GIPS Reports vs. SEC Investment Adviser Marketing Rule

Introduction

The following tool is our understanding of the potential impact of the SEC Investment Adviser Marketing Rule IA-5653 ("SEC Marketing Rule") on GIPS Reports. This analysis examines the SEC Marketing Rule impact on a compliant firm's GIPS Reports. We provide general comments and thoughts one should consider based on understanding of the rule impact from CFA Institute and SEC legal consultants. However, this only supplements whatever your compliance team and/or compliance consultant and/or legal counsel is doing specific to your facts and circumstances. We will largely focus on highlighting differences (not similarities—which there are many) between the Marketing Rule and the GIPS Reports. There are topics in the final rule where industry is seeking additional guidance from the SEC (e.g., portability/ predecessor performance of acquired firms; performance/risk attribution using gross or net).

If you are a client of The Spaulding Group, your verifier is available for guidance. If you are not yet a client, please contact Chris Spaulding by email: CSpaulding@SpauldingGrp.com, by phone: 732-873-5700, or at our website: www.spauldinggrp.com/contact-us/ to learn more about our services and how we can help.

Marketing Rule Background

The SEC Marketing Rule is available and investment adviser must comply by November 4, 2022, which governs both investment adviser advertisements and solicitor arrangements.

- Link to the Marketing Rule: https://www.sec.gov/rules/final/2020/ia-5653.pdf
- Scoped in: an investment adviser's investment advisory accounts and communications directed to investors in 3(c)(1) and 3(c)(7) funds (together, "private funds")
- Scoped out: Registered Investment Companies (RICs), Business Development Companies (BDCs), 3(c)(5) funds, 3(c)(11) funds, and non-US funds
- An advertisement is any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund or offers new investment advisory services with regard to securities to current clients or investors in a private fund.
  - An advertisement does not include:
    - Hypothetical performance when provided in response to an unsolicited request for such information or in a one-on-one presentation with a private fund investor
    - Extemporaneous, live, oral communications
    - Information contained in a statutory or regulatory notice, filing, or other required communication

- The SEC Marketing Rule Adopting Release states, "if an adviser maintains a database of performance information inserts or tables that it uses in otherwise customized investor communications, the adviser must treat the duplicated inserts as advertisements subject to the rule."
    - This indicates that if some aspects of a presentation are customized while others are not, the portions of the presentation that have not been customized will be considered advertisements, even if the presentation is only delivered to prospects in a **one-on-one setting**.
    - Because **GIPS Reports are typically standardized, they will generally be viewed as an advertisement**, or part of other materials that are, together with the GIPS Report, considered an advertisement (e.g., part of a pitch book)
- A GIPS Advertisement (not to be confused by GIPS Reports) is any material that is distributed to or designed for use in newspapers, magazines, firm brochures, pooled fund fact sheets, pooled fund offering documents, letters, media, websites, or any other written or electronic material distributed to more than one party, and there is no contact between the firm and the reader of the advertisement. A GIPS Advertisement will be considered an advertisement under the SEC Marketing Rule
- One-on-one presentations and individual client reporting are not considered advertisements

The second solicitations prong of the rule covers compensated testimonials, endorsements, third-party ratings. We will not cover these rules in the following analysis.

Composite Creation and Maintenance:

SEC Marketing rule states firms may rely on the GIPS standards composite construction criteria to identify substantially similar portfolios.

GIPS STANDARDS

- Composite performance must be used in a GIPS report
- A composite is defined as an aggregation of one or more portfolios that are managed according to a similar investment mandate, objective, or strategy
- A composite must include all fee-paying, discretionary portfolios that meet the composite definition

SEC MARKETING RULE

- When presenting performance of a strategy, may present related performance
    - Related performance is the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria
    - Related portfolio means a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement
- If related performance is presented, it may exclude related portfolios as long as:
    - Performance is not materially higher than if all related portfolios had been included, and
    - The exclusion of any related portfolio does not affect the time periods presented

Firms may rely on the GIPS standards composite construction criteria to identify substantially similar portfolios, which, we believe, means non-fee-paying accounts can be excluded.

General Impact to GIPS Compliant Firms: No changes required.

Non-Fee-Paying Portfolios

GIPS STANDARDS

- May include non-fee-paying portfolios in composites or may exclude non-fee-paying portfolios

- If a composite includes non-fee-paying portfolios, and net returns are calculated using actual investment management fees, the percentage of composite assets represented by non-fee-paying portfolios as of each annual period end must be presented
- Segregated accounts with a minimal investment management fee ("a very small investment management fee that is not representative of the investment fee that a segregated account would typically pay" (e.g., friends and family, affiliated accounts) must be considered fee-paying portfolios for purposes of composite inclusion.
- For pooled funds that have a partnership structure, where some assets may be non-fee-paying (e.g., General Partner assets), must disclose on which assets the net returns are calculated
- See "Model Fees" section below

SEC MARKETING RULE

- Advisers generally should apply a model fee to non-fee-paying portfolios and portfolios with reduced rates unavailable to unaffiliated clients when calculating net returns
- The model fee can be either:
  - The highest fee that was charged historically, or
  - The highest potential fee that the adviser will charge the investors or clients receiving the particular advertisement

General Impact to GIPS Compliant Firms: If a composite includes non-fee-paying or minimal fee-paying portfolios, and net returns are calculated using actual fees, a model fee should be applied at the portfolio level or the composite level. If a pooled fund's net return is calculated using non-fee-paying or minimal fee-paying assets, and net returns are calculated using actual fees, a model fee should be applied to these assets or to the total pooled fund.

Proprietary and Seed Capital Portfolios

GIPS STANDARDS

- There are no requirements specifically addressing the inclusion of proprietary or seed portfolios in composites
- Proprietary and seed capital portfolios may be included in a composite, if they are managed consistent with the composite's investment mandate, objective, or strategy

SEC MARKETING RULE

- An adviser must invest an amount of seed capital that is sufficient to demonstrate the strategy to investors
- If the seed capital amount is not sufficient to demonstrate the strategy to investors, it would be considered hypothetical performance
  - There are limitations on the use of hypothetical

General Impact to GIPS Compliant Firms: Ensure that any seed capital accounts are a sufficient size for the strategy. If it is determined they are not, can change the start date of the composite and exclude the seed portfolio, or leave the composite as is and treat it as performance that is subject to the additional protections for hypothetical performance.

Return Time Periods

GIPS STANDARDS

- Time-Weighted Returns:
  - Annual time periods are required
- Money-Weighted Returns:

  - A single since-inception annualized return is required

SEC MARKETING RULE

- An adviser must present 1-, 5-, and 10-year returns (prescribed time periods)
- If the relevant portfolio did not exist for a particular prescribed time period, then an adviser must also present performance for the life of the portfolio.
- There are no prescribed time periods for private funds
- It is not specified whether cumulative or annualized returns should be used for prescribed time periods, so either return type is permitted

General Impact to GIPS Compliant Firms: Assuming a GIPS Report is a standalone advertisement for SEC purposes, the firm must add 1, 5, and 10-year returns (or since inception) for each series of returns included in all GIPS Reports. (This is not required for GIPS Pooled Fund Reports for private funds.) Per the GIPS standards, firms will also need to include benchmark returns for the prescribed periods. It is unclear what the prescribed periods mean for composites that present MWRs when used to market advisory services (rather than funds).

Length of Track Record

GIPS STANDARDS

- When initially attaining compliance, a firm must present at least 5 years of performance (or since inception if less than 5 years) and build up to 10-year track record
- Firms may not present non-compliant performance in GIPS Reports
  - For periods beginning on or after 1 January 2000 for most composites and pooled funds

SEC MARKETING RULE

- Because an adviser has to present performance for the prescribed time periods (1-, 5- and 10-years), the adviser must present a 10-year track record, if it exists, or a since-inception track record if it has existed for less than 10 years
- Not required for private funds

General Impact to GIPS Compliant Firms: Firms that claim compliance for less than 10 years may need to present performance that links non-GIPS compliant performance to GIPS-compliant performance. A firm has two options: 1) Include the linked performance in the GIPS Report and disclose the conflict between the GIPS standards and regulations 2) Include the linked performance in materials that are part of the advertisement but outside of the GIPS Report.

PRESENTING GROSS AND/OR NET RETURNS

GIPS STANDARDS

- In a GIPS Report, firms may present:
  - gross returns only
  - net returns only
  - both gross and net returns
- There is one exception – for wrap fee composites, must present net returns that reflect the deduction of the entire fee that a prospect would pay

SEC MARKETING RULE

- **Requires net returns**
- When gross returns are presented, net returns must be:
    - Presented with at least equal prominence to gross returns
    - In a format designed to facilitate comparison with gross returns
    - Calculated using the same type of returns and methodology as the gross returns
    - Calculated for the same time periods as the gross returns

General Impact to GIPS Compliant Firms: Ensure that GIPS Reports include gross and net returns for the same periods and that gross and net returns are shown with equal prominence.

COMPOSITE NET RETURNS

GIPS STANDARDS

- Composite net returns must reflect the deduction of transaction costs and investment management fees
- If portfolios in the composite invest in underlying pooled funds, net returns must also reflect the deduction of all fees and expenses, including administrative fees, incurred by these pooled funds
- Pooled fund net returns included in a GIPS Pooled Fund Report must reflect the deduction of transaction costs, investment management fees, and all other fees and expenses charged to the pooled fund
- For pooled funds invested in underlying pooled funds, net returns must also reflect the deduction of all fees and expenses, including administrative fees, incurred by these pooled funds

SEC MARKETING RULE

- **Requires net returns**
- Net performance must reflect the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio, including, if applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the investment adviser.
- While net performance must reflect the deduction of advisory fees paid by underlying investment vehicles, it is not required to reflect the deduction of administrative fees paid by underlying investment vehicles
- Net performance must reflect the deduction of custody fees if the client or investor pays the adviser, rather than a third party, for custodial services
- While net performance is not required to reflect the deduction of transaction fees and expenses, or administrative fees of underlying investment vehicles, if gross returns reflect the deduction of these items, then they should also be deducted when calculating net returns

General Impact to GIPS Compliant Firms: If clients pay or reimburse the firm for custody fees, net returns will need to be adjusted to reflect the deduction of these fees.

GROSS RETURNS

GIPS STANDARDS

- A gross return must reflect the deduction of transaction costs
- For portfolios invested in underlying pooled funds, gross returns must also reflect the deduction of all fees and expenses, including administrative fees, incurred by these pooled funds
    - Exception: When the firm controls the investment management fees of the underlying pooled funds, the firm may calculate gross returns that do not reflect the deduction of the underlying pooled fund investment management fees.

- A pure gross return does not reflect the deduction of transaction costs - Pure gross returns may be included in GIPS Reports as supplemental information

SEC MARKETING RULE

- Gross performance is the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio.
- Gross returns do not have to reflect the deduction of transaction costs
- For portfolios invested in an underlying investment vehicle, gross returns are not required to reflect the deduction of any fees and expenses paid by the underlying investment vehicle
- May present pure gross returns
    - Should disclose that pure gross returns do not reflect the deduction of transaction costs

General Impact to GIPS Compliant Firms: No changes required.

Model Fees

GIPS STANDARDS

- May use actual or model investment management fees to calculate net returns
- If a model fee is used,
    - Net returns calculated using a model fee must be equal to or lower than returns that would have been calculated if actual investment management fees were used (i.e., model net returns are more conservative);
    - The model investment management must be appropriate to the prospective client or investor.
- Net returns calculated using a model fee that do not generate returns that are equal to or lower than returns that would have been calculated if actual investment management fees were used may be included in a GIPS Report only as a second series of net returns, as supplemental information

SEC MARKETING RULE

- If a model fee is used, investment advisers have two options:
    - Net returns calculated using a model fee must be equal to or lower than returns that would have been calculated if actual investment management fees were used (i.e., model net returns are more conservative); **or**
    - Net returns may reflect the deduction of a model fee that is equal to the highest fee charged to the intended audience to whom the advertisement is disseminated

General Impact to GIPS Compliant Firms: None

TIMELINESS OF RETURNS

GIPS STANDARDS

- GIPS Reports must include returns for annual periods
- GIPS Reports may include year-to-date returns, but this is not required
- Firms must update GIPS Reports to include information through the most recent annual period end within 12 months of that annual period end

SEC MARKETING RULE

- The prescribed time periods must end on a date that is no less recent than the most recent calendar year-end. However, more recent performance may be required:
    - "Depending on the facts and circumstances, an adviser may be required to present performance results as of a more recent date than the most recent calendar year-end to comply with the rule's general prohibitions. For example, 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 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."
- The SEC issued a Q&A to address the fact that firms will not have year-end performance ready immediately after year end. It states: "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."

General impact to GIPS Compliant Firms: Firms should update their GIPS Reports that are being distributed within one month of calendar year end. Firms may also need to update GIPS Reports to include more recent returns when more recent returns are not provided separately and not doing so would result in misleading information.

THEORETICAL AND HYPOTHETICAL PERFORMANCE

GIPS STANDARDS

- Theoretical performance is performance that is not derived from a portfolio or composite with actual assets invested in the strategy presented. Theoretical performance includes model, backtested, hypothetical, simulated, indicative, ex ante, and forward-looking performance
- Does not differentiate between who can and cannot receive hypothetical performance

SEC MARKETING RULE

- Hypothetical performance is performance results that were not actually achieved by any portfolio of the investment adviser
- Hypothetical performance includes, but is not limited to:
    - Performance derived from model portfolios;
    - Performance that is back-tested by the application of a strategy to data from prior time periods when the strategy was not actually used during those time periods; and
    - Targeted or projected performance returns with respect to any portfolio or to the investment advisory services with regard to securities offered in the advertisement
        - A target or projection is any type of performance that an advertisement presents as results that could be achieved, are likely to be achieved, or may be achieved in the future by the investment adviser with respect to an investor
- The adviser must adopt policies and procedures reasonable designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the advertisement's intended audience.
- The intent is for advertisements including hypothetical performance to 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.
- The adviser must provide additional information about the hypothetical performance that is tailored to the audience receiving the advertisement, such that the intended audience has sufficient information to understand the criteria, assumptions, risks, and limitations.

General Impact to GIPS Compliant Firms: Firms will need to develop policies and procedures to determine who can receive theoretical performance. Firms can create general criteria about the intended recipients to determine if they are able to receive it (e.g., qualified investors), rather than on a case-by-case basis. In most cases a firm may not include theoretical performance on its website. Firms should review the use of target information, including targets used to describe a strategy or used as a benchmark, and determine if it should be treated as hypothetical performance.

CARVE-OUTS (GIPS) AND EXTRACTED (SEC) PERFORMANCE

GIPS STANDARDS

- A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It may be used to create a track record for a narrower mandate from a multiple-strategy portfolio managed to a broader mandate.
- Carve-outs may be included in a composite
- Carve-outs included in a composite must include cash and any related income - Cash may be accounted for separately or may be allocated synthetically
  - Carve-outs can take three forms:
    - A sub-portfolio managed with its own cash within the sub-portfolio
    - A sub-portfolio managed with a separate dedicated cash account
    - A segment of a broader portfolio account, where performance is extracted and cash is synthetically allocated
  - A composite that includes carve-outs with allocated cash is subject to additional requirements

SEC MARKETING RULE

- Extracted performance is the performance results of a subset of investments extracted from a single portfolio
- Extracted performance includes attribution and segment returns from a single portfolio
- Advisers may present extract performance as long as the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted
- Does not explicitly require disclosure regarding the selection criteria and assumptions underlying extracted performance, unless the absence of such disclosures would result in performance information that is misleading or otherwise violates one of the general prohibitions
- Does not require a cash allocation, but must disclose whether the extracted performance reflects an allocation of the cash held by the entire portfolio, and the effect of such cash allocation, or the absence of such an allocation, on the results
- A composite of extracts is not considered extracted performance
  - Extracted performance can only be derived from a single portfolio
- A composite of extracts is subject to the additional protections that apply to advertisements containing hypothetical performance

General Impact to GIPS Compliant Firms: Firms do not need to make any changes to their carve-out calculation policies and procedures. However, firms will need to determine which types of carve-outs are considered extracts that will cause a composite to be considered a composite of extracts and subject to the conditions of hypothetical performance.

PORTABILITY (GIPS) /PREDECESSOR (SEC) PERFORMANCE

GIPS STANDARDS

- Performance from a past firm may be used to represent the historical performance of the new or acquiring firm and linked to the performance of the new or acquiring firm if the new or acquiring firm meets the following requirements on a composite-specific or pooled fund-specific basis:
    - Substantially all of the investment decision makers must be employed by the new or acquiring firm (e.g., research department staff, portfolio managers, and other relevant staff)
    - The decision-making process must remain substantially intact and independent within the new or acquiring firm
    - The new or acquiring firm must have records to support the performance
    - There must be no break in the track record between the past firm or affiliation and the new or acquiring firm
- If there is a break between the prior firm and the new firm, but all of the other tests are met, the performance from the prior firm may be used, but it may not be linked to the track record
- When porting a composite, the track record from the prior firm must include all portfolios that were managed in the strategy at the prior firm
    - This is true even if the prior firm did not claim compliance
- The firm must disclose when it presents performance from a prior firm, and for which periods the performance is from the prior firm
- Changes in a firm's organization must not lead to alteration of historical performance
    - Performance is the record of the firm, not of the individual

SEC MARKETING RULE

- The following requirements must be met for an adviser to be able to use predecessor performance.
    - The person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;
    - The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to investors;
    - all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods; and
    - the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.
    - The Marketing Rule does not differentiate between linked and non-linked performance.

General Impact to GIPS Compliant Firms: To be determined. The industry is currently seeking additional guidance from the SEC with respect to predecessor performance.

Additional SEC Marketing Rule Considerations

In addition to the above comments and thoughts provided, the SEC Marketing Rule provides general prohibitions and a list of required disclosures which were gathered from the SEC Adopting Release believed <u>related to composite construction</u> should be considered. We suggest carefully going thru this list to determine whether these requirements were already addressed within the standard firmwide disclosures the firm provides in any advertisement. Many of the SEC required disclosures have likely been largely developed in your GIPS Policies and Procedures or may already be in your firmwide disclosures. Other

SEC requirements disclosures (outside of composite construction) may need additional attention to align fully with SEC rule.

SEC Marketing Rule General Prohibitions in an advertisement, an adviser may not:

- Include any untrue statement or omit a material fact
- Include a material statement of fact that the adviser cannot substantiate
- Include information that would likely cause an untrue or misleading implication or inference
- Discuss potential benefits to clients without providing fair and balanced treatment of any material risks or limitations - Include specific investment advice that is not fair and balanced
- Include or exclude performance results, or time periods, in a manner that is not fair and balanced
- Otherwise be materially misleading

SEC Marketing Rules Required Disclosures (subset related to composite construction) fact and circumstances

- Whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings
- The effect of material market or economic conditions on the results portrayed
    - May not be required if benchmark returns are included
- The possibility of loss
- Material facts relevant to any comparison made to the results of an index or other benchmark
    - The GIPS standards recommend disclosure of material differences between the benchmark and the composite or the pooled fund's investment mandate, objective, or strategy
    - Example: When the volatility of the index is materially different from that of the model or actual performance results with which the index is compared
- A description of the type of performance return presented, including what elements are included in the return presented so that the audience can understand, for example, how it reflects cash flows and other relevant factors
- If current performance is not presented or available, and events have occurred since the date of the performance presented that would have a significant negative effect on the adviser's performance, the adviser should include appropriate disclosure about the performance presented in the advertisement
    - Example – the adviser includes performance through the most recent calendar year end but does not include YTD returns
- If presenting related performance on a portfolio-by-portfolio basis, disclose the size of the portfolios and the basis on which the adviser selected the portfolios
    - Example – the adviser presents performance of individual predecessor funds as supplemental information
- Disclose the criteria used in defining the related portfolios and crafting the composite.
    - The GIPS standards require disclosure of some criteria used to define the composite, such as a composite minimum or the use of a significant cash flow policy, but not all
    - For example, the GIPS standards do not require disclosure of the types of portfolios included in the composite, but it is common practice for firms to disclose the types of portfolios included in the composite, e.g., The Core Fixed Income Composite includes all tax-exempt institutional portfolios that are benchmarked to the ABC Index and allow up to a 10% allocation to non-investment grade investments.
- When presenting extracted performance, disclose that it represents a subset of a portfolio's investments
    - An adviser is not required to provide detailed information regarding the selection criteria and assumption underlying extracted performance, unless the absence of such a disclosure, based on the facts and circumstances, would result in performance information that is misleading or otherwise violates one of the general prohibitions
    - An adviser should take into account the audience for the extracted performance in crafting disclosures
    - While this disclosure applies to extracted performance from a single portfolio, it is clear from the context that a composite of extracts should also include this disclosure

- Whether the extracted performance reflects an allocation of the cash held by the entire portfolio, and the effect of such cash allocation, or the absence of such an allocation, on the results
    - While this disclosure applies to extracted performance from a single portfolio, it is clear from the context that a composite of extracts should also include this disclosure
- When hypothetical performance is included, the adviser must disclose information about the hypothetical performance that is tailored to the audience, such that the intended audience has sufficient information to understand the criteria, assumption, risks, and limitations
    - The GIPS standards require disclosure of a basic description of the methodology used to calculate the theoretical performance (i.e., the criteria and assumptions), but do not require disclosure of the risks or limitations

General Impact to GIPS Compliant Firms: Review and ensure the general prohibitions and the list of SEC Required Disclosures sufficiently conform in either firm-wide disclosures or within GIPS Report.

- For firm's SEC marketing rule, we assume the required SEC disclosures will likely be available and already disclosed in the firm wide disclosures in any advertisement. As such, the firm wide disclosure should be provided for all firm wide advertisements including GIPS Reports.
    - Ensure the firm wide disclosures cover the required SEC disclosures above
- For firm's using the GIPS report **solely** as the advertisement, **without** providing additional firm wide disclosures either:
    - update and consider providing firm wide disclosure with required disclosures, or
    - update and provide expanded GIPS Report disclosures inclusive of required SEC disclosures