November 24, 2010

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

Dear Sir or Madame:

Thank you for allowing us to comment on the exposure draft of the Guidance Statements on Private Equity, Real Estate, and Verification. Our comments are as follows:

**Private Equity**

*Private equity guidance should be applicable to more than just closed end direct investment portfolios.*

We are very pleased that the draft Guidance Statement clarifies that the private equity provisions are applicable to both open and closed end private equity funds of funds. We are also pleased to see that the private equity provisions are applicable to closed-end captive and semi-captive funds. Both of these changes acknowledge that the private equity industry today is not the same as it was just a few years ago. While we applaud these changes, we believe such changes should go further and apply to open end private equity funds as well. The guidance statement states that the private equity provisions are not applicable to evergreen funds that are invested in the same private equity investments as closed-end funds, and instead must follow the general provisions of the GIPS standards in sections 0-5. The rationale provided is that since inception internal rate of return (SI-IRR) is not an optimal calculation for an investment vehicle without a fixed start date and fixed investment cost basis, and that a time weighted return (TWR) is more appropriate. We strongly disagree. This argument seems to equate cash flows in a private equity fund to a “regular” institution portfolio that is invested in liquid securities and has frequent cash flows. This also does not acknowledge that client portfolios managed by firms may not be technically closed-end, but that they operate as if they were closed-end. Private equity firms work very closely with their clients to coordinate cash flows so that the SI-IRR is the appropriate performance calculation. TWR attempts to strip out the impact of the timing of cash flows, which is not appropriate for most private equity managers. Also, the SI-IRR calculation itself is not dependent on a fixed amount of committed capital. Total committed capital is not a factor in the calculation. Committed capital is a component of the SI-IRR only when the capital is called. There is no impact to the SI-IRR calculation if the total amount of committed capital changes. We believe that the driver behind applicability of the private equity provisions should be the investments and not the fund type.

**Clarify treatment of side by side vehicles.**

The introduction to the Guidance Statements states that side-by-side funds must be included in the same composite as the primary fund. The description of provision 7.A.8 states that side-by-side vehicles should be included in the same composite as the related primary fund. While most private equity composites will contain only one fund, a side-by-side fund is often an entity that exists on paper only but is effectively an extension of the primary fund. Therefore we believe that the side-by-side vehicle’s performance should be combined with the related primary fund. If that is the intention, then the guidance
for provision 7.A.8 should be enhanced to clarify the required treatment.

**Add guidance re: what is included in transaction expenses and what is not included.**

All gross and net returns must reflect the deduction of actual transaction expenses during the period. Transactions expenses are defined as all actual legal, financial, advisory and investment banking fees related to buying, selling, restructuring, and/or recapitalizing investments. While this seems to be a straightforward concept, the fees that are described in the definition may be paid by the firm managing the fund, or from the fund’s assets. Some costs might be rebated or offset against future management fees. We believe it would be impossible to provide guidance that would address all situations, but additional language describing what is intended would be very helpful.

**Include language specific to Excel’s annualization of all XIRR calculations.**

The discussion of provision 7.A.21 warns that many spreadsheets and software applications automatically annualize all returns. Any annualized return would need to be “de-annualized” for inclusion in the compliant presentation. We accept the fact that this may be a common issue, but we believe that the functionality in Excel should be explicitly stated given the widespread use of Excel and the XIRR function. The XIRR function automatically annualizes all returns. The XIRR function would also most likely be used by a firm that is not primarily a private equity manager and may need a bit more guidance as to the proper calculation of the SI-IRR.

**Clarify what information, if any, must be presented prior to the effective date of 1 January 2006.**

The discussion of provision 7.A.20 states, “If the firm chooses to present SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as being non–compliant.” Assume a private equity composite has an inception date of 1 July 2003, and the annual reporting period is as of December 31st. We read this to mean that in this instance the first SI-IRR a firm would be required to present is for the period from 1 July 2003 through 31 December 2006, and that SI-IRRs for periods ending prior to 1 January 2006 would not be required. If this is the intention, we recommend explicitly stating this, and including an example compliant presentation of such a situation. However, please note that we do not agree with this interpretation as it does not seem to be in line with the full disclosure objective of the GIPS standards. We also believe that this approach seems to contradict the general provisions of the GIPS standards, which do not allow the option for not presenting returns prior to the effective date of 1 January 2000, if returns for those periods were necessary to meet the minimum periods that must be presented.

**Our response to the questions soliciting comments are as follows:**

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?

   **VPS response:** We believe the industry and vehicle descriptions are clear. Please see our first comment re: our recommended expansion of the applicability of the private equity provisions.

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?

   **VPS response:** We agree with the characteristics and find the language clear.

3. Is the detail on the IRR calculation and other required metrics adequate? If not, what additional information would be helpful?
VPS response: We believe that additional language and detail on the SI-IRR calculation would be helpful. A discussion of the J-curve and the initial negative impact would be very helpful, particularly now that firms are explicitly required to present the SI-IRR for the initial partial year of a private equity composite.

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?

VPS response: We recommend clarifying the language describing net return calculations, and better differentiate between the required net return calculation and the optional net-net return calculation that reflects the deduction of fees and expense other than investment management fees.

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?

VPS response: We believe that the language is sufficient.

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Real Estate

Composite inclusion for new portfolios.

Provision 3.A.5 states that composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. The GIPS Handbook states that it is the responsibility of the firm to set reasonable guidelines for each composite regarding the inclusion of new portfolios into the composite. Such a policy allows a firm time to invest the new portfolio in the intended strategy. However, if this Guidance Statement is adopted as is, this would not be the case for real estate as new real estate portfolios would be required to be included in composites on the inception date (for the time weighted composite calculation.) We strongly disagree with this requirement. We do not believe a real estate manager should be told when it is proper to include new portfolios in composites and do not understand why real estate portfolios should be treated differently from all other portfolios. We also wonder exactly how a composite that includes more than one portfolio would be handled, given the illiquidity of the asset class. Assume a composite includes one portfolio, and a second portfolio in the same strategy is funded on February 12. Most real estate managers value their portfolios quarterly. If the firm wished to combine the two portfolios beginning February 12, the firm would be required to do a mid-quarter valuation. This is no simple task for a real estate portfolio. We believe this requirement should be eliminated, and at best should be a recommendation.

While we disagree with this requirement, we can understand some of the motivation for making this a requirement. Many real estate portfolios are closed-end pooled funds, and they incur a large amount of expenses at the inception of the fund. If performance does not begin from inception date, these expenses would not be captured in the portfolio’s performance. While we appreciate this point, we would argue that the same is true for any closed-end pooled fund. We suggest recommending that the firm instead “roll forward” these expenses to the initial period of performance that is included in the composite. While we believe this is best practice, we again would not make this a requirement. Funds can be launched in a variety of ways, and start-up expenses are not incurred consistently across all closed-end funds. We instead suggest incorporating language to remind firms to consider the ethical spirit of the GIPS standards, and determine for themselves how such expenses should be reflected in performance. A
recommendation could also be included to disclose how a firm handles start-up expenses and whether or not such expenses are reflected in returns.

We also would like to point out that many of the expenses incurred at start up would qualify as administrative expenses. A firm is not required to reflect the deduction of administrative expenses in either gross or net returns. If the concern is that transaction expenses are incurred at start up, and these expenses should be reflected in returns, we question how this is any different from a portfolio that is not invested in real estate. A new portfolio would incur trading expenses upon inception, but the portfolio would typically not be included in the composite until after the portfolio is invested and the trading expenses were incurred. Returns would not reflect the deduction of the trading expenses incurred at start up of the portfolio. We do not believe that real estate portfolios should be singled out over concerns for how initial start-up expenses are handled.

**Component return calculations.**

In addition to composite total returns, firms must present income and capital component returns. The GIPS standards glossary includes definitions for income and capital returns, as well as capital employed (the denominator in component return calculations.) We believe that additional guidance for these specific calculations would be very helpful, and would improve comparability between real estate managers.

**Transaction expenses, Excel’s XIRR calculation, and effective date of 1 January 2006.**

Comments on the Guidance Statement on Private Equity above on these three issues apply to real estate closed end fund composites as well.

**Our response to the questions soliciting comments are as follows:**

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?

   **VPS response:** We do not agree with the proposed requirement to include new portfolios in a composite upon portfolio inception. We agree that this could be a recommendation. Please see our comments above.

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

   **VPS response:** We do not agree with the proposed requirement to include new portfolios in a composite upon portfolio inception, whether closed-end or not. Please see our comments above.

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

   **VPS response:** We do not agree with the proposed requirement to include new portfolios in a composite upon portfolio inception. We do not understand what disclosure requirement is proposed. As described above, we suggest recommending that firms disclose how start-up expenses are handled and whether or not these expenses are reflected in returns.

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?
VPS response: As described above, we appreciate the concern about reflecting start up expenses in returns. However, this issue is not limited to real estate portfolios. This same concern would apply to many other portfolios that follow the general provisions of the GIPS standards as they do not fit into private equity or real estate provisions, and are forced to use a time weighted return. We agree with rolling forward the start up expenses to the first period of performance, but believe that this should be a recommendation. We also suggest including a recommendation to disclose how start up expenses are handled and whether or not these expenses are reflected in returns.

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

VPS response: We assume that in this case the word termination means liquidation. For SI-IRR calculation purposes, a closed end fund would be included in the composite through termination/final liquidation. For inclusion in the composite for time weighted calculation purposes, we do not agree with requiring real estate portfolios to be included in the composite through termination date. As we described in our opposition to requiring new real estate portfolios to be included in composites from inception date, we do not believe that real estate portfolios should be treated differently than any other portfolio for composite exclusion purposes. Also, if this were to be required, a firm would be required to continue to include in a composite a portfolio that is in the process of termination and has effectively become non-discretionary for GIPS purposes. This would contradict provision 3.A.7., which states that non-discretionary portfolios must not be included in composites.

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

VPS response: Requiring a firm to include real estate portfolios in composites from inception date through liquidation date would require a firm to be able to calculate composites daily. This would require portfolio level returns to be calculated daily, and would be very difficult and costly. We do not support the proposed mid-month inclusion or exclusion of real estate portfolios.

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

VPS response: Most widely used real estate benchmarks are available monthly or quarterly. Requiring a composite to start mid-month would prevent a firm from having a comparable benchmark for all periods. We do not support the proposed mid-month inclusion or exclusion of real estate portfolios.

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Verification

Overall we support this guidance statement. We recognize that several topics briefly mentioned in this document, such as verifier independence, are now covered in more detail in other Guidance Statements or the GIPS standards themselves. The one item that we think could be slightly misleading is the section named Knowledge of Firm Policies. A series of policies of a firm that the verifier must understand are listed, and it states that these are only examples. We believe that this section could be enhanced by adding language on the following issues:

- The verifier must obtain the policies and procedures from the firm. The understanding of the policies must be obtained from the verifier’s review of the firm’s policies and procedures documentation;
- While the verifier must understand the firm’s policies and procedures, the verifier must also
ensure that the firm’s policies meet any applicable requirements of the GIPS standards; and

- The verifier should see Chapter IV of the GIPS standards for additional information.

We also question the change from “confirm” to “affirm” in the section describing the language to be included in a management representation letter. The difference between these two words is nuanced, at best, and we question why such a change was made. We have searched several online sources as well as dictionaries, and we can find no support for such a change. We believe the word confirm should continue to be used.

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We appreciate your consideration of our comments.

Sincerely,

Karyn D. Vincent

Karyn D. Vincent, CFA, CIPM
Vincent Performance Services LLC