4-9 GUIDANCE STATEMENT ON PRIVATE EQUITY

Introduction

For purposes of compliance with the GIPS standards, private equity encompasses investment in nonpublic companies at various stages of development and includes venture capital, buyout, mezzanine, and some distressed securities investing. Private equity also includes investments in public companies with the intent of taking them private or investments directly in public companies though structures known as PIPEs (private investment in public equity).

Private equity investments can be made in virtually any industry or geographic sector. Venture capital investments normally take a minority equity position in a company, while buyout funds will take a controlling position in or total ownership of a company. As the industry has evolved, it has become more specialized, providing prospective clients with investment opportunities outside of the investment categories popular even in the recent past.

The private equity industry has evolved from being principally composed of primary fund vehicles investing in individual companies to a complex mix of primary fund vehicles, secondary fund vehicles, funds of funds, direct investments, co-investments, and sponsored primaries, among others. The industry has evolved to the extent that some investment strategies that were novel some years ago are now common. For example, historically, investors in funds invested only in the funds themselves. It is now common for investors to invest directly in companies rather than only in funds. Private equity investments may overlap investments in sectors also invested in by other asset classes, such as real estate. As a result, there has been increasing interest in how the overlap creates issues for harmonizing the provisions among the various asset classes.

Investments by private equity vehicles may include investments in individual companies, in other funds, in debt securities, and in infrastructure projects, among others. Technically, all of those investments are ultimately investments in securities because the investor takes some ownership position; therefore, these collectively will be termed "underlying investments" for purposes of this guidance.

Investment Vehicles

Investments in private equity are made through a variety of investment vehicles. This is generally done through fund vehicles that are referred to in these provisions as "primary funds" or through a fund of funds.

Primary Funds

Primary funds are investment vehicles that make investments in individual companies, which are typically termed "portfolio companies." The strategy of the fund may be broad or may have a specific investment stage and/or geographic focus.

Funds of Funds

Funds of funds invest in primary funds rather than directly in portfolio companies (also see the section on co-investment later in this section) with the fund of funds taking a position as an investor in the underlying primary funds.

Secondary Funds

Secondary investment funds, which themselves may be structured either as a primary fund or a fund of funds, acquire an interest in a private equity fund from one or more of the original investors before the end of the fund's fixed life.

There are also specialized secondary funds that focus on acquiring portfolio companies from other private equity funds. These are typically seen as another type of primary fund and are not synonymous with secondary funds that acquire interests in private equity funds and thus must be considered a primary fund for compliance purposes.

There is often confusion as to the difference between a secondary fund and a fund of funds because both have interests in other primary funds. The difference is that a fund of funds is typically an original investor in an underlying fund while a secondary fund acquires the interest from another investor. There are exceptions because a fund of funds may make an opportunistic secondary investment, but its primary focus is to be an original investor.

Co-Investment

In some instances, an investor in a primary fund may invest directly into portfolio companies alongside the primary fund. A fund of funds may also invest directly in portfolio companies alongside its underlying funds. These are termed "co-investments." To take advantage of this particular investment, there are now specialized funds that focus on co-investments.

Investment Flows

When investing in private equity through a closed-end primary fund or closed-end fund of funds, an investor makes an initial commitment of capital that is then "called" or drawn down as the investment manager of the primary fund or the investment managers of the underlying funds in a fund of funds find investment opportunities. Capital is returned to the investor via distributions on the sale or recapitalization of individual portfolio companies by the private equity funds, although in some cases, investors may also receive earnings-derived distributions.

Private equity investment vehicles typically have a limited life (i.e., they are not open ended) and are generally illiquid. The ultimate return of the private equity investment vehicle is not known until the fund or partnership is finally liquidated. Because of the unique characteristics of this asset class, additional performance reporting requirements are needed. The GIPS standards, which are based on the principles of fair representation and full disclosure, seek to provide prospective clients with the critical pieces of information needed to evaluate the firm's performance.

Compliance

Compliance with the GIPS standards can only be achieved on a firm-wide basis and requires adherence to not only the private equity provisions but also all provisions in Sections 0-5 in Chapter I of the GIPS standards, unless otherwise noted.

Valuations

Accounting standards up through the 1990s were driven in part by an overriding principle of prudence, seeking to protect investors and creditors from overstatements of asset values and profits. Traditional valuation methodologies, such as the use of historical cost, were easy to justify, thus placing a burden of proof on those seeking to deviate from conservative valuations. However,

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there are a number of shortcomings in historical cost methods, which led to pressure for change. Although the precise tipping point for change from a historical cost basis differed by jurisdiction, it became apparent over various market cycles that in some cases conservatism can operate against the interests of some stakeholders.

For example, the historical cost approach has an outward appearance of being conservative and thus in the best interest of stakeholders. However, the use of historical cost can become a defense against the proper write-down of impaired investments. Conversely, the true value of a company's assets may be materially understated, leading to a potentially undervalued takeover bid. Furthermore, as valuation methodologies in public markets became more sophisticated by incorporating cash flows, brand values, the value of intellectual property, and earnings growth, traditional balance sheet conservatism became a less compelling approach.

Fair Value

It has been the position of the GIPS Executive Committee (and previously the Investment Performance Council) for some time that fair value is the most appropriate way to view private equity valuations. It was recommended that a fair value basis be used to value private equity investments in the 2005 edition of the GIPS standards. As fair value is progressively adopted as the preferred industry practice, and is mandated by various accounting standards, the GIPS standards require the use of fair value for all investments, including private equity investments, as of 1 January 2011.

Scope

The following are provisions that apply to the calculation and presentation of private equity investments made by fixed-life, fixed-commitment private equity investment vehicles, including primary funds and funds of funds. These provisions also apply to fixed-life, fixed-commitment secondary funds, which must apply either the provisions applicable to primary funds or the provisions applicable to funds of funds, depending on which form the secondary fund uses to make investments. Private equity open-end and evergreen funds must follow Sections 0–5 in Chapter I of the GIPS standards. Real estate closed-end funds must follow Section 6 in Chapter I of the GIPS standards.

Investment Structures

Closed-End Fund Vehicles (GIPS private equity provisions are applicable)

The predominant vehicle in the global private equity industry is the independent, private, fixed-life, closed-end fund. These vehicles may be organized in a variety of legal forms (e.g., limited partnership, trust, unit trust) depending on the jurisdiction. A firm may have several funds in existence at any one time, each of which is independent from the others. These funds by and large have a defined "start date" and most often have a fixed life (typically ten years) that can be extended by a pre-set number of defined periods (e.g., two one-year periods) upon agreement of the investors. This is termed a closed-end fund because the number of investors/shares is fixed for the life of the fund and closed to new investors, although ownership interest may be transferred (sold) to another investor under certain circumstances. This also means that the capital available for investment (capital commitments) is also fixed for the life of the fund.

An example of a closed-end fund vehicle is the limited partnership. A limited partnership is the most common structure used in the United States and is a fund of pooled interests managed by a general partner (generally an affiliated entity of the firm) who raises capital (i.e., committed capital)

from outside investors (limited partners). The general partner charges an investment management fee, typically from 1% to 3% per annum, on the total committed capital. Most funds require at least a nominal 1% investment by the general partner. In addition, the general partner will take a profit split (known as the "carried interest" or simply the "carry") of usually 20% of profits.

The general partner will "call" the capital from the limited partners in tranches as needed for investment in underlying companies. These capital calls are also termed "drawdowns" or "takedowns." The cumulative capital calls are known as paid-in capital. Another unique feature of this type of vehicle is that any proceeds from investments must be distributed to the limited partners; reinvestment is only permitted if allowed in the contract (known as a limited partnership agreement [LPA] or partnership agreement) between the general partner and the limited partners. In recent years, there has been an increasing number of cases where (by agreement) distributions may be recalled for subsequent investment. In addition, committed capital in these vehicles cannot be withdrawn ("redeemed"), as is the case in other pooled investment vehicles, such as hedge funds. In a typical private equity limited partnership, the cash flows are easy to enumerate because return is calculated on the basis of the cash flows between the partners (general and limited) and the fund. The investment management fee is generally charged on the total assets committed to the fund by the limited partners rather than on the value of the invested capital of the fund.

Funds of Funds (GIPS private equity provisions are applicable)

A fund of funds is a special type of fund vehicle that makes investments in primary private equity funds rather than in individual portfolio companies. The private equity fund of funds operates much like a primary fund vehicle except that the underlying investments are funds rather than companies. Recognizing that funds of funds do not necessarily control the underlying funds in which they invest, it is not necessary for each underlying fund in a fund of funds to be in compliance with the GIPS standards in order for the fund of funds firm to be compliant. A closed-end fund of funds that invests in open-ended vehicles would be required to follow the private equity provisions. Funds of funds must meet all relevant private equity requirements at the fund of funds level. Unless otherwise noted, each private equity provision applies to fund of funds vehicles.

Direct Investments and Co-Investments (GIPS private equity provisions are applicable)

Although an investment by a primary fund into a portfolio company is technically a "direct investment," because the investment is made directly into the company, the term is generally applied to separate investments in companies by investors outside of a primary fund. For example, an investor who invests directly in a company is said to be making a direct investment, rather than investing through a fund. Co-investments are a special case of direct investments where an investor in a fund makes a direct investment in a portfolio company along with the fund. This is generally allowed in a pre-established co-investment agreement. In many cases the direct investment or co-investment will have a different fee structure than a comparable investment in a fund. It is not uncommon for these co-investments to be "no-fee, no-carry" transactions. If a composite includes any non-fee-paying portfolios, the firm must present, as of each period-end, the percentage of the composite that is represented by non-fee-paying portfolios.

Side-by-Side Vehicles (GIPS private equity provisions are applicable)

There are instances in which parallel vehicles are created that invest alongside a primary fund for reasons such as individual client accommodation, jurisdictional considerations, or tax considerations. The vehicle itself usually invests on a pro-rata basis with its affiliated primary fund. Best

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practice is for firms to disclose if there is a side-by-side vehicle associated with a fund. While the terms and conditions for the side-by-side vehicle may be significantly different from those of the primary fund, if the side-by-side vehicle has a similar strategy and the same vintage year as the primary fund, the side-by-side vehicle must be included in the same composite as the primary fund. In the case that a side-by-side vehicle is materially different in strategy or other characteristic from the primary fund, then the side-by-side vehicle should be included in a separate composite.

Evergreen Funds (GIPS private equity provisions are not applicable)

In contrast to the typical closed-end, fixed-life limited partnership (described earlier) there are investment vehicles that are neither fixed life nor fixed commitment. They are often called "open-end funds" or "evergreen funds." While they do not have the same structure as a limited partnership, they may make the same type of investments into venture capital, buyouts, distressed debt, and similar investments and are usually also classified as private equity funds. However, the GIPS standards have excluded these from application of the private equity provisions, even though they may make the same type of investments. The investment structure typically doesn't lend itself to the same type of treatment as the closed-end, fixed-life fund.

To understand why the private equity provisions do not apply, it should be understood that the basic metric and industry practice used in measuring performance in the private equity industry is the since inception internal rate of return (SI-IRR). In the typical open-ended vehicle without a fixed amount of committed capital, an investment manager does not have control over the timing of the cash flows. While an SI-IRR can technically be calculated for such a cash flow stream, a time-weighted return is more appropriate given the cash flow stream and the decision process being measured. For this reason, evergreen vehicles are not good candidates for using the SI-IRR but, rather, are best treated using a time-weighted rate of return (TWRR) calculation.

As a result, the private equity provisions exclude funds that have an evergreen structure and require that they instead comply with the provisions in Sections 0-5 in Chapter I of the GIPS standards. The exception is the special case of evergreen funds of funds where the GIPS private equity provisions can be applied (see discussion later in this section).

Captive and Semi-Captive Funds (GIPS private equity provisions are applicable if funds are closed end)

Some private equity 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 (e.g., corporation, university, foundation). 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. A captive or semi-captive vehicle that is closed end would qualify for private equity provisions application.

A semi-captive vehicle is a vehicle that invests both parent entity capital as well as outside capital. These funds normally charge an asset-based investment management fee and/or carried interest to the outside investors, and are usually closed end because the number of investors is fixed, although a number of evergreen semi-captive funds also exist. If a captive or semi-captive vehicle is a closed end vehicle, then the GIPS private equity provisions apply. If the vehicle is evergreen, the GIPS private equity provisions do not apply.

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

Another investment structure is an open-end investment vehicle that acts much like a publicly quoted mutual fund. The fund is an investment vehicle that is traded on an exchange and priced daily. In addition, there are open-ended vehicles that, although not traded on an exchange, may be "priced" monthly. In these open-end investment vehicles, where the investment manager does not have control of the timing of cash flows from its investors, the IRR calculation is not appropriate. These types of open-end investment vehicle must adhere to the provisions in Sections 0-5 in Chapter I of the GIPS standards, rather than the private equity provisions.

Special Case of Evergreen Funds of Funds (GIPS private equity provisions can be applied)

The private equity provisions generally exclude evergreen open-ended vehicles. While not explicit in the provisions, there is one exception to the applicability of the private equity provisions. The private equity provisions of the 2010 edition of the GIPS standards provide funds of funds with the ability to define composites by vintage year of the funds of funds or by strategy. This flexibility accommodates a common type of structure used by funds of funds that have characteristics of an evergreen vehicle but the terms and structure resemble a typical private equity investment. This particular vehicle has the following characteristics:

- It is an open-end fund of funds vehicle that is neither publicly traded nor available to the general public.
- It does not have a finite life and is in essence evergreen.
- It invests in private equity funds as is typical for a fund of funds as either a limited partner or external investor. The fund of funds manager has full discretion regarding selection of the underlying funds. The underlying funds are managed by independent third-party managers/general partners. The fund of funds manager does not influence the investment decisions taken by those third-party managers. The fund of funds may also have other co-investments with the underlying funds.
- The fund of funds typically invests by strategy rather than by vintage year.
- The manager of the fund of funds charges a management fee to the investors.
- The timing and size of external cash flows into/from the fund of funds are determined by the third-party managers managing the underlying funds as they call the capital to make use of the investment opportunities or make distributions.

A vehicle of this structure may, but is not required to, comply with the private equity provisions that apply to funds of funds. If an evergreen fund of funds vehicle meets the above criteria and chooses to apply the private equity provisions, it must also comply with all of the private equity requirements in Section 7 of Chapter I of the GIPS standards. Alternatively, these vehicles can apply the provisions in Sections 0-5 of Chapter I of the GIPS standards.

Determining the Non-GIPS-Compliant SI-IRR Performance Period for Private Equity Composites

The private equity provisions require that private equity composites present the since inception internal rate of return (SI-IRR) of the composite through each annual period-end in the compliant presentation. When coming into compliance, firms must initially present at least five years of performance (or for the period since the firm's inception or the composite inception date if the

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firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The measurement period for an SI-IRR is the period from the inception date of the investment vehicle and/or composite through the end of the period that is being reported. Please note that the term "since inception" is independent of the calculation method used. For example, it is possible to calculate a "since inception time-weighted rate of return." Although it is not required or recommended in the GIPS standards, it is also possible to calculate an IRR between any two points in time within an investment period that is not necessarily since inception.

In a "since inception" IRR calculation, the beginning date remains constant and does not change. The measurement period for an SI-IRR becomes increasingly longer as the ending date is extended, whereas the beginning date is constant. A TWRR, as typically disclosed in a compliant presentation, does not have a constant beginning date like an SI-IRR but, rather, is a mathematical linking of several interim independent sub-periods. Conversely, an SI-IRR has only one measurement period—from inception to the end of the period being measured, with no linking of interim independent sub-periods.

It is necessary to use the period-end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the private equity composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period-end, starting with the period ending 31 December 2006 (assuming a calendar year-end period). If this firm chooses to present the SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non–compliant.

Effective Date

The effective date for this Guidance Statement is 1 October 2012. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with prior versions that were in effect at the time. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

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