

Investment Management

March 26, 2025

SEC Updates Guidance on the Use of Gross and Net Performance in Advertisements

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On March 19, the Securities and Exchange Commission (SEC) issued a new FAQ response¹ that softens prior guidance on the use of gross and net performance in advertisements. The new FAQs (the New Guidance) reduce the burden of certain positions advanced by the SEC's January 11, 2023 FAQs (the Prior Guidance) relating to the application of amendments to Rule 206(4)-1 (the Marketing Rule) under the Investment Advisers Act of 1940, as amended (the Advisers Act).

Background on the Marketing Rule and Prior Guidance

The Marketing Rule, which became effective in November 2022, contains explicit instructions relating to how investment advisers may incorporate performance information into their advertisements. Among other things, the Marketing Rule states that the presentation of gross investment performance requires that net performance is also presented with (at least) equal prominence. Although the Marketing Rule only applies to investment advisers that are registered with the SEC, unregistered investment advisers, including exempt reporting advisers, are nonetheless subject to the antifraud provisions included in the Advisers Act. Therefore, it is good practice for all investment advisers (whether registered or unregistered) to comply with the Marketing Rule to avoid practices that the SEC may deem misleading.

Building on the Marketing Rule, the Prior Guidance stated that displaying the performance of one investment or a group of investments in marketing materials (e.g., case studies) would constitute "extracted" performance under the Marketing Rule, and for that reason, the presentation of gross extracted investment performance must be accompanied, with at least equal prominence, by net extracted performance. However, the Prior Guidance did not address how investment advisers should calculate net returns for such extracted performance, leading to uncertainty as managers grappled with how best to apply fee and expense assumptions to their gross extracted performance figures.

New Guidance

The New Guidance provides certain relief from the hard-line positions set forth in the Prior Guidance. To provide flexibility with respect to the presentation of extracted performance, the New Guidance states that if investment advisers prominently display the gross and net performance of the total portfolio from which the extract was taken, and this information is presented in a non-misleading manner, they do not need to show the net performance of the extract, provided that the investment advisers:

- Clearly identify the extracted performance as gross performance;
- Accompany the extracted performance with the total portfolio's gross and net performance;
- Ensure the total portfolio's performance is presented with equal prominence and facilitates comparison with the extracted performance; and
- Calculate the total portfolio's performance over the same period as the extracted performance.²

Similarly, the SEC staff provided needed clarity with respect to the use of certain portfolio or investment characteristics (e.g., yield, contribution to return, volatility, or sector/geographic returns) that are considered “performance” under the Marketing Rule. The SEC acknowledged that attempts to calculate these characteristics net of fees and expenses might be impractical or misleading. With that in mind, the New Guidance states that the staff will not recommend enforcement action if investment advisers display gross characteristics without corresponding net characteristics, provided that the investment advisers:

- Clearly identify the gross characteristic as being calculated without the deduction of fees and expenses;
- Accompany the characteristic with the total portfolio’s gross and net performance;
- Ensure the total portfolio’s performance is presented with equal prominence and facilitates comparison with the gross characteristic; and
- Calculate the total portfolio’s performance over the same period as the characteristic.

Practical Considerations and Next Steps

The New Guidance provides much-needed flexibility for SEC registered investment advisers, but it also introduces certain ambiguities that need to be carefully navigated. For example, footnote 3 of the New Guidance states that with respect to performance extracted from a representative account, an investment adviser “*could* satisfy the ... [Marketing Rule] if the gross performance of the extract was accompanied by the gross and net performance of a composite aggregation of all of the representative account’s related portfolios (rather than the gross and net performance of the total representative account from which the extract was extracted) [emphasis added].” Certain investment advisers may not wish to provide gross and net performance of a composite aggregation of all of the representative account’s related portfolios, as opposed to gross and net performance of the total representative account. There is ambiguity as to what an investment adviser may do in such situations, as footnote 3 of the New Guidance provides only one example of how the Marketing Rule “could” be satisfied in this context.

Moving forward, we expect that many investment advisers will welcome this New Guidance and revise their practices with respect to the disclosure of net extracted performance and risk metrics. We further expect many investment advisers will rely on the New Guidance to limit the net extracted performance figures and risk metrics included in their marketing materials.

Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you require assistance in reviewing or revising your marketing materials or have any questions regarding the New Guidance or the Marketing Rule.

¹ The response can be found [here](#).

² Acknowledging that the time periods over which extracts are calculated may not easily align with the time periods required by Rule 206(4)-1(d)(2), the SEC staff stated it would not recommend enforcement action under Rule 206(4)-1(d)(2) if the extracted performance presented was calculated over a single, clearly disclosed period.

Contacts

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