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False Advertising

Question:

I provide performance reports on the accounts of some of my selected clients to prospective clients. Any information by which a client could be identified is redacted from the performance reports. When I mentioned this to a rep who works at another firm, he told me that it isn't ethical to show the results of selected accounts. I've got to show results from all accounts, assuming they're all scrubbed for identifying information. Is what I'm doing appropriate or not? If not, why not?

Answer:

Your conduct could be considered fraudulent and misleading: It may violate NASD rules, federal securities regulations [specifically Rule 10b-5], almost certainly your firm's compliance rules, and it potentially subjects you and your firm to civil action, regulatory fines and suspension.

By selecting to include performance information from certain accounts in your report, you create an incomplete — and thus misleading — picture of the total performance of all accounts you advise, control, manage or oversee. Further, you don't say whether the performance reports apply to accounts over which you exercise discretion, whether the account owners have any say in the investment decisions, and whether all accounts engage in transactions at the same time.

You also fail to mention whether the performance reported on the different accounts covers identical periods, and whether these numbers have been audited by an independent entity. A strong argument can be made that the absence of any combination of the above factors renders the reports false, misleading and inaccurate.

The starting point for analysis is to define your conduct. By sending "performance reports" to prospective clients, you have engaged in "communications with the public," governed by NASD Rule 2210. Among the things that qualify as "communications with the public" in Section 2210a is "sales literature" or any written or electronic communication other than an advertisement, independently prepared reprint, institutional-sales material and correspondence that is generally distributed or made generally available to customers or the public, including performance reports or summaries. You mention that you only send performance reports representing the accounts of "select clients." I interpret this to mean only those accounts with positive results. A reasonable interpretation of your conduct is that you're using the performance of these accounts to imply that similar future results are likely. Paragraph (d)(2)(N) of the Rule cited above states that investment results cannot be predicted or projected. And investment performance illustrations may not imply that gain or income realized in the past will be repeated in the future. As a registered broker/dealer and member of the NASD, your firm and you, its registered representative, are subject to all of the requirements in NASD Conduct Rules, including the prohibition on predictions provided in NASD Conduct Rule 2210(d)(2)(N). A strong case can be made that your conduct violates Rule 2210.

Further, if you haven't received written approval prior to sending the performance reports, your conduct may place your firm in violation of its supervisory requirements. In addition, most NASD member firms have compliance manuals that prohibit advisors from distributing their own sales or marketing materials. You'd be well advised to discuss this issue with your compliance principal. I'm confident he'll find sending "performance reports" impermissible.

Jeffrey S. Feinberg, Esq.
Nackman & Feinberg LLP
Attorneys at Law
110 Wall Street
11th Floor
New York, New York 10005
(212) 748-4800
jfeinberg@bnfcounsel.com