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Practice Groups:

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GIPS Guidance Statement on Alternative Investment Strategies and Structures

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On May 18, 2012, the CFA Institute's GIPS Executive Committee, governing body for the Global Investment Performance Standards ("GIPS"® or "GIPS Standards"), formally adopted the "Guidance Statement on Alternative Investment Strategies and Structures" (the "Guidance Statement"), which becomes effective on October 1, 2012. The Guidance Statement is primarily intended to address difficulties that arise in applying the GIPS Standards to non-traditional asset classes; however, firms that claim compliance with the GIPS Standards must comply with the new guidance for all of the firm's composites regardless of the asset classes the firm manages.

The Guidance Statement includes guidance on the following topics:

- Firm definition;
- Composite construction;
- Input data;
- Valuation (methodology, frequency and estimated valuation);
- Performance calculation (fees and expenses for fund of funds and master-feeder structures);
- Side pockets (composite construction and performance); and
- Disclosure (risks and benchmarks).

This alert summarizes the key, high-level guidance principles contained in the Guidance Statement.[1]

Fundamentals of Compliance

Firm Definition

The Guidance Statement advises that in situations where it may be difficult to assess whether a particular portfolio should be included in the definition of the firm (*e.g.*, where a firm manages alternative investment portfolios or other portfolios that involve complex legal arrangements), firms must apply a "substance over form" principle, as it would be inappropriate and against the ethical spirit of the GIPS Standards to make use of formal legal structures to avoid inclusion of certain portfolios or assets in the definition of the firm.

[1] Firms must keep in mind that compliance with the GIPS Standards is subject to all applicable Securities and Exchange Commission ("SEC") and Financial Industry Regulatory Authority ("FINRA") rules and guidance, which are not discussed herein, and which will override the GIPS Standards and guidance where contradictory positions exist. The SEC regulates investment adviser performance presentation and advertising under Section 206(4) of the Investment Advisers Act of 1940, Rule 206(4)-1 thereunder, and numerous no-action letters, enforcement actions and other public statements. Similarly, FINRA regulates performance presentation and advertising in its Conduct Rule (NASD Rule 2210), Notices to Members and enforcement actions.

The Questions & Answers section of the Guidance Statement also provides that where a firm acts as an investment sub-adviser to a foreign fund that is managed by a third party who is theoretically free to follow the firm's advice or not, the firm definition should be based on the "substance over form" principle. The Guidance Statement states that in the preceding situation, if the firm can demonstrate that it effectively exercises discretionary investment management and can provide documented evidence that all investment advice has been implemented accordingly, it must include the foreign fund in the firm definition.[2]

Composite Construction

Strategies with Unique Defining Characteristics

The customization of alternative strategy portfolios can often present difficulties with respect to composite membership and assignment. The Guidance Statement advises that when constructing composites for alternative strategies, a firm should assess: (1) whether an alternative investment vehicle may be included in an existing composite; (2) whether it can be grouped with other alternative (or traditional) vehicles for a new composite; or (3) whether a separate single-portfolio (*e.g*., fund) composite should be created. The firm should consider the following factors, among others, when constructing alternative composites:

- investment mandate, objective, or strategy;
- concentration and/or degree of diversification;
- leverage; and
- risk objectives.

In addition, the Questions & Answers section of the Guidance Statement provides a composite construction example relating to Liability Driven Investment ("LDI") strategies for pension fund clients, particularly in the case of an actively managed bond portfolio with a swaps overlay.[3] The Guidance Statement advises that composite construction should be based on the strategy that the firm has been hired to manage. If the firm has been hired to manage the entire LDI strategy (including both fixed income and the swap overlay), the entire portfolio must be included in the composite. If the firm has been hired as a fixed income manager but implements a swap overlay strategy according to client instructions, the firm may treat the overlay portion of the strategy as non-discretionary and exclude it from the composite. This is similar to how GIPS treats overlay strategies in a Multiple Strategy Portfolio or similar program.[4]

Consistent with the GIPS Standards, the Guidance Statement reminds firms that all of a firm's actual, fee-paying discretionary portfolios must be included in at least one composite.

Inclusion of Hypothetical Back-Tested Performance

Firms are permitted under the GIPS Standards to present simulated, model or hypothetical back-tested performance as supplemental information. The Guidance Statement advises firms that where a fund or

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[2] *See,* Guidance Statement, Question & Answer 4.1.2.

[3] *See,* Guidance Statement, Question & Answer 4.4.4.

[4] *See,* GIPS 2010, introductory text to Standard 8; GIPS Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios (effective Jan. 1, 2011).

portfolio includes derivatives/leverage, presenting performance of only the “unleveraged” portion of the portfolio is considered to be hypothetical performance.[5] Performance of only the unleveraged portion must not be included in a composite (*i.e.*, the entire portfolio must be included) but may be presented as supplemental information, consistent with the GIPS Guidance Statement on the Use of Supplemental Information as well as with applicable rules and regulations. Alternatively, if the use of derivatives is non-discretionary, the non-discretionary derivatives positions can be removed from the portfolio entirely and their contribution to return excluded.

Master-Feeder Structures – Composite Construction

The Guidance Statement recognizes that firms managing master-feeder structures may have difficulty determining which level of the fund structure is relevant for composite inclusion. For traditional asset classes, a composite should include the fund in which a prospective client may actually invest. However, the Guidance Statement recognizes that in master-feeder structures, it may be more appropriate in some instances to instead include the master fund in the composite. In determining what level of the structure to include in the composite, the Guidance Statement advises firms to consider:

1. the level of the investment structure that is effectively subject to investment management decisions; and
2. the level of investment structure in which prospective clients can effectively invest.

Most importantly, the Guidance Statement gives firms latitude to determine the appropriate investment level to include in the composite (provided that assets are not double-counted). The firm must document its policies and procedures for determining the appropriate level of the structure to include in the composite, and must apply such procedures consistently.

Input Data

The current GIPS Standards require that when accounting for investment transactions, assets/liabilities must be recognized on a trade date basis (T+3 is sufficient) and not on a settlement date basis.[6] The Guidance Statement acknowledges that hedge fund subscriptions and/or redemptions often cannot be recognized within three days of the transaction because the fund administrator’s confirmation may be provided only several days or even weeks after the subscription/redemption trading order has been submitted, and the final quantity and settlement price is not known until the administrator’s confirmation has been received.

For alternative investments, firms may need to differentiate between the date of placing a subscription/redemption order and the date of the effective asset ownership transfer. The Guidance Statement states that the date of the execution or transfer of ownership will be considered the “trade date” for GIPS purposes, notwithstanding that such date may be, and often is, more than three days following the submission of a subscription for such investment.[7]

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[5] *See,* Guidance Statement, Question & Answer 4.3.1.

[6] *See,* GIPS 2010, Standard 1.A.5; Glossary (Definition of Trade Date Accounting).

[7] *See*, Guidance Statement, Question & Answer 4.2.1.

Valuation Methodology, Frequency, and Estimation

Methodology and Frequency for Valuation of Illiquid Investments

For periods beginning on or after January 1, 2011, portfolio valuation must comply with the definition of fair value included in the GIPS Valuation Principles and valuation hierarchy, and firms must disclose if a composite's valuation hierarchy materially differs from the GIPS valuation hierarchy.[8] The Guidance Statement makes it clear that this requirement is equally applicable to alternative investment valuation.

Notably, however, the Guidance Statement recognizes that for some alternative investments, market prices may not be readily available on a monthly basis and/or at the time of large cash flows due to an investment's illiquidity, lack of transparency in underlying funds or because the pricing source provides valuations on a less frequent basis. In such cases, the Guidance Statement permits firms to value portfolios on a less frequent than monthly basis (but no less frequent than annually).

The Guidance Statement contains specific guidance in a fund of funds context, noting that the subscription and redemption cycles of the underlying fund (*i.e.*, when such funds must necessarily determine value) may determine the frequency of the firm's valuations for a fund of funds. Firms must disclose if they valued portfolios less frequently than monthly. The GIPS Standards provide similar flexibility with respect to valuation frequency for other types of illiquid investments. For example, the GIPS Standards require that real estate investments be valued at least quarterly, and require that private equity investments be valued at least annually.[9] The firm must adopt appropriate valuation procedures for determining fair value on a less frequent basis than monthly, and must apply such procedures consistently.

Similarly, the Guidance Statement permits the use of estimated values for alternative investments where final valuations may not be available provided that the firm has adopted composite-specific valuation policies and procedures for determining estimated value. The GIPS Standards provide similar relief in the private equity context.[10] The Guidance Statement provides three possible scenarios in the fund of funds context for how a firm may determine value using the estimated values of underlying funds:[11]

> (1) Produce a compliant presentation on a timely basis using the estimated value to determine fair value after making a determination that estimated value is a reliable basis for determining fair value, based on an established and documented process for determining estimated value. Firms must disclose that performance reflects estimated values, including the percentage of composite assets for which estimates are used and any other information necessary or appropriate to enable the recipient to evaluate the performance presented.
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> (2) Produce a compliant presentation on a timely basis using last available historical final values to determine fair value.

[8] *See*, GIPS 2010, Standard 1.A.2; Valuation Requirement 8.

[9] *See,* GIPS 2010, Standard 6.A.2 and 7.A.2.

[10] *See*, GIPS Guidance Statement on Private Equity (effective Jan. 1, 2011), discussion regarding GIPS Standard 7.A.1.

[11] Although the Guidance Statement provides specific examples with reference to funds of funds, we believe the same principles regarding the use of estimated values apply to illiquid investments generally. Private equity and real estate assets are also subject to the GIPS guidance statements specific to such asset classes.

(3) Produce compliant presentations with a time lag only after final valuations have been received.

Performance Calculation – Fees and Expenses

The Guidance Statement reaffirms that the GIPS Standards permit composite returns to be presented on either a gross-of-fees or net-of-fees basis, so long as the returns are clearly identified as such. For a fund of funds, net composite returns must reflect the deduction of the fund of funds' fees and expenses in addition to any fees and expenses charged at the underlying fund level that are passed through to the investor. Similarly, net-of-fees returns for master-feeder funds must reflect any fees and expenses charged at the feeder-fund level.

Firms may present performance gross or net of fees.[12] When presenting returns for a fund with multiple classes of shares or a composite strategy with multiple portfolios, net-of-fee returns must generally either: (1) reflect all actual fees from all share classes, series and portfolios; or (2) deduct a model fee that reflects the highest investment management fee incurred among all share classes, series and portfolios in a composite.[13]

However, the Guidance Statement acknowledges that where portfolios in a composite are subject to both asset-based and performance fees, it may be impossible to determine which investment management fee is the highest among all portfolios in a composite. In such cases, net-of-fee returns may reflect deduction of the highest model fee applicable to the specific prospective client or intended recipient of the compliant presentation so long as the net-of-fee returns presented are no higher than the returns that would have been presented had actual fees been used. The Guidance Statement acknowledges that the highest model fee for prospective clients may differ, resulting in the creation of multiple GIPS-compliant presentations for the same composite.[14]

Side Pockets and Illiquid Investments

Many alternative investment strategies utilize "side pockets" to segregate illiquid investments or assets held for a special purpose from other investments. The existence of side pockets can create difficulties in composite construction and performance calculation. Typically, only investors in a pooled fund at the time the side pocket is created are entitled to the side pocket's returns. Further, investors may not be able to redeem assets held in a side pocket until after the side pocket is liquidated. The Guidance Statement clarifies that the treatment of side pockets differs depending on whether the side pocket is discretionary or non-discretionary; however, whether discretionary or non-discretionary, a GIPS-compliant presentation must disclose the existence of side pockets. For composite strategies that intend to invest in illiquid assets, the Guidance Statement adds a requirement to specifically disclose such intent.

Discretionary Side Pockets

For single-fund composites that include discretionary side pockets – that is, side pockets created for investment purposes at the discretion of the adviser – composite performance must be presented both including and excluding the side pocket, despite the fact that a potential investor may not participate in

[12] *See*, GIPS 2010, Standard 5.A.1.b.

[13] *See,* Guidance Statement, Section 2.3.1; Question & Answer 4.4.1.

[14] *See*, *id*.

the side pocket. This reflects that: (1) the potential client has an interest in performance excluding the side pocket because the investor will not participate in the side pocket's performance; and (2) the potential client still has an interest in the composite's overall performance history. Where the composite includes more than one account, discretionary side pocket performance must be included, but performance excluding such performance is not required.[15]

Non-Discretionary Side Pockets

Where a side pocket (or particular assets included in the side pocket) is non-discretionary – that is, the adviser no longer has investment discretion over the side pocket or particular assets in the side pocket – the side pocket must be excluded from the composite. Noting that illiquidity alone is not a sufficient basis for determining that a side pocket is non-discretionary, the Guidance Statement contains specific guidance for determining when a side pocket is non-discretionary. Specifically, a side pocket may only be classified as non-discretionary where all of the following criteria are met: (1) it is segregated into a separate sub-portfolio; (2) its assets are no longer considered in the fund asset allocation and investment process; (3) there are no investment decisions for the side pocket assets (other than monitoring and liquidating); and (4) side pocket assets are subject to no (or reduced) investment management fees.

Conclusion

The Guidance Statement provides valuable insight and guidance into how firms claiming compliance with the GIPS Standards should apply the standards to alternative investments and non-traditional investment structures. However, the guidance should not be viewed in a vacuum. Firms managing traditional asset classes also need to reconsider certain aspects of performance presentation and reporting in light of the Guidance Statement. In addition, firms must be mindful that where the GIPS Standards conflict with applicable SEC and/or FINRA rules and guidance, the firm must comply with the rules of the regulatory authorities to the extent they impose stricter requirements than those imposed by GIPS.

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[15] *See*, Guidance Statement, Section 2.4.3.

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