HYPOTHETICAL PERFORMANCE CRACKDOWN: NINE FIRMS CHARGED WITH VIOLATIONS OF INVESTMENT ADVISER MARKETING AND RECORDKEEPING RULES

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On 11 September 2023, the Securities and Exchange Commission (SEC) announced charges against nine investment advisers for violations of: (i) the hypothetical performance requirements set forth in Advisers Act Rule 206(4)-1 (the Marketing Rule), and (ii) the recordkeeping requirements relating to retention of a copy of each advertisement an adviser disseminates. These settlements, representing combined penalties of US$850,000, reinforce the message that the SEC staff will be closely examining adviser compliance with the Marketing Rule.

BACKGROUND

Hypothetical Performance Requirements

The Marketing Rule came into effect on 4 May 2021 with a compliance deadline of 4 November 2022, just over 10 months ago. While much of Marketing Rule generally codified existing interpretive guidance under the SEC's prior advertising rule, the provisions relating to the presentation of hypothetical performance are new. Before the adoption of the Marketing Rule, advisers inferred the requirements governing the presentation of hypothetical performance exclusively from findings in several SEC enforcement actions. In adopting the Marketing Rule, the SEC noted its concerns around the potentially misleading nature of hypothetical performance and set forth new requirements relating to its use. Specifically, an adviser may not present hypothetical performance unless it adopts policies and procedures concerning its use and limits its distribution where it is "relevant to the likely financial situation and investment objectives of the intended audience of the advertisement." In the Marketing Rule's adopting release, the SEC stated its view that advisers "generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation" because an adviser would not be able to form any expectations relating to the intended audience's financial situation or investment objectives.[1]

The novelty of these new requirements, coupled with SEC concern about the potential for hypothetical performance to be misleading to investors informs the SEC's focus on compliance with these provisions.[2]

Recordkeeping

In addition to the requirements of the Marketing Rule, Advisers Act Rule 204-2(a)(11) requires advisers to keep a "copy of each" advertisement the adviser disseminates. As investment adviser websites would generally meet the

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definition of “advertisement,” especially those that include performance information, this effectively requires advisers to maintain archives of their websites or to be able to recreate the content of such websites over time.

THE SETTLEMENTS

In each of the nine settlements, the SEC notes that the respondent advisers included hypothetical performance on their websites, which resulted in hypothetical performance being disseminated in advertisements to a mass audience in contravention of the Marketing Rule requirement to limit the presentation of such performance only where relevant to the likely financial situation and investment objectives of the intended audience. In fact, in each settlement, the SEC references the language in the adopting release noting that advisers would not be able to include hypothetical performance in advertisements directed to a mass audience. The SEC further notes that the advisers did not have, or did not implement, the policies and procedures governing the presentation of hypothetical performance reasonably designed to ensure that the hypothetical performance was relevant to the likely financial situation and investment objectives of the intended audience.

The SEC settlements do not describe the hypothetical performance in any detail other than to note that the advisers were presenting: (i) performance derived from the application of a model, (ii) performance derived from backtesting an investment strategy, or (iii) both.

In two of the settlements, the SEC brought additional charges relating to failures associated with the recordkeeping requirements under Advisers Act Rule 204-2. Specifically, the two respondent advisers were unable to produce a copy of the website presentation of their hypothetical performance either because the webpage was changed prior to being saved or because the adviser failed to ensure the outside service provider had archived the pages.

TAKEAWAYS

These settlements show that the SEC will be aggressively enforcing the Marketing Rule's provisions on hypothetical performance. In fact, one of the settlements appears to be premised on a single advertisement containing hypothetical performance. Further, the recent settlement with Titan Global Capital Management, issued on 31 August 2023, also related (in part) to the public dissemination of hypothetical performance on a website. Although these settlements clearly reflect the SEC's view that it is virtually impossible for advisers to meet the standards necessary to use hypothetical performance in advertisements disseminated to a mass audience, advisers should not read these cases as prohibiting hypothetical performance in all cases. Rather, advisers should use this as an opportunity to revisit their approach to hypothetical performance, keeping in mind the following:

- Advisers can continue to show hypothetical performance to a “particular intended audience” (as opposed to a mass audience) so long as the adviser has adopted and implemented the required policies and procedures governing the distribution of hypothetical performance. However, this is still a high bar that requires consideration of whether the particular intended audience has access to the resources to independently analyze this information and has the financial expertise to understand the risks and limitations of hypothetical performance.

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- If advisers are planning to show hypothetical performance in a more limited manner, they should define the intended audience and memorialize their determination that the hypothetical performance is relevant to the likely financial situation and investment objective of the intended audience. Advisers may look to various factors in making this determination, including the following:
  - The nature of the hypothetical performance that is shown (e.g., is it limited to blended performance based on actual returns of underlying investments, or is it more complex based on a range of different assumptions);
  - The rationale for showing hypothetical performance to the intended audience (e.g., to demonstrate a particular investment strategy or illustrate the performance of a particular investment manager that the adviser is recommending);
  - Whether the hypothetical performance is provided by a representative or consultant who can explain the hypothetical performance presentation and answer any client questions;
  - Whether the adviser has implemented training for its sales personnel around the use and limitations of hypothetical performance and how to present it to clients; and
  - Whether the adviser has developed any educational materials that describe the use and limitations of hypothetical performance to clients.
- Hypothetical performance should always be labeled appropriately, and advisers should consider the proximity and prominence of disclosure about the methodology, risks, and limitations of hypothetical performance.
- The settlements focus on the first condition for using hypothetical performance, but advisers should also make sure they satisfy the additional requirements to provide sufficient information about: (i) the criteria used and the assumptions made in calculating the hypothetical performance, and (ii) the risks and limitations of using the hypothetical performance in making investment decisions.
- The Marketing Rule's general prohibitions and the requirements around the presentation of gross and net performance continue to apply to hypothetical performance.
- There are certain exceptions to the definition of “hypothetical performance,” such as the use of interactive analysis tools.

In addition, these settlements serve as a reminder that advisers should ensure that their websites are being appropriately archived in compliance with the recordkeeping rules, such that the adviser can produce prior versions of the website when changes are made.

Finally, it is worth noting that these settlements represent the third set of settlements reached as a group, suggesting that the SEC is willing and able to scale its enforcement efforts by pursuing multiple registrants on similar violations at the same time.

FOOTNOTES

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[1] Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020) (effective May 4, 2021) at 220.

[2] The SEC press release announcing these settlements noted that "[b]ecause of their attention-grabbing power, hypothetical performance advertisements may present an elevated risk for prospective investors whose likely financial situation and investment objectives don't match the advertised investment strategy." Press Release, SEC, Sweep into Marketing Rule Violations Results in Charges Against Nine Investment Advisers (Sept 11, 2023), https://www.sec.gov/news/press-release/2023-173.

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