

Investment Management Alert

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SEC Staff Extends ‘Net’ Performance Presentation Requirement to Case Studies

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As a general principle, the Marketing Rule requires registered investment advisers to include net performance alongside any presentation of gross performance. Market practice on whether or how this principle applies to case studies and other portfolio highlights in the context of an advertisement that already presents net and gross performance information for the portfolio as a whole has varied widely in the two months since the effectiveness of the Marketing Rule.

However, on January 11, 2023, the Staff of the U.S. Securities and Exchange Commission Division of Investment Management sought to eliminate any heterodoxy on this point by issuing a new FAQ requiring that net performance always be shown whenever gross performance is displayed, even when the performance relates to a single investment or group of investments.

In response to the question,

When an adviser displays the gross performance of one investment (e.g., a case study) . . . must the adviser show the net performance of the single investment[?]

the SEC Staff stated that:

an adviser may not show gross performance of one investment . . . without also showing the net performance of that single investment[.]

Unfortunately, calculating what is sometimes termed “derived net,” “regulatory net” or “imputed net” performance is not as simple as one might hope. Fund managers and sponsors that intend to show performance for case studies or other portfolio highlights will need to consider questions such as the following:

- How to equalize performance when some investors were admitted after the position was initialized.
- How and whether to include high water mark credits, especially in older funds where not all investors are under the high water mark (or under the same high water mark).
- For funds with multiple investments and an American-style waterfall, whether to assume that all assets are sold at once, whether to make a reasoned assumption

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about the order of their sale or whether to apply the full carry or incentive to that investment on a stand-alone basis.

- How to adjust the calculation for preferential returns.
- Whether and how to account for (or whether to ignore) the possibility of a clawback.
- Which fees to utilize for funds and strategies with multiple share classes or fee arrangements.
- Whether fund expenses should be spread across the entire portfolio or attached to specific investments.
- Whether to adjust for any tax distortions.
- If applicable, whether to impute a liquidity discount.

There are no instructions on how to address these questions and considerations, and it is unlikely that comprehensive guidance will be forthcoming.

In addition to the operational difficulties of calculating regulatory/derived/imputed net performance, fund sponsors and managers must assess whether the resulting figures are misleading under a Rule 10b-5 anti-fraud analysis and whether they meet the Marketing Rule's "fair and balanced" standards.

While Staff positions do not reflect the views of the Commission itself and do not have the force of law, they are indicative of positions that SEC Examination and Enforcement personnel may take when assessing an adviser's marketing materials. Accordingly, comprehensive explanations of the steps taken and the assumptions made will be more important than ever.

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