The Spaulding Group's FAQ's for
The Security & Exchange Commission's
Marketing Rules

Version 1.0

Caveat: This document 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.

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.

<u>FAQ #1</u> 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.

<u>FAQ #1a</u> 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 <u>not</u> 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.

<u>FAQ #2</u> 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.

<u>FAQ #3</u> 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.

<u>FAQ #4</u> 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.

<u>FAQ #5</u> 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.

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.

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.

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.

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.

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.

