



A Practical Understanding of the New SEC Marketing Rules: their impact on performance measurement, and what you need to know and do

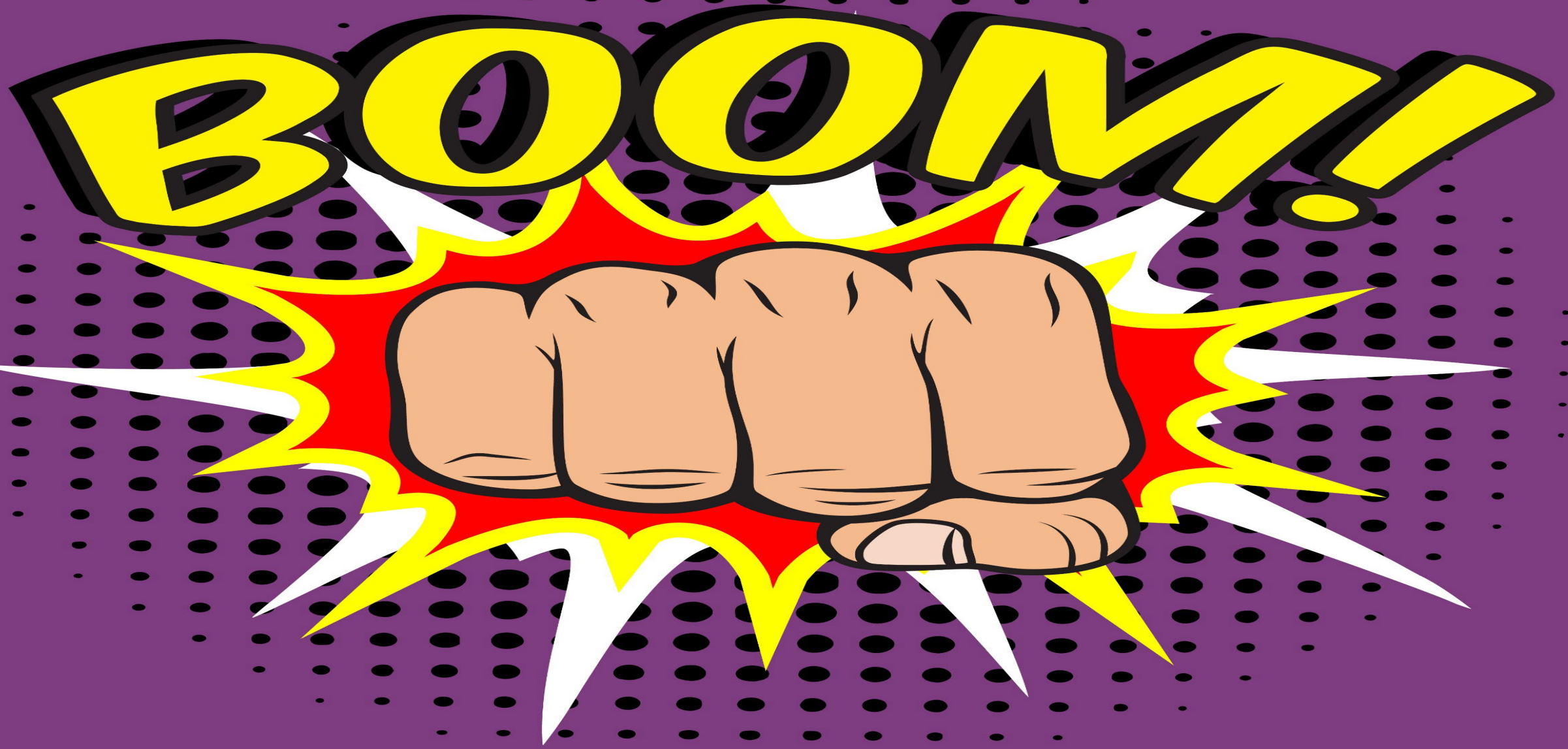
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The SEC's New Marketing Rules

November 16, 2022

WHAT'S
NEW





Agenda

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- We'll go through some of the most significant changes, and discuss how you are responding
- We'll review several FAQs we've encountered
- As well as address any questions you might have



Your GIPS reports are now
advertisements!



WHAT DOES
IT MEAN?

The concept of one-on-one goes away

- Must report NOF returns w/= prominence to GOF
 - You may have noticed the 2020 version of GIPS recommends showing both GOF & NOF
- Must adhere to all SEC advertising requirements

Inclusion of transaction costs

- SEC doesn't care if GOF and NOF returns are net of transaction costs
 - Of course, GIPS does (e.g., GOF w/o transaction costs = "pure gross")
- This means you need to say whether they are

NOF returns using actual fees if the composite includes non-fee paying accts

- GIPS requires firms to show % of assets held by non-fee paying accounts
- SEC requires firms to use model fees to derive NOF returns for these accounts
- As w/other aspects of the SEC rules, are the software vendors ready to support these changes?

Impact on attribution & risk?

- That is, if you report attribution in your GIPS reports and/or pitch book, must you show it both gross and net?
- What about risk measures?
- And, what about risk-adjusted returns?
 - What qualifies as being a risk adjusted return?
 - To me, M^2 is (so need to show gross & net)
 - Sharpe, Treynor, Information, Sortino ratios are not
 - Jensen = risk-adjusted excess return (thus, gross & net)

Annualized returns make an appearance

- Must include 1-, 5-, and 10-year annualized returns
 - What if have $> 1 < 5$; $> 5 < 10$?
- Must returns be in the GIPS report, if they're in the "pitch book"?
- For a firm coming into compliance, w/ >10 years history, who only wants to bring 5 into compliance
 - Must they still show 10-year annualized return?

Carve-outs = Extracted Performance

- Firms that use carve-outs must either
 - Provide the performance of the portfolio from which the information was extracted
 - Or offer to provide it
 - P&P and Composite Reports will need to reflect this.

BIG IMPACT

BEYOND GIPS

Hypothetical Performance

- This includes: model, back-tested, carve-outs
- Cannot show unless the recipient is sophisticated enough to be able to evaluate the risks
- If a firm is going to employ them, must have P&P to address their use and how the firm ensures recipients meet this criteria
- This change has a major impact on the 2020 version that re-introduces carve-outs w/allocated cash

Model Performance

- Some firms rely extensively on the reporting of model returns
- This ability will likely go away for many, many firms

**BIG
IMPACT**

BEYOND GIPS

Representative Portfolios

- Rep portfolios can be used, in conjunction w/a composite; but not stand alone

**BIG
IMPACT**

BEYOND GIPS

Portability of performance changes?



If the key decision makers of an acquired firm depart, can the acquiring firm continue to show past performance?



FREQUENTLY ASKED QUESTIONS

Before we begin, an important caveat

This following represents The Spaulding Group's list of responses to FAQs (Frequently Asked Questions) it has compiled. The responses are based on its own interpretations and understanding of the rules, and at times, coupled with information gathered from conversations with others who are knowledgeable about the Standards. This document is in no way official SEC doctrine. Anyone who uses this information should be aware of its limitations and that these responses might, in fact, be in error. Despite our confidence, we recognize that these rules are quite new and, at times, a bit ambiguous. Consequently, we urge anyone who relies upon this information to do so with a degree of caution. We also suggest that individuals who wish to rely upon this information to discuss the topic with their internal compliance team as well as outside counsel.

Before we begin, an important caveat

We are not aware of when the SEC, itself, will issue a series of FAQs, but believe it will not be done until some time in 2023, in order to allow the industry time to adopt the new rules and identify issues and concerns which will warrant a formal response from the Commission. In the meantime, we hope this list will prove helpful to the reader and their firm.

FREQUENTLY ASKED QUESTIONS

FAQ #1: The GIPS® standards require us to report the percentage of non-fee paying accounts in a composite, if the returns are calculated using actual fees. Will this meet the SEC's requirements?

Actually, no. The SEC will require you to calculate net returns using model fees for the non-fee paying accounts. This will necessitate a revision to your disclosures.

An alternative would be for you to retroactively switch from using actual fees to using model for all accounts. The downside of this is that your net returns will most likely be lower than what you show by using actual fees. The advantage is the ease in which this can probably be done. If you rely on an outside software provider to calculate these returns for you, ask them whether they are (or will be) prepared to calculate the net for non-fee-paying using model fees, while continuing to calculate the net returns using actual fees for fee-paying accounts.

FAQ #1a: If we elect to use model fees for our non-fee paying accounts, and continue to use actual fees for accounts that pay fees, must we continue to show the percentage of non-fee paying accounts as required by the GIPS standards?

We sent this question to the GIPS Help Desk and were told that this disclosure will not be required if the firm uses model fees for the non-fee paying accounts. That said, we believe there is still value in showing the percentage, as it will let the reader know the percentage of the composite that used model vs. actual fees to derive the net-of-fee return.

FREQUENTLY ASKED QUESTIONS

FAQ #2: The new rules require us to report net returns if we also show gross. Must we do this retroactively, or can we do it going forward as of November 2022?

The rules do not specify an effective date; our conclusion is that whatever you report needs to adhere to the rules. This means that if, for example, you show 10 years of gross returns, start reporting 10 years of net returns, too.

FREQUENTLY ASKED QUESTIONS

FAQ #3: Our firm acquired another manager five years ago. And two years ago, that firm's CIO left. We've previously shown ten years of this manager's track record prior to the acquisition. Can we still do this?

It is our belief that you will be allowed to continue to show the manager's track record prior to the date of acquisition.

In some circumstances, this may not be permitted. For example, if the CIO from the acquired firm leaves almost immediately after the acquisition, we believe the SEC will disallow the use of the track record.

This is our opinion on this very important topic; we look forward to seeing what the SEC has to say. In the meantime, we recommend that managers who have acquired other managers where the CIO or lead manager(s) depart to discuss the continued use of the manager's prior track record with their compliance team and/or outside counsel.

FAQ #4: Our firm has less than five years of history for some composites and for a few others, more than five but less than 10. A new requirement is to show one, five, and ten year annualized returns. Do we wait until we hit five and wait until we hit 10 before we start reporting?

The rules require you to show the highest number of years below five, if you have less than five years, and the highest number of years below ten, if you have more than five and less than ten. And so, if, for example, you have three years of history, report 1- and 3-year returns; if you have seven years, report 1-, 5-, and 7-year returns. In this first example, when you hit four years, you'll show 1- and 4-; when you hit five, you'll of course show 1- and 5-. For the second, when you hit eight years report 1-, 5- and 8-; when you hit nine, you'll report 1-, 5- and 9-; and, when you hit 10, then you'll be able to report the 1-, 5-, and 10-years of performance.

FAQ #5: We understand we must update our returns within a month following year-end. And so, does this mean that come January 2023, we'll have to update all of the returns in our GIPS report to be through December 31, 2022?

This is an area of some confusion. First, the updating only applies to the 1-, 5- and 10-year annualized returns. This means that you could continue to have your GIPS table show returns through 12/31/2021 while your annualized return table would be showing returns through 12/31/2022. You can easily explain the disparity by citing the different rules you're adhering to: the SEC's and the GIPS standards'. Second, as to how soon you have to have the returns updated, the wording is a bit unclear. We suggest you try to have the annualized returns table updated by the end of January, but if you have a legitimate reason to delay, you might want to do this, but document this reason. In addition, discuss this with your compliance folks, to ensure they're comfortable with the delay. Just don't delay for too long.

FAQ #6: As for the annualized return table (1-, 5-, and 10-year), do we only have to update it annually?

Again, there's a bit of confusion here. The SEC expects you to do it more frequently: we think quarterly. However, if for some reason you can't, then you will need to document why this is the case. In addition, if there is a material change in the market returns between the prior period and the most recent one, you'll need to disclose this. We recommend you do it quarterly, to avoid issues. And so, this would be another example of where your GIPS report might be through year-end while your annualized return table is through the most recent quarter.

FREQUENTLY ASKED QUESTIONS

FAQ #7: Our GIPS report is included in our “pitch book.” We intend to include the SEC’s annualized return table within the same pitch book, but separate from the GIPS report. Is this okay, or do we have to have it in the GIPS report?

If you can be confident that you only provide GIPS reports within the pitch book, we believe this will be sufficient, since the entire pitch book will constitute the advertisement. However, if it’s possible someone might give a prospect just the GIPS report, you’ll need to have it there. Our recommendation, to avoid problems: include it in the GIPS report.

FREQUENTLY ASKED QUESTIONS

FAQ #8: We typically use model returns to market our strategies. Can we continue to do this?

Under the new rules, model returns fall under the broad category of hypothetical performance. And the rules have an entire section devoted to it (starting on page 200). All hypothetical performance must adhere to these rules. First, the “adviser takes certain steps to address its potentially misleading nature.” The hypothetical information must “relevant to the likely financial situation and investment objectives of the advertisement’s intended audience.” A key requirement is that this information 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.” If the prospect is an institution, one might reasonably believe they will meet this criteria; but if it’s a retail investor, even one that qualifies as being “high net worth,” some validation would likely be in order. Firms that have typically distributed model, back-tested, or other forms of hypothetical information (including carve-outs) will want to ensure they have policies in procedures in place to ensure they do not violate this new rule.

FAQ #9: We occasionally include performance attribution in our advertising. This is done using gross-of-fee returns. Must it also be shown using net-of-fee returns?

Attribution is not performance; rather, it is an analysis of performance; an explanation as to the source of the performance. Consequently, we do not believe it will be necessary to calculate attribution using net returns; i.e., you can continue to only use gross-of-fee returns for attribution.

FREQUENTLY ASKED QUESTIONS

FAQ #9a: When we report performance attribution with sector or other sub-portfolio results, does this constitute extracted performance and therefore require additional care and treatment as being hypothetical information?

We do not believe so. Attribution does not produce hypothetical information as defined within the SEC's Marketing Rules. That said, the firm should be aware that the meaning and interpretation of attribution results may be difficult for the novice or less sophisticated investor. Consequently, its inclusion in marketing materials should be done with a degree of caution, so that it is not confusing or misleading to the reader.

FREQUENTLY ASKED QUESTIONS

FAQ #10: We include risk measures in our advertising, as well as our GIPS reports. For example, in our GIPS reports we report the 36-month annualized standard deviation. Today, these statistics are based solely upon gross-of-fee returns. Must we do the same calculations using net-of-fee returns?

Risk is not performance; rather, it is an evaluation of performance, in an attempt to report the risks that were taken to achieve the results. Therefore, we do not believe, nor do we see any benefit in, calculating these statistics using net returns.

In fact, net-of-fee returns are often the result of quarterly fees, which would introduce a “false” level of volatility. This could be eliminated if the firm accrues fees, in which case the result will essentially be identical to that of risks based on gross-of-fee returns.

FREQUENTLY ASKED QUESTIONS

FAQ #10a: We include risk-adjusted returns, based on gross-of-fee returns, in our advertising. Must these be done using net-of-fee returns?

First, a clarification: the industry often labels the Sharpe ratio, Treynor ratio, Information ratio, and Sortino ratio as risk-adjusted returns. We do not believe they are; rather, these are ratios that represent the units of gain per unit of risk taken. Modigliani-Modigliani (M-Squared) is a true, risk-adjusted return. In addition, Jensen's Alpha is a risk-adjusted excess return. Therefore, we believe that in the case of the ratios here noted, using gross-of-fee returns is sufficient; there is no added benefit to using net-of-fee returns and these statistics do not constitute returns.

This, however, is not the case with M-Squared and Jensen's Alpha. We believe showing them using net-of-fee returns should be required and therefore done.

FAQ #11: Our quarterly newsletter is sent to our clients, and includes model returns for all of our strategies. Do we need to make any changes to it?

If the model returns are only for strategies a client is in, then I would say this is not an advertisement, since the recipients are clients.

However, if the newsletter includes model results of strategies the client isn't in, it becomes an advertisement, and therefore must follow the new rules.

Recall that model results are classified as "hypothetical" performance. Therefore, you will need to ensure that all recipients are sophisticated enough to understand what they're getting, to understand what the numbers represent, and the risks associated with it.

If they are, then you will also need to make sure you have everything else that is required for an advertisement, including the 1-, 5-, and 10-year annualized returns. I.e., once the newsletter becomes an advertisement, it falls under these rules.

FAQ #12: We will implement the changes to our GIPS reports in time to meet the new rules effective date (i.e., November 4, 2022). Do we therefore begin to show the 1-, 5-, and 10-year annualized returns as of December 31, 2022?

Since the requirement for this information is as of November 4, 2022, we would expect it to be shown as of December 31, 2021, at a minimum, and ideally through the third quarter, 2022 (i.e., rolling years as of September 30, 2022).

FREQUENTLY ASKED QUESTIONS

FAQ #13: We calculate net returns using actual fees; and, several of our composites include non-fee paying accounts. Until now, we have therefore used zero fees for the non-fee paying accounts, but will start to use model fees in November, 2022. Will this meet the SEC's rules?

Actually, no. The rules are not effective "as of" November 4, 2022, but must be implemented retroactively. Therefore, we expect the returns for all periods shown to have model fees for non-fee paying accounts.

FREQUENTLY ASKED QUESTIONS

FAQ #14: Do we need to disclose that model fees are used for non-fee paying accounts, when actual fees are used for fee paying, in deriving our net returns?

We do not believe the SEC requires such a disclosure, as the expectation is that you're doing this. However the GIPS standards require you to disclose if net returns are based on model or actual fees, so you'll need to state this. Something like "net returns are based on actual fees, except for non-fee paying accounts, where model fees are used" will suffice.

FREQUENTLY ASKED QUESTIONS

FAQ #15: Must the SEC's 1-, 5-, and 10-year annualized returns be combined with the GIPS table? Seems like it might be too crowded; too busy.

We agree: it would be too crowded and busy, and would likely result in very small font sizes being used. We recommend that you craft a separate table for the annualized returns.

FREQUENTLY ASKED QUESTIONS

FAQ #16: Can we show the 1-, 5-, and 10-year annualized returns just in gross?

Sorry, but no. There is no requirement to show gross, but if you can, you should; as for net, it must be shown with equal prominence to the gross returns.

FREQUENTLY ASKED QUESTIONS



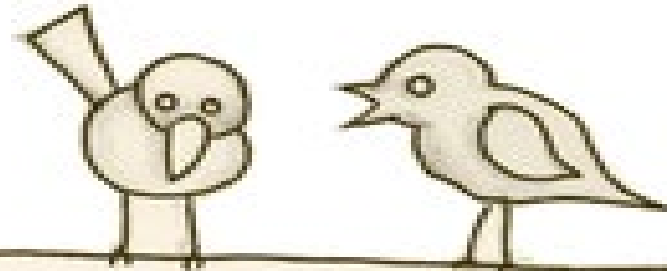


WHERE ARE YOU?





Have
any
questions?



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