

## Regulation of Index Performance under the Advisers Act Advertising Rule

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Investment advisers routinely accompany the performance of their separately managed account clients (SMA Performance) with the performance of one or more securities indexes (Index Performance) in advertisements. This Index Performance often serves as a benchmark against which prospective and existing clients can measure SMA Performance on a relative basis. Consequently, Index Performance arguably implicates regulatory concerns under Rule 206(4)-1 of the Investment Advisers Act of 1940, as amended (Advisers Act) (Advertising Rule) comparable in importance to those associated with SMA Performance.

Despite this fact, the Securities and Exchange Commission (SEC) and the SEC staff historically have devoted a substantial amount of time addressing SMA Performance issues but have provided very little in the way of guidance with respect to Index Performance. In the absence of such guidance, a number of common industry practices have evolved over the years to fill in the gaps and address other potential compliance concerns in this area. Unfortunately, to date, the limited SEC guidance and common industry practices have rarely been reduced to a single writing aimed at practicing compliance professionals.

This brief article seeks to remedy this deficiency. To that end, the first sec-

tion summarizes the limited SEC staff guidance and related SEC enforcement proceedings under the Advertising Rule pertaining to Index Performance. The second section provides a non-exhaustive list of common industry compliance practices in this area. The concluding section provides a few practical observations and recommendations. It is hoped that compliance professionals will use this article as a starting point for understanding the application of the Advertising Rule to Index Performance and developing their own unique compliance policies to address this critical area of advertising.

### I. SEC Staff Guidance

The Advisers Act does not directly address the presentation of Index Performance (or any other type of performance, for that matter) in investment adviser advertisements. However, Rule 206(4)-1(a)(5) under the Advisers Act prohibits an investment adviser from publishing, circulating, or distributing any advertisement that “contains any untrue statement of a material fact” or that is “otherwise false or misleading.” The SEC staff takes the position that whether a specific advertisement is false or misleading depends on the particular facts relating to the advertisement and the statements contained in

it, including: (1) the form and content of the advertisement; (2) the investment adviser’s ability to perform what is advertised; (3) the implications or inferences arising from the context of the communication; and (4) the sophistication of prospective clients. See, e.g., *Triad Asset Management, Inc.* (Apr. 22, 1993). Further, the determination of whether an advertisement containing SMA Performance is false or misleading turns on whether “it implies, or a reader would infer from it, something about the adviser’s competence or about future investment results that would not be true had the advertisement included all material facts.” *Clover Capital Management, Inc.* (Oct. 28, 1986) (*Clover*).

To date, the SEC staff has not articulated a general standard or core set of principles for determining whether Index Performance is false or misleading. Presumably, however, the same core principles laid out in the preceding paragraph apply equally to Index Performance. In addition to these core principles, the SEC staff has expressed its views over the years on two specific topics relating to the presentation of Index Performance under the Advertising Rule.

First, as a general matter, the SEC staff has held that the Advertising Rule

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does not prohibit an investment adviser from presenting SMA Performance in advertisements and comparing “that performance with the performance of an appropriate index.” *Oberweis Securities, Inc.* (July 25, 1983). In fact, SMA Performance, alone, may be misleading “in the absence of a comparison with the performance of an appropriate index over the same period.” *Id.* Thus, for example, a statement that accounts have “appreciated in value 25% may cause an inference to be drawn about advisory competence that would not be drawn if it was also stated that the S&P 500 increased 40% during the same period.” *Anametrics Investment Management* (May 5, 1977) (*Anametrics*).

Second, the SEC staff repeatedly has noted that the Advertising Rule prohibits an investment adviser from comparing SMA Performance to Index Performance “without disclosing all material facts relevant to the comparison.” *Clover*. In other words, to present Index Performance along with SMA Performance for comparative purposes, “it is necessary that any facts bearing on the fairness of any comparison be stated.” *Anametrics*.

Thus, for example, “if dividends or income are included in one of the figures to be compared . . . they should be included in the other, and, if not, that mention should be made of the fact.” *Id.* Similarly, differences in “volatility of market prices . . . should be mentioned.” *Id.* Other differences which might require further explanation include the following: (1) type of security (e.g., equity or debt); (2) investment objective (e.g., growth, income, stability or some combination of the foregoing; and (3) level of diversification. *Id.*

Based on the foregoing, the requisite amount and detail of disclosure should increase as the comparability level between SMA Performance and Index Performance decreases. At some point, however, the comparability level may be so low that no amount of disclosure would be sufficient. Under these circumstances, the SEC staff may take

the position that the comparison falsely states or implies “that a dissimilar index is comparable to the adviser’s investment strategies.” *Letter from the Office of Compliance Inspections and Examinations to Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections* (May 1, 2000).

### Enforcement Proceedings

The SEC has not provided any substantive guidance to date on the application of the Advertising Rule to Index Performance. It has, however, occasionally instituted administrative proceedings against advisers for presenting misleading Index Performance in advertisements under the Advertising Rule. However, in most instances, the SEC also alleged other, often more serious, Advisers Act violations. Thus, it is unclear whether the SEC would have brought these proceedings solely on the basis of misleading Index Performance.

In addition, these proceedings often involved situations squarely addressed in prior SEC staff interpretations and, thus, did not break any new ground. For example, earlier this year, the SEC instituted and settled proceedings against an adviser under the Advertising Rule, among other provisions under the Advisers Act, because the adviser’s advertised SMA Performance “included the reinvestment of dividends, while the S&P 500 index number did not.” *In the Matter of Trust & Investment Advisors, Inc., et al.*, Investment Advisers Act Release No. 4087 (May 18, 2015). See also *Meridian Investment Management Corp., et al.*, Investment Advisers Act Release No. 1779 (Dec. 28, 1998) (adviser failed to disclose “relevant information regarding the indices with which . . . [it] compared its performance,” including the differences in volatility”).

The SEC has instituted enforcement proceedings addressing novel issues related to Index Performance on at least two occasions. In one proceeding, the

SEC alleged, among other things, that an adviser distributed advertisements comparing SMA Performance to understated Index Performance. *In the Matter of Seaboard Investment Advisers, Inc., et al.*, Admin. Proc. File No. 3-9725 (Sept. 21, 1999). As a result, the adviser falsely overstated SMA Performance relative to Index Performance. The proceeding underscores the importance of confirming the accuracy of Index Performance presented in advertisements.

In the other proceeding, the SEC alleged that an adviser distributed false advertisements presenting SMA Performance on an annual total return basis relative to Index Performance on an average annual total return basis over the same period. *In the Matter of Bell Capital Management, Inc., et al.*, Investment Advisers Act Release No. 1813 (Aug. 6, 1999). Specifically, the adviser presented as SMA Performance individual annual total return numbers for each year comprising the measurement period. The adviser accompanied this with a graph summarizing Index Performance on an average total return basis. The SEC alleged that, by not including the individual annual total return numbers as part of Index Performance, the adviser failed to disclose that SMA Performance was lower than Index Performance “for three out of four years.” This proceeding, thus, underscores the importance of presenting Index Performance in the same manner and format as SMA Performance.

## II. Common Industry Practices

As noted above, the determination of whether Index Performance is false or misleading under the Advertising Rule turns on the relevant facts and circumstances. While the regulatory pronouncements outlined above are helpful, they either broadly articulate a few general anti-fraud principles or prescribe a handful of specific advertising

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practices. This means that, for the most part, compliance professionals must review advertisements containing Index Performance without the benefit of any clear regulatory guidance.

Fortunately, over the years, a number of standard industry disclosure and other practices have evolved to address possible compliance concerns arising under the Advertising Rule in connection with the presentation of Index Performance. Some of the more common practices are listed below. This list is not an exhaustive one under the Advertising Rule and does not seek to address other possible compliance obligations applicable to advisers.

### 1. Index Selection

- **Comparability**—Comparability clearly is a critical factor to consider under the Advertising Rule when selecting an index for performance comparison purposes. For this reason, advisers tend to go with an index that reasonably is comparable based on the following factors, among others: (1) volatility; (2) type of security; (3) investment objective; and (4) level of diversification. Conversely, they tend to avoid using an index so dissimilar under these factors that no amount of disclosure could make it an appropriate index for comparison purposes. In most instances, the decision is not problematic since a standard industry accepted comparable index is used.
- **Index Integrity and Reliability**—Index integrity and reliability often is another critical factor in the selection process. For this reason, advisers tend to favor indexes that meet certain core eligibility criteria that they have established. Possible criteria might include some or all of the following: (1) the index is operated and maintained according to a clearly defined and publicly disclosed set of rules that are objectively-based and applied consistently; (2) the index data is broadly disseminated, widely followed, and readily accessible; and (3) the index sponsor is established and reputable.

### 2. Common Advertising Disclosures

Investment adviser advertisements containing Index Performance often contain the following standard disclosures.

- **Index Definition**—A basic definition of each index for which performance is presented. This definition mirrors or closely tracks the index creator's own proprietary definition.
- **Nature of Index**—Statement that the index is not (1) managed, (2) accessible through direct investment, or (3) subject to management fees, brokerage commissions, or other expenses.
- **Presentation Period**—The period over which performance is presented, including the starting date and the ending date.
- **Source Attribution**—The source of the Index Performance. When Index Performance is obtained from a party other than the index provider, that the source is the third-party, based on information supplied by the index provider.
- **Material Calculation Methodology Differences**—Any material calculation methodology differences that result in enhanced SMA Performance relative to Index Performance. For example, unlike SMA Performance, Index Performance has not been calculated assuming the reinvestment of dividends or income.
- **Comparability Issues**—Any material index construction and composition differences potentially impacting the comparability of Index Performance to SMA Performance. In particular, differences in the following areas: (1) volatility; (2) type of security; (3) investment objective; and (4) level of diversification.

- **Customized Indexes**—In the case of Index Performance derived from two or more other indexes (a so-called customized index), the weightings of the constituent indexes and the fact that the index is customized.
- **Proprietary Indexes**—In the case of a proprietary index, that the adviser or an adviser affiliate created and maintains the index.

### 3. Presentation

- **Format**—Index Performance is presented in the same graphic or tabular format as SMA Performance.
- **Proximity**—Index Performance is presented directly together with, or proximate to, SMA Performance.
- **Presentation Period**—Index Performance is presented over the exact same time periods as SMA Performance.

4. **Recordkeeping**—Investment advisers typically keep and maintain, or can easily access over the Internet, backup records supporting the accuracy of the Index Performance that they present.

5. **Written Compliance Policies**—Finally, many advisers maintain and enforce written compliance policies that address the presentation of Index Performance. While these policies vary considerably in detail, a few common topics include the following: (1) index selection criteria; (2) presentation requirements; (3) recordkeeping; (4) a list of pre-approved indexes and corresponding types of SMA Performance that may be presented on a comparative basis; (5) an approval process for replacing existing comparative indexes or adding new ones; and (6) a reconciliation process to confirm the accuracy of Index Performance data contained in advertisements.

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### III. Conclusion

The article concludes with a few practical observations and recommendations for compliance professionals relating to the presentation of Index Performance in investment adviser advertisements.

- **Written Compliance Policies**—Consider reviewing and revising your written compliance policies and procedures to more specifically address Index Performance, if needed. Possible topic areas include index selection, required disclosures, Index Performance presentation, and recordkeeping.
- **Testing**—Periodically test for compliance. Possible tests include the following: (1) index comparability; (2) data accuracy; (3) index consistency (e.g., no index switching to enhance

relative performance); (4) presentation consistency; (5) recordkeeping; and (6) required disclosures.

- **SEC Enforcement**—Do not misconstrue the paucity of SEC enforcement proceedings in this area, to date, as predictive of the future. There has been a tremendous recent growth in the number, type, and complexity of new and innovative index-based products. Examples include actively managed index, back-tested index, and proprietary indexed products. These products potentially can raise difficult comparability, disclosure, conflicts and other issues under the Advertising Rule. The SEC may elect to address certain of these issues through the enforcement process.
- **Other Applicable Requirements**—Finally, remain mindful of other applicable regulatory requirements or contractual commitments relating to

Index Performance. For example, prior index provider approval may be required to reference an index or reproduce index data.

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