

Net Returns, Track Records, and Substantiation:

Tackling The Tough Advertising Issues For Private Market Managers

10/14/2022



IRON ROAD
PARTNERS

▶ Marketing Rule Overview

- ▶ Performance Requirements
- ▶ Performance Calculations
- ▶ Other Considerations



Why this Rule?

Many at the Commission thought the advertising and marketing regime was arcane, outdated, and fragmented.

Unclear if it applied to investors or just fund “clients”

Guidelines fragmented among rules, no-action letters, enforcement cases, and practices

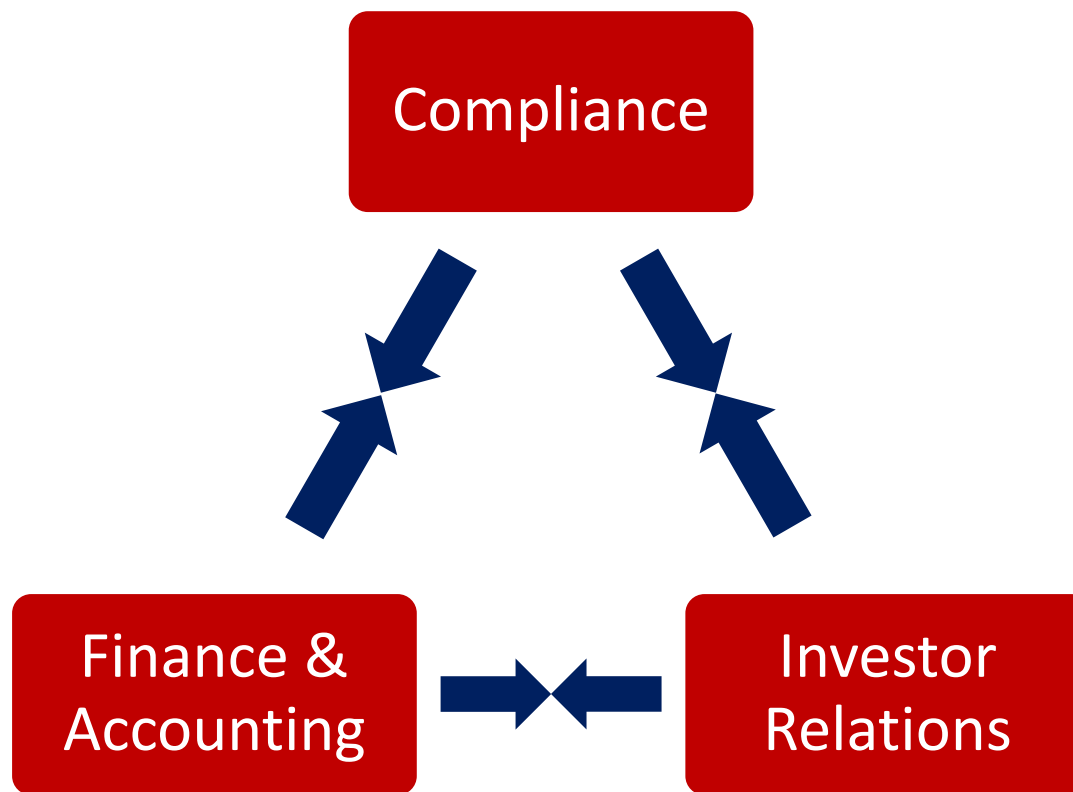
Growth of finance in size and complexity

New Updated Rule

Release: 430 Pages

The Challenges of the Marketing Rule

The Marketing Rule could create a disconnect between compliance with the rule, what prospective investors want to see, and what is possible to calculate.

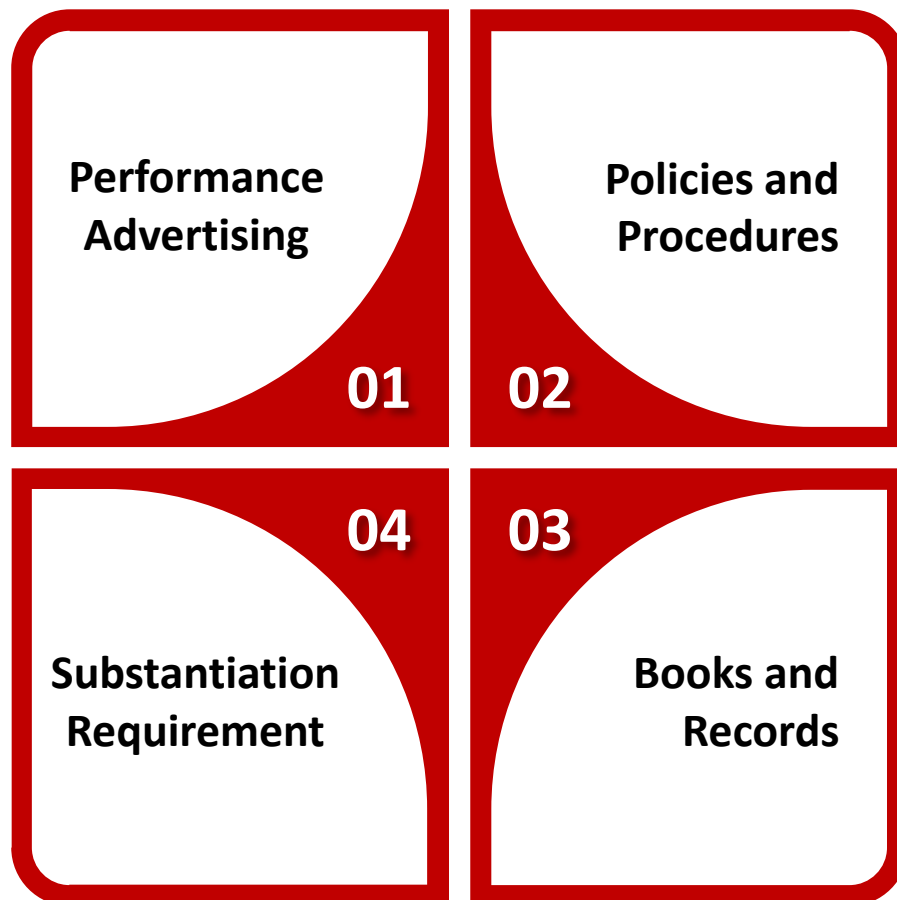


The SEC Will Review These Areas in the Upcoming Sweep

The Commission has signaled an upcoming sweep focused on the most complex areas of this rule.

The Risk Alert highlights six areas of performance advertising compliance that will be reviewed in the private fund context.

The Risk Alert suggests that managers will have to point to specific documentation supporting their claims of substantiation.



The Commission appears to be signaling that it will focus at least some effort on the quality and existence of a marketing testing program.

The Commission will review how each manager has handled the recordkeeping requirements arising from the new marketing rule.

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▶ **Performance Requirements**

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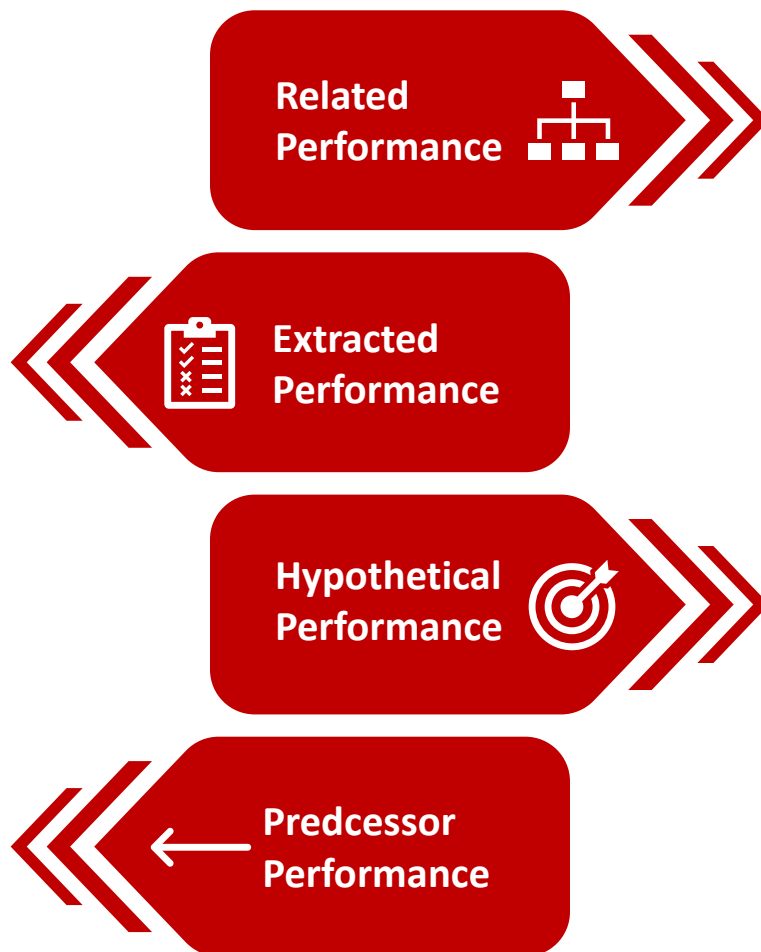
▶ Other Considerations



Types of Performance

The rule defines four types of performance, with specific requirements for presenting each type.

Performance results of a subset of investments from a single portfolio. Showing realized investments or sub-strategy performance.



Performance results of one or more related portfolios. Shown on composite or portfolio-by-portfolio basis.

Performance results that were not actually achieved. Includes targets, projections, and model portfolios.

Performance achieved by a group of investments that was not always advised during the period shown.

Where is Net Performance Needed and Why?

The Marketing Rule prohibits **any** presentation of Gross Performance, unless the advertisement also presents Net Performance.

“

Case studies that include performance information also will be subject to the final rule’s restrictions and requirements for performance advertising.

”

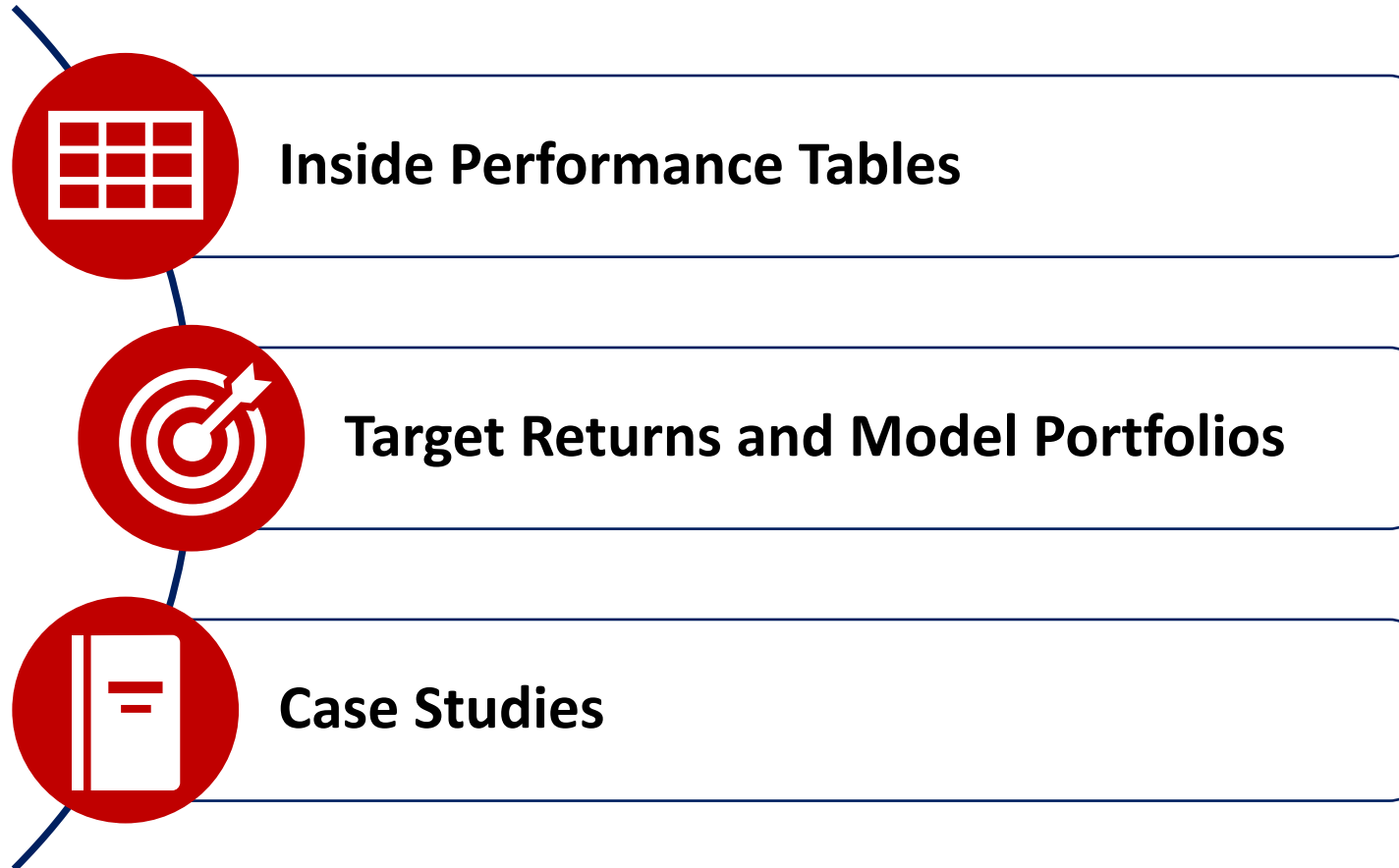
“

Net performance applies not only to an entire portfolio but also to a **portion** of a portfolio that is included in extracted performance.

”

Where is Net Performance Needed and Why?

The Marketing Rule will require advisers to display net performance in non-traditional areas.



Related Performance

The rule requires **all** related portfolios to be shown when showing Related Performance unless the advertised performance is not materially higher than it would be if all portfolios were shown.

Fund	Number of Investments	Gross IRR	Gross MOIC	Net IRR	Net MOIC
Flagship Fund I (2000)	12	15.0%	1.5x	11.0%	1.3x
Flagship Fund II (2004)	14	13.0%	1.7x	9.0%	1.4x
Flagship Fund III (2008)	15	16.0%	2.1x	12.0%	1.8x
Flagship Fund IV (2012)	10	8.0%	2.1x	3.0%	1.7x
Flagship Fund VI (2020)	10	44.0%	1.8x	30.0%	1.5x

Flagship Fund V (2016) would need to be included if all funds followed a sufficiently similar investment strategy, objectives, and policies.

Extracted Performance

Extracted Performance applies only to extractions from a **single** portfolio or fund.

Fund	Number of Investments	Realized Investments	Realized Gross IRR	Realized Gross MOIC	Realized Net IRR	Realized Net MOIC
Flagship Fund I (2008)	12	12	15.0%	1.5x	11.0%	1.3x
Flagship Fund II (2012)	14	14	13.0%	1.7x	9.0%	1.4x
Flagship Fund III (2016)	15	13	18.0%	2.1x	14.0%	1.8x
Flagship Fund IV (2020)	10	1	38.0%	2.2x	30.0%	1.7x

Will need to provide or offer to provide the performance of the total portfolio (realized and unrealized).

Hypothetical Performance


Advisers may need to draft new disclosures and adopt **policies and procedures** to show Hypothetical Performance under the new Marketing Rule.

Fund	Mid-Cap Investments	Gross IRR	Gross MOIC	Net IRR	Net MOIC
Flagship Fund I (2008)	3	16.0%	2.1x	12.0%	1.8x
Flagship Fund II (2012)	4	8.0%	2.1x	3.0%	1.7x
Flagship Fund III (2016)	5	28.0%	1.9x	22.0%	1.6x
Flagship Fund IV (2020)	2	44.0%	1.8x	30.0%	1.5x
Total Mid-Cap Investments	14	19.0%	2.0x	17.0%	1.7x

Composites of Extracted Performance from multiple funds will be subject to the Hypothetical Performance requirements of the Marketing Rule.

Predecessor Performance

Requirements applicable to Predecessor Performance generally conform to current no-action letter guidance with new **clear and prominent** disclosure requirements.



Fund	Number of Investments	Gross IRR	Gross MOIC	Net IRR	Net MOIC
Pre-Adviser Fund (2000)	12	15.0%	1.5x	11.0%	1.3x
Flagship Fund I(2004)	14	13.0%	1.7x	9.0%	1.4x
Flagship Fund II (2008)	15	16.0%	2.1x	12.0%	1.8x
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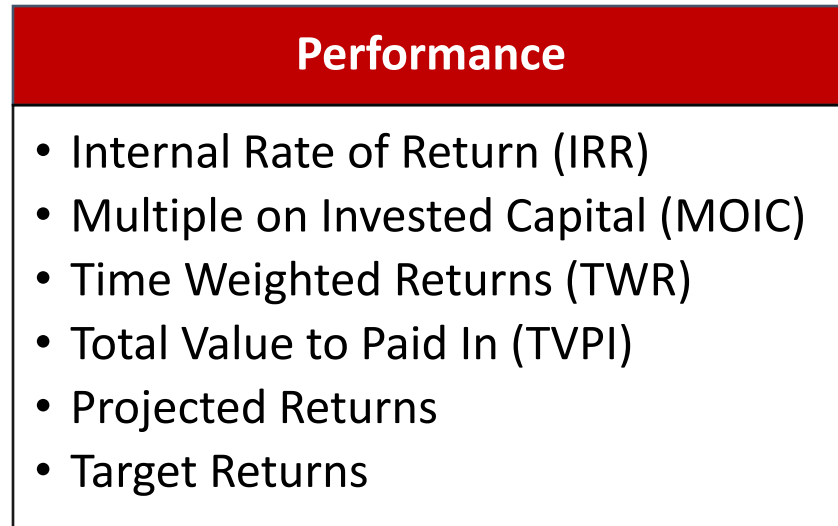
Will need to provide clear and prominent disclosure that performance results were from another entity.

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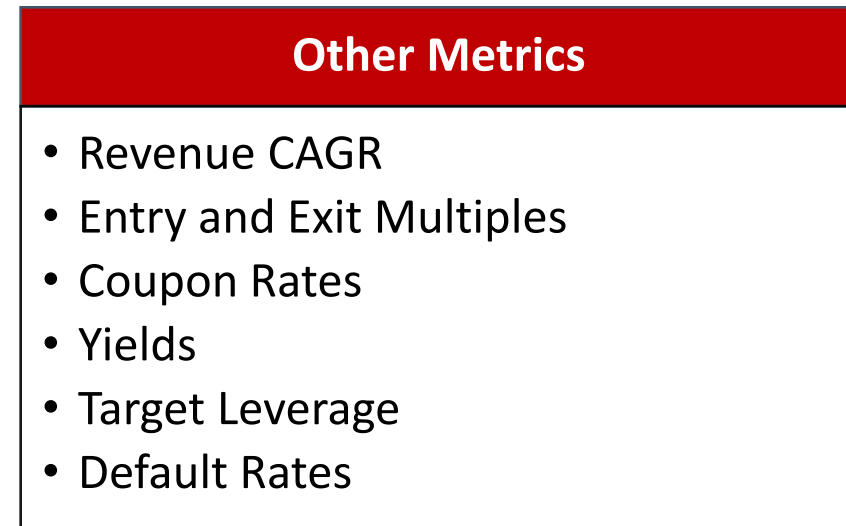


Performance

Many metrics may be components of returns but not the performance results of a portfolio themselves.



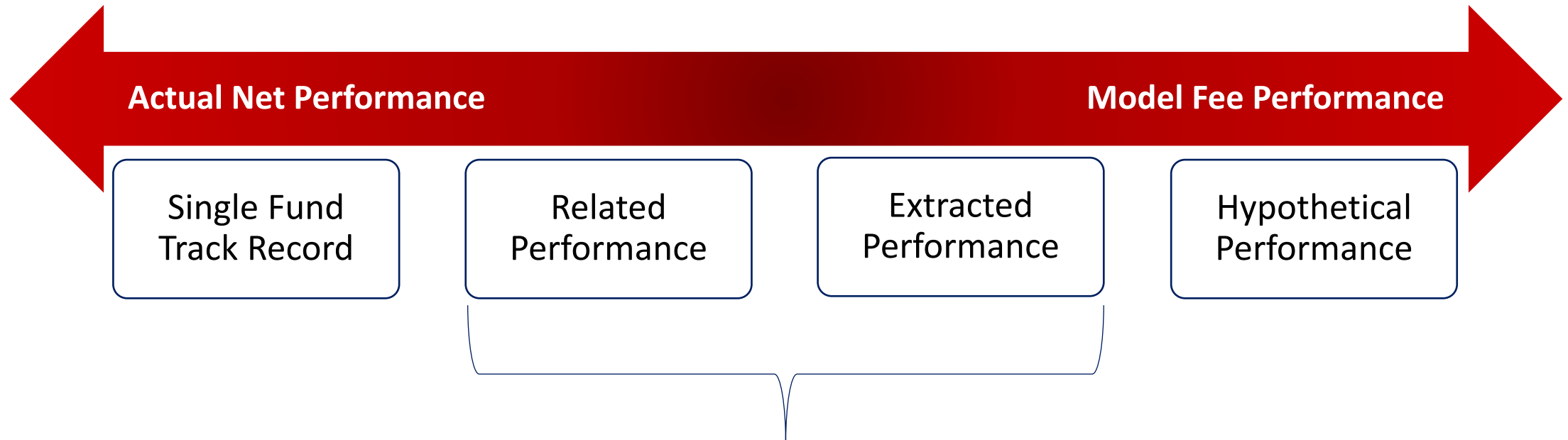
Net and Gross Presented with Equal Prominence



General Prohibitions and Substantiation Requirements

When to use Model Fees?

Net Performance may reflect the deduction of Model Fees.



Whether performance **must** reflect the deduction of highest fee-paying investor Model Fees will depend on the intended audience of the advertisement and the General Prohibitions.

Gross Net Spread

The simplest approach to calculating net returns also leads to the most inaccurate results.

Investment	Date Invested	Invested Capital	Realized Proceeds	Unrealized Proceeds	Total	Gross IRR	Gross MOIC	Net IRR	Net MOIC
1	Nov-17	\$138	\$67	\$57	\$124	-1.0%	0.9x	-4.9%	0.6x
2	Dec-17	\$240	\$58	\$0	\$58	-22.0%	0.2x	-25.9%	-0.1x
3	Jul-18	\$130	\$108	\$365	\$473	41.0%	3.6x	37.1%	3.4x
4	Dec-18	\$75	\$0	\$168	\$168	27.0%	2.2x	23.1%	2.0x
5	Jan-19	\$112	\$0	\$374	\$374	60.0%	3.3x	56.1%	3.1x
6	Feb-19	\$109	\$0	\$229	\$229	32.0%	2.1x	28.1%	1.8x
7	Nov-19	\$71	\$222	\$0	\$222	41.0%	3.1x	37.1%	2.8x
8	Jan-20	\$274	\$0	\$381	\$381	30.0%	1.4x	26.1%	1.1x
9	Apr-20	\$112	\$34	\$109	\$143	8.0%	1.3x	4.1%	1.0x
10	Nov-21	\$66	\$0	\$67	\$67	0.0%	1.0x	-3.9%	0.7x
Highest Fee-Paying Gross		\$1,327	\$489	\$1,750	\$2,239	15.8%	1.7x		
Highest Fee Pay Net						11.9%	1.4		

$Net\ IRR = -1.0\% - 3.9\%$

$Net\ MOIC = .9x - .3x$

$Gross\ Net\ Spread = 15.8\% - 11.9\%$

$Gross\ Net\ Spread = 1.7x - 1.4x$

Gross Net Discount Factor – MOIC

For any fund, GNDF is the highest fee-paying investor net return divided by the highest fee-paying investor gross return.

Investment	Date Invested	Invested Capital	Realized Proceeds	Unrealized Proceeds	Total	Gross IRR	Gross MOIC	Net IRR	Net MOIC
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*Net MOIC = .9x * GNDF*

$$MOIC\ GNDF = \frac{1.4x}{1.7x}$$

Gross Net Discount Factor – IRR

For any fund, GNDF is the highest fee-paying investor net return divided by the highest fee-paying investor gross return.

$$\text{Net IRR} = (1 + -1.0\%) * \text{GNDF} - 1$$

Investment	Date Invested	Invested Capital	Realized Proceeds	Unrealized Proceeds	Total	Gross IRR	Gross MOIC	Net IRR	Net MOIC
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Highest Fee-Paying Gross **\$1,327** **\$489** **\$1,750** **\$2,239** **15.8%** **1.7x**

Highest Fee Pay Net **11.9%** **1.4**

$$\text{IRR GNDF} = \frac{(1 + 11.9\%)}{(1 + 15.8\%)}$$

Hypothetical Cash Flows and Carry

Estimating cash flows may lead to more precise results. However, assumptions around timing may have significant impacts on IRRs.

Fund Cash Flows

	Jan-19	Jul-19	Jan-20	Jul-20	Jan-21	Jul-21	Jan-22	Jul-22	IRR
Gross Cash Flows	(\$180)	(\$210)	(\$330)	(\$12)	(\$60)	(\$25)	\$465	\$885	21.48%
Net Cash Flows	(\$190)	(\$215)	(\$340)	(\$20)	(\$65)	(\$30)	\$430	\$850	16.77%

Gross Investment Cash Flows

Investment	Jan-19	Jul-19	Jan-20	Jul-20	Jan-21	Jul-21	Jan-22	Jul-22	Gross IRR
1	(\$180)	(\$10)	-	-	(\$20)		\$465	-	32%
2	-	(\$200)	-	(\$12)	-	-	-	\$400	24%
3	-	-	(\$150)	(\$10)	(\$20)	-	-	\$235	12%
4	-	-	(\$180)	\$10	(\$20)	(\$25)	-	\$250	7%

Hypothetical Net Cash Flows

Investment	Jan-19	Jul-19	Jan-20	Jul-20	Jan-21	Jul-21	Jan-22	Jul-22	Net IRR
1	(\$190)	(\$12)	(\$3)	(\$2)	(\$21)	(\$1)	\$465	-	29%
2	-	(\$203)	(\$3)	(\$14)	(\$1)	(\$1)	(\$12)	\$383	19%
3	-	-	(\$152)	(\$12)	(\$21)	(\$1)	(\$10)	\$227	7%
4	-	-	(\$183)	\$8	(\$21)	(\$26)	(\$12)	\$240	1%

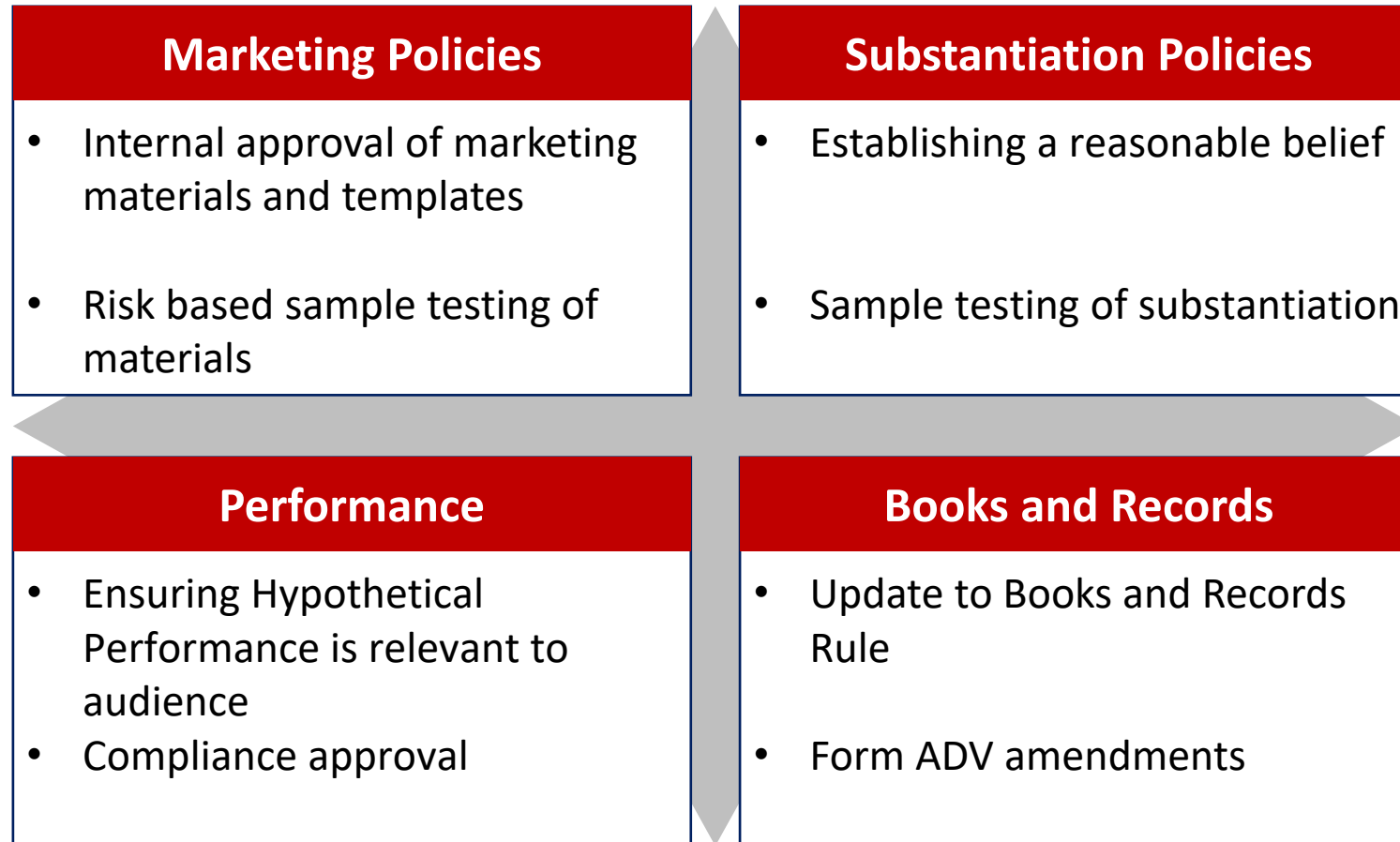


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Policies and Procedures

The Risk Alert highlights areas where advisers may not yet have developed policies.



Substantiation of Material Facts

The new requirement to substantiate **all** material facts “upon demand” can be a significant burden on managers and compliance departments.

