

CFA Institute
Centre for Financial Market Integrity
Reference: Global Investment Performance Standards
P.O. Box 3668
Charlottesville, Virginia 22903

BY E-MAIL

Basel, June 9, 2009
A.170.4 / MST / ISE

Comments on Exposure Draft GIPS 2010

Dear Sirs

We refer to your invitation to comment on the Exposure Draft of the 2010 Global Investment Performance Standards of January 2009 and would like to thank you very much for the opportunity to present our views.

The Swiss Bankers Association (SBA) is the leading professional organisation of the Swiss financial centre. We offer the following comments in our capacity as Country Sponsor for GIPS in Switzerland. Our remarks and suggestions have been developed in the context of our Expert Group on GIPS in which both banks as well as auditors are represented.

In general, the Swiss Bankers Association welcomes the revision of GIPS to GIPS 2010. We are convinced that the goals and main directions of the proposed revision are to be supported.

As one of our main points, however, firms should not be required to present the standard deviation of the composite and benchmark because this specific risk measure is not adequate for all types of products (4.A.29 and 5.B.7).

In addition, the proposed valuation hierarchy for determining Fair Value for portfolio investments should not be declared a mandatory requirement, but should be formulated as a recommendation (Appendix D, 7). In contrast, the disclosure of the description of the benchmark should be upgraded into a requirement (4.B.3, first half).

The remarks below, both regarding content and form, follow the chronology of the Exposure Draft. Thereby, we also address the specific questions asked in the Consultation Package.

0. Fundamentals of Compliance

- 0.A.3, Footnote 1: In order to make the wording in this footnote consistent with provision 0.A.3, the word “defined” should be deleted.
- 0.A.7, Paragraph 1: We suggest to delete the word “applicable” because generally all requirements must be met. If any requirements are not applicable to a particular firm (e.g., the firm does not have portfolios with bundled fees), it should in our opinion be self-understood that in such cases the firm does not have to comply with the corresponding requirements.
- **Question “Do you agree with including disclosure of the firm’s verification status in the claim of compliance?” NO, we do not agree with the proposed categories called “currently verified”, “verified, but not currently verified” and “not verified”. Instead, and in the interest of practicality and transparency, we recommend to only introduce two different categories, “verified” and “not verified”. It should be possible to use the “verified” status if the verification report covers a period ending not more than 24 months ago. In addition, of course, the exact verification period should be mentioned.**
- **Question “Do you agree with the classification of a current verification being within the last 24 months?” NO, see above.**
- 0.A.8: In analogy to our comment to 0.A.7, we suggest to delete the word “applicable” because typically all requirements have to be met.
- 0.B.2: This provision might be highly difficult and costly in practical implementation, especially in large firms with a huge number of private clients. Therefore, we suggest to restrict the recommendation to cases of request instead of automatic delivery on an annual basis: “FIRMS SHOULD provide to each existing client, upon request, a COMPLIANT PRESENTATION for the COMPOSITE(S) in which the client’s PORTFOLIO is included.”
- 0.B.4: The recommendation that “firms should be verified“ could additionally suggest that this should happen “on a regular basis”.

1. Input Data

- **Question: “Do you agree with the change from market value to fair value?” YES, we basically agree.** Reservations with respect to some provisions of the GIPS Valuation Principles are outlined below.
- 1.A.2 and Valuation Principles in Appendix D: We recommend to clarify valuation aspects regarding the handling of delayed prices in the form of Q&A. What should happen, e.g., with the monthly valuation of a composite containing illiquid investments which have delayed prices / valuations of three months? Please see also our comments to the proposed GIPS Valuation Principles.
- 1.A.3: Point c) is worded in a confusing way and should be clarified, e.g., item (b) should read: “At least on the date of all LARGE CASH FLOWS” because

firms are certainly permitted to value portfolios on a daily basis regardless of cash flows.

2. Calculation Methodology

- 2.A.2: We suggest to allow the use of the money-weighted return method (e.g., IRR or Modified Dietz) if the manager controls the timing and size of external cash flows (similar to the Private Equity portfolios). This would make sense, for example, in the case of a start-up manager who wishes to present the performance track-record of his own portfolio he has managed before, in which case he obviously took the decisions regarding cash flows. This change would also require an amendment to the Guidance Statement on Calculation Methodology (Application 1).
- 2.A.7: We encourage you to reconsider the language with respect to the trading expenses in bundled fees. The sentence "If the actual direct TRADING EXPENSES cannot be identified and segregated from a BUNDLED FEE" seems to be a contradiction in itself. The trading expenses are only implicit in a bundled fee, so strictly speaking there are no actual trading expenses to be identified. Decomposition of a bundled fee will always involve a certain degree of approximation as there are no direct trading expenses attributed to the portfolio. If a firm uses a bundled fee split ratio defined on the basis of sound and reliable management accounting records, one would argue that this is rather a close approximation than an estimation. We encourage you to replace this sentence with "If the TRADING EXPENSES cannot be reasonably identified and segregated from a BUNDLED FEE" and also suggest to delete the superfluous sentence in a-b "FIRMS MUST NOT use estimated TRADING EXPENSES" because this is already stated in 2.A.5.

3. Composite Construction

- **Question relating to 3.A.1: "Do you agree with requiring the inclusion of non-fee paying discretionary portfolios in composites?" YES, we agree.** The only criterion whether to include or exclude assets from the GIPS firm should be the existence of investment management. If assets are managed on a discretionary basis, they must be included regardless of their fee-paying status.
- 3.A.2: We believe that it should be explicitly mentioned that firms are not permitted to include portfolios with different investment strategies or objectives in the same composite. This is a very fundamental matter and is already in the Guidance Statement on Composite Definition. However, experience shows that firms sometimes pay little attention to that guidance statement. Meaningless "catch-all" composites are to be avoided.
- **Question: "Do you agree with changing 3.A.9 from a recommendation to a requirement?" No, we do not agree.** Clients may approach firms with an initial intention to invest a certain amount of money, however, the portfolio size may be subsequently increased during the negotiation process if the potential client becomes aware of a more successful strategy requiring a bigger portfolio.
- 3.B.1: This provision should be removed from the main body of GIPS as it is already in the Guidance Statement on Significant Cash Flows and its

importance is questionable. The theoretical treatment using temporary new accounts is away from the reality as it is usually not supported by IT systems and very few firms apply this method.

4. Disclosure

- General Remark: We suggest to combine the current sections 4 (“Disclosure”) and 5 (“Presentation and Reporting”) into one section (“Presentation and Disclosures”) because both sections basically deal with the same subject. The allocation of provisions between section “Disclosure” and section “Presentation and Reporting” is sometimes not logical, e.g., the proposed provisions regarding the presentation of standard deviation (dealing with the same subject) are included both in sections 4.A.29 and 5.B.7.
- **Question: “Should firms be allowed to remove certain disclosures after a defined period of time? If so, which disclosures would be eligible for removal and after what period of time?” YES, we believe that the following disclosures should be allowed to be removed if the firm determines the disclosure is no longer meaningful (eligible for removal after 5 years): 4.A.9, 4.A.19, 4.A.21, 4.A.22, 4.A.23 and 5.A.6.b.**
- 4.A.3: We suggest to add that firms must disclose their definition of discretion in general. The minimum asset level is just one of the specific cases of discretion, so firms could be required to disclose their whole definition of discretion.
- **Question: “Do you agree with the inclusion of short positions in provision 4.A.5?” YES, we agree that disclosure of short positions would be beneficial to prospective clients.**
- 4.A.13: Our experience shows that providing this information does not offer any substantial value added, but constitutes an unnecessary burden for firms. We recommend deleting it.
- 4.A.17: We believe that firms should be required to disclose their performance calculation method and to make further detailed information available upon request.
- 4.A.20: For the interpretation of this provision, sample disclosures and examples should be given in the form of a Q&A.
- **Question: “Do you agree with requiring the disclosure of key characteristics and risks in the composite description?” YES, we absolutely agree that the disclosure of key characteristics and risks of the composite strategy should be required.**
- 4.A.29 and **Question: “Do you agree with the inclusion of a standard deviation disclosure?” NO, we do not support requiring firms to present the standard deviation of the composite and benchmark because this specific risk measure is not adequate for all types of investment products.** Instead, we suggest to introduce the possibility of using “an adequate risk indicator”(see also 5.B.7): “FIRMS MUST disclose the 3 year annualized EX-POST STANDARD DEVIATION or an adequate risk indicator...”. Furthermore, the calculation of the standard deviation needs to be explained in an example illustrating the use of the corresponding formula. This could be done in the form of a Q&A.

- 4.B.2: From our perspective, this recommendation should (i) be turned into a requirement and (ii) be applicable only upon request. We suggest the following wording: “FIRMS MUST disclose upon request the key assumptions used to value investments.”
- 4.B.3: This provision is worded in a misleading way because it might be understood in the sense that a description or definition of the composite benchmark does not have to be disclosed in the compliant presentation. We believe it is crucial for the understanding of a compliant presentation that investors know what the benchmark of the composite is, especially as the benchmark return presentation is a required disclosure. This is specifically important in the case of customised (balanced) benchmarks consisting of several market indices. There should be an explicit requirement in the GIPS standards that firms must disclose the composition and nature of the benchmark (if any benchmark is defined for a particular composite). Therefore, we suggest upgrading the first part of 4.B.3 into a requirement in section 4.A (“FIRMS MUST disclose the description of the BENCHMARK.”) and leaving the rest of 4.B.3 as a recommendation (“FIRMS SHOULD disclose material differences between the BENCHMARK and COMPOSITE strategy.”).

5. Presentation and Reporting

- 5.A.1.b: The wording should be changed to “FIRMS MUST present returns from the COMPOSITE inception through the initial period-end.” This would also capture the case that, e.g., a composite starts on 1 May and the compliant presentation is presented as of 30 September.
- **Question: “Is it appropriate to discontinue disclosure 5.A.5 for periods after 1 January 2011?” YES, we think this is appropriate.**
- 5.A.6.c: Referring to our comment to provision 4.B.3, we suggest that the wording of provision 5.A.6.c be changed as follows: “If a custom BENCHMARK or combination of multiple BENCHMARKS is used, the FIRM MUST disclose the BENCHMARK composition, creation and re-balancing process.”
- 5.A.7: We believe that this disclosure requirement should be deleted because no differentiation will be made between fee-paying and non-fee-paying portfolios going forward. Our experience shows that this disclosure has caused additional costs for GIPS compliant firms without adding much value to investors.
- **Question: “Do you agree with the requirement to present the percentage of the composite assets composed of proprietary assets?” NO, we disagree with this proposed disclosure.** Why should potential investors be concerned about whether the managed portfolios were proprietary or third-party? This disclosure would cause additional costs for GIPS compliant firms without adding much value to investors. Instead, we suggest to add another requirement that explicitly states that proprietary assets must always be included in a relevant composite.
- 5.B.7: Similarly to 4.A.29, we strongly recommend to also permit the use of other adequate risk indicators in cases where the standard deviation is not appropriate. The wording should be adjusted correspondingly.

6. Real Estate

- The excluded category “Commercial mortgage-backed securities (CMBS)” should be generally extended to include all mortgage-backed securities.
- **Question: “Do you agree that real estate investments must be valued by an independent external appraiser every 12 months beginning 1 January 2012?” NO, because this is a too short notice** given the effective date of the revised GIPS as of 1.1.2011. We suggest to keep this as a recommendation and to evaluate a potential upgrade in future when more experience will have been gathered with the implementation of GIPS in the real estate area.
- 6.A.4. Please provide, in a Q&A, a calculation example how the mentioned geometrical linking of the quarterly income and capital returns should be calculated, especially how the sum of the geometrically linked annual income and capital returns can be reconciled with the annual total return.
- **Question relating to 6.A.6: “Do you agree with the additional requirements and recommendations for closed-end real estate funds as defined?” We believe that the Internal Rate of Return should stay a recommendation also for closed-end funds.**
- 6.A.7: We do not agree with the proposed requirement that composites for closed-end real estate funds must be defined by vintage year. Firms should have flexibility to construct composites.
- 6.A.8.c: This provision requires firms to explain and disclose the impact of material differences between (i) the valuation used in performance reporting and the valuation used in financial reporting as well as between (ii) the external valuation and the valuation used in performance reporting. Financial reporting and performance reporting are not the same (financial reporting may also be mainly geared towards existing clients), so introducing aspects of financial reporting into the performance report adds a level of unnecessary complexity. A firm that manages mutual funds and includes them in composites along with other portfolios is not required to disclose differences between information reported by the mutual fund and the fund information used for composites. It is not clear why a real estate manager should be required to do so. Accordingly, we suggest to delete provision 6.A.8.c.
- **Question: “Do you agree that component returns must be disclosed, and that the method described in provision 6.A.9.b will no longer be acceptable for periods beginning after January 2011?” YES, but we suggest to provide. e.g. in a Q&A, a calculation example for both situations in (a) and (b).**
- 6.A.15: The term “component return” is not defined the GIPS Glossary, while the terms “income return” and “capital appreciation return” are.
- 6.A.17: We believe that the requirement “When the initial period is less than a full year, FIRMS MUST present NET-OF-FEES annualized SI-IRR from COMPOSITE inception through the initial year end” is a violation of provision 5.A.3, “Returns for periods of less than 1 year MUST NOT be annualized.” A similarly confusing sentence is also included in 6.A.18.

7. Private Equity

- Regarding the applicability of the GIPS Private Equity Provisions for certain types of open-end Private Equity Fund-of-Funds vehicles, please see our detailed comments and suggestions in the Appendix to this letter.
- 7.A.8: Direct investments may be made as co-investments with funds and be a part of the same investment product and composite. We believe that the creation of composites should be left to the manager and should not be dictated by GIPS. Therefore, this requirement should be deleted.
- 7.A.17: For reasons similar to our comments on 6.A.8.c above, we recommend to delete this provision.
- 7.A.20: We believe that the requirement “When the initial period is less than a full year, FIRMS MUST present NET-OF-FEES and GROSS-OF-FEES annualized SI-IRR from the COMPOSITE inception through the initial year end” is a violation of provision 5.A.3, “Returns for periods of less than 1 year MUST NOT be annualized.”, cf. our comments on 6.A.17.
- 7.A.21: We do not agree with this proposed requirement and do not see the rationale why the returns of the underlying funds by vintage year must be presented and what the value of this information would be.
- GIPS Private Equity Interpretative Guidance, page 6, states: “Firms must disclose when fees are paid outside of the fund vehicle”. If this is really meant to be a disclosure requirement, then it should be added to the main body of the GIPS Standards in Section 7, “Private Equity”.

8. WRAP Fees / Separately Managed Accounts (SMA)

- **Question: “Is it appropriate and/or necessary to include provision 8.A.6, which addresses presenting performance to existing clients, in the GIPS standards? Should firms be allowed to present a “sponsor-specific composite” as opposed to a “style-specific composite”?”** **NO**, we understand that this provision was already included in the GIPS Guidance Statement for Wrap Fee Portfolios. However, we believe that the GIPS Standards should be currently geared towards prospective clients and that their extension to performance presentation to existing clients (this being wrap-fee sponsors or whoever else) should be addressed in a separate dedicated GIPS guidance. In this respect, we also oppose to the creation of “sponsor-specific” composites because we believe that this contradicts with the following provision of the GIPS Guidance Statement on Composite Definition: “Client type alone must not be used as the primary criteria for defining a composite.”

III. Verification

- Section A, Provision 6 can be combined with Provision 2.
- Section A, Provision 7: “A principal verifier may also choose to rely on the audit and/or internal control work of a qualified and reputable independent third party. In addition, a principal verifier may choose to rely on the other audit and/or internal control work performed by the VERIFICATION firm.” This wording is not clear regarding the difference supposed to be between a “qualified and

reputable independent third party” on the one hand and “the verification firm” on the other. In the same context, the difference between a “verifier” and a “verification firm” should be clarified.

- Section A, Provision 8: Although we agree with the fact that a more important sample must be tested if the verifier cannot reduce its risk with other procedures, we do not agree with the wording that, in our view, could imply sampling procedures in each case. This part should be in line with international auditing standards (such as ISA). We propose the following wording for the first sentence: "Verifiers MUST obtain a sufficient assurance on the adequacy of the process implemented at firm level. In order to have so, verifiers can reduce its risk by testing the efficiency of internal controls (control approach) and/or by taking a representative sample of accounts (substantive approach). The verifier can rely on internal controls only if tested and considered efficient. If it is not the case, the verifier will reduce its risk with a substantive approach. Verifiers may use a sampling methodology ...".
- **Section B, Question “Should specific verification procedures be included for GIPS provisions 0.A.16 and 0.A.17?” Here, our answer is “NO”.** Provision 0.A.16 relates to the legal and regulatory compliance which is a very large and comprehensive matter and cannot be included in the scope of GIPS verification. Verification of compliance with provision 0.A.17 would effectively mean a dedicated search for fraud which is not in the scope of assurance services such as the GIPS verification either. A pragmatic solution could be to include a statement regarding compliance with local laws and regulations in the representation letter obtained by the verification firm at the end of the verification. Obviously, if the verifier notes a breach of local law or regulation, this should be addressed in the verification report.
- Provision B.1.c: The definition of the firm in terms of GIPS is structured primarily around the concept of “distinct business entity” with an autonomous investment process and not around its legal or corporate structure. In this respect, it is strange to see that the focus in terms of the understanding of the firm is placed on the corporate structure. We suggest to modify this language to state that verifiers must obtain the relevant information about the investment management business of the firm (e.g., investment process descriptions, overview of the investment products offered to clients, etc).
- Section B: The proposed verification procedures do not reflect the recent developments in the auditing profession (a reference can be made to various auditing standards such as the International Standards on Auditing, ISA), which is a shift from a detailed-test-based to a process-and-controls-based audit. In addition, the big progress achieved in the area of IT support of GIPS compliance resulting in an increased automation of the GIPS compliance processes is not taken into account in the proposed provisions either. In this respect, we suggest to include the following provision after item 1.d: “A verifier should evaluate the IT systems employed to maintain and support the GIPS compliance and the internal controls system in place in the GIPS compliance area. Depending on the results of this evaluation, a verifier should ascertain whether he may be able to obtain the necessary verification comfort from the reliance on the IT support and internal controls and design his further verification procedures accordingly.”

- Section B, Provision 2, Verification Procedures: B.2.b.i and B.2.b.vi are very similar and could be combined.
- Section B, Provision 2.d.iii: “PORTFOLIO SUMMARY” should be defined in the Glossary.
- Section B, Provisions 2.d, Allocation of Accounts to Composites and 2.e, Data Review: Since “testing” is just one way to perform verification, we recommend to replace it by “procedures”. Moreover, Provision 2.e “Data review” should include “The market index data used by the FIRM for calculation of the BENCHMARK performance data to ensure that it is consistent with the BENCHMARK definition and applied correctly”.
- Section B, Provision 2.f: As explained above, we do not agree with the wording and would use the same wording as in B.2.d: “Verifiers must perform sufficient procedures to be satisfied that: (i) rates of returns are calculated using an acceptable return formula (...); (ii) all required presented quantitative statistics are calculated in compliance with the Standards”.
- Section B, Provision 2.g: We would replace “Verifiers must TEST a sample of COMPLIANT PRESENTATIONS...” by “Verifiers must obtain sufficient assurance that presentations comply with all the information ...”.
- Section B, Provision 2.i, Representation Letter: In the context of our remarks to the question in Section B, we suggest to reword as follows: “The representation letter must confirm that the firm complies with the GIPS standards and the local laws and regulations for the period verified.”

Appendix C: GIPS Advertising Guidelines

- We strongly oppose to the newly added provision “FIRMS may include other information beyond what is REQUIRED under the GIPS Advertising Guidelines, provided the information is shown with equal or lesser prominence to the information REQUIRED by the GIPS Advertising Guidelines... “. First, from the wording of this sentence it is not clear whether it constitutes a requirement or a recommendation. Second, GIPS should not dictate firms how to structure their advertisements in terms of layout. We do not think it is important whether the information required under the GIPS Advertising Guidelines is presented in a larger or smaller font than the other information, as long as this required information is included in the advertisement.
- Item 3: Concerning the text of the compliance statement for firms that are currently verified, we do not find it appropriate to offer a copy of the verification reports(s) upon request in an advertisement. Instead, potential clients should be given a list and description of the firm’s composites first, and this is what the claim of compliance in an advertisement should point to.
- Item 5: The three options are still worded in a very complex way. We would prefer to have these three options presented in a more illustrative manner (e.g., in table form).
- Item 9: We believe that a description of the composite investment strategy similar to 4.A.20 should be presented here, and not only the information on leverage, derivatives and short positions.
- Item 11: We disagree with this proposed requirement. Many jurisdictions would have local regulations with respect to performance advertising which differ from the GIPS Advertising Guidelines. The advertisement space is usually limited,

and including this additional disclosure would impose additional restrictions with respect to the advertisement layout.

Appendix D: GIPS Valuation Principles

- **Question: “Do you agree with the requirements and recommendations in the GIPS Valuation Principles below?” YES, see below.**
- Item 6: We believe that this requirement is redundant because it is included and elaborated in Item 7.
- Item 7: The requirement of following the described hierarchy in the valuation process does not seem adequate. Since GIPS are not primarily intended to be standards for valuation, the proposed valuation hierarchy for determining Fair Value for portfolio investments should not be declared a mandatory requirement, but should be formulated as a recommendation. Especially, we do not agree with the hierarchical superiority of quoted prices in inactive markets (option c) over “mark-to-model” (option e). Recent pronouncements of accounting standard-setters (e.g., FASB and IASB) discourage the use of observable market prices from inactive markets or from “distressed sales” and recommend using model valuation instead. In addition, we think that the hierarchy is defined too rigidly. It is questionable whether it is practicable to incorporate the provisions from the accounting and financial reporting standards in the GIPS standards because the accounting standards keep changing especially in the current environment. Linking GIPS to accounting standards would necessitate a continuous updating and adjustment of the GIPS standards to reflect the changing accounting standards. In addition, the expensive and time-intensive fair value presentation process required for accounting purposes in the annual or quarterly financial reporting is unlikely to be practicable on a monthly basis for GIPS purposes, let alone to be applied on the date of every large cash flow as will be required by GIPS from 2010.
- Item 8: Some banks and asset management firms use proprietary valuation models for sophisticated over-the-counter instruments. Therefore, we suggest the following wording: “FIRMS MUST disclose if PORTFOLIO investments are valued using subjective unobservable inputs or proprietary valuation models that are material to the COMPOSITE as of each period end.”

Appendix E: GIPS Glossary

- **Question: “Do you agree with the definition of prospective client? If not, how should it be defined?” YES, we basically agree with the proposed definition.** However, it should be clarified whether the statement “Investment consultants and other third parties are included as PROSPECTIVE CLIENTS if they represent investors that qualify as PROSPECTIVE CLIENTS” also implies that general enquiries from consultants to provide data for consultant databases are considered as a request from a prospective client. Furthermore, the definition needs additional guidance on how competitor firms and the media should be treated when it comes to requests for composite performance information. The difficulty is how firms are supposed to determine that a person “qualifies” to invest in a composite as well as determine if the investment

consultant and other third parties “represent investors” that “qualify” as prospective clients. This is especially sensitive in cases where competitor firms or journalists approach a firm with requests for composite investment performance. Additionally in the definition of “PROSPECTIVE CLIENT”, it should in our view be made precise that it is up to the firm to determine how it defines a prospective client.

- CAPITAL RETURN: There is a reference to the term “ENDING FAIR VALUE”, which, however, is not in the Glossary.
- Regarding the revised definition of the term “COMPOSITE DESCRIPTION”, we recommend to provide further guidance and examples in the form of Q&A.
- The existing definition of “PROPRIETARY ASSETS” should be replaced by the following definition of “PROPRIETARY PORTFOLIO”: “Portfolio that is funded by the firm itself”.
- In the Glossary, the term “Regulation” should be defined. Particularly, “Regulation” should explicitly include “Self-Regulation”, at least to the extent that self-regulation can be recognised as a binding minimal standard by supervisory authorities (cf., e.g., Verification, provisions B.1.b and Appendix D, Item 12).
- VERIFICATION: The proposed definition is not appropriate. The word “tests” should be replaced with “confirms”, “provides assurance” or “opines”.
- Throughout the whole document, the use of the terms “return” and “performance” does not seem to be consistent.

Again, we would like to thank you for the opportunity to comment on your exposure draft. We are very interested, of course, in seeing the further development of GIPS 2010 and wish you plenty of success in finalising this important project. Please do not hesitate to contact us should you need additional information.

Yours sincerely,
Swiss Bankers Association



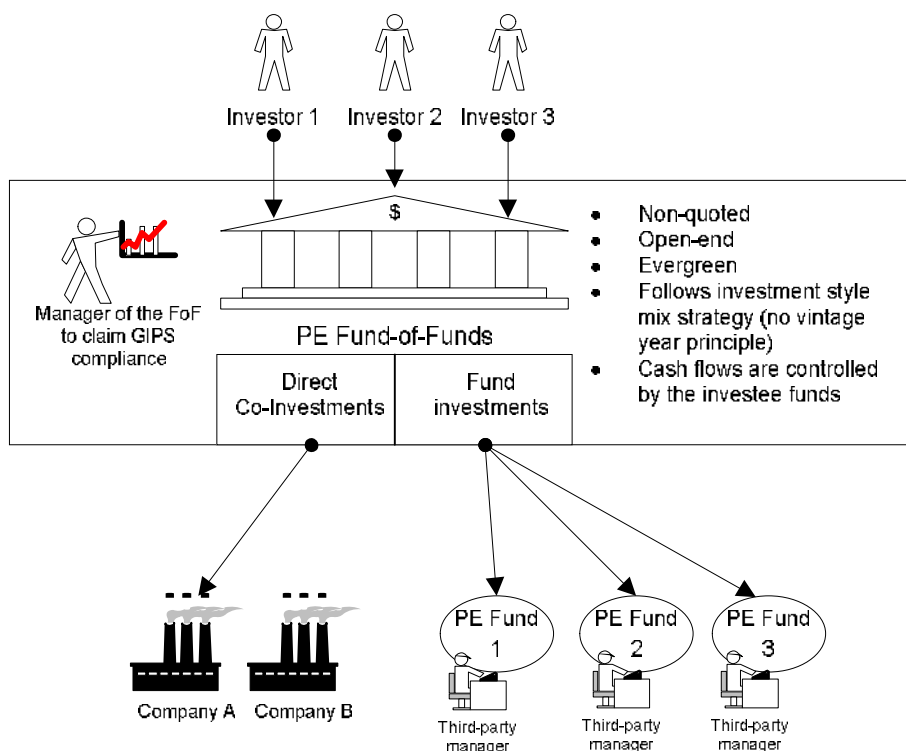
Renate Schwob Markus Staub

APPENDIX: Applicability of the GIPS Private Equity Provisions for certain open-end private equity fund-of-funds-vehicles

Situation

A private equity fund-of-funds vehicle (further “the FoF”) has the following features:

- 1) It is an open-end fund-of-funds established by an investment management firm to provide private equity investment opportunities to its existing asset management clients. The FoF is generally only available to the existing asset management clients of the firm who invest a portion of their assets into this FoF. The FoF is thus not publicly quoted.
- 2) The FoF does not have a finite life and is in essence evergreen.
- 3) The FoF invests in third-party private equity funds (further “the Investee Funds”) as either a limited partner or investor. The FoF has full discretion regarding selection of the Investee Funds. The Investee Funds are managed by third-party managers / general partners, whereas the FoF manager does not influence the investment decisions taken by those third-party managers. The FoF may also have other direct investments as a co-investor with the Investee Funds (upon recommendation of the managers of the Investee Funds). See the following diagramme for illustration:



- 4) The investment strategy of the FoF (selection of the Investee Funds) is not based on a vintage principle but on the investment style of the Investee fund (e.g., buy-out funds).
- 5) The manager of the FoF charges a management fee to the clients.
- 6) The timing and size of external cash-flows into/from the FoF are determined by the third-party managers managing the Investee Funds as they call the capital to make use of the investment opportunities or make distributions.
- 7) The firm managing the FoF would like to claim GIPS compliance to market the performance track record to further potential clients.

Problem with the application of GIPS

In its essence, the FoF described above is similar to a semi-captive fund described in the GIPS Interpretive Guidance for Private Equity. For some unclear reasons, GIPS explicitly exclude semi-captive funds from the scope of the GIPS Private Equity provisions. The Interpretive Guidance for Private Equity (revised as of 1.1.2006) states on page 2: "Another type of hybrid vehicle, called a semi-captive fund, mixes capital from both outside investors and the parent organization. These funds typically charge a management fee and carried interest to the outside investors and are usually closed-ended, as the number of investors is fixed, but a number of evergreen semi-captives also exist. Therefore, the scope of the GIPS private equity provisions is in no way directed toward captive or evergreen funds within this industry. These structures must follow the general provisions of the GIPS standards".

The problem arising here is that the general provisions of GIPS cannot be applied to the private equity vehicles like the FoF above, for the following reasons:

- 1) The FoF contains private equity investments (through the Investee funds), for which no monthly valuations required by the general GIPS provisions are available (typically, fair valuations are only available on a quarterly or annual basis). Therefore, the GIPS Private Equity Valuation Principles must apply to these assets, especially as the investee funds would apply these principles for their own GIPS compliance.
- 2) Following the general GIPS provisions would mean calculating TWR. Although the manager of the FoF does not control the cash flows, it is not at discretion of investors of the FoF either. The cash flows are controlled by the managers of the Investee Funds. So from the point of view of the investors in the FoF, the cash flows are controlled within the investment management vehicle they invest in and are beyond their influence. Use of the TWR method required by the general GIPS provisions would not be appropriate in this case. The IRR method must be used instead (which is also effectively the case in practice for such vehicles).

Conclusion and proposed action

The GIPS Private Equity provisions must be applicable to such FoF private equity vehicles and there seems to be no compelling reason to exclude such vehicles from their scope. The fact that this FoF is open-end and evergreen does not have any particular impact on the feasibility of the IRR calculation (although it is suggested to be problematic in the Interpretive Guidance for Private Equity). Although the capital base of the FoF is not fixed, the IRR still can be easily calculated. The other premise postulated in the Interpretive Guidance as a reason not to use IRR for open-end funds, which is “In an open-end fund., the timing of cash flows in and out of the fund is totally at the discretion of the investors”, does not hold true either.

We propose to explicitly allow such open-end evergreen private equity vehicles as described above to apply GIPS Private Equity provisions where applicable. In particular, the GIPS provisions should be amended as follows (underlined):

GIPS Standards

Chapter 7 (page 18):

The following are provisions that apply to the calculation and presentation of PRIVATE EQUITY investments other than publicly-traded PRIVATE EQUITY OPEN-END and EVERGREEN FUNDS (which MUST follow the main GIPS provisions).

Interpretive Guidance for Private Equity

(Page 2)

Captive and Semi-Captive Funds (GIPS private equity provisions may be applicable)

The private limited partnership is not the only investment vehicle that makes private equity investments. Some vehicles are organized as captive vehicles or semi-captive vehicles. Captive refers to a fund that only invests for the interest of its owner organization. This parent may be a regular corporation, a financial corporation, insurance company, university, and so on. The salient feature is that the fund only invests its parent’s capital—there are no outside investors. Corporate venture groups of technology companies are examples of this type of vehicle, although several insurance companies and investment banks also have similar vehicles.

The notable feature of this type of vehicle is that typically the vehicle is not a fixed-life investment pool - it is “evergreen” (i.e., a fund with no fixed cost basis as the parent can contribute additional capital or withdraw capital from the vehicle whenever it chooses). This lack of a fixed cost basis complicates the cash flow calculations because the cost basis fluctuates as the capital managed increases and decreases. The other problem is that a fund of this type charges no management fee to its owner and does not really have a “carried interest” profit split, although a few creative groups have compensation schemes for the investment officers that work in a similar manner to carried interest.

Another type of hybrid vehicle, called a semi-captive fund, mixes capital from both outside investors and the parent organization. These funds typically charge a management fee and carried interest to the outside investors and are usually closed-ended, as the number of investors is fixed, but a number of evergreen semi-captives also exist.

As such, captive and semi-captive structures are not comparable to private fixed-life limited partnerships on a net-of-fees basis. Therefore, the scope of the GIPS private equity provisions may not always be applicable (delete: “is in no way directed toward”) to captive or evergreen funds within this industry. These structures must assess on a case-by-case basis whether they should follow the GIPS Private Equity provisions or the general provisions of the GIPS standards.

Publicly-traded Open-End Funds (GIPS private equity provisions are not applicable)

Another investment structure is an open-end public entity that acts much like a publicly-quoted mutual fund. The fund is a public investment vehicle traded on an exchange and priced daily. These vehicles typically operate much like a mutual fund or publicly-traded company and are not required to follow the GIPS private equity provisions, but must follow the general provisions of the GIPS standards.

Calculation Methodology

(Page 4)

One of the reasons IRR is preferred is that this type of partnership generally has a fixed number of investors and a fixed commitment basis and proceeds cannot be reinvested so the cost basis of investment does not increase and decrease as it would with an evergreen or open-end fund. An open-end publicly-traded fund can find its investment pool increased (decreased) as investors invest (withdraw) more capital or by the addition (withdrawal) of investors.

One of the basic tenets of performance attribution is that the manager not be rewarded or penalized by decisions outside of their control. In an open-end fund as mentioned previously, the timing of cash flows in and out of the fund is totally at the discretion of the investors. As a result, a time-weighted return will (paradoxically) remove timing of the cash flows out of the performance calculation. Accordingly, publicly-traded open-end funds must follow the provisions of the general GIPS standards and report a time-weighted rate of return.
