DINSMORE COMPLIANCE SERVICES

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Special Alert

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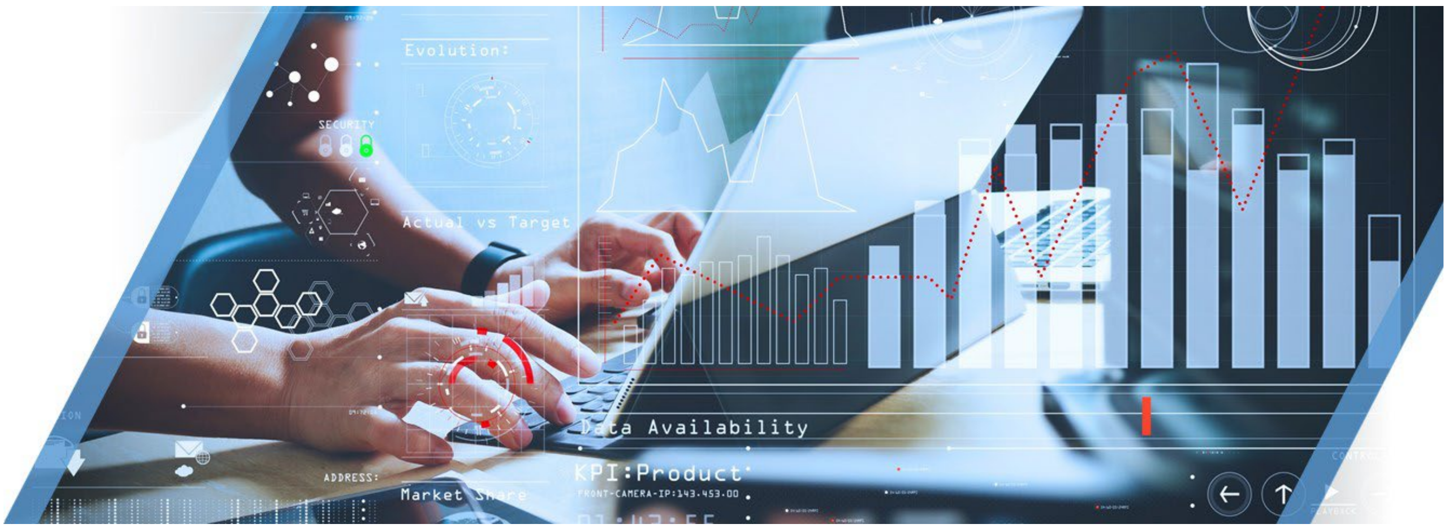
SEC Enforcement Actions Related to the Marketing Rule and Hypothetical Performance Data



On September 11, 2023 the SEC announced settled Administrative Proceedings with nine investment advisers for advertising hypothetical performance to the general public on their websites without adopting and/or implementing policies and procedures required by the Marketing Rule. In addition, two of the investment advisers failed to maintain required copies of their advertisements. The nine investment advisers were subject to $850,000 in combined penalties, with the penalties per investment adviser ranging from $50,000 to $175,000. In the press release announcing the actions, Gurbir S. Grewal, Director of the SEC's Division of Enforcement, addresses the elevated risk that hypothetical performance advertisements present, and further provides the following: "[W]e will remain vigilant and continue our ongoing sweep to ensure that investment advisers comply with the Marketing Rule, including the requirements for hypothetical performance advertisements."

Summary of the Marketing Rule Requirements Relating to Hypothetical Performance Advertising

Definition of Hypothetical Performance

The Marketing Rule defines hypothetical performance as performance results that were not actually achieved by any portfolio of the investment adviser, which include:

- Model performance;
- Back-tested performance; and
- Targeted or projected performance returns.

Model performance includes, but is not limited to, performance generated by the following types of models:

- Models where an investment adviser applies the same investment strategy to actual investor accounts, but where the investment adviser makes slight adjustments to the model (e.g. allocation and weighting) to accommodate different investment objectives;
- Computer-generated models; and
- Models created or purchased from model providers that the investment adviser does not use for actual investors.

Back-tested performance is performance calculated after the end of the relevant period, which may allow an investment adviser to claim credit for investment decisions that may have been optimized through hindsight. Back-tested performance includes the application of a strategy to data from a prior period when the strategy was not actually used during that prior period, instead of applying only to the application of market data from a prior period.

Targeted returns reflect an investment adviser's aspirational performance goals. Projected returns reflect an investment adviser's performance estimate, which is often based on historical data and assumptions.

Requirements for the Presentation of Hypothetical Performance

The Marketing Rule provides the following conditions applicable to investment advisers that utilize hypothetical performance advertising:

- The investment adviser must adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement;
- The investment adviser must provide sufficient information to enable the intended audience to understand the criteria and assumptions made in the calculation of hypothetical performance (the "criteria and assumptions"); and
- The adviser must provide (or if the intended audience is a private fund investor, provide, or offer to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions (the "risk information").

The Marketing Rule does not require an investment adviser to comply with certain conditions applicable to the presentation of performance information in advertisements, specifically the requirement to present specific time periods and the requirement related to the presentation of related portfolios/performance.

The policies and procedures adopted by investment advisers are to be tailored to the types of hypothetical performance advertised by the firm, e.g. models, projections. Disclosure regarding criteria, assumptions and risk information is directly related to the type of model performance distributed. In addition, the audience approved to receive hypothetical performance advertising may be subject to variance depending upon the type and risk level of the hypothetical performance advertising.

In regards to the nine advisers listed above as subjects of the enforcement actions, in the Adopting Release for the Marketing Rule the SEC announced its belief that advisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation. In such cases, because an advertisement would be available to mass audiences, an adviser generally could not form any expectations about the audience's financial situation or investment objectives.

Here is the link to the Press Release Announcing the Enforcement Actions: https://www.sec.gov/news/press-release/2023-173

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