



Webinar

SEC Marketing Rule Developments & Implementation Updates

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AGENDA

- Marketing Rule Developments
- Gross and Net Performance FAQ
- Scope of the FAQ
- FAQ and Current Calculation Approaches
- FAQ and Attribution
- Attribution Example
- Sector Net Returns and Net Contribution – Model Fee
- Practical Implications
- Resources/Q&A



Marketing Rule Developments

- On January 11, 2023 SEC staff from the Division of IM published a new FAQ interpreting the Marketing Rule.
- The FAQ states that the performance of a single investment (or group of investments) is “extracted performance”.
- This guidance has had extraordinary repercussions for the marketing practices of many investment managers.
 - Timing of guidance places many investments managers in a challenging position.
 - FAQ applies broadly, not only to private funds.
 - FAQ creates calculation issues as fees are typically charged at the portfolio level.



Gross and Net Performance FAQ

Q. When an adviser displays the gross performance of one investment (e.g., a case study) or a group of investments from a private fund, must the adviser show the net performance of the single investment and the group of investments?



Gross and Net Performance FAQ

A. Yes. The staff believes that displaying the performance of one investment or a group of investments in a private fund is an example of extracted performance under the new marketing rule. Because the extracted performance provision was intended, in part, to address the risk that advisers would present misleadingly selective profitable performance with the benefit of hindsight, the staff believes the provision should be read to apply to a subset of investments (i.e., one or more). Accordingly, an adviser may not show gross performance of one investment or a group of investments without also showing the net performance of that single investment or group of investments, respectively. In addition, the adviser must satisfy the other tailored disclosure requirements as well as the general prohibitions, including the general prohibition against specific investment advice not presented in a fair and balanced manner, when showing extracted performance.



Scope of the FAQ

Although the FAQ specifically addressed case studies in private funds, the staff's position has broad consequences

- Private fund advertisements vs. all advertisements

“the performance of one investment...”

- Case studies
- Top 5 / bottom 5
- Schedules of investments
- Quarterly performance summaries

“...or a group of investments”

- Carve-outs
- Sector performance
- Performance contribution?
- Performance attribution?



FAQ and Current Calculation Approaches

Example: fund gross IRR is 10%, fund net IRR is 8% and the investment gross IRR is 12%.

- “Spread” Method
 - Subtract the fund net performance from the fund gross performance ($10\% - 8\% = 2\%$) and then subtract that difference from the investment gross return: $12\% - 2\% = \mathbf{10\% \text{ investment net return}}$.
- “Ratio” Method
 - Calculate the fund net performance as a percentage of fund gross performance ($8\%/10\%$) then multiply the investment gross performance by that ratio: $12\% \times (8\%/10\%) = \mathbf{9.6\% \text{ investment net return}}$.
- Benefits and drawbacks to each method



FAQ and Attribution

- What is “**performance**” under the Marketing Rule?
- Advertisements will often contain different types of performance-related data under the general heading “Attribution”:
 - **Sector returns / geographic returns**
 - **Contribution to return**
 - **(Actual) attribution**
 - **Risk metrics**
- While the FAQ directly addresses the performance of individual investments, it is likely that the SEC staff will take a similar position with respect to some of this data as well.



FAQ and Attribution

- Are sector returns or geographic returns attribution?
 - These are not “relative attribution” or “attribution analysis” that examine the excess, active, or relative return.
 - These returns **explain sources of return of a portfolio in isolation rather than in comparison with a benchmark**, and from the perspective of the SEC staff, could “**present misleadingly selective profitable performance with the benefit of hindsight**”.
- What is contribution to return?
 - Contribution to return is the product of the security or sector weight multiplied by the security/sector return.
 - Return contribution analysis can tell us **which securities or sectors have the greatest (and least) impact on the total portfolio return.**



FAQ and Attribution

- What is attribution? Performance attribution is a **set of techniques used to identify the sources of the excess return of a portfolio against its benchmark in order to understand the consequences of active investment decisions.**
- This type of attribution may be more accurately called “relative return attribution” or “attribution analysis”.



Attribution Example

Sector Returns \neq Contribution to Returns \neq Attribution Analysis

2 Factor Attribution									
12/31/2015 - 12/30/2016 Economic Sector									
	European Select Fund			MSCI Europe			Attribution Analysis		
	Port. Average Weight	Port. Total Return	Port. Contrib. To Return	Bench. Average Weight	Bench. Total Return	Bench. Contrib. To Return	Allocation Effect	Selection + Interaction Effect	Total Effect
Total	100.00	6.02	6.02	100.00	2.58	2.58	3.08	0.37	3.44
+ Financials	18.59	10.23	-0.05	18.96	-1.59	-0.77	-1.24	2.68	1.44
+ Health Care	10.40	7.70	0.87	13.67	-9.38	-1.44	0.42	1.63	2.05
+ Consumer Staples	11.04	-0.19	0.48	15.51	-0.32	0.06	-0.03	0.87	0.85
+ Real Estate	4.77	5.81	0.73	1.49	-2.77	-0.05	-0.25	0.21	-0.04
+ Information Technology	1.69	-7.53	-0.01	4.29	4.00	0.20	-0.25	0.09	-0.17
+ Utilities	3.48	-5.07	0.06	3.82	-5.59	-0.25	0.08	0.08	0.15
+ Telecommunication Services	0.99	-5.60	-0.07	4.74	-13.34	-0.79	0.60	0.05	0.65
+ [Cash]	0.48	-0.28	-0.00	--	--	--	-0.02	--	-0.02
+ Energy	5.23	44.06	1.45	6.95	32.36	2.22	0.22	-0.62	-0.40
+ Consumer Discretionary	7.36	-11.79	-0.94	10.79	-1.49	-0.24	0.35	-1.26	-0.91
+ Industrials	22.06	4.32	0.90	12.49	11.23	1.47	1.02	-1.50	-0.48
+ Materials	13.92	14.75	2.59	7.31	28.72	2.16	2.17	-1.86	0.32

Source: FactSet

Sector Net Returns – Model Fee

Annual Management Fee 1.00%
 Monthly Management Fee 0.08%

	Gross Returns												Annual
	1/31/2022	2/28/2022	3/31/2022	4/30/2022	5/31/2022	6/30/2022	7/31/2022	8/31/2022	9/30/2022	10/31/2022	11/30/2022	12/31/2022	
Financials	1.22%	-2.33%	1.56%	0.55%	2.30%	0.26%	-0.48%	2.41%	1.01%	1.15%	0.01%	2.22%	10.23%
Health Care	-0.23%	0.54%	1.01%	-0.02%	0.59%	0.77%	0.44%	1.11%	0.61%	0.98%	0.72%	0.93%	7.70%
Consumer Staples	-1.05%	0.01%	-0.26%	-0.58%	0.22%	0.03%	-0.11%	0.50%	0.37%	0.48%	-0.04%	0.25%	-0.19%
Real Estate	0.57%	0.31%	0.25%	0.80%	0.13%	-0.21%	1.00%	0.65%	0.59%	0.70%	0.26%	0.62%	5.81%
Information Technology	-0.64%	-3.00%	0.05%	-0.75%	0.11%	-1.08%	-0.39%	0.54%	-1.00%	-0.47%	-1.20%	0.07%	-7.53%
Utilities	-1.23%	-0.78%	0.30%	-0.65%	-0.24%	-0.99%	-0.36%	0.23%	-0.87%	-0.16%	-0.68%	0.25%	-5.07%
Telecommunication													
Services	-2.51%	-0.66%	0.25%	-1.28%	0.00%	-0.63%	-0.71%	0.13%	-0.33%	0.25%	-0.45%	0.23%	-5.60%
Cash	0.01%	0.05%	-0.22%	0.01%	-0.03%	0.00%	0.02%	0.14%	-0.11%	-0.06%	-0.09%	0.00%	-0.28%
Energy	2.36%	3.65%	3.60%	3.41%	2.07%	2.68%	2.92%	2.60%	3.44%	3.98%	3.64%	2.74%	44.06%
Consumer Discretionary	-1.41%	-1.36%	0.28%	-0.97%	-0.62%	-1.45%	-0.89%	0.31%	-0.55%	-1.78%	-2.21%	-1.80%	-11.79%
Industrials	-0.52%	-0.25%	0.56%	0.45%	1.36%	0.23%	0.05%	0.78%	0.63%	0.20%	0.44%	0.32%	4.32%
Materials	1.00%	0.59%	1.57%	0.58%	0.13%	-0.47%	0.91%	1.59%	1.87%	1.52%	2.65%	1.94%	14.75%

	Net Returns												Annual
	1/31/2022	2/28/2022	3/31/2022	4/30/2022	5/31/2022	6/30/2022	7/31/2022	8/31/2022	9/30/2022	10/31/2022	11/30/2022	12/31/2022	
Financials	1.14%	-2.41%	1.48%	0.47%	2.22%	0.18%	-0.56%	2.33%	0.93%	1.07%	-0.07%	2.14%	9.14%
Health Care	-0.31%	0.46%	0.93%	-0.10%	0.51%	0.69%	0.36%	1.03%	0.53%	0.90%	0.64%	0.85%	6.63%
Consumer Staples	-1.13%	-0.07%	-0.34%	-0.66%	0.14%	-0.05%	-0.19%	0.42%	0.29%	0.40%	-0.12%	0.17%	-1.18%
Real Estate	0.49%	0.23%	0.17%	0.72%	0.05%	-0.29%	0.92%	0.57%	0.51%	0.62%	0.18%	0.54%	4.76%
Information Technology	-0.72%	-3.08%	-0.03%	-0.83%	0.03%	-1.16%	-0.47%	0.46%	-1.08%	-0.55%	-1.28%	-0.01%	-8.46%
Utilities	-1.31%	-0.86%	0.22%	-0.73%	-0.32%	-1.07%	-0.44%	0.15%	-0.95%	-0.24%	-0.76%	0.17%	-6.02%
Telecommunication													
Services	-2.59%	-0.74%	0.17%	-1.36%	-0.08%	-0.71%	-0.79%	0.05%	-0.41%	0.17%	-0.53%	0.15%	-6.54%
Cash	-0.07%	-0.03%	-0.30%	-0.07%	-0.11%	-0.08%	-0.06%	0.06%	-0.19%	-0.14%	-0.17%	-0.08%	-1.27%
Energy	2.28%	3.57%	3.52%	3.33%	1.99%	2.60%	2.84%	2.52%	3.36%	3.90%	3.56%	2.66%	42.67%
Consumer Discretionary	-1.49%	-1.44%	0.20%	-1.05%	-0.70%	-1.53%	-0.97%	0.23%	-0.63%	-1.86%	-2.29%	-1.88%	-12.68%
Industrials	-0.60%	-0.33%	0.48%	0.37%	1.28%	0.15%	-0.03%	0.70%	0.55%	0.12%	0.36%	0.24%	3.29%
Materials	0.92%	0.51%	1.49%	0.50%	0.05%	-0.55%	0.83%	1.51%	1.79%	1.44%	2.57%	1.86%	13.62%

Net Contribution to Return by Sector – Model Fee

Gross Contribution to Return

	1/31/2022	2/28/2022	3/31/2022	4/30/2022	5/31/2022	6/30/2022	7/31/2022	8/31/2022	9/30/2022	10/31/2022	11/30/2022	12/31/2022	Annual	Sum of Annual Sector Contributions	Diff to be Allocated	Adjusted Gross Contribution
Financials	0.21%	-0.42%	0.29%	0.10%	0.42%	0.05%	-0.09%	0.43%	0.19%	0.21%	0.00%	0.40%	1.81%			1.83%
Health Care	-0.02%	0.06%	0.10%	0.00%	0.06%	0.08%	0.05%	0.12%	0.06%	0.10%	0.07%	0.10%	0.78%			0.79%
Consumer Staples	-0.12%	0.00%	-0.03%	-0.06%	0.02%	0.00%	-0.01%	0.06%	0.04%	0.05%	0.00%	0.03%	-0.02%			-0.01%
Real Estate	0.03%	0.01%	0.01%	0.04%	0.01%	-0.01%	0.05%	0.03%	0.03%	0.03%	0.01%	0.03%	0.27%			0.28%
Information Technology	-0.02%	-0.09%	0.00%	-0.02%	0.00%	-0.02%	-0.01%	0.01%	-0.02%	-0.01%	-0.02%	0.00%	-0.18%			-0.18%
Utilities	-0.04%	-0.03%	0.01%	-0.02%	-0.01%	-0.04%	-0.01%	0.01%	-0.03%	-0.01%	-0.02%	0.01%	-0.18%			-0.18%
Telecommunication Services	-0.08%	0.00%	0.00%	-0.02%	0.00%	-0.01%	-0.01%	0.00%	0.00%	0.00%	-0.01%	0.00%	-0.11%			-0.11%
Cash	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%			0.00%
Energy	0.08%	0.14%	0.16%	0.15%	0.10%	0.11%	0.13%	0.12%	0.17%	0.19%	0.18%	0.14%	1.69%			1.69%
Consumer Discretionary	-0.12%	-0.11%	0.02%	-0.08%	-0.05%	-0.12%	-0.07%	0.02%	-0.04%	-0.13%	-0.17%	-0.15%	-0.98%			-0.97%
Industrials	-0.12%	-0.06%	0.13%	0.10%	0.30%	0.05%	0.01%	0.17%	0.14%	0.04%	0.10%	0.07%	0.94%			0.96%
Materials	0.13%	0.08%	0.22%	0.08%	0.02%	-0.06%	0.13%	0.22%	0.26%	0.21%	0.36%	0.27%	1.92%			1.94%
Total Gross Return	-0.05%	-0.42%	0.91%	0.27%	0.88%	0.04%	0.16%	1.20%	0.80%	0.71%	0.50%	0.89%	6.02%	5.93%	0.10%	6.02%

Net Contribution to Return

	1/31/2022	2/28/2022	3/31/2022	4/30/2022	5/31/2022	6/30/2022	7/31/2022	8/31/2022	9/30/2022	10/31/2022	11/30/2022	12/31/2022	Annual	Sum of Annual Sector Contributions	Diff to be Allocated	Adjusted Net Contribution
Financials	0.19%	-0.44%	0.27%	0.09%	0.41%	0.03%	-0.11%	0.42%	0.17%	0.20%	-0.01%	0.39%	1.62%			1.63%
Health Care	-0.03%	0.05%	0.10%	-0.01%	0.05%	0.07%	0.04%	0.11%	0.06%	0.09%	0.07%	0.09%	0.68%			0.68%
Consumer Staples	-0.13%	-0.01%	-0.04%	-0.07%	0.01%	-0.01%	-0.02%	0.05%	0.03%	0.04%	-0.01%	0.02%	-0.13%			-0.13%
Real Estate	0.02%	0.01%	0.01%	0.03%	0.00%	-0.01%	0.04%	0.03%	0.02%	0.03%	0.01%	0.02%	0.22%			0.23%
Information Technology	-0.02%	-0.10%	0.00%	-0.02%	0.00%	-0.02%	-0.01%	0.01%	-0.02%	-0.01%	-0.02%	0.00%	-0.20%			-0.20%
Utilities	-0.05%	-0.03%	0.01%	-0.03%	-0.01%	-0.04%	-0.02%	0.01%	-0.03%	-0.01%	-0.03%	0.01%	-0.22%			-0.22%
Telecommunication Services	-0.08%	-0.01%	0.00%	-0.02%	0.00%	-0.01%	-0.01%	0.00%	0.00%	0.00%	-0.01%	0.00%	-0.12%			-0.12%
Cash	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	-0.01%			-0.01%
Energy	0.08%	0.13%	0.15%	0.14%	0.10%	0.11%	0.12%	0.12%	0.16%	0.19%	0.18%	0.14%	1.64%			1.64%
Consumer Discretionary	-0.12%	-0.11%	0.01%	-0.08%	-0.06%	-0.13%	-0.08%	0.02%	-0.05%	-0.14%	-0.17%	-0.15%	-1.06%			-1.05%
Industrials	-0.14%	-0.07%	0.11%	0.08%	0.28%	0.03%	-0.01%	0.15%	0.12%	0.03%	0.08%	0.05%	0.71%			0.73%
Materials	0.12%	0.07%	0.21%	0.07%	0.01%	-0.08%	0.11%	0.21%	0.25%	0.20%	0.35%	0.26%	1.78%			1.79%
Total Net Return	-0.14%	-0.51%	0.82%	0.19%	0.80%	-0.04%	0.07%	1.11%	0.71%	0.62%	0.42%	0.81%	4.97%	4.92%	0.05%	4.97%

Difference Gross vs Net

	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	1.05%			
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Practical Implications

- Treatment of risk metrics
- How to approach existing marketing materials (created prior to the FAQ) with extracted performance
- Refinements to calculation methodologies
- Disclosures for net performance calculations
- Is further SEC staff guidance anticipated?
- Preparing for upcoming sweep exams



Resources

- Sign up for K&L Content [Stay Informed | K&L Gates \(emailcc.com\)](#)
- K&L speakers
 - [Michael W. McGrath | People | K&L Gates \(klgates.com\)](#)
 - [Pamela A. Grossetti | People | K&L Gates \(klgates.com\)](#)
- Subscribe to the [GIPS Standards Newsletter](#)
- Reconciling the SEC Marketing Rule and the GIPS Standards [Whitepaper](#)
- Sector and Contribution Model Net Performance spreadsheet [\(available on the Tools webpage\)](#)
- GIPS Standards Help Desk gips@cfainstitute.org

