CIBC PRIVATE WEALTH

Fiduciary Risk Management Conference

SEC Marketing – Performance Issues

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What is an advertisement?

The SEC regulates advertising through section 206(4) of the Investment Advisers Act of 1940. The Act prohibits any investment adviser from engaging in fraudulent, deceptive, or manipulative activities.

For purposes of the Act an advertisement is defined as as any written communication addressed to more than one person or any notice or announcement in any publication or by radio or television which offers any analysis, report, or publication regarding securities, any graph, chart, formula or other device for making securities decisions, or any other investment advisory services regarding securities.

- This includes electronic advertisements, including websites, and social media.
- Does not include all communication, it must involve the offer of an “investment advisory service”
- Generally, includes any material designed to maintain existing clients or solicit new clients

Performance Advertising

1. History
2. Model Results
3. Net of Fees
4. Predecessor Performance
5. Cherry Picking

History

The Advertising Rule focuses on principle-based prohibitions on advertisements.

Until the 1970’s the SEC took a very strict view on performance advertising, saying that most performance advertising was per se fraudulent.

This strict position was replaced with a “facts and circumstances” approach, which prohibits any advertisement that would allow a reader to infer something about an adviser’s competence or future investment results that would not be true if all material facts had been disclosed. The SEC required that all performance advertisements disclose all material facts to avoid any such inferences.

Model Results

Model results refers to any results for hypothetical or model portfolios and does not reflect the performance of any actual portfolio or account.

When discussing MODEL or ACTUAL performance results, the SEC believes the following would be misleading:

- Failing to disclose the effect of material market or economic conditions
- Failing to reflect the deduction of advisory fees, brokerage commissions, and other expenses
- Failing to disclose whether and to what extent the results include the reinvestment of dividends and other earnings
- Suggesting potential profits without also disclosing the possibility of loss
- Comparing results to an index without disclosing all the material factors relative to the comparison
- Failing to disclose any material conditions, objectives, or investment strategies used to obtain the performance

When discussing MODEL performance results, the SEC believe the following would be misleading:

- Failing to disclose prominently the limitations inherent in model results
- Failing to disclose, if applicable, material changes in the conditions, objectives, or investment strategies of the model portfolio during the period portrayed and the effects
- Failing to disclose, if applicable, that some of the securities or strategies reflected in the model portfolio do not relate, or relate only partially, to the services currently offered by the adviser
- Failing to disclose, if applicable that the adviser’s clients actually had investment results that were materially different from those portrayed.

Net of Fees

The SEC takes the position that it is misleading to show performance without deducting advisory fees, brokerage commissions and other expenses a client would have incurred.

Including a range of fees is not adequate to meet the net of fee requirement because of the compounding effect on performance when fees are not deducted. The onus should not fall on the client to calculate these effects.

Gross and net can be shown if shown with equal prominence.

Exception: Impact of fees can be shown in a footnote during one-on-one presentations with qualified or institutional clients where appropriate disclosures are included.

Predecessor Performance

What is it? A track record from a prior firm or portfolio.

When can it be used? Predecessor performance may be used if:

- The person who manages the accounts at the current firm was primarily responsible for the prior performance results
- Accounts managed at the predecessor adviser are so similar that the results would be relevant to client or investors of the current firm
- All accounts that were managed in a substantially similar manner are advertised, unless exclusion would not affect performance shown
- Includes all relevant disclosures

Cherry Picking

Rule 206(4)-1 prohibits advertisements which refer to profitable past specific recommendations but allows an adviser to provide a comprehensive list of *all* recommendations within in the past 12-month period, or longer.

The Franklin no-action letter refined the rule to allow advisers to show a sample for recommendations made. The requirements include:

- The sample must be chosen using objective non-performance based criteria, which is consistently applied. For example, the largest positions held
- The advertisement must not discuss realized or unrealized profits or loses of those specific securities
- Relevant disclosures are included
- A record of the selection criteria is maintained

New Rule

1. What’s new?
2. Net of Fees
3. Prescribed Time Periods
4. Related Performance
5. Extracted Performance
6. Predecessor Performance
7. Hypothetical Performance

What’s new

The new Marketing Rule amends the current Rule 206(4)-1 (the Advertising Rule) and imbeds Rule 206(4)-3 (the Cash Solicitation Rule) into a single comprehensive rule. The new definition of “advertisement” contains two prongs - the first covers communications that offer advisory services and the second covers testimonials or endorsements for which cash or non-cash compensation is provided.

Key Takeaways:

- Advertising and solicitation rules have been combined into a single rule
- Per se prohibitions have been replaced with general prohibitions that are more principles-based
- Record keeping requirements have been expanded - includes records related to T&E and evidence that substantiates facts presented in communications
- Hypothetical performance has been given a broader definition
- No distinction between retail and non-retail clients
- Communications to current clients that do not offer new or additional services are not considered advertisements (unless they contain hypothetical performance)
- No pre-review and approval requirement
- Expanded Compliance or Legal oversight in some areas
- Requirement for expanded policies and procedures (hypotheticals, T&E, etc.)

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Net of Fees

The rule prohibits including gross performance in an advertisement without also providing net performance results.

Net and gross of fees must be presented with equal prominence in a format designed to facilitate comparison and calculated over the same time period using the same type of return methodology.

May reflect the deduction of a model fee that is equal to the highest fee charged.

Prescribed Time Periods

Performance must be shown using one, five, and 10 year periods (or since inception).

As of date should be no less recent than the most recent calendar year-end.

Prescribed time periods must be shown with equal prominence.

Not applicable to private funds.

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Related Performance

Refers to the performance results of one or more “related portfolios” either on a portfolio-by portfolio basis or as a composite aggregation of all portfolios falling within a stated criteria.

Must include all related accounts – unless the exclusion of a particular account would not result in materially higher performance results and does not alter the presentation of any applicable time periods.

Extracted Performance

Refers to the performance results of a subset of investments from a single account or fund.

The rule prohibits extracted performance in an advertisement unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted.

Extraction from multiple portfolios is considered “hypothetical performance”.

Predecessor Performance

Refers to the performance results of accounts or private funds that were not advised at all times during the period show by the current adviser.

Predecessor performance can only be shown if:

- The person who manages the accounts at the current firm was primarily responsible for the prior performance results
- Accounts managed at the predecessor adviser are so similar that the results would be relevant to client or investors of the current firm
- All accounts that were managed in a substantially similar manner are advertised, unless exclusion would not affect performance shown
- Includes all relevant disclosures

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Hypothetical Performance

Definition includes model performance, back-tested, targeted or projected, and extraction from multiple portfolios.

Under the new rule, hypothetical performance is permitted if the advertisement:

- Provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating they hypothetical performance
- Provides sufficient information to allow the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions
- **Firm adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience**

Materials using hypothetical performance are do not qualify for the one-on-one communication exceptions.

Hypothetical Performance Continued

Definition does not include use of investment analysis tools.

Under the new rule, advertisements using investment analysis tools must:

- Provide a description of the criteria and methodology used, including limitations and assumptions
- If applicable, describe the universe of investments considered in the analysis. Explain how the tool determines which investments to select and if the tool favors certain investments, explain the reason for the selectivity
- Explain that the results may vary with each use and over time
- State that results are hypothetical

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Comparison Chart

Topic	Existing Rules	New Rules
Fees	Net and gross of fees presented with equal prominence. Allowed only gross of fees to be shown for certain sophisticated investors.	Net of fees must always be presented (model fees permitted) even with sophisticated investors. Must be of equal prominence and use the same type of methodology in order to facilitate comparison.
Prescribed time periods	No prescribed time periods.	Performance must be shown in one, five, and ten-year time periods (or since inception).
Related performance	Allowed but subject to conditions.	Permitted, as long as performance of all related accounts are shown, unless exclusion would not result in materially higher performance results and does not alter applicable time periods.
Extracted performance	Allowed but subject to conditions.	Permitted, as long as extracted performance is accompanied by the results of the portfolio from which it was extracted.
Predecessor performance	Permitted if same person responsible for prior performance manages current accounts, all accounts that were managed in a substantially similar manner are advertised, prior results would be relevant to clients of current firm and includes relevant disclosures.	Substantially similar to existing rules.
Hypothetical performance	Permitted subject to disclosures that would prevent the advertisement from being misleading. Does not apply to one-on-one communications.	Hypothetical performance is prohibited, unless the adviser: (1) adopts and implements policies and procedures reasonably designed to ensure that information is appropriate for the intended audience of the advertisement (2) provides information to enable the intended audience to understand the criteria and assumptions made in calculating performance; and (3) provides information to enable the intended audience to understand the risks and limitations of using hypothetical performance. Does not qualify for one-on-one exemption.

Q & A