Guidance Statements on Private Equity, Real Estate and Verification

Dear Sir, Dear Madam

With the GIPS Newsletter of August 2010, you have informed us about the release of the exposure drafts of the above mentioned three Guidance Statements for public comment. We would like to thank you 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 the Country Sponsor for GIPS in Switzerland. Our comments are organised along the Exposure Drafts on Private Equity (Section A), Real Estate (Section B) and Verification (Section C).

A. EXPOSURE DRAFT OF THE GUIDANCE STATEMENT ON PRIVATE EQUITY

1. Are the descriptions of the private equity industry and vehicles clear enough to distinguish private equity from other asset classes? Is it clear in which instances the private equity provisions apply?

Generally these points are clear. However, we have the following comments for potential improvement:

- The difference between a “secondary fund” and a “fund of funds” is not absolutely clear (it is actually also confusing in the GIPS Glossary). The statement “Secondary investment funds, which may be structured either as a primary fund or a fund of funds…” on page 2 adds more to the confusion.
- Section “Investment Structures” on page 3: The distinction between “Closed-End Funds” and “Closed-End Limited Partnerships” in their description is not absolutely clear, especially as it says that closed-end funds are usually organized as a limited partnership, etc.

The description of private equity vehicles lacks a more detailed discussion about open-end and evergreen vehicles, both unlisted and quoted on an exchange.
2. The private equity provisions can be applied to special cases of evergreen funds of funds. Do you agree with the characteristics? Is it clear how firms would comply with these provisions?

We absolutely support that the Private Equity Provisions can be applied to evergreen funds-of-funds. They should actually be allowed to apply to any private equity vehicles regardless of their capital or investor structure. The criterion should be investing in private equity assets and not whether they have a finite life and / or closed-end structure (exception being listed / traded open-end funds that have a daily market value, for which the fund manager does not control cash flows and the TWR can be easily measured).

In this respect, the statement on page 5 saying that “The SI-IRR is not an optimal calculation for an investment vehicle without a fixed start date and fixed investment cost basis. While a SI-IRR can 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”, if applied to non-listed vehicles, appears to lack a conceptual justification and is not necessarily supported in practice either. It would be helpful to at least provide a theoretical and methodological discussion corroborating this statement in this Guidance.

3. Is the detail on the IRR calculation and other required metrics adequate? If not, what additional information would be helpful?

The IRR calculation details are generally adequate. Referring to our comments to question 2 above, we would like to point out that the statement “In an open-end fund, the timing of cash flows in and out of the fund is at the discretion of the client” on page 7-8 is not true in many specific situations of open-end funds.

The discussion on provision 7.A.4 on page 8 includes a clarification saying: “Daily cash flows mean that the cash flows should be dated on the date the cash flows occurs, ostensibly the date of the capital call or the date of the distribution”. However, it does not clarify whether in case of capital calls it is the date when the general partner / fund manager received the money from investors or the date when the capital calls are effectively invested in the underlying private equity assets, as there is always a time lag between these two dates.

4. Is the discussion on commitment-based asset management fees and performance-based fees clear? Is the derivation of gross-of-fees and net-of-fees returns understandable? Are there other issues related to fees and the calculation of returns that should be clarified?

The discussion is clear and understandable. However, it might be more appropriate to use the term “fixed” or “ad valorem” fee instead of “commitment-based” to clearly stress the difference to a performance-based fee.
5. Do you find the explanation regarding how a firm can create funds of funds composite by vintage year of the fund of funds and/or investment mandate, objective, or strategy sufficient? Are the examples illustrative?

The explanation is sufficient.

6. Is the guidance on fair value and valuations for purpose of claiming compliance with the GIPS standards clear?

It is clear and we welcome that the recently issued International Private Equity and Venture Capital Valuation Guidelines are explicitly referred to in the Guidance.

Other:

- We welcome that the discussions in relation to the disclosure provisions include sample disclosures, which is very helpful.

- Under “Side-by-Side Vehicles” on page 3, the last sentence should read “Any non-fee paying portfolios…” instead of “Any none-fee carrying portfolios…”.

- In the discussion with respect to Provision 7.A.15, since GIPS is a global standard, we believe it would also be appropriate to mention the relevant International Financial Reporting Standards (IAS 39 and IFRS 9) in addition or instead of focusing on the US reporting regulations.

- In the discussion with respect to Provision 7.A.16, a new term “public market equivalent benchmark” is used. We understand the concept behind, but are not sure whether this term properly reflects this concept. In addition, it would be helpful to provide an illustrative working example of how a public market equivalent benchmark can be calculated.

- Provision 7.A.22 requires that “for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy, FIRMS MUST also present the SI-IRR of the underlying investments aggregated by VINTAGE YEAR as well as other measures as REQUIRED in 7.A.23.” The related discussion explains that the underlying investments of a fund of funds composite may span a number of vintage years, and hence it would be helpful to show statistics reflecting this vintage year perspective of the underlying investments. When a fund of fund composite is defined only by vintage year, this would be the vintage year of the fund (not of the underlying investments) as explained in the discussion to Provision 7.A.10. So even in this case, the same issue would remain: The statistics presented at the fund of fund level would not reflect the vintage year perspective of the underlying investments. Nevertheless this is not required for fund of fund composites defined by vintage year. We believe this is an inconsistency.
It would be helpful to have a rationale or explanation in the discussion why this is only required for composites defined by strategy and not required for composites defined by vintage year.

B. EXPOSURE DRAFT OF THE GUIDANCE STATEMENT ON REAL ESTATE

1. Do you agree with the proposed requirement to include new portfolios in a composite upon portfolio inception? Should this be a recommendation? Should this be an optional policy?

Generally new portfolios should only be included in composites when they are fully invested according to the intended investment strategy and starting from the next full performance measurement period. In the context of this Guidance Statement, we suggest defining the concept of portfolio inception as the client's first cash flow.

However, we recognize that due to the nature of some real estate portfolios directly investing in real estate development projects, in the initial phase of its life cycle the portfolio may be excessively incurring costs and expenses associated with the real estate investments while the investments themselves may not yet be generating the expected returns, so some firms may be tempted to exclude the initial phase of the portfolio life cycle from the composite performance track record in order to “hide” such costs, which would not be in the spirit of the GIPS standards. In such situations, the portfolios should be included in composites upon portfolio inception (which is deemed to be the date of the portfolio’s first external cash flow).

On the other hand, it may be inappropriate to include new real estate portfolios in composites on the portfolio’s inception date when the portfolio is not yet fully invested in real estate assets and largely composed of cash. This may prompt firms to selectively include portfolios to improve the cumulated returns, e.g., when during the initial investment period a portfolio was holding excessive cash positions that had performed better than in some periods when the portfolio was fully invested in real estate (e.g., due to the subprime crisis).

We agree with the proposed requirement to include new portfolios in a composite upon portfolio inception. In addition, provision 0.A.3 should be reminded, whereby no misleading performance information must be presented. The Guidance Statement should also require firms not including new, non-invested portfolios (i.e., consisting of cash only) for a period that is longer than what is normal for the type of real estate business of which the composite is consisting.

2. Do you believe this requirement should be limited to new portfolios in real estate closed-end fund composites?

Yes, for the closed-end fund composites presenting IRR this should be a requirement. Otherwise the IRR will not be meaningful if the initial cash flows are not included.
3. Do you believe there should be a corresponding disclosure requirement regarding partial-period returns? If so, please explain.

Yes, if this is a requirement for the closed-end fund real estate composites, it would be helpful to disclose that during the initial investment period ("stub period") the portfolio may not have been fully invested in real estate assets according to the intended strategy.

4. Alternatively, if a portfolio experiences an event that materially impacts performance prior to the portfolio's inclusion in a composite (the period from a portfolio's inception up to the beginning of the first full period), should this impact be brought forward and reflected in performance once the portfolio is included in the composite? If so, should this be required or recommended?

Similar to question 1, this should be treated on a case by case basis.

5. Should portfolios be required to remain in composites until the portfolio is terminated?

Portfolios must remain in composites as long as they are invested according to the composite strategy. If the client terminates the portfolio and divesting starts, the portfolio should be removed from the composite as soon as its investment structure no longer reflects the composite strategy due to the liquidation, or according to the consistently applied policy for treatment of liquidated portfolios of the firm.

6. Are there any composite construction or calculation issues that arise as a result of the proposed changes?

If the proposed requirement to include new portfolios in a composite upon portfolio inception becomes a requirement, there may be issues with the composite construction in terms of their representativeness of the intended strategy, which should be treated on a case by case basis.

7. Would the proposed changes create any issues in regards to benchmarks?

Similarly to question 6, if this becomes a requirement, the comparability with benchmarks may suffer if the portfolio was not fully invested according to the intended strategy. Depending on the benchmark, this may necessitate an additional disclosure in the GIPS compliant presentation explaining the differences with the benchmark.
Other:

- We would welcome structuring this Guidance Statement along the GIPS provisions, in a similar way the Guidance Statement on Private Equity is structured.

- We regret that the revised version of the Guidance Statement does not include any discussion on the calculation of the real estate component returns, especially that this complex area is not adequately addressed elsewhere in the GIPS framework (not even in Q&As). Our experience shows that firms often struggle with the correct calculation of component returns. It would be very helpful to include a working calculation example in the Guidance Statement, similar to that included in the respective area of the CFA Curriculum.

C. EXPOSURE DRAFT OF THE GUIDANCE STATEMENT ON VERIFICATION

- Verifier qualification requirements: In addition to the listed qualities, verifiers should possess the knowledge of the auditing techniques developed by the audit profession for third-party assurance engagements such as GIPS verification (a specific reference can be made in this respect to the International Standard on Assurance Engagements 3000 or the US Attestation Standard AT 101).

- Those verifiers that are not members of professional bodies and not formally subject to any code of ethics and professional conduct, should be required to sign up for a relevant ethical standard, e.g., the CFA Code of Ethics and Standards of Professional Conduct.

- Knowledge of Firm Policies: The list of the firm’s policies and procedures that verifiers are supposed to understand should include the policy on the construction and calculation of composite benchmarks, the definition of the firm as well as the policy on error correction. In addition, we suggest the following wording for bullet 8 of the corresponding list: “Handling of cash flows (assumptions on the timing of capital inflows/outflows and handling of large and, where applicable, significant cash flows).”

- We support the possible elements of the management representation letter.

- GIPS Verification Report: We support the proposed required elements of the verification report. For the sake of clarity, bullet 4 (“the defined firm for which the verification has been performed”) could be changed into “the key criteria of the definition of the firm for which the verification has been performed.” Additionally, we suggest that GIPS as a global standard should include, in the list of the required elements of the verification report (last bullet point on page 3), a reference to the International Standards on Auditing (ISA), in addition to the local auditing standards.
Furthermore, it could be mentioned that the verifier may also issue an additional management letter to the firm, describing some specific findings and recommendations arising from the conducted verification.

Of course, we continue to strongly support the GIPS 2010 revisions. In particular, we would like to thank you again for the opportunity to comment on the three draft Guidance Statements.

Please do not hesitate to contact us should you have questions regarding our views and suggestions.

Yours sincerely,
Swiss Bankers Association

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