

Alert

The SEC's Staff Issues a New Marketing Rule FAQ on Net Performance Requirements

January 18, 2023

On Jan. 11, 2023, the staff of the U.S. Securities and Exchange Commission's Division of Investment Management ("Staff") issued an FAQ update ("FAQ"), excerpted below,¹ stating the Staff's belief that Investment Advisers Act Rule 206(4)-1 ("Marketing Rule") prohibits registered investment advisers from disseminating advertisements showing the gross performance of one investment or a group of investments in a private fund without showing, with equal prominence, the net performance of such single investment or group of investments. This FAQ addresses a key point of ambiguity and market divergence, and comes over two months after the Marketing Rule's compliance date on Nov. 4, 2022.

Background on the Net and Gross Debate

The Marketing Rule prohibits any presentation of "gross performance" in an advertisement unless accompanied by "net performance" that is shown with equal prominence, calculated over the same time period and uses the same type of return and methodology. Gross and net performance are both defined as relating to the "performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable)."² Prior to the FAQ, the Staff had not formally indicated whether it views "extracted performance", which is defined as a "subset of investments extracted from a portfolio"³ (and is inherently plural), as including the performance of a single investment.

What the Staff Said in the FAQ

In the FAQ, the Staff articulated its belief that presenting the performance of one investment or a group of investments in a private fund *is* an example of extracted performance under the Marketing Rule, and such performance must be shown on a net basis.

The Staff cites as its rationale the risk that advisers "would present misleadingly selective profitable performance with the benefit of hindsight." The FAQ reminded advisers to ensure that their presentation of net extracted performance complies with other applicable disclosure requirements (i.e., the requirement to provide or offer to promptly provide the performance results from the total portfolio from which the performance was extracted). The Staff also noted that such performance is subject to the Marketing Rule's general prohibition against referencing specific investment advice in a manner that is not fair and balanced.

¹ The SEC's FAQs relating to the Marketing Rule can be found [here](#).

² 17 C.F.R. § 275.206(4)-1(e)(7), 1(e)(10).

³ *Id.* at 206(4)-1(e)(6).

What the Staff Didn't Say in the FAQ

The FAQ does not address why the presentation of net performance is necessary to address the identified risk of presenting “misleadingly selective profitable performance” when the Marketing Rule already prohibits presenting individual investments in a manner that is not fair and balanced, and it does not detail how the requirement to show net performance would address that problem.

The FAQ also did not specifically address several critical points, including:

- What methodologies are acceptable for calculating net performance for individual investments or groups of investments;
- The level of disclosure required in order to ensure that net performance calculations are not themselves misleading;
- Timing expectations for managers switching to comply with the FAQ's guidance; and
- Whether comprehensive presentations of each individual investment or category of investments (e.g., schedules of investments; attribution reports), when shown alongside the fund's net and gross performance, can be treated differently because such presentations show the entire portfolio and do not raise the same concerns about selective performance cited in the FAQ.

Key Takeaways for Private Fund Managers

Private fund managers should be prepared to support on examination the approach they have taken to presenting performance in advertisements, including how that approach addresses the Marketing Rule, the SEC's adopting release,⁴ and the Staff's FAQ.

Attribution Reports and Schedules of Investments. The FAQ does not specifically address the common practice of showing, in close proximity to the fund's overall gross and net performance, the performance of (i) each of a fund's individual investments (e.g., schedules of investments) or (ii) each aspect of a fund's portfolio grouped into categories (e.g., an attribution report). Nonetheless, the FAQ should be considered when preparing such materials and assessing the risks associated with presenting gross performance in those contexts.

Calculation Methodology. The Staff has not articulated a specific calculation methodology for preparing net performance of single investments or sections of a fund's portfolio where fees and expenses are taken at the fund level. Several methodologies have evolved through market practice, each of which has limitations and requires fulsome disclosures of the methodologies, assumptions and limitations of such performance calculations in order to comply with the Marketing Rule's general prohibitions. Some examples of common items we have observed requiring consideration in the preparation of such returns include: the impact of a hedge fund's “high water mark,” the operation of different waterfall carried interest structures, how to incorporate clawbacks (if applicable), the impact of hedging and leverage, the timing of investment dispositions and how to determine an appropriate expense allocation for an investment or attribution category.

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⁴ Investment Adviser Marketing, 86 Fed. Reg. 13024 (March 5, 2021). The adopting release can be found [here](#).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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EXCERPT FROM THE FAQ

Gross and Net Performance

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

A. Yes. The staff believes that displaying the performance of one investment or a group of investments in a private fund is an example of extracted performance under the new marketing rule.^[1] Because the extracted performance provision was intended, in part, to address the risk that advisers would present misleadingly selective profitable performance with the benefit of hindsight, the staff believes the provision should be read to apply to a subset of investments (i.e., one or more). Accordingly, an adviser may not show gross performance of one investment or a group of investments without also showing the net performance of that single investment or group of investments, respectively.^[2] In addition, the adviser must satisfy the other tailored disclosure requirements as well as the general prohibitions, including the general prohibition against specific investment advice not presented in a fair and balanced manner, when showing extracted performance.^[3]

^[1] Extracted performance means “the performance results of a subset of investments extracted from a *portfolio*.” Rule 206(4)-1(e)(6). See section II.E.5 of the adopting release.

^[2] The rule prohibits any presentation of gross performance in an advertisement unless the advertisement also presents net performance. See section II.E.1 of the adopting release. The gross and net performance requirement applies to not only an entire portfolio but also to any portion of a portfolio that is included in extracted performance. See sections II.E.1(a) and (b) and the definitions of gross and net performance in rule 206(4)-1(e)(7) and (10) (“*Net performance* means the performance results of a *portfolio* (or portions of a portfolio that are included in *extracted performance*...”)). The adopting release also states that the rule requires that advisers that show extracted performance must show net and gross performance for the applicable subset of investments extracted from a portfolio. See section II.E.1.a. of the adopting release (discussing gross performance).

^[3] The adopting release states that “advisers should evaluate the particular facts and circumstances that may be relevant to investors, including the assumptions, factors, and conditions that contributed to the performance, and include appropriate disclosures or other information such that the advertisement does not violate the general prohibitions...or other applicable law.” See section II.E.1 of the adopting release (discussing the net performance requirement). In addition, it would be considered “misleading under the final rule to present extracted performance in an advertisement without disclosing whether it reflects an allocation of the cash held by the entire portfolio and the effect of such cash allocation, or of the absence of such an allocation, on the results portrayed.” See section II.E.5 of the adopting release (discussing extracted performance).