Stay Current

PAUL HASTINGS

August 2023

Follow @Paul_Hastings

Investment Funds & Private Capital – Market Insights

SEC Charges FinTech Adviser for Misrepresenting Hypothetical Crypto Performance Resulting in Million Dollar "Marketing Rule" Enforcement

3-MINUTE READ

By John Budetti, Esther Chiang, Scott Gluck, Ira Kustin, Eric Sibbitt, and Ryan Swan

On August 21, 2023 the SEC announced charges (available here) against a FinTech-focused registered investment adviser (the "Adviser")[1] alleging the use of misleading hypothetical performance metrics in advertisements.

The SEC alleged that the Adviser, whose client base primarily is comprised of retail investors, provided misleading hypothetical performance results, including by claiming a 2,700% annualized return for its crypto strategy but failing to disclose that the performance was based on a hypothetical account (rather than an actual account) or that the annualized performance was based on a three-week period, and assumed the performance in the three-week period would continue for the entire year.

In addition to the marketing rule issues, the SEC also charged the Adviser with the following:

- Compliance failures due to misleading disclosures about the custody of clients' crypto assets;
- Improper use of "hedge clauses" in agreements with clients purporting to waive non-waivable causes of action;
- Unauthorized use of clients' signatures; and
- Failure to adopt policies and procedures concerning crypto asset trading by employees.

The SEC is expected to finalize, on August 23, highly anticipated new rules under the Advisers Act.

We are tracking those developments and will issue additional client alerts and guidance.

[1] Titan Global Capital Management USA LLC.

Why it matters: This case represents the first SEC enforcement action related to the amended marketing rule (available here), which took effect in November 2022. Although the amended marketing rule allows for the use of hypothetical performance metrics, with this action, the SEC is warning advisers to fully comply with the rule's related conditions and disclosure requirements. While the Adviser's alleged compliance and disclosure failures represent an extreme case, this enforcement signals that over-extrapolation of investment performance to imply a hypothetical return without appropriate disclosure and explanation of methodology may be viewed by the SEC as misleading.

Sponsors should ensure they are displaying performance information on a fair and balanced basis, including by incorporating robust disclosures detailing how performance metrics (and, in particular, any hypothetical performance) in advertisements are calculated, including potential risks and other information that may be material to an understanding of the metrics being presented. Sponsors should also review their advisory and other agreements in light of views expressed by the SEC and also further tailor them to the nature of the assets they support.

The Adviser agreed to a cease-and-desist order, a censure, and payment in the aggregate of more than $1 million in total disgorgement, prejudgment interest and a civil penalty.

While the implications are broader than digital assets, the case is also notable in its focus on digital assets, which have increasingly become an established asset class. Traditional advisers are expanding portfolios to include digital assets, while crypto native market participants are launching funds and expanding their reach into investment advisory capacities. Sponsors supporting digital assets may wish to be mindful of how best to address and disclose the unique nuances and complexities of issues like custody, trading policies and procedures and risks in the digital asset context.

Go Deeper:

Paul Hastings' Investment Funds & Private Capital practice has a truly global footprint, with more than 70 lawyers across the U.S., Europe, and Asia. We represent a diverse set of asset managers, private fund sponsors, and institutional investors.

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.

Paul Hastings' Global FinTech and Payments practice is the preeminent FinTech and Payments Group, regularly representing private equity and venture capital firms, the world's largest payments networks, financial technology companies, cryptocurrency exchanges, custodians, and bank and non-bank financial institutions as well as innovative emerging growth digital asset and FinTech companies with respect to the entire spectrum of transactional and regulatory issues such entities face.

Our range of transactional and regulatory engagements gives us unparalleled insights into both "what's market" today—in markets around the world—and critical new developments that may impact our clients.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

John Budetti
1(212) 318-6736
johnbudetti@paulhastings.com

Esther Chiang
1(212) 318-6412
estherchiang@paulhastings.com

Scott Gluck
1(212) 318-6610
scottgluck@paulhastings.com

Ira Kustin
1(212) 318-6094
irakustin@paulhastings.com

Eric Sibbitt
1(415) 856-7210
ericsibbitt@paulhastings.com

Ryan Swan
1(312) 499-6080
ryanswan@paulhastings.com