ACA COMPLIANCE GROUP PERFORMANCE SERVICES

November 27, 2017

CFA Institute
Global Investment Performance Standards
915 E. High Street
Charlottesville, VA 22902

Dear Sir or Madam:

Thank you for allowing us to comment on the Exposure Draft of the Guidance Statement on Overlay Assets (the "Guidance Statement"). We would like to offer the following responses to the questions posed within the Guidance Statement:

<u>Questions posed within the Guidance Statement:</u>

Question 1: Are these examples regarding the determination of discretion appropriate or are additional examples or other criteria needed? If additional examples or other criteria are needed, please explain your suggestions.

We believe that the examples are appropriate but we feel that there should be additional guidance provided about how passive management could be a consideration for deeming assets as non-discretionary. In managing passive hedging programs, managers may buy or sell different currencies in the market to establish exposure levels that have been prescribed by clients and they do not have discretion to deviate from the exposure levels prescribed. Hence, managers that market themselves as active managers would want to deem the passive portion of the portfolio to be non-discretionary and only include the active portion in composites. This is based upon the interpretation of the following sentence from the Guidance Statement on Composite Definition: "In the case of client-restricted securities (e.g., low-cost-basis stocks, held to maturity securities), the firm may choose to classify the restricted portion of the portfolio as non-discretionary (also commonly referred to as "unmanaged" or "unsupervised") and keep the remaining discretionary portion of the portfolio in the composite, provided the remaining portion is representative of the composite's strategy."

Question 2: Are the three "allowable methods" for calculating overlay exposure appropriate?

Although we agree with the three allowable methods, we believe that additional guidance should be provided to address different types of situations. For example, take a situation where a firm manages an overlay strategy with a net swap exposure equal to zero between the pay and receive sides. Another example could be a situation where the overlay manager is unaware of the underlying assets. They are mandated a maximum amount of exposure to take but often times only invest a portion of it. In that situation, how much would be considered in calculating the exposure amount?

Question 3: Are there other methods for calculating overlay exposure that are also appropriate? If so, please explain.

See our responses to Question 2. We believe that there are going to be situations that come up that are not covered by this guidance statement. For these situations, is it acceptable for a firm to define policies & procedures to address the specific situation, assuming the methodology meets the requirement of fair representation and relevant details are fully disclosed?

Question 4: Should the allowable method(s) be required or recommended by strategy type? If so, please propose a required or recommended method by strategy type.

We do not believe that these methods should be required or recommended by strategy type. Furthermore, we believe that the three methods should be recommended approaches, acknowledging that that there are situations that will come up that do not allow for the three approaches mentioned to be used.

Question 5: Are the methods used to calculate the denominator in an overlay portfolio return calculation appropriate?

We agree with the methods used to calculate the denominator but we do not see why all accounts within a composite would be required to follow the same approach. We believe that this should be based on account type. For example, a composite may be made up of funded and unfunded accounts where for some it may make sense to use the underlying assets and for others it may make sense to use either the notional or the target notional. Allowing for different calculations of exposure within a composite based on client type allows for firms to include these different types of accounts within one composite rather than separating them into separate composites.

We would also like to see additional guidance provided for overlay strategies implemented through the purchase of calls and puts (i.e. long calls and long puts). In these situations, often there are no underlying assets, with the exception of a collateral release, and the notional value of the options would not be considered exposure. The investor is not “at risk” for the notional value as their maximum loss is the initial cost of the option. Does this guidance statement apply to this type of strategy? If so, what is the denominator? What is the value of the portfolio?

Question 6: Is the requirement to include collateral income in the overlay portfolio return when the collateral is actively managed appropriate? If not, should this be changed to a recommendation?

We agree that if the management of the collateral is part of a firm's strategy that the income should be included in the return. We believe that they key distinction here is that the management of the collateral needs to be part of the intended strategy. If the manager is managing the collateral as a separate service to the client then the income must not be included. It would be up to the firm and their definition of discretion to determine if the collateral needs to be in a separate composite or deemed as non-discretionary assets.

Question 7: Is the requirement to establish a composite specific policy on the treatment of collateral appropriate? If not, should this be changed to a recommendation?

No, this should not be a composite specific policy. It should come down to whether or not the collateral is part of the intended strategy or not, and if the management of the collateral is a material part of overall return. For example, take a firm that manages two separate accounts to the same strategy but in one account they managed the collateral and in one they do not. If the management of the collateral was considered part of the strategy and represented a material portion of the return then the portfolios should be in separate composites. If the collateral was not managed as part of the strategy then the collateral assets should not be included in the composite. If the collateral is managed as part of the strategy but did not represent a material portion of the account then the accounts could be in the same composite.

Question 8: Do you agree that the returns for overlay portfolios must be geometrically linked when the overlay exposure changes over the time period? If not, please explain what method(s) you believe is appropriate.

We agree that performance must be geometrically linked if the exposure changes for the time period. We think that this should be clarified in that the change in exposure must be due to incorporating the gains and losses from the prior period. A change in exposure that is client directed should be treated differently. Additionally, we would recommend providing additional guidance as it relates to the differences between a fixed and floating denominator.

Question 9: Do you agree that overlay returns must not be geometrically linked when the exposure remains constant, but rather the returns must be calculated as the cumulative profit/loss for the calculation period divided by the denominator? If not, please explain what method(s) you believe is appropriate.

We believe that there should be a recommendation, but not a requirement, to arithmetically link returns when an overlay's exposure remains constant. Requiring arithmetic linking could cause a significant burden to firms as nearly all portfolio accounting systems link performance using the geometric method. Firms would likely need to calculate arithmetically linked returns outside of their portfolio accounting systems, causing an operational burden and potentially decreasing the reliability of performance data due to the higher risk of errors associated with manual calculations. We believe this should be a recommendation and require firms to disclose which method of linking is used.

Question 10: Should text be added to this Guidance Statement recommending disclosure of the sum of (a) total firm overlay exposure and (b) total firm assets, also known as total firm economic exposure?

We think guidance should be added regarding the disclosure of total firm economic exposure which should include guidance provided to managers that control the underlying and overlaid assets. In this situation it could be assumed that the combination of both represent the intended strategy. How would a firm present this type of strategy within a compliant presentation?

Question 11: Are the required disclosures appropriate? If not, please explain.

- Collateral income should only be disclosed if it represents a material portion of the overall account/strategy.
- What would be required to be disclosed when composite assets or firm assets are not presented? Would a firm meet this requirement by simply stating that they are not shown or would they need to disclose why?

Question 12: Is the proposed effective date appropriate or would additional time be needed to implement this Guidance Statement?

We believe that additional time will be needed. This guidance statement is attempting to put required procedures on investment strategies that historically did not have widely accepted best practices. This guidance could result in substantial changes for all firms currently managing overlay strategies. Additionally, the guidance states that a firm is not required to apply this guidance retroactively. In our experience, some firms will choose to apply this guidance retroactively for multiple reasons. As a result, some firms will need to do a detailed review of each of their portfolios to identify the appropriate exposure, the appropriate performance calculation and the appropriate linking methodology. Marketing material will have to be updated as well as institutional consultant databases. Because of this, we recommend pushing the effective date to at least 1 January 2020.

One final recommendation that we would like to make is to remove the sentence that specifically calls the calculation of performance based off of the underlying collateral as "misleading." By labeling it as misleading, a firm would no longer be able to present this information in any format. This may even be interpreted to mean that a firm would be required to retroactively apply this guidance if they have used this as their denominator in the past. Allowing it to be shown as supplemental information is our recommendation.

Thank you for considering our comments.

Sincerely,

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