“Bad Ad” Case Study and
Adviser Advertising Procedures

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<u>“We Don’t Advertise”</u>

I wince every time I hear advisers say “We don’t advertise” because it implies they may not be thinking broadly enough about their communications to understand that they probably <u>are</u> advertising and may therefore be overlooking important regulatory requirements. While it is conceivable that an adviser in this day and age may not be “advertising,” it would certainly be the exception rather than the rule. Regardless of whether they are “advertising” as strictly defined, wise advisers will familiarize themselves with the rules governing adviser advertising because the most important among them -- the basic prohibition against “fraud” – applies to <u>all</u> adviser communications regardless of whether they constitute “ads.”

This paper explains the advertising rules by first answering some basic questions about adviser advertising. It then discusses a fictitious “bad ad” and the legal authority governing the issues raised by the ad. In the last section, this paper suggests practical procedures that might be used to oversee advertising compliance.

<u>First, What is an “Ad”?</u>

“Advertisement” is defined broadly in Rule 206(4)-1 under the Investment Advisers Act of 1940 (Advisers Act) as including any notice, circular, letter or <u>other written communication</u> addressed to <u>more than one person</u>, or any notice or other announcement in any publication or by radio or television, which offers:

- 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
- 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
- any other investment advisory service with regard to securities.

This definition is broad enough to embrace communications traditionally thought of as advertisements, such as ads appearing in newspapers and magazines and promotional spots running on TV or radio. But it is also broad enough to embrace many other types of communications, which may surprise even advisers long subject to the rule. For example, most advisers that say they don’t advertise probably have websites that describe their firms, services and personnel. Those websites may contain commentary discussing particular securities or investment strategies. They may describe how prospects can get in touch with the firm or even provide an electronic contact form for doing so. When considered in light of the broad definition in Rule 206(4)-1, websites with even the most basic features could be viewed as “advertisements,” that is, as “written communications” “addressed to more than one person” that “offer” an “investment advisory service.”

Similarly, social media posts, electronic messages, blogs, online forums, chat rooms, discussion boards and other communications could also fall within the Rule 206(4)-1 definition of “advertisement,” depending on their content. The content is key -- not the medium used – as was emphasized in a Risk Alert issued in early 2012 by the SEC Staff addressing advisers’ use of social media.[1] All doubt about this was erased after the SEC enforced against an adviser in a case specifically citing communications made through Twitter among other means.[2] Generally speaking, any material that promotes advisory services for the purpose of inducing potential clients to buy those services will be considered an "advertisement" covered by the rule.[3]

The breadth of the definition in Rule 206(4)-1 has caused concerns about how advisers can communicate effectively with clients and prospective clients without inadvertently violating the rule. This question was addressed in part by a no-action letter issued to the Investment Counsel Association of America (pub. avail. March 1, 2004) that carves out of the definition of "advertisement" any adviser report sent to existing clients, unless the context indicates that the material is being used to offer advisory services. It also carves out any written communications sent in response to unsolicited requests by a client, prospective client or consultant, even if those communications contain content that might otherwise be prohibited under the rule.

Aside from its extraordinary breadth, the Rule 206(4)-1 definition can surprise advisers for other reasons. First, the definition is not completely consistent with the definitions of "advertisement" and similar terms used elsewhere in 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
- FINRA rules (see, for example, Conduct Rule 2210(a)(1) and (2) defining "advertisement" and "sales literature").

Second, the "addressed to more than one person" element of the definition can easily be confused with the Advisers Act books and records rule, 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 adviser circulates or distributes to 10 or more persons. Technically, then, a communication can meet the definition of "advertisement" if provided to only two people, even though it is not required to be kept under the books and records rule until it is circulated to 10 or more.

Third, it is not always clear what the definition means for material to be "addressed" to more than one person. If material is created for and used with only one client or prospective client, it might not be considered an "ad" because it is not "addressed" to more than one person. However, an adviser might be surprised to find that even material not "addressed" to anyone in particular – like a pitch book, slide presentation or pamphlet -- might well be considered "addressed" to more than one person if it is simply used more than once.[4]

Which Advisers are Subject to the Advertising Rule?

By its terms, Rule 206(4)-1 applies to advisers registered or required to be registered with the SEC. As noted above, even long-registered advisers are often surprised by the breadth of the rule. This means private fund advisers that recently registered for the first time might be in for a real shock. Indeed, they might assume they are not "advertising" under Rule 206(4)-1 because they are already avoiding "general advertising" as defined under other SEC rules in order to maintain exemptions for their private funds.[5] These advisers in particular would be wise to consider the very broad definition of "advertising" under the Advisers Act in order to avoid running afoul of the rules that will now apply to them. This is especially true since the SEC has just recently lifted the long-standing ban on "general advertising" in connection with certain private offerings.[6]

While state-registered advisers are technically not covered by Rule 206(4)-1, many states have adopted their own restrictions on advertising applicable to advisers registered at the state level.[7] Moreover, as discussed in more detail below, all advisers – registered or not – are subject to the anti-fraud jurisdiction of both federal and state regulators, so any communication deemed fraudulent could result in regulatory action, as well as in private party claims.

What Standards Apply 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, no 'magic formulas,' no free reports that aren't truly free – which are all prohibited except under certain conditions specified in the rule. These bans are based on the premise that certain statements are inherently misleading -- or pose too great a risk of being misleading -- and are therefore not allowed.

In addition to these specific prohibitions, Section (a)(5) of the rule also contains a general prohibition on any adviser ad that contains "any untrue statement of a material fact, or which is otherwise false or misleading." The rule, then, covers the waterfront on "fraud," banning specific items that are treated as inherently misleading and generally prohibiting anything else that is misleading, whether or not it is specifically banned.

Importantly, though, Rule 206(4)-1 is not the only legal restriction governing adviser ads. As already mentioned, all adviser communications -- whether contained in an ad, a letter addressed to one client, an oral communication or wherever -- are subject to legal prohibitions against "fraud." Even adviser communications that are not "advertisements" within the advertising rule are subject to SEC enforcement under 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." Moreover, even claims for in-person oral communications outside the jurisdiction of the federal securities laws (for example, because they are not in "interstate commerce") could be pursued by clients and state regulators if they fall within the scope of common law prohibitions against fraud and/or state securities laws that prohibit fraud, which apply whether or not an adviser is SEC-registered.

As a result, wise advisers will focus not only on whether their communications fall within Rule 206(4)-1, but also on whether their communications could be considered "fraudulent" or misleading regardless of whether they constitute "ads." This is the standard that advisers should apply to all their communications, including websites, responses to requests for proposals (RFPs), one-on-one presentations, social media posts, online commentary, newsletters, client reports, introductory brochures, pitch books and all other materials that may be used to market, prospect for clients or communicate with those outside the firm.

What is "Fraud"?

The concept of "fraud" under the securities laws is far-reaching. It includes far more than a bald-faced intentional lie. In fact, advisers can violate the anti-fraud provisions in Section 206 of the Advisers Act – which generally prohibit fraud, deceit and manipulation -- without any fraudulent "intent" at all. This may seem counterintuitive since we tend to think of securities fraud violations requiring proof of "scienter" -- the intent to deceive based on conduct that was at least reckless.[8] However, "scienter" is not always required for a violation under Section 206 of the Advisers Act. Subsection (2) of Section 206 can be violated even if conduct is merely negligent. [9] Subsection (4) can also be violated without "scienter," at least according to the SEC.[10] In addition, advisers that do act with "scienter" have violated Subsection (1).[11]

Aside from issues of intent, the securities laws also recognize that clients can be defrauded not only by what is said, but also by what is omitted. Therefore, communications – including ads -- must avoid both material misstatements and material omissions. In short, they must be materially accurate, fair and balanced.[12]

Information is considered “material” for these purposes if a reasonable client ought to know it in order to evaluate and understand the material provided.[13] The test for materiality is very contextual and depends on the facts and circumstances of each case. While it defies a formulaic or “bright line” definition,[14] “materiality” remains the decades-old standard applicable under the federal anti-fraud laws.

All adviser communications should be prepared with these standards in mind. Advisers should ask themselves, is their communication an “ad” subject to the specific prohibitions in Rule 206(4)-1, and even if not, is there something else in the communication – or omitted from it – that might otherwise render it “fraudulent”?

What Specific Issues are Raised by the “Bad Ad”?

The fictitious “bad ad” in Figure 1 raises a host of legal and practical issues. The issues raised are not the only issues advisers might face in creating a compliant ad, but they are among the more common. The numbered paragraphs in the discussion below correspond to the numbered text and tabular items depicted in the “bad ad.”

FIGURE 1 -- FICTITIOUS "BAD AD"

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&P 500 for every period since inception.*[3]*

	[4] 2nd Quarter	YTD	1-year	5-year	10-year *[8]*	Since inception *[8]*
XYZ Small Cap *[5]*	-10.05% *[6]*	5.69% *[6]*	36.61% *[6]*	0.84% *[6]*	4.94% *[6]*	12.31% *[6]*
S&P 500 *[7]*	-11.45% *[6]*	-0.18% *[6]*	14.33% *[6]*	-0.91% *[6]*	-1.67% *[6]*	9.02% *[6]*

Partial Client List: *[9]*
On-the-Brink Inc.
Local U Pension Fund
Goodstuff Foundation

"XYZ invested us in Microsoft when it was still $21. We couldn't recommend them more highly!" *[10][11]*
-- I.M. Friend, Trustee, Goodstuff Foundation

XYZ Investment Management is an investment adviser registered with the United States Securities and Exchange Commission.*[12]*

We are a recognized firm with a favorable performance track record in a wide variety of markets. Our investment professionals have over 100 years of combined experience. *[13]*

XYZ INVESTMENT MANAGEMENT CO. (Estab. 2005)

PAT XYZ, CFA, RIA, Certified Retirement Expert *[12]*

Call us today for your free consultation! *[14]*
Phone: 800-555-XXXX

[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 not 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 in any respect misleading (inaccurate or incomplete).

[2] "Top 5-Star Manager" -- Ratings and Rankings

The fictitious "bad ad" states that XYZ has been rated as a top 5-star manager by Fill-in-the-Blank Magazine. Third-party ratings (including rankings) may be viewed as having a "testimonial nature" and, as mentioned above, testimonials are generally prohibited in adviser ads by Section (a)(1) of Rule 206(4)-1.

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.[15] 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 (pub. avail. Dec. 2, 2005). According to that letter, third-party ratings will be considered "testimonial" if they are based primarily on information obtained from client surveys. 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. 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.

Advisers should consider these factors when determining whether a third-party rating in an advertisement -- including one that is a testimonial -- is false or misleading:

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

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 (for example, 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 shown, the fictitious "bad ad" fails to disclose even the most basic information about the rating XYZ received from Fill-in-the-Blank Magazine. Accordingly, XYZ would be wise -- at a minimum – to consider including in the ad information about the rating along the lines suggested by the factors listed above. While this may significantly lengthen the ad, it is not uncommon for a fair number of footnotes and textual disclosures to be required in order to make an ad materially accurate and complete.

Of course XYZ should also consider whether the Fill-in-the-Blank Magazine 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.[16]

[3] "XYZ beat the S&P 500 for every period" -- Possible Literal Inaccuracy

This statement is an example of imprecise wording that could possibly be inaccurate as stated. Although the performance table in the ad suggests that XYZ's performance exceeded the S&P 500 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. Did XYZ beat the S&P 500 for all those periods too? What about other time periods, such as during particular bull or bear markets? It is improbable that an adviser beat the S&P 500 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. In most cases, it would be of particular concern if XYZ were holding out the performance of any one account – or any small group of accounts – as "its" performance. Often 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 probably be avoided by deleting the entire statement from the ad, without losing any substance. In other words, the table can speak for itself.

[4] Time Periods in Headings of Table -- Poor/Misleading Labeling

The performance data in the fictitious "bad ad" lack clarity and context because nowhere in the table is it stated what year is involved. 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 current to within the last available quarter end. 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 lack of clarity. For example, it is unclear whether "XYZ Small Cap" refers to a composite that XYZ maintains of actual client accounts or whether it is a hypothetical model portfolio that XYZ manages.[17] Not knowing more raises concerns about cherry-picking. If it is a composite, it is unclear whether it depicts all of XYZ's small cap accounts or, if not, why some are 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.[18] 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 double-check 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.[19]

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 there may be other information that is material and relevant to disclose, such as how the adviser defines "small cap," whether the portfolio is 100% small cap all the time, whether there are any fixed income or cash holdings in the portfolio and whether there is 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 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 Staff guidelines articulated in a series of no-action letters, including one issued to Clover Capital Management, Inc. (pub. avail. Oct. 28, 1986).[20] In these 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. Among those criteria is the "net-of-fees" requirement, which requires that performance be calculated to reflect the deduction of investment advisory fees, brokerage or other commissions and any other expenses that a client would have paid or actually paid, subject to various exceptions that have been carved out over time, such as the side-by-side presentation exception, the multi-manager exception, the custodial fees exception and the one-on-one institutional presentation exception.[21]

Thus the fictitious "bad ad" raises the question of whether the 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 fictitious "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, and so on, could all uncover material information that should be disclosed.

Other relatively “standard” disclosures that are missing from the fictitious “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 is not annualized.

How material disclosures of this nature might be depends on the context. For example, ads used with more sophisticated clients might not be misleading if they do not disclose that “past performance is no guarantee of future results” since sophisticated clients are likely to know that already. On the other hand, even sophisticated clients would likely want to know how the performance was calculated.

[7] S&P 500 – Appropriate Benchmark?

While the S&P 500 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&P 500 as a comparison benchmark, XYZ would be wise to 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, a performance presentation should disclose any material factors that are relevant to understanding the comparison, such as whether both the adviser’s data and the index data include the reinvestment of dividends and whether derivatives were used to generate the adviser’s performance that would not be used in connection with the index. 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 the common stock prices of 500 large U.S. companies”) and an indication that the index does not bear fees and expenses and 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 2005. This raises the question of how XYZ could have a performance track record that stretches all the way back to 10 years or more as shown in the ad and, more specifically, whether 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 in a series of no-action letters, including the key letter issued to Horizon Asset Management LLC (pub. avail. Sept. 13, 1996). 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. 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. Even if XYZ’s 10-year and Since Inception data were properly “ported” from a predecessor firm consistent with 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, one might wonder whether it is hypothetical model performance. The use of hypothetical model performance in advertisements is permissible, subject to criteria set out in the "Clover" no-action letter, discussed under paragraph [6] above. In any case, the approach taken in the "bad ad" would most likely be considered misleading if model performance has been simply linked or melded onto actual performance and does not include any disclosures clarifying whether and what portion of the performance is model versus actual.[23] 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 contemporaneous hypothetical model performance, it might be "backtested" performance data. "Backtested" data refers to data derived by a backward-looking application of a particular strategy or formula to historical financial data. Backtested 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.[24]

In any event, XYZ's approach in the "bad ad" would be inadequate if it includes backtested data -- apparently linked onto actual performance data – without disclosing either that backtested data has been included or anything else clients ought to know about the data in order to not be misled.

[9] 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 the 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,[25] 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 definitive) 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."[26]

Aside from the advertising rule, advisers should also get all relevant client consents before using client lists or partial lists in any advertising or marketing materials. Otherwise, use of a client's name in that way might be inconsistent with the adviser's own privacy policy (and therefore violate SEC Regulation S-P), advisory agreement confidentiality provisions or other applicable legal restrictions.

[10] Client says "We couldn't recommend them more highly!" – Prohibited Testimonial

In the "bad ad," client I.M. Friend from Goodstuff Foundation says, "XYZ invested us in Microsoft when it was still $21. We couldn't recommend them more highly!" These statements are a classic testimonial recounting a client's own experience with the adviser and effectively endorsing the adviser. This kind of classic testimonial is banned under Section (a)(1) of the Advisers Act advertising rule. As noted above, testimonials are considered inherently misleading because they tend to focus on the favorable while ignoring 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 permitted, such as:

- Third-party ratings and rankings (see the discussion about ratings and rankings under paragraph [2] above);
- Client lists (see the discussion about client lists under paragraph [9] above); and
- Article reprints, which are permitted under certain circumstances, for example, if they are prepared by an unbiased third party, do not include a statement of a client's experience or a client endorsement and otherwise meet general anti-fraud standards, meaning that they are accompanied by any additional disclosure that is necessary to ensure that they are not false or misleading.[27]

[11] "XYZ invested us in Microsoft when it was still $21" – Prohibited Past Specific Recommendation

The statement from I.M. Friend in the fictitious "bad ad" is not only a testimonial, it also refers to a past specific recommendation that the adviser made (investing in Microsoft when it was still $21). Referring to past specific recommendations in ads is also specifically prohibited by Section (a)(2) of the Advisers Act advertising rule if the recommendation was or would have been profitable to any person, 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. This makes it impractical if not impossible to include any past specific recommendations in an ad like the fictitious "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.

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.[28] While the statement in the fictitious "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 the like). Although references of that sort could potentially implicate the ban on past specific recommendations, the SEC issued a no-action letter to Franklin Management, Inc. (pub. avail. Dec. 10, 1998), 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:

- 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 concerns about violating the rule. This was addressed in a later no-action letter – issued to the Investment Counsel Association of America (pub. avail. Mar. 1, 2004) -- 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 letter is to allow advisers to discuss past specific recommendations with existing clients and those who have made an unsolicited request for the information. Caution must still be exercised, however, when a discussion of past specific recommendations is included in any communication (for example, 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.

In an even more recent no-action letter issued to TCW Group, Inc. (pub. avail. Nov. 7, 2008), an adviser proposed to provide "Best Performer/Worst Performer" charts demonstrating the effect that individual holdings in a representative account had on the account's return during a particular period. Referencing specific holdings raised the question of whether these charts would be a prohibited reference to "past specific recommendations." These charts were proposed to appear in materials distributed not only to the adviser's existing clients, but also to prospective clients, consultants and others on an unsolicited basis. Based upon the conditions imposed in the letter, aimed at ensuring the charts were balanced and objective and did not present the abuses Rule 206(4)-1 was intended to avoid, the SEC Staff did not object to use of the charts as requested.

[12] "Registered Investment Adviser," "RIA" and "Certified Retirement Expert" Designations – Misleading or Unbalanced References?

The SEC and other regulators have become increasingly concerned about advisers referring to themselves as "registered" advisers. This bubbled to the surface again not long ago, when the SEC adopted amendments to Form ADV, Part 2. According to the SEC, some advisers' marketing materials have appeared to suggest that registration either carries some official imprimatur or indicates that the adviser has attained a particular level of skill or ability.[29] Although Section 208(a) of the Advisers Act already makes suggestions of that nature unlawful, the SEC adopted a specific requirement that if an adviser refers to itself as a "registered investment adviser" in its Form ADV Part 2 Firm Brochure, it also must include a disclaimer that registration does not imply a certain level of skill or training. By now, that disclaimer is in widespread use in adviser Brochures.

Although the disclaimer technically applies only to an adviser's Firm Brochure, cautious advisers are providing similar disclaimers on their websites and in other places where a reference to the adviser as "registered" might be misunderstood. XYZ Investment Management would be wise to consider this in the "bad ad," particularly if the ad is to be used with unsophisticated, retail prospects who may not understand what it means to be "registered."

The SEC Staff has also 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.[30] Indeed, the fictitious “bad ad” might be even more susceptible to this issue because, in the ad, “RIA” appears after Pat XYZ’s name following “CFA,” which refers to the “Chartered Financial Analyst” certification from the CFA Institute, a highly regarded certification that <u>does</u> require special competence demonstrated through examination and continuing education. Moreover, using “RIA” next to Pat’s name confuses Pat XYZ with Pat’s firm. XYZ Investment Management is the “registered” adviser, not Pat. Even if Pat is a founder, owner and senior officer of XYZ, it would be technically inaccurate to refer to Pat as a “registered” investment adviser. Accordingly, the “RIA” designation should be deleted from the “bad ad.” Generally speaking, it would be wise for advisers to avoid using “RIA” altogether on any marketing materials, letterhead, business cards or similar materials.

Similar concerns have been raised about other professional designations that may be confusing to clients, especially those that imply specialized skill or knowledge about “seniors issues” such as retirement, estate planning or the like.[31] The SEC permits advisers to use professional designations in Brochure Supplements (Form ADV, Part 2B) describing advisory personnel if they also explain the minimum qualifications required for the designation so clients can understand its value.[32]

Other regulators are not as liberal on this issue, however. For example, the North American Securities Administrators Association (NASAA) promulgated a Model Rule making it a “dishonest and unethical practice” for a senior specific certification or designation to be used in any misleading way, including in the myriad specific ways that are enumerated in the rule. The Model Rule or a version of it has already been adopted in nearly 30 states around the country.[33]

FINRA (the self-regulatory organization overseeing broker-dealers) has also issued guidance on the use of senior designations, reminding firms that senior designations may only be used when consistent with FINRA’s rules, including a broker’s obligation to avoid false, exaggerated, unwarranted or misleading statements or claims in communications with the public.[34] While FINRA’s guidance would apply directly only to advisers that are dual-registered as broker-dealers, all advisers would be wise to familiarize themselves with the guidance since it provides valuable insight on what regulators could view as misleading.

The “bad ad” raises this issue by referring to Pat XYZ as a “Certified Retirement Expert” without any explanation of who provided the certification and what it takes to become “certified.” XYZ would be prudent to delete the reference from the ad or, alternatively, to disclose the minimum qualifications required to obtain the certification.

<u>[13] References to Adviser’s Track Record and Experience -- Material Misstatements or Omissions?</u>

The “bad ad” says XYZ is a “recognized firm with a favorable performance track record in a wide variety of markets” and that its investment professionals have “over 100 years of combined experience.” These statements raise a number of concerns.

First, the “bad ad” uses imprecise and poorly defined terms -- “favorable” track record, “wide variety” of markets -- which raise concerns about fairness and balance. 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. XYZ should also ask whether the information is fair as it currently appears or whether it lacks balance.

While the statements may not be misleading *per se*, questions are raised. For example, stating that XYZ is 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 (the Investor Intelligence no-action letter, pub. avail. April 18, 1975), 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, compared to what and over what periods? Similar issues are raised by the phrase "wide variety of markets," such as whether "market" is intended to mean stock market versus bond market, or perhaps 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," there might be another "market" one could point to where its track record might be considered less than "favorable." A cautious approach would be to delete the reference to XYZ's 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 that they've "seen it all"! However, this could raise issues, for example, if XYZ has 20 investment professionals with only five years of experience each, or two retired senior professionals with 45 years of experience and five other professionals with only two years of experience each. Although the statement may still be technically true, the implication of the statement may create the wrong impression in those contexts. This may be particularly problematic if XYZ is including in 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.

[14] "Call us today for your free consultation" -- Prohibited Offer?

Section (a)(4) of the Advisers Act advertising rule specifically prohibits an adviser from offering any report, analysis or other service for "free" or "without charge," unless it actually is or will be furnished entirely free and without any condition or obligation. 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.

What Procedures or Practices Might Advisers Implement to Mitigate Advertising Risk?

Advisers Act Rule 206(4)-7 requires, among other things, that registered investment advisers adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules, by the adviser and its supervised persons. This includes violations of the advertising rules.[35]

Following are suggested procedures or practices that might be useful in overseeing an adviser's advertising and marketing. These procedures are not legally mandated. Moreover, they are not necessarily suitable for every adviser and, if integrated into an adviser's compliance program, must be appropriately tailored to meet the adviser's particular compliance needs. These suggestions are adapted largely from the following sources:

- The 2007 "free lunch" sales seminar report issued by the SEC and other regulators, which lists practices that appeared effective to oversee sales seminars and related advertisements.[36]
- The Risk Alert issued by the SEC in January 2012 on adviser use of social media,[37] which references compliance practices observed at various firms.

- The 2011 Coordinated Investment Adviser Exams report issued by NASAA, which references best practices for investments advisers.[38]
- FINRA Regulatory Notice 11-52 (November 2011), which references practices firms might use to oversee use of senior designations. (While the FINRA Notice would not apply directly to advisers unless dually registered as broker-dealers, it provides useful guidance for any firm overseeing use of professional designations.)

Procedures for Overseeing Marketing Meetings, Marketing Materials and Advertising

- Centralize the process for reviewing and approving proposed marketing meetings, materials used for the meetings and any other advertising.
  - Reviews should be conducted by dedicated compliance personnel with knowledge of the securities laws and rules with respect to marketing materials and advertising.
  - Clearly set forth in the firm's policies and procedures the process for proposing marketing meetings, marketing materials and advertising and make them known to all firm employees.
  - Identify inaccuracies, disclosure mistakes and potential problem areas through supervisory reviews of marketing materials and advertising.
  - Correct issues prior to the time the materials are used.
- Include specific timeframes for supervisory review and approval in the policies and procedures for proposed marketing meetings.
  - For example, require all materials to be submitted 3 to 4 weeks prior to the meeting date, allowing adequate time for supervisors to review and correct disclosure issues and any other issues identified prior to the meeting.
- Forward all marketing material and advertising to the home office for review and approval prior to use.
- Use two levels of supervisory approval for marketing meetings and all marketing materials and advertisements to be used for those meetings.
  - Supervisor review should be the first level of approval.
  - Materials should then be sent for review and approval by the compliance department.
- Provide written guidance to all individuals who may be involved in marketing.
  - Include the individuals who conduct marketing meetings, the supervisors who review and approve marketing materials, as well as any compliance staff who may also review the marketing materials prior to use.
  - Provide clear explanations in the guidance of what is permissible and what is not permissible, both in terms of compliance with the securities laws and compliance with the firm's own policies.
- Use written checklists to aid firm employees in reviewing and approving marketing materials and advertisements to ensure that the materials used comply with regulatory requirements and the firm's policies.
- Require supervisors or compliance personnel to make written edits to proposed marketing materials or advertising.
  - Require the marked-up draft to be provided along with a final copy of the materials (showing that the changes had been made) to the reviewing officer for the permanent file.
- Use only standardized, pre-approved marketing materials and advertisements.
  - Create all marketing materials at a central level.
  - Do not involve individuals in creating their own marketing materials or advertisements.
  - Use only a standardized outline for marketing meetings.
- Maintain materials for marketing meetings in a centralized location.
  - File and maintain in one place a complete package of marketing materials and advertising for marketing meetings, including a copy of the request to host a marketing meeting with indications of approval by the supervisor and any other authorized approving official.
  - Include in the file the date of the meeting, location, speaker, any guest speakers, the company they represent, the date the approval was given and the list of people who were invited to attend the meeting.
  - Also include in the file a list of attendees, whether they were a client or prospect, a photocopy of any ad that ran in the newspaper or other media, the approved marketing pieces that were

distributed at the meeting, approved copies of any slide presentation shown at the meeting and any other information given to attendees.

- Require supervisors to attend a percentage of the marketing meetings presented by the individuals they supervise.
- Use “mystery shoppers” (unidentified firm employees) on a random basis to attend public marketing meetings to identify potential disclosure and compliance weaknesses, and report any issues back to the direct supervisors of the meeting hosts.
- Have all individuals certify to their supervisor each month that they have provided all marketing materials, advertisements and similar items used during the month.

Practices for Overseeing Use of Professional Designations

- Prohibit the use of all professional designations, except those specifically authorized by the firm.
- Develop an “approved designations list,” listing designations and titles that may be used by appropriate firm personnel.
- Determine whether a specific designation may be approved by taking into consideration all factors deemed relevant, including:
  - whether the designation is issued or recognized by a reputable or accredited organization;
  - whether the issuing organization has a code of ethics or a standard of professional conduct that must be followed; and
  - whether the designation program has:
    - a rigorous curriculum;
    - an emphasis on ethics;
    - continuing education requirements;
    - a method for determining the registered person’s status regarding the designation; and/or
    - a public disciplinary process.
- Require personnel who use an approved designation to remain current with continuing education or other criteria necessary to remain in good standing with the issuing organization.
- Require personnel to certify to the firm at least annually:
  - all the designations they use or have used since the last certification;
  - that the designations they use are not self-conferred and are approved by the firm;
  - that they meet the continuing education and other requirements of any approved designation used; and
  - that they are in good standing with the organization that has conferred the designation.

  Have the compliance department periodically verify with the issuing organization that personnel using designations are in good standing.
- Prohibit use of senior designations during marketing meetings with senior investors in order to curtail instances where senior investors could be most vulnerable.
- Include approved and unapproved designations in the key word search lexicon used to monitor emails.

Practices for Overseeing Use of Social Media

- Address explicitly which firm procedures apply to the use of social media, to avoid unclear overlap with procedures that apply to advertisements, as well as those that apply to client communications and electronic communications generally (such as an “Acceptable Use” policy) and/or recordkeeping.
- Address explicitly in firm procedures key issues related to social media, including:
  - Usage guidelines spelling out which sites and functionalities are permissible and which are not, and whether personnel may post business related information on personal sites.
  - Content standards spelling out which content is permissible within certain guidelines or prohibited altogether, addressing in particular whether personnel may post anything more than basic contact information and background, and addressing sensitive content such as investment recommendations, investment performance or information on specific investment services.
  - Controls over posting of (or linking to) third-party content, if it is to be permitted at all.

        - Disable any “like” button or similar functionality to avoid content that may be deemed to be an impermissible testimonial.[39]
        - If the site does not allow disabling the “like” functionality, monitor and remove any third-party content that may raise similar issues.
    - How use will be monitored effectively, taking into account whether sites restrict access, thereby thwarting effective monitoring.
    - How frequently use will be monitored, taking into consideration resources available (both in-house and outsourced), the volume and pace of communications and the risk of violation.
    - How content will be approved, whether before the fact or after the fact.
    - Criteria relevant to approving participation in social media, such as reputation of the social media site, the site’s privacy policy, the ability to block or remove third-party posts, the information security risks posed by participation and the like.
- If the firm hosts its own social media site, adopt controls over third-party postings.
    - Allow third parties to post messages, forward links and post articles on the firm’s site, only if monitoring and content controls are workable.
        - Do not include a social media “plug-in” such as a “like” button or similar functionality that may be viewed as an impermissible testimonial.
        - Institute controls prohibiting (or deleting) the posting of any third-party content that may be deemed to be an impermissible testimonial or otherwise problematic.
    - Alternatively, limit third-party use to “one way postings,” where the firm’s personnel or solicitors may post on the firm’s site but may not interact with third parties or respond to third-party postings.
    - Alternatively, limit third-party postings to authorized users only and prohibit postings by the general public.
    - Post disclaimers directly on the site stating that the firm does not approve or endorse any third-party communications posted on the site, to help avoid having a third-party posting attributed to the firm.

General Supervisory Practices

- Address explicitly in firm procedures the review and monitoring of communications with clients and prospective clients.
    - For example, implement monitoring systems to effectively detect problematic communications by personnel in email communications.
- Address explicitly in firm procedures which procedures apply to third-party solicitors acting on behalf of the firm and how the conduct of third-party solicitors will be monitored and enforced.
- Have supervisors actively review communications, make frequent inquiries and provide feedback to personnel.
    - Aim this at enhancing the firm’s ability to identify and prevent any marketing issues that may exist and provide supervised persons with individual training and guidance through active supervisory feedback on their communications.
- Provide annual training programs with thorough and clear information about compliant and non-compliant practices.
    - Do not simply recite rule requirements in training, but include examples that are relevant to the nature of the work performed by the employees being trained.
    - Include information regarding use of senior and other designations and certifications.
    - Include issues raised by developing trends, such as increased use of social media.
    - Include training relating to recordkeeping obligations.
- Require pre-hiring vetting of all third-party service providers – such as email or web hosts, cloud computing hosts, mobile communications providers, etc. – to ensure that the adviser and its personnel using their services can adhere to all rule requirements, including the monitoring, capturing and retention of required records.[40]

Advertising Recordkeeping Practices[41]

- Before permitting firm personnel to engage in electronic communications – including email, texting, instant messaging, participation in discussion boards, social media, forums or chat rooms and so on -- consider whether and how the firm can meet its recordkeeping obligations if any of the content communicated is a record required to be maintained and preserved under the Advisers Act books and records rule, including an advertisement.
  - Determine, among other things, (1) whether each communication is an advertisement or other required record, and, if so, (2) the applicable retention period, and (3) the accessibility of the records.
  - Determine in what form/format the communication can be handled as a practical matter (screen shot printed out on paper or saved to PDF, electronic storage in native format or other format), so that the communication can be captured, backed-up, stored for required periods, arranged and indexed in a way to permit easy location, access and retrieval, and safeguarded from loss or alteration.
- Maintain a separate file for each type of "ad" or other marketing materials or written communications circulated or distributed to 10 or more persons, such as print ads, Internet ads, firm website, promotional brochures, and so on.
  - For each piece that recommends the purchase or sale of a specific security and does not state the reasons for the recommendation, include a memorandum indicating the reasons for the recommendation.
  - Accompany each piece by records indicating when and by whom it was created and approved for use, as well as where, when and to whom it was circulated or distributed.
  - Maintain and preserve these records in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on the record, the first two years in an appropriate office of the adviser.
- For each ad or other piece containing performance information, maintain in addition to the above all materials necessary to form a basis for the performance.
  - Where available, maintain contemporaneous client account statements and worksheets that can be used to calculate the adviser's performance information.
  - If contemporaneous account statements or similar materials are unavailable due to inadvertent destruction (for example, in a natural disaster) or if performance includes performance of accounts managed by personnel while with a previous employer, consult with counsel about whether other available records may suffice to satisfy this requirement, such as:
    - published materials indicating net asset values for managed accounts;
    - worksheets generated by an outside entity;
    - custodial and brokerage statements; or
    - independent auditors' reports.
  - Maintain and preserve these records in an easily accessible place for a period of not less than five years (the first two years in an appropriate office of the adviser) from the end of the fiscal year during which the ad or other written communication was last published or disseminated.
- Periodically check (using key word searches or otherwise) to determine whether personnel are complying with recordkeeping procedures or, for example, whether they are improperly deleting required electronic records.

Conclusion

Amendments to the Advisers Act advertising rule may be in the offing as the SEC considers whether and to what degree advertising regulations should be "harmonized" between investment advisers and broker-dealers.[42] In the meantime, advisers must continue to operate within the existing regulatory framework, derived largely from Advisers Act Rule 206(4)-1, interpretations of the anti-fraud rules and a patchwork of no-action letters. This paper explains that complex framework by answering basic questions about adviser advertising, analyzing a fictitious "bad ad" against relevant legal authority and suggesting procedures for overseeing advertising compliance.

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.

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1 See "Investment Adviser Use of Social Media," SEC Office of Compliance Inspections and Examinations, National Examination Risk Alert, Volume II, Issue 1 (January 4, 2012) at 6: "In the staff's view the content of the communication is determinative." For a discussion of similar guidance issued to broker-dealers, see Erin Reeves, "Falling in Line Without Falling Behind: Social Media Compliance for Broker Dealer Firms," *Practical Compliance and Risk Management for the Securities Industry,* Vol. 4, No. 6, at 53-59 (Nov.-Dec. 2011); and FINRA Regulatory Notices 11-39 (August 2011) and 10-06 (January 2010).

2 See In the Matter of Navigator Money Management, Inc. and Mark A. Grimaldi, Release Nos. 33-9521, IA-3767, IC-30897 (January 30, 2014) (Navigator) (alleging false and misleading statements made on Twitter, on the adviser's website and in newsletters sent to subscribers).

3 SEC v. C.R. Richmond & Co., 565 F.2d 1101, 1105 (9th Cir. 1977) (citing Paul K. Peers, Inc., 42 S.E.C. 539, 540-41 (1965)).

4 See Denver Investment Advisors, Inc. (SEC No-Action Letter available July 30, 1993) (general booklet profiling adviser and provided to consultants is "clearly a communication addressed to more than one person" under the rule); and SEC v. C.R. Richmond & Co., 565 F.2d 1101 (9th Cir. 1977) (published book describing adviser's investment philosophy and techniques held to be an "ad" within the meaning of the rule).

5 Private funds often maintain exemptions under the Securities Act of 1933 and the Investment Company Act of 1940, which have historically required that they avoid general advertising to avoid the implication that they are making a "public offering" of their securities.

6 See Rule 506(c) adopted under Regulation D of the Securities Act of 1933 in Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release Nos. 33-9415, 34-69959, IA-3624 (July 10, 2013). A full discussion of those changes and their implications is beyond the scope of this paper.

7 See, for example, the NASAA Model Rule on use of senior-specific designations, referenced in Note 33 below.

8 See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) (mere negligence is not enough to show "scienter"); 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 Imaging, 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).

9 See Aaron v. SEC, 446 U.S. 680, 696-97 (1980), citing Capital Gains Research Bureau, Inc. v. SEC, 375 U.S. 180, 200 (1963). Note that enforcement of Section 206 is largely reserved to the SEC since the U.S. Supreme Court has held that the only private rights of action under the Advisers Act are a limited remedy under Section 215 (the Validity of Contracts section) to void an advisory contract. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979).

10 See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. IA-2628 (August 3, 2007) and cases cited there.

11 In the Matter of Jamison, Eaton & Wood, Inc., Advisers Act Release No. 2129 (May 15, 2003) (citations omitted).

12 See the discussion of fraud in adviser ads generally in Michael S. Caccese, "A Practical Guide to Performance Presentation for Compliance Personnel," *Practical Compliance and Risk Management for the Securities Industry,* Vol. 2, No. 5, at 21-28 (Sep.-Oct. 2009). See also In the Matter of BTS Asset Management, Inc., Release No. IA-3495 (October 29, 2012), where an adviser's ads touted a strategy that "has avoided negative annual returns for 27 years." Although the adviser disclosed in footnotes to the ads that, depending on the funds used in client accounts, "not all clients experienced no down years," but this was still deemed materially

misleading because the ads failed to disclose "with sufficient prominence and detail" that, in certain periods, a significant number of clients (54% by one calculation) would have experienced a down year.

[13] See 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 Basic Incorporated v. Levinson, 485 U.S. 224 (1988) (applying the same basic standard of materiality for purposes of Rule 10b-5).

[14] See In the Matter of Michael R. Pelosi, Initial Decision Release No. 448 (January 5, 2012) (citing Basic v. Levinson, administrative law judge rejected 1% or 2% formulaic approach to "materiality" and instead used a more holistic, fact-specific approach).

[15] See the Risk Alert referenced in Note 1 above, at 6.

[16] See, for example, the SEC's enforcement action in the Navigator case, Note 2 above, which included allegations that the adviser had touted itself in emails, on websites and in its newsletters as a "five-star [Morningstar] manager," when Morningstar rates funds, not advisers, and when during the period referenced, the adviser was not the investment manager of any fund rated five stars by Morningstar. Indeed, according to the SEC's order in this case, Morningstar had even notified the adviser that the statements were inaccurate and unauthorized.

[17] "XYZ Small Cap" might also refer to a small cap mutual fund or other pooled vehicle if XYZ is a fund manager. In that case, a host of other rules governing fund advertising and marketing potentially come into play, which are beyond the scope of this paper.

[18] For a general explanation of the GIPS requirements, see Karyn D. Vincent, "Primer on the Global Investment Performance Standards (GIPS®)," *Practical Compliance and Risk Management for the Securities Industry,* Vol. 5, No. 4, at 45-54 (Jul.-Aug. 2012).

[19] This process has been aided by a white paper issued by a GIPS committee reconciling the GIPS standards for performance presentations with the requirements imposed by the Advisers Act and related SEC guidance. The white paper also helps to dispel the idea that a GIPS compliant performance presentation will automatically comply with SEC requirements, which is not necessarily the case. The paper addresses some of the key areas where GIPS and SEC requirements are not always aligned. The white paper can be accessed here: http://www.gipsstandards.org/resources/Documents/sec_gips_white_paper_final.pdf.

[20] Other important letters addressing these issues are Anametrics Investment Management (SEC No-Action Letter available May 5, 1977), Investment Company 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). For another discussion of the Clover letters and adviser performance presentations, see Michelle Jacko, "Investment Adviser Performance Marketing and Advertising – What You Need to Know," *Practical Compliance and Risk Management for the Securities Industry*, Vol. 5, No. 3 (Jul.-Aug. 2012).

[21] See the AIMR, ICI-I and ICI-II No-Action Letters cited above for details.

[22] See the Navigator case cited at Note 2 above, in which the SEC enforced against an adviser who touted the past 10-year performance of 'his' model portfolio when the adviser had not had any involvement in the performance of that model for at least 3 or 4 of the 10 years referenced. Even though that case involved model portfolio performance, not "ported" actual performance, the principle is the same.

[23] See the Navigator case, Note 2 above, which included allegations about the misuse of model performance in various adviser communications, such as on websites and in newsletters. In at least one circumstance cited, the adviser's model performance presentation could raise concerns about confusion between the adviser's model performance and the performance of the adviser's mutual fund. See also In the Matter of Jason A. D'Amato, Release Nos. 34-67773, IA-3455, IC-30192 (August 31, 2012), where fraud allegations against the adviser included blending audited actual composite returns with hypothetical backtested returns.

[24] See, for example, LBS Capital Management, Inc., Advisers Act Release No. 1644 (July 18, 1997); In the Matter of William J. Ferry, Advisers Act Release No. 1747 (August 19, 1998); and In the Matter of Schield Management Company, et al., Investment Company Act Release No. 1824 (September 9, 1999).

[25] 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).

[26] See the Cambiar Investors and Denver Investment Advisors no-action letters cited above for details.

[27] 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).

[28] See the Navigator case, Note 2 above, in which the adviser allegedly cherry-picked successful past specific recommendations to include on newsletter websites without disclosing other unsuccessful recommendations made during the same period and without listing all the adviser's recommendations made within the past year with the name of the security and market price.

[29] See Amendments to Form ADV, Release No. IA-3060 (July 28, 2010), at 11.

[30] See 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.

[31] See Protecting Senior Investors: Report of Securities Firms Providing "Free Lunch" Sales Seminars, Joint Report by the Staff of the SEC's Office of Compliance Inspections and Examinations, NASAA and FINRA (September 2007); and SEC Investor Alert, "Senior" Specialists and Advisors: What You Should Know About Professional Designations.

[32] See Amendments to Form ADV, Release No. IA-3060 (July 28, 2010), at 57.

[33] See NASAA Model Rule on the Use of Senior-Specific Certifications and Professional Designations (Adopted March 20, 2008) at http://www.nasaa.org/wp-content/uploads/2011/07/3-Senior_Model_Rule_Adopted.pdf. For a list of states that have adopted the Model Rule, see the Senior Certification/Designation Information Center on NASAA's website.

[34] See FINRA Regulatory Notice 11-52 (November 2011).

[35] See the Navigator case referenced in Note 2 above, which included alleged violations of Rule 206(4)-7 because the adviser's policies and procedures concerning advertisements simply parroted the SEC's rules and did not include anything specifically tailored to prevent advertisements in newsletters, client correspondence or other communications with clients (such as Twitter or websites) from violating applicable rules.

[36] Procedures and practices are listed in Appendix B to the Protecting Senior Investors ("free lunch") report referenced in Note 31 above.

[37] See the Risk Alert referenced in Note 1 above. Also see the guidance on social media issued by the Massachusetts Securities Division to Massachusetts registered investment advisers, dated January 18, 2012, which in many respects parallels the guidance provided by the SEC. For more information about use of social media in the industry, see the Investment Management Compliance Testing Surveys done each year by the Investment Adviser Association (along with others) and posted on the IAA's website, particularly the surveys from 2012 and 2013 which included a number of questions directed at use of social media.

[38] See "Coordinated State Exams Identify Top Investment Adviser Deficiencies" and related examination report posted on NASAA's website.

[39] Testimonials are addressed in more detail in the Risk Alert referenced in Note 1 above, at 6.

[40] Note that the SEC has taken action against an adviser for recordkeeping failures in electronic communications. See In the Matter of Anthony Fields, CPA d/b/a Anthony Fields & Associates and d/b/a Platinum Securities Brokers, Advisers Act Release No. 3348 (January 4, 2012), where the adviser allegedly failed to maintain required books and records by utilizing several email and online communication providers -- including Netzero, LinkedIn and Trade Key -- which routinely delete emails and online communications after six months, without doing anything to retain the communications for the adviser's files.

[41] See Advisers Act Rule 204-2(a)(11), (a)(16), (e)(1), (e)(3) and (g) for key books and records requirements relating to advertisements.

[42] See the SEC Study on Investment Advisers and Broker-Dealers (January 2011), at 130-132.