



Survey Report on SEC Marketing Rule Compliance Practices

CFA Institute
Investment Adviser Association

July 2024

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SURVEY REPORT ON SEC MARKETING RULE COMPLIANCE PRACTICES

Executive Summary

Implementing the SEC's Marketing Rule¹ remains a significant compliance focus for investment advisers.² The CFA Institute United States Investment Performance Committee (USIPC) and the Investment Adviser Association (IAA) conducted a survey to identify current practices for complying with the performance requirements of the Marketing Rule.

Key takeaways from the survey include the following:

- When calculating net returns, model fees are more popular than actual fees, but 37% of firms are still primarily using actual fees.
- Roughly half of the respondents do not include contribution to return in marketing materials, and roughly half do not include attribution effects either. Many respondent comments indicate that this information was removed because of the Marketing Rule.
- There is no predominant policy for classifying attribution effects, contribution, or yield as performance.
- Most firms that are calculating investment-level net internal rates of return (IRRs) use the spread method.
- Approximately 74% of responding firms treat information submitted to databases as an advertisement that is subject to Marketing Rule requirements.
- Approximately 39% of firms do not present hypothetical performance.
- Of those firms that present hypothetical performance, most do so only on a one-on-one basis or in response to unsolicited requests.
- Firms take a variety of approaches for defining which prospect types qualify to receive hypothetical performance, with 36% classifying institutional investors as qualified.
- According to survey respondents, the biggest challenge for complying with the Marketing Rule is determining which information is considered "performance" that must be presented on a net basis.

¹Rule 206(4)-1 under the Investment Advisers Act of 1940.

² 2024 Investment Management Compliance Testing Survey Results: www.investmentadviser.org/resources/investment-management-compliance-testing-surveys/.

In April 2024, the SEC's Division of Examinations released a Risk Alert on Marketing Rule compliance, which included observations on Form ADV reporting and on advertisements. The IAA's analysis of recent Form ADV Part 1A filings made by SEC registered advisers reveals that larger advisers were more likely to engage in the specified advertising practices than smaller advisers. For example, 89.4% of respondents with more than \$100 billion in assets answered "yes" to at least one question, whereas only 31.6% of advisers with less than \$100 million in assets indicated that they engage in any of the specified marketing activities. Inclusion of performance results is the most common advertising practice of advisers (almost 41%), followed by the inclusion of hypothetical performance (almost 23%).³

About the Survey Respondents

The survey was promoted by both CFA Institute and the IAA, and 189 firms took the survey.

To gain insight into the firms that responded to the survey, we asked respondents to provide total firm assets under management (AUM) at the time the survey was taken. Respondents represented firms of all sizes, with smaller firms (AUM of \$1 billion to \$5 billion) and mid-size firms (AUM of \$50 billion to \$250 billion) making up the largest groups of survey participants. **Exhibit 1** shows the full breakdown of respondents by AUM.

Although a firm did not have to claim compliance with the Global Investment Performance Standards (GIPS®) to take the survey, most respondents (80%) claim compliance with the GIPS standards. **Exhibit 2a** shows the responses, and **Exhibit 2b** breaks down compliance claims by AUM.

At least 63% of the respondents in the four smaller AUM groups claimed compliance with the GIPS standards. As firm AUM increases, the percentage of respondents that claim compliance with the GIPS standards steadily increases, reaching 100% compliance in the largest AUM bucket. Exhibit 2b illustrates this fact.

³Investment Adviser Industry Snapshot 2024: www.investmentadviser.org/wp-content/uploads/2024/06/Snapshot2024_FINAL.pdf.

Exhibit 1. Survey Respondents' AUM

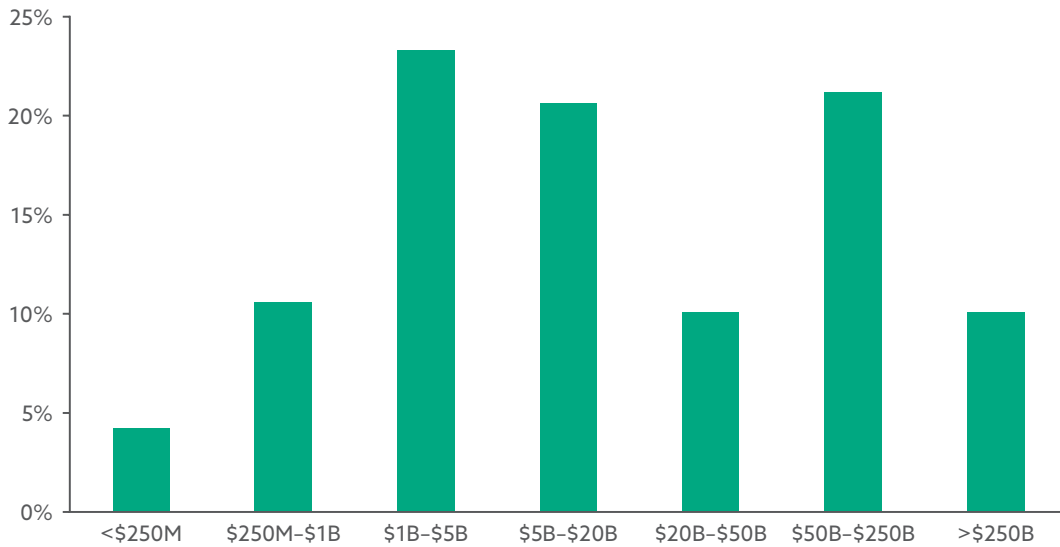
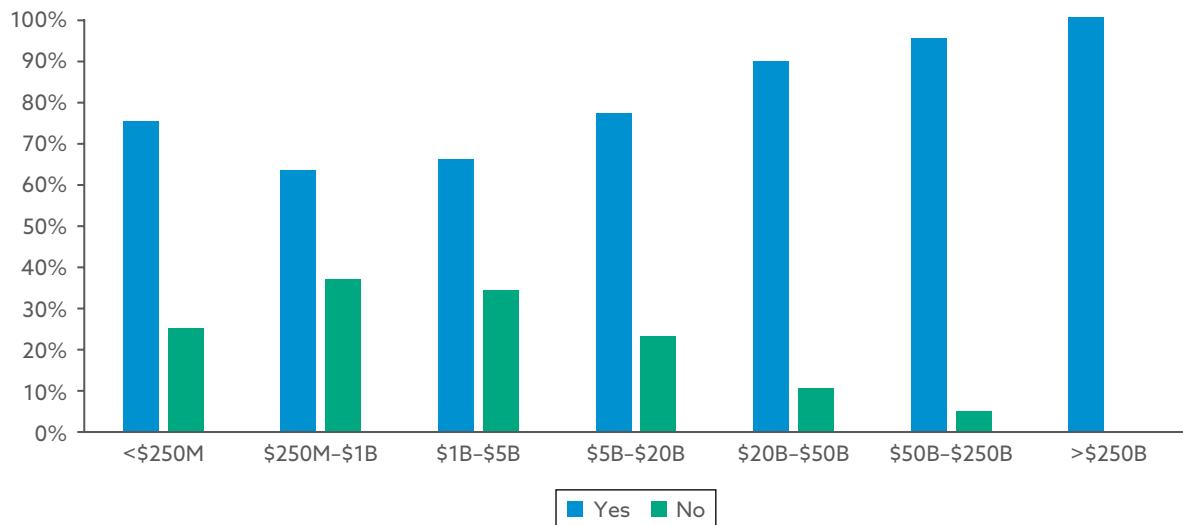


Exhibit 2a. Claim of Compliance with the GIPS Standards

Does your firm claim compliance with the GIPS standards?	
Yes	80%
No	20%

Exhibit 2b. Claim of Compliance with the GIPS Standards by AUM



Use of Model or Actual Fees for Composite Net Returns

The Marketing Rule generally permits firms to use net returns that reflect actual fees paid or a model fee.

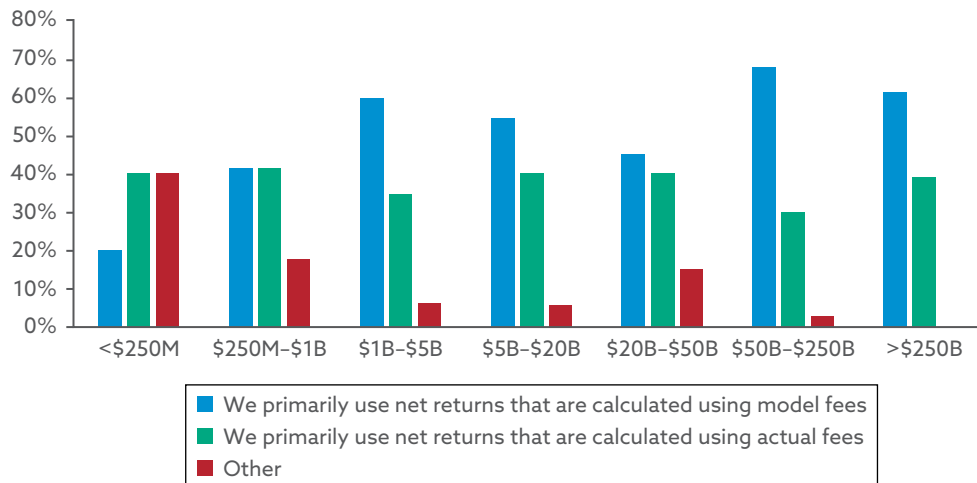
Survey respondents were asked whether they primarily use model fees or actual fees to calculate composite net returns that are included in marketing materials. As **Exhibit 3a** shows, although 54% of survey respondents primarily use model fees for composite net returns, more than one-third (37%) primarily use actual fees. In the comments, most of the respondents that selected “Other” indicated that they use both actual and model fees.

Exhibit 3b shows the results by AUM.

Exhibit 3a. Use of Model or Actual Fees for Composite Net Returns

Which option best describes the composite net returns that are included in your marketing materials?	
We primarily use net returns that are calculated using model fees	54%
We primarily use net returns that are calculated using actual fees	37%
Other	9%

Exhibit 3b. Use of Model or Actual Fees for Composite Net Returns by AUM



Firms with larger AUM levels were more likely to calculate composite net returns using model fees. We believe this relationship could result from a combination of factors. For example, the use of actual fees may be operationally challenging at larger firms, including when multiple systems are used and portfolios have more complicated structures and fee agreements. Moreover, at larger firms, actual fees may not be representative of the fees a prospect would be charged, such as when a variety of fees may be offered or negotiated. Smaller firms, on the other hand, may be more likely to use standard fee agreements.

Surprisingly, almost 40% of the largest firms still reported using actual fees, an approach likely driven by marketing. We believe that when firms use model fees, they typically opt to use the highest tier of the fee schedule as the model fee. That fee may be higher than what most prospects are charged, especially if the prospect has a large portfolio that would benefit from a tiered fee schedule. Moreover, institutional segregated account clients primarily look at composite gross returns and do not place much reliance on composite net returns. In such cases, using a high model fee would not put the firm at a marketing disadvantage. Some firms, however, may take the opposite view, believing that clients may be looking at the composite net returns without knowing that a higher fee has been applied, and therefore want to use actual fees.

Another reason some larger firms may continue to use actual fees is that most performance systems are designed to calculate net returns using actual fees. Some firms may be reluctant to take on an additional technology project or to restate historical net returns.

Prescribed Time Periods

When advertising performance of a portfolio or composite, the Marketing Rule requires performance of that portfolio or composite to be presented for 1-, 5-, and 10-year periods. If the portfolio or composite did not exist for a particular prescribed time period, then performance since inception must also be included. This requirement does not apply to private funds.

Prescribed Time Periods: Inside or Outside of GIPS Reports

Firms that claim compliance with the GIPS standards are required to make every reasonable effort to provide a GIPS Report to all prospects. A GIPS Report includes all of the information required by the GIPS standards for a specific composite or pooled fund. We asked firms that claim compliance with the GIPS standards whether they include returns for the prescribed time periods in their GIPS Composite Reports or in materials provided along with their GIPS Composite Reports. The responses were roughly split down the middle, but slightly more firms (56%) choose to include returns for the prescribed time periods in materials provided along with their GIPS Composite Reports. Another 41% of firms include the prescribed time periods in their GIPS Composite Reports. **Exhibit 4a** details the responses.

Exhibit 4a. Prescribed Time Periods with Respect to GIPS Composite Reports

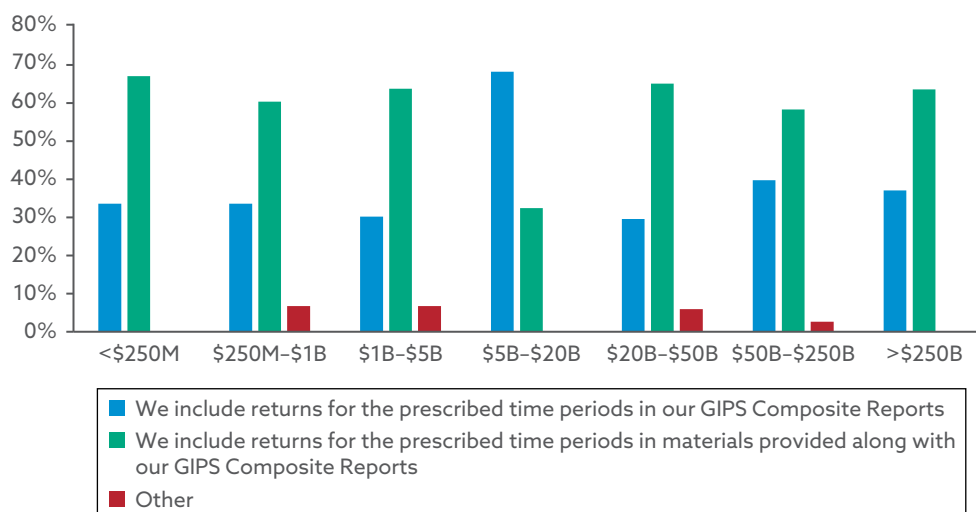
Which option best describes how you address the requirement under the Marketing Rule to include performance for the prescribed time periods with respect to GIPS Composite Reports, if applicable?	
We include returns for the prescribed time periods in our GIPS Composite Reports	41%
We include returns for the prescribed time periods in materials provided along with our GIPS Composite Reports	56%
Other	3%

The firms that include the prescribed time periods in their GIPS Composite Reports may do so because the firm uses, or may use, the GIPS Reports as a standalone advertisement. Some firms may already include these time periods in their GIPS Composite Reports as additional time periods.

Not surprisingly, most respondents reported providing the prescribed time periods outside of the GIPS Composite Reports. Many firms update GIPS Reports annually but update other marketing materials more frequently during the year.

Exhibit 4b illustrates the approach chosen by firm size. Except for firms in the \$5 billion–\$20 billion AUM range, most firms provide returns for the prescribed time periods in separate materials rather than within GIPS Composite Reports.

Exhibit 4b. Prescribed Time Periods with Respect to GIPS Composite Reports by AUM



Prescribed Time Periods: Return Types

The Marketing Rule does not specify which type of returns should be used for the prescribed time periods. Based on our survey, an overwhelming majority (92%) are reporting these returns on an annualized basis. Several firms that selected “Other” stated that they include both annualized and cumulative returns for the prescribed time periods. **Exhibit 5** details the responses.

What Is Considered Performance

The Marketing Rule prohibits any presentation of gross performance in an advertisement unless the advertisement also presents net performance. The same rule applies to extracted performance—any presentation of gross extracted performance must be accompanied by net extracted performance. Extracted performance is defined as the performance results of a subset of investments extracted from a portfolio.

The term “performance” is not defined within the Marketing Rule. How to determine what is considered “performance” has been the subject of much debate, especially for extracted performance and attribution. Attribution reports typically show a variety of performance-related information, sector or investment-level returns, contribution to return,⁴ and attribution effects.⁵ The sector or investment-level returns, contribution to returns, and attribution effects have historically been shown on only a gross basis. If a firm classifies any of these measures as “performance,” it will need to calculate such measures on a net basis.

We asked firms whether they treat contribution to return, attribution effects, and yield as performance.

Exhibit 5. Type of Returns for Prescribed Time Periods

When your firm presents returns for the prescribed time periods, which option best describes the type of returns used for the prescribed time periods?	
Annualized Returns	92%
Cumulative Returns	2%
Other	5%

⁴In the question to survey respondents, contribution to return was described as the sector weight multiplied by the sector return.

⁵In the question to survey respondents, examples of attribution effects included the allocation effect or spread effect.

Firms That Do Not Include Selected Performance Metrics in Marketing Materials

Many firms do not include contribution to return, attribution effects, or yield in marketing materials. **Exhibit 6a** details the responses.

Some firms commented that they removed these performance metrics from their marketing materials because they lack the ability to calculate them on a net basis and/or it would be too costly to implement. One respondent said:

“We view the SEC FAQ from 1/2023 as requiring fees to be deducted from each component of return and have stopped including CTR [contribution to return] in SEC advertisements because we do not have a system to calculate them net of fees.”

The previous prevalence of these performance metrics suggests that clients found them useful in their due diligence of managers. Based on the survey results, however, it appears that many firms removed these helpful metrics to avoid regulatory risk.

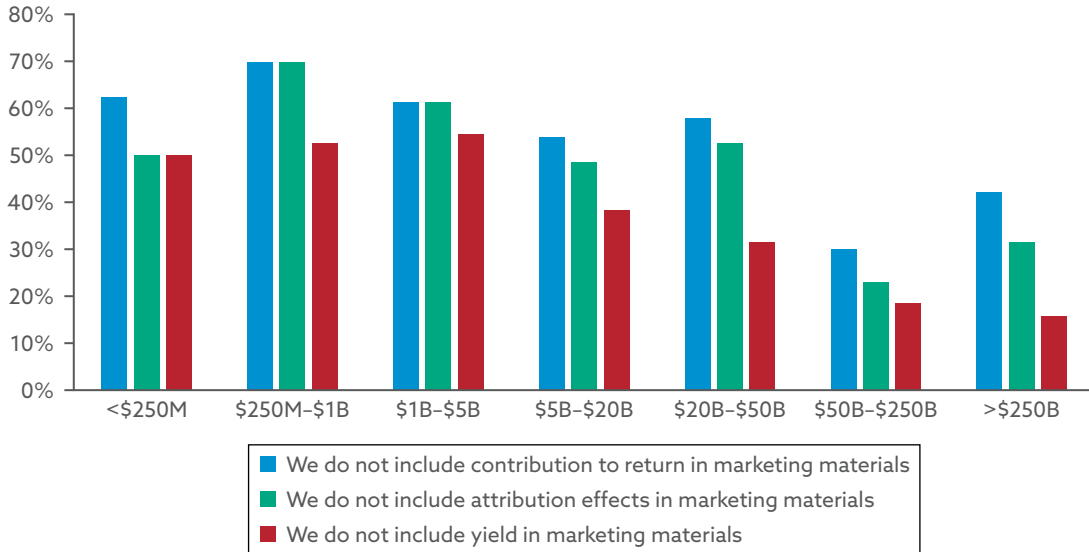
Some firms indicated that they would provide these metrics only upon request, with the appropriate disclosures. Some firms also commented that they did not include these metrics in marketing materials before the Marketing Rule.

Considering firm AUM, we find that smaller firms are more likely to exclude these three metrics from marketing materials, as **Exhibit 6b** illustrates. We expect that some of the respondents in the smaller AUM buckets are catering to retail clients and thus would be less likely to have these types of metrics in their marketing materials.

Exhibit 6a. Exclusion of Selected Performance Metrics from Marketing Materials

Answer Choice	
We do not include contribution to return in marketing materials	52%
We do not include attribution effects in marketing materials	47%
We do not include yield in marketing materials	37%

Exhibit 6b. Exclusion of Selected Performance Metrics from Marketing Materials by AUM



Contribution to Return

Of the survey respondents that include contribution to return in marketing materials, approximately half treat it as performance that must be presented on a net basis and half do not treat it as performance that must be presented on a net basis. A small minority (7%) chose "Other." **Exhibit 7a** details the responses.

Exhibit 7a. Whether Contribution to Return Is Treated as Performance

Which option best describes how you treat contribution to return (e.g., the sector weight multiplied by the sector return) in marketing materials?	
We treat contribution to return as performance that must be presented on a net basis	48%
We do not treat contribution to return as performance that must be presented on a net basis	45%
Other	7%

Some of the comments we received from respondents supporting each answer include the following:

We Treat Contribution to Return as Performance

- “Since it can be attributed to ‘dollars earned,’ we view it as a performance measure. We’d rather be conservative here.”
- “Out of an abundance of caution, we are treating it as performance (and hence ‘extracted performance’), until and unless the SEC issues guidance to the contrary.”
- “We consider this extracted performance.”

We Do Not Treat Contribution to Return as Performance

- “Our intention for presenting contribution to return is to provide a more detailed breakdown of performance for the product being pitched and *not* part of an effort to hold out those more-detailed returns as a separate and independent ‘track record,’ which we believe is the true intent of the rule guidance around ‘extracted performance.’”
- “We feel contribution to return is a metric used to analyze returns. Our sector returns are presented net of fees.”
- “We view this information as descriptive of performance inputs rather than actual performance, and therefore [we] do not believe that the addition of fee data creates meaningful information for the client.”
- “While attribution is provided gross of returns, it is always included in a presentation that provides the full set of performance periods since inception net of returns.”

Other

- “For sector contribution, we have stopped showing performance numbers (gross and net). Instead, we show the weightings and effect. In general, however, we do not agree that contribution to returns should be required to be shown net.”
- “Our firm does not consider total return contribution to be performance under the rule. Due to the uncertainty of the SEC’s view on it, for the time being, we have taken a more conservative approach and removed total contribution from our materials.”
- “The firm provides factor-based attributions (e.g., Fundamental, Country, Sector) in its marketing materials on a gross of fee basis provided that net performance of the relevant composite is presented in order to understand the effect of fees on investment performance.”
- “We are still grappling with this. We only provide contribution upon request.”

- “We do not include contribution to return in marketing materials because we are unable to calculate it net of fees. If, in the future, we are able to calculate contribution net of fees, the data will be added back to marketing materials.”

Looking at the results by firm size, we find a variety of practices across the different AUM ranges. **Exhibit 7b** illustrates each approach by AUM range.

Attribution Effects

Of the firms that include attribution effects in marketing materials, approximately half classify all or some attribution effects as performance, and half classify no attribution effects as performance. Within the group of firms that classify all or some attribution effects as performance, approximately half classify all attribution effects as performance, and the other half classify some attribution effects as performance. **Exhibit 8a** details the responses.

Exhibit 7b. Whether Contribution to Return Is Treated as Performance by AUM

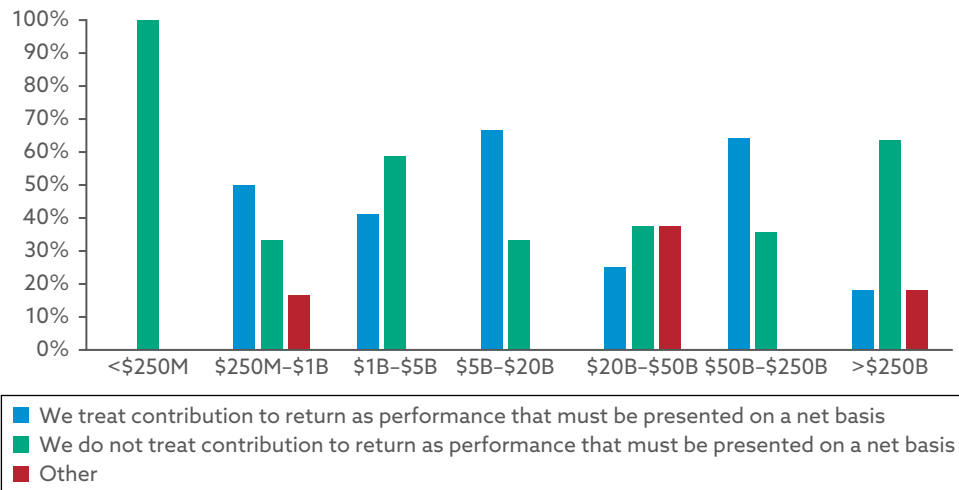


Exhibit 8a. Whether Attribution Effects Are Treated as Performance

Which option best describes how you classify attribution effects (e.g., allocation effect, spread effect) in marketing materials?	
We classify all attribution effects as performance that must be presented on a net basis	23%
We specifically define and classify various types of attribution effects as being or not being performance that must be presented on a net basis	19%
We do not classify any attribution effects as performance that must be presented on a net basis	53%
Other	5%

Some of the comments we received from respondents supporting each answer include the following:

We Specifically Define and Classify Various Types of Attribution Effects as Being or Not Being Performance

- “Attribution that interprets the performance of a portfolio based on certain characteristics shared by some or all positions in the portfolio is not performance under the Rule and does not need to be presented net of fees.”
- “Attribution that results in a figure that implies performance is excluded unless we can show net of fees. Attribution that results in a figure that does not imply performance is shown as is without contemplating a net of fees figure.”

We Do Not Classify Any Attribution Effects as Performance

- “Relative attribution impact explains a difference between a fund’s return and a benchmark. It is not a return on investment.”
- “We view this information as descriptive of performance inputs rather than actual performance, and therefore [we] do not believe that the addition of fee data creates meaningful information for the client.”

Other

- “Attribution effects presented for the entire portfolio are not shown net, because we show the composite net of fees within the same presentation. And we don’t view attribution for the entire portfolio to be extracted performance as defined in the Marketing Rule.”
- “We do not classify attribution effects as performance that must be treated on a net basis *unless* those numbers are being used to represent an investible strategy of the firm (we are trying to sell a capability), in which case they must be shown net. Otherwise, they are treated as portfolio analytics and not performance.”
- “We show the total return and returns on the sectors as net.”

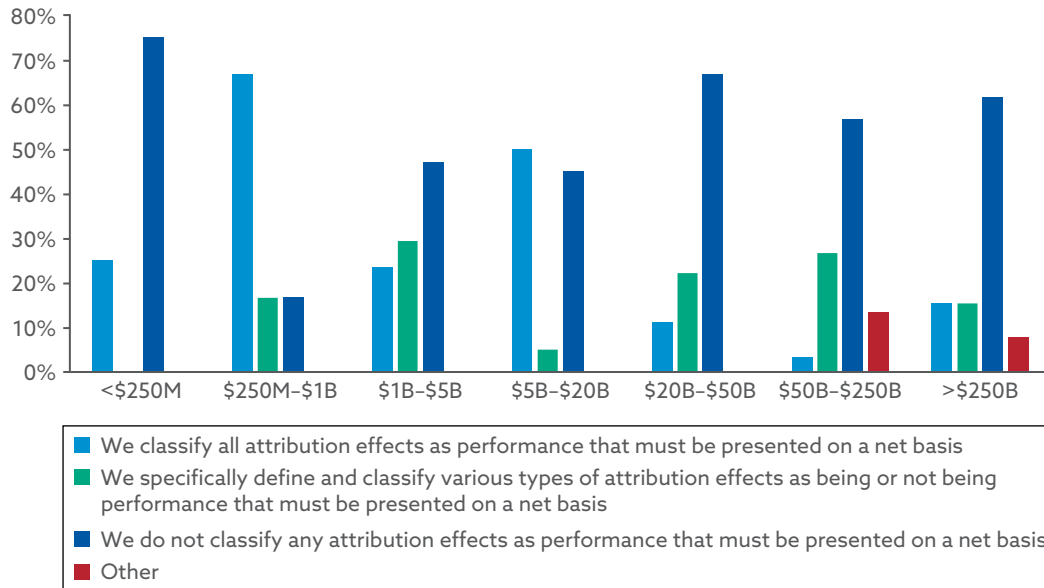
Looking at the results by firm size, we find that larger firms are more likely to not consider attribution effects to be performance. **Exhibit 8b** breaks down the results by AUM.

Yield

We provided two answer choices for firms that classify yield as performance in their marketing materials—classify all yields as performance or classify some yields as performance.

Approximately half of the respondents classify all or some types of yield as performance, and half do not classify any types of yield as performance. Within

Exhibit 8b. Whether Attribution Effects Are Treated as Performance by AUM



the group of firms that classify all or some types of yields as performance, approximately half classify all types of yields as performance, and the other half classify some types of yields as performance. **Exhibit 9a** details the responses.

Some of the comments we received from respondents supporting each answer include the following:

We Treat All Yields as Performance

- “If the yield is calculated by using the holdings in a portfolio, then it’s considered performance where we calculate gross and net yield.”
- “We believe that yield is an important performance characteristic and should be presented net of fees.”
- “We typically show gross and net yields.”

Exhibit 9a. Whether Yield Is Treated as Performance

Which option best describes how you treat yield in marketing materials?	
We treat all yields as performance that must be presented on a net basis	26%
It depends on the type of yield—we treat some yields as performance that must be presented on a net basis, but we do not treat other yields as performance that must be presented on a net basis	24%
We do not consider any yield to be performance that must be presented on a net basis	49%
Other	1%

We Treat Some Yields as Performance

- Commenter 1
 - “Not performance: If a yield is an aggregated statistic at a given point, that is indicative of the type of securities held, rather than actual income received in the portfolio. If this number were to be considered performance, it would also be hypothetical since the portfolio may or may not hold the same securities to actually produce the indicated yield.”
 - “Performance: If the yield is a calculation of income received into or distributed by a portfolio, then it would be a realized return to the portfolio or investor.”
- Commenter 2
 - “Not Performance: Yields as characteristics of the underlying securities as of a specific point in time; stats representative only of the securities held on a given day; stats used to give an investor an idea of the risk or return profile of a fund as of a specific date but are not reflective of what was actually earned by the portfolio/fund; Yield to Maturity (YTM), Yield to Worst (YTW); Current Yield.”
 - “Performance: SEC Yield based on actual income received, yield to 3-year if includes actual income; current yield based on actual income received; distribution yield, trailing 12-month distribution yield.”
- Commenter 3
 - “Not Performance: YTM/YTW/coupon or other characteristics based on contractual elements.”
 - “Performance: if presented as what an asset/portfolio has paid/yielded (i.e., dividend yield).”
- Commenter 4
 - “Not Performance: Standard yield metrics like YTM, YTW.”
 - “Performance: If yield is meant to represent return to investors, we would treat as returns.”

We Do Not Consider Any Yield to Be Performance

- “Have now restricted the use of yield to certain audiences.”
- “Include a disclosure—e.g., ‘yield should not be used as an indication of the income that has or will be received.’ We do not consider yield as performance but instead as relating to the income production profile of the portfolio and its underlying assets.”
- “The typical yield we are including is the average dividend yield of the companies in the portfolio. We see this as an attribute of the portfolio and not as a take-home performance for the investor.”

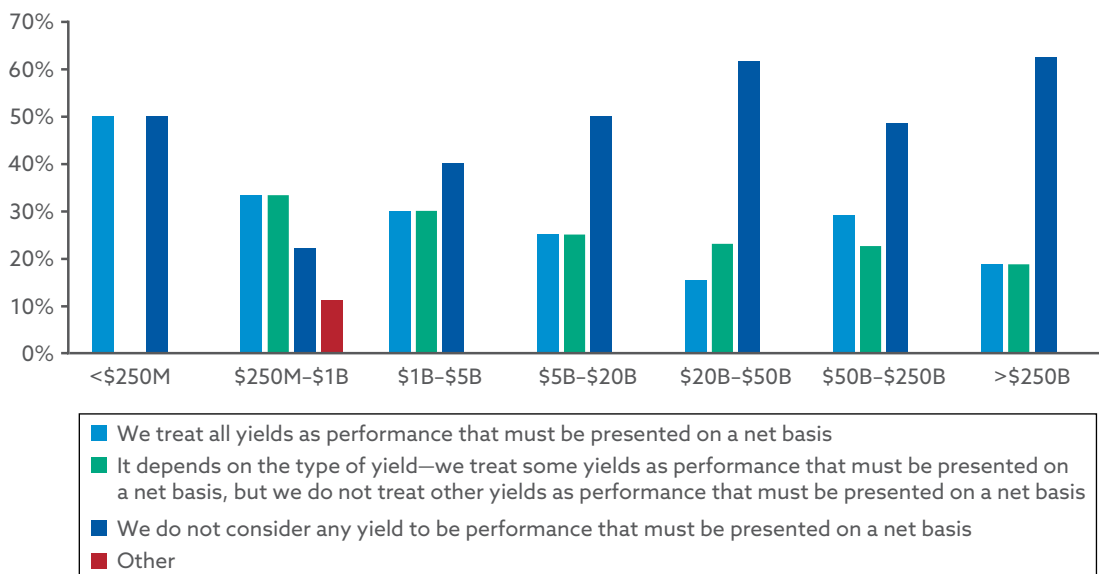
- “When dividend yield is presented, it is a snapshot at that moment in time, and the dividend can increase, decrease, or no longer be paid.... [D]ividend yield is simply a metric or portfolio characteristic and often does not lead to either positive or negative performance by itself.”
- “Yields are considered indicators of returns and not specific asset or fund performance.”
- “Yield changes [are] dependent on other market and instrument-specific conditions.”

Other

- “We rarely display yield characteristics in our materials, but where dividend yield or yield to maturity have been shown, we have defaulted to the characteristics provider’s original number and have not attempted to convert those to some ‘net’ format. In our limited opinion, these are really in the realm of ‘characteristics/statistics,’ as they are almost exclusively asked for as part of evaluating the portfolio’s construction and risk characteristics, not its performance. Even in the marketing questionnaires and databases, this data is asked for along with sector weights, top ten, market cap, etc. ... and never on sections designed to collect performance data.”

Looking at the results by firm size, we find the conclusions are similar to attribution effects. In the smallest AUM group, some firms are treating all types of yield as performance, whereas others are not treating any types of yield as performance. Among small to mid-size firms, more firms treat yield as performance. For larger firms, the majority are not treating yield as performance. **Exhibit 9b** illustrates these findings.

Exhibit 9b. Whether Yield Is Treated as Performance by AUM



Investment-Level Net Return Calculations

In January 2023, the SEC issued an FAQ interpreting the Marketing Rule, which states that displaying the performance of one investment (e.g., a case study) or a group of investments from a private fund is considered extracted performance under the Marketing Rule. Accordingly, an adviser may not show gross performance of one investment or a group of investments from a private fund without also showing the net performance of that single investment or group of investments, respectively. We asked how firms are meeting this requirement.

Time-Weighted Returns

Approximately 40% of survey respondents do not calculate investment-level returns on a time-weighted return basis. Of those firms that calculate investment-level net returns on a time-weighted return basis, more than 50% perform these calculations in a performance or attribution system. Approximately 40% perform the calculations in a spreadsheet, and 7% responded "Other." **Exhibit 10** details the results.

More than half of the respondents already are using a system to calculate investment-level net returns. We expect this percentage to increase as more system providers offer the functionality to calculate investment-level net returns on a time-weighted return basis.

A few firms mentioned using the following methodologies in the comments:

- Applying model fees (the most popular approach)
- Allocating actual fund fees based on the number of days
- Adjusting the gross return for a weighted portion of the difference between the net and gross performance for the portfolio

Exhibit 10. Calculation of Investment-Level Net Time-Weighted Returns

How does your firm calculate investment-level net returns on a time-weighted return basis?	
We calculate investment-level net returns in a performance/attribution system	53%
We calculate investment-level net returns using a spreadsheet	39%
Other	7%

Note: The percentages do not sum to 100% because of rounding.

Internal Rates of Return

A significant majority of survey respondents (77%) do not calculate investment-level net IRRs. We believe this result reflects the population of firms that chose to take the survey—predominantly GIPS-compliant firms that manage more-traditional asset classes.

When the survey was issued, we were aware of two commonly used methods to calculate investment-level net IRRs—the “spread” method and the “ratio” method. We knew firms were using other methods as well, and we wanted to hear what those were. We asked firms whether they were using the spread method, the ratio method, or another method. For those selecting the latter option, we asked what other methods they used.

The spread method takes the difference between the portfolio’s gross and net return and subtracts that difference from the investment-level gross return. For example, if the fund-level gross IRR is 10% and the fund-level net IRR is 8%, subtract the 2% difference from the investment-level gross IRR. The ratio method takes the ratio of the portfolio’s net return to the portfolio’s gross return and then applies that ratio to the investment-level gross IRR. Using the same example, the ratio is calculated as 8%/10%, or 80%. The investment-level gross IRR is multiplied by the 80% ratio to arrive at the investment-level net IRR.

Exhibit 11 shows that more than 50% of survey respondents use the spread method, 12% use the ratio method, and 35% use another method. We believe that the ratio method is more widely used than indicated by our survey, however, and that our results, once again, are the product of the type of firms that responded to our survey.

Some respondents explained their choice as follows:

- “We are currently researching what method we should be using to calculate investment-level net returns. The current recommendation/process has been to use the “ratio” method, and we’ve been informed that this is the preferred method of most investment firms, but we’d prefer to use the “spread” method because the output seems more reasonable. However, we’re also not sure if we want to be in the minority with other firms choosing this methodology.”

Exhibit 11. Calculation Methodology for Investment-Level Net IRRs

When your firm calculates investment-level net returns on an internal rate of return basis, which option best describes your calculation methodology?	
We use the “spread” method	53%
We use the “ratio” method	12%
Other	35%

- “We calculate net returns in Excel. For most of our reporting, the net of fee, promotes, and fund level expenses are based on actual fees. For returns slices where we have to allocate the fund level fees, we base the allocation on the number of days invested and the ratio of capital contributed per investment. We are contemplating switching to the spread method, as it is easier and we are finding more in the industry use this.”

Some respondents that selected “Other” explained their approaches as follows:

- “Allocate expenses to the underlying investments, then calculate returns based on LP cash flows.”
- “Apply a model fee calculation.”
- “The calculations are done on a case-by-case basis with robust disclosure. Some returns may use the spread method; some may use the ratio method.”
- “We calculate a debt cash flow for each investment based on actual fund-level leverage and actual investment-level cost basis. Then we allocate actual fund-level expenses and fees across investments to arrive at a levered net cash flow for each investment to calculate their IRRs.”
- “We use different methodologies depending on the scenario (e.g., prospective investments for an existing fund, prospective investments for a co-investment fund, case studies for investments in the portfolio being presented, etc.). In certain situations, we use the spread methodology. We do not use the ratio methodology.”

Databases

We asked how firms treat database submissions under the Marketing Rule.

Do Firms Treat Information Submitted to Databases as an Advertisement?

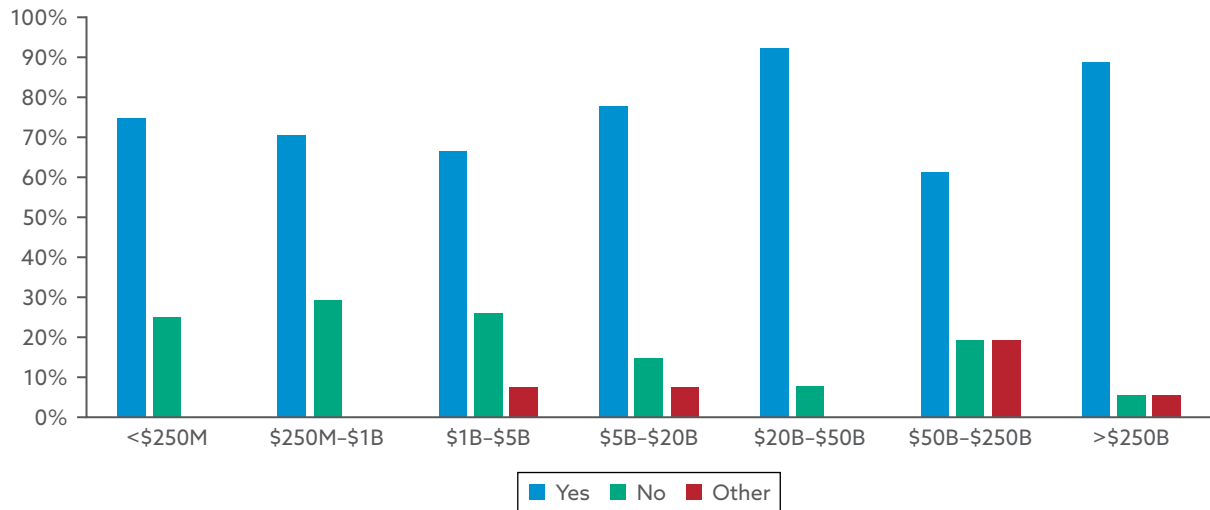
Most survey respondents (74%) treat information submitted to databases as an advertisement, but 18% do not. Another 8% selected Other. **Exhibit 12a** details the results.

Looking at the data by firm size, the policies are similar regardless of AUM. **Exhibit 12b** illustrates these results.

Exhibit 12a. If Databases Are Treated as an Advertisement

Does your firm treat information submitted to databases as an advertisement that is subject to SEC Marketing Rule requirements?	
Yes	74%
No	18%
Other	8%

Exhibit 12b. If Databases Are Treated as an Advertisement by AUM



How Information Is Submitted to Databases

We asked survey respondents what kind of information they provide to the database. More than half (57%) of the survey respondents provide only the information requested by the database, whereas 38% also provide information outside of the database submission requirements. **Exhibit 13** details the responses.

Hypothetical Performance

The Marketing Rule requires firms to establish policies and procedures to ensure that they provide hypothetical performance only 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.” Hypothetical performance includes, but is not limited to, performance derived from model portfolios, backtested performance, and targeted or projected performance returns. The use of hypothetical

Exhibit 13. Composite Information Provided to Databases

When your firm enters composite information in a database, which option best describes the information your firm provides to the database?	
We provide only the information requested by the database	57%
We provide information outside of the database submission requirements that includes other information required by the SEC Marketing Rule	38%
Other	5%

performance has been the focus of recent SEC examinations and enforcement actions. We asked a general question about the treatment of all hypothetical performance.

Use of Hypothetical Performance

Approximately 39% of survey respondents indicated that they do not provide any hypothetical performance. As firm size increases, so does the firm’s use of hypothetical performance. **Exhibit 14** illustrates this dynamic.

Providing Hypothetical Performance

Of the firms that provide hypothetical performance, **Exhibit 15a** shows that 47% provide it through one-on-one meetings, and 29% provide it through unsolicited requests. Only 3% of firms provide hypothetical performance through a password-protected website or a website that requires attestation.

We received numerous comments, including the following:

- “When sharing our actual composite performance with UMA [unified managed account]/model sponsors, we consider our actual performance “hypothetical” in that case, since the UMA/models haven’t earned that performance in the same way our discretionary clients have.”
- “We act as subadvisor for a number of models/wrap portfolios that are distributed by third parties. On occasion, they may ask for performance based on these model portfolios that may be sent externally or included

Exhibit 14. Use of Hypothetical Performance by AUM

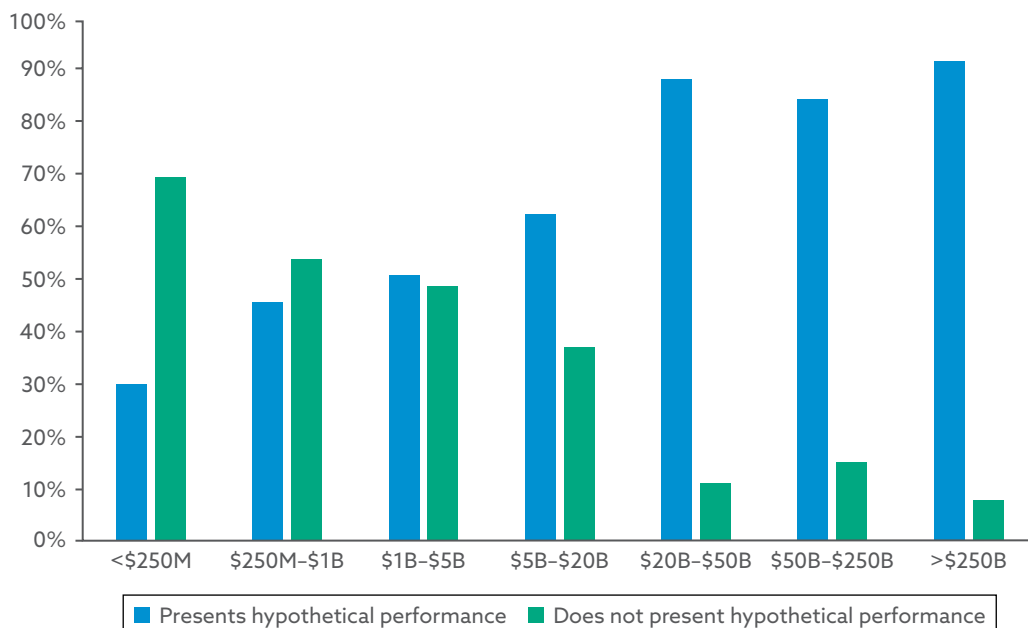


Exhibit 15a. How Hypothetical Performance Is Provided

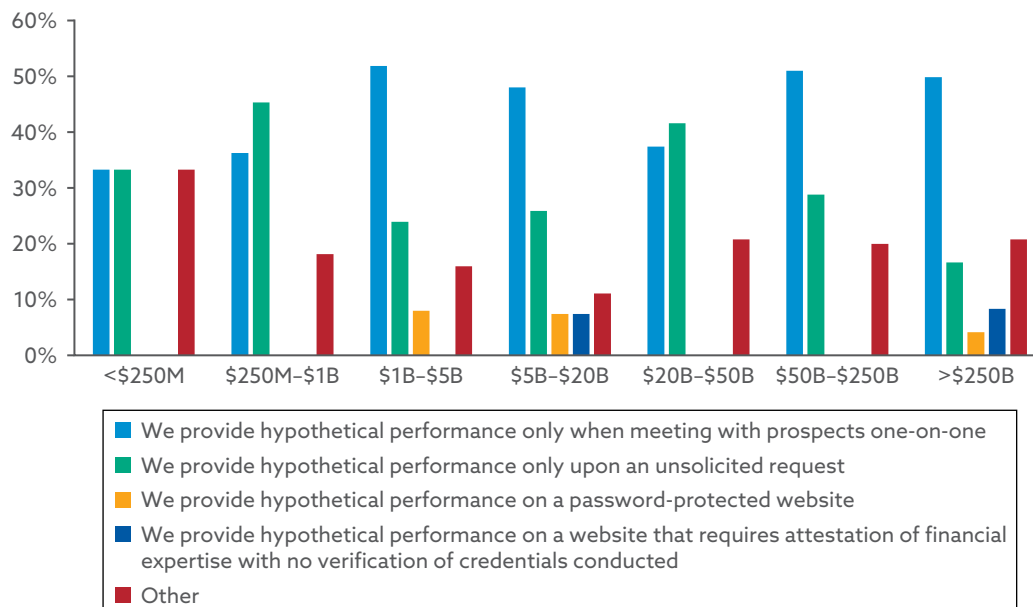
Which options describe how you ensure hypothetical performance (e.g., model performance, backtested performance) is provided only to those who have the resources and financial expertise necessary to understand the hypothetical performance (i.e., to an intended audience(s) that have been clearly specified in your policies and procedures)? Select all that apply.	
We provide hypothetical performance only when meeting with prospects one-on-one	47%
We provide hypothetical performance upon an unsolicited request	29%
We provide hypothetical performance on a password-protected website	3%
We provide hypothetical performance on a website that requires attestation of financial expertise with no verification of credentials conducted	3%
Other	18%

in presentations. This will include a footnote explaining it is hypothetical. Hypothetical performance information is available to: investors we know are interested in a particular product, intermediaries who offer the product, or (only if the intermediary has agreed to certain responsibilities in writing) clients of intermediaries. Hypothetical performance is not necessarily presented one-on-one, but it is not publicly available."

- "Our investors are typically sophisticated, institutional investors. In addition, prospective investors complete a suitability questionnaire when we begin engaging with them."
- "When we provide illustrative hypothetical performance, the market materials are intended for financial professionals only."
- "We have expressly approved specific types of hypothetical performance for all clients with appropriate disclosure (e.g., one-on-one account growth illustrations). Types of performance that have not been expressly vetted and permitted by our policy for broad client use are reviewed on a case-by-case basis. Typically, hypothetical performance, such as backtested performance or other performance not actually achieved, would be prohibited unless requested by a specific client or prospect."
- "We only provide it to certain investors (e.g., QIBs [qualified institutional buyers], institutional investors)."
- "We provide hypothetical performance only when meeting with current clients one-on-one."
- "We require a prequalification to make sure prospects are eligible to receive the data."

Responses were generally consistent across firms of all sizes, as illustrated in **Exhibit 15b**.

Exhibit 15b. How Hypothetical Performance Is Provided by AUM



Prospect Types That Can Receive Hypothetical Performance

We asked firms which audiences are generally approved for receiving hypothetical performance. **Exhibit 16a** details the responses.

The most common policy is for firms to define certain institutional investor types in their policies and procedures as being qualified to receive hypothetical performance. We asked firms that follow this policy to describe how they

Exhibit 16a. Audiences Approved for Receiving Hypothetical Performance

Which audiences has your firm generally approved for receiving hypothetical performance? Select all that apply.	
Institutional Investors as defined in our policies and procedures. Please describe below how you define institutional investors for this purpose (e.g., QIB, accredited investor, etc.)	36%
Institutional Investors as defined by FINRA Rule 2210	16%
Retail Investors (i.e., individuals)	6%
Financial Professionals	27%
Plan Sponsors	10%
Other	5%

define institutional investors. The comments provided by respondents included a variety of investor types, with “accredited investors” mentioned the most frequently:

- accredited investors
- qualified institutional buyers
- qualified eligible participants
- qualified clients
- consultants
- qualified purchasers, those defined in FINRA Rule 2210 and FINRA Rule 4512
- non-retail clients who meet the criteria of a “sophisticated investor”
- financial professionals
- institutions or plan sponsors
- institutional investors as defined under the UK Financial Conduct Authority’s Conduct of Business Sourcebook (COBS) Rule 3.5
- non-individual investors
- clients and prospects from endowments, pension funds, insurance companies, managed accounts, retirement plan sponsors, consultants, state and corporate treasurers, and financial intermediaries

Firms also noted that policies will differ depending on the type of hypothetical performance. For example, one firm said that the type of audience for which hypothetical performance is approved depends on how complex the performance is and how easily risks and assumptions can be explained.

We specifically asked about some of the investor types the respondents mentioned in the comments described in the previous paragraph. Sixteen percent of respondents will provide hypothetical performance to institutional investors as defined by FINRA Rule 2210, 27% will provide it to financial professionals, and 10% will provide it to plan sponsors.

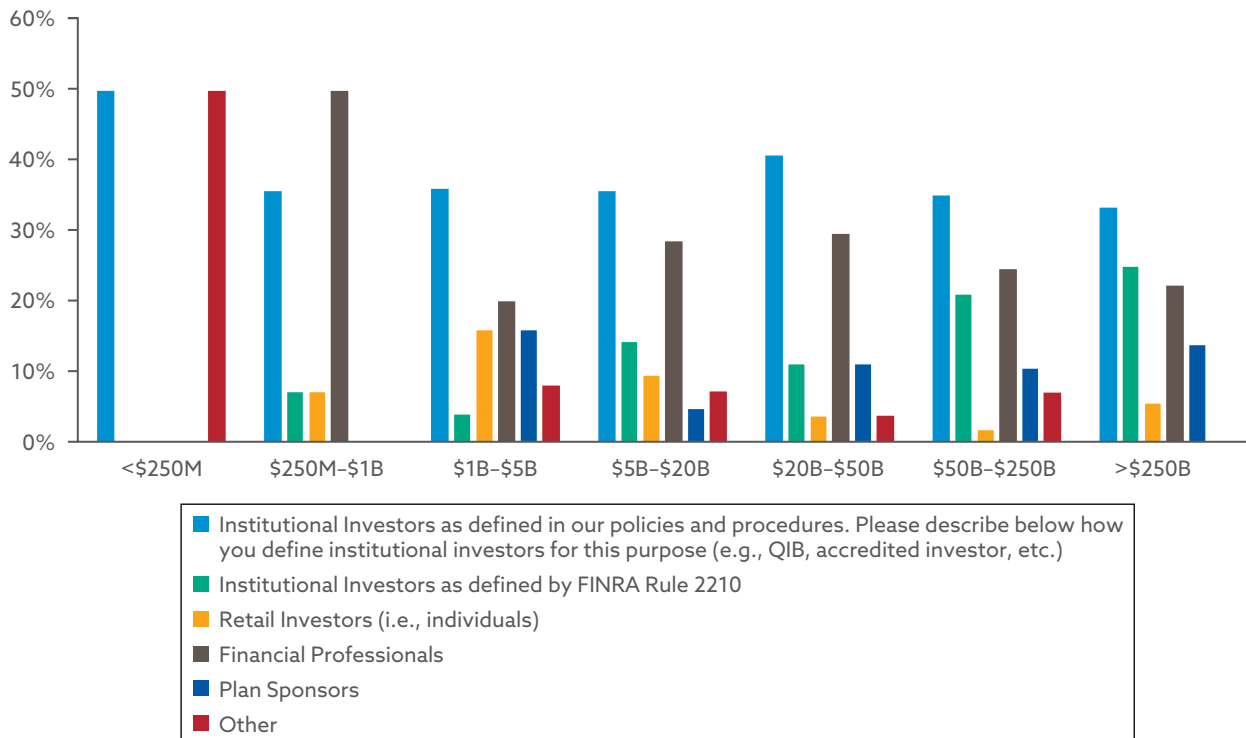
Although 6% of firms indicated they provide hypothetical performance to retail investors, several of these respondents added comments. One firm indicated that for retail investors, the firm allows provision of certain, but not all, types of hypothetical performance only if the investor is a qualified purchaser or accredited investor. Another firm also indicated that the investor must be an accredited or qualified investor.

Five percent of firms indicated using other policies. Some of these policies include the following:

- “Only clients who ask for cash flow analyses and with whom we meet and review those hypothetical cash flows on a one-on-one basis. From time to time, a potential client may ask for such hypothetical cash flow analyses—in those unique situations, we meet one-on-one to review those spreadsheets and fully disclose their hypothetical nature and risks of investing.”
- “We do not differentiate at a client/prospect level. In any case in which hypothetical performance is required, compliance approves and adds disclosures.”
- “We have not specifically defined, but based on the ways in which we use, we believe the recipient is qualified to receive. Most prospects are HNW [high net worth], AI [accredited investors], [or] QCs [qualified clients].”
- “We provide hypothetical performance if requested.”

We also looked at responses by firm AUM, which did not show meaningful differences based on firm size. **Exhibit 16b** illustrates these results.

Exhibit 16b. Audiences Approved for Receiving Hypothetical Performance by AUM



Biggest Challenges

We asked firms about their biggest challenges with implementing the Marketing Rule. **Exhibit 17a** shows that the most popular answer was “Determining what is considered performance that must be presented on a net basis,” selected by 36% of respondents. Calculating investment-level net returns (16%), restricted use of hypothetical performance (11%), and determining what is considered extracted performance (10%) were also selected as the biggest challenges by many firms. Only 7% of firms chose determining which fees to use to calculate net returns as their biggest challenge.

Some of the respondents’ comments about other challenges include the following:

- “Defining appropriate disclosures for hypothetical performance scenarios.”
- “Identifying the balance between providing minimally required disclosures versus over-disclosing to the point [at] which the disclosures overtake the marketing piece out of an abundance of caution.”
- “Initially working with databases to get them to help us comply with the new rule requirements and the lack of any leverage to get them to modify their systems to bring in line with new requirements.”
- “The challenge is the fact that all communications with clients or prospects fall under the Marketing Rule. We routinely need to impress this fact on advisers and representatives of the firm.”
- “Trying to decipher what the SEC is really looking for in certain situations without any guidance from them.”
- “The overall frustration of the loss of meaning of performance numbers sent to institutional investors because of the net-of-fees.”

Exhibit 17a. Biggest Challenges with Implementing the Marketing Rule

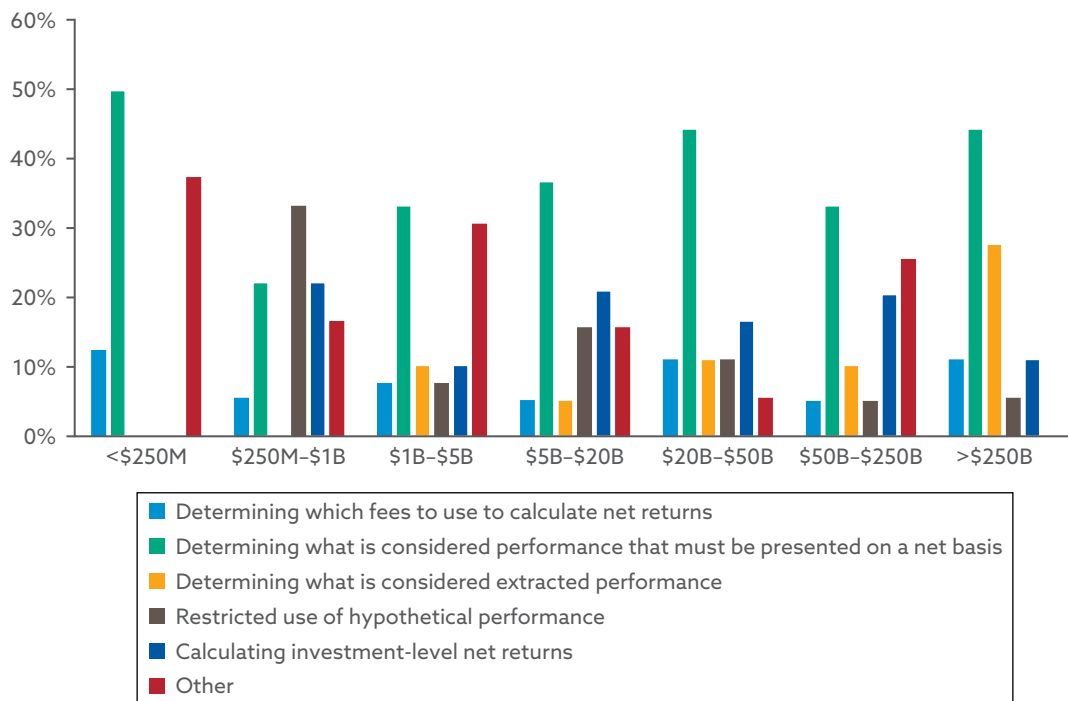
What has been your biggest challenge with implementing the Marketing Rule requirements?	
Determining what is considered performance that must be presented on a net basis	36%
Calculating investment-level net returns	16%
Restricted use of hypothetical performance	11%
Determining what is considered extracted performance	10%
Determining which fees to use to calculate net returns	7%
Other	20%

- “Removing predecessor performance from composites when investment team changes occur years after the performance was ported over from the previous firm. We believe the industry is still grappling with how and whether to act on the predecessor guidance in the Marketing Rule.”

When we look at the challenges by firm AUM, it seems that firms of all sizes find it challenging to determine both what is considered performance that must be presented on a net basis and which fees to use to calculate net returns. The restricted use of hypothetical performance is more of a challenge for smaller firms. This finding is not surprising, given that firms with a focus on retail clients often provided model performance before the Marketing Rule, but model performance is now considered hypothetical performance that has restrictions on its distribution.

Determining what is considered to be extracted performance becomes increasingly more challenging for firms as AUM increases. This could be the case because larger firms may typically have more sophisticated clients who will want more performance-related metrics, such as attribution and risk measures. The number of firms that selected calculating investment-level net returns as the biggest challenge was generally consistent for all AUM levels. **Exhibit 17b** illustrates these findings.

Exhibit 17b. Biggest Challenges with Implementing the Marketing Rule by AUM



Conclusion

More than two years have passed since the Marketing Rule came into effect. After implementing their policies and procedures in this area, firms want to know the common practices in the industry to determine if they should refine their approach. We hope these survey results will help firms assess their Marketing Rule compliance policies.

We welcome your feedback. Please submit any feedback or questions to CFA Institute at gips@cfainstitute.org or Sanjay Lamba at the IAA at sanjay.lamba@investmentadviser.org.



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