

THE SEC'S MARKETING RULE: OPEN ISSUES AND LOOMING SWEEP EXAMS

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U.S. Asset Management and Investment Funds Alert

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More than a month has passed since the 4 November compliance date for the Securities and Exchange Commission's (SEC) [Modernized Marketing Rule for Investment Advisers](#) (the Marketing Rule or the Rule), and many in the industry are eagerly—or perhaps anxiously—awaiting the start of sweep exams by the SEC's Division of Examinations (EXAMS).

The SEC staff (the Staff) previewed these exams in a September [risk alert](#) that also outlined portions of the Rule that it intends to focus on when exams begin.¹ In a series of public appearances this fall, members of both EXAMS and the Division of Investment Management (IM) have shared additional insight regarding what to expect from initial sweeps.

This alert summarizes what we know—and do not know—about the Staff's plans for Marketing Rule sweep examinations, including anticipated areas of focus for EXAMS Staff. It also discusses current industry approaches and recent Staff commentary related to a number of “gray areas” in the Rule that remain unclear post-compliance date and will likely be areas of intense scrutiny in upcoming sweep exams.

WHAT TO EXPECT FROM SWEEP EXAMS

At several public events over the past two months, members of the Staff have suggested that sweep exams focused on Marketing Rule compliance would begin soon after the Rule's compliance date, and will be similar in many respects to those that occurred following the industry's implementation of Form CRS in 2020.²

EXAMS Staff have stated in several public appearances that they will not be “playing gotcha”³ in initial sweeps, and that they will instead conduct exams with a goal of ensuring that examined advisers are aware of the amended Rule and have engaged in good faith efforts to comply. In addition, initial sweeps will afford EXAMS Staff the opportunity to better understand the industry's approach to compliance with the Rule. At a recent public event, a member of the EXAMS Staff acknowledged that early deficiency letters will “receive a lot of attention” and that EXAMS Staff will therefore work closely with IM Staff to review and analyze any potential issues before issuing letters.⁴

Although EXAMS Staff has indicated it will still consider enforcement referrals for registrants that have demonstrated a complete failure to comply with the Rule, these statements should provide some comfort to advisers that have worked in good faith over the past several months to develop policies and procedures, conduct employee trainings, revise marketing materials, and otherwise comply with the Rule.

ANTICIPATED AREAS OF FOCUS

In both the September risk alert and subsequent public comments, the Staff has emphasized that the impending sweep exams will evaluate advisers' compliance with all aspects of the Marketing Rule. However, the Staff has also indicated that it will devote enhanced attention to certain focus areas:

Substantiation Requirement

The Rule's general prohibitions require advisers to have a reasonable basis for believing that they will be able to substantiate all material statements of fact in their advertisements upon demand by the SEC. Advisers should anticipate requests from examiners for information designed to test their compliance with this substantiation requirement and should be prepared to provide backup documentation for all factual statements contained in their advertisements. We anticipate that EXAMS Staff may even seek substantiation for statements of opinion in some cases, as a means to test whether advisers could reasonably hold certain opinions at the time they were stated.

Performance Presentation

The Staff will evaluate whether advisers have complied with each of the Marketing Rule's performance requirements. Individual members of the Staff have recently suggested that hypothetical and predecessor performance introduce higher risks to investors, and consequently, examiners may devote enhanced scrutiny to compliance with the Rule's hypothetical and predecessor performance requirements.

Policies, Procedures, and Training

The Staff has acknowledged that some advisers may not have significant volumes of marketing materials for examiners to review early in the sweep exam process. Accordingly, from a practical perspective, many initial sweep exams are likely to center on whether advisers have implemented compliance policies and procedures that are objective, testable, and reasonably designed to prevent violations of the Rule. EXAMS Staff will also likely request information related to Marketing Rule trainings conducted for investor relations, marketing, and other personnel utilizing an adviser's marketing materials.

Books and Records

The Staff has also stated that it will review for compliance with Advisers Act Rule 204-2 (the Recordkeeping Rule), with a focus on amendments to the Recordkeeping Rule adopted in connection with the new Marketing Rule.

DEALING WITH “GRAY AREAS” THAT REMAIN OPEN TO INTERPRETATION

Although the Marketing Rule introduced a “principles-based” framework to address certain issues, most of the Rule imposes prescriptive requirements on investment adviser advertisements, particularly with respect to the presentation of investment performance. While these requirements are largely straightforward, investment advisers preparing for compliance with the Rule have encountered numerous interpretive challenges applying the Rule to real-world scenarios. At a virtual event last month, a member of the IM Staff encouraged advisers grappling with these “gray-area” questions to consider the risks the SEC was trying to address in adopting the Rule, particularly in connection with performance presentation.⁵ In multiple public statements over the last several months, IM Staff members have also recommended that advisers faced with interpretive uncertainty document the reasoning behind their approaches and why their approaches would not be misleading to investors.⁶

In light of these statements, advisers facing any of the “gray areas” outlined below are encouraged to document their interpretation of the Rule's requirements, why the interpretation is consistent with the policy goals of the Rule, and the steps taken to mitigate any potential risks to investors.

Performance of Individual Holdings

The Marketing Rule imposes a requirement that gross performance results in any advertisement be accompanied by net performance results, presented with equal prominence and calculated using the same conventions. The Marketing Rule defines “gross performance” in relevant part as “the performance results of a *portfolio* (or *portions of a portfolio* that are included in extracted performance, if applicable)...”⁷ Many in the industry have taken the position that the performance of individual holdings (e.g., a case study or a schedule of holdings) is not a type of extracted performance. Under this interpretation, the performance of individual holdings would need to be presented on a fair and balanced basis, but would fall outside of the prescriptive gross and net performance requirement. In practice, it can also be confusing and potentially misleading to calculate investment-level performance net of fees in certain scenarios (because actual fees are applied at the portfolio level). To mitigate the risk that an investor could be misled, advisers adopting this approach generally supplement the gross performance of individual holdings with information that clearly demonstrates the effect of fees, such as the gross and net performance of the applicable portfolio.

Although variations on this approach have been adopted widely in the market, it is not entirely without risk, particularly in light of recent statements made by the Staff suggesting that case study performance *is* subject to subsection (d) of the Marketing Rule (the source of the gross and net performance requirement—as well as several other prescriptive requirements related to investment performance).⁸ The treatment of the performance of individual holdings has not been addressed by the Staff in any formal written guidance, and the industry will be paying close attention to this issue during sweep exams.

Risk Statistics

Although “gross performance” and “net performance” are defined in the Marketing Rule, the Rule does not define the universe of information that constitutes “performance” subject to the requirements in subsection (d). Because “performance” is not precisely defined, there has been significant discussion in the industry regarding the treatment under the Rule of statistical measures that are often used to demonstrate the characteristics or risk profile of a portfolio or composite (sometimes referred to as “risk statistics,” “risk-adjusted returns,” or “performance-related metrics”). Absent additional Staff guidance, these determinations require subjective judgment, and some statistical measures may be viewed by the Staff as “performance” while others are not.

In recent statements, members of the IM Staff have stated that any information or metrics illustrating how “well” an adviser performed in providing its advisory services should be treated as “performance” for purposes of the Rule, and that the treatment of performance-related metrics is dependent on the particular facts and circumstances.⁹

In light of this guidance, advisers approaching these issues should seek to distinguish between statistical measures that interpret the performance obtained by a portfolio and those that express whether a portfolio performed well (appreciated) or poorly (depreciated). For example, risk statistics such as a standard deviation that do not express whether a portfolio gained or lost capital are almost certainly not “performance” under the Rule (and therefore could be calculated on gross performance). Additionally, at the 2022 GIPS® Standards Conference

in late October, a member of the IM Staff stated that Sharpe Ratio likely would not be subject to the gross and net requirement.¹⁰ This conclusion suggests that similar metrics like Sortino Ratio and Information Ratio may also be excluded from the gross and net requirement.

While the exact universe of risk statistics that are “performance” is still not entirely clear, a good rule of thumb for identifying risk statistics that should be subject to the net performance requirement is whether the statistic: (i) *interprets* performance through a risk lens, or (ii) *demonstrates* how well a fund or account has performed (alpha, relative returns, etc.). Advisers that have elected to present certain risk statistics or performance-related metrics in an advertisement on a gross basis generally also include the gross and net performance of the referenced portfolio or composite in a proximate location, which reduces the risk that an investor would be misled by this practice.

Performance Attribution

As noted above, the Marketing Rule specifically prohibits presenting the gross performance of a portfolio (or portions of a portfolio that are included in extracted performance) without also showing net returns with equal prominence and calculated according to the same conventions.

In addition to the actual performance of a portfolio or composite, advisers often include attribution analyses in advertisements in order to: (i) demonstrate to investors those attributes of a portfolio that contributed to or detracted from the overall performance results of the portfolio, or (ii) describe the reasons for outperformance or underperformance of a portfolio compared to its benchmark. Such performance attribution can take a number of forms, including attribution that shows the contribution of security selection and asset allocation, the contribution of one or more factors of a quantitative model, or the performance of a portfolio broken down by sector, geography, or region, among others.

While certain types of attribution clearly are not extracted performance because they are derived from characteristics shared by the entire portfolio, sector and geographic attribution may be viewed as extracted performance under a strict reading of the Rule. Members of the IM Staff have also recently stated that “in some cases there is going to be overlap between the definition of extracted performance and the presentation of sector attribution.”¹¹

Notwithstanding this position, much of the industry views the illustration of sector, geographic, and other forms of attribution as entirely different from the presentation of a “carve out” used to demonstrate an adviser’s ability to manage a particular strategy or market a new investible product. Consequently, many in the industry have taken the position that performance attribution that is not clearly extracted performance—when presented for purposes of demonstrating characteristics of a portfolio’s performance and not to market new or different investment products—does not need to be treated as “extracted performance” as defined in the Marketing Rule, and that it is therefore not expressly subject to the net-of-fees requirement in the Rule. In order to mitigate risk, advisers taking this approach typically present the gross and net performance of the entire portfolio from which the performance attribution was calculated (e.g., the representative account) on the same page as the attribution or in a similarly proximate location, although we have also seen other means of showing the effect of fees. While the Marketing Rule imposes the requirement to include or *offer to provide* the performance of the portfolio from which extracted performance is derived, the inclusion of this performance for all attribution, even attribution that is not clearly extracted performance, can help ensure that investors have as much information about the portfolio as reasonably possible.

Use of Actual and Model Fees

The Marketing Rule permits advisers to present net performance calculated based on the application of actual or model fees. When applying model fees, the Marketing Rule requires that the model fee used either: (i) results in performance that is no higher than if the actual fees had been deducted, or (ii) is equal to the highest fee charged to the intended audience of the advertisement.¹²

In each case (whether deducting actual or model fees), the SEC stated in the Adopting Release that advisers must ensure that the performance presented is representative of the fees that the prospective client receiving the advertisement would pay.¹³ Under this requirement, if the actual fees paid by existing client accounts are materially lower than the fees currently charged by an adviser for the same strategy, then the adviser *must* calculate net performance using a higher model fee (which could be based on the highest fee charged or some other methodology that is representative of what the intended audience would pay). Since the discussion in the Adopting Release does not tie directly to any specific requirement in the Rule, the industry will likely pay close attention to the Staff's interpretation of this standard in sweep exams. Of particular interest is whether minor, immaterial differences between actual fees and currently offered fees require use of a model fee.

Submission of Performance to Consultant Databases

In addition to the presentation of performance in direct advertisements, advisers have also faced challenges applying the Rule's gross and net performance requirements in the context of performance provided to consultant databases for dissemination to prospective clients. For example, although many major databases appear to be accepting both net and gross performance, database providers are not necessarily agreeing to present the returns side by side in all cases (e.g., where functionality allows database users to select the returns shown) or with all (or any) of an adviser's narrative performance disclosures. In these situations, advisers will be eager to ascertain whether the Staff believes it is reasonable for managers to confirm that the database makes net and gross performance equally *available* to database users. In a public statement, a member of the IM Staff acknowledged that the Staff is aware of issues related to consultant databases accepting or presenting net returns and has received related requests for guidance.

LOOKING AHEAD

Sweep exams are coming—and likely soon. Although these and many other interpretive gray areas remain, recent public statements made by the Staff indicate that it is at least aware of many of these issues. The Staff has also suggested that initial sweeps will be used as a tool to better understand current industry approaches before the Staff issues additional risk alerts, FAQs, or other formal guidance.

In the interim, advisers grappling with “gray area” interpretive issues should ensure their approaches are well documented and consistently implemented, that employees preparing and disseminating marketing materials are sufficiently trained, and that all advertisements disseminated following the compliance date otherwise comply with the Marketing Rule.

FOOTNOTES

¹ SEC Div. of Examinations, Risk Alert, Examinations Focused on the New Investment Adviser Marketing Rule

(Sept. 19, 2002), <https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf>.

² Welcome Remarks and Regulatory Update, IAA 2022 Compliance Workshop (Oct. 13, 2022). In 2019, the SEC adopted Form CRS, which provides retail investors a brief summary of the services offered by SEC-registered investment advisers and broker-dealers. Subject firms were required to deliver initial Forms CRS to new and existing retail investors in the summer of 2020.

³ Panel II: New Marketing Rule Panel, 2022 Compliance Outreach Program (For Investment Adviser and Investment Company Senior Officers) (Nov. 15, 2022) (hereinafter, 2022 Compliance Outreach Program).

⁴ *Id.*

⁵ *Id.*

⁶ See, e.g., Are You Ready for the SEC Marketing Rule?, 26th Annual GIPS® Standards Conference (Oct. 25, 2022) (hereinafter, 2022 GIPS Standards Conference).

⁷ 17 C.F.R. § 275.206(4)-1(e)(7) (emphasis added).

⁸ 2022 Compliance Outreach Program.

⁹ See, e.g., *id.*

¹⁰ 2022 GIPS Standards Conference.

¹¹ 2022 Compliance Outreach Program.

¹² 17 C.F.R. § 275.206(4)-1(e)(10)(ii).

¹³ Investment Adviser Marketing, Advisers Act Rel. No. 5653 at n.590 (Dec. 22, 2020) (Adopting Release) (“If the fee to be charged to the intended audience is anticipated to be higher than the actual fees charged, the adviser must use a model fee that reflects the anticipated fee to be charged in order not to violate the rule’s general prohibitions.”) This requirement is not expressed in the Rule itself, and it most likely is an interpretation of the prohibition in subparagraph (a)(7) against including performance results in a manner that is not fair and balanced.

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