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Circuit Court Affirms SEC's Expanded Views on Backtested Performance

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On August 9, 2016, in the first court decision directly interpreting and addressing the use of backtested performance by an investment adviser, the United States Court of Appeals for the District of Columbia Circuit declined a petition for review of the decision of Securities and Exchange Commission (“SEC”) in *In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.*¹ In denying the petition for review, the court left standing the SEC’s imposition of sanctions for violations of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and Rule 206(4)-1(a)(5) thereunder, which prohibit the publication or distribution of any advertisement that contains any untrue statement of material fact or that is otherwise false or misleading.²

Background

The court affirmed the SEC’s findings that Raymond J. Lucia Companies, Inc., a registered investment adviser, and its owner, Raymond J. Lucia, Sr., made misrepresentations in various presentations at free retirement-planning seminars. According to the SEC, the investment adviser and its owner advocated a “Buckets-of-Money” investment strategy, which called for spreading investments among several types of assets, by using a slideshow to illustrate how the strategy would have performed in the past relative to other common strategies.

The court found substantial evidence to support the SEC’s findings that, among other things, the investment adviser and its owner misled prospective investors at free retirement planning seminars by stating that they were “backtesting” the Buckets-of-Money investment strategy. Rather than relying exclusively on historical data, the actual calculation relied on a mix of historical data and assumptions regarding the inflation rate and the rate of return on real estate investment trusts (that the SEC found to be flawed). The court also affirmed the SEC’s findings that the hypothetical performance showing how the strategy would have performed during historical periods was not calculated in a manner fully consistent with the Buckets-of-Money strategy they were advertising. Finally, the court affirmed the lifetime industry bar on Mr. Lucia, Sr., citing the SEC’s conclusions that his conduct “violated a fiduciary duty he owed to his prospective clients . . . over the course of dozens of seminars” and that “even without investor injury as an aggravating factor, [his] misconduct was egregious.”

¹ See *In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.*, Investment Advisers Act of 1940 Release No. 4190, Admin. Proceeding File No. 3-15006 (SEC September 3, 2015). The SEC’s decision was previously discussed in our client alert titled “Recent SEC Actions Highlight Adviser Responsibilities with Respect to Performance Advertising” (January 5, 2016), <http://www.klgates.com/recent-sec-actions-highlight-adviser-responsibilities-with-respect-to-performance-advertising-01-05-2016/>

² In the first ruling directly addressing this question, the court also affirmed the constitutionality of the SEC’s administrative law judges.

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Key Takeaways

1. *The SEC Has Expanded Its Views on the Use of Backtested Performance.* The court affirmed the SEC's now-public view, which was initially set forth in its decision on this matter, that the term "backtested" will be understood to mean that performance is calculated based on actual historical data rather than hypothetical assumptions (even reasonable assumptions that do not result in misleading performance numbers).
2. *The Backtest Should Match the Strategy.* Any backtested performance should be calculated in a manner fully consistent with the investment strategy that the backtested data is used to advertise.
3. *Disclaimers May Not Cure Otherwise Misleading Statements.* The presentations in question had disclaimers stating that a particular backtest would utilize some hypothetical assumptions, a point recognized by both the SEC and the court. However, the court affirmed the SEC's finding that prospective investors would have understood the presentation as showing actual historical data rather than hypothetical assumptions, primarily because the presentations also introduced historical illustrations of how the Buckets-of-Money strategy would have performed during certain periods. In affirming the SEC's decision, the court found substantial evidence that "the overall impression" that the presentation materials had on prospective investors was misleading, notwithstanding the existence of the disclaimers.

Next Steps

The court's decision lends support to, and further emphasizes the importance of, the SEC's recent focus on ensuring that performance disclosures are not false or misleading. Investment advisers should review their performance presentations and their calculation methodologies to confirm that any performance presentations labeled as "backtested" are calculated in a manner fully consistent with the strategy being advertised and do not contain assumptions that are inconsistent with historical observations. The decision is also a reminder that advisers should not rely on disclaimers to cure statements that otherwise create a misleading impression.

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.

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