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5 Takeaways From SEC's First Marketing Rule Action

By **Adam Kanter, Stephanie Monaco and Leslie Cruz** (September 7, 2023, 5:10 PM EDT)

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On Aug. 21, the U.S. Securities and Exchange Commission ordered Titan Global Capital Management USA LLC to pay over $1 million to settle charges that it misled investors about performance metrics and the custody of clients' cryptocurrency assets.

The commission also charged Titan with compliance failures that led to the use of improper hedge clauses in client agreements, the unauthorized use of client signatures and the failure to adopt policies concerning crypto-asset trading by employees.

The charges against Titan mark the first settlement involving a violation of the SEC's amended marketing rule, the Investment Advisers Act Rule 206(4)-1, adopted in December 2020 and effective as of Nov. 4, 2022.

Background

Titan is a fintech investment adviser that offers retail investors a mix of traditional and alternative investment strategies and personalized investment advice, all provided solely through its mobile app. As of October 2022, Titan offered seven investment strategies, including the Titan Crypto strategy, which was launched on Aug. 10, 2021.

Although investment advisers were not required to comply with the marketing rule until November 2022, the SEC permitted advisers to opt-in to earlier compliance, and Titan elected to follow the new rule beginning in June 2021, months before it launched Titan Crypto.

Improper Use of Hypothetical Performance Metrics

The marketing rule prohibits investment advisers from using any hypothetical performance unless it

> (i) adopt[ed] and implement[ed] policies and procedures reasonably designed to ensure the hypothetical performance [was] relevant to the likely financial situation and investment objectives of the intended audience … (ii) provide[d] sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and (iii) provide[d] … sufficient information to enable the intended

> audience to understand the risks and limitations of using such hypothetical performance in making investment decisions.

In addition, the marketing rule requires that advertisements include performance results in a manner that is "fair and balanced," and not materially misleading.

The SEC found that between Aug. 11, 2021, and Oct. 3, 2022, Titan failed to adopt policies and procedures reasonably designed to ensure that the hypothetical performance results included in its advertisements complied with the marketing rule and, as a result, advertised hypothetical results that were materially misleading in violation of Section 206 of the Investment Advisers Act and the marketing rule itself.

For example, Titan advertised a projected annualized return of 2,700% for Titan Crypto, based in part on only three weeks of actual performance history. However, those advertisements did not disclose, as required by the marketing rule, the material criteria used and assumptions made in calculating the hypothetical performance projection.

Specifically, Titan did not disclose in the advertisements that

> the 2,700 percent annualized return was based on a purely hypothetical account in which no actual trading had occurred, that this annualized return had been extrapolated from a period of only three weeks (from August 10, 2021 to August 31, 2021), that the hypothetical return for this three-week period was calculated at twenty-one percent, that the projected 2,700 percent annualized return was based on the assumption that the Titan Crypto strategy would continuously generate a twenty-one percent return every three weeks for an entire year, or Titan's views as to the likelihood that this assumption would bear out. The advertisements also did not disclose whether the hypothetical projection was net of fees and expenses.

Titan also failed to provide sufficient information to allow the intended audience — for Titan, primarily retail investors — to appreciate the significant risks and limitations associated with this hypothetical performance projection.

Specifically, the SEC noted that Titan provided some information about the assumptions it used to calculate the hypothetical performance projection and describe certain risk factors, but the information was not "as clear and prominent" as the advertised 2,700% performance projection, according to the SEC's order. The commission emphasized that this information could only be accessed through hyperlinks embedded in the advertisement.[1]

The links, generically labeled "Disclosures" and "Track Record," provided investors and potential investors with general information, stating that the annualized return calculation was based on "short-term results," was "not indicative of future expectations" and was performed over a yearlong period, based on an account balance of $10,000 for an investor with an aggressive risk profile.

The SEC concluded that Titan's advertisement failed to present the hypothetical projected performance in a fair and balanced way, or otherwise in a way that was not materially misleading.

Misleading Information About Custody of Titan Crypto Assets

Titan was also charged with making conflicting and misleading disclosures concerning the custody of

Titan clients' crypto-assets.

On its website, Titan disclosed that a clearing firm and an affiliate of the clearing firm were providing execution and custody services. Titan's Wrap Fee Brochure, which was distributed to clients and potential clients, stated that "[Affiliate] will buy and sell supported crypto assets," and "store crypto assets acquired by Clients, and track crypto transactions via the Titan App. The investments in each Client's crypto account are held in a separate account in the name of the Client at [Affiliate], and not with Titan."

However, elsewhere in the Wrap Fee Brochure, Titan contradicted the prior disclosure, stating that "[Affiliate] does not custody crypto assets, but instead relies on unaffiliated third parties to provide custody of crypto assets."

The SEC found that neither the clearing firm nor the affiliate ever held Titan clients' crypto-assets, and that Titan failed to disclose the actual custodians of such assets. As a result, Titan clients — mostly retail — received misleading information about who held their assets, how their assets were secured and whether their assets were subject to financial risk, such as custodian bankruptcy.

Inclusion of a Hedge Clause in Client Agreements

Between August 2021 and October 2022, Titan's advisory agreements with its mostly retail clients included a hedge clause intended to limit Titan's liability.

As noted in the SEC's order, in determining whether a hedge clause violates the Advisers Act's antifraud provisions depends on the facts and circumstances, including the circumstances of the client. The SEC cited its 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers, in which it explained that

> there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions, where the hedge clause purports to relieve the adviser from liability for conduct as to which the client has a non-waivable cause of action against the adviser provided by state or federal law. Such a hedge clause generally is likely to mislead those retail clients into not exercising their legal rights, in violation of the antifraud provisions, even where the agreement otherwise specifies that the client may continue to retain its non-waivable rights.

Titan's contractual clause provided, in relevant part, that

> [Client] will defend, indemnify and hold [Titan] harmless from any and all Losses sustained by [Titan] arising out of or in connection with (i) any breach of this agreement by Client. … Titan and its Indemnified Persons will not be liable for any indirect, special, incidental, non-compensatory, punitive or consequential damages or other losses (regardless of whether such damages or other losses were reasonably foreseeable).

The contract did not include a nonwaivable rights provision.

According to the SEC, the hedge clause was inconsistent with an adviser's fiduciary duty because it may mislead Titan's clients, who were retail in nature — e.g., an account could be established with $100 — into not exercising their legal rights.

Unauthorized Application of Client Signatures to Account Documents

Titan's compliance issues were not limited to those uncovered by the SEC.

In August 2022, while conducting compliance reviews, Titan discovered that its employees frequently applied client signatures to account documents, rather than seeking signatures from clients personally. This practice gave Titan access to client funds and, in some cases, the ability to transfer client funds without first obtaining client signatures.

Titan voluntarily disclosed this practice to SEC staff and retained an independent auditing firm to investigate. The auditor did not identify any unauthorized asset transfers or other account-related actions for which clients' electronic signatures were applied.

Nevertheless, the SEC determined that Titan failed to adopt and implement appropriate policies and procedures related to verifying transfers in client accounts, which led to Titan's failure to obtain client signatures prior to effecting transfers. Notably, the commission made no allegations that Titan had violated the custody rule.

Failure to Adopt and Implement Policies and Procedures for Titan Employees' Personal Trading

Lastly, the SEC charged Titan with failing to adopt and implement policies and procedures related to its employees and associated persons' personal crypto-asset trading, despite stating in its Wrap Fee Brochure that it had created such policies and procedures.

Notably, the SEC's allegation related to disclosure was not a code of ethics violation under Section 204A of the Advisers Act, and the order does not address whether the crypto-assets in question, with respect to this allegation or the allegation regarding custody disclosures described above, were securities.

Remedial Efforts and Penalties

The SEC explained that since July 2022,

> Titan has voluntarily undertaken remedial measures to improve its compliance programs. This includes hiring a new Chief Compliance Officer and Chief Legal Counsel and additional legal and compliance staff, and conducting internal audits to review and modify policies and procedures … and adopting new advertising rules designed to be consistent with the Marketing Rule.

SEC staff considered Titan's remedial efforts and cooperation when determining to accept the offer of settlement. The SEC ordered Titan to pay $192,454 in disgorgement, prejudgment interest and an $850,000 civil fine. Titan did not admit or deny the commission's findings.

Conclusion

As noted above, the SEC's enforcement action against Titan was the first under the marketing rule. There are several takeaways from this aspect of the order:

1) Advisers should expect close scrutiny of marketing materials that include hypothetical performance, and should exercise a high degree of caution when using this type of performance, particularly with retail clients.

2) The disclosures that the marketing rule requires for hypothetical performance should be fair and balanced in substance, as well as in form. The use of click-throughs and links that contain those required disclosures clearly entails substantial risk.

3) The need for fair and balanced, as well as sufficient hypothetical performance disclosures is significantly magnified when hypothetical performance is used to market advisory services to retail investors.

4) An adviser using hypothetical performance must adopt and should test policies and procedures prior to such use.

5) It appears that a byproduct of the SEC staff not issuing FAQs under the marketing rule is that the industry should expect more regulation by enforcement. Providing investment advisory services in this regulatory environment places greater stress on those who are regulated to take very careful and thoughtful approaches to marketing in general and, in particular, when marketing to retail investors and clients.

Investment advisers should also take a fresh look at their contractual limitations of liability. While as a general matter, indemnification or exculpatory provisions arguably can be fashioned appropriately with institutional clients under certain circumstances,[2] the reference to the fiduciary interpretation repeated in the order indicates that there appears to be no tolerance for the type of limitation of liability clause that Titan used when it comes to advisory contracts with retail clients. This message in the order encourages a fresh look at standard template agreements.

In conclusion, we expect to see additional SEC enforcement actions alleging violations of the marketing rule, each of which will convey, in an enforcement context, the SEC's interpretation of the marketing rule's requirements as they relate to specific facts and circumstances.

Notably, the SEC and its staff have stated that they do not expect to provide regulatory guidance regarding the marketing rule's requirements — e.g., FAQs or the like. Unfortunately for investment advisers, the marketing rule raises numerous interpretive questions, which apparently will be answered at least in part through SEC enforcement.

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[1] Although in the release adopting the Marketing Rule the SEC endorsed the use of hyperlinks and other mechanisms to effect disclosure in certain contexts, the SEC also warned that these types of disclosure methods should not be used to "obscure important information."

[2] But see: https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf.