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GPS INSIGHTS

LESSONS TO BE LEARNED FROM SEC ENFORCEMENT CASES RELATING TO PERFORMANCE ADVERTISING & MODEL RETURNS

The Securities and Exchange Commission (SEC) continues to scrutinize performance presentations that include hypothetical model or backtested returns. A number of enforcement actions have been initiated in recent years that involve investment advisers who advertise such performance results, two of which are summarized below.

While each enforcement action has unique facts and circumstances, there are clearly lessons that other investment advisers can learn to help them avoid putting themselves in a similar situation.

CASE STUDY

AUGUST 2012, the SEC alleged an adviser fraudulently misrepresented performance of a mutual fund allocation program.[i] More specifically, the SEC indicated that the adviser blended hypothetical performance data with actual performance to create five-year, seven-year and since inception annualized returns and did not provide adequate explanation that the performance represented a blend of hypothetical performance data with actual returns. In addition, it was noted that the adviser labeled the blended actual and hypothetical returns as "historical performance," which suggested the entire set of data represented actual performance.

In addition, one of the adviser's employees misrepresented themselves as a CFA charterholder and the examination staff noted that the adviser should have independently verified the validity of the credential. The adviser relied on an email that the employee forwarded to the firm's human resources and compliance departments. The SEC indicated that the employee fabricated the email which appeared to be from CFA Institute congratulating the employee for passing the CFA Level III exam. In reality, the employee actually failed the CFA Level I exam the first and only time he took it. The adviser referenced this employee's falsified CFA designation in firm marketing materials and responses given in RFPs, while the employee used the designation in emails and on business cards.

Update:
JUNE 2013, the SEC charged the adviser's (former) employee with aiding and abetting violations of the Advisers Act's antifraud rules. Specifically, indicating that the (former) employee, "…owed a duty to exercise the utmost good faith in dealing with clients, a duty to disclose all material facts, a duty to employ reasonable care to avoid misleading clients, and a duty to disclose all conflicts of interest."[iii] Clearly, the SEC feels that it is not only the RIAs responsibility to make full disclosure but also the investment adviser representative as well.

CONSIDERATIONS

- When presenting model or hypothetical performance, advisers should clearly describe that performance is not based on the management of actual assets. Each page within a presentation that includes performance should include adequate disclosure to explain what the performance presented represents.
- Ensure the font size of the disclosures is large enough to be legible. Compare the font size used for the content on each slide and to the size of the font used for the disclosures to confirm reasonableness.
- Although not explicitly prohibited under the SEC advertising rules, firms should not link model and actual performance given the potentially misleading nature of the practice. (Note that firms claiming compliance with the Global Investment Performance Standards (GIPS®) are explicitly prohibited from linking model and actual results).
- Firms with supervised persons who hold and use specific credentials such as CFA or CFP should not solely rely on the information provided by supervised persons supporting the legitimacy of a credential. Firms should take reasonable steps to verify credentials. Often this can be done by simply searching membership directories available online. For example, CFA Institute and the Certified Financial Planner Board of Standards (CFP Board) provide access to member directories through their website to verify credentials. Advisers can also call the organization directly to verify credentials if not available online.

CASE STUDY

DECEMBER 2012, the SEC announced settlement of charges against an adviser and its owner for circulating misleading performance reports to clients and prospects.[iii] More specifically, the SEC claims the firm provided clients or prospective clients with reports generated using Morningstar® Principia® ("Principia") software. Among other things, the Principia reports outlined historical model performance and risk statistics for the adviser's equity and fixed income models and compared the results to applicable benchmarks. The results were generated by inputting the current investments of one of the firm's models into the Principia software and analyzing how the model would have performed had the model held its current holdings for the entire time period. It was alleged that the models did not exist throughout the entire time period and when the models did exist the models' holdings changed over time. The SEC also noted that the firm's model performance reports did not disclose that the model results portrayed were based on hypothetical, not actual, results.

In addition, it was alleged that the firm failed to implement adequate written policies and procedures relating to performance advertising.

CONSIDERATIONS

- Rule 206(4)-1(a)(5) prohibits advertisements that "contain any untrue statement of a material fact, or which is otherwise false or misleading." While the rule does that specify the exact disclosures that must be included when presenting model or hypothetical performance, there are numerous enforcement cases and no-action letters (such as the famous letter to Clover Capital Management[iv]) that investment advisers can refer to for guidance. In any event, when presenting model or hypothetical performance results firms must ensure that the disclosures are robust enough to dispel the misleading suggestion that the performance represents actual trading.
- Backtested performance results produced by retroactively applying a particular investment strategy or model using historical financial data are viewed differently by regulators than model results that are produced on a go-forward basis. The SEC staff considers hypothetical backtesting as highly suspect since performance was derived from the retroactive application of a model developed with the benefit of hindsight, rather than through actual real-time decision making. Not surprisingly, backtested results tend to have a bias toward outperformance. Because of their potentially misleading nature, backtested returns should only be presented to sophisticated (i.e. non-retail) clients. In addition, the disclosures should not be buried in small text at the back of the pitch book or flash report.
- Investment advisers should not solely rely on the standard disclosures that are automatically generated from the system or software of a third-party vendor as these disclosures may not address all of the requirements of Rule 206(4)-1 of the Advisers Act—"the Advertising Rule." The rule is written very broadly and the disclosures that firms need to make are often based on the facts and circumstances of the information presented and methodology used to construct the performance results.
- It is important to adopt performance advertising policies and procedures specific to the types of materials and media used at the firm. Firms who present model or hypothetical performance should have documented policies and procedures for the use of such results.

- Adequate training should be provided regarding performance advertising requirements so staff understand what is prohibited. While it's important to make sure the firm's materials include required disclosure, it is equally important for the adviser's employees not to mislead clients or prospective clients when explaining the information presented in the materials.

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i www.sec.gov/litigation/admin/2012/34-67773.pdf
ii www.sec.gov/litigation/admin/2013/34-69816.pdf
iii www.sec.gov/litigation/admin/2012/ia-3516.pdf
iv www.sec.gov/divisions/investment/noaction/clovercapital102886.htm

ABOUT GPS

Guardian Performance Solutions is a specialty compliance consulting firm dedicated to providing customized solutions to the investment management industry with the objective of assisting advisers to create compliant performance advertising materials. We help investment advisers achieve their goals of marketing their services and growing their business, while also meeting their regulatory obligations and adhering to industry accepted standards and best practices.

One of our focus areas is helping asset managers to implement GIPS® compliance programs. Because we don't provide verification services, we are free from independence concerns and can take a hands-on approach to developing and managing the GIPS compliance process. Additional information can be found at www.GuardianPerformanceSolutions.com.