

SEC to Firms: Avoid These Advertising Pitfalls

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By [Beagan Wilcox Volz](#) September 19, 2017

The SEC recently highlighted the most frequent violations of its advertising rule, in an effort to nudge firms toward strengthening their own oversight.

Chief among the infringements are ads with misleading performance results. The agency's Office of Compliance Inspections and Examinations based its Sept. 14 [risk alert](#) on findings from more than 1,000 exams. The risk alert also draws upon the SEC's 2016 sweep of dozens of advisors that referred to third-party accolades and awards in their ads.

SEC examiners saw ads that "contained hypothetical and backtested performance results, but did not explain how these returns were derived and did not include other potentially material information regarding the performance results," the risk alert states.

Firms that oversee subadvisors and smaller managers that use the services of series trusts may be particularly at risk of running afoul of SEC regulations, industry lawyers and compliance consultants say.

The use of back-tested performance data is "problematic" both for advisors of mutual funds and separately managed accounts in part because of the "potential for manipulation and misleading presentation," notes Terrence Davis, partner at **Holland & Knight**.

The SEC's November 2015 enforcement action involving [Virtus](#) "is illustrative of the potential pitfalls of using back-tested performance information," says Davis.

At that time, Virtus agreed to pay \$16.5 million to settle the agency's claims that it misled investors about the performance of the strategy underlying a number of funds subadvised by [F-Squared Investments](#). The SEC acknowledged that F-Squared lied to Virtus about the history and performance of its AlphaSector strategy but also faulted Virtus for not properly verifying those claims.

"The Virtus matter is an important statement from the staff of its views that each investment advisor is ultimately responsible for verifying the accuracy of any performance data presented in its advertisements" and should have processes in place for doing so, says Davis.

Indeed, the SEC's recent risk alert also calls attention to firms with lax compliance policies and procedures related to advertising. Specifically, some firms have not confirmed the accuracy of performance results, the agency noted. Use of subadvisors and outside managers complicates this.

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Problems also sometimes crop up when firms are launching new funds and don't have actual performance to present, says Karen Foley, partner with **ACA Compliance**. Firms will piece together the performance of portions of existing portfolios or take an existing track record and change some of the assumptions to create hypothetical performance.

“When you're doing that, while it's not prohibited, the risk comes in the lack of disclosure,” she says.

Smaller asset managers that rely on series trust providers for numerous services may also be vulnerable to advertising pitfalls, says Amy Lynch, founder and president of [FrontLine Compliance](#). There can be gaps in the communication between the compliance department at the fund manager and the compliance department at the series trust provider about performance, she says.

The bureaucracy of the series trust provider “can sometimes get in the way,” she adds, noting that advisors' point of contact is often a customer relationship manager.

Smaller managers don't have the compliance resources that bigger ones do, which can also lead to issues, notes Rob Prucnal, president of [Cipperman Compliance Services](#).

FrontLine Compliance's Lynch notes that compliance with the SEC's advertising rule can be challenging because the specifics of how to comply are found within multiple SEC no-action letters from previous decades and enforcement cases.

“Unless you know of the case history and the regulatory history via no-action letters, you're going to run afoul,” she says.