OVERVIEW

The U.S. Securities and Exchange Commission (SEC) and state inspectors pay particular attention to an investment adviser’s marketing and advertising of its services and performance to current and prospective clients. Advertising and marketing subjects are often focal points of examinations and deficiency letters. However, the SEC has provided guidance for advisers through several rules, no-action and interpretive letters and releases. Familiarity with this guidance will provide the necessary direction for an investment adviser to advertise and market its services while avoiding infringement.

What is an “Advertisement”? Investment advisers are expected to provide clear and accurate disclosure to their current and prospective clients. Both the Advisers Act and applicable state laws prohibit fraudulent, deceptive, misleading or manipulative conduct and statements in advertising. “Advertisement” is defined broadly and includes “any notice, circular, letter or other written communication addressed to more than one person, or any notice or announcement [in any medium] … 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 services with regard to securities.”

Accordingly, a good rule of thumb for investment advisers is to assume that any written materials, pitchbooks, Internet content, or radio or television advertisements fall within the definition of “advertisement” for regulatory purposes and act accordingly.

Advertising Standards. Any advertisement must disclose all “material facts” necessary to avoid misleading impressions. Even when individual statements may technically be true, if the overall impression of the advertisement is false or misleading, the investment adviser is in violation. Accordingly, determining whether an advertisement is false and misleading is based on the specific facts and circumstances surrounding the creation and content of the advertisement, such as form and substance, ability to perform as advertised, inferences that result from the information, and the ability of the current or prospective client to understand the information being presented.

TESTIMONIALS, SOCIAL MEDIA AND PAST SPECIFIC RECOMMENDATIONS

Testimonials. Investment advisers are specifically prohibited from using, directly or indirectly, any testimonial concerning the adviser or its advice, reports, analyses or services. A testimonial can mean any statement of a client’s experience with, or endorsement of, an adviser, including a testimonial about the character of the adviser or

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1 Investment Advisers Act, Section 206(1) and (2).
2 17 C.F.R. § 206(4)-1.
4 17 C.F.R. § 206(4)-1(a) (1).
knowledge about investing. Note, however, that reprints of an article or other publication written by an unbiased third party regarding the adviser’s performance are acceptable.

**Public Commentary and Social Media.** The rise of social media has further nuanced the SEC’s guidance concerning public commentary and the prohibition of testimonials in advertising. An advertisement may include or refer to public commentary from independent, third-party websites as long as the adviser has no ability to affect the inclusion or display of the public commentary, the commentator is not restricted in making a public comment and the third-party website allows for the viewing of all public commentary. Not surprisingly, in order for the third-party site to be eligible for inclusion in an advertisement, the adviser and adviser representatives may not comment on such third-party site.⁵ Additionally, the SEC has determined that a social media site that displays pictures or names of contacts, but does not categorize them as clients and nonclients, is not a prohibited testimonial.

**Past Specific Recommendations.** Investment advisers are generally prohibited from using, directly or indirectly, past specific recommendations that were or would have been profitable to any person.⁶ A specific recommendation can be included in an advertisement if the advertisement lists all the recommended securities made within the immediately preceding year, stating the following:

1. The name of each recommended security;
2. The date and nature of such recommendations (e.g., buy, sell, hold);
3. The market price of the security at the time of recommendation;
4. The price at which the security was traded; and
5. The market price of each security as of the most recent practicable date.⁷

The advertisement must also include a legend stating that “[i]t should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities in this list.” Any list of past recommendations must be complete and cannot include only select recommendations, even if the investment adviser indicates that a current or prospective client can obtain a list of any nonlisted recommendations in a separate document.

The SEC has stated that an adviser may distribute an advertisement that either (i) contains a list of all the recommendations during the applicable period; or (ii) contains no recommendations but offers to provide a complete list of such recommendations in a separate document. This means that an investment adviser is also prohibited from providing a list of specific recommendations relating to only one type of managed account if the adviser manages multiple types of accounts (e.g., fixed income and mid-cap equity), even if it offered to provide other account types upon request.

**PERFORMANCE ADVERTISING**

*General Limitations on Use.* As a general rule, an investment adviser is permitted to use past performance in advertisements (whether based on actual trading results or trading in a “model” portfolio). However, such performance advertisement is subject

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⁵ SEC IM Guidance Update (available March 2014).
⁶ 17 C.F.R. § 206(4)-1(a) (2).
⁷ Id.
to the general prohibition against “false or misleading” advertising. Generally, since the mid-1980s, the SEC has taken the position that the following uses of performance data are “false or misleading”:

With respect to actual performance results:

1. Presenting results relating only to a select group of clients, recommended trades or trading period that demonstrate value appreciation while failing to disclose data regarding clients, trades or trading periods that demonstrate material losses;
2. Failure to disclose the effect of material market or economic conditions (e.g., statements that an adviser’s accounts appreciated 20 percent in value while failing to state that the market generally appreciated 40 percent during the same period);
3. Failure to disclose the risks of loss when presenting the potential for profit;
4. Failure, except in very specific circumstances, to reflect how the deduction of fees, expenses or commissions would affect results (although a presentation of “gross” and “net” performance may be given, provided they are presented in an equally prominent manner);
5. Failure to disclose the effects of reinvestment of dividends or other earnings on total asset value appreciation;
6. Failure to disclose all material facts relevant to any comparison of past performance with an index (e.g., differences in volatility, substantive differences in allocation or use of leverage); or
7. Failure to disclose any other material information necessary to accurately evaluate the relevance of the past performance (e.g., conditions, objectives, strategies involved in obtaining the performance).  

With respect to “model” or “hypothetical” performance results:

1. Failure to disclose the limitations inherent in the model or the results advertised;
2. Failure to disclose any material changes made to the model during the performance period;
3. Failure to disclose whether any of the securities or methods used in the model portfolio will not be available with respect to the current or potential client to whom the advertisement is targeted; or
4. Failure to disclose actual trading results that differed materially from the results portrayed in the model.

**Required Disclosures.** The SEC has stated that in certain circumstances, the disclosure of fees and expenses with actual or model performance results is unnecessary. For example, when gross performance results are presented to certain wealthy and/or sophisticated prospective clients in private and confidential meetings, and the client has an opportunity to discuss the applicable fees and expenses, an advertisement will not be found to be “false and misleading” provided there are certain

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9 Id.
disclosures. The investment adviser must disclose (a) that the gross performance results do not reflect fees and expenses; (b) that a return will be reduced when such fees and expenses are incurred; (c) an example of how fees and expenses, compounded over several years, could affect the portfolio’s asset value; and (d) that the fees charged by the investment adviser can be found in Part 2 of the advisers Form ADV. Additionally, if an investment adviser presents performance results for a composite of accounts using a common strategy, “model fees” equal to the highest fee charged to one of the accounts may be used to calculate the net results.

**PERFORMANCE IN PERSONAL ACCOUNTS**

In certain circumstances, an investment adviser has no prior performance results to include in advertising. Often, an investment adviser will seek to use the performance results of personal accounts managed under his or her sole discretion. The SEC will allow such a presentation provided that (a) no other individual or entity played a significant part in the performance and (b) the results were not materially different from the performance of any personal accounts that did not become accounts of the investment adviser. It should be noted that the SEC has approved the presentation of personal performance results only in the context of private presentations (not in advertisements or seminars) and that the investment adviser needs to provide those disclosures that would normally be provided for the presentation of “gross performance” results (e.g., results do not reflect fees, returns will be returned by fees incurred, an example of how such reduction, compounded over years, can reduce an account, and that fees can be found in Part II of the ADV).

**PERFORMANCE AT A PRIOR FIRM**

When a portfolio manager moves from one advisory firm to another or becomes “independent,” or when one advisory firm acquires another, a question that often arises is whether performance results from the prior firm can be presented to current and potential clients.

*Relocation of Single Portfolio Manager.* A portfolio manager who moves from one advisory firm to another or who starts his or her own independent investment advisory firm may include the performance results of accounts managed at a previous firm if:

1. No other person other than the portfolio manager played a significant part in the results; and
2. Performance for any transferred account was not materially different from the performance of the portfolio manager’s accounts that were not transferred (no “cherry picking”).

Additionally, if the portfolio manager responsible for performance of the transferred accounts will not be the only portfolio manager responsible for the performance of such accounts going forward, the SEC would view any presentation of such prior performance as fraudulent and misleading.

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12 Fiduciary Management Associates, Inc. (available March 5, 1984).
13 Great Lakes Advisors, Inc. (available April 3, 1992).
Relocation of Advisory Firm. Similarly, the SEC has stated that where an investment committee is responsible for the performance results of certain accounts transferred from a prior firm, the successor firm may use such prior performance in its advertising only under the following conditions:

1. The person(s) who will manage the accounts at the successor firm were primarily responsible for achieving the performance results at the prior firm (the identity of the personnel on the committees are substantially similar);
2. The accounts managed at the predecessor and successor firms are similar enough that the performance results of the predecessor firm are relevant to the management by the successor;
3. All accounts that were substantially similar and would be material to an analysis of the successor managers are included, unless their exclusion would not result in materially higher performance results; and
4. The successor manager provides disclosures that prior performance results were achieved under the management of another firm.\textsuperscript{14}

"BACKTESTING"

An investment adviser may want to see if particular investment strategies used today would have produced certain performance results in prior periods. Typically, this type of query arises with the use of certain quantitative or formula-based strategies, and the investment adviser wants to use the theoretical performance of the strategy as applied to historical market data. The hypothetical performance results produced through backtesting are typically presented to prospective clients in the form of various charts and graphs depicting the strategy applied retroactively. The SEC generally regards backtesting as highly suspicious due to the ease of manipulating data in order to prove the strategy works. Use of performance results obtained from “backtesting,” while not prohibited, requires an adviser to meet a high bar set by the SEC, achieved by providing strong support for its findings and disclosing the following:

1. The strategies were implemented after the performance period depicted in the advertisement (footnote disclosure is inadequate);
2. Performance results do not represent the results of actual trading but were achieved by retroactive application of a strategy designed with the benefit of historical observation;
3. All material economic and market factors that might have had an impact on the investment decisions made using the model;
4. Performance results reflect/do not reflect the deduction of fees, commissions or any other expenses that would have been incurred; and
5. The strategies involve the potential risk of loss as well as the potential for profit.\textsuperscript{15}

An investment adviser must also disclose any actual performance results obtained using the strategy, especially if such actual results achieved are materially

\textsuperscript{14} Horizon Asset Management LLC (available September 13, 1996).
\textsuperscript{15} In re Patricia Owen-Michael, Advisers Act Release No. 1584 (September 27, 1996).
different from the performance results derived from backtesting. The presentation of actual results and backtesting results should be clearly delineated, such that the prospective client can determine which were theoretical and which were actual. The investment adviser must also disclose any material differences in the implementation of the strategy in actual trading versus backtesting and the inherent limitations associated with performance results produced through backtesting models. All this disclosure must be presented with sufficient prominence and detail.

**CHARTS, GRAPHS AND TABLES**

Investment advisers who rely on quantitative methods, computer programs or other charts, graphs, tables, formulas or devices in selecting securities to buy and sell, or identifying when to buy and sell, must be mindful when describing any such “devices” in their advertisements. References to such devices in advertisements must be accompanied by prominent disclosures regarding the limitations and difficulties of using the devices to make investment decisions or otherwise provide advisory services. The Advisers Act specifically prohibits any advertising that directly or indirectly implies that a particular chart, graph, table, formula or other device can be used to make securities selections or decisions for investors.

**PRIVATE FUND ADVERTISING**

The landscape for investment advisers to pooled investment vehicles or private funds has changed dramatically in recent years. First, prior to 2010 many investment advisers to private funds were able to remain exempt from registration as an investment adviser under the “15-Client Rule” exemption. The repeal of the “15-Client Rule” under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 brought more advisers into the fold of the Advisers Act and its many rules and regulations, including those on advertisements.

Second, in 2012 the Jumpstart Our Business Startups Act (JOBS Act) added a new wrinkle to the private fund advertising landscape by allowing, for the first time, general solicitation and advertising of privately placed offerings made to accredited investors. Whereas previously advisers to private funds were not permitted to advertise publicly these investments in private funds, the JOBS Act removed many of these restrictions. However, these advertisements and general solicitations are not exempt from the Advisers Act’s restrictions on advertising and must comply with the advertising rules described above.

**ADVERTISING RULES IN VIRGINIA**

In addition to complying with the federal statues and rules on advertising, investment advisers must also conform to rules imposed by the states in which the investment adviser conducts business. Fortunately for investment advisers in Virginia, the state’s rules closely mirror the federal rules and requirements imposed on investment advisers. However, investment advisers who have clients in other states should be sure to confirm their marketing and advertising obligations with the laws in such other states to ensure compliance.

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Hirschler Fleischer
