JONES DAY

COMMENTARY

MAY 2017

SEC's Unwavering Focus on Disclosure of Valuation Methods and Calculation of IRRs by Fund Sponsors

IN SHORT

The Inquiry: The SEC recently has subpoenaed at least one fund sponsor for information related to the firm's practices in calculating its internal rates of return.

The Impact: The SEC continues to be focused on how fund sponsors calculate investment performance metrics, such as IRRs, and the related disclosure.

Looking Ahead: Fund sponsors should ensure they are following best practices for valuation methods and related investment performance disclosures, including the calculation of IRRs.

The recent SEC subpoena of a fund sponsor for additional information concerning how it calculates internal rates of return ("IRRs") indicates that investment performance disclosure, and specifically the calculation of IRRs, remains a focus for SEC inquiries. Fund sponsors will be well served by revisiting their IRR calculation methods and related disclosures.

IRRs have long been used by both investors and fund sponsors to measure and compare investment performance. Although the general rubric of antifraud requirements applies to the disclosure of investment performance metrics, there is no standard method for how IRRs are calculated and reported. As a result, IRR calculation methods vary widely among private equity and real estate firms. For example, inclusion or exclusion of capital from reinvestment, capital from subscription or other lending facilities, or capital from the fund sponsor or other entities that do not pay fees or carried interest can all affect the resulting IRR. Consequently, IRRs, without more description, do not always provide accurate comparisons and have become the subject of SEC scrutiny.

When it comes to disclosing investment performance information, fund sponsors, as investment advisers, owe fiduciary duties to their clients and are subject to specific regulatory requirements. Under the Investment Advisers Act of 1940, investment advisers have an affirmative obligation to disclose all material facts to their clients and a duty to avoid misleading them. Section 206(4) of the Advisers Act covers the antifraud requirements that apply to advertisements by investment advisers. Historically, the SEC took the position that any use of model or actual results in an advertisement for a fund would be considered per se fraudulent. In 1986, however, the SEC granted no-action relief to Clover Capital Management, allowing the company to use a model portfolio in its advertisements.

The SEC then took that opportunity to interpret Rule 206(4)-1(a)(5). Among other requirements, the SEC concluded that advertisements must disclose pertinent information for the potential investor, such as market conditions and whether the prior performance results included the reinvestment of dividends.

In addition, the SEC specifically noted that investment advisers must deduct fees, commissions, and other expenses from their calculations, resulting in a de facto requirement that advisers provide investors with net, rather than gross, performance results. The common theme of these early interpretations—which continues today—is clear and meaningful disclosure when reporting investment performance.

Over the last few years, the SEC has highlighted valuation methods and the lack of transparency in performance advertising as a source of concern. The former Chief of the SEC Enforcement Division's Asset Management Unit, Bruce Karpati, focused on this in a 2013 speech. Karpati explained that interim valuations of a fund may be the best source of data available to investors and that these figures take on enhanced significance during fund marketing. He warned of the potential for exaggerated performance when valuating illiquid assets.

Over the last few years, the SEC has highlighted valuation methods and the lack of transparency in performance advertising as a source of concern.

In 2014, Andrew Bowden, then Director of the Office of Compliance Inspections and Examinations ("OCIE"), gave a speech in which he expressed that a common valuation issue he had seen was that advisers disclose one valuation methodology to investors but then use a different methodology, which can create a substantial change in the interim performance marketed to investors through measures such as IRRs. Bowden explained that OCIE's aim was not to second-guess fund sponsors' valuations but to ensure that the actual valuation processes used by fund sponsors aligned with those promised to investors.

The recent inquiries by the SEC into funds' IRR calculation methodologies show that this issue is still on the SEC's radar.

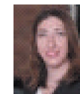
As a result, fund sponsors should keep valuation methodology and its effect on IRRs in mind when reporting their investment performance. Any advertising materials should contain clear and detailed disclosure about IRR calculations for the benefit of prospective investors. For example, fund sponsors should consider whether disclosure of factual circumstances, such as capital from reinvestment, credit facilities, or fee or carry free sources, that affect the IRR calculation is necessary. Net IRRs should always be included in advertisements, although gross IRRs may be permitted if both IRRs are presented in an equally prominent manner. Ultimately, fund sponsors should ensure that their reported IRRs provide a fair and accurate reflection of investment performance.

THREE KEY TAKEAWAYS

1. The SEC has repeatedly emphasized the importance of clear and meaningful disclosure of investment performance.
2. Fund sponsors should take this opportunity to review their methods for calculating investment performance metrics, such as IRRs.
3. Fund sponsors should consider whether disclosure can be improved through examination of the details of the IRR calculation and other investment performance metrics.

AUTHORS

Michael P. Earley
Chicago



Jessica L. Panza
Chicago

Katherine Thrapp, an associate in the Chicago Office, assisted in the preparation of this Commentary.

All Contacts >>>

YOU MIGHT BE INTERESTED IN: **Go To All Recommendations >>**

Accounting True-Up vs. Valuation Dispute

Treasury Releases Final Debt/Equity Regulations

SUBSCRIBE SUBSCRIBE TO RSS

Jones Day is a legal institution with more than 2,500 lawyers on five continents. We are One Firm Worldwide℠.

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our website at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.

© 2017 Jones Day. All rights reserved. 51 Louisiana Avenue, N.W., Washington D.C. 20001-2113