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The SEC’s New Marketing Rule – Practically Speaking: Hypothetical Performance

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In December 2020, the Securities and Exchange Commission (SEC) finalized amendments to its advertising and solicitation rules under the Investment Advisers Act of 1940, as amended. Those finalized amendments merged the Advisers Act’s current advertising rule (Rule 206(4)-1) with the cash solicitation rule (Rule 206(4)-3) under a new rule: Rule 206(4)-1, the Investment Adviser Marketing rule.

SEC-registered investment advisers (RIAs) must comply with the new marketing rule by November 4, 2022.

Commentary going back to December 2020 has explained what the new marketing rule says. But considerably less commentary has explained what, practically speaking, RIAs should be doing to ensure their marketing efforts, documents, systems, and procedures comply with the new marketing rule.

This is one of five “Practically Speaking” alerts providing succinct and practical high-level guidance from our attorneys regarding five aspects of the new marketing rule that we see as most impactful on RIAs’ marketing efforts.

Hypothetical Performance

Overview

The new marketing rule’s guidelines for performance advertising allows including hypothetical performance in certain circumstances.

The new rule defines “hypothetical performance” as performance results that were not actually achieved by any portfolio of an RIA. Such performance includes, but is not limited to, model performance, backtested performance, and targeted or projected performance returns.

The new rule allows RIAs to present hypothetical performance in their advertisements, so long as an RIA:

1. Institutes policies and procedures reasonably designed to ensure any hypothetical performance included in an advertisement is relevant to the intended audience’s likely financial situation and investment objectives;
2. Enables the intended audience, by providing enough information in its advertisement, to understand the criteria used and assumptions made in calculating the hypothetical performance; and

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3. Enables the intended audience, by providing (or, if the intended audience is a private fund investor, provides or offers to provide promptly,) enough information in the advertisement, to understand the risks and limitations of using such hypothetical performance in making investment decisions.

However, the SEC noted that it believes RIAs "generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation," because RIAs would have trouble forming expectations about the recipients' financial situations or investment objectives.

Practically Speaking, What Now?

The new marketing rule's guidelines for including hypothetical performance in advertisements under certain conditions is one of the biggest changes the rule brings to RIAs' advertising efforts. Before the rule, inclusion of such information was viewed skeptically by the SEC, as managers may have been incentivized to overstate their hypothetical performance results.

Though the new rule should provide comfort to RIAs about including hypothetical performance in their post-November 4, 2022, advertisements, there are some considerations legal, compliance, and marketing personnel at RIAs who have not yet adopted the new Rule should keep in mind when reviewing (and revising) their pre-November 4, 2022 marketing materials for continued use in a compliant manner under the rule, and/or when creating new compliant materials:

1. Ensure your compliance policies and procedures properly identify all performance that could be deemed hypothetical, particularly where the new rule diverges from Global Investment Performance Standards (GIPS) on carve outs.
2. Generally speaking, RIAs will need to make sure their models (and the assumptions underlying such models) informing their hypothetical performance claims are reasonable (and – although not emanating from the marketing rule – have been stress-tested). Additionally, they'll need to have the contemporaneous books and records to support the assumptions they're making in their models should the SEC approach them about substantiating those assumptions.
3. Ensure that policies and procedures distinguish the types of clients and investors eligible to receive hypothetical performance information. RIAs should be able to explain on exam the basis of that distinction. For example, such policies and procedures could distinguish investor types on the basis of criteria, such as previous investments with the adviser, net worth or investing experience if that information is available to the adviser, certain regulatory defined categories (e.g., qualified purchasers or qualified clients), or whether the intended audience includes only natural persons or only institutions.
4. When providing information to enable the intended audience of an advertisement to understand the criteria used and assumptions made in calculating the hypothetical performance referenced, RIAs should calibrate both the depth and style of its description based on that audience.
5. Many RIAs who use marketing materials containing hypothetical performance already include disclosures in them regarding the risks and limitations of relying on hypothetical performance. Those RIAs should review those disclosures to ensure they comply with the new rule, and strengthen those that could be seen by the SEC as deficient.

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