

# Global Investment Performance Standards

## *Exposure Draft*

### **INVITATION TO COMMENT:**

#### **Exposure Draft of the Guidance Statement on Private Equity**

CFA Institute established the GIPS Executive Committee as the governing body for the Global Investment Performance Standards (GIPS®). The GIPS Executive Committee seeks comment on the proposal set forth below regarding proposed revisions to the Guidance Statement on Private Equity.

Comments must be submitted in writing and received no later than 25 November 2010. Responses will be accepted in hardcopy and via fax, but should also be submitted via e-mail. Please submit your comments as early as possible to facilitate the review process. Unless otherwise requested, all comments and replies will be made public on the GIPS standards website ([www.gipsstandards.org](http://www.gipsstandards.org)). Comments may be submitted as follows:

E-mail: [standards@cfainstitute.org](mailto:standards@cfainstitute.org)

Fax: 1-434-951-5320

Post: CFA Institute  
Global Investment Performance Standards  
Re: Guidance Statement on Private Equity  
P.O. Box 3668  
Charlottesville, Virginia 22903

### **Executive Summary**

The current version of the Guidance Statement on Private Equity became effective 1 January 2006. The GIPS Executive Committee, in collaboration with various technical subcommittees including the GIPS Private Equity Working Group, has revised the Guidance Statement on Private Equity to reflect the 2010 edition of the GIPS standards and to improve existing guidance on the private equity requirements and recommendations. This Guidance Statement, unlike the other Guidance Statements, has been revised to follow the formatting of the GIPS Handbook. Due to the number of edits and change in format of this Guidance Statement, a red-line version is not available.

The questions & answers (Q&As) originally included in the Guidance Statement on Private Equity have been removed and will be reviewed and updated as deemed necessary by the GIPS Executive Committee and Private Equity Working Group. Additional history and background on the GIPS standards can be found on the GIPS standards website.

### **Effective Date**

The expected effective date of the revised Guidance Statement on Private Equity is 1 January 2011 to coincide with the effective date of the 2010 edition of the GIPS standards. Prior versions of this Guidance Statement are available on the GIPS standards website.

### **Comments Requested**

The GIPS Executive Committee is seeking comments on the proposed revisions to the Guidance Statement on Private Equity. In addition to commenting on the items listed below, please provide

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feedback on the entire document, including items you support. Issues to consider in conjunction with this proposal include:

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?
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?
3. Is the detail on the IRR calculation and other required metrics adequate? If not, what additional information would be helpful?
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?
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?
6. Is the guidance on fair value and valuations for purpose of claiming compliance with the GIPS standards clear?

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### Guidance Statement on Private Equity

#### Introduction

Private equity has become a mainstream asset class for sophisticated investors. Private equity typically entails investment in nonpublic companies at various stages of development and encompasses venture capital, buyout, mezzanine, and distressed securities investing. Private equity may also make investments in public companies with the intent of taking them private. There are also funds that provide primary capital to public companies through investments called PIPES (private investment in public entities).

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 or total ownership in 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 industry has evolved from being composed of primary fund vehicles investing into 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 progressed to the extent that some investment strategies that were novel some years ago are now main stream. For example, historically, limited partners in funds in general only invested in the funds themselves. However, it is not uncommon for limited partners (including funds of funds) to invest directly into companies rather than 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, in infrastructure projects among others. Technically, all these investments are ultimately investments in securities as the investor takes some ownership position but collectively these will be termed “underlying investments” for purposes of this guidance.

It is important to note at this date that the application of the private equity provisions has much more to do with the structure of the private equity investment vehicle than the sector or type of investment that is made. The primary intent is that the private equity provisions are mainly applicable to private equity closed-end funds. However, there are some exceptions to this in that the private equity provisions also apply to hybrid investment vehicles created by funds of funds managers which have some aspects of an open-end fund.

#### Investment Vehicles

Investors typically invest in private equity investments through a variety of investment vehicles. This is generally done either through fund vehicles which are referred to in these provisions as “primary funds” or through a “fund of funds” Primary funds are usually structured as limited partnerships with a specified investment stage and/or geographic focus and make investments into portfolio companies. Funds of funds are also usually structured as limited partnerships but instead of investing in individual portfolio companies, investments are made in primary funds with the fund of funds taking a position as a limited partner.

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In some instances, a limited partner may invest directly alongside its primary fund into portfolio companies. A fund of funds may also invest directly into portfolio companies alongside its underlying funds. These are termed “co-investments.” To take advantage of this particular investment, there are now specialized funds which may focus on co-investments, a structure in which a fund of funds may invest into portfolio companies alongside its underlying fund investments as part of its strategy. Secondary investment funds, which 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.

### **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 management firm of the primary fund or the investment manager of the underlying funds in a fund of funds structure finds 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 investment in the fund 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**

Firms should understand that compliance with the GIPS standards refers to firm-wide compliance which requires adherence to not only the private equity provisions but to all provisions of the GIPS standards in Section 0-5 in Chapter 1 unless otherwise noted.

The GIPS standards are primarily designed for presenting a firm’s performance to a prospective client rather than reporting performance to an existing client. While that does not preclude using the GIPS standards when reporting performance to existing clients, there is not a requirement to do so. It is also important to note that the GIPS standards are not requirements for firms themselves for internal reporting. While the GIPS standards represent best practices and are suitable for general performance reporting either to prospective clients or internally by firms, there is no requirement that firms use the GIPS standards for internal reporting purposes.

### **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 historic cost, were easy to justify, thus placing a burden of proof on those seeking to deviate from conservative valuations. However, there are a number of shortcomings in historic cost methods which led to pressure for change. Although the precise tipping point for change from a historic 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 historic cost approach ostensibly has an outward appearance of being conservative and thus in the best interest of stakeholders. However, the use of historic cost can become a defense against

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the proper write down of impaired investments. Conversely, the true value of a company's assets may be materially understated, leading to a potential undervalued takeover bid. Furthermore, as valuation methodologies in public markets became more sophisticated by incorporating cash flow, 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 was 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 as mandated by various accounting standards, the GIPS standards require the use of fair value for private equity investments.

### **Scope**

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**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. REAL ESTATE CLOSED-END FUNDS MUST follow Section 6 in Chapter I.**

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### **Investment Structures**

#### *Closed-End Funds (GIPS private equity provisions are applicable)*

The predominant vehicle in the global private equity industry is the independent, private, fixed-life, closed-end fund, usually organized as a limited partnership, which may be one of many funds managed by an investment management firm. The firm may have several funds in existence at any one time, each of which is independent from the other. These funds by and large have a defined “start date” and typically have a fixed life of 10 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 partnership interest may be transferred (sold) to another limited partner with general partner approval. This also means that the capital available for investment (capital commitments) is also fixed for the life of the fund.

#### *Closed-End Limited Partnerships (GIPS private equity provisions are applicable)*

The limited partnership is a fund of pooled interests managed by a general partner who raises capital (i.e., committed capital or commitments) from outside investors (limited partners). The general partner charges an investment management fee, typically from one to three percent per annum, on the total commitments raised. Most funds require at least a nominal one percent 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 percent of profits.

The general partner will “call” the capital from its clients in tranches as needed for investment into underlying companies. These capital calls are also termed “draw downs,” or “takedowns”. The cumulative capital calls are known as paid-in capital. Another unique feature of these types of vehicles is

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that any proceeds from investments must be distributed to clients; reinvestment is only permitted if allowed in the contract (known as a limited partner agreement or LPA) between the general partner and the limited partners. In recent years there have 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 as return is calculated on the basis of the cash flows between the limited partners and the fund. The investment management fee is generally charged on the total assets committed to the fund rather than on the value of the invested capital of the portfolio.

#### *Funds of Funds (GIPS private equity provisions are applicable)*

A fund of funds is also typically structured as a limited partnership but instead of investing in individual portfolio companies, investments are made in primary private equity funds, with the fund of funds taking a position as a limited partner in the underlying funds. Recognizing that funds of funds firms do not 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. Fund of funds must meet all relevant private equity requirements at the fund of fund’s level.

While investments by primary funds into portfolio companies are technically “direct investments” as they are invested directly into the companies, the term is generally applied to investments into portfolio companies by investors in primary funds. For example, a limited partner in a fund who invests into a portfolio company is said to be making direct investments 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 that fund. This is generally allowed in a pre-established co-investment agreement. In the case where the limited partner making the direct investment or the co-investment is a fund of funds or a firm claiming compliance with the GIPS standards, the GIPS private equity provisions apply. 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 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 presented, the percentage of the composite that is comprised of none-fee paying portfolios. In the spirit of full disclosure, a firm should also disclose the percentage of the composite these transactions represent.

#### *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 or other reasons. The vehicle itself usually invests pari passu with its affiliated primary fund. While the terms and conditions for the side-by-side may be significant different than those of the primary fund, if the side by side vehicle has similar strategies and vintage year the side by side vehicle is a pro-rata extension of the parent fund. As such, the side by side fund must be included in the same composite as the primary fund. Any none-fee carrying portfolios must be disclosed as well as the percentage of the composite these transactions represent.

#### *Evergreen funds (GIPS private equity provisions are not applicable)*

In contrast to the typical closed-end, fixed life limited partnership (described above) are those investment vehicles that are not fixed-life or 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

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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 application as the closed-end fixed-life fund.

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). 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. 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 returns (TWRR) calculation.

As a result, the private equity provisions exclude funds that have an evergreen structure and require that they apply the general provisions of the GIPS standards in Sections 0-5 in Chapter 1. The exception is the special case of evergreen funds of funds where GIPS private equity provisions can be applied (see discussion below).

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

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 semi-captive vehicle is a vehicle which invests both parent entity capital as well as outside capital. These funds normally charge a management fee and carried interest to the outside clients and are usually closed-ended, as the number of clients is fixed, although a number of evergreen semi-captives 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 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 in general operate much like a mutual fund or publicly-traded company and are not required to follow the private equity provisions, but must follow the general provisions of the GIPS standards in Section 0-5 in Chapter 1.

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

The private equity provisions generally exclude evergreen open-ended vehicles. However, there is one exception to this exclusion. The current GIPS private equity provisions provide funds of funds with the ability to define composites based on vintage year of the funds of funds or strategy. By allowing this flexibility, it also accommodates a type of funds of funds structure that formerly had to apply the general GIPS standards. This change was made because, for all intents and purposes, the SI-IRR is the most appropriate metric for fund of funds return calculations and the structure of the vehicle makes compliance with the general provisions of GIPS standards very difficult, if not impossible. With the exception of the evergreen nature of this vehicle, 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 which is neither publicly traded nor available to the general public.

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- 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 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. As a limited partner, 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 direct investments as a co-investor with the underlying funds.
- The fund of funds typically invests by strategy rather than by vintage year.
- The manager of the funds of funds charges a management fee to the clients.
- 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 which apply to funds of funds.

If an evergreen vehicle meets the above criteria and chooses to apply the private equity provisions, it must also comply with all of the private equity provisions.

### INPUT DATA – REQUIREMENTS

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#### **7.A.1 For periods ending on or after 1 January 2011, PRIVATE EQUITY investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II.**

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**Discussion:** Performance reporting is of little value unless the underlying valuations are based on sound valuation principles. The GIPS Valuation Principles, including requirements and recommendations specific to the private equity section, establish a broad foundation for valuing investments. In order to create comparable valuations for consistent performance calculation and avoid discontinuities in return calculations before and after the effective date, for periods ending on or after 1 January 2011, private equity investments must be valued in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II. For periods ending prior to 1 January 2011, private equity investments must be valued according to either the GIPS Private Equity Valuation Principles in Appendix D of the 2005 edition of the GIPS standards or the GIPS Valuation Principles in Chapter II of the 2010 edition of the GIPS standards.

These broad principles can be supplemented with more detailed valuation guidelines such as the standardized methods used for valuing private equity investments developed by the British Venture Capital Association (BVCA) or the European Venture Capital Association (EVCA), who have harmonized their valuation guidelines into the International Private Equity and Venture Capital Valuation (IPEV) Guidelines.

#### *Fund Reporting Considerations*

One of the misunderstandings is that that fair value is often seen as synonymous with “marked to market”. However, although related, they are not the same. A private equity portfolio can be valued on a periodic

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basis but may not be based on today's market prices due to an inherent lag effect in the industry. In private equity reporting, there is typically a lag effect in valuation reporting. A private equity fund has to apply the firm's valuation methodology to portfolio investments, accumulate its total portfolio valuations, and report this information upstream to its clients. The reporting lag inherent in this process means that there can be a valuation lag of a quarter or in some cases sometimes more. Thus, a March 31 valuation may be what is termed a roll-forward valuation – i.e. a valuation based on December 31 of the prior year adjusted by interim cash flows between January 1 and March 31. This has the added effect that valuations of private equity holdings may not be contemporaneous with marketable securities that can truly be “marked to market.”

#### *Portfolio Company Considerations*

Given the subjective methods used in private equity valuation, it should be noted that two funds invested in the same company may agree on a valuation on the date of initial or subsequent investment but at other times it may be possible, and is likely, that valuations may diverge as there is no market price and each firm invested in the portfolio company can use their own valuation methodologies to value those investments.

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#### **7.A.2 PRIVATE EQUITY investments MUST be valued at least annually.**

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**Discussion:** The general GIPS standards in Section 0-5 in Chapter 1 require that portfolios be valued monthly for periods beginning on or after 1 January 2001, and that portfolios be valued at the time of all large cash flows for periods beginning on or after 1 January 2010. In a calculation where time-weighted returns are used, these valuations at key cash flow events are needed as those cash flow events become terminal values in the time-weighted approach to performance calculation. In a time-weighted return calculation, sub-period time-weighted returns are calculated between each cash flow and geometrically linked together to derive a return for the period.

The GIPS standards require a SI-IRR rather than a TWRR for private equity portfolios. In a SI-IRR, valuations are only needed at the end of the period being measured. Valuations in private equity investments are by and large performed on a less frequent basis as they are not marketable securities. More often than not, valuations are reported on a quarterly basis rather than monthly or daily. The GIPS standards require private equity investment to be fair valued at least annually and recommend a quarterly valuation practice. In addition, firms must value portfolios as of the calendar year-end or the last business day of the year for period beginning on or after 1 January 2006.

The practical implication of this is that private equity portfolios typically have a quarterly value but must be fair valued at least once in a 12 month period. Most private equity firms have annual audits for their funds, meaning that this year end valuation will most likely be the most accurate “fair value” valuation and will comply with the GIPS standards. More frequent valuations are generally required for client reporting purposes and are considered good business practice thus the GIPS standards recommend quarterly valuation for private equity.

### **CALCULATION METHODOLOGY – REQUIREMENTS**

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#### **7.A.3 FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).**

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**Discussion:** An investment manager should neither be rewarded nor penalized for investment decisions outside of his or her control. In an open-end fund, the timing of cash flows in and out of the fund is at the

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discretion of the client. As a result, the time-weighted rate of return, which adjusts for the effect of the timing of the cash flows in the portfolio, is required for open-end funds.

On the other hand, in an independent, fixed-life private equity fund, the decisions to raise money, take money in the form of capital calls and distribute proceeds are all at the discretion of the private equity manager. Timing of cash flows is part of the investment decision process. The private equity manager should be rewarded or penalized for the results of those timing decisions and thus the IRR is required.

The IRR is the discount rate (effective compound rate) that equates the present value of the since inception paid-in capital associated with an investment with the sum of the present value of the distributions from it plus the present value of the residual value (if any).

IRR is calculated as follows:

$$0 = \sum_{i=0}^n \frac{CF_i}{(1+r)^i} + \frac{RV_n}{(1+r)^n}$$

where  $CF$  is the cash flow for period  $i$  using negative cash flows for capital calls and positive cash flows for distributions and/or terminal valuations,  $n$  is the total number of periods over which performance is measured,  $i$  is the period of the cash flow,  $RV$  is the valuation of the investment at the end of the last time period  $n$ , and  $r$  is the IRR.

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#### **7.A.4 For periods ending on or after 1 January 2011, the SI-IRR MUST be calculated using daily cash flows. Stock DISTRIBUTIONS MUST be included as cash flows and MUST be valued at the time of DISTRIBUTION.**

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**Discussion:** Calculating performance using daily cash flows provides the most accuracy in all performance calculations, including the SI-IRR. For private equity investments, the GIPS standards therefore require daily cash flows for periods after 1 January 2011 and recommend daily cash flows for periods prior to 1 January 2011. For periods ending prior to 1 January 2011, the SI-IRR must be calculated using either daily or monthly cash flows.

There has been confusion as to what daily cash flows mean and how to reconcile daily cash flows with historical results based on cash flows with a different frequency. 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. Due to the administrative burden, historically cash flows were accounted for on a less frequent basis. For some funds in the 1980s, cash flow data was only provided to investors on a quarterly basis or even, in some cases, on an annual basis. The same is still true in some emerging markets today. Since cash flows were usually reported to clients on a quarterly basis (or, in some cases on an annual basis), there was little reason to calculate returns with cash flows on a more frequent basis, even if available.

There were practical reasons for this aside from the administrative burden. Before the advent of the modern financial calculator, it was very difficult to calculate a SI-IRR. There were approximations and formulas for calculating both TWRR and IRRs, such as Dietz and the modified Dietz. Both the Dietz and the modified Dietz methods were conventions used to try to approximate some average cash flow recognition date. Other methods included using a monthly midpoint with some weighting to

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approximate daily cash flows. However, these methods were still not as accurate as a daily cash flows stream incorporating the actual dates of the cash flows involved.

Even with the introduction of spreadsheets, the ability to create a spreadsheet that used daily cash flows meant creating extremely large and cumbersome spreadsheets as these tools typically needed an entry for every date from beginning to end even if the date didn't have a cash flow.

Software products addressed this issue and the spreadsheets and performance systems only required dates on which cash flows actually occurred. However, some conventions are difficult to change and monthly cash flow streams are still often used. In some cases, whole businesses have been created in order to consolidate cash flows into monthly streams in order to accommodate legacy performance measurement systems. However, there was feedback indicating that daily cash flow conventions are now the norm and are not difficult to produce with systems now in place.

The principal issue is what to do with legacy cash flows streams that might be dated monthly for periods prior to 1 January 2011. Do they have to be reconstructed and are they compatible with daily dated cash flows which are required for periods after 1 January 2011? While it may not be as accurate as requiring reconstruction of a daily cash flow stream historically, the administrative burden and cost of reconstruction would be difficult to reconcile given the benefit gained. Thus, a cash flow dated with a month-end convention can be part of a full cash flow stream that uses daily cash flows and still be compliant as long as the same compounding period is used. While the resultant SI-IRR is not as precise as retroactively reconstructing the cash flows to a daily dated basis, the difficulty of daily cash flow reconstruction means that combining the monthly and daily cash flow streams is a reasonable accommodation. If monthly cash flows are used with daily cash flows in the same cash flow stream, the IRR formula must use a daily compounding convention for the entire cash flow, even if there are also monthly cash flows in the same cash flow stream. Thus, a firm that dates cash flows at month end until 1 January 2006 and then uses daily cash flows after 1 January 2006 and compounds the entire stream daily is in compliance with the GIPS standards.

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#### **7.A.5 All returns MUST be calculated after the deduction of actual TRANSACTION EXPENSES incurred during the period.**

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**Discussion:** Firms are required to deduct actual transaction expenses when calculating both gross and net-of-fees returns. Transaction expenses include all legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing portfolio investments as well as trading expenses, if any.

Transaction expenses that are allowable as a capitalized cost can vary depending on local accounting standards. As a result, good practice should include disclosure of the treatment of organizational or other costs to derive the returns being reported.

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#### **7.A.6 NET-OF-FEES returns MUST be net of actual INVESTMENT MANAGEMENT FEES (including CARRIED INTEREST).**

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**Discussion:** Investment Management fees in private equity include two components-- a commitment-based asset management fee which is paid on an ongoing basis and the performance-based fee known as carried interest which is typically accrued and paid as agreed in the limited partnership agreement. Collectively these fees are referred to as investment management fees. Firms are required to deduct these actual investment management fees when calculating net-of-fees returns. The carried interest fee can often have a greater impact than the commitment-based asset management fees.

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When calculating net-of-fees returns, the terminal value should be net of investment management fees (which include carried interest) that have been accrued but not yet paid. The intent is to provide an estimate of what the limited partner would receive if the portfolio were liquidated, unrealized gains and losses were realized, and the fund was distributed at the date of the performance calculation.

When calculating both gross-of-fees and net-of-fees returns, a firm may reflect the deduction of other expenses incurred at the fund of funds level, such as administrative expenses, but it is not required to do so. In the case of an investment management firm that manages a fund of funds, the firm must calculate all returns that reflect the deduction of all of the underlying funds' investment management fees and expenses, as well as the fund of fund's investment management fees. The firm may also deduct other expenses from the fund of fund's net-of-fees return to arrive at what is generally referred to as a "net-net" return. Deducting this added layer of fees reflects the true return to the ultimate investor. The net asset value used in the net-of-fees SI-IRR calculations and other required metrics should be adjusted to recognize accrued investment management fees that have not yet been paid.

In constructing cash flows for calculating gross-of-fees performance, investment management fees should be recognized as cash flows dated at the actual date when such investment management fees are paid. This is in contrast to the occasional practice in which a firm simply adds back paid investment management fees to the ending net asset value used in calculating performance rather than dating them at the actual cash flow date. This treatment does not allow for a proper the gross-of-fees SI-IRR calculation.

In the case of an investment management firm that manages a fund of funds, the firm must calculate both gross and net returns net of all of the underlying funds' expenses, which would include but is not limited to investment management fees of the underlying funds. In addition, when calculating the fund of funds net-of-fees return, the net return must reflect the deduction of actual investment management fees paid at the fund of funds level.

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#### **7.A.7 For FUNDS OF FUNDS, all returns MUST be net of all underlying partnership and/or fund fees and expenses, including CARRIED INTEREST.**

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**Discussion:** For funds of funds, all returns must be calculated after the deduction of actual transaction expenses incurred during the period. In addition, all expenses related to investments in underlying funds, whether or not reflected in the valuations of the underlying funds, must reduce both gross-of-fees and net-of-fees IRRs. Such expenses might include management fees billed in addition to or outside of the limited partners' capital commitment, or limited partner clawback expenses (e.g., portfolio company litigation) charged directly to the fund of funds.

Fund of fund expenses used in calculating net returns to investors a fund of funds may include, but are not limited to: the fund of funds advisory fee; legal, auditing, consulting, accounting and custodian fees and expenses; out-of-pocket expenses incurred in connection with transactions not consummated; expenses of the advisory board and annual meetings; premiums for insurance obtained by the fund of funds to protect it; any taxes, fees or other governmental charges levied against the fund of funds; organizational expenses up to a specified limit; expenses incurred in connection with the managed distribution of marketable securities; advertising and public notice costs; and costs of dissolving and liquidating the partnership.

### **COMPOSITE CONSTRUCTION – REQUIREMENTS**

Firms must remember that the GIPS standards have requirements and recommendations regarding composite construction, which can be found in Section 3 in Chapter 1 of the GIPS standards as well as the

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*Guidance Statement on Composite Definition.* Of most importance, firms are required to include *all* discretionary portfolios, including funds and partnerships, in at least one composite that is managed according to a particular investment mandate, objective, or strategy. Creating meaningful composites is critical to the fair representation, consistency, and comparability of performance results over time and among firms. Firms must understand that the GIPS standards require a firm-wide level of compliance and not for just selected composites or funds.

Firms should realize that all provisions and guidance related to composites apply to funds and partnerships. For example, when the GIPS standards state that the annualized SI-IRR (since inception—internal rate of return) must be presented for the composite, because each composite will typically contain only one fund or partnership, this will be the same as the annualized SI-IRR for the fund or partnership.

The GIPS standards are structured around the concept of composites. A composite is an aggregation of one or more portfolios managed according to similar investment mandate, objective or strategy. It is only appropriate to create composites that show a firm's capabilities or past performance with regard to a particular investment mandate, objective or strategy. Firms must also separate primary funds with different vintage years into different composites. The following hierarchy may be helpful as firms consider how to define private equity composites:

#### *Vintage Year*

*Strategy* (e.g., venture, buyout, generalist, mezzanine, fund-of-funds, other private equity, etc.)

*Sub-strategy* (e.g., size of fund, stage, geography, etc.)

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#### **7.A.8 COMPOSITE DEFINITIONS MUST remain consistent throughout the life of the COMPOSITE.**

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**Discussion:** The GIPS standards require that these classifications of vintage year and investment mandate, objective, or strategy remain consistent through the life of the composite. Thus, a fund cannot change from being classified as a generalist private equity composite to a venture focused composite even though it may have invested in more venture deals as the fund evolved. Since there are two methods of classifying funds by vintage year (the year of the investment vehicle's first drawdown or capital call from its investors; or the year when the first committed capital from outside investors is closed and legally binding), the vintage year selected for the composite must be consistent through the life of the fund to avoid gaming. In most cases, a composite will contain only one fund/partnership. If a firm has multiple funds/partnerships with the same vintage year and strategy, they must be combined into a single composite. Side by side investment vehicles should be included in the same composite as their affiliated parent fund. Co-investments in underlying portfolio companies should be included in the same composites as the primary fund making the investment in those portfolio companies.

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#### **7.A.9 PRIMARY FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR and investment mandate, objective, or strategy.**

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**Discussion:** The introduction outlined the features of the three most prevalent fund structures: the primary fund, the secondary fund and the fund of funds. To review, a primary fund invests directly in portfolio companies or other underlying private equity investments. A secondary fund buys partnership interests from other investors. A fund of funds invests in primary fund vehicles rather than making direct investments in portfolio companies. A secondary fund may be organized as a primary fund or as a fund of funds. The private equity provisions apply to all of the above structures as long as they are fixed-life fixed-commitment vehicles. Composite construction may be impacted by the investment vehicles' structure so it's important to note which composite construction requirements apply. A primary fund's

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composite definition will be a combination of vintage year and investment mandate, objective, or strategy. A secondary fund's composite inclusion will depend on whether it has structured itself as a primary fund or as a fund of funds.

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#### **7.A.10 FUNDS OF FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR of the FUND OF FUNDS and/or investment mandate, objective, or strategy.**

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**Discussion:** A fund of funds is a vehicle that invests in private equity funds as a limited partner. These underlying fund investments are not typically in the same vintage year and do not necessarily share the same investment mandate, objective, or strategy. Thus, a fund of funds might include investments in a 1998 venture fund, a 2003 buyout fund, a 2004 buyout fund and a 2006 distressed fund. In addition, a fund of funds firm may have separately managed accounts that follow this same investment style but with different vintage years and strategies.

Requiring a firm to create fund of funds composites based on both vintage year AND investment mandate, objective, or strategy requirement was found to be impractical, intractable and not consistent with the information that prospective clients require for their fund of funds investments. Therefore, a firm may create fund of funds composites based on either vintage year of the fund(s) of funds or investment mandate, objective, or strategy, or may choose to create a composite which encompasses both. In either case, all discretionary funds of funds must be included in at least one of the composites discussed above. For examples of how a fund of funds firm could present composite performance, refer to Appendix A: Sample Presentations.

Funds of Funds have to be careful in their use of the term “vintage year”. In a fund of funds context, the generic term “vintage year” can refer to the vintage year of the fund of funds itself or the vintage year of the underlying fund vehicles in which it invests. In addition, a firm may have separately managed accounts that have a “subscription year” which denotes the year an investor signed their investment agreement with the fund of funds. This is often also termed “vintage year”.

To be clear, when the term “vintage year” is used to create a fund of funds composite, the term refers to the vintage year of the fund of funds vehicle itself. It does not refer to the vintage year of the underlying fund investments. However, provision 7.A.22 does require that if a fund of funds composite is defined by strategy only, the firm must also provide performance of the underlying fund investments aggregated by the vintage year of the underlying investments. It is only in this context that the underlying fund investments' vintage year is considered.

### **DISCLOSURES – REQUIREMENTS**

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#### **7.A.11 FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.**

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**Discussion:** Firms are required to disclose the vintage year of the composite and how the vintage year is defined. The disclosure of the vintage year increases transparency by allowing prospective clients to understand the time frame when the fund was initiated or locked up.

The concept of the vintage year is to set a starting date so that funds started in the same year can be equitably compared on an equal start basis. While there may be several ways that start date could be determined, for compliance with the GIPS standards the relevant start date is the vintage year of the fund. The industry has determined vintage years in two ways - the date of first close and the date of first capital call. First close is the date when the firm has signed subscription agreements with clients and has the

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right to call capital from a client. First capital call date is the date when the firm actually has received investors' capital. The GIPS standards require vintage year to be determined based on either first close or first call.

Historically, the vintage year was determined by the date of the first close of a fund which is the date it receives subscription agreements for its first commitments "AKA first close". This date typically also coincided with the fund's first capital calls for investments. As the industry evolved, there were more and more cases where the first close did not coincide with actual capital calls but were "dry closes" where the fund closed its first commitments but drew no capital because it had no investments. Thus another method evolved in which vintage year was defined by the date of the first capital call rather than the first close, whether for investment or management fees.

These two methods are both legitimate methods of defining vintage year. The GIPS standards require disclosure of the vintage year and how the vintage year is defined for the composite. The vintage year chosen must be the same for the entire life of the composite.

Various methods of defining vintage year are used in the industry and there is enough dissension over vintage year definition to warrant disclosure rather than mandating one treatment over the other. It is important to note that the calculation of the SI-IRR relies on the first cash flow. The definition of vintage year does not impact the SI-IRR calculation but it may have an impact on the benchmark that is chosen. The benchmark chosen to compare performance of the composite must reflect the same vintage year used for the composite.

*Sample Disclosure:* The vintage year of the Venture Capital Composite is 2001 and was determined by the year of the first drawdown of capital.

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#### **7.A.12 FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.**

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**Discussion:** While most private equity funds in general have a ten year life, it is common to have multiple extensions whereby some funds may have lives as long as 17 or 18 years. The residual value of the investments may be de minimis at that final liquidation date, but the longer the life, the lower the fund's SI-IRR will be, all other things being equal. At some point the fund is finally liquidated either by disposing of the remaining investments or writing off any remaining investments. It is important that the prospective client know the final liquidation date in order to evaluate how the extensions have affected the performance calculations.

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#### **7.A.13 FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period.**

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**Discussion:** Given the subjective nature of the judgments that are required in valuing private equity investments, it is important that the latest valuation methodologies used be fully disclosed. Portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles as of 1 January 2010. Firm must disclose the national or international association guidelines which have been used, if any, and disclose any valuation methodology changes from the previous valuation date. Any key assumptions and subjective judgments made should be disclosed.

*Sample Disclosure:* Accounting convention is U.S. GAAP. Partnership fund investments are carried at fair value as determined by the General Partner at its discretion. The Partnership's fund investments are generally carried at the valuations provided by the general partners or managers of such investments. The valuations provided by the general partners or managers reflect the fair value of the Partnership's capital

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account balance of each fund investment, including unrealized gains and losses, and reflect the values as reported in the audited financial statements of the respective fund at the fund's fiscal year end. The valuations used were based upon the fund managers' valuations as at [date] or at the latest available date. In reviewing these underlying valuations, the General Partner is advised by the Investment Advisor, who reviews the capital account balances and may adjust the value of each fund investment. The General Partner uses the market approach to estimate the fair value of private equity investments. The market approach utilises prices and other relevant information generated by market transactions, type of security, size of the position, degree of liquidity, restrictions on the disposition, latest round of financing data, current financial position and operating results, among other factors. In circumstances where fair values are not provided in respect of any of the partnership's fund investments, the Investment Advisor will seek to determine the fair value of such investments based upon information provided by the general partners or managers of such funds or from other sources. Notwithstanding the above, the variety of valuation bases adopted and quality of management data of the ultimate underlying Investee companies means that there are inherent difficulties in determining the value of these investments. Amounts realised on the sale of these investments may differ from the values used to calculate returns and other fund measures this composite presentation and the difference could be significant.

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#### **7.A.14 For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies.**

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**Discussion:** Consistent with the recognition that valuations are a significant input into the performance equation and that the valuation of private equity investments involves the use of subjective estimates, it is required to disclose any changes in valuation policies or methodologies which might affect performance results or make historical comparability of performance results difficult. This includes any changes to international guidelines which have had an impact on valuation practices, or adoption of different accounting principles valuation policies or industry guidelines. Some examples of a material change would include but are not limited to:

- new valuation principles adopted by a local accounting standards board,
- adoption of new international standards in lieu of local standards,
- change of economic criteria used to value investments,
- change from discounted cash flows basis to a comparables basis.

*Sample Disclosure:* Effective [date] our valuation policy was changed from a discounted cash flow methodology to a market comparable basis. The reason for this change is that market comparables is more reflective of the value of the investments given the changes in the sectors we have invested in over the last few years. The new methodology is consistent with the definition of fair value and the GIPS Valuation Principles and the International Private Equity Valuation principles, policies and recommended methodologies.

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#### **7.A.15 If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied.**

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**Discussion:** Since the advent of regular performance statistics analysis in the early 1990s, there have been several local, national and international valuations principles adopted which have specifically addressed private equity. Almost every major national industry association has developed their own valuations guidelines. The National Venture Capital Association (NVCA) endorsed the use of the valuation guidelines of the Private Equity Industry Guidelines Group (PEIGG) later subsumed by Financial Accounting Standard (FAS) 157 / Accounting Standards Codification (ASC) Topic 820. However, many

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valuation standards and guidelines have now merged. Many of the European standards have been subsumed into the International Private Equity Valuation (IPEV) standards. The U.S. industry's attempt to codify standards have been subsumed into FAS 157/ ASC Topic 820. There are often reasons why the GIPS Valuation Principles may be supplemented by other local or international standards. For example, local standards may be more stringent in their requirements.

The disclosure of which jurisdiction's valuation guidelines have been used in addition to the GIPS Valuation Principles will help readers to determine the comparability of different sets of compliant presentations. While there is no requirement to do so, it would be useful to indicate how the additional valuation guidelines differ or do not differ from the GIPS Valuation Principles.

*Sample Disclosure:* The Global Diversified Distressed Composite adheres to the LMN Venture Capital Association's valuation guidelines as well as the GIPS Valuation Principles. The LMV valuation standards are based on fair value but provide more prescriptive advice in terms of how to value specific investments such as secondary investments and distressed debt investments.

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#### **7.A.16 FIRMS MUST disclose the calculation methodology used for the BENCHMARK. If FIRMS present the PUBLIC MARKET EQUIVALENT of a COMPOSITE as a BENCHMARK, FIRMS MUST disclose the index used to calculate the PUBLIC MARKET EQUIVALENT.**

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**Discussion:** The GIPS standards require that the calculation methodology be disclosed for the benchmark used in the compliant presentation. This provides transparency as to the comparability of the performance of the composite and the benchmark. The disclosure includes the calculation method itself (e.g. is the benchmark a net IRR, compounded on a particular basis, the method by which the vintage year is determined for the benchmark, as well as the metric being used for comparison.) For example, the metric for a benchmark could be an average, median, upper quartile, and other percentile. It is expected that the benchmark description include the name or source of the benchmark as well as the metric being used. The public market equivalent (PME) is a method where public market indices are used to create a comparable SI-IRR from the series of synthetic cash flows that can be compared to the SI-IRR of the private equity composite. If a PME is used as a benchmark, the firm must disclose which public market index is used to create the PME.

*Sample Disclosure:* The benchmark is the 2008 vintage year, determined by the date of first capital call, pooled SI-IRR for US venture capital funds published by ACME advisory.

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#### **7.A.17 FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011.**

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**Discussion:** The SI-IRR calculation is sensitive to the relative timing of cash flows. In some cases, especially early in the life of a fund, using a quarterly cash flows dating convention (only allowed for periods prior to 1 January 2006) can have a much different outcome from using a monthly or daily convention due to the compounding effect of the SI-IRR. Accordingly, firms are required to disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011. Daily cash flows must be used for period ending on or after 1 January 2011.

*Sample Disclosure:* The SI-IRR calculation incorporates monthly cash flows for periods prior to 31 December 2009 and daily cash flows thereafter.

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**7.A.18 For GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.**

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**Discussion:** In order to assist prospective clients in better understanding the gross-of-fees return calculation, firms must disclose if any other fees are deducted in addition to actual transaction expenses. For example, a closed-end fund's gross-of-fees return might reflect the deduction of administrative expenses such as custodian and fund accounting fees. The same is true for a fund of funds. While fund of funds gross-of-fees returns must be reduced by all fees and expenses of the underlying funds, including carried interest, such returns could also reflect the deduction of other expenses at the fund of funds level. Firms are required to disclose if other fees have been deducted to derive the gross-of-fees return.

*Sample Disclosure:* Gross returns reflect the deduction of administrative expenses at the fund of fund level but do not reflect the deduction of ABC Fund of Funds Manager's management fees.

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**7.A.19 For NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.**

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**Discussion:** When presenting private equity performance, firms are required to present both gross-of-fees and net-of-fees returns. Net-of-fees returns must be net of actual investment management fees, and transaction expenses. Net returns may reflect the deduction of other expenses such as administrative expenses. Expenses in addition to the investment management fees and transaction expenses that are reflected in net returns must be disclosed.

*Sample Disclosure:* Net returns are net of transaction expenses, administrative expenses, management fees, and carried interest.

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**7.A.20 For any performance 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.**

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**Discussion:** Recognizing that firms may not be able to gather historical valuations and/or records for transactions of private equity investments for periods prior to 1 January 2006, a firm may present and link the non-compliant performance, but must disclose as the periods of non-compliance with the GIPS standards. Note that the SI-IRR and other private equity performance measures are "since-inception" measures. The period for a SI-IRR is from the inception date through the end of the period that is being reported. Unlike time-weighted rates of return, the beginning period for a SI-IRR remains constant and does not change. Therefore, 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 fund composite history begins 1 January 2003, SI-IRR are required to be presented from 1 January 2003 (inception) through each annual period starting with the period ending 31 December 2006. If the firm chooses to present S-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as being non-compliant.

*Sample Disclosure:* Fund IV was formed in 1996. During 1996 and 1997, cash flows were dated to the end of the quarter as actual cash flows were kept in a manual system that can't be easily reconstructed. The cash flows beginning January 1, 1997 are all dated as of the end of the month, while cash flows beginning January 1, 2003 are all dated as of the actual cash flow date.

## PRESENTATIONS AND REPORTING - REQUIREMENTS

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#### 7.A.21 The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- a. **FIRMS MUST present both the NET-OF-FEES and GROSS-OF-FEES SI-IRR of the COMPOSITE through each annual period end. 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 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. COMPOSITE returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.**
- b. **For periods beginning on or after 1 January 2011, when the initial period is less than a full year, FIRMS MUST present the non-annualized NET-OF-FEES and GROSS-OF-FEES SI-IRR through the initial annual period end.**
- c. **For periods ending on or after 1 January 2011, FIRMS MUST present the NET-OF-FEES and GROSS-OF-FEES SI-IRR through the COMPOSITE FINAL LIQUIDATION DATE.**

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**Discussion:** a) The five year reporting requirement is most relevant for asset classes reporting performance on a periodic time-weighted basis. For example, a non-private equity investment firm that is first coming into compliance with the GIPS standards and has a ten year track record can report performance on the last five years of their track record. These results will be independent of any performance preceding those five years. In the case of private equity based on since inception basis, the current performance is dependent on all transactions historically. If a fund is has been in existence less than five years, it must present performance though each annual period end from inception until year five.

Most investors will want to see the entire track record of annual since inception IRR's in order to gauge the effect of the "j-curve" in the early years of the fund's life. The "j-curve" is the plot of the cumulative since-inception net cash flows or since inception returns of a fund. It is typical that early returns or net cash flows will be negative in the early years and will then likely turn positive. The early negative results are the result of the fact that in some funds, like venture funds, it will take time before distributions outpace paid-in capital. In addition in the early cash flows, the cash flows called for management fees may be larger than the cash flows made for investment. As a result, it is recognized that the early years of a fund are not indicative of long-term performance. This is especially true for venture capital funds as the early capital calls for management fees and length of time for investment development and growth means that early returns will be attenuated and usually highly negative until the fund recovers from the j-curve. However, the j-curve effect should be minimized as management fees are not deducted in the gross-of-fees calculation.

b) The current edition of the GIPS standards requires that a firm present any partial year performance in the initial reporting period on a non-annualized basis, for composites that begin on or after 1 January 2011. For example, a fund that began on 30 November 2011 and has a one month initial return through the end of 31 December 2011 of 3% would report that 3% as the initial year's performance rather than an annualized 42.6%. Many spreadsheet and software applications automatically annualize the return and firms are reminded that for periods of less than a year, the firm must "de-annualize" the return that is calculated.

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c) Funds typically have an initial ten year life that can be extended through either prior or current agreement for a stipulated number of years. Many times, a fund may have one or two portfolio companies that have not been liquidated and continue to be held in the fund. On a since inception basis, the returns do not vary much during those extension periods unless the investment has some significant events that cause significant revaluation. In the end, the investment is liquidated by some means and the fund eventually is also liquidated. A firm must report performance through that final liquidation date in order to capture the residual value, either good or bad, in the last stages of the portfolio. This extension has a negative impact on performance so performance needs to be calculated through the final liquidation date.

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**7.A.22 For periods ending on or after 1 January 2011, 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. These measures MUST be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES and MUST be presented as of the most recent annual period end.**

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**Discussion:** Each fund of funds manager determines the strategies to invest in and the vintage years over which to invest. These distinguishing characteristics are routinely described in detail in the limited partnership agreement. Fund of fund firms differentiate themselves from each other by offering narrow or broad strategies, regional or global geographical focuses, investing in primary or secondary markets, and whether they will invest using direct investments or co-investments. These investment mandates are generally employed over 2-5 consecutive vintage years although this can vary widely.

One of the significant changes in the 2010 edition of the GIPS standards is in how fund of funds composites can be defined. In the 2005 edition of the GIPS standards, fund of funds were required (as were primary funds) to be included in composites that were defined by vintage year AND investment mandate, objective, or strategy. Given how funds of funds structure their investment portfolios, this often led to a tremendous number of composites, many of which were irrelevant to prospective clients. In response to feedback and discussion, the 2010 edition of the GIPS standards allows fund of funds firm to create composites that are defined by vintage year and/or investment mandate, objective, or strategy. A fund of funds firm with five funds, each of which had the same strategy but different vintage year, would create five composites. Following the 2010 edition of the GIPS standards, the same firm could choose to define composites either by vintage year (five composites) or investment mandate, objective, or strategy (one composite).

If the firm chooses to create a fund of funds composite defined only by investment mandate, objective, or strategy, the firm is required to present the SI-IRR of the underlying investments that have been aggregated by vintage year as of the most recent annual period end. The firm must also present, as of the most recent annual period end, all of the metrics required by provision 7.A.23 by vintage year as well. See Appendix A for examples.

This has the added benefit of increased comparability with benchmarks. Because of the numerous variations and structures of funds of funds, fund of fund composites may have underlying investments that span a number of vintage years. Since the number of vintage years of the underlying investments varies significantly, fund of funds composites are not usually comparable with vintage year benchmarks or with other funds of funds. By stratifying the fund of fund composites by the vintage year of the underlying investments, additional analysis of the composite can be performed. This allows for analysis by vintage year of all investments made by the fund of funds by comparing them directly to an appropriate vintage year benchmark.

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#### 7.A.23 FIRMS MUST present as of each annual period end:

- a. **COMPOSITE SINCE INCEPTION PAID-IN CAPITAL;**
  - b. **COMPOSITE SINCE INCEPTION DISTRIBUTIONS;**
  - c. **COMPOSITE cumulative COMMITTED CAPITAL;**
  - d. **TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI);**
  - e. **SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI);**
  - f. **SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE); and**
  - g. **RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).**
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**Discussion:** While the since inception IRR is the basic metric used to report performance for private equity investments, it is not the only useful metric used to gauge performance. Other measures are also useful to provide additional insight. The IRR by its nature is sensitive to early cash flow events and the IRR calculation assumes that the residual value of a composite is totally liquid, whereas in reality, the residual value is the unrealized (and often illiquid) portion of the composite. As a result, other metrics have been developed that allow a prospective client to examine other aspects of performance other than simply a rate of return.

The SI-IRR uses four components – three cash flow components and one non-cash flow component. The three cash flow items are: 1) the since inception paid-in capital; 2) the since inception distributions; and 3) expenses that have been paid. The paid-in capital consists of all capital inflows to an investment vehicle from the limited partners while the distributions include all cash and stock distributed to limited partners. Expenses paid by the limited partners are also cash flows. The one non-cash flow item in the SI-IRR calculation is the residual value. The residual value is the fair value of remaining equity that the limited partners have in an investment vehicle at the end of the reporting period. This is often referred to as the net asset value. In addition to these components, a second non-cash component, cumulative committed capital, is also required for certain other performance metrics. The committed capital represents the total pledges of capital to an investment vehicle by the limited partners. These five components can be used to calculate the performance metrics, as well as the since inception IRR which assumes that the residual value is treated as the terminal cash flow.

Unlike the SI-IRR, the following are simple multiples that do not incorporate the time-value of money into their calculation:

- investment multiple (total value to since inception paid-in capital or TVPI),
- the realization multiple (since inception distributions to paid-in capital or DPI),
- the PIC multiple (since inception paid-in capital to cumulative committed capital), and
- the unrealized multiple (residual value to paid-in capital or RVPI)

#### *Recycling/Reinvestment and recallable cash flows*

Private equity vehicles are usually characterized by the prohibition (unless stipulated by agreement) to reinvest proceeds or allow redemptions. This means that unless otherwise agreed to, private equity funds must distribute proceeds from investments to limited partners and cannot reinvest that capital. In some cases, distributions are ‘recallable’, that is, after the fund distributes proceeds to its investors, it can draw down the same capital again, which makes it possible for the fund to draw capital in excess of its total committed capital.

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The GIPS standards require distributions to be treated as “gross of callable features.” This means that a callable distribution must be treated as an actual distribution and, if and when that distribution is called again, it must be treated as additional paid-in capital rather than being netted against unfunded commitments.

It should be noted that callable distributions have an impact on the metric calculations. For example, this callable feature means that cumulative paid-in capital can be higher than cumulative committed capital. It also means that, all other things being equal, the DPI multiple (distributions to paid-in capital) will be lower for funds with callable distributions. It also means that the PIC multiple (paid-in capital to cumulative committed capital) will be higher for funds with callable distributions, all other things being equal.

While there is neither a formal requirement nor recommendation to disclose callable distributions, it would be prudent practice to disclose the fact if there is material distortion to the PIC or DPI multiples.

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#### **7.A.24 FIRMS MUST present the SI-IRR for the BENCHMARK through each annual period end. The BENCHMARK MUST:**

- a. Reflect the investment mandate, objective, or strategy of the COMPOSITE;**
- b. Be presented for the same time periods as presented for the COMPOSITE; and**
- c. Be the same VINTAGE YEAR as the COMPOSITE.**

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**Discussion:** Firms are required to present the annualized SI-IRR of a benchmark that reflects the same investment mandate, objective, or strategy of the composite corresponds to the same time periods as the composite, and has the same vintage year as the composite. Firms must disclose the calculation methodology of the benchmark and if a custom benchmark or multiple benchmarks is used, how that benchmark is constructed, including the benchmark components, weights, and rebalancing process. If the firm determines no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented.

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#### **7.A.25 For FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy and a BENCHMARK is presented for the underlying investments, the BENCHMARK MUST be the same VINTAGE YEAR and investment mandate, objective, or strategy as the underlying investments.**

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**Discussion:** A variety of appropriate benchmarks can be used for direct comparison or opportunity cost comparison. A fund of fund is comprised of underlying funds of various vintage years. If a firm chooses to present a benchmark for the underlying investments, an appropriate benchmark is one that mirrors the exact vintage year of the underlying funds for direct comparison. If the benchmark is presented for the underlying investments that span a number of vintage years, a corresponding benchmark including multiple vintage years should be used. For a composite with underlying buyout funds with 2004, 2006 and 2008 vintage years, for example, the benchmark should be comprised of buyout funds with 2004, 2006 and 2008 vintage years as this is the direct peer comparison to those who invested in the same years.

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#### **7.A.26 For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.**

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## Global Investment Performance Standards

### *Exposure Draft*

**Discussion:** Direct investments (or co-investments) by a fund of funds may augment the strategy they use in their investment in underlying fund vehicles. Direct investments may have different terms and conditions which might change the return characteristics of the fund of funds. By providing the percentage of investments dedicated to direct investments, the fund of funds firm is displaying additional transparency and allowing the prospective client to factor in additional criteria when analyzing the returns provided by the firm.

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**7.A.27 For periods ending on or after 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.**

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**Discussion:** Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending on or after 1 January 2011, firms must disclose, for primary fund composites, the percentage of the composite that is invested in other funds as of each annual period end

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**7.A.28 FIRMS MUST NOT present non-GIPS-compliant performance for periods ending on or after 1 January 2006. For periods ending prior to 1 January 2006, FIRMS may present non-GIPS-compliant performance.**

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**Discussion:** As discussed in 7.A.20, there may be legitimate reasons for which reported performance may not be compliant prior to 1 January 1 2006. Given the fact that performance for private equity is always reported on a since inception basis, the past is always incorporated into the IRR as contrasted with a TWR which may not necessarily incorporate since inception results. It could be argued that the since inception basis of private equity reporting would mean that any period of historical non-compliance could legitimately mean the current period would also be non-compliant because the current calculation may depend on inputs that were not in compliance with the GIPS standards. The early use of quarterly cash flows or the inability to value portfolios in accordance with private equity valuation standards for investments prior to 1 January 2006 does not invalidate current compliance with the GIPS standards.

### **PRIVATE EQUITY – RECOMMENDATIONS**

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**7.B.1 PRIVATE EQUITY investments SHOULD be valued at least quarterly.**

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**Discussion:** The use of quarterly valuations is recommended as it provides prospective clients with earlier notification of any significant movements and allows more effective tracking of investments against the market and other asset classes.

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**7.B.2 For periods ending prior to 1 January 2011, the SI-IRR SHOULD be calculated using daily cash flows.**

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**Discussion:** Daily cash flows improve the accuracy of the return calculations, including the SI-IRR required by the GIPS standards for private equity investments. Firms should therefore use daily cash flows for periods prior to 1 January 2011, and are required to use daily cash flows for period ending on or after 1 January 2011.

## Global Investment Performance Standards

### *Exposure Draft*

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**7.B.3 FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end.**

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**Discussion:** Valuations used for financial and performance reporting purposes should be consistent. This should ensure that performance reported to current investors is no different from that presented to prospective clients. However, in some cases, valuations are retrospectively updated (for instance, as a result of a financial statement audit). This could lead to different valuations being used in performance reporting compared to those used in financial reporting. If these differences are material, then they should be disclosed.

*Sample Disclosure:* “Since the year end, there was a material movement in the value of XX, caused by YY. In the opinion of the GP, this represents a material impact on the valuation of ZZ and as such, has been accounted for.”

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**7.B.4 For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.**

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**Discussion:** A firm must disclose material changes to valuation policies and/or methodologies used to value private equity investments for periods ending on or after 1 January 2011. Firms are recommended to disclose material changes to valuation policies and/or methodologies for periods ending prior to 1 January 2011.

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**7.B.5 For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by VINTAGE YEAR of the FUND OF FUNDS, FIRMS SHOULD also present the SI-IRR of the underlying investments aggregated by investment mandate, objective, or strategy and other measures as listed in 7.A.23. These measures SHOULD be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES.**

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**Discussion:** As a corollary to provision 7.A.22, where a fund of fund firm is required to provide summary statistics by vintage year if the firm chooses to create composites by investment mandate, objective or strategy, 7.B.5 recommends that if a fund of funds firm chooses to create a composite by vintage year, it should also provide summary statistics by strategy.

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**7.B.6 For periods ending prior to 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.**

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**Discussion:** Direct investments (or co-investments) by a fund of funds may augment the strategy they use in their investment in underlying fund vehicles. Direct investments may have different terms and conditions which might change the return characteristics of the fund of funds. By providing the percentage of investments dedicated to direct investments, the fund of funds firm is displaying addition transparency and allowing the prospective client to factor in additional criteria when analyzing the returns provided by the fund of funds firm.

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**7.B.7 For periods ending prior to 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in fund**

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## Global Investment Performance Standards

### *Exposure Draft*

**investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.**

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**Discussion:** Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending prior to 1 January 2011, firms should disclose, for primary fund composites, the percentage of the composites that is invested in other funds as of each annual period end.