

SEC marketing rule and GIPS

What investment advisers need
to know

The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. A yellow diagonal bar is positioned above the 'Y'.

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Marketing has been a focal point of the Global Investment Performance Standards (GIPS or GIPS Standards), and now it is front and center at the SEC with the recent effectiveness of the SEC Marketing Rule.



Many firms that are GIPS-compliant (or looking to become compliant) have asked the question, “If I am already compliant with GIPS, is it a heavy lift to comply with the SEC marketing rule?” or “How similar is the SEC marketing rule to the GIPS Standards?” In this article we provide more information around the SEC marketing rule and include a compare and contrast between the main items of the rule and the GIPS Standards.

GIPS Standards

The GIPS Standards are a set of standards for dissemination of a firm’s performance results to prospective clients. It is a set of ethical principles focused around full and fair disclosure of performance information. The GIPS Standards were updated in 2020 to provide more flexibility for alternative managers to apply the standards. GIPS 2020 tailored the standards for pooled funds, which have been difficult to integrate within the composite-focused model of the previous versions of the GIPS Standards.

As part of the GIPS Standards, there is a set of advertising guidelines (GIPS Advertising Guidelines) that provide options to a firm when advertising a firm’s GIPS compliance. In addition to these guidelines, firms are required to maintain composite/pooled fund reports that are also included within advertisements. Given the requirements around the composite/pooled fund reports, as well as the GIPS Advertising Guidelines, GIPS-compliant firms (or those looking to become compliant) need to understand the differences between GIPS and the SEC Marketing Rule that require attention.

SEC’s new Marketing Rule – what SEC registered investment advisers need to know

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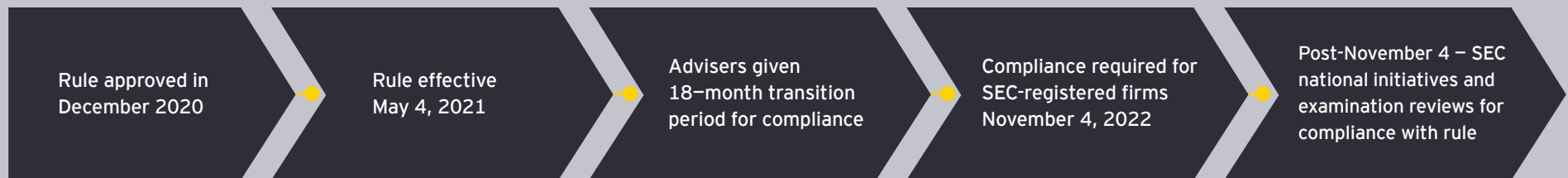
The technology used for communications has advanced, the expectations of investors seeking advisory services have changed, and the profiles of the investment advisory industry have diversified. The new marketing rule recognizes these changes and the Commission’s experience administering the current rules.¹

In a drive to keep up with the evolution of financial markets and technology, the SEC has overhauled its advertising and cash solicitation rules by adopting amendments to Rule 206(4)-1 and Rule 206(4)-3, respectively, as well as related amendments to Form ADV and record keeping requirements.

The new rule aims to remove the patchwork of marketing and advertising regulations and incorporates previous “no action letters” that many firms relied on. In a 2021 Investment Management Information Update,² the SEC stated that previous no-action letters and SEC statements related to the existing Advertising and Cash Solicitation Rule was withdrawn effective November 4, 2022, while others will be modified.

In illustrating compliance with the new rule, firms will be required to tailor their policies and procedures to document how the new rule relates to their business model and business activities and what processes the firm will take to monitor compliance with the new rule.

Rule timeline



Scope and definitions

The rule applies to any investment adviser (IA) registered or required to be registered with the SEC under section 203 of the Investment Advisers Act of 1940 (the Advisers Act) who directly or indirectly disseminates an advertisement. In addition, the rule expressly applies to communications by private fund advisers.

The rule has modified the definition of an “advertisement” to be more “evergreen,” and allows for testimonials and endorsements. Furthermore, the new definition does not differentiate between retail and non-retail investor communications and applies uniformly to both institutions and individuals.

The rule applies to communications that fall within a two-pronged definition of “advertising”:

1

Communications by an investment adviser (traditionally covered by the advertising rule)

- ▶ Any direct or indirect communication by the IA to more than one person (or to one or more persons if the communication includes hypothetical performance) that offers the IA’s investment advisory services to prospective clients or investors in a private fund advised by the IA, or offers new investment advisory services regarding securities to current clients or investors in a private fund advised by the IA.

2 Testimonials and endorsements (traditionally covered by the Cash Solicitation rule)

- ▶ Testimonials or endorsements, including oral communications, directed to at least one person
- ▶ Includes any testimonial or endorsement for which the IA paid compensation to the individual giving the testimonial or endorsement
- ▶ Compensation can be cash or non-cash paid directly or indirectly by the IA (i.e., quid pro quo for the testimonial or endorsement)

What is not considered an “advertisement”

- 1 Extemporaneous, live oral communications (only excluded under Prong 1)
- 2 Information contained in statutory or regulatory notices and filings, provided that such information is reasonably designed to meet the requirements of such notice or filing
- 3 Training, educational meetings and company-sponsored meetings are not considered compensation if it is not provided in exchange for an endorsement or testimonial
- 4 Communication that includes hypothetical performance provided the communication is:
 - ▶ In response to an unsolicited request for such information from a prospective or current client or investor
 - ▶ To a prospective or current investor in a private fund advised by the IA in a one-on-one communication



Key changes

- ▶ **Expansion of advertising definition:** Modified to be more “evergreen” and now also includes testimonials and endorsements
- ▶ **Performance illustration:** Changes include net performance to be provided alongside gross performance, prescribed time periods, restrictions on showing hypothetical and predecessor performance, and a prohibition on any express or implied statements that SEC review or approval has been obtained.
- ▶ **Record-keeping requirements:** IAs must make and keep copies of all advertisements they directly or indirectly disseminate as well as retain key records necessary to substantiate all material statements of fact contained in all advertisements.
- ▶ **Amendments Form ADV reporting:** IAs are required to provide additional information regarding their marketing practices to help facilitate the SEC’s inspection and enforcement capabilities.
- ▶ **Third-party ratings:** IAs must meet conditions relating to being fair and balanced as well as needing to have clear and prominent disclosures.
- ▶ **Testimonials and endorsements:** Permissible if certain disclosures, oversight and disqualification provisions are met

Seven general prohibitions

There are **seven prohibitions** under the rule that preclude an advertisement from:

- ▶ Including any untrue statements or omissions of material fact
- ▶ Including any unsubstantiated material statement of fact
- ▶ Including untrue or misleading implications or inferences
- ▶ Failing to provide fair and balanced treatment of any material risks or material limitations
- ▶ Failing to present specific investment advice in a fair and balanced way
- ▶ Cherry-picking performance results or presenting time periods in a manner that is not fair or balanced
- ▶ Otherwise, being materially misleading

SEC examination approach

In September 2022, the SEC issued a risk alert³ to inform IAs about its areas of focus for upcoming examinations of the new rule. The following areas were listed; however, the SEC also made it clear that it wouldn’t be limited to these areas:

- ▶ Whether IAs have adopted and implemented **written marketing rule policies and procedures** that are reasonably designed to prevent violations
- ▶ Whether IAs have a reasonable basis for believing they will be able to **substantiate material statements of fact in advertisements**
- ▶ Whether IAs are in compliance with the **performance advertising requirements**
- ▶ Whether IAs are in compliance with the amendments to **books and records**



Comparison between SEC Marketing Rule and Global Investment Performance Standards (GIPS)⁴

Theme	SEC Marketing Rule	GIPS Standards	GIPS actions needed
Calculation of gross returns	No prescribed methodology	Requires gross returns to reflect the deduction of transaction costs. For portfolios that invest in underlying pooled funds, gross returns must also reflect the deduction of all fees and expenses, including administrative fees, incurred by these portfolio investments.	No changes required for GIPS compliant firms.
Calculation of net returns	<p>Composites: The rule does not require net returns to reflect the deduction of transaction fees and expenses.</p> <p>Net returns must reflect the deduction of custody fees if they are paid to the investment adviser.</p> <p>Pooled funds: Net returns must reflect the deduction of advisory fees paid by the underlying investment vehicles to the investment adviser but whether administrative fees and expenses must be expensed depends on the facts and circumstances.</p>	<p>Composites: When calculating net returns, transaction costs and investment management fees are required to be deducted.</p> <p>Pooled funds: The above applies with the addition of any other fees and expenses charged to the pooled fund.</p>	<p>For composites: Firms that provide custody services need to recalculate net returns to reflect the deduction of custody fees paid to the firm if these custody fees are not already deducted.</p> <p>Pooled funds: No changes required for GIPS-compliant firms.</p>

Theme	SEC Marketing Rule	GIPS Standards	GIPS actions needed
Presentation of gross and net returns	<p>Prohibition of any gross performance unless the advertisement also presents net performance.</p> <p>Net performance must also be presented with at least equal prominence to gross performance; in a format designed to facilitate comparison with gross performance; calculated using the same type of return as the gross performance, using the same type of return and the same methodology as the gross performance.</p>	<p>Permits gross returns, net returns or both. There is an exception for composite of wrap fee portfolios, which must reflect the deduction of the entire wrap fee that a prospect would pay.</p> <p>Time-weighted returns (TWRs) should be used unless specific circumstances are met.</p> <p>Money-weighted returns (MWRs) may be used instead of TWRs if the firm has control over the external cash flows into and out of the composite portfolios or pooled fund and certain other criteria are met.</p>	<p>GIPS standards do not explicitly require firms to present gross and net returns for the same periods. However, if net returns are shown, gross returns calculated under GIPS will satisfy the marketing rule.</p>
Use of composite performance	<p>Allows performance of related portfolios to be presented which can be presented for each related portfolio on a portfolio-by-portfolio basis, or for the combination of all related portfolios.</p>	<p>When presenting performance of a strategy, a firm must present composite performance and it must include all portfolios managed in that strategy.</p>	<p>GIPS-compliant firms will not need to make any changes.</p>
Model investment management fee (IM fee)	<p>Allows using model advisory fees as long as the deduction of a model fee results in net returns that are no higher than if actual fees had been deducted or it is equal to the highest fee charged to the intended audience.</p>	<p>If a model IM fee is used, the model fee must be appropriate to prospects and must also be equal to or lower than net returns that would have been calculated if actual IM fees were used.</p>	<p>GIPS-compliant firms will not need to make any changes.</p>

Theme	SEC Marketing Rule	GIPS Standards	GIPS actions needed
Non-fee-paying portfolios	Advisers must apply a model fee to non-fee-paying portfolios when calculating net returns.	When calculating net returns for a composite that includes a non-fee-paying portfolio, and actual IM fees are used to calculate net returns, the GIPS Standards allow the firm to use the actual IM management fee of \$0.	Changes will need to be made for firms that calculate composite net returns using actual IM fees and include non-fee-paying portfolios.
Time periods	All advertisements except those for private funds need to include performance for one-, five- and 10-year time periods. If the relevant portfolio did not exist for a particular prescribed period then the adviser must present performance information for the life of the portfolio. Performance for prescribed time periods must also be presented with equal prominence and must end on a date that is no less recent than the most recent calendar year.	Must present at least a five-year track record and must subsequently build toward presenting a minimum 10-year compliant track record.	Firms that provide GIPS reports on a stand-alone basis will need to include the prescribed time periods of one-, five- and 10-year time periods. To meet the requirements of the SEC Marketing Rule, firms may also need to provide performance outside of their GIPS reports.
Predecessor performance	Permitted provided that it meets specific requirements, including that the predecessor performance reflects all portfolios that were managed at the predecessor adviser in a substantially similar manner, and only as long as the person(s) who were primarily responsible for achieving the prior performance results continue to manage accounts at the advertising adviser.	GIPS Standards include requirements that (i) substantially all of the investment decision-makers will need to be employed by the new or acquiring firm, (ii) the decision-making process must remain substantially intact and independent within the new or acquiring firm (iii) there must not be a break in the track record between the past firm or affiliation and the new or acquiring firm.	Under the GIPS Standards, the prior performance becomes that of the current firm; however, under the SEC rule, the firm would not be able to use the track record if the person(s) responsible for achieving that performance no longer manage the portfolios.

Theme	SEC Marketing Rule	GIPS Standards	GIPS actions needed
Benchmarks	Not disclosing how material market conditions affect the performance of the portfolio could be misleading.	Benchmark returns are required. If no appropriate benchmark exists, this must be disclosed.	If a firm concludes there is no appropriate benchmark, the firm should determine if it needs to have a disclosure addressing how material market conditions affected the performance results of the composite/ pooled fund (if applicable).
Theoretical and hypothetical performance	<p>Those that can and cannot receive hypothetical performance are differentiated.</p> <p>Target returns may be considered hypothetical performance.</p>	Do not differentiate between firms that can or cannot receive hypothetical performance.	Firms must create policies and procedures to determine who can receive hypothetical performance. In most cases, hypothetical returns cannot be included within the firm's website. Firms should clarify if hypothetical returns are gross or net.
Carve-outs and extracted performance	<p>Extracted performance can be a subset of any extracted investments.</p> <p>Must present – or for private funds, offer to provide – performance of the total portfolio that the extracted performance is taken from.</p> <p>A composite that includes extracted performance is subject to the conditions of hypothetical performance.</p>	<p>Carve-outs must be representative of a distinct investment strategy.</p> <p>Performance of the total portfolio that the carve-out performance is taken from does not need to be presented.</p> <p>A composite may include carve-outs.</p> <p>Displaying the performance of one investment or a group of investments in a private fund is considered “extracted performance” under the new rule, therefore advertising materials that show gross performance (e.g., case studies) or show the investment return of a list of individual portfolio positions must show the net return for each one, even if presented together with fund-level investment performance on a net basis.⁵</p>	<p>GIPS-compliant firms will not need to make any changes to the carve-out calculation policies and procedures.</p> <p>Firms will need to determine which carve-outs will be considered extracts and subject to the conditions of hypothetical performance.</p>

What firms need to consider

For firms already in compliance with GIPS, the various firm stakeholders will need to continue to communicate to maintain compliance with both the SEC Marketing Rule and the GIPS Standards. For firms looking to become compliant, putting efforts into compliance with the SEC Marketing Rule would allow the firm to achieve GIPS compliance much easier and faster. This will also allow the firm to attract assets under management from additional sources (i.e., internationally). It is critical that firms spend the necessary time on updating the policies and procedures for the new requirements to properly address any differences between both the SEC Marketing Rule and GIPS. This will also involve training the relevant employees on the new requirements and inform them of their new obligations. It is also essential that the effort is multi-departmental (i.e., it should include compliance, legal, marketing, accounting, finance and portfolio management). All departments should have a say given how multifaceted both the rule and the GIPS Standards are.

How can Ernst & Young LLP help?

Alternative asset managers have more complexities and unique scenarios than traditional asset managers, many of whom have been compliant for decades now. Our GIPS professionals have extensive experience delivering verification or consulting projects related to GIPS compliance. In addition to verification engagements, these professionals service investment managers in the areas of regulated and unregulated investment company audits, SOC 1 reporting and other advisory-related engagements. With these services, our professionals bring a breadth of knowledge and experience that enable our teams to be proactive in helping clients manage their GIPS compliance – providing added value along the way.

The EY organization is known for its deep network of experienced asset management professionals, relationships with the industry's key stakeholders and strong global capabilities. Our Wealth and Asset Management (WAM) sector is dedicated to offering industry insight and coordinating a network of more than 21,250 professionals who are ready to develop

practical approaches to the issues our clients face. Our WAM professionals have significant compliance, risk, SEC and investment adviser experience and knowledge to provide insightful, relevant, and actionable observations and recommendations, and we understand the current regulatory environment and know how to deliver results in a timely and efficient manner.

Our team has worked with clients in their initial phases of compliance with GIPS and new SEC regulatory requirements by performing gap analyses as well as verification upon their completion. Our approach to compliance is client-focused and will vary depending on the situation because we know every asset manager is different. To be effective, our approach is “co-developed” with each client. Our initial verifications start with a gap analysis and scoping exercise as well as an evaluation of the client's current state (e.g., performance measurement, policies, procedures, the surrounding control environment, client's goals).

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¹“SEC Adopts Modernized Marketing Rule for Investment Advisers,” SEC website, www.sec.gov/news/press-release/2020-334, 22 December 2020.

²“Division of Investment Management staff statement regarding withdrawal and modification of staff letters related to rulemaking on investment adviser marketing,” SEC website, www.sec.gov/files/2021-10-information-update.pdf, October 2021.

³“Examinations Focused on the New Investment Adviser Marketing Rule,” SEC website, www.sec.gov/files/exams-risk-alert-marketing-rule.pdf, 19 September 2022.

⁴“Reconciling the SEC Marketing Rule to the GIPS® Standards for GIPS-Compliant Firms,” CFA Institute Global Investment Performance Standards website, <https://stage.gipsstandards.org/wp-content/uploads/2021/10/nscp-currents-sep-2021.pdf>, September 2021.

⁵“SEC Breaks its Silence on the New Marketing Rule’s Net Performance Requirements,” Proskauer website, www.proskauer.com/alert/sec-breaks-its-silence-on-the-new-marketing-rules-net-performance-requirements, 18 January 2023.