



So You Think Your Marketing Practices Are Compliant?

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With the advent of Securities and Exchange Commission (SEC) Rule 206(4)-7, which requires SEC-registered investment advisors to implement and maintain policies and procedures appropriate for their investment advisory businesses, it is now more critical than ever for all registered investment advisors to recognize that compliance is an ongoing process that requires the review, update, and amendment of regulatory filings, disclosures, and procedures. Laws and rules applicable to your practice and representatives are subject to change. Agreements and disclosure statements may require review and update due to changes in regulatory or state law and/or changes to your business operations. *Do not* become complacent with respect to compliance matters. The scope of SEC examination issues continues to grow and become more complex and your compliance policies and procedures must reflect amendments and appropriateness given the then-current state of the law and your business operations.

The SEC has begun to replace its five-year examination cycle approach with a risk-based approach. For SEC-registered investment advisors, the frequency and scope of compliance inspections is, for the most part, determined by the Commission's perception of the advisors' compliance risk profile.

Examiners will focus reviews on issues that represent the greatest potential threat to investors, and the corresponding frequency of examinations will be based upon the scope of the advisor's operations and the results of previous exams.

The SEC will require that an advisory firm demonstrate the processes by which it identifies and monitors those areas that expose the firm to operational and compliance risks. Given that all advisory firms differ in some respect, each firm's level of risk in any particular operational and compliance area may vary. The SEC has indicated that each advisor, in designing its policies and procedures, first should identify conflicts and other compliance factors that create risk exposure for the firm and its clients in light of the firm's particular operations, then design policies and procedures that address those risks. The SEC further has indicated that it would expect that an advisor's policies and procedures, at a minimum, should address several key areas to the extent that they are relevant to that advisor, including "marketing advisory services, including the use of solicitors."

Regulatory Exams

Marketing and advertising practices are addressed, in detail, on the most current SEC examination checklist. Accordingly, a firm must be prepared to demonstrate to the SEC that it has considered the applicability to its operations and has implemented an appropriate corresponding policy to the extent applicable.

To be prepared for the SEC examination of marketing and advertising practices, an advisor should consider the following two important issues:

Previous audit deficiencies. Make sure that you have properly addressed any marketing-related deficiencies cited in previous regulatory examinations. Depending upon the nature of the issue, failure to correct previously cited deficiencies can result in a referral to enforcement. These issues should be reviewed by the chief compliance officer on a periodic basis to detect/prevent reoccurrence.

Conduct a mock examination. By so doing, you will be in a much better position to successfully complete an actual regulatory examination. Remember that verbal communications and written reports to and from counsel are privileged and not subject to turnover, disclosure, or production during a regulatory proceeding, including a compliance examination. Correspondence, compliance reviews, and verbal communications between an advisory firm and a non-law firm provider are not privileged and are subject to turnover, disclosure, or production during a regulatory compliance examination, a client lawsuit or arbitration, and a regulatory enforcement proceeding.

Marketing through Advertisements

I am constantly amazed by advisors who pay large sums to marketing consultants and advertising agencies that know very little about the advisory industry and its regulations to prepare marketing materials but

>> “MARKETING PRACTICES” CONTINUED

fail to have those marketing materials (e.g., brochures, Web sites, media advertisements, etc.) reviewed by counsel to determine if they run afoul of applicable securities laws or rules.

The SEC regulates investment advisor advertising pursuant to Section 206 of the Advisors Act. Section 206 and corresponding Advisors Act Rule 206(4)-1 generally prohibit an investment advisor (whether registered or exempt from registration) from engaging in fraudulent, deceptive, or manipulative activities. For example, Rule 206(4)-1(a)(1) prohibits an advisor from utilizing any advertisement that contains a testimonial. While not specifically defined in the Rule, “testimonial” refers to any statement by a former or current advisory client or investor that endorses the advisor or refers to a favorable investment experience (investment management, financial planning, or otherwise) with the advisor. Testimonials are prohibited because the SEC believes that they could create a deceptive or mistaken inference that all of the advisor’s clients typically experience the same favorable results as the person providing the testimonial. While the SEC, in various no-action letters, has provided limited exceptions to the testimonial prohibition, when in doubt advisors should consult with counsel to determine if a proposed advertisement or marketing campaign runs afoul of the testimonial prohibition.

The SEC defines “advertising and sales literature” to include “any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio, television, or Internet that offers any report, analysis, graph, chart, or formula concerning securities or to be used in determining what securities to buy or sell, or any other investment advisory service with regard to securities.” Advisors Act rules, releases, and no-action letters govern the

use of advertising and sales literature by the advisory firm. The SEC generally will base its determination as to whether an advertisement is “misleading” on all the particular facts relative to the advertisement and would look carefully at the form and content of the advertisement, the implications or inferences that reasonably could be made from the advertisement in its total context, and the overall sophistication of the audience that received the advertisement’s message. The SEC objects to the use of superlatives in marketing materials, brochures, and Web sites (e.g., state-of-the-art, outstanding, superior, world-leading, etc.). These qualifiers generally cannot be substantiated and usually are unnecessary. They should be minimized and/or eliminated.

As a fiduciary, the advisor must ensure that marketing materials are not misleading. When in doubt, qualify any statement with appropriate disclosure. For example, the SEC has been objecting to an advisor’s advertising that it has been named to a particular publication or ranking organization’s “best advisors” list. All such advisors should qualify any such advertisement by indicating that: 1) it should not be construed by any client or prospective client as a guarantee that they will experience a certain level of results if they engage or continue to engage the advisor’s services; 2) it should not be construed as a current or past endorsement of the advisor by any of its clients; and 3) lists or rankings published by magazines and others generally base their selections exclusively on information prepared and submitted by the recognized advisor.

In addition, the use of investment performance data in advertising and marketing materials is a highly complex subject and is carefully scrutinized by the SEC. The reason for the complexity of this subject is that the SEC has not established any fixed formulas for the calculation of investment advisor performance. Over the years,

however, the SEC has issued numerous no-action letters setting forth required practices for performance advertising. Particular care must be taken to ensure that materials presenting the advisor’s performance contain required disclaimers and legends.

Finally, the contents of an advisor’s Web site constitute advertising materials. Advisors that maintain a Web site should include appropriate disclosures to make sure the site’s content is not misleading. Moreover, additional substantive Web site disclosures should be included depending upon specific Web site content and links to third-party sites.

Marketing through Solicitors

Many advisors market their services through solicitors. Solicitors generally refer clients to advisors in return for the payment of an ongoing referral fee. Advisors that engage solicitors should be cognizant of the corresponding regulatory requirements pertaining to the engagement of solicitors.

Although the rules governing solicitors differ from state to state, many states have indicated that individuals who refer prospective clients to an SEC-registered advisor are not subject to investment advisor or investment advisor representative registration, or any other qualification requirements (i.e., investment-related designation, passing of exam, etc.) so long as the advisor complies with the requirements of Rule 206(4)-3 under the Advisors Act (i.e., the referral fee rule) as discussed below, and provided that the solicitor is neither: 1) a person supervised by the advisor (i.e., partner, officer, director, employee); nor 2) gives investment advice on behalf of the advisor. Those states that do permit such individuals to serve as solicitors without registration and/or qualification generally do not provide the same exemption for entities (i.e., CPA firms, insurance agencies, etc.). Thus, to the extent that an advisor seeks to

establish and/or continue referral arrangements with professional firms in these states, it may opt to do so with the individual members thereof rather than with the entity, unless the entity is not opposed to becoming registered as an investment advisor, which would require at least one member to pass a qualifying examination (unless he or she qualifies for an examination exemption).

Rule 206(4)-3 under the Advisors Act requires the following: 1) a written agreement between the advisor and the solicitor setting forth certain terms and conditions of the referral arrangement; 2) the solicitor to provide the prospective client with a copy of the advisor's written disclosure statement at the time of the solicitation; 3) the solicitor to provide the client with a separate written disclosure document containing certain information pertaining to the solicitation arrangement, including a description of the compensation to be paid to the solicitor; and

4) the advisor to obtain (and maintain for Rule 204-2 recordkeeping purposes) a signed and dated acknowledgment from the client that he/she/they/it has received both the advisor's and the solicitor's written disclosure statements.

Because laws regulating solicitors differ from state to state, it is important that advisors, before engaging solicitors in or for a particular state, first determine if any corresponding filing, registration, and/or qualification requirements are applicable to the advisor and/or the solicitor. Thereafter, for both regulatory and liability protection purposes, the roles and obligations of the parties should be set forth in a well-defined solicitation agreement, certain terms of which will differ depending upon the identity of the solicitor (i.e., an individual, another investment advisor, a broker-dealer, etc.)

Conclusion

An investment advisory firm that engages in advertising and market-

ing, whether through the Internet, media, or solicitors, must have an understanding of the corresponding Advisors Act and Rules. While the SEC, in various no-action letters, has provided limited exceptions to certain prohibited advertising practices, when in doubt, advisors should consult with legal counsel to determine if a proposed advertisement or marketing campaign is compliant. **M**

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