A Review of the New SEC Marketing Rules

The SEC has introduced new rules that govern the advertising registered investment advisors must comply with, and their impact will be massive, on just about all advisors. This article summarizes many of the key points of these rules.

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The U.S. Securities & Exchange Commission (SEC) has developed new rules[1] that govern the way investment advisors are to advertise their past performance. These rule changes are massive, to say the least. In some ways, they will be quite disruptive to ways firms had previously reported their performance.

These changes go into effect November 4, 2022. And while that may sound like a lot of time, it's critically important for advisors who are registered with the SEC to become familiar with these rules and develop a strategy to ensure they are compliant.

This article will not cover all aspects of the rule change, but will focus on the key ones and how they might affect you and your firm.

WHAT IS AN ADVERTISEMENT?

From the rule we read "Under the final marketing rule, the definition of an advertisement includes two prongs. The first prong includes any direct or indirect communication an investment adviser makes that: (i) offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser ("private fund investors"), or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. This prong will capture traditional advertising, and will not include one-on-one communications, unless the communication includes hypothetical performance information that is not provided: (i) in response to an unsolicited investor request or (ii) to a private fund investor. It also excludes (i) extemporaneous, live, oral communications; and (ii) information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication.

"The new second prong will cover compensated testimonials and endorsements, which will include a similar scope of activity as traditional solicitations under the current solicitation rule. This prong will include oral communications and one-on-one communications to capture traditional one-on-one solicitation activity, in addition to solicitations for non-cash compensation. It will exclude certain information contained in a statutory or regulatory notice, filing, or other required communication."

Perhaps one of the most significant changes that will impact any SEC registered investment advisor who claims compliance with the GIPS® standards is their GIPS reports will become advertisements.

While there are a few differences between what the GIPS standards require and the SEC will require, this is perhaps the biggest. The Standards do not consider GIPS reports advertisements; and previously, the SEC did not, either, unless they were distributed to multiple individuals at the same time, included on the firm's website, or printed in publications. The SEC previously distinguished items that are presented in a one-on-one scenario; however, this has gone away.

Consequently, your GIPS reports must conform to these new rules!

GROSS AND NET OF FEE RETURNS WITH EQUAL PROMINENCE

The Standards have traditionally recommended that compliant firms present their returns gross-of-fee. The 2020 version has, for the first time, recommended reporting both gross and net returns.

The SEC issued a no-action letter[2] in 1996 that mandated that firms show net-of-fee returns with equal prominence to gross returns, if gross were reported, except in one-on-one situations. This has essentially gone away. Under the new marketing rules, firms must show net returns; reporting gross returns are optional.

Non-fee paying accounts

Composites will, on occasion, include non-fee-paying accounts. Here is an example of another difference between the GIPS standards and the new rules:

- The GIPS standards require the firm to show the percentage of non-fee paying, if their net returns were derived by using actual performance.
- The SEC rules require the firm to use the appropriate model fee for those non-fee-paying accounts.

HYPOTHETICAL PERFORMANCE

The marketing rules go to great length to address hypothetical performance: the term appears almost 300 times and there is a section devoted to it.

Such performance is prohibited unless "the adviser takes certain steps to address its potentially misleading nature. Largely as proposed, the final rule will condition the presentation of hypothetical performance in advertisements on the adviser *adopting policies and procedures* reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the advertisement's intended audience. We intend for advertisements including hypothetical performance information to *only be distributed to investors who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitations of these types of presentations* (referred to herein collectively as 'investors who have the resources and financial expertise')."

Because of this requirement, especially the second part (providing hypothetical information only to those with certain capabilities), many firms who had previously used hypothetical will stop.

What are examples of hypothetical performance?

Model performance is included, which will be hugely problematic to firms that create and manage models, but don't actually have clients invested in their models. I recently spoke with a fellow whose firm employs many models for which there are no actual accounts being managed. What are they to do?

Backtested performance, not surprisingly, falls under this category. As they saying goes, "No one ever showed backtested results that didn't look good."

Targeted returns are hypothetical; they "reflect an investment adviser's aspirational performance goals." Projected returns, too, are included, as they "reflect an investment adviser's performance estimate, which is often based on historical data and assumptions." They are "commonly established through mathematical modeling."

Another classification of returns that fall within this group are carve-outs, which is hugely disappointing for the GIPS standards, that only recently (with the introduction of the 2020 version) returned to allowing firms to allocate cash. But the new rules do not distinguish between cases where cash is managed separately or allocated: my interpretation is that all carve-outs will be considered hypothetical.

Representative portfolios

While "rep portfolios" are not considered "hypothetical," they will no longer be allowed, except when they accompany a composite's performance.

A known problem with such portfolios is the risk of the advisor "cherry-picking" the portfolio to use. What assurance is there the selection was objective and truly representative of what a typical investor might have achieved? It should probably not be too surprising the SEC has decided to disallow its use, except under limited situations.

<u>Composites of all accounts</u>

Composites are not hypothetical; however, if the firm has a select group of accounts that make up the composite, leaving some out, that will be a problem with these new rules, as they expect all accounts that meet the criteria of the composite to be included.[3]

If the firm complies with the GIPS standards, then they likely have such composites, and the firm's rules for "discretion" (*i.e.*, representativeness of the portfolios) should align with the SEC's expectations. *If a firm doesn't comply, and ends up creating composites, they should consider how much further it would be to achieve actual compliance!*

<u>Impact on TAMPs</u>

Turnkey Asset Management Platforms provide efficient ways for managers to showcase their performance. While these TAMPs typically require returns to have been "verified," or for the firm to comply with the GIPS standards (and been verified), they often allow the use of model, backtested, representative, and subset-composite returns.

We can expect that starting in 2020, all TAMPs will mandate compliance with the new rules, and disallow anything but full composite returns. Anything short of this would create challenges for both the TAMPs and the advisors showcased on their platforms.

HANDLING TRANSACTION COSTS

Interestingly, the new rules do not require either gross or net-of-fee returns to be net of transaction costs, as the GIPS standards do. The CFA Institute's comments suggested that gross returns that were not net of transactions costs should be labeled "pure gross," as they are within the GIPS standards. However, the SEC did not agree.

Because gross and net returns can be either net or not net of transaction costs, we believe it will be necessary for firms to disclose whether they are or not.

REPORTING PERFORMANCE

The rules require firms to report one, five, and ten-year annualized rates of return. They are required for "all advertisements that include performance advertising." Thus, the GIPS reports must now include these returns. The firm must show them for net performance; if they also elect to show gross returns, net must be equal prominence to gross.

"If the relevant portfolio did not exist for a particular prescribed period, then an adviser must present performance information for the life of the portfolio. For example, if a portfolio has been in existence for seven years, then the adviser must show performance results for one and five-year periods, as well as for the seven-year period." These time periods must be shown "with equal prominence." Additional periods (*e.g.*, three-year) may be included.

While the SEC wants these returns shown on a rolling basis, through the most recent quarter, they allow for them to be shown annually. However, "it could be misleading for an adviser to present performance returns as of the most recent calendar year end if more timely quarter-end performance is available [*sic*] and events have occurred since that time that would have a significant negative effect on the adviser's performance. If more recent quarter-end performance data is not available, the adviser should include appropriate disclosure about the performance presented in the advertisement."

Consequently, if the firm is able to calculate these annual returns on a rolling quarterly basis, they should. If your firm complies with the GIPS standards, your GIPS table can remain as of the prior year-end, while your SEC-mandated table can show more current results.

<u>Updating the information</u>

Note how the SEC has responded to the timing requirement for the information to be revised: "The staff *believes* that a reasonable period of time to calculate performance results based on the most recent calendar year-end *generally would not exceed one month*.[4]"

I find this a bit confusing: does this mandate that the information be revised within a month following year-end? It seems unclear. The use of "generally would" suggests there might be justifiable reasons to not meet this timing. If, however, the firm does meet the timing requirement, I would expect there would not be a problem if there is a need to revise the returns, if they later determine an error occurred. I would also expect that a GIPS compliant firm's policies and procedures would have their error correction policy address these new returns. Note that this "one month" rule does not apply to the GIPS table of returns and statistics, which have their own one-year rule.

How far back must a firm go?

Let's say a firm has never created a composite, but has showcased their 15 years of past performance using a representative portfolio. They now wish to create a composite, in order to comply with the new rules. How far back must they go? We believe the answer is a minimum of 10 years, since the SEC requires 1-, 5-, and 10-year annualized returns.

SUMMARY

These new rules are massive. Many (or, perhaps, most) of what were not considered advertisements (*e.g.*, GIPS composite reports) now are, meaning they fall within these rules. Much of what had been "standard practice" (*e.g.*, the use of model and representative portfolios) has essentially been done away with. The limitations around "hypothetical" performance (*e.g.*, carve-outs, back-testing) make their continued use unlikely, at least for many advisors.

This paper provides a summary of the major items, which will apply to many of our readers. The firm's chief compliance officer needs to become acquainted with what is allowed and disallowed, as well as what is now required in terms of reporting and calculations.

Having until November 4, 2022 probably sounds like a fairly long time, but it will behoove all advisors to begin their work to achieve compliance. I suggest the following as a starting point?

Step 1: understand the rules. This article serves as an introduction, though more education will be needed. The Spaulding Group will host a webinar in January 2022. To learn more, please email info@SpauldingGrp.com.

Step 2: identify the areas that impact your firm. What changes are necessary? For some, these will be minor; for some, very disruptive and cumbersome.

Step 3: map out a schedule of activities your firm will undertake over the coming months.

We hope you find this article of value. Feel free to email the author with your questions.

The author wishes to acknowledge assistance from Michael McGrath, a partner with K&L Gates LLP who has, on occasion, offered clarity on some of these rules. The author also benefitted from the presentation Michael did with Sanjay Lamba, of the Investment Advisors Association; and both Karyn Vincent and Krista Harvey of CFA Institute, at the GIPS Annual Conference in October 2021.

The author is neither an attorney nor a compliance professional; however, he spends a great deal of time with performance measurement, the GIPS standards, and dealing with SEC rules. That said, the reader is advised to review the rules themselves, as well as to discuss them, and perhaps points raised in this article, with their compliance professionals.

ENDNOTES

[1] These rules can be found here: https://www.sec.gov/rules/final/2020/ia-5653.pdf.

[2] See https://www.sec.gov/divisions/investment/noaction/1996/association-for-investment-management-and-research-121896-206.pdf.

[3] There are exceptions, similar to the GIPS allowance for "non-discretionary" (*i.e.*, accounts that are not "representative" of the strategy) to be excluded, though the terminology differs.

[4] See https://www.sec.gov/investment/marketing-faq.