1.1.2 OSC Staff Notice 33-729 - Marketing Practices of Investment Counsel/Portfolio Managers

OSC STAFF NOTICE 33-729
MARKETING PRACTICES OF
INVESTMENT COUNSEL/PORTFOLIO MANAGERS

Purpose of Notice

Staff of the Compliance team of the Ontario Securities Commission (OSC) conducted a focused review of the marketing practices of firms registered as investment counsel/portfolio managers (ICPMs). This report summarizes our findings and provides guidance to market participants on best practices in the preparation and use of marketing materials.

Background

Marketing practices have increasingly become an area of concern. During our field reviews in recent years, we have identified an increasing number of deficiencies in this area. Marketing was the number one significant deficiency identified by the Compliance team in its 2006 and 2007 annual reports.

In particular, we have seen a rise in the number of issues in the marketing practices of ICPMs for non-prospectus qualified securities, such as pooled funds and hedge funds. We have also seen claims that are more aggressive and a greater complexity in the types of performance data in marketing materials.

We are concerned about marketing materials because investors are influenced by these types of documents. Naturally, ICPMs are motivated to present their performance, skills and services in a favourable light in these materials as a way to attract new clients and to retain existing ones. However, we have seen a number of instances where the materials were prepared in a way that highlights or exaggerates favourable points while omitting or failing to disclose facts that may be less favourable to the ICPM.

As a result, we decided to conduct a focused review of the preparation and use of marketing materials by ICPMs.

Reviews

Objectives

The main objectives of the reviews were to:

- broaden our understanding of the type and content of marketing materials used by ICPMs
- assess ICPMs' compliance with Ontario securities law
- identify any regulatory gaps

Scope

The Compliance team gathered preliminary information from about 50 ICPMs that we had not recently reviewed and that were actively carrying on marketing activities. We applied a risk-based approach to select 21 ICPMs for an in-depth review of their marketing practices. The sample included ICPMs that were portfolio managers of non-prospectus qualified investment funds, ICPMs that catered to large institutional investors and ICPMs with a variety of clients, including private clients.

Our review did not focus on ICPMs that act as fund managers solely for prospectus-qualified mutual funds. The marketing materials for these funds are subject to requirements under specific legislation, such as National Instrument 81-102 – *Mutual Funds* (NI 81-102).

Compliance staff reviewed a variety of marketing documents, including brochures, offering documents for products managed by the ICPM, newspaper and magazine advertisements, one-on-one presentations made by ICPMs to clients, websites and market commentaries.

OSC Rules

When reviewing marketing materials for compliance with Ontario securities law, we look to section 2.1 of OSC Rule 31-505 – *Conditions of Registration* (OSC Rule 31-505). This rule requires registrants to deal fairly, honestly and in good faith with their clients. This provision is a broad principle that applies to registrants generally and we expect registrants to apply it to all areas of their activities, including marketing practices and marketing materials.

We also look to the mutual fund rules for sales communications and prohibited representations for guidance on what constitutes misleading performance advertising in marketing materials. These rules, which are in Part 15 of NI 81-102 and Part 13 of its Companion Policy, contain guidance on specific issues, such as the use of benchmarks.

Although NI 81-102 applies to prospectus-qualified mutual funds, it provides principles that are appropriate and consistent with a registrant's obligation to deal fairly, honestly and in good faith with its clients. As such, these rules provide a best-practices standard that can be applied to the marketing materials of other types of investment funds and investment strategies.

Summary of suggested practices

As a result of the review, we have several key suggested practices. These suggested practices are intended to assist registrants in meeting their obligation to deal fairly, honestly and in good faith with their clients. We expect that market participants will look to these practices when preparing marketing materials. Failure to follow these practices may result in inaccurate and unfair marketing materials, which we consider misleading to clients.

The suggested practices include the following:

- ICPMs should present performance data that is based on their actual client performance returns, not on hypothetical returns which have a number of inherent risks and are difficult to verify.
- Performance composites should be constructed to include all portfolios with a similar investment strategy.
- Performance data should be calculated using a consistent methodology so that any comparisons are not misleading.
- Benchmarks should be relevant to the ICPM's investment strategy. There should be adequate disclosure to make the comparison fair and meaningful for clients.
- ICPMs should be able to support the claims made in their marketing materials.

These suggested practices are discussed in further detail in this notice.

Summary of the results

We identified a number of deficiencies in the preparation and use of marketing materials in the ICPMs we reviewed.

Most of the deficiencies fall into one of the following areas:

1. preparation and use of hypothetical performance data
2. linking actual performance of the ICPM's investment fund or investment strategy with the performance of another fund or investment strategy
3. construction and marketing of performance composites
4. construction and use of benchmarks in marketing materials
5. use of exaggerated and unsubstantiated claims in marketing materials

The following is a discussion of the issues in each of these areas and suggested practices.

1. Hypothetical performance data

Hypothetical performance data refers to performance data that is not the performance of actual client portfolios. It is also sometimes referred to as "simulated performance data".

There are different types of hypothetical performance data, including back-tested performance data and model performance data, which are discussed below.

Almost all of the ICPMs that presented hypothetical performance data in marketing materials used it in ways that were misleading or provided inadequate disclosure. Most of these deficiencies related to the marketing of non-prospectus qualified investment funds.

The following are some of the issues that we identified:

- ICPMs presented:
  - hypothetical performance data in a way that may mislead clients to believe that it is the actual performance returns of their investment fund or investment strategy
  - the returns of an index or indexes as returns of the ICPM's own fund or investment strategy
  - model performance data for a strategy that no actual clients were following
  - model performance data instead of the returns of actual client accounts
- There was a lack of disclosure accompanying hypothetical performance data. For example, there was no disclosure of the fact that the performance data was hypothetical, how the hypothetical performance data was calculated and the underlying assumptions on which the hypothetical performance data was based.
- Disclosure accompanying the hypothetical performance data was not clear and prominent.

General concerns

There are a number of general concerns related to the use of hypothetical performance data. For example:

- Any outcome can be achieved. The returns are generally always positive; otherwise, ICPMs would not present them to prospective clients.
- Hypothetical performance data is often combined with, or confused with, actual performance.
- ICPMs do not disclose the assumptions used to derive hypothetical performance data.
- It is difficult to verify the calculation of hypothetical performance data.
- ICPMs can take bigger risks with hypothetical portfolios and act differently than they otherwise would with actual client portfolios.

a) Back-tested performance data

Back-tested performance data refers to hypothetical performance data created by applying a particular investment strategy to historical data over a period of time. The data may be created using quantitative methods or formulas. We also saw the term "back-tested performance data" used to refer to hypothetical performance constructed from the historical performance of existing funds.

Back-tested results aim to show investment returns that theoretically would have been achieved if the strategy had been used during a past time period. ICPMs often use back-tested performance data to attract clients when the ICPM has no track record or has a short track record of less than five years.

An example of back-tested performance data that we saw involved ICPMs managing funds-of-funds that constructed hypothetical performance data from the historical performance of existing funds. This hypothetical performance data was based on assumptions made by the ICPM on what the fund-of-funds would have invested in if it had existed at that time, and used the historical performance data of the underlying funds.

We identified several instances where ICPMs presented performance data for periods that were much longer than the life of the firm's non-prospectus qualified investment fund. In some instances, the back-tested performance data for the period prior to the fund's inception was based on purely hypothetical performance data, such as the performance of an index. In other instances, the back-tested performance data for the period prior to the fund's inception was based on the performance of other existing funds or the underlying funds for a fund-of-funds structure.

In addition, we identified many cases where there was inadequate disclosure about the back-tested performance data, including the underlying assumptions, calculation methodology, and the risks and limitations of the back-tested performance data.

In a number of instances, the disclosure accompanying the back-tested performance data was not prominent and clear. For example, the disclosure was in very small print in a footnote at the end of a marketing piece.

Concerns

In addition to the general concerns with the use of hypothetical performance data outlined above, the following are specific concerns we have about the use of back-tested performance data:

- ICPMs have the benefit of hindsight and do not have to manage in real market conditions.
- ICPMs can alter their strategy to fit the historical data.

Suggested practices

ICPMs should only market their actual performance. They should not use back-tested performance data because it is subject to manipulation and has many limitations. As such, back-tested performance data may be misleading and inappropriate. In addition, there is no way to verify whether the returns would have been achieved.

However, we recognize that there are limited circumstances where back-tested performance data may not be misleading or the risks relating to its use may be mitigated with appropriate disclosure. ICPMs may use back-tested performance data if it is based on actual fund performance (either in a fund-of-funds situation or where a newly created fund follows the same investment strategy of an existing fund) and the following conditions are met:

- **For a newly created fund that follows the same investment strategy of an existing fund.** The actual performance and name of the existing fund is shown separately from the newly created fund's performance, and the newly created fund has the same ICPM as the existing fund.
- **For newly created fund-of-funds or a newly created fund that is based on the investment strategy of more than one existing fund.** Disclose the details about the underlying funds that it invests in and upon which the back-tested performance data is based. This includes the name of each underlying fund and the percentage of the portfolio allocated to each of these funds, provided that the percentage that is invested in each of the existing funds does not change over time.
- **For both situations:**
  - The presentation of the back-tested performance data clearly discloses that the performance data is that of the existing or underlying fund(s) and not the performance of the newly created fund.
  - The actual performance data for the existing or underlying fund(s) that the back-tested performance data is based on is presented for appropriate periods (e.g. 1, 3, 5 and 10 years or since inception). Each of these funds must be in existence for the entire periods presented.
  - Any differences in fees between the newly created fund and the existing or underlying fund(s) are adjusted for and disclosed.

If the back-tested performance data meets the criteria outlined above, the disclosure should be clear and prominent and provide enough detail about the methodology and assumptions used to calculate the back-tested performance data. These are critical in calculating the returns. Failing to disclose them would be omitting information that is integral to making the presentation fair and not misleading. Failure to include this information is contrary to section 2.1 of OSC Rule 31-505.

In addition, the disclosure should clearly state that the performance returns are hypothetical and describe the limitations of the back-tested performance data. For example, ICPMs should disclose that back-tested performance data is hypothetical performance, it is not actual performance returns for the fund and that it was calculated with the benefit of hindsight.

Lastly, the back-tested performance data that satisfies the criteria outlined above should be presented separately from actual performance data. See "Linking performance" below.

b) Model performance data

Model performance data refers to the investment results of a "model" portfolio or "imaginary" portfolio of securities that are presented over a period of time. Most model portfolios are forward-looking in that they use an investment strategy from a point in time going forward and are managed on an ongoing basis (as opposed to applying an investment strategy to historical data).

A model portfolio is often presented as the ideal balance of securities for a particular client's portfolio. ICPMs usually have clients whose portfolios follow the same investment strategy and hold the same securities as the model, but will vary in the percentage held in each security, the timing of purchases and sales, and price per security.

We identified situations where ICPMs presented performance data of a model portfolio instead of the actual performance data for clients. One ICPM presented performance data of a model portfolio but did not have any clients who were following that investment strategy. The ICPM presented the hypothetical performance data of the model portfolio to attract new clients.

Concerns

Our concerns about hypothetical performance also apply to model performance data. In addition, a significant concern with using model performance data is that it is difficult to assess whether it represents actual performance results of existing clients.

Actual performance data may differ from model performance data because:

- Trading costs may not be deducted in the model. If they are deducted, they are estimates and not actual trading costs.
- The trading prices for securities in the model may differ from trading prices in clients' portfolios. The ICPM may not have actually been able to trade at the price used for a given security in the model portfolio, especially for thinly traded securities.
- Model portfolios tend to be fully invested in securities, while actual client accounts typically maintain cash for liquidity. Therefore, the model may have better results than actual results in rising markets and poorer results in falling markets.

Suggested practices

ICPMs should present actual performance data for an investment strategy instead of model performance data. Actual results are more accurate and better reflect the investment strategy's true performance.

In particular, ICPMs should not present the performance data of a model portfolio if no clients are following that investment strategy. If they do, it is misleading because the model performance cannot be verified. For example, there is no way to ensure that the ICPM would have made the same investment decisions in the past or that the securities selected in the model would actually have been traded on a given date at a given quantity and price. This is consistent with an ICPM's obligation under section 2.1 of OSC Rule 31-505 to deal fairly, honestly and in good faith with its clients.

2. Linking performance

ICPMs sometimes link the actual performance data of their investment fund or investment strategy with the performance data of another fund or investment strategy. For example, back-tested performance data of another existing investment fund with a longer track record is presented as the actual performance data of the ICPM's fund, even though the ICPM's fund did not exist for the entire period presented.

In many instances, the performance data of the other existing fund or investment strategy is linked to the actual performance data of the investment strategy or fund in the same table or graph. This may also include performance metrics or risk analysis, such as standard deviation and the Sharpe ratio.

Concerns

Linking these separate sets of performance data in the same table or graph or mathematically is misleading because:

- clients may be misled to believe that the performance data is the actual performance of the fund or investment strategy
- it appears that the fund or investment strategy has a longer track record than it really has
- the performance may not be comparable across time periods, or
- the same method of calculating performance may not have been used for each set of data

Suggested practices

The actual performance data of an ICPM's fund or investment strategy should be presented separately from the back-tested performance data of the other existing fund(s) or investment strategy. It should not be mathematically linked or presented in the same table or graph with the actual performance data of the fund or investment strategy managed by the ICPM. Each graph or chart should be clearly labelled. This will distinguish the actual performance data of the fund or investment strategy from that of the other existing fund(s) or investment strategy.

3. Performance composites

A performance composite is an aggregation or grouping of the performance of one or more client portfolios that represent a similar investment mandate, objective or strategy. ICPMs often use performance composites in reporting performance to prospective clients.

More than half of the ICPMs adopted unsatisfactory practices in the construction and/or presentation of their composites. We identified the following:

- A composite did not include all relevant client portfolios.
- Client portfolios were not consistently included in a composite over time. For example, the historical performance of terminated portfolios was excluded from the composite.
- An inconsistent or inappropriate methodology was used to calculate the performance of a composite. For example, average returns were used instead of asset-weighted returns.
- ICPMs did not have adequate policies and procedures for constructing and presenting composites.
- There was a lack of adequate disclosure about the performance returns of composites. For example, ICPMs did not disclose whether the returns were net of fees, or gross of portfolio management fees and/or other expenses.
- The disclosure claimed that the ICPM complied with the Global Investment Performance Standards (GIPS) of the CFA Institute when it did not.
- Inadequate books and records were maintained to support performance composite data.

Concerns

Each of the issues noted above results in an inaccurate and unfair presentation of performance data. We consider this misleading to clients.

If the composite does not include all client portfolios with a similar investment strategy, there is a risk that the ICPM will “cherry-pick” the portfolios with the best performance returns in order to present the most favourable results. In some instances, we found that ICPMs used one client’s performance to represent the investment strategy instead of presenting the performance returns for a composite.

Also, without a proper process in place over composite construction, composites may be prepared inconsistently or inappropriately. This results in performance data that is not comparable from period to period and is misleading.

Suggested practices

All portfolios that meet the criteria of the composite should be included in the composite. Inappropriately including or excluding portfolios in a composite results in performance returns that do not truly reflect the actual performance of the ICPM’s investment strategy. This improper practice is misleading to clients and contrary to section 2.1 of OSC Rule 31-505.

In addition, composite returns should be calculated by asset-weighting the individual portfolios’ returns.

ICPMs should provide adequate disclosure in their marketing document that explains all the factors that are necessary to make the composite presentation meaningful. For example, the disclosure should:

- clearly outline the investment strategy that is reflected in the composite
- state whether the composite returns are net of fees, or gross of portfolio management fees and/or other expenses, and
- include any other key information about the client portfolios included in the composite, such as:
    - minimum asset level, if any

- use of a sub-adviser, and
- currency used to express performance

Section 1.2 of OSC Rule 31-505 requires ICPMs to establish and enforce written procedures for dealing with clients that conform to prudent business practice and enable the ICPM to serve its clients adequately.

Prudent business practice requires ICPMs to establish policies and procedures for the construction of composites to ensure that they are constructed appropriately and consistently. These policies and procedures should cover how to treat terminated portfolios, new portfolios and portfolios that have changed strategies and switched composites.

4. Benchmarks

A benchmark is a standard against which the performance of an investment strategy managed by an ICPM can be compared or measured. In general, benchmarks are chosen to represent the characteristics of the investment strategy and help to measure its degree of success.

More than half of the ICPMs we reviewed were deficient in the presentation and use of benchmarks. We identified the following:

- Benchmarks were not:
  - comparable to the fund or investment strategy
  - widely recognized and/or available
  - presented in the same currency or on the same basis as the fund or investment strategy (e.g. total return vs. return without reinvested dividends).
- There was inadequate disclosure about the use of a benchmark. For example, there was no disclosure of the name of the benchmark or inadequate disclosure regarding the composition of a blended benchmark.
- Inadequate books and records were maintained to support benchmark data. For example, there was no evidence to support calculations in the case of a blended benchmark.

Concerns

Presenting an inappropriate benchmark does not result in a meaningful comparison. As a result, the wrong conclusions could be drawn or implied by it. For example, compared to the benchmark, the performance of a fund or investment strategy may appear better than it really is.

Suggested practices

ICPMs should compare their performance returns against a relevant benchmark. That is, there should be a connection between the investment strategy and the benchmark used.

The benchmark's full name should be disclosed and the components of a blended benchmark should be clearly disclosed (e.g. 40% S&P/TSX Composite Index and 60% S&P 500 Index).

However, in limited instances, an ICPM may want to compare performance returns against a benchmark that has a different composition than its investment strategy. For example, an ICPM may compare its investment strategy to the S&P/TSX Composite Index because the index is widely known and followed.

If the ICPM's investment strategy is not similar to that of the benchmark and the benchmark is widely known and followed, adequate disclosure is necessary to explain the relevance of the use of this benchmark. This should include a discussion of the differences between the benchmark and the investment strategy of the ICPM. This disclosure would make the comparison fair and meaningful for clients.

In addition, as a best practice, paragraph 15.3(1)(a) of NI 81-102 provides that a sales communication shall not compare the performance of a mutual fund with the performance of a benchmark unless it includes all facts, that if disclosed, would be likely to alter materially the conclusions reasonably drawn or implied by the comparison. Paragraph 15.3(1)(c) of NI 81-102 provides that the sales communication must explain any factors necessary to make the comparison fair and not misleading.

5. Exaggerated and unsubstantiated claims

Exaggerated and unsubstantiated claims are statements and claims made by ICPMs in marketing materials without evidence to support these claims. These claims often relate to the ICPM's performance, skills, education, portfolio management experience or services.

For example, we identified claims of "superior performance" that were unsubstantiated or where the actual performance of the fund or investment strategy was lower than the returns of a comparable benchmark. We also found claims that the ICPM was a "leading expert" in a particular area without sufficient evidence to support this claim.

Two-thirds of the ICPMs reviewed used these types of claims.

Concerns

Exaggerated claims are misleading to clients because they do not accurately reflect the ICPM's actual performance, skills, education, experience or services. In addition, investors may base their decision to contract the services of an ICPM on inaccurate information.

Suggested practices

ICPMs should be able to substantiate all claims made in their marketing materials. They should reference the information supporting the claim where the claim is made in the marketing material so that clients can easily assess it. ICPMs should ensure that all claims accurately reflect their performance, skills, education, portfolio management experience and services. This is consistent with their obligation under section 2.1 of OSC Rule 31-505.

In addition, there are provisions in the Securities Act (Ontario) (the Act) that deal with specific types of claims made by a registrant. ICPMs should also follow these provisions in the preparation of marketing materials. For example, subsection 38(2) of the Act states that no person or company, with the intention of effecting a trade in a security, shall give any undertaking relating to the future value or price of the security. Section 45 of the Act provides that an unregistered person or company cannot hold himself/herself or itself out as being registered.

Other marketing-related deficiencies

We identified other deficiencies in the preparation and use of marketing materials, including:

Lack of appropriate policies and procedures

One-third of the ICPMs did not have appropriate policies and procedures dealing with marketing activities or had policies and procedures that did not reflect their actual marketing practices. The majority of these ICPMs had an inadequate process for reviewing and approving their marketing materials.

Section 1.2 of OSC Rule 31-505 requires registrants to develop and enforce written procedures for dealing with clients that conform to prudent business practice and enable them to serve clients adequately. These policies and procedures should be in sufficient detail and cover all aspects of the ICPM's marketing activities, from preparing the materials to reviewing and approving them.

Suggested practices

ICPMs should develop and enforce written policies and procedures that are tailored to their specific marketing activities. At a minimum, the policies and procedures should include guidelines on:

- preparing and reviewing marketing materials to prevent false or misleading statements and to ensure compliance with securities legislation
- having marketing materials approved by an appropriate person
- preparing performance data to be used in marketing materials
- constructing and presenting performance composites, including:
    - composite definitions
    - calculation methodologies

    - valuation policies
    - treatment of new and terminated portfolios
    - treatment of large cash flows

- selecting and presenting benchmarks

Outdated or incorrect information

More than one-third of ICPMs were deficient in this area. In some instances, the marketing materials contained outdated information (e.g. firm's website contained outdated performance returns or information about the ICPM itself). In other instances, marketing materials contained errors (e.g. errors in performance returns presented).

As described above, section 1.2 of OSC Rule 31-505 requires registrants to develop and enforce written procedures for dealing with clients that conform to prudent business practice and enable them to serve clients adequately.

Suggested practices

ICPMs should ensure that their marketing materials contain accurate and up-to-date information. As described above, implementing a process for independent review and approval of marketing materials can help eliminate errors in marketing materials. In addition, regular review of an ICPM's website can help to ensure that the content is up-to-date.

Our response

We sent compliance deficiency reports to each of the ICPMs we reviewed. Each ICPM was required to provide a written response to the deficiencies identified in our report within 30 days.

We are working directly with these ICPMs to help them understand our concerns with the issues identified with their marketing practices. We will continue to proactively work with them to ensure that deficiencies are resolved appropriately within a reasonable time frame. If they do not resolve their deficiencies, we may take further action, such as imposing terms and conditions on their registration, conducting follow-up reviews or referring the matter to the OSC's Enforcement Branch.

Next steps

We will continue to review the marketing practices of market participants during our regular field reviews. While the provisions in Ontario securities law dealing with marketing practices are broad in nature, the suggested practices described in this notice are intended to provide guidance to market participants on how we expect them to apply these provisions. The suggested practices are the guidelines that Compliance staff will apply in assessing and monitoring the compliance of marketing practices with Ontario securities law.

We encourage market participants to use this notice to help them enhance their marketing practices. In the meantime, we will continue to gather more information and consider whether any further guidance to the industry in this area is necessary.

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