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Hypothetically Speaking

We are approaching the one-year anniversary of the official launch of the SEC Marketing Rule ("Rule") (November 4). It introduced massive changes to the advertising rule; one of the major being that GIPS® reports are now advertisements.

For years, the SEC was rather tolerant of firms using model, back-tested, and other forms of what has been labeled "hypothetical performance." Yes, there have been many instances when fines were levied, but in general firms could freely use hypothetical returns.

Steve Stone, Esq. of Morgan Lewis and I did a talk at the annual GIPS conference more than ten years ago that spoke to this topic, and we strongly advised firms to ensure the language they used to accompany such performance was sufficiently clear to alert the reader what the numbers actually represented.

For some unknown reason, with the introduction of its 2020 version, the GIPS standards decided to introduce a totally new term: "theoretical performance," which the glossary defines as "Performance that is not derived from a portfolio or composite with actual assets invested in the strategy presented. Theoretical performance includes model, backtested, hypothetical, simulated, indicative, ex ante, and forward-looking performance." The SEC and many others think of this as simply "hypothetical performance," and that is the term we will use.

One of the categories the Rule has for hypothetical is "extracted performance," and the GIPS standards' carve-out option fits into this grouping.[1]

For years (decades), it was acceptable for firms to showcase their performance using hypothetical returns. The problem was that either the advertising materials failed to provide clear disclosures that these numbers were not real, or the recipients simply didn't fully comprehend this. I testified a few years ago against an advisor who used back-tested results, that arguably masqueraded as actual results (not to mention other advertising misdeeds). [2]

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I recall an interview the motivational speaker Tony Robbins conducted with an author who explained that if investors, over the past X years, properly timed the market, so that they moved in and out of cash, bonds, and equities at just the right moment, their returns would have been massive. The key word:

IF

The ability for someone to actually do this is virtually non-existent, and not worthy of consideration. That said, if advisors speak with prospects in language that makes similar suggestions, we have a case of deception.

And so, the SEC's tolerance for this gave out, and the Marketing Rule has introduced some pretty stringent requirements, which we have addressed previously, but are worthy of doing so again.

First, there is a section devoted to this topic starting on page 200 of the Rule; anyone producing or showcasing such returns needs to become very familiar with this section.

The first sentence in this section should be sufficient to be a clear warning: "The final rule will prohibit an adviser from providing hypothetical performance in an advertisement, unless the adviser takes certain steps to address its potentially misleading nature."

The SEC is kind enough to tell us what these steps are:

- "the adviser adopting policies and procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the advertisement's intended audience"

- "We intend for advertisements including hypothetical performance information to only be distributed to investors who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitations of these types of presentations,"

A recent event motivated us to touch on this topic, again. As it's critically important for advisers to understand the risks they have of failing to properly adhere to the Rule, in terms of hypothetical performance.

The U.S. Securities & Exchange Commission announced in a September 11, 2023 press release[3] that it has **imposed fines totaling US$850,000 against nine investment advisors.**[4]

These fines deal with the advisors' use of hypothetical performance.

Key takeaways:

1. The SEC is quite serious about these new rules. You obviously will be fined if you fail to properly adhere to the Rule.
2. Do not, under any circumstance, have such returns on your website, where you cannot control who will see them.
3. Have detailed, written policies and procedures that speak to your handling of such performance, and how you ensure that recipients meet the requirements of the Marketing Rule.

4. Only provide such performance to investors who have the ability to properly understand and interpret what you provide, and the associated risks. You should probably document who gets them and be prepared to explain why you feel they were qualified to receive them under the Rule.
5. Ensure you provide detailed disclosures, that make it clear what is actually being shown.

If you produce and report performance that fits into the broad category of "hypothetical performance," be cautious, become very familiar with the Rule's requirements, review the press release, and ensure you are properly adhering to the SEC's mandate.

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1. Firms using the carve-out guidance under the GIPS standards are required to create carve-outs from all portfolios that are managed to that strategy and include them in the composite. In most instances, this will result in a carve-out composite with more than one portfolio of extracted performance, which is considered hypothetical under the Rule.
2. Despite my best efforts, the SEC has yet to fine this advisor. Oh, well.
3. http://www.sec.gov/news/press-release/2023-173
4. We thank K&L Gates for their recent summary about this matter: http://tinyurl.com/8zwb6h9h

TSG'S 2023
INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
October 25, 2023	Addressing Performance Measurement Analysis Challeges with Alternatives	Webinar
November 9-10, 2023	Performance Measurement Forum	Porto, Portugal
November 29, 2023	Asset Owner Roundtable	Orlando, FL
November 30 - December 1, 2023	Performance Measurement Forum	Orlando, FL

For additional information on any of our 2023 events, please contact Patrick Fowler at 732-873-5700.