Proskauer

Unrepresentative Returns: SEC Sanctions Hedge Fund Manager for Misleading Marketing Practices

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On June 14, 2024, the SEC announced an enforcement action settlement with a Pennsylvania-based hedge fund manager for violating the Marketing Rule under the Investment Advisers Act. The SEC found that the adviser had misled investors by advertising a hedge fund's investment performance based on the investment performance of a single investor in the fund. While it is not an uncommon market practice to calculate a hedge fund's since-inception investment returns by simply using the investment performance of a representative "Day 1" investor, the SEC's primary complaint was that this particular "Day 1" investor was not in fact representative. Consequently, the investment performance listed in the advertisements "differed substantially from, and was significantly higher than, the fund's overall performance and the returns achieved by other investors in the fund." These differences in performance primarily stemmed from investment restrictions in the fund related to FINRA "new issue" rules, which prohibited certain other fund investors from participating in the fund's often highly profitable investments in equity IPOs. As noted in the SEC's Settlement Order, the adviser "presented as the Fund's returns the positive 44.8% net performance that the single investor achieved in 2021, whereas the undisclosed net performance of the Fund was negative 5.7% in 2021." In the view of the SEC, presenting the fund's investment performance in this way was misleading and not "fair and balanced" as required by the Marketing Rule.

Without admitting or denying the allegations, the adviser agreed to a cease-and-desist order, censure, and a $100,000 civil penalty.

Ongoing SEC Exam and Enforcement Focus

This enforcement action is part of a broader SEC effort to ensure compliance with the Marketing Rule. In April 2024, the SEC announced enforcement settlements with five retail-focused registered investment advisers (RIAs) for Marketing Rule violations. The firms were penalized for advertising hypothetical performance without proper policies and procedures, and some for having made misleading statements in their advertisements. And in August and September 2023, the SEC announced enforcement settlements with a total of ten other investment advisers for similar violations.

This focus is also reflected in the SEC's investment adviser examination program. Recently, the Division of Examinations issued an April 2024 Risk Alert that highlighted non-compliant marketing practices observed during routine compliance examinations of RIAs. Key issues included inadequate policies and procedures, failure to keep or inability to produce required records upon request, failure to report advertising practices as required in Form ADV and the use of advertisements containing untrue or misleading statements, information presented in a manner that was not "fair and balanced" or other misleading content.

Implications

The SEC's enforcement action against this adviser underscores the critical importance of transparency and a "fair and balanced" approach in performance advertising. Ensuring that the information in an advertisement is factually accurate is of course a requirement under the Marketing Rule, but it is not the only requirement. Advertisements must also include any information that is material to a reasonable understanding of what is being presented. Context is key. Without it, an adviser's advertisements run the risk of being labeled misleading in its next SEC exam, or even worse, in an enforcement action.

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