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ALERT

# Marketing Rule FAQ – Impact of Subscription Lines of Credit on Presentation of Net IRRs

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On Feb. 6, the staff of the US Securities and Exchange Commission’s Division of Investment Management (“Staff”) issued an updated FAQ (“FAQ”) with respect to Investment Advisers Act Rule 206(4)-1 (“Marketing Rule”), excerpted below,<sup>1</sup> addressing the presentation of gross and net internal rates of return (“IRRs”) when the fund uses subscription lines to fund investments. Although the Staff, for quite some time, has focused during examinations on the methodology used to calculate gross and net IRRs when subscription lines are used to fund investments, the amended Marketing Rule that went into effect in November 2022<sup>2</sup> specifically requires that gross and net performance be calculated and presented using the same methodology and over the same period of time. In the FAQ, the Staff expressed its view that certain historical performance reporting practices are no longer permitted under the Marketing Rule, even with clear disclosure regarding the differences in methodologies utilized to calculate the net and gross performance shown.

The FAQ clarifies the Staff’s view with respect to two methods of reporting the performance of a private fund under the Marketing Rule:

- Presenting a gross IRR that is calculated without taking into account the impact of fund borrowings (including subscription facilities) alongside a net IRR that incorporates the impact of such borrowings, even with disclosure explaining the rationale for, and impact of, the different methodologies, violates the Marketing Rule’s requirement to show gross and net performance with equal prominence, calculated over the same time period, using the same methodology and shown in a manner designed to facilitate comparison between gross and net performance; and
- Presenting net IRR that includes the impact of fund-level subscription facilities without either (a) showing comparable net IRR without the impact of fund-level subscription facilities or (b) providing appropriate disclosures describing the impact of such subscription facilities on the net IRR, violates the general prohibitions of the Marketing Rule.

While we are not expecting further guidance on the Private Fund Adviser Rules<sup>3</sup> (“PFARs”) at this time due to pending litigation challenging the SEC’s authority to adopt the PFARs, this FAQ appears to signal the Staff’s intention to not only clarify certain aspects of the Marketing Rule, but also to align the

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<sup>1</sup> Div. of Inv. Mgmt., US Sec. & Exch. Comm’n, Marketing Compliance Frequently Asked Questions, *available at* <https://www.sec.gov/investment/marketing-faq> (last updated Feb. 6, 2024).

<sup>2</sup> Investment Adviser Marketing, 17 C.F.R. § 275.206(4)-1 (2020).

<sup>3</sup> The PFARs consist of five new rules (and one rule containing definitions informing the others): 17 C.F.R. § 275.206(4)-10 (2023) (the “Audit Rule”); 17 C.F.R. § 275.211(h)(1)-1 (2023) (the “Definitions Rule”); 17 C.F.R. § 275.211(h)(1)-2 (2023) (the “Quarterly Statement Rule”); 17 C.F.R. § 275.211(h)(2)-1 (2023) (the “Restricted Activities Rule”); 17 C.F.R. § 275.211(h)(2)-2 (2023) (the “Adviser-Led Secondaries Rule”); and 17 C.F.R. § 275.211(h)(2)-3 (2023) (the “Preferential Treatment Rule”). The SEC also adopted rule amendments to 17 C.F.R. § 275.204-2 and 17 C.F.R. § 275.206(4)-7 to make conforming changes to books and records requirements and to introduce the written report requirement for annual compliance reviews. The Audit Rule, Quarterly Statement Rule, Restricted Activities Rule, Adviser-Led Secondaries Rule, Preferential Treatment Rule, and the relevant rule amendments, are included in the “PFARs” definition.



Marketing Rule with the PFARs' quarterly statement requirement that is due to come into effect in March 2025, which requires private fund sponsors advising an illiquid fund (as that term is defined in the PFARs) to present an illiquid fund's gross and net IRRs both before and after the use of a subscription line.

### **Implications for Showing Both Gross and Net Performance**

Even prior to the amendments to the Marketing Rule, private fund sponsors routinely presented fund-level returns on both a gross and net basis. It has not been uncommon for such sponsors to present gross IRR at the fund level ("fund-level gross IRR"), which calculate cash flows based on the date that a credit line or subscription facility was drawn down to make investments. Sponsors frequently compared such fund-level gross IRRs with net IRRs based on a representative investor's cash flow ("investor-level net IRR"), which calculate cash flows based on the date when capital was called from the investor (or, in the case of an earlier credit line drawdown by the fund, to repay the credit line), with appropriate disclosure as to the differing methodologies.

When a portfolio investment is funded through a drawdown on a credit line, the investor capital call occurs at a later date, affecting the cash flow timing used to calculate the net IRR. Correspondingly, when historically presenting performance based on these differing methodologies, a common practice has been to disclose the methodologies used to calculate gross and net IRRs, and include a description of the impact of the use of a subscription line or other credit facility on net IRRs, including that net IRRs may be lower if the same methodology were applied for gross IRRs.

Nevertheless, the Staff has articulated its view in this FAQ that presenting gross and net IRRs in this manner violates the Marketing Rule's requirement to use the same calculation methodology (e.g., based on either use of a credit line by the fund or capital contribution by the investor) and same time periods (e.g., either when the credit line was drawn or investor capital was called), and this will affect certain historical performance reporting practices.

### **Implications for Showing Only Investor-Level Net IRRs**

The Marketing Rule does not prohibit sponsors from including solely net performance (i.e., no gross performance) in advertisements. Fund sponsors have the option of including solely net IRRs in advertisements; however, if such investor-level net IRRs calculate cash flows using the date(s) investors' capital was called instead of the date(s) that the credit line was drawn, the FAQ clarifies the Staff's view that this practice is misleading unless the sponsor (i) also shows fund-level net IRRs that calculate cash flows based on the date that the fund's credit line was drawn down to make investments, or (ii) includes appropriate disclosures regarding the impact of credit line usage on such net IRRs.

### **Key Next Steps for Private Fund Advisers**

Registered investment advisers that use subscription lines for funding investments should ensure that:

- Gross IRRs and net IRRs in advertisements are presented using the same methodology over the same period of time (e.g., both presented *without* the impact of any subscription facilities); and
- Net IRRs presented *with* the impact of any subscription facilities are presented along with either:
  - Net IRRs *without* the impact of any subscription facilities, or
  - Appropriate disclosure describing the impact of such subscription facilities on net IRR.



Schulte has seen a substantial focus on gross and net performance issues in recent investment adviser examinations and we expect significant scrutiny from the Staff on this issue going forward.

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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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