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## Hypothetical Performance Advertising Just Got Real: SEC Charges Nine Registered Investment Advisers for Marketing Rule Violations



### Executive Summary

On September 11, 2023, the U.S. Securities and Exchange Commission (SEC) announced settled enforcement actions against nine registered investment advisers for their alleged illegal marketing practices — advertising hypothetical performance to the general public on their websites without the necessary policies and procedures required by the so-called Marketing Rule<sup>1</sup>.

(The settlement announcement and SEC Orders are available [here](#).)

Under the Marketing Rule, which was amended in December 2020, investment advisers are required to adopt and implement policies and procedures to ensure the relevance of hypothetical performance to the likely financial situation and investment objectives of their intended audience.

Without admitting or denying the SEC’s allegations, the firms agreed to settle the charges by collectively paying \$850,000 in penalties, which ranged from \$50,000 to \$175,000. Additionally, all nine firms agreed to be censured, cease and desist from violations and any future violations of the Marketing Rule, and comply with undertakings not to advertise hypothetical performance unless they have established the requisite policies and procedures.

These cases reaffirm that the SEC is committed to upholding the principles of investor protection and regulatory compliance in the investment advisory industry, and that compliance with the Marketing Rule is not optional. Registered investment advisers must ensure that their policies and procedures are in place

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<sup>1</sup> Rule 206(4)-1(d)(6)(i) under the Investment Adviser Act of 1940. A copy of the text can be found [here](#).

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and effectively implemented to align with the rule’s requirements, especially concerning hypothetical performance.

### **Key Requirements of the Marketing Rule**

The Marketing Rule, which came into effect in May 2021, regulates the marketing practices of SEC-registered investment advisers, aiming to ensure that any hypothetical performance presented to prospective clients or current clients is relevant to their financial situation and investment objectives.

In adopting the Marketing Rule, the SEC expressed its concerns around the potentially misleading nature of hypothetical performance and established new requirements relating to its use.

Under the amended Marketing Rule:

- **Policies and Procedures:** Advisers are required to adopt and implement policies and procedures reasonably designed to ensure that any hypothetical performance included in their advertisements meets the standard of relevance to the intended audience.
- **Definition of “Hypothetical Performance”:** The rule explicitly defines “hypothetical performance” as performance results that were not actually achieved by any portfolio of the investment adviser. This includes performance derived from model portfolios, back-tested performance that is generated by the utilization of a strategy to prior time periods when that strategy was not actually used to manage client accounts, and targeted or projected performance returns.
- **Compliance Deadline:** The rule mandated that registered investment advisers must come into compliance by November 4, 2022, providing them with eighteen months from the effective date (May 4, 2021) to align their marketing practices with the new requirements.

Notably, in the release accompanying the Marketing Rule’s adoption, the SEC expressed its opinion that advisers “generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation” due to the adviser’s inability to anticipate the financial circumstances or investment goals of such a broad audience.<sup>2</sup>

The SEC’s apprehension arises from the inherent limitation that hypothetical performance typically fails to capture real-time investment decisions or the actual outcomes of client accounts. Moreover, particularly in the case of back-tested performance, it can be “optimized through hindsight.” Despite these concerns, the Marketing Rule allows advisers to feature hypothetical performance, subject to the stipulation, amongst others, that 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.”

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<sup>2</sup> “Investment Adviser Marketing,” Release No. IA-5653 (Dec. 22, 2020) (effective May 4, 2021) at 220, available [here](#).

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## Investment Advisers' Compliance Obligations

The SEC's decision to take enforcement actions against multiple registered investment advisory firms within a relatively short timeframe sends a clear message to the industry:

- **Compliance Is Not Optional:** Compliance with the Marketing Rule is not a matter of choice but a regulatory obligation. Investment advisers should take immediate steps to review their marketing practices and policies to ensure they align with the rule's provisions.
- **Policies and Procedures:** Investment advisers should assess and, if necessary, enhance their existing policies and procedures. These policies must be reasonably designed to ensure that any hypothetical performance presented to clients or prospective clients is relevant to their financial situations and investment objectives. In this regard, advisers should:
  - consider whether the intended audience possesses the resources and financial expertise needed to independently analyze and understand the risks and limitations of the hypothetical performance
  - provide sufficient information about the criteria and assumptions behind the hypothetical performance, as well as its risks and limitations, to aid investors in making informed decisions
  - develop educational materials for clients that describe the use and limitations of hypothetical performance information
  - train their sales teams on the hypothetical performance information and ensure they can answer any client questions related to it
  - document their determination that the hypothetical performance is relevant to the audience's financial situation and investment objectives
- **Continual Monitoring and Review:** Compliance with the Marketing Rule is not a one-time task. Investment advisers should institute mechanisms for continual monitoring and review of their marketing materials to ensure ongoing compliance.

### Takeways

The SEC's recent enforcement actions serve as a wake-up call to the investment advisory industry. These actions emphasize that compliance with regulatory requirements, especially the Marketing Rule, is not optional but a fundamental obligation.

Investment advisers must remain vigilant, continually monitoring and updating their marketing practices and policies to align with the Marketing Rule's provisions, including reviewing their websites to verify that access to any hypothetical performance is restricted to its specific intended audiences. An investor-

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centric approach, transparency, and relevance in marketing materials should remain at the core of every advisory firm's operations.

Ultimately, these enforcement actions underscore the SEC's dedication to maintaining market integrity and protecting investors. Investment advisers should take heed and prioritize compliance to ensure a secure and trustworthy investment landscape for all stakeholders.

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