



CFA Institute

Webinar – 29 June 2023

SEC Marketing Rule Developments

Webinar sponsored by

K&L GATES

SPEAKERS



Pamela Grossetti
Partner
K&L Gates, LLP



Mike Caccese
Chairman
Lead Practice Area Leader –
Asset Management and
Investment Funds
K&L Gates, LLP



Ken Robinson
CFA, CIPM, CPA, PFS
Director, Global Industry
Standards
CFA Institute



Karyn D. Vincent
CFA, CIPM
Senior Head, Global
Industry Standards
CFA Institute

AGENDA

- Marketing Rule Developments – Exams
- Marketing Rule Developments – FAQ Update
- Additional Compliance Challenges
- Practical Implications
- Looking Ahead
- Resources/Q&A



Marketing Rule Developments – Exams

- In a September 2022 Risk Alert, the Division of Enforcement announced that SEC staff will conduct a number of specific national initiatives, as well as a broad review through the examination process, for compliance with the Marketing Rule, including the following areas:
 - Marketing Rule policies and procedures
 - Substantiation Requirement
 - Performance Advertising Requirements
 - Books and Records



Exam Approach Overview

- The SEC Exam staff approach:
- Phase 1 - 500 advisers examined
 - Approximately 90% had deficiencies
 - Up to ten sent to enforcement
 - Surprise calls to CCOs
- Phase 2A – June 2023 Risk Alert
 - Reviewing ADVs to determine further examination focus
- Phase 2B - Records review/substantiation



Exam Document Request Letters

Requests include:

- Copies of all advertisements used during the review period (e.g., pitch books, performance presentations, etc.)
- All written compliance and operational policies and procedures addressing marketing and advertising activities of the adviser, which includes solicitation activities that are performed for cash and non-cash compensation
- Copies of any inventory or log of advertisements, including whether hypothetical performance was presented
- Names of parties or committees responsible for performance advertising and/or performance calculation
- Training materials (including modifications to trainings) related to the Marketing Rule



June 2023 Risk Alert

- On June 8th the Division of Examinations published a Risk Alert to inform investment advisers, including private fund advisers, about additional areas of emphasis during examinations focused on the Marketing Rule.
- The Risk Alert sets forth these additional areas, which include (1) testimonials and endorsements; (2) third-party ratings; and (3) Form ADV.
- The Risk Alert demonstrates Exam staff will undertake a comprehensive approach in the examination process.



June 2023 Risk Alert

- Focus on testimonials/endorsements and third-party ratings may indicate weaker compliance in these areas as advisers may have focused on performance advertising.
- Risk Alert also indicates Exam staff will have continued focus on the general prohibitions and performance advertising, including specifically:
 - Hypothetical Performance
 - Extracted Performance
- Review your websites!



Additional Exam Priorities

Off-Channel Communications

- Advisers are subject to record retention requirements set forth in Advisers Act Rule 204-2
- Determinative factor is the content, not the medium of the communications. Recordkeeping requirements apply to all advertisements regardless of the type of communication.
- In addition, communications related to “business-related” communications and “market color, analysis, activity trends or events” should be preserved.
- Enforcement activity in this area.



Marketing Rule Developments – FAQ Update

- 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”.
- Challenges in addressing net performance in areas not specifically addressed by SEC
- Expected to be an Exam focus
- Status of marketing materials that pre-date the FAQ



FAQ and Investment-Level Performance

- FAQ applies broadly
- Considers performance of a single investment or group of investments to be extracted performance
 - Sector performance
 - Contribution to return
 - Top 5 and Bottom 5 returns
 - Investment-level TWRs
 - Investment-level IRRs



Sector Time-Weighted Returns and Contribution

Can apply a model fee to calculate net sector returns and net contribution

Annual Management Fee	1.00%				
Quarterly Management Fee	0.25%				
	Gross Returns	Sector Weights	Contribution to Gross Return	Net Returns	Contribution to Net Return
Financials	1.22%	17.00%	0.21%	0.97%	0.16%
Health Care	-0.23%	10.00%	-0.02%	-0.48%	-0.05%
Consumer Staples	1.05%	11.05%	0.12%	0.80%	0.09%
Real Estate	0.57%	5.00%	0.03%	0.32%	0.02%
Information Technology	0.64%	2.50%	0.02%	0.39%	0.01%
Utilities	-1.23%	3.50%	-0.04%	-1.48%	-0.05%
Telecommunication Services	2.51%	3.00%	0.08%	2.26%	0.07%
Cash	0.01%	0.50%	0.00%	-0.24%	0.00%
Energy	2.36%	3.55%	0.08%	2.11%	0.07%
Consumer Discretionary	1.41%	8.20%	0.12%	1.16%	0.10%
Industrials	-0.52%	22.50%	-0.12%	-0.77%	-0.17%
Materials	1.00%	13.20%	0.13%	0.75%	0.10%
Total Portfolio	0.59%	100.00%	0.59%	0.34%	0.34%

Investment-Level Net TWRs

Need to know:

- Period the investment was held
- Gross return for the full period
- Model annual fee/expense ratio

Annual Management Fee		1.00%	
	Security 1	Security 2	Security 3
Purchase date	12/31/2021	1/31/2020	4/1/2022
Sell date or date of valuation	12/31/2022	4/30/2022	12/31/2022
Number of months held	12	27	9
Compounded Management Fee % for total period held	1.00%	2.26%	0.75%
Cumulative Gross	10.00%	10.00%	10.00%
Annualized Gross	10.00%	4.33%	N/A
Cumulative Net	8.91%	7.57%	9.18%
Annualized Net	8.91%	3.30%	N/A
Diff	1.09%	1.03%	0.82%
N/A - Periods for less than 1 year not annualized			

Investment-Level Net IRRs

Currently two methods are used – spread method and ratio method

Assume a fund gross IRR is 10% and net IRR is 8%

Spread Method						
Fund			Investment Level Return			
Gross	Net	Spread	Gross	Net	Gross - Net	
10%	8%	2%	12%	10%	2%	
9%	7%	2%	12%	10%	2%	
8%	6%	2%	12%	10%	2%	
7%	5%	2%	12%	10%	2%	
6%	4%	2%	12%	10%	2%	
5%	3%	2%	12%	10%	2%	
4%	2%	2%	12%	10%	2%	
3%	1%	2%	12%	10%	2%	
2%	0%	2%	12%	10%	2%	
1%	-1%	2%	12%	10%	2%	
0%	-2%	2%	12%	10%	2%	
-1%	-3%	2%	12%	10%	2%	
-2%	-4%	2%	12%	10%	2%	
-3%	-5%	2%	12%	10%	2%	
-4%	-6%	2%	12%	10%	2%	

Ratio Method					
Fund			Investment Level Return		
Gross	Net	Ratio	Gross	Net	Gross - Net
10.00%	8.00%	80%	12.00%	9.60%	2.40%
9.00%	7.00%	78%	12.00%	9.33%	2.67%
8.00%	6.00%	75%	12.00%	9.00%	3.00%
7.00%	5.00%	71%	12.00%	8.57%	3.43%
6.00%	4.00%	67%	12.00%	8.00%	4.00%
5.00%	3.00%	60%	12.00%	7.20%	4.80%
4.00%	2.00%	50%	12.00%	6.00%	6.00%
3.00%	1.00%	33%	12.00%	4.00%	8.00%
2.00%	0.00%	0%	12.00%	0.00%	12.00%
1.00%	-1.00%	-100%	12.00%	-12.00%	24.00%
0.00%	-2.00%	#DIV/0!	12.00%	#DIV/0!	#DIV/0!
-1.00%	-3.00%	300%	12.00%	36.00%	-24.00%
-2.00%	-4.00%	200%	12.00%	24.00%	-12.00%
-3.00%	-5.00%	167%	12.00%	20.00%	-8.00%
-4.00%	-6.00%	150%	12.00%	18.00%	-6.00%

Ratio Method

Benefits

- Simple calculation
- Easy to understand
- Widely used –
safety in numbers

Drawbacks

- Can generate returns that are not reasonable
- Calls into question the appropriateness of the methodology
- May need to use a different method for investments within the same marketing piece

Additional Compliance Challenges

- Model Fees
 - Are Model Fees Hypothetical Performance?
 - When to use Model Fees?
- Consultant Databases
 - Gross/Net Return Data
 - 1/5/10 Year Performance
 - Disclosure Challenges



Additional Compliance Challenges

- Recordkeeping Requirements
 - Requires retention of certain records (e.g., copies of advertisements, all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return).
 - Stricter than Substantiation Requirement
- Substantiation Requirement
 - Advisers must have a “reasonable basis” for believing they are able to substantiate material statements of fact included in advertisements
 - Upon demand by the SEC
 - If an adviser is unable to substantiate a material statement of fact, the SEC will presume that the adviser does not have a “reasonable basis”.



Practical Implications

- Advisers should ensure:
 - That they have developed methodologies and disclosures to comply with the FAQ's net performance requirement for extracted performance;
 - That they have adopted and implemented policies and procedures reasonably designed to prevent violations of the Marketing Rule;
 - That their websites, brochures, slide decks, and other advertisements comply with the Marketing Rule's substantive requirements related to performance advertising, testimonials and endorsements, substantiation of material facts, and third-party ratings, among other requirements; and
 - That they have reviewed and updated (or implemented new) recordkeeping procedures and practices for off-channel communications and conduct trainings with employees.



Looking Ahead

- Private Fund Advisers, Documentation of Registered Investment Adviser Compliance Reviews - Final Rule scheduled for October 2023
 - The SEC is considering adopting rules under the Advisers Act to address lack of transparency, conflicts of interest, and certain other matters involving private fund advisers.
- Economic Analysis – significant costs for advisers to implement.
- Expect significant litigation challenges to follow.



Resources

- Sign up for K&L Content [Stay Informed | K&L Gates \(emailcc.com\)](#)
- K&L speakers
 - [Michael S. Caccese | People | K&L Gates \(klgates.com\)](#)
 - [Pamela A. Grossetti | People | K&L Gates \(klgates.com\)](#)
- Subscribe to the [GIPS Standards Newsletter](#)
- CFA Institute [SEC Marketing Rule resources](#)
- CFA Institute [Annual GIPS Standards Conference](#)
- GIPS Standards Help Desk gips@cfainstitute.org
- Save the date – next webinar on 13 September 2023

