Hypothetical Performance Advertisements May Create Real Compliance Problems

February 8, 2022

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On January 13, 2022, the SEC settled an enforcement action brought against a Registered Investment Advisor ("RIA") in Malvern, Pennsylvania. The SEC alleged that the RIA failed to adopt and implement policies and procedures that are reasonably designed to prevent false or misleading advertisements. According to the SEC, those policies and procedures were inadequate in relation to the RIA's hypothetical, backtested performance of the firm's algorithmic strategies. Those policies and procedures were also inadequate because they failed to preserve certain advertisements that promoted the firm's trading strategies.

Backtested performance returns must be consistent with live versions of the strategy

The SEC determined that the RIA advertised hypothetical, backtested performance results for its opportunistic all asset strategy without disclosing certain dissimilarities between the funds and other products used

in the backtest and the funds included in the “live” version of the strategy. The backtest and the live strategy utilized different securities when constructing a model portfolio. Furthermore, certain funds used in the backtest were not adequately correlated with the securities they replaced in the live strategy.

The RIA maintained written policies and procedures that required the firm to comply with the SEC’s rules applicable to advertising. Unfortunately, the RIA failed to adopt and implement policies or procedures governing the preparation, presentation, and disclosure of hypothetical, backtested performance returns. This failure created a risk that the firm’s advertising of backtested results would incorporate an untrue statement of a material fact or might be otherwise false or misleading.

In addition, the RIA failed to preserve copies of the advertisements marketing its strategy, which were distributed to prospective clients between January 2016 and June 2016. During that time frame, the RIA prepared “tear-sheets” that advertised historical performance returns for the firm’s strategy. These advertisements were posted on the RIA’s public website and were provided to third-party advisors.

The SEC concluded that the RIA violated Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder. The RIA’s failure to preserve certain advertisements violated Section 204(a) of the Investment Advisers Act and Rule 204-2(a)(11) thereunder.

Without admitting or denying the findings, the RIA agreed to a cease-and-desist order, as well as censure. Furthermore, the RIA agreed to pay a civil penalty of $70,000. The enforcement action is available here.

New Marketing Rule’s application to hypothetical, backtested performance

Although this enforcement action was brought under the prior Advertising Rule, it is helpful to look at the requirements for hypothetical, backtested performance under the new Marketing Rule. The new rule establishes a compliance date of November 4, 2022.

“Hypothetical performance” refers to results that were not actually achieved by any portfolio of the RIA. Hypothetical performance specifically includes but is not limited to model performance, backtested performance, and targeted or projected performance returns.

Although hypothetical performance can potentially mislead investors, its use is permitted in advertisements under certain conditions. Before advertising hypothetical performance, an RIA must:

- Adopt and implement policies and procedures that are reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement;
- Provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the

hypothetical performance; and
- Provide sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

Policies and procedures should ensure that the RIA’s advertisements are accompanied by robust disclosures to keep them from being misleading. When the intended audience is an investor in a private fund, the RIA only has to offer to provide sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

The new Marketing Rule does not apply to certain hypothetical performance presentations:

- Communications containing hypothetical performance returns when given in response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the advisor; or
- Communications containing hypothetical performance returns when given to a prospective or current investor in a private fund are advised by the advisor in one-on-one communication.

Even if communications containing hypothetical performance returns do not fall within the purview of the new Marketing Rule, they are still subject to the general antifraud requirements of the Investment Advisers Act.

Conclusion

As RIAs make the transition to the new rule, examiners will be scrutinizing firms’ advertisements, whether or not they include hypothetical, backtested performance results. Although this enforcement action was based upon the old Advertising Rule, there are valuable lessons that can be applied when the new Marketing Rule’s compliance date arrives.

As before, the new Marketing Rule requires RIAs to make and keep true, accurate, and current copies of advertisements in accordance with the Books and Records Rule. RIAs must retain thorough and complete books and records to support the performance presented, including calculation information.

RIAs that advertise hypothetical, backtested performance are unlikely to stay under the SEC’s radar. As part of the new Marketing Rule, the SEC added an item to Form ADV that requires the RIA to state whether any of its advertisements include hypothetical performance. According to the Adopting Release, this information is useful for examiners when preparing for examinations, especially considering that hypothetical performance can pose a heightened risk of misleading investors.