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Swiss Private Equity & Corporate Finance Association
Schweizerische Vereinigung für Unternehmensfinanzierung
Association Suisse des Investisseurs en Capital et de Financement

Guidelines for the calculation and disclosure of costs of private market funds[1]

Zug/Zurich, 7 March 2016

1 Principles and objectives

These guidelines concern the calculation and disclosure of the costs of private market funds, such as unincorporated firms (LPCIs according to CISA or Limited Partnerships), SICARs (venture capital firms under Luxembourg law), listed companies with a focus on private market investments or similar investment vehicles ("closed-ended collective investment schemes or CIS"). These guidelines should ensure the consistent implementation of art. 48a OPO 2 on the disclosure of the costs of private market funds and, thus, the highest possible transparency on the costs of private market funds in the Swiss market.

In substance, the present guidelines are based on the Swiss Funds and Asset Management Association (SFAMA) guidelines for the calculation and disclosure of the Total Expense Rate (TER) and Portfolio Turnover Rate (PTR) of collective investment schemes dated 16 May 2008, as well as the directive on the reporting of asset management costs of the Oberaufsichtskommission Berufliche Vorsorge (Occupational Pension Supervisory Commission ("OPSC directive")) dated 23 April 2013.

Unlike the TER proposed by the SFAMA, the present guidelines govern the costs only, but are not used in a ratio to the net assets of the investment schemes in question. Such an additional ratio (cost in relation to the net assets) is not required by the above-mentioned legal provisions.

On the other hand, these guidelines shall not prevent the additional disclosure of such a ratio, either based on the net asset value or the capital commitments (as preferred by the SECA). The calculation of the TER according to the OPSC directive must be based on the net asset value of the CIS as of the reporting date of the calculation.

[1] Comprises, among others, private equity, private infrastructure, private real estate investments and mezzanine financing

2 Principles

2.1 Total Expenses ("TE")

The remuneration and costs in connection with the administration of a private market fund comprise the total of all remuneration and costs charged against a fund's assets on an on-going basis (operating expense); usually, such items are calculated retrospectively.

TE are calculated annually on the basis of the latest audited financial statements available.

The costs disclosed in the income statement of the private market fund are the basis for the calculation.

This applies to funds for direct investments as well as funds of funds.

2.2 Operating expense

TE include all costs charged to the private market funds in the reporting period; an economic cost concept is the basis of the guidelines, e.g.

- Management fees of the general partner, potentially reduced by income from transaction and consulting fees, provided these were credited to the fund or the investor.
- Carried interest or other performance-based fees of the general partner.
- Costs of any administrators and of any depositories / custodians.
- Other expenses, depending on the structure of the income statement, not included in the above items, such as:
  - Administration fees/costs,
  - Distribution fees/costs,
  - Charges for supervision of the fund for private market investments,
  - Costs of calculating the net asset value,
  - Publication costs,
  - Auditor fees,
  - Legal expenses,
  - Other expenses, taxes and expenditure related to the fund.

In principle, the operating expenses correspond to the expenditure side of the income statement of the fund, excluding negative investment income (e.g. interest expenses, currency hedging costs). Costs included in operating expenses may not be offset against investment income.

3 Exceptions

3.1 Composite (synthetic) TE from purchase of units in other private market funds (target funds)

If, in its capacity as a fund of funds, a private market fund invests at least 10% of its net asset value in other private market funds (target funds), a composite (synthetic) TE for the fund of funds must be calculated. This corresponds to the sum of the pro rata TE of the individual target funds, weighted according to the portion held by the fund of funds (measured against the NAV) as of the reporting date, plus the TE of the fund of funds.

If a target fund does not disclose its TE in accordance with these guidelines, the TE shall be determined as follows:

- The TE shall be determined based on the latest available audited financial statements of the target fund in accordance with these guidelines.
- If the income statement is not sufficiently detailed to allow such a calculation to be made, the disclosed total costs (e.g. total expenses, operating costs or similar) may be used for the calculation.
- The TE of a target fund may be estimated, especially in the following cases
  - if no audited financial statements are available, and
  - if a target fund represents less than 5% of the NAV of the fund of funds and it is possible to calculate the TE of at least 50% of the target funds (measured against the NAV of the fund of funds).

The estimation method should aim to create cost transparency and, when in doubt, it should be based on conservative assumptions. For cost and fees required by these guidelines, it is permissible to rely on the costs and fees specified in the contractual documents, complemented by additional empirical data. The estimation method must be disclosed.

The TE of one or more target funds may be extrapolated if it is possible to calculate the TE of at least 75% of the target funds (measured against the NAV of the fund of funds). An extrapolation of an unknown TE is only permissible for target funds, which individually represent less than 5% of the NAV of the fund of funds.

3.2 First-time publication of the TE for newly founded private market funds

For newly founded private market funds, the TE are calculated initially based on the income statement published in the first audited annual financial statements. If the first annual financial statements are not yet available, the TE may be estimated (for estimation methods, see section 3.1).

3.3 Private market funds with multiple unit classes

If private market funds charge different fees and costs for individual unit classes, the TE must be calculated separately for each unit class on the basis of the income statement relating to the respective unit class concerned.

4 Publication and audit of the TE

For private market funds set up domestically, the TE have to be published in the annual financial statements or be specifically communicated to investors.

For private market funds set up abroad, the domestic representative, for example, may calculate the TE in accordance with these guidelines and make it available to Swiss pension funds. The latter are free to calculate the TE themselves or engage an external service provider (e.g. investment advisor, asset manager) to do so.

Domestic and foreign funds must have the TE calculation audited by an audit firm. The auditors confirm to the Swiss pension funds that the published TE has been calculated and audited in accordance with the requirements set out in these guidelines.

5 Other provisions

These guidelines were approved by the SECA Executive Committee on 7 March 2016. They enter into force as of the date of their approval by OPSC.

Zug/Zurich, 7 March 2016

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Notes to the guidelines for the calculation and disclosure of the costs of private market funds

1 Introduction

Collective investment schemes (CISs) in private markets have specific characteristics compared with CISs with exchange-listed instruments; such characteristics have to be considered in the calculation of the TE.

With their approval by the OPSC, the guidelines for Swiss pension funds should serve as a standard for the disclosure of the costs of their collective private market investments.

Listed private-market firms do not have to disclose their TE unless they are subject to a domestic or international fund supervisor (see section 2.1 of OPSC directives dated 23.4.2013; hereinafter "the Directives").

The OPSC, as the regulatory body, recognises the SECA guidelines as the minimum standard for all private market funds; in this respect, they are mandatory, as compliance with them enables the Swiss pension funds to qualify these funds as cost transparent in accordance with art. 48a OPO 2.

For the purposes of publishing the costs calculated on the basis of the above-mentioned legal provisions, it is recommended that Swiss pension funds use the TE calculated and made available to them in accordance with the SECA guidelines. It should be noted that a Swiss pension fund should only use the pro rata TE corresponding to such pension fund's share in the respective CIS. A pension fund's share of the TE of a CIS can be calculated based on the share of a CIS held by such pension fund as of the reporting date of the calculation. A CIS must confirm this share (as a percentage of the total size of the CIS) to the pension fund within a reasonable time after the reporting date of the calculation of the TE.

As mentioned, the user is free to additionally express the costs thus calculated as a ratio of the assets under management. If the latter is calculated based on the net asset value, the result represents the TER as defined by the SFAMA, which is usually used with regards to traditional investments. Given that the net asset value of closed CISs, according to the SECA, leads to distorted or even, in some cases, impracticable results, the SECA prefers to calculate the relevant assets based on the total capital commitments[2]. The OPSC prefers the calculation based on the net asset value because, among other reasons, it enables comparisons with conventional investments.

[2] Management fees levied on private market funds are usually calculated as a percentage of the capital commitments from investors to the funds. While the net asset value of a private market fund varies widely over its lifetime, the capital commitments remain constant for most of the fund's lifetime. The calculation of the TER for a private markets fund must be performed on the basis of audited figures. Such figures are usually only available after a significant delay following the end of the financial year in question; in particular, Swiss pension funds regularly have them available more than four months after the end of their own financial year. To comply with the OPSC directive, pension funds must use the TER calculated in accordance with such directive for the purpose of calculating costs effectively incurred within private market funds. As such TERs are not available in a timely manner, pension funds may use TERs whose reporting date may be up to 18 months prior to the end of the pension fund's financial year under review. Hence, the outcome is that pension funds regularly use the TER based on an up to 18-month

2 Notes on TE

a. Total Expenses, variables, periodicity

The TE are calculated annually on the basis of the latest available audited financial statements. According to the Directives, the cut-off date may be a maximum of 18 months after the balance sheet date of the pension fund concerned.

Example

Situation:

- Balance sheet date of recipients of the calculation: 31.12.20X5
- Currently available audited financial statements: 31.12.20X4

Operating expenses from available audited financial statements according to art. 2.2 SECA guidelines:

Management fees:	CHF	1,000k
Carried interest:	CHF	1,500k
Administrator and depository/custodian costs:	CHF	80k

- Other expenses, depending on the structure of the income statement and provided they are not included in the above items:

Administration fees/costs:	CHF	10k
Distribution fees/costs:	CHF	25k
Charges for supervision of the funds for private market investments:	CHF	10k
Costs of calculating the net asset value:	CHF	15k
Publication costs:	CHF	18k
Audit costs:	CHF	35k
Legal advice costs:	CHF	50k
Total operating expenses	CHF	2,743k

- TE in CHF according to art. 2.1 SECA guidelines: 2,743,000

old net asset value and multiply such TER with the net asset value as of the end of the pension fund's financial year in order to disclose the costs effectively incurred. The fluctuations in the net asset value (as described above) combined with the constant management fees leads to an inappropriate calculation of effective costs, which, depending on the circumstances, may or may not be in favour of the pension fund.

b. Pro rata allocation of TE to a pension fund

The audited TE for a reporting period as provided by the CIS to a pension fund, are based in each case on the CIS as a whole. The pro rata allocation of the TE to a pension fund can be readily determined based on the pension fund's percentage share of the entire CIS as reported to the pension fund by the CIS.

Example

Situation:

- TE of the entire CIS in CHF according to art. 2.1 SECA guidelines: 2,743,000
- Share of the CIS held by the pension fund in percent: 15.00

Pro rata allocation of TE to a pension fund:

TE of CIS x pension fund's share

CHF 2,743,000 x 15.00% = CHF 411,450

c. Calculation of operating expenses

The Directives are based on an economic cost concept. Therefore, it is not a question of the name given to the items charged to a private market fund, but what they comprise.

According to the SECA guidelines, management fees or administrative fees may be reduced by income from transaction and consulting fees, as long as these are credited to the fund.

Often, the general partners, especially with regard to funds for direct private market investments, receive various additional fees, in particular for services in connection with a transaction, a sale or IPO, or for consulting services. The portfolio company typically pays these fees to the general partner. If such fees are credited to the fund in full or in part, or are offset against the management or administrative fees, the asset management costs are reduced accordingly. Otherwise, they must be included in the cost calculation.

d. Organisational fees and similar

Typically, this concerns one-off fees and compensation for the set-up of a private market fund and, possibly, its placement. Such fees correspond in many ways to the issuing commission for an investment fund with liquid assets (e.g. equity fund) which are not part of the TE.

If organisational fees are included in the income statement of a private market fund, they may be deducted from the operating expenses because issuing commission is also not a part of the income statement of equity funds.

e. Carried interest

Carried interest is the most common form of performance-based remuneration for the general partner of a CIS in the private market. The general partner is allocated, according to a predefined method, a share of the profit of regularly divested private market investments that exceeds their proportional capital contribution to the CIS. Such an allocation is reflected in in the audited financial statements in various ways, depending on the accounting standards applied by the CIS: in some cases, carried interest is recognised as an expense in the income statement (usually as an incentive fee or performance fee, or as a movement in the accruals for such), while in others it is recorded as an equity transaction (similar to a dividend).

As the performance-based fees of the general partner are considered in the calculation of the TE, carried interest that is recognised in the income statement as well as that recognised as an equity transaction must be considered. In the latter case, therefore, it is not sufficient to rely only on the operating expenses according to art. 2.2 of the SECA guidelines. Rather, the carried interest (according to the further information included in the audited financial statements of a private market CIS) must also be considered. Otherwise, it would not be possible to ensure the objective comparability of the various TE of private market CISs reporting under different accounting standards.

Further, in connection with carried interest, the time component must be considered: the predefined method mentioned in the above paragraph usually includes a clause governing the repayment to the limited partner of profits already allocated to the general partner (‘clawback’). If a clawback clause enters into force, a ‘negative expense’ is created for the private market CIS, i.e. income.

Such potential fluctuations in carried interest correspond to the economic cost principle mentioned previously. Consequently, the income generated from a reduction in the carried interest of the general partner represents a cost reduction that has to be considered in the TE. In extreme cases, therefore, the TE of a private market CIS may be negative.

Example

Situation:

- Balance sheet date and available audited financial statements: 31.12.20X4 and 31.12.20X5
- Audited data as of 31.12.20X4:

- Carried interest allocated	CHF	2,000k
- Other operating expenses	CHF	1,800k

- Audited data as of 31.12.20X5:

- Clawback	CHF	1,500k
- Other operating expenses	CHF	1,950k

<u>TE calculation 31.12.20X4</u>

TE in CHF=2,000,000 + 1,800,000=3,800,000

<u>TE calculation 31.12.20X5</u>

TE in CHF=1,950,000–1,500,000=450,000

Notes to the exceptions

f. Composite (synthetic) TE from purchase of units in other private market funds (target funds)

The majority of target funds held in the portfolio of a private market CIS operating as a fund of funds tends to be foreign companies that report according to recognised accounting standards. Therefore, the TE calculated in accordance with the SECA guidelines and published in the CIS's audited financial statements will be an exception rather than a standard. For this reason, it will often be necessary to provide a synthetic TE calculated according to art. 3.1 of the SECA guidelines to the investing pension fund. Below, we provide a few illustrative examples:

Example 1 (extrapolated according to art. 3.1. SECA guidelines):

A fund of funds is invested in four target funds, none of which discloses TE in accordance with the SECA guidelines. Audited financial statements are available for three of the four target funds; the fund of funds has no other investments apart from in the four target funds. Relevant figures (all in CHF 000s unless indicated otherwise):

Based on the data, the synthetic TE of the fund of funds are calculated as follows:

TE of fund of fund + pro rata TE of target funds (1 + 2 + 3 + 4)

As target fund 4 has no audited financial statements available, but the fund of funds' three remaining target funds represent more than 75% of the NAV of the fund of fund, the TE of target fund 4 are calculated as follows:

TE of target funds 1 + 2 + 3:
TE in CHF=(operating expenses 1 x fund of funds share of target fund 1)+(operating expenses 2 x fund of funds share of target fund 2)+(operating expenses 3 x fund of funds share of target fund 3)=(CHF 2,100k x 15%)+(CHF 1,250k x 8%)+(CHF 800k x 23%)=599,000

Each target fund's share of the NAV of the fund of funds is as follows.

Target fund 1: 32.53%
Target fund 2: 25.33%
Target fund 3: 37.33%

The TE of the target funds 1, 2 and 3 represent a target fund TE of 95.20% of the fund of funds' NAV. Correspondingly, the TE for all target funds are extrapolated to 100% of the fund of funds as follows:

TE of all target funds in CHF=TE of target funds 1, 2 and 3=599,000/95.20%=629,202

Thus, the total TE of the fund of funds is given by the TE of fund of funds + pro rata TE of target funds (1 + 2 + 3 + 4): of CHF:
1,500,000+629,202=2,129,202

Example 2 (estimate according to 3.2 SECA guidelines):

A fund of funds is invested in two target funds. At the level of the fund of fund, the TE are 750,000. Target fund 1, which represents 40% of the NAV of the fund of funds and holds 20% of the unit shares in the fund of funds, discloses TE of 1,200,000 (management fees only). Target fund 2, which represents the remaining 60% of the NAV of the fund of funds and holds 10% of the unit shares in the fund of funds was set up recently and therefore has no audited financial statements available. The contractual documents for target fund 2 specify that each unit holder pays 2% p.a. of its commitments as management fees to the general partner.

The commitment of the fund of funds in the target fund is CHF 50,000k, the NAV of this share is CHF 40,000k. Taking this into account, the TE at the target fund level must be estimated:

Pro rata TE of target fund 1 in CHF= 1,200,000 x 20%=240,000

Estimate of TER of target fund 2 based on the contractual documents:
TE in CHF=2% x 50,000k=1,000,000

Pro rata TE of target fund 2 at the target fund level in CHF:
1,000,000 x 10%=100,000

Thus, the total of the TE are:
TE of fund of funds + pro rata TER target fund 1 + pro rata TER target fund 2 in CHF=
750,000 + 240,000 + 100,000=1,090,000