SEC Marketing Rule FAQ: Net Performance Requirements

On Wednesday, January 11, 2023, the staff of the Division of Investment Management (the "Staff") published a long-awaited FAQ response providing guidance on the treatment of single position performance of private fund investments[1] (the "FAQ") under the SEC's new Marketing Rule 206(4)-2 (the "Rule"), for which the mandatory compliance deadline was November 4, 2022 ("Compliance Date"). The FAQ[2] states that displaying performance information of one investment would be an example of "extracted performance," thereby subjecting individual investment performance displayed in advertisements to the Rule's "net performance" requirement. The FAQ and link to the full webpage is included below.

Previous interpretations and SEC silence. In the months preceding the Compliance Date, several interpretations emerged and were debated among law firms and other industry experts on the treatment of individual investment performance information under the Rule. However, an SEC EXAMS risk alert published on September 19, 2022 was silent with respect to these interpretations.[3]

Interpretation A: At the recent SEC Compliance Outreach Program National Seminar on November 15, 2022, the SEC was asked specifically if it intended to treat single positions as extracted performance. A chief compliance officer of a registered investment adviser ("RIA") offered up a seemingly reasonable interpretation that many stakeholders hoped the SEC would adopt – the ability to treat single positions as "specific investment advice," which would enable RIAs to provide single position performance on a gross basis, displayed in a manner designed to facilitate comparison with the net performance of the entire applicable portfolio for the same time period in order to meet the "fair and balanced" standard for specific investment advice. The SEC declined to comment on this interpretation.

Interpretation B: A second argument against treating single positions as extracted performance emerged based on the definitional nuance of extracted performance, which the Rule states is a "subset of investments of a portfolio." The interpretation notes the SEC's use of the plural word "investments" suggest that displaying performance of a single position would not meet the definition of extracted performance, and that more than one investment would be required to form such a subset.

Interpretation C: The third interpretation of the relevant portions of the Rule would require single positions to be treated as extracted performance. This would require each investment to be shown net of fees. This is the interpretation that the Staff has articulated in the FAQ.

The SEC weighs in. The FAQ, without addressing Interpretations A and B, adopted Interpretation C and clarified its expectation that performance information for individual investments instead must be treated as extracted performance. Under the Rule, all performance information, including extracted performance, must be presented on a net basis.[4] **Therefore, the FAQ clarifies that all registered investment advisers who intend to include performance information of individual investments of private funds in their**

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[1] The Rule's Adopting Release notes that "private funds" include 3(c)(1) and 3(c)(7) funds. *See* Adopting Release at https://www.sec.gov/rules/final/2020/ia-5653.pdf.

[2] *See* FAQ at https://www.sec.gov/investment/marketing-faq

[3] *See* Risk alert at https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf.

[4] Gross Performance may be presented alongside Net Performance subject to certain requirements.

advertising materials must show those positions on a net basis. Calculating net performance for a single position has been particularly challenging for fund managers for a variety of reasons such that simply applying or fashioning a fund's gross-net spread could produce irrelevant or potentially misleading results. The Staff points to guidance in the Adopting Release 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" noting that it would be "misleading… 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."

Next Steps. RIAs who currently use case studies showing performance information or who otherwise show single position performance on a gross basis should amend their marketing materials by either (1) including net performance information alongside the gross performance information with revised disclosures explaining the assumptions made in those calculations, including with respect to treatment of cash allocations, or (2) removing the gross performance figures from their marketing materials. Because the Compliance Date has already passed, RIAs should act swiftly to come into compliance with this guidance. The Rule allows advisers to present net performance calculated based on the use of actual or model fees. The Rule requires that the model fee applied 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 that can or will be charged to the intended audience of the advertisement.[5]

Neither the Marketing Rule, Adopting Release nor the FAQ specify a particular methodology when calculating net performance. Please reach out to any of the compliance consultants you usually work with at Optima for more information and assistance in complying with this new staff guidance.

Link to Marketing FAQ: https://www.sec.gov/investment/marketing-faq.

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[5] 17 C.F.R. § 275.206(4)-1(e)(10)(ii). Additionally, an RIA showing extracted performance would also be required to provide, or offer to provide, the performance of the entire portfolio from which the extract was pulled.