**UK Investment Performance Committee (UKIPC)**
**Response to**
**GIPS Exposure Draft Guidance Statement on Alternative Investment Strategies and Structures**

## 1 About the UKIPC

The UK Investment Performance Committee (UKIPC) is the UK national sponsor for the Global Investment Performance Standards (GIPS). It brings together representatives of asset owners, advisors, managers, verifiers, measurers, analysts and other parties with an interest in the continuing development and promotion of transparent, consistent and ethical investment measurement performance standards.

We are grateful to the CFA Institute and the volunteers on the various GIPS committees, subcommittees and working groups for their work in updating the GIPS Guidance Statements in line with the 2010 version of the GIPS. We welcome the opportunity to comment on the Exposure Draft Guidance Statement on Alternative Investment Strategies and Structures.

## 2 Response

2.1 We believe that the proposed Guidance Statement is well considered, thorough, balanced and pragmatic and that it will serve the needs of UK asset managers well. We welcome its emphasis on the principle of substance over form.

2.2 Our response is two parts. The first part answers the specific questions set out in the Exposure Draft; the second part sets out some suggestions on how the text could be further improved, which we hope will prove useful in finalising the Guidance Statement. We would particularly like to draw your attention to our concerns, set out in our answer to Question 4 (page 12 of the Exposure Draft), about the 'non-discretionary' exceptions proposed for side pockets and leverage. We would be happy to elaborate in greater detail should you wish.

2.3 We would also like to make suggestions for additional guidance for already compliant firms and on transitional arrangements for the hedge fund industry:

- *Guidance for already compliant firms.* The document is designed to walkthrough in a logical order the principles of GIPS compliance and discuss how they apply to a firm managing alternative investments. We feel that it would be useful at the end of section 1 (or the beginning of section 2) to address the needs for guidance of the considerable number of managers of alternative strategies who already comply with GIPS. It may not be easy to succinctly insert a paragraph (or two) covering "what is new for those already claiming compliance". However, even if it only directs the compliant firm to look at each provision in detail to see if they interpreted it correctly, this would at least serve to respond to the feedback of a number of UK asset managers.

- *Transitional arrangements for the hedge fund industry*. The hedge fund industry has well established but quite widely divergent marketing and reporting practices, some of which are significantly different from the GIPS Standards. Firms considering whether to bring themselves into compliance with GIPS would want to understand clearly whether the guidance is retrospective or, alternatively, whether there is a transition timetable over which the firm may move into compliance with the Standards, but crucially without recourse to substantial restatement of history. The guidance as drafted gives no view either way.

## 3 Answers to Specific Questions

*Q1 (Page 6) Do you agree with the proposed requirements related to the frequency of portfolio valuations? Why or why not?*

Yes. The overwhelming majority of alternative strategies (other than private equity and real estate) are well suited to monthly, even daily, valuation using official NAVs priced by third party administrators. It should be recognised that a small minority of assets are, because of their investment characteristics, less frequently valued; when updated valuations become available in these circumstances, there can be step changes from the previous values leading to material changes in performance.

A tough default position should be taken, with extensive disclosure requirements imposed in the absence of monthly or more frequent valuations.

*Q2 (Page 8) Do you agree with the proposed treatment of estimated versus final values? Do you support different guidance for pooled funds and managed portfolios? Do you agree with requiring the disclosure of the use of estimated values? Why or why not?*

We agree with the proposed treatment of estimated versus final values and on requiring disclosure of the use of estimated values. Our Committee is divided on the question of different guidance for pooled and managed portfolios.

We comment in more detail on estimated versus final values in our comments on the Guidance Statement text (see paragraph 4.3 on page 5 of our response).

*Q3 (Page 9) Do you agree with the proposed treatment of gross-of-fees returns and net-of-fees returns for master-feeder structures? Why or why not?*

Yes, but with a pragmatic approach permitted for determining the highest fee scales – as explained in paragraph 4.6 of our comments on the Guidance Statement text (see page 6 of our response).

*Q4 (Page 12) Do you agree with the proposed treatment of side pockets? Why or why not? Should a firm be required to disclose the creation of a side pocket in all instances? Or, only when a side pocket is created to hold non-discretionary assets that are no longer reflected in composite performance? What should be required to be disclosed?*

Yes. The proposed treatment of side pockets applies two principles that are essential to GIPS and to any externally reported performance information:

- performance follows the accounting records, so that performance is adjusted when those responsible for portfolio accounting recognise any write-downs; and
- the performance reported is what the investor (especially the 'day one' investor) earned.

There are, however, divergent views on grounds for non-disclosure, one view being that lack of significance could be grounds for non-disclosure. Other members believe the existence and size of a side pocket should always be disclosed, irrespective of the reasons for its creation.

We have significant concerns about the 'non-discretionary' exemption. On reading the draft guidance, many asset managers might incorrectly conclude that their side pocket is non-discretionary. This is because the rationale for the creation of a side pocket is a loss of control by the manager over his ability to generate the promised returns from an investment for which a third party is often responsible. But a lack of investment discretion is rarely the culprit.

The guidance should make clear that distressed assets and, in particular, those assets that have been seized either in relation to lending covenant or counterparty failures cannot be deemed to be non-discretionary. In doing so, the guidance should re-affirm the GIPS principle that the treatment of any assets as non-discretionary must be supported by a signed client agreement.

*Q5* *(Page 14) Do you agree with the proposed treatment of illiquid investments? Why or why not?*

Yes. Much of this does no more than apply GIPS 2010, which we fully support.

*Q6 (i)* *(Page 18) Should portfolios managed with discretionary leverage be allowed to be deleveraged for inclusion in composite performance? Why or why not?*

No. Performance reported in this way would not reflect the manager's skill, nor would the composite performance represent the returns earned by the investors in the fund. It would be nothing more than a simulated return. We believe that leverage should be considered a significant differentiator in product design and applied accordingly to composite construction through the segregation of leveraged and unleveraged versions of the same strategy.

*Q6 (ii)* *(Page 18) Should portfolios managed with nondiscretionary leverage be allowed to be deleveraged for inclusion in composite performance? Why or why not?*

We recognise the principle of this argument on technical grounds but side towards the same position as with discretionary leverage, in that the removal of leverage, irrespective of grounds for deployment, creates a synthetic return which is contrary to the basic principles of the GIPS Standards.

*Q7 (i)* *(Page 20) Should firms be allowed to adjust portfolio and composite performance for the double counting of assets?*

Firms must adjust for the double counting of composite and firm assets. It would be misleading to do otherwise.

*Q7 (ii)* *(Page 20) Alternatively, do you agree that firms should be prohibited from recalculating portfolio and composite performance to eliminate double-counted assets? Why or why not?*

We are not sure about the wording of this question, but our central contention is that all double counting of assets should be eliminated and performance adjusted accordingly, so as to present a real picture of the performance of the assets being managed.

*Q8* *(Page 21) When presenting net-of-fees returns, firms are allowed to reduce gross-of-fees returns by the actual investment management fee incurred by each portfolio or a model fee. The model fee must be the highest investment management fee incurred by portfolios in the composite.*

*Should firms also be allowed to present net-of-fees returns that are reduced by a model fee which is the maximum investment management fee applicable to the prospective client, even if it is not the highest investment management fee that is incurred by portfolios in the composite? Why or why not?*

Yes, but the fact should be disclosed. Furthermore, as this is a prospect specific calculation, firms should be prohibited from more general marketing of the resultant returns. See also paragraph 4.5 of our comments on the Guidance Statement text (page 5 of our response).

## 4 Comments on the Guidance Statement text

4.1 *Scope (Section 2.1, final paragraph – half way down page 4)*

The necessary interaction with the Private Equity and Real Estate provisions should be addressed directly. We suggest the following wording:

> "Private Equity and Real Estate have their own sections and related guidance that must be considered when claiming compliance with the GIPS standards. Where firms also engage in activities other than those covered by the Private Equity and Real Estate guidance, it is important that they consider this Guidance Statement where appropriate."

4.2 *Frequency of Valuation of Portfolio (Section 2.2.2, final paragraph, line 6 – page 6)*

For disclosing the use of an internal valuation in the case of an absent month-end valuation from the official source, we believe that the "should" needs to be replaced by a "must" ('firms **must** disclose if pricing has been performed internally …'). We believe that this qualifies as a significant piece of information for the user of any such composite report. It is also important to encourage a monthly official valuation as the default premise for all portfolios.

4.3 *Estimated Versus Final Values (Section 2.2.3, last line on page 7)*

We believe option (b) needs further clarification. Provided the use of an estimated NAV and the firm's policy for retroactive adjustment of performance in relation to the re-measurement of composite returns using the final NAV is disclosed, we do not believe that any such retroactive adjustments should be considered an 'error correction event'. As a general point, there is too much for "firms to consider" and we recommend a greater leaning towards prescription, perhaps along the lines of:

a) If a firm measures a portfolio return using estimated values, they must have policies and procedures for comparing the performance when measured using the final values and for determining when to make retroactive adjustments. Where the regular periodic update of information from estimated or provisional to final occurs (such as peer group universe updates), firms generally do not regard this as an error event but build this characteristic into their policies and procedures.

b) In the composites affected, those policies must be disclosed in the compliant report.

c) Where retroactive adjustments are made as a result of significant divergences between estimated and final NAVs:

    i) These are not considered an error on the grounds that the firm acted with the best information available at the time and disclosed that fact to the users.

    ii) While not an error, the firm must apply the related principle of considering whether any recipients of the outdated composite reports have been adversely affected as a result of relying on such information in that they may have drawn conclusions which would now either be considerably modified or even contradicted.

4.4 *Page 8, line 2.* There is a typographical error: for "disclosing" write "disclose".

4.5 *Return calculation and treatment of fees (Section 2.3.1, final paragraph on page 8, line 2)*

In the interests of clarity, add the following to the end of the first sentence of the paragraph ('…..of the underlying funds' fees and expenses'):

> ', which is typically achieved by virtue of their being "in" (i.e. deducted from) the NAV / Price Per Share of the underlying fund'.

We feel that it is important that the text make clear that the underlying accounting and valuation policies would usually facilitate this approach without composite performance measurers having to perform the adjustments, even though they are responsible for determining that they may take this approach.

4.6 *Master-feeder Structures – Fees (Page 9)*

In light of the SEC 'no action letter' and what we consider to be reasonable discretion that firms should be permitted to exercise, the section on model fees and the highest management fee should be less prescriptive.

The Guidance Statement should recognise the substantial prevalence of product divisions according to investor types. Firms should be allowed to select fee scales on the basis of the intended recipient of the marketing presentation, thus avoiding a retail-based model fee being disclosed on a composite report intended for institutional investors. We suggest language along the lines of "…..highest investment management fee incurred by the portfolios **that is relevant to the status of the intended recipient of the composite report provided it is known by the firm**".

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