

RECENT SEC ACTIONS HIGHLIGHT ADVISER RESPONSIBILITIES WITH RESPECT TO PERFORMANCE ADVERTISING

Date: 5 January 2016

Investment Management Alert

By: Richard F. Kerr, Kenneth G. Juster, Michael W. McGrath

In a series of recent administrative proceedings, the Securities and Exchange Commission (the "SEC") has clarified its expectations regarding the use of performance data in investment adviser advertisements.^[1] Specifically, these proceedings highlight the SEC's views that:

1. Hypothetical or back-tested performance data should not be based on assumptions when actual historical data is available;
2. Investment advisers should maintain adequate backup for performance claims made in their advertisements, including claims based on information provided by third parties;
3. Disclosure that performance data is hypothetical or back-tested should be complete and prominently displayed with the performance data; and
4. The prohibition on past specific recommendations in advertising material contained in Section 206(4)-1(a)(5) of the Advisers Act, as modified by SEC guidance, continues to be an important investor protection tool the violation of which is subject to SEC enforcement.

These proceedings highlight the importance of ensuring that an investment adviser's advertising — and performance advertising in particular — is presented in a manner consistent with the Investment Advisers Act of 1940, the rules thereunder, and related guidance published by the SEC and its staff.^[2]

THE LUCIA MATTER

In the first matter, *In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.* (the "**Lucia Matter**"), the SEC affirmed a 2013 decision^[3] by an administrative law judge sanctioning Raymond J. Lucia Companies, Inc. ("**Lucia**") and its principal, Raymond J. Lucia Sr., for allegedly using misleading performance data that was labeled as back-tested data. Among other things, the SEC found that Lucia had used performance data labeled as back-tested data that was based on certain assumptions rather than historical rates of inflation and historical rates of return, did not deduct advisory fees or clarify that they were not accounted for, and failed to calculate the data in a manner that fully followed the investment strategy which the performance data was designed to support.

The use of back-tested performance in investment adviser advertisements has always been subject to several requirements articulated by the SEC in connection with various no-action requests and administrative proceedings, including requirements that (i) the calculation methodology be fully described, (ii) the performance

be presented net of fees or the effect of fees be disclosed, and (iii) the performance not be otherwise misleading.^[4] The ruling in the Lucia Matter provides additional parameters that registrants need to consider prior to utilizing similar advertisements that back-tested data presented by an investment adviser must be (i) based on actual historical data rather than assumptions, and (ii) calculated in a manner fully consistent with the investment strategy that the back-tested data is used to advertise.

Practice Tip: The SEC has publicly indicated its views on the ability of an adviser to calculate back-tested performance based on assumptions — even reasonable assumptions that do not result in misleading performance numbers — when observed data is available.

THE VIRTUS MATTER

In the second matter, *In the Matter of Virtus Investment Advisers, Inc.* (the "**Virtus Matter**"), the SEC instituted and settled proceedings against Virtus Investment Advisers, Inc. ("**Virtus**") based on, among other things, its inclusion in advertisements and filings of allegedly false and misleading performance data that had been provided to it by one of its third-party sub-advisers, F-Squared Investments, Inc. ("**F-Squared**").^[5] In the order, the SEC acknowledged that F-Squared and its President had lied to Virtus about the history and performance of F-Squared's AlphaSector strategy, but alleged that Virtus had relied on F-Squared's representations without properly verifying them. In addition, based on statements made by Virtus in advertisements and filings, which were based on the representations made by F-Squared to Virtus, the SEC alleged that Virtus itself made false and misleading statements about the past performance of the AlphaSector strategy.^[6]

The Virtus Matter is an important statement from the SEC of its views that each investment adviser is ultimately responsible for verifying the accuracy of any performance data presented in its advertisements and should adopt and implement procedures reasonably designed to do so. With this ruling, the SEC has indicated its views that this obligation is equally true of an investment adviser operating in a manager-of-managers structure or otherwise relying on information provided by third parties to produce its performance data.

Practice Tip: Advisers should be cognizant of the basis for the SEC's allegations in this case: the failure to retain books and records necessary to support the basis for unaffiliated third-party performance information in advertisements. An investment adviser must have adequate backup for performance claims made in its advertisements, including claims based on information provided by third parties.

THE ALPHA FIDUCIARY MATTER

In a third matter, *In the Matter of Alpha Fiduciary, Inc., and Arthur T. Doglione and In the Matter of Michael L. Shea*, the SEC instituted and settled proceedings against Alpha Fiduciary, Inc. ("**Alpha Fiduciary**") and its owner, manager, and president, Arthur T. Doglione, and separately against Alpha Fiduciary's former business development director, Michael L. Shea, for, among other things, distributing advertisements that failed to disclose in sufficient prominence and detail that the performance data was hypothetical and not actual performance.^[7] The SEC also alleged that Alpha Fiduciary's advertising materials included past specific recommendations in violation of SEC rules by including examples of investment decisions without providing or offering to provide all investment decisions made during the same period.

Practice Tip: Notably, Alpha Fiduciary provided general disclosure in certain advertisements that the performance was hypothetical, but the SEC asserted that this disclosure was imprecise, in many cases not

included on the same page as the performance data, and inconsistent with other statements that suggested the performance of the advertised strategy represented actual returns. Advisers that elect to present hypothetical performance should consider not only whether they have disclosed that the performance is hypothetical, but also whether this disclosure is complete and prominent.

NEXT STEPS AND HOW WE CAN HELP

Each of these matters reinforce the notion that the SEC is focused on assuring investment advisers provide investors with performance disclosure that is not false or misleading and that it is willing to pursue enforcement actions where necessary to deliver this message. Investment advisers using back-tested or otherwise hypothetical performance data in marketing materials, or relying on performance data provided by third parties, should consider reviewing their policies and procedures in light of the actions taken by the SEC in these matters.

If you have any questions regarding these matters or the presentation of performance in investment adviser advertisements, please contact any of the authors listed below, or one of the K&L Gates attorneys with whom you work.

Notes:

[1] Investment adviser advertising is generally subject to the anti-fraud provision of the Investment Advisers Act of 1940, as amended, found in Section 206 and Rule 206(4)-1 thereunder, which generally prohibit an investment adviser from publishing an advertisement that contains an untrue statement of material fact or that is otherwise false or misleading.

[2] The importance of transparent advertisements and knowledgeable compliance staff is evidenced by the frequency of enforcement actions related to advertising and the inclusion of advertising compliance as one of the SEC staff's examination priorities in each of the last three years. See SEC Office of Compliance Inspections and Examinations ("OCIE"), [*Examination Priorities for 2015 \(January 13, 2015\)*](#); [*OCIE, Examination Priorities for 2014 \(January 9, 2014\)*](#); [*OCIE, Examination Priorities for 2013 \(February 21, 2013\)*](#). See also, e.g., [*In the Matter of F-Squared Investments, Inc.*](#), Investment Advisers Act of 1940, Release No. 3988 (Dec. 22, 2014); [*In the Matter of Strategic Capital Group, LLC and N. Gary Price*](#), Investment Advisers Act of 1940, Release No. 3924 (Sept. 18, 2014); [*In the Matter of Navigator Money Management, Inc. and Mark A. Grimaldi*](#), Securities Act of 1933, Release No. 9521 (January 30, 2014); [*In the Matter of ZPR Investment Management, Inc. and Max E. Zavanelli*](#), Investment Advisers Act of 1940, Release No. 3574 (April 4, 2013).

[3] See [*In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.*](#), Administrative Proceeding File No. 3-15006 (Dec. 6, 2013).

[4] See, e.g., [*In re Schield Management Company et al.*](#), Investment Advisers Act Release No. 1872 (May 31, 2000); [*In re Meridian Investment Management Corp. et al.*](#), Investment Advisers Act Release No. 1779 (Dec. 28, 1998); [*In re LBS Capital Management, Inc.*](#), Investment Advisers Act Release No. 1644 (July 18, 1997); [*In re Patricia Owen-Michel*](#), Investment Advisers Act Release No. 1584 (Sept. 27, 1996).

[5] See [*In the Matter of Virtus Investment Advisers, Inc.*](#), Investment Advisers Act of 1940 Release No. 4266 (Nov. 16, 2015).

[6] F-Squared was the subject of a separate administrative proceeding regarding hypothetical and back-tested performance brought by the SEC in 2014 related to the AlphaSector strategy.

[7] See *In the Matter of Alpha Fiduciary, Inc., and Arthur T. Doglione*, Investment Advisers Act of 1940 Release No. 4283 (November 30, 2015); see also *In the Matter of Michael L. Shea*, Investment Advisers Act of 1940 Release No. 4284 (November 30, 2015).

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.