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## Investment Funds & Private Capital – Market Insights

# SEC Charges Nine Investment Advisers for Advertising Hypothetical Performance to the General Public Without Adopting Policies and Procedures

4-MINUTE READ

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On September 11, 2023 the SEC announced settlements ([available here](#)) with nine registered investment advisers (the “Advisers”)<sup>1</sup> for alleged violations of the Investment Advisers Act’s new marketing rule (Rule 206(4)-1, [available here](#), the “Marketing Rule”) as a result of advertising hypothetical performance information to the general public on their respective websites, without having adopted 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. This follows the SEC’s enforcement action from last month that focused on an adviser’s use of misleading hypothetical performance, which was the first enforcement action under the Marketing Rule (see our Client Alert on this topic, [available here](#)). Each of the nine Advisers agreed to be censured, cease and desist from violating the charged provisions, comply with undertakings not to advertise hypothetical performance without having adopted policies and procedures, and pay a fine that ranged from \$50,000 to \$175,000.

### Why it matters:

With two recent Marketing Rule enforcement actions, the SEC is signaling its focus on adviser compliance. Each of the early cases thus far represents relatively conspicuous instances of non-compliance with a focus on the use of hypothetical performance. For example, the adopting release for the Marketing Rule expressly suggested that the use of hypothetical performance information in a mass-market advertisement generally would not be compatible with the Marketing Rule’s requirements. Nonetheless, advisers should take note of the SEC signaling and be prepared upon examination for attention and scrutiny regarding all facets of Marketing Rule compliance. This case represents one of the first SEC enforcement actions related to the

<sup>1</sup> Banorte Asset Management Inc.; BTS Asset Management Inc.; Elm Partners Management LLC; Hansen and Associates Financial Group Inc; Linden Thomas Advisory Services LLC; Macroclimate LLC; McElhenny Sheffield Capital Management LLC; MRA Advisory Group; and Trowbridge Capital Partners LLC.

Marketing Rule, which took effect in November 2022. Although the Marketing Rule allows for the use of hypothetical performance metrics in advertisements, registered investment advisers must adopt 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. The SEC noted in its adoption of the Marketing Rule that they did not believe advisers would generally be able to include hypothetical performance in advertisements that were intended for a mass audience, because in that situation an adviser would presumably not be able to form any expectations about the audience's financial situation or investment objectives. It's worth noting that inclusion of any performance information on a generally available website is not a common practice for private fund sponsors.

**Key Takeaways:**

- Registered investment advisers should ensure they have adopted policies and procedures with respect to the use of hypothetical performance that are reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement.
  - As a reminder, under the Marketing Rule, hypothetical performance reflects “performance results that were not actually achieved by any portfolio of the investment adviser” and includes, but is not limited to: (i) performance derived from model portfolios; (ii) performance that is backtested by the application of a strategy to data from prior time periods when the strategy was not actually used during those time periods; and (iii) targeted or projected performance returns with respect to any portfolio or to the investment advisory services with regard to securities offered in the advertisement. It also includes composite performance information that is comprised of multi-fund extracts (e.g., an industry vertical composite across multiple funds, or realized investment composite comprised of multiple funds).
- Given the recent enforcement focus on the Marketing Rule, and in particular, the use of hypothetical performance, it is reasonable to expect continued scrutiny on Marketing Rule compliance, including with respect to whether an adviser has updated its policies and procedures appropriately. In particular, registered investment advisers that utilize hypothetical performance in their marketing materials should keep in mind who the audience for their communications are, and maintain appropriate policies and procedures.

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Our [Investment Funds & Private Capital – Regulatory](#) practice includes attorneys with deep experience handling sensitive and complex regulatory and compliance issues. In the U.S., we regularly advise on Investment Company Act status and structuring issues, private fund investment manager registration, Investment Advisers Act, Securities Act, Securities Exchange Act and other compliance, SEC examinations and enforcement.



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