Proskauer

SEC Breaks its Silence on the New Marketing Rule's Net Performance Requirements

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The SEC staff has issued an FAQ related to amended Rule 206(4)-1 under the Investment Advisers Act (the "Marketing Rule") clarifying that the net/gross rules apply to extracted performance that may consist of returns of single investments. This addresses one of the many ambiguities of the Marketing Rule, which has been in effect since November 4, 2022.

Background

The Marketing Rule codified the SEC staff's long-held position prohibiting any presentation of gross performance in an advertisement unless the advertisement also presents net performance. The Marketing Rule also requires that extracted performance, e.g., the performance of a group of investments (such as those representing a single strategy drawn from a multi-strategy fund), be shown net of expenses if shown gross of expenses. Net performance must be shown with at least equal prominence to, and in a format designed to facilitate comparison with, gross performance.

The rule text was unclear, however, as to whether returns of an individual investment would be considered performance or "extracted performance." In addition, it was not clear (and remains unclear) how fund-level expenses should be attributed to individual investments.

The Staff FAQ

The Staff FAQ clarified that presenting the performance of one investment in a private fund is a form of extracted performance under the Marketing Rule, such that gross performance of that investment must be accompanied by net performance of the investment. Thus, advertising materials that show gross performance in case studies or which include the investment return of a list of individual portfolio positions must show net return for each one, even if presented together with fund-level investment performance on a net basis.

Showing net performance of individual investments will require adoption of a methodology to attribute fund fees and expenses to portfolio holdings and, thus, derive an imputed return for each. There are various types of pro forma calculation methodologies that we understand advisers to private funds are adopting in an effort to implement this net performance requirement. One common approach is to apply a uniform "haircut" to each investment within the portfolio, whereby the difference between the portfolio's gross and net performance as of the relevant measurement date is used to reduce each individual investment's gross return.

Advisers deriving net performance need to be aware that the results may be considered to be misleading under other provisions of the Marketing Rule or Rule 10b-5 under the Securities Exchange Act of 1934. Thus, disclosure of the methodology used and assumptions made is critical. The assumption made in the simple method described above is that the investment was held throughout the period for which performance was measured (although it may not have been) and that fees and expenses did not attach to a specific investment (although some may have). Other assumptions would have to be made if the fund had multiple classes or portfolios that held the investment but carried different fees or expenses.

This guidance is new, and, thus, industry standards related to the manner and methods of presenting such net performance will continue to develop and resulting compliance policies and procedures will need to be adopted. Moreover, SEC examiners have yet to have their say on methodologies they will find acceptable. Please contact one of our Private Funds Group partners for more information about the amended Marketing Rule.

Related Professionals

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