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SEC Issues Marketing Rule FAQ: Subscription Lines and Net IRR Calculations

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On February 6, the SEC Staff issued new “frequently asked question” guidance (“FAQ”) under the Advisers Act’s November 2022 Marketing Rule for SEC-registered advisers displaying performance of private funds that use subscription lines in their “advertisements” (e.g., pitch decks or PPMs).[1] This FAQ addresses how gross and net IRRs should be presented under the Marketing Rule when subscription lines are used and continues a recent trend of deficiencies issued by SEC examination Staff in certain regional offices.

The use of private fund subscription lines has grown increasingly common in recent years. Many private fund managers have historically shown, among other performance metrics, both gross and net IRRs. In many instances, the gross IRR is computed at the fund level showing cash flow drawdowns for portfolio investments at the time such drawdown is made from the fund (“Fund-Level Gross IRR”) to fund the investment. However, many sponsors calculate the net IRR based on the experience of the investor (“Investor-Level Net IRR”), where cash flows are calculated using the date of the investor’s capital call. When the fund uses a subscription line to acquire a portfolio investment, the investor would meet its capital call to repay such line at a later date and the Investor Level Net IRR calculation would reflect such later cash flow timing. Many sponsor marketing materials currently disclose this methodology and describe its effect on Net IRRs.

Use of Gross and Net IRRs Together. The FAQ asserts that use of Fund-Level Gross IRR together with only Investor-Level Net IRR does not comply with the Marketing Rule’s requirement to use the same methodology and time periods in computing returns.[2] Instead, according to the FAQ, SEC-registered advisers using Fund-Level Gross IRRs[3] should calculate and present net IRRs without the impact of use of the subscription line (i.e., as if the draw on the subscription line was a capital contribution from investors) (“Net Fund-Level IRR”). This interpretation seems to be an attempt by the Staff to align this aspect of the Marketing Rule with the Private Funds Rules' quarterly statement requirement coming into effect in the first quarter of 2025, which requires investor reporting of an illiquid fund's gross and net IRRs both before and after use of a subscription line.[4]

Use of Investor-Level Net IRRs. The FAQ also discusses use of Investor-Level Net IRRs by SEC-registered advisers and indicates that if the manager uses this performance metric it should either (1) include Fund-Level Net IRRs, or (2) include "appropriate" disclosure regarding the impact of subscription lines on the net IRRs shown. This aspect of the FAQ appears to be aimed at managers that show only net IRRs (to the exclusion of gross IRRs) in marketing materials, which is not the current presentation format for most private fund managers. However, it appears consistent with the FAQ and the methodology to be required in the new quarterly statements to include the required Fund-Level Net IRRs alongside Investor-Level Net IRRs, provided a reasonable format is used and appropriate disclosure is made.[5]

Impact on Private Fund Marketing. SEC-registered private fund managers using subscription lines and showing Investor-Level Net IRRs in marketing materials (e.g., pitch decks and PPMs) should seek to promptly align such materials with the new FAQ, particularly pitch decks and PPM supplements prepared after February 6. Such managers should also expect SEC examination Staff to now have firmer ground to assert the Staff's view on the IRR calculations to be used in marketing materials.

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1. See "Calculating Gross and Net Performance" Section, https://www.sec.gov/investment/marketing-faq ↩

2. Unlike certain other aspects of the Marketing Rule, such as the requirement to use the highest fee rates when presenting model fees, the FAQ included no materiality qualifier. ↩

3. The FAQ does not expressly discuss whether SEC-registered advisers could use a gross IRR calculation more consistent with an Investor-Level Net IRR calculation (i.e., by treating the investment drawdown to occur later when capital is called from investors to repay the subscription line when calculating gross IRRs) and continue to show Investor Level Net IRRs; however, we expect this practice would draw scrutiny from SEC examination Staff. ↩

4. For managers marketing private funds through placement agents or affiliated broker-dealers, FINRA also currently requires registered broker-dealers to present unrealized IRRs both with and without the effect of subscription lines of credit, unless the subscription line was repaid within 120 days, among other requirements. ↩

5. Managers using a "spread" of net-to-gross IRR performance to model individual portfolio investment net returns should also consider the appropriate net IRR metric to be used and include disclosures describing the calculation. ↩

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