

## **SECURITIES ACT INTERPRETIVE STATEMENT -21**

### **RE: Performance Standards in Advertisements**

RCW 21.20.020 Unlawful acts of persons advising another.

WAC 460-24A-100 Advertisements by investment advisers - -100(1)(e)-False or misleading statements of material facts in advertisements constitute fraud pursuant to RCW 21.20.020.

### **Questions Presented:**

1. May an investment adviser advertise its past performance?
2. If advertisement of past performance/performance standards are allowed what conditions or restrictions apply?
3. Do these conditions apply to information on past performance provided to customers in correspondence or account statements?

### **Statutes and Regulations:**

RCW 21.20.020 states that "any act, practice, or course of business which operates or would operate as a fraud" is an unlawful act when engaged in by persons advising others regarding securities, if consideration for such advice is received.

WAC 460-24A-100(1)(e) states that any advertisement for an investment adviser which contains any untrue statement of a material fact, or which is otherwise false or misleading constitutes a fraud under RCW 21.20.020.

### **Discussion:**

Investment advisers often use past performance figures in an effort to communicate their effectiveness to existing clients and in seeking new clients. Members of the public often misunderstand the meaning of such performance figures. For the protection of public investors, investment advertisements that are misleading constitute fraud under WAC 460-24A-100(1)(e) and RCW 21.20.020 of the Securities Act. In order to help investment advisers to avoid inadvertent misrepresentations the Division is setting forth this policy statement as a guide to acceptable practices when using performance standards in advertising.

Advertising past performance (also referred to as "performance standards," "performance data" or "performance results") is permitted as long as those figures do not constitute fraud under RCW 21.20.020. The statute and related regulations do not create a ban on the use of performance standards in advertisements by investment advisers; however, they do circumscribe their use. The facts and circumstances surrounding the use of performance results must be reviewed as to the form and content, implications or inferences arising from the advertisement and the sophistication of the present or prospective client. The same considerations that apply to determining whether information relating to performance results in advertising constitute fraud under RCW 21.10.020 also apply to information relating to performance results contained in investment adviser correspondence with clients and in client account statements.

## **A. Basic Performance Results:**

When using performance data in advertisements or communications with clients all material facts necessary to avoid any unwarranted inference must be disclosed. In order to avoid misleading inferences the following standards must be adhered to:

1. The effect of material market or economic conditions on portrayed results must be stated;
2. The effect of fees, commissions or other client paid expenses (with the exception of custodial fees) on performance must be stated;
3. The effect of dividends and earnings on the results portrayed must be stated;
4. Disclosure of the potential for both profit and loss must be made;
5. Comparison of results to an index or other portfolio must disclose facts relevant to the comparison which include disclosure of the following:
  - a. Capital gains and losses, both realized and unrealized;
  - b. Type of security;
  - c. Objective;
  - d. Volatility or stability;
  - e. Diversification;
  - f. Cash infusions/new money;
  - g. Reinvestment of dividends; and
7. Appropriate time frames to compute results must be used;
8. Disclosure of any material conditions, objectives, or investment strategies used to obtain the performance result must be made;
9. Where the performance results are only for a selected group of clients, the basis on which the selection was made must be disclosed.

## **B. Model Performance Results:**

In addition to the disclosures required when using basic performance figures, where the performance data is based on the use of certain types of "model" portfolios further specific disclosures must be made. Model results are essentially hypothetical portfolios, which are first created, then monitored based upon forward-looking strategies and are measured as if they constituted a real portfolio.

In order to be presented in a manner that is not misleading to the investing public, model results must be authenticated and may not employ the use of "backtested" figures. Backtesting involves developing a strategy based upon historical performance and then applying the strategy to those past figures. Such backtested performance results often create misleading inferences. Therefore, to eliminate any confusion, backtested performance results may not generally be used in investment adviser advertising unless accompanied by prominent disclosure regarding the origin of the figures.

Authenticated model performance results may be used in advertising when the following disclosures appear:

1. Prominent disclosure of the limitations inherent in the model results;
2. Material changes in the conditions, objectives, or investment strategies of the model portfolio;
3. 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;
4. If applicable, that the advisers clients actually had investment results that were materially different from those portrayed in the market; and
5. A statement advising the reader that the results do not represent actual trading.

**Conclusion:**

Investment advisers may use performance standards in advertising. Any use of performance standards in advertising must disclose all information necessary to ensure that the advertisement does not lead readers to draw unwarranted conclusions from the advertisement. The advertisement may not contain any untrue statement of material fact.

The points discussed above are not intended as the exclusive factors to consider in determining the disclosures necessary to make performance figures not false or misleading.

Adopted: 1/25/99

Deborah R. Bortner, Securities Administrator

Prepared by: Kristina Kneip, Securities Examiner