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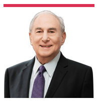
Court Upholds SEC on “Backtested” Investment Strategy Illustrations

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS | SECURITIES AND DERIVATIVE LITIGATION | DECEMBER 22, 2016



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An investment adviser seeking to show how a particular investment strategy would have performed during specified time periods would be well advised to:

- use only historical performance data and not a mix of historical data and hypothetical assumptions and
- reflect all aspects of the investment strategy and not omit the impact of any key aspect of the strategy.

These are the lessons of *Lucia v. SEC* , an August opinion of the D.C. Circuit Court of Appeals upholding an SEC decision that an adviser violated the anti-fraud provisions of Section 206 of the Investment Advisers Act and the SEC’s advertising Rule 206(4)-1(a)(5) thereunder.

The case, which involved an adviser’s free seminars on retirement planning, clarifies what is required for so-called "backtesting" illustrations. The adviser purported to show prospective clients that the adviser’s investment strategy was superior to others in allowing retirees to live comfortably off their investment income while also leaving a large inheritance.

The adviser showed slides that it claimed "backtested" the strategy. But the SEC found they overstated the strategy’s success by understating historical inflation rates, overstating historical investment return rates, and, contrary to the strategy, using an artificially high percentage of assets invested in stocks during a period of favorable stock market performance.

The SEC concluded that had the adviser used only historical data and reallocated assets as the strategy required, the illustrations would have revealed the strategy had run out of assets, not grown as advertised.

The court upheld the SEC in rejecting the adviser’s defense that the slides contained disclaimers disclosing that the "backtesting" illustrations were based on certain assumptions. Rather, such disclaimers did not alter the erroneous "overall impression" conveyed by the adviser that the "backtests" showed how the strategy would have performed.