action letter³⁰ stating that it would not object to an adviser sending clients and prospective clients a quarterly report discussing some but not all of the securities the adviser bought, sold or held for client accounts, so long as the following criteria were met:

²⁵ See Rule 206(4)-1(a)(1).

²⁶ See the discussion about ratings and rankings above under heading (2).

²⁷ See the discussion about client lists below under heading (10).

²⁸ See Stalker Advisory Services (SEC No-Action Letter available January 18, 1994); Kurtz Capital Management (SEC No-Action Letter available January 18, 1988); Richard Silverman (SEC No-Action Letter available March 27, 1985); and New York Investors Group (SEC No-Action Letter available September 7, 1982). However, even a reprint is subject to general anti-fraud standards, meaning that it should be accompanied by any additional disclosure that is necessary to ensure that it is not false or misleading.

²⁹ See Rule 206(4)-1(a)(2).

³⁰ See Franklin Management, Inc. (SEC No-Action Letter available December 10, 1998).

- The securities to be described in the reports are selected on the basis of objective, non-performance based criteria;
- The adviser must use the same selection criteria for each quarter for each investment category;
- The report should not discuss the extent to which investments were or were not profitable; and
- The adviser maintains certain records relating to the securities and the selection process.

While this guidance was helpful, it still left advisers wondering how they could discuss with their clients the performance of specific securities in their accounts without concern about violating the rule. Later, this was addressed in another no-action letter³¹ which essentially carves out of the definition of “advertisement” for purposes of the advertising rule certain specific communications, including:

- Oral communications (other than those in radio or TV broadcasts);
- Written communications in response to unsolicited requests by a client, prospective client or consultant for specific information about the adviser’s past specific recommendations; and
- Written communications to an adviser’s existing clients, unless the context suggests that a purpose of the communication is to offer advisory services.

The effect of this latest letter is to allow advisers to discuss past specific recommendations with existing clients and those who have made an unsolicited request for the information, without concern about contravening the advertising rule prohibition. Caution must still be exercised, however, when a discussion of past specific recommendations is included in any communication (even a sample client report) that may be later used for marketing purposes, since a marketing use would likely cause the communication to once again fall within the “advertisement” definition and be subject to the prohibitions in the adviser advertising rule.

(10) Partial Client List -- Testimonial

Client lists could also be viewed as having a “testimonial nature” and therefore raise the question of whether they too are prohibited under advertising rule. Over the years, the SEC Staff seems to have done a flip-flop on whether a client list will be considered a testimonial under the advertising rule,³² with the later view being that a list that does no more than identify certain clients of the adviser will not be treated as a testimonial. Nonetheless, use of any client list will be subject to the general prohibition against misleading statements and the Staff has indicated that it would be relevant (although not determinative) in determining whether any client list is misleading to consider whether the following conditions have been met:

- Performance-based criteria are not used to select the clients on the list;
- Each list includes a statement describing the objective criteria used to determine which clients to include in the list;
- The ad contains the following disclaimer: “It is not known whether the listed clients approve of [adviser] or the advisory services provided.”³³

Aside from the advertising rule, advisers should also be cognizant of the need to get all relevant client consents before using client lists or partial lists in any advertising or marketing materials.

³¹ See Investment Counsel Association of America (SEC No-Action Letter available March 1, 2004).

³² Compare Denver Investment Advisors, Inc. (SEC No-Action Letter available July 30, 1993) (the Staff does not necessarily agree with the view that client lists are not testimonials) with Cambiar Investors, Inc. (SEC No-Action Letter available August 28, 1997) (the Staff agrees that a partial client list that does no more than identify certain clients of the adviser cannot be viewed as a statement of the client’s experience with, or endorsement of, the investment adviser and is therefore not a testimonial).

³³ See Cambiar Investors and Denver Investment Advisors, the no-action letters cited above for details.

Otherwise, use of a client's name in that context might be inconsistent with the adviser's own privacy policy, advisory agreement confidentiality provisions or other applicable legal restrictions.

(11) Statements Regarding XYZ's Track Record and Experience -- Material Misstatements or Omissions?

The statements at the bottom of the "bad ad" referring to XYZ's track record and experience raise basic concerns about accuracy, fairness and balance. Use of imprecise and poorly defined terms ("favorable" track record; "wide variety" of markets) exacerbates these concerns. At a minimum, XYZ should ask itself whether it can back up each and every one of these statements (and the implications of or impressions made by the statements) with hard data to support its claims. In addition, XYZ should ask whether the information is fair as it currently appears or whether it lacks balance.

While the statements may not be misleading *per se*, revisions should be considered. First, referring to XYZ as a "recognized" firm raises the question of whether the statement is a "testimonial" (or of a "testimonial nature") and therefore prohibited under the advertising rule. Albeit in somewhat dated authority,³⁴ the SEC Staff has interpreted the word "recognized" as testimonial in nature, so cautious advisers would avoid use of that term.

Referring to XYZ's track record as "favorable" raises questions about what is meant by "favorable" and what a reader might be misled into thinking it means. "Favorable" by what measure and compared to what? Over what periods? If XYZ's track record was negative in the last bear market, would it still be considered "favorable"? Similar issues are raised by the phrase "wide variety of markets." Is "market" intended to mean stock market versus bond market, for example? Or does it mean bull markets ("up" periods) versus bear markets ("down" periods)? These types of statements would be very difficult to back up with supportive facts due to their vague nature. For every "market" that XYZ could point to where its track record looks "favorable," is there another "market" one could point to where its track record might be considered less than "favorable"? Cautious counsel might advise XYZ to delete the reference to its track record altogether and let the performance table speak for itself.

The statement in the "bad ad" about the "combined experience" of XYZ's investment professionals also raises questions about accuracy and balance. Whether it would be considered misleading in any given case depends on the context and background facts. The statement implies that XYZ's investment professionals are so experienced, there is very little they haven't been through. They've "seen it all"! However, what if XYZ has 10 investment professionals with only 5 years of experience each? Or one senior professional with 40 years of experience and 5 other professionals with only 2 years of experience each? Although the statement may still be technically true, the implication of the statement may be misleading in those contexts. This may be particularly problematic if XYZ is throwing into the category of "investment professionals" all of its analysts, traders and portfolio managers, if the decision maker concerning investments is really a portfolio manager who is among the least experienced at the firm. Accordingly, XYZ should consider whether the facts in its case justify both the "combined experience" statement as it appears in the ad, as well as its implication.

(12) "Free Consultation" -- Prohibited Offer?

The Advisers Act advertising rule specifically prohibits an adviser from offering any report, analysis or other service for "free" or "without charge," unless the report, analysis or other service actually is or will be furnished entirely free and without any condition or obligation.³⁵

³⁴ See Investor Intelligence (SEC No-Action Letter available April 18, 1975).

³⁵ Rule 206(4)-1(a)(4).

Therefore, XYZ should not include in its ad an offer for free consultation unless the consultation is really entirely free and is not contingent on hiring the adviser at the end of the consultation or subject to any other obligation.

(13) *“RIA” – Misleading Reference*

The SEC Staff has taken the position that it is misleading for an adviser to use the initials RIA (meaning “registered investment adviser”) following a person’s name on printed materials because, among other things, it suggests that the person has some level of professional competence, education or other special training, when in fact there are no specific qualifications for becoming a registered investment adviser.³⁶ Indeed, the sample “bad ad” might be even more susceptible to this issue because there the initials RIA appear next to the initials CFA, which refers to the “Chartered Financial Analyst” certification from the CFA Institute, which does require special competence (demonstrated through examination) and specialized continuing education. Accordingly, XYZ should delete the RIA initials next to Pat’s name in the “bad ad.” Advisers should avoid using the RIA initials on any marketing materials, letterhead and business cards as well.

* * *

Although the sample “bad ad” contains numerous points for consideration or revision under the adviser advertising rule and generally applicable “fraud” standards, it could be improved if revisions are made consistent with the authority discussed in this commentary.

The information in this paper is provided strictly as a courtesy to readers for educational purposes. It does not constitute legal advice, nor does it establish or further an attorney-client relationship. All facts and matters reflected in this paper should be independently verified and should not be taken as a substitute for individualized legal advice.

³⁶ Mandell Financial Group (SEC No-Action Letter available May 21, 1997), cited in Letter From the Office of Compliance Inspections and Examinations To Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections, May 1, 2000.

Rule 206(4)-1 -- Advertisements by Investment Advisers

a. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act for any investment adviser registered or required to be registered under section 203 of the Act, directly or indirectly, to publish, circulate, or distribute any advertisement:

1. Which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser; or

2. Which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person: *Provided, however,* That this shall not prohibit an advertisement which sets out or offers to furnish a list of all recommendations made by such investment adviser within the immediately preceding period of not less than one year if such advertisement, and such list if it is furnished separately: (i) State the name of each such security recommended, the date and nature of each such recommendation (e.g., whether to buy, sell or hold), the market price at that time, the price at which the recommendation was to be acted upon, and the market price of each such security as of the most recent practicable date, and (ii) contain the following cautionary legend on the first page thereof in print or type as large as the largest print or type used in the body or text thereof: "it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list"; or

3. Which represents, directly or indirectly, that any graph, chart, formula or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which represents directly or indirectly, that any graph, chart, formula or other device being offered will assist any person in making his own decisions as to which securities to buy, sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use; or

4. Which contains any statement to the effect that any report, analysis, or other service will be furnished free or without charge, unless such report, analysis or other service actually is or will be furnished entirely free and without any condition or obligation, directly or indirectly; or

5. Which contains any untrue statement of a material fact, or which is otherwise false or misleading.

b. For the purposes of this section the term *advertisement* shall include any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.