

September 5, 2023

Client Alert | Investment Management

SEC Brings First Enforcement Action Under Amended Advisers Act Marketing Rule

The Securities and Exchange Commission (SEC) recently brought and settled its first administrative proceeding (Proceeding) against a registered investment adviser for violating Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended on Dec. 22, 2020 (the Amended Marketing Rule).¹ This Adviser Alert provides a general overview of the Proceeding, including a discussion of the relevant facts, the applicable provisions of the Amended Marketing Rule and the SEC's findings. It then suggests a few practical takeaways for registered investment advisers to consider when preparing advertising materials under the Amended Marketing Rule.

The Proceeding

The Relevant Facts

The SEC order instituting and settling the Proceeding (Order) states that the respondent investment adviser (Respondent) provides personalized investment advice to retail investors through a number of different traditional and nontraditional managed account strategies, including a cryptocurrency strategy (the Crypto Strategy).

The Respondent elected to comply with the Amended Marketing Rule beginning in June 2021.² It then posted advertisements about the Crypto Strategy on its website (Crypto Strategy Advertisements), which, at certain times, presented an annualized return for the Crypto Strategy of 2,700% (Annualized Return). The Annualized Return was derived from the 21% return of a hypothetical account over a three-week period. The Respondent then assumed that this hypothetical account would continue to generate this same 21% return every three weeks for the remainder of the year.

The Crypto Strategy Advertisements did not provide any additional substantive information about the Annualized Return on the webpage where it was presented. They simply disclosed the Annualized Return figure and identified the Crypto Strategy as the relevant mandate. In addition, they disclosed the Crypto Strategy's inception date and number of coin holdings. Below these disclosures, the Crypto Strategy Advertisements also provided two embedded hyperlinks generically labeled "Disclosures" and "Track Record." There was no language

¹ *In the Matter of Titan Global Capital Management USA LLC*, Release No. IA-6380 (Aug. 21, 2023) <https://www.sec.gov/files/litigation/admin/2023/ia-6380.pdf>. The SEC also brought this Proceeding for violations of the Advisers Act unrelated to the marketing of advisory services. This Adviser Alert does not address those unrelated violations.

² Firms were permitted to voluntarily comply with the Amended Marketing Rule beginning on or after May 4, 2021. They were required to comply with the Amended Marketing Rule beginning on Nov. 4, 2022.

accompanying the hyperlinks underscoring the importance of clicking on them and carefully reviewing the accessed disclosures.

Moreover, the disclosures accessible through the hyperlinks did not address the Annualized Return with any degree of specificity. For example, the disclosures stated that the Annualized Return was based on “short-term results” and was “not indicative of future expectations.” They also stated that the Annualized Return was calculated “using an extended internal rate of return calculator and was performed over a year-long period, based on an account balance of \$10,000 for an investor with an aggressive risk profile.” The Crypto Strategy Advertisements also did not disclose whether the Annualized Return was presented net of fees and expenses.

Applicable Provisions of the Amended Marketing Rule

The Amended Marketing rule applies to all investment adviser advertisements. The term “advertisement” includes any communication from an investment adviser “that offers ... investment advisory services with regard to securities.”³

The Amended Marketing Rule contains a number of general prohibitions applicable to all investment adviser advertisements (General Requirements).⁴ First, as is relevant here, an advertisement may not include or exclude performance results or present performance time periods in a manner that is not fair and balanced” (Fair and Balanced Performance Requirement).⁵ Second, an advertisement may not “[o]therwise be materially misleading” (the Not Otherwise Misleading Requirement).

The Amended Marketing Rule also contains a number of provisions specifically applicable to hypothetical performance (collectively, the Hypothetical Performance Requirements).⁶ First, a registered investment adviser may not present hypothetical performance in an advertisement unless it “adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives” of the intended audience (Hypothetical Policies and Procedures Requirement)⁷ Second, the advertisement must provide “sufficient information to enable the intended audience to understand the criteria used and assumptions made” in calculating the hypothetical performance (Criteria and Assumptions Disclosure Requirement).⁸ Finally, it must provide “sufficient information to enable the intended audience to understand the risks and limitations” of using hypothetical performance in making investment decisions (the Risks and Limitations Disclosure Requirement).⁹ The term “hypothetical performance” is defined as “performance results that were not actually achieved by any portfolio of the investment adviser.”¹⁰

³ Rule 206(4)-1(e)(1).

⁴ Rule 206(4)-1(a).

⁵ Rule 206(4)-1(a)(6).

⁶ Rule 206(4)-1(d)(6)

⁷ Rule 206(4)-1(d)(6)(i).

⁸ Rule 206(4)-1(d)(6)(ii).

⁹ Rule 206(4)-1(d)(6)(iii).

¹⁰ Rule 206(4)-1(e)(8).

It includes performance “derived from model portfolios ...”¹¹ as well as “projected performance returns ...”¹²

Violations

The SEC’s Order finds that the Respondent violated multiple provisions of the Amended Marketing Rule.¹³ The Annualized Return presented in the Crypto Strategy Advertisements was hypothetical performance as defined in the Amended Marketing Rule. This is because the Annualized Return was derived from a hypothetical account and was projected from the performance of that hypothetical account over a three-week period. As a result, the Crypto Strategy Advertisements were subject to the Hypothetical Performance Provisions of the Amended Marketing Rule.

Despite this fact, the Respondent failed to comply with the Hypothetical Policies and Procedures Requirement. In addition, the Respondent violated the Criteria and Assumptions Disclosure Requirement to the extent that the Crypto Strategy Advertisements failed, among other things, to disclose the following:

- The Annualized Return was derived from the performance of a purely hypothetical account in which no actual trading had occurred.
- The Annualized Return was extrapolated from a partial period return of just three weeks.
- The three-week return was 21%.
- The Annualized Return was based on the assumption that the hypothetical account would continuously generate a 21% return every three weeks for an entire year.
- The Respondent’s views of the likelihood that this assumption would bear out.
- Whether the Annualized Return was net of fees and expenses.

The Crypto Strategy Advertisements also violated the Risks and Limitations Disclosure Requirement for many of the same reasons.

The information accessible through the two embedded hyperlinks did not cure these violations. In this connection, the hyperlinks themselves were generically labeled and failed to disclose the importance of clicking on them. In any event, the information accessible through them was general in nature and failed to discuss the Annualized Return with any level of specificity.

Finally, the Order finds that the Respondent violated the more general Fair and Balanced Performance Requirement as well as the Not Otherwise Misleading Requirement. For example, the Crypto Strategy Advertisements failed to disclose the significant risks associated with the Annualized Return, including that it was highly unlikely that the hypothetical account would continuously generate a 21% return every three weeks for an entire year.

¹¹ Rule 206(4)-1(a)(8)(i)(A).

¹² Rule 206(4)-1(a)(8)(i)(C).

¹³ The Order also finds that the Crypto Strategy Advertisements were misleading and, therefore, that the Respondent violated Section 206(2) of the Investment Advisers Act of 1940, as amended. That section makes it unlawful for any investment adviser, “directly or indirectly, to “engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client.”

Suggested Takeaways

Status of Cryptocurrency-Related Marketing Materials

The Amended Marketing Rule's definition of advertisement is limited to communications that offer investment advisory services "with regard to securities."

The SEC's Order states as a factual matter that the Respondent's Crypto Currency Advertisements were subject to the Amended Marketing Rule. It does not provide any legal analysis supporting this factual statement, including an explanation as to why the Crypto Strategy Advertisements offered advice about securities as opposed to other types of assets.

This lack of analysis could be interpreted to mean that the SEC operates under a general presumption that all investment adviser communications offering advice about cryptocurrencies are advertisements subject to the Amended Marketing Rule. For this reason, registered advisers should ensure that all cryptocurrency-related marketing materials either comply with the Amended Marketing Rule or they should be prepared to demonstrate why the materials do not offer advisory services about securities or do not otherwise satisfy the Amended Marketing Rule's definition of advertisement.

Status of Annualized Returns

An investment strategy's annualized return is that strategy's one-year return extrapolated from its performance over a period of less than one year. An annualized return is hypothetical performance within the meaning of the Amended Marketing Rule because it is a projected performance. This is so, regardless of whether the annualized return is derived from the performance of a hypothetical account.

Presentation of Annualized Returns

Investment adviser advertisements that present annualized returns must comply with both the General Requirements and the Hypothetical Performance Requirements of the Amended Marketing Rule. Thus, they should disclose the following, at a minimum:

- That the annualized return was extrapolated from a partial-year return.
- The dates and length of time over which the partial-year return was measured.
- The partial-year return itself.
- That the annualized return was based on the assumption that the investment strategy would continue generating the same partial-year return each successive period for an entire year.
- The likelihood that this assumption will be accurate.
- Whether the annualized return is net of fees and expenses.

Additionally, in those instances where an annualized return is derived from the performance of a hypothetical account, disclosure should be made of this fact and that no actual trading ever occurred. Notwithstanding the foregoing, it should be noted that firms claiming compliance with the Global Investments Performance Standards (GIPS) are prohibited from including annualized returns in their marketing presentations.¹⁴

¹⁴ See Section 2.A.12. of the GIPS Standards.

Use of Hyperlinks

Investment advisers that present annualized returns or other types of hypothetical performance in their advertisements should place all related material disclosures, including those listed above, in proximity to the performance itself. In those instances where space is limited and certain information is made accessible through embedded hyperlinks, clear and prominent disclosure should be made about the importance of clicking on the embedded hyperlinks.

Nature of Audience

The SEC stated in the release adopting the Amended Marketing Rule that “advisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience ... because ... an adviser generally could not form any expectations about their financial situation or investment objective.”¹⁵ It is interesting to note that the SEC’s Order never expressly finds that the Respondent violated the Amended Marketing Rule simply because it distributed advertisements containing hypothetical performance to retail investors. It seems unlikely that this signals a change in the SEC thinking in this area.

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¹⁵ Investment Advisers Act Release No. 4653 (Dec. 22, 2020).