

April 16, 2003

Jonathan Boersma  
Vice President, Standards of Practice  
Professional Standards & Advocacy Department  
RE: GIPS Venture Capital and Private Equity Provisions  
Association for Investment Management and Research (AIMR)  
560 Ray C. Hunt Drive  
Charlottesville, VA 22903

Dear Mr. Boersma:

The Committee on Investment of Employee Benefit Assets (CIEBA) is the voice of the Association for Financial Professionals on employee benefit, plan asset management and investment issues. CIEBA members represent more than 120 of the country's largest pension plans. Members manage some \$700 billion in defined benefit assets and around \$440 billion in defined contribution assets on behalf of 16 million participants and beneficiaries. As such, CIEBA welcomes the opportunity to provide our comments to AIMR on the draft of your document "The Addition of Venture Capital and Private Equity Provisions and Guidance to the Global Investment Performance Standards (GIPS)".

We are generally pleased with this first attempt to add guidelines for the valuation of private equity investments and the presentation of investment returns for the asset class. Our primary comment is that this valuable contribution can be made more so by modifying the emphasis of these standards to focus on valuation methodologies. Performance standards are neither meaningful nor relevant if the valuation bases upon which they report are problematical. In part, this can be addressed by rearrangement rather than renovation: the Venture Capital and Private Equity Valuation Principles section of the draft, currently in Appendix A, should become the centerpiece of the document. Beyond that, however, the document's valuation guidelines should be expanded and strengthened; there are currently no valuation standards in the United States similar to those promulgated by the British Venture Capital Association (BVCA) and the European Venture Capital Association (EVCA), which are widely and consistently applied throughout the industry overseas. For this reason, AIMR is in a position to move the industry towards adopting a set of principles that will become the de facto standard in the U.S. Although providing guidance for quantitative performance reporting is useful, CIEBA feels that filling the standards gap is a much more critical issue for AIMR, one which would provide immense value to investors in private market vehicles.

Our detailed input follows.



## **General Comments:**

Our main recommendations:

1. As referenced above, it is our observation that the discussions in the document pertaining to valuation methodology generally lack depth and comprehensiveness. Valuation methodology should be the main focus of this document.
2. To that end, the main points appearing under “Additional Considerations” in Appendix A should be shifted to form the first section (7A) of the main document. The mechanics of returns presentation would then follow as Section 7B, and “Recommendations” would form Section 7C. The Interpretive Guidance section should be similarly rearranged. This approach would be consistent with previous efforts by the BVCA and the EVCA.
3. Language throughout the draft should be tightened to clarify meaning of key terms.
4. A distinction should be made throughout the document between investments in established entities (buyout) and those in venture capital. The valuation and performance standards that make the most sense in each case are not identical.
5. In order to ensure that these standards become industry practice, it is recommended that AIMR vigorously solicit comments from leading venture capital and private equity firms, as well as those offering fund of funds vehicles before finalizing these standards.

Below are more specific comments on the document.

## **Summary of Proposed Venture Capital and Private Equity Provisions for the GIPS Standards:**

Pg 2: How is compliance with the rules enforced? What does the limited partner do if the private equity firm is non-compliant or goes from compliant to non-compliant? Presumably, the partnership will no longer be able to cite their reporting as “AIMR compliant”, and that absence may be sufficient, if having an AIMR compliant presentation becomes the industry standard. However, are other measures contemplated, such as a complaint review/censure procedure of some sort?

## **Calculation Methodology Requirements:**

In general, we agree with the proposed calculation methodology requirements, but suggest the following:

Sec. 7.A.3. Since Inception Internal Rate of Return (SI-IRR) is the appropriate return calculation for venture capital and private equity investments. However, the annualized SI-IRR should be calculated using **monthly** (not daily) cash flows, along with the period-end valuation of the unliquidated remaining holdings (residual value or net asset value).

Sec. 7.A.4. This definition should be changed; net-of-fees returns must be net of Investment Management Fees, **Expenses**, and Carried Interest. Fund Expenses should be a defined term and added to Appendix B. Expenses are expenses incurred at the fund level and charged to the fund, other than management fees (e.g., legal expenses, accounting expenses).

Since Carried Interest is included as part of the return calculation, it should also be specified that there is a requirement for a “clawback” to ensure that the Carried Interest amount, and hence payments to the General Partner, have not been overstated. As well, this point should be added to the Principles section (i.e., the Appendix A material that should be moved up).

### **Composite Construction Requirements:**

Sec. 7.A.6. “Strategy” is not a defined term, and should be. What level of detail in sub-classifications (buyout, venture capital, mezzanine, distressed, etc.) is recommended?

### **Disclosure Requirements:**

In general, we agree with the disclosure requirements but recommend the following additions and modifications:

- We recommend adding the requirement that firms disclose **returns** for all composites when providing results to investors for each investment strategy provided. A public equity manager’s performance is often judged over several time periods. Therefore, a private equity manager should be required to provide returns for all composites, closed or currently active, within the same strategy in order for investors to judge performance.

Sec. 7.A.8. “Vintage Year” should be capitalized as a defined term, referencing the Appendix B Glossary of the document.

Sec. 7.A.11. Firms must disclose the total committed capital (capital the Limited Partners agreed to provide upon subscription to the partnership) **for each composite.**

Sec 7.A.12. Add: **“If local or regional guidelines are utilized, any significant differences between the application of the regional guidelines and GIPS valuation principles in valuing a portfolio company should be stated.”**

Sec. 7.A.15. Prior to the existing sentence add: **“Firms must utilize an appropriate benchmark and disclose the nature and source for the benchmark (e.g., Venture Economics vintage year median IRR)”.**

## Presentation & Reporting Requirements

Overall, we agree with the presentation and reporting requirements as shown, but recommend the following additions and modifications:

- Sec. 7.A.16: The “Net-of-Fees” definition (in the parentheses) should be modified to read: “(net of Investment Management Fees, Expenses and Carried Interest)”. As mentioned above, net of fees returns should also be net of expenses incurred at the fund level and charged to the fund (i.e. legal expenses, accounting expenses). Gross returns on realized investments should be added as a required reporting item.
- Sec. 7.A.18.a: The definition of “Investment Multiple” is the same as “Total Value to Paid-In-Capital (TVPI)” and is therefore redundant. One of these should be removed from the reporting requirements in this section as well as from page 14, with the sole “survivor” only appearing in Appendix B.
- Sec. 7.A.18.b: The definition of “Realization Multiple” as “ending market value less unrealized appreciation to paid-in-capital” appears to be incorrect. This equates to the cost of remaining investments to paid-in-capital, a seemingly meaningless ratio. On page 14, the Realization Multiple is correctly defined as a measure of distributions from the investments compared to the capital under management, but the formula described for calculating this ratio is incorrect. The Realization Multiple should be distributed capital to paid-in-capital, which is the same as the term defined as “DPI” included in Sec. 7.A.18.d.

## Presentation and Reporting Recommendations

- Sec. 7.B.1.: The periodicity of valuations as “at least quarterly” is fine, but an annual audit should also be stipulated. Note that the quarterly periodicity mandated here seems inconsistent with the Interpretive Guidance on page 10 (Input Data), second paragraph, third sentence and with Appendix A (Valuation Principles), point 6, both of which only call for annual valuations (see below).
- Sec. 7.B.2: The average and median investment size for the composite should be reported.

## Interpretative Guidance

- We recommend adding the following modifier, on page 8 in the fourth paragraph: “Most funds now require at least a nominal one percent investment by the General Partner.”
- On page 9, second paragraph, second sentence, the following clause should be added: “The investment management fee is typically charged on the total capital (delete “assets”) committed to the fund during the investment period.” Delete the rest of the sentence and add the following sentence: “After the investment period, this fee is often charged on the net invested capital remaining in the fund”.

- With reference to page 10, second paragraph, last sentence: it is hoped that the GIPS standards are designed for more accurate reporting of performance to existing clients (limited partners) as well as prospective clients. As such, the final sentence of this paragraph seems to be an unnecessary limitation of scope. The overvaluation of portfolios can overstate the private equity asset allocation of a current investor as well, and thereby affect future investment initiatives. *This is a key reason for CIEBA’s abiding interest in these guidelines.* This point was raised emphatically by several of our reviewing members; clearly, performance measurement is not intended to be solely in the service of selling.
- Regarding the second Input Data paragraph on page 10: we feel that this section could be strengthened by specifying that funds that do not provide quarterly valuations not be allowed to revalue upward during any intra-reporting period. Increases and decreases in value because of contributions and distributions should still be taken into account, however. Alternatively, these Standards could be altered to require quarterly valuations, rather than annual (see above under Section 7.B.1 and below under the comment on page 16 of Appendix A).
- As part of the overall document rearrangement, the section on IRR calculation on pages 10-12 should be moved to an appendix.
- On page 12, in addition to the required disclosures mentioned, firms should be required to disclose the amount of carried interest received to date and the amount of carried interest available based on the current carry value of portfolio holdings. If carry has been overpaid, firms should be required to explain how and when the limited partners will be recompensed (see above under Section 7.A.4 – “clawback”).
- Again on page 12, with respect to the last sentence of the first paragraph at the top of the page, note that this statement may not hold for a fund of funds advisor that also manages and liquidates partnership stock distributions, which would add another layer between net and gross. Furthermore, there are funds of funds that charge a carried interest, which this sentence does not address.

### **Appendix A: Venture Capital and Private Equity Valuation Principles**

As discussed above, CIEBA recommends that this section be moved to form Section 7A of the Principles. We feel this is the critical area in which guidance and rules are required. In general, we agree with the GIPS Valuation Principles as stated, but wish to make the following recommendations:

#### Valuation Principles

Pg 16: Under point 6: Valuations should be performed at least **quarterly and audited annually** (per Sec. 7.B.1).

It is recommended that the term “qualified person or entity” be clarified.

## Fair Value Recommendation

In general, this discussion would benefit from more specificity and/or should include illustrative examples. Furthermore, although it may be beyond the purview of this document, the formation of an advisory committee of investors to review proposed valuations and procedures could be included here as a recommendation. Other suggestions:

Pg 16: **Section 1. Market transaction:** The term “recent” should be defined. A modifier should be added in order to clarify that the “material investment” is being made by the third party **at arm’s length**. The EVCA guidelines address this issue.

Pg 16: **Section 2. Market-based model:** The meaning of “more accurate and meaningful valuation” should be defined. Valuations are by their nature not precise. The market-based method should be the preferred method for valuing buyouts and investments that generate positive earnings and/or cash flow. In other words, it should be pointed out explicitly that without positive cash flow or net income, the market-based model cannot be used (only the market transaction model). Moreover, cash flows from funds may not be as clean as is presented in the document. Some discussion on this subject may be warranted, such as in the case of non-cash contributions and distributions.

In general, this section could be much more extensively defined. For example, a listing of examples of acceptable methodology for valuation could be provided, and a statement requiring that the Investment Manager specify the method used could be added.

## Additional Considerations

Pg. 17.1. We recommend flatly ignoring third party transactions that are largely strategic in nature instead of the use of the phrase “consider ignoring” and the allowing of the procedure of “applying an appropriate discount”.

Pg. 17.2. We agree with changes from the EVCA guidelines, to wit, the deletion of the word “permanent” in describing the diminution in the value of an investment and the addition of “**quoted** market conditions”. Furthermore, we would suggest two additional factors that could result in a material value diminution of an investment: *industry conditions* (e.g., weakness in the portfolio company’s environment, the strengthening or the entry of potential competitors), and *liquidity* (the requirement for, likelihood and timing of additional capital that may be required).

Pg. 17.3. Extreme caution should be recommended in applying actual entry multiples paid for the investment to the investment’s last trading figures, due to the lack of independence of source valuation.

To those listed in this section, we recommend adding the following considerations:

- Appropriate adjustments should be made to enterprise level valuations to arrive at the valuation of the security in question, i.e. adjusting for debt and cash on the balance sheet.
- All valuations should be adjusted to account for realistic dilution which will occur on the conversion of ratchets and options.

- Publicly traded investments should be valued on the basis of the quoted price on the last day of trading in the valuation period to which discounts should be applied for illiquidity, lockups, etc. A level of discount should be applied to all publicly traded investments regardless of the situation. Larger discounts should be taken for investments that are large in comparison to trading volume. For quoted investments subject to lock-ups, a minimum discount of 25% should be applied to investments with lock-up periods longer than 90 days.
- We recommend an additional requirement to the effect that upward revisions not be permitted within the first twelve months after investment.

### **Venture Capital and Private Equity Glossary**

- Definition of Limited Partnerships: “**Governance**” should be added to items covered in the Agreement.
- Definition of Paid-in Capital: Remove “venture” or replace it with “private equity” in this definition, since paid-in capital applies to all private equity funds, including venture capital.
- Definition of Private Equity: Since the definition of private equity includes venture capital, the use of the phrase “Venture Capital and Private Equity” here, and indeed, in the title of the overall document as well, appears to be redundant and could be misleading.
- Definition of Realization Multiple: As discussed earlier, this definition appears to have little meaning as defined. We also were not able to arrive at the calculations for Realization Multiple used in the Sample Presentation in Appendix C.

This is the extent of our comments on the draft. Representatives of CIEBA would be happy to consult or meet with members of the Professional Standards and Advocacy Department of AIMR to discuss any and all of the above at greater length. Please contact Ms. Judy Schub of CIEBA (301-961-8682; [jschub@afponline.org](mailto:jschub@afponline.org)) if CIEBA can be of further assistance as the drafting process continues.

Sincerely,



Gary A. Glynn

Chairman

Committee on Investment of Employee Benefit Assets