USIPC’s response to GIPS Executive Committee’s invitation to comment

Exposure Draft of Guidance Statements (Verification, Real Estate and Private Equity)

29 October, 2010

GIPS Executive Committee
c/o CFA Institute
P.O. Box 3668
Charlottesville, VA 22903
Re: Exposure Draft – Guidance Statements

Dear GIPS Executive Committee:

On behalf of the United States Investment Performance Committee (USIPC), I am pleased to attach our comments concerning the three revised Guidance Statements available for public comments through 25 November 2010.

We reviewed the exposure drafts on verification, real estate, and private equity, assessed the appropriateness of the deletions from the 2005 edition, discussed the changes resulting from 2010 edition, and examined the newly added sections. In the attached, we are pleased to provide general feedback on the Guidance Statement on Verification, Real Estate, and Private Equity in their entirety as well as to answer the specific questions posed on the cover letter to each Guidance Statement.

As ever, we thank you for giving us the opportunity to comment on this work and look forward to the publication of the final document. If you have any questions, please feel free to contact me at annp@munder.com.

On behalf of USIPC,

Ann Putallaz
Chairman, USIPC
USIPC Comments on Exposure Draft: Guidance Statement on Verification

Members agreed with the upgrade of information required to be included in the verifier’s opinion and the moving of knowledge of firm policies from Section III of the 2005 edition to this guidance statement. Members felt that the ten listed required items are appropriate and that the two additional items added to the listing are consistent with the claim of compliance and disclosure requirements of a compliant presentation. Members look forward to the revised questions and answers related to verification.

In the Verifier Qualification Requirements section, Members suggest that the opening sentence be revised to be consistent with #1 of A. Scope and Purpose of Verification in section IV Verification: The verification must be performed by a “qualified independent third party” in lieu of “verifier”.

Members concurred that verifiers must follow accepted standards within their industry. Members do not consider these applicable standards a higher bar, since it is appropriate to expect verifiers to follow accepted industry practices. However, while the GIPS standards do not include additional qualification requirements to conduct verification, the Committee encourages that verifiers pursue relevant credentials.

Members felt the general discussion on fairness and independence of the Investment Management Firm – Verifier Relationship section is adequate for this guidance statement. Members look forward to the in-depth discussion of this topic in the revised Guidance Statement on Independence Considerations for Investment Management Firms and Verifiers to be released by the GIPS EC for review in the coming months.

The content of Using the Work of Other Verifiers and Independent Third Parties section is aligned with the #6 of A. Scope and Purpose of Verification in section IV Verification. Members asked for clarification on the term “independent third parties” and how it is different from the word “verifiers” in addition to the consistent usage of the term/reference throughout the document.

Members acknowledged that a verifier cannot issue a verification report unless the firm has corrected the history if an error was discovered but that the principal verifier is not required to confirm that the firm has corrected this history. Members felt that the deleted paragraph from 2005 edition of the Standards clarifies the accountability of multiple verifiers. Members recommended that the verbiage be reinstated and that the verifier disclose if it relied upon the work of other verifier(s) on the verification report.

Members also discussed the verification of supplemental information. As all guidance statements are being revised only to include the changes from the 2010 revision of the GIPS standards, the Committee was comfortable with this guidance statement pending review of the Guidance Statement on Supplemental Information that is currently with the Interpretation Subcommittee.
USIPC Comments on Exposure Draft: Guidance Statement on Real Estate

Overall, Members felt the guidance statement needed more in-depth explanations of the real estate provisions. It was also thought that giving examples, such as the formula for calculation of income and capital returns, would be helpful. Members suggest that this guidance statement follow the model format of the Guidance Statement on Private Equity to provide additional clarity. Having the additional information would facilitate the review process and allow the industry to provide more substantive feedback.

While enhanced guidance on discretion was listed as one of the significant revisions, Members thought what is written in the Investment Discretionary section wasn’t clear and needed more clarification. Members did not feel that investment discretion was unique for real estate – that if a manager has sufficient decision-making authority to implement the intended investment mandate, objective or strategy, the portfolio is considered discretionary.

Members also felt that the Composite Construction section needed clarification, specifically as it relates to open-end and closed-end funds and what reporting metrics (TWRR or IRR) are presented if both types of funds are in the same composite. There was also confusion as to whether closed-end real estate funds can or cannot be included jointly with open-end real estate funds. The sentences in this section can be structured to be clearer in their intent. Also, Members thought the disclosure of the types of portfolios in the composite as part of the composite description should be required, not merely “should consider.”

Furthermore, Members inquired why TWRR is still required to be presented for closed-end funds now that IRR is required. Members also requested additional clarification on what is a property level return, how it differs from portfolio level as property is a common calculation used in the industry.

It was felt that the new Fees and Expenses section was a useful section that was well written.

There was confusion and a number of issues related to the Inclusion of New Portfolios in Composites section, as addressed in the comments below.

Members suggest issuing a Q&A in reference to determining the non-GIPS-compliant performance period.

Members are comfortable with the deletion of sections from the 2005 edition: time weighted and internal rate of return, separation of income and capital appreciation components, disclosures, valuation, source of valuation, frequency of valuations of real estates, income return, capital return, and capital employed.

Q #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?

A: Members would like background information on why this is a requirement and ask how practical it would be for the GIPS EC to change this requirement if it is already part of the provisions of the finalized 2010 edition of the GIPS standards.
As stated in the *Inclusion of New Portfolios in Composite* section of the document, composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. Different strategies may result in different time frames for inclusion based on the liquidity of the assets involved but the key determining factor is the firm’s ability to implement the said strategy regardless of the “ramp up” period and the resulting partial stub period return.

While the nature of the real estate asset class is unique and is often composed of illiquid investments with frequent acquisition and disposition activities, these factors alone do not justify standardizing the treatment of partial period performance. Emerging market debt is also illiquid but new emerging market debt portfolios are not required to be included in the respective composite on their inception. Members do not believe that the unique characteristics of real estate justify the mandate of inclusion upon inception.

New portfolios must be added to a composite according to reasonable and consistently applied manager criteria which the Members felt is generally at the start of the next quarter for real estate and not in the middle of the full measurement period.

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

A: Members were not clear why this question would be asked. For a real estate closed-end fund composite, the firm is required to report both the time weighted rates of return as well as the since inception internal rate of return. From an SI-IRR perspective, a new portfolio would be considered as a cash flow and is not revalued except at the end points. The same issues raised regarding Q#1 remain.

**Q #3: Do you believe there should be a corresponding disclosure requirement regarding partial-period returns? If so, please explain.**

A: Consistent with the GIPS standard’s basic principles of fair representation and full disclosure of investment performance, there should be disclosure of a portfolio that is not in the composite for the entire period. This disclosure will help in the comparison of composites.

**Q #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?**

A: Members request an example of an event that materially impacts performance prior to inclusion in a composite and how the effect can be brought forward (i.e. qualitative or quantitative disclosure, side-by-side comparison of pre and post inclusion...etc). It is understood that the valuation is reflective of events that have occurred and captures the changes in market conditions. Furthermore, activities for the period should be contained in the period reported and not be shifted over time in a way that makes the returns unrepresentative of the measurement.
period. It is not clear to the USIPC what is intended by this question. Additional information is needed before the USIPC can offer its opinion.

**Q #5: Should portfolios be required to remain in composites until the portfolio is terminated?**

A: Members seek clarification on the term “termination.” Within Sections 0-5 of the GIPS standards, termination denotes lost of discretion over the portfolio and removal of the portfolio from the composite in the current full measurement period. In the context of real estate, does termination refer to departure of clients, disposition of investments, complete liquidation of properties or some other interpretation? The term is not defined in the Glossary, whereas final liquidation date is defined. Meanwhile, as a corollary to the issue addressed by Q#1, if the treatment of partial period performance is to be standardized to capture the stub period from the portfolio inception date, then consistent treatment must be given to the stub period through “termination”

**Q #6: Are there any composite construction or calculation issues that arise as a result of the proposed changes?**

A: As discussed in the general comment section above, more in-depth explanations are needed to clarify the intent of some of the questions posed. Without descriptive narrative and illustration of each provision, it is difficult for Members (acknowledging that we are reading this Guidance Statement from the non-real-estate insider perspective) to understand what is meant in some parts of the Guidance Statement. Members applied concepts and analogies from Sections 0-5 of the GIPS standards while factoring in unique characteristics of real estate. On this basis, Members felt that there is no tangible evidence that would support exceptions.

**Q #7: Would the proposed changes create any issues in regards to benchmarks?**

A: Members thought the proposed change regarding partial-period inclusion would be problematic, given the industry practice of quarterly calculation of real estate benchmark.
USIPC Comments on Exposure Draft: Guidance Statement on Private Equity

Members felt this guidance statement, including the examples, was very clear and thorough and provided the reader with good, solid, valuable information.

In the Open-End Funds section, the Members questioned whether open-ended funds that were not priced daily or that weren’t traded on an exchange would be applicable to the private equity provisions given the definition listed on page 4. Members thought funds that do not have either of the listed two characteristics should not adhere to the private equity standards and recommend that the sentence be changed to: the fund is a public investment vehicle traded on an exchange or priced daily.

In the Funds of Funds section, Members requested clarification on whether funds of funds managers who invest in open-end mutual funds, closed-end funds, separately managed accounts, and/or other private companies, etc are automatically subject to the private equity provision regardless of what the underlying investments are. Would a fund-of-funds manager who invests solely in open-end funds be subject to private equity provisions?

Q #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?

A: It is unclear whether the private equity provisions apply to other alternative investment strategies such as distressed debt or whether they only apply to equity-based strategies for purpose of the Guidance Statement.

Q #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?

A: Members agreed with the characteristics but weren’t clear why these funds would have to be treated differently and asked for more amplification in this area (i.e. what is it about the structure that makes compliance with the general provisions of the GIPS standards difficult). Members look forward to the investigative finding of a separate working group on this special case of funds-of-funds.

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

A: Yes, it is adequate.

Q #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?

A: Members thought this section should include how rebates (ex: offsets of the management fees) are handled.
Q #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?

A: Yes, this section is sufficient and the examples were helpful.

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

A: Yes, this section was very clear and the examples were extremely helpful.