CFA INSTITUTE COMMENCES GIPS 20/20 INITIATIVE

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Investment Management, Hedge Funds and Alternative Investments Alert

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INTRODUCTION

The CFA Institute GIPS Executive Committee (the "Executive Committee") recently issued a consultation paper related to the commencement of its GIPS 20/20 initiative (the "Consultation Paper").[1] The GIPS 20/20 initiative is an effort to further the mission of the Executive Committee by redesigning the Global Investment Performance Standards ("GIPS" or "GIPS Standards") in a way that is relevant and applicable to all asset managers, regardless of structure, client type, asset class, or investment strategy. In issuing the Consultation Paper, the Executive Committee has provided its thoughts on important potential changes to the GIPS Standards and is seeking feedback from the asset management industry on those positions and the standards more broadly. The Executive Committee intends to release a GIPS 20/20 Exposure Draft by early 2018 reflecting streamlined standards that are as relevant and straightforward as possible, with the ultimate goal of implementing a revised version of GIPS by 2020.

The Consultation Paper offers a series of 13 proposals and requests for feedback (each, a "Proposal") for revising the GIPS Standards, the Executive Committee's current views on the Proposals, and open-ended questions designed to solicit feedback from the industry on the Proposals. Additionally, the Consultation Paper includes a general request for comment on the existing GIPS Standards. We encourage all managers that claim compliance with GIPS, as well as asset owners and other interested parties, to consider the Proposals set forth by the Executive Committee and the impact that they may have on your claim of compliance and your business. The Proposals, taken as a whole, constitute a significant change in the GIPS Standards, which may require GIPS-compliant firms to invest significant human resources and economic capital to achieving compliance with the revised standards. Moreover, the compliance and other burdens presented by the new and modified standards could deter firms considering adoption of the GIPS Standards from doing so. The Executive Committee would also have to reconcile current guidance statements with each of the Proposals, as some Proposals would currently be at odds with previously issued guidance. Comments on these Proposals are due to the Executive Committee no later than July 16, 2017.

PROPOSALS AND CONSIDERATIONS

A brief summary of each of the Proposals is set forth below, along with our thoughts on some additional questions and considerations that asset managers and asset owners may consider as they prepare comments in response to the Consultation Paper.

1. **Structure:** The Executive Committee recognizes that the current focus on the use of composites in presenting performance information may not be relevant to firms that primarily manage pooled investment vehicles. To address this concern, the Executive Committee is proposing that the standards be revised to adopt a "three-pillar" approach to the presentation of performance information:

> Pillar One – one-to-one manager/client relationships, where the presentation of composite performance is appropriate; Pillar Two – one-to-many relationships related to the marketing of interests in a specific pooled fund, where performance of the fund is appropriate; and Pillar Three – one-to-none relationships, where an asset owner has no prospective clients and presentation requirements similar to those currently described in the Guidance Statement on the Application of the GIPS Standards to Asset Owners are appropriate.[2]

Considerations: The reorganization of the GIPS Standards into a three-pillar approach for the presentation of performance information would represent a substantial revision. In evaluating the proposed three-pillar approach, firms should consider whether the proposed pillars provide sufficient clarity and definition. For example, in the proposed Pillar Two, a pooled investment vehicle would be required to present only the performance of the pool in its GIPS-compliant performance presentation; however, the proposal does not address how this approach would apply to single-investor vehicles or "funds-of-one." In responding to the Consultation Paper, firms should consider whether other structures would create similar uncertainty and whether other categories of presentation may be more appropriate. A move to the pillars approach may result in GIPS Standards that are more relevant and straightforward for GIPS-compliant firms, and especially for managers of pooled funds, but a lack of clarity or flexibility in the definitions of the pillars could result in unnecessarily burdensome compliance requirements.

- **Pooled Funds:** One of the stated goals of the GIPS 20/20 initiative is to better accommodate the presentation of performance by pooled funds in a manner that is compliant with GIPS. To achieve this goal, the Consultation Paper proposes to expand upon the concepts in the recent adopted Guidance Statement on Broadly Distributed Pooled Funds (the "Pooled Fund Guidance Statement")[3]. Under the Proposal, firms would be required to present a fund-specific performance report to potential pooled fund investors. This is meant to alleviate the requirement to create single-fund composites presently faced by many pooled fund managers. A pooled fund that meets the criteria of a strategy composite would still be required to be included in that composite; however, the presentation of composite performance information to investors in the fund would not be required. Under the Proposal, the information required to be contained in a pooled fund performance report will depend on whether the pooled fund is broadly distributed and whether it is a closed-end, fixed life, fixed commitment fund where the investment manager controls the cash flows. Pooled fund performance would be presented net-of-fees

  Considerations: When considering how to respond to the proposed treatment of pooled funds under the GIPS 20/20 initiative, firms should evaluate whether the concepts in the Pooled Fund Guidance

Statement sufficiently addressed industry comments provided with respect to the Exposure Draft of the Guidance Statement on Broadly Distributed Pooled Funds,[4] and any implementation issues experienced with respect to the Pooled Fund Guidance Statement. Compliance with the proposed treatment of pooled funds under the GIPS 20/20 initiative may result in operational issues, and the delivery of a specific pooled fund performance report may conflict with the rules or regulations of the Securities and Exchange Commission, self-regulatory organizations such as the Financial Industry Regulatory Authority, Inc., and other regulatory requirements. While we assume that the 2020 edition of GIPS will permit GIPS-compliant firms to comply with local law to the extent it conflicts with the GIPS Standards, we are also of the view that, to the extent possible, the GIPS Standards should align with applicable law and regulation. Furthermore, the delivery of a pooled fund performance report that differs from the information presented in the pooled fund's composite may create investor confusion. Firms may consider whether appropriate disclosure should be mandated by GIPS in such circumstances. Firms may also consider how best to calculate net-of-fee performance reporting for pooled fund structures in which management fees are charged directly to investors rather than to the fund. Lastly, the Pooled Fund Guidance Statement contains a "safe harbor" provision that permits firms subject to certain regulatory regimes that meet requirements of the provision to comply with the content and distribution of pooled fund information requirements in the statement through compliance with the regulatory regime. Firms currently relying on the "safe harbor" provision may wish to seek clarification that it will be maintained following the release of the 2020 edition of the GIPS Standards.

- **Asset-Class-Specific Guidance:** The Executive Committee recognizes that under the current structure, GIPS has specific provisions and guidance related to private equity, real estate, and other alternative investment strategies and structures, which were created primarily as a result of the investment structure (e.g., a closed-end limited partnership). In an effort to streamline the GIPS Standards, it is proposed that asset-class-specific-guidance be consolidated into standards that are based on a vehicle's operating structure rather than the character of its portfolio assets. For example, the current private equity guidance and closed-end fund provisions could be consolidated with other strategies with similar investment structures.

Considerations: In theory, the consolidation of asset-class-specific-guidance will create a more streamlined version of GIPS; however, if the consolidation does not take into account the unique features of individual asset classes, GIPS could become unduly restrictive and lose the ability to capture the specific performance attributes of an asset class. Accordingly, firms should consider whether differences in asset classes may present difficulties in implementing a broader approach. For example, the provisions and guidance related to certain asset classes calls for assets to be valued monthly and at the time of any large cash flows.[5] Certain asset classes (e.g., real estate) cannot reasonably be valued on such a schedule. Any consolidation of asset class-specific guidance should also be sufficiently flexible such that firms can understand and implement appropriate GIPS-compliant processes for new asset class categories that may develop over time.

- **Time-Weighted Rates of Return vs. Internal Rates of Return:** Under the current GIPS Standards, whether a firm is required to present time-weighted rates of return ("TWRR") or internal rates of return

("IRR") depends on the underlying investments in the portfolio. The Executive Committee is proposing that the determination of whether to use TWRR or IRR be based on the portfolio structure. Specifically, it is proposed that open-end funds and composites that include separately managed accounts ("SMAs") would be *required* to present TWRR, whereas closed-end, fixed life, and fixed commitment funds would be *allowed* to present IRR instead of TWRR.

Considerations: In evaluating this Proposal, firms may consider, among other things, whether the performance of certain SMAs with characteristics similar to closed-end funds would be more accurately represented by the use of IRR rather than TWRR, as would be required under the proposal in the Consultation Paper. More generally, permitting firms to consider the underlying composition of a portfolio may result in the presentation of performance that is more meaningful to potential investors, and certain allowances may be necessary for portfolios where the manager is in control of the cash flow. Firms should also consider the costs and operational burden of revising policies related to the calculation and presentation of TWRR or IRR, as current practices are generally focused on the underlying investments in the portfolio.

- **Valuation Frequency:** Under the current GIPS Standards, portfolios utilizing TWRR must be valued at least monthly and at the time of large cash flows. The Consultation Paper notes that due to the unpredictability of cash flows, many firms have indicated that the requirement to value the portfolio at the time of large cash flows effectively *requires* the firm to be ready to value on a daily basis. There is no proposal to change the required valuation frequency for portfolios using TWRR at this time; however, the Executive Committee is requesting input on whether the required frequency under the current GIPS Standards is sufficient. With respect to portfolios that present IRR, the Executive Committee is proposing that the portfolio be valued at least annually and at any time that performance is calculated and reported to prospective clients or investors.

Considerations: In responding to this question, we recommend that firms consider the operational and practical issues, as well as the cost, that may arise in the event that more frequent valuation is required in the 2020 version of GIPS. Firms should also consider the interplay between Proposal 4 and Proposal 5. If adopted, Proposal 4 could result in certain pooled funds which hold instruments for which daily valuation (or even monthly valuation) is impracticable being subject to mandatory TWRR reporting. Any increase in the frequency of valuation for portfolios using TWRR would further exacerbate the mismatch between the reasonable valuation timeline for these assets and the valuation frequency required under GIPS. With respect to the Proposal that portfolios reporting performance as IRR be valued at least annually and each time that performance is calculated, firms should consider whether certain portfolio investments should be carved out from this requirement. For example, the underlying assets in real estate, private equity, or other illiquid investment funds are typically valued at times and in accordance with procedures adopted by the manager, either independently or through negotiation with investors at the time of investment in the fund. An annual valuation requirement may create significant additional cost to funds not currently valuing on an annual basis, as, among other things, third-party valuation agents may be needed to value each underlying investment. Identification of the additional costs and obligations that would result from a requirement to value the portfolio annually and at the time of each performance calculation may help the Executive Committee understand the potential impact of such a requirement. Additionally, to the extent that industry participants believe that more frequent valuation requirements may deter some fund managers from adopting GIPS, this point should be stressed in comment letters, as a focus of the GIPS 20/20 initiative is enhancing the relevance of GIPS to all asset managers, regardless of structure, client type, asset class, or investment strategy. Lastly, firms may want to consider suggesting necessary modifications to the GIPS Guidance Statement on Calculation Methodology and other related guidance statements that may be necessary.[6]

- **Distribution of Composite Compliant Presentations and Pooled Fund Reports to Existing Clients:** Under the current GIPS Standards, firms are required to make every reasonable effort to provide GIPS-compliant presentations to *prospective* clients. The Consultation Paper stresses that existing clients are also prospective clients, and the Proposal would require that firms provide a GIPS-compliant presentation to existing clients or, alternatively, that firms offer to provide the relevant GIPS-compliant presentation.

Considerations: In considering what feedback to provide on this Proposal, firms should consider the operational aspects of delivering, or making an offer to deliver, a GIPS-compliant presentation to existing clients on an annual basis, as well as the economic costs associated with such delivery. Moreover, firms may want to seek input from their clients on whether they desire such information and, if so, for what reasons. For example, distribution of an annual GIPS-compliant presentation may be of little value to investors in closed-end vehicles and, as such, may not be worth the costs associated with the production and delivery of such presentations.

- **Total Firm Assets:** The Consultation Paper states that advisory assets (as opposed to managed assets) are becoming a larger part of the investment management industry, noting the increase in, among other things, unified management accounts, model portfolios, advisory-only portfolios, and underlying portfolios in overlay strategies, which are not captured in the GIPS definition of Total Firm Assets. The Consultation Paper seeks input from the industry as to whether a new category of assets should be defined that would include assets of the firm that are managed, advised, and overlaid.

Considerations: Under the current version of the GIPS Standards, Total Firm Assets is defined to include all discretionary and nondiscretionary assets for which a firm has investment management responsibility, and, as noted in the Consultation Paper, excludes assets that are advisory-only or considered to be overlay assets. In considering a response to this item, industry participants should consider whether the creation of such new definition of firm assets would be practically useful in furthering an overarching goal of GIPS to provide a mechanism for consistent comparison of firms. A new, broader definition of firm assets may create distortions in those comparisons unless implemented consistently across all GIPS-compliant firms and may not provide an accurate reflection of total firm assets. Moreover, there are important distinctions between assets that are under discretionary management by a firm and those for which a firm provides either nondiscretionary advice or overlay management, and to report them all together as part of a single definition of firm assets may not be useful to potential or existing investors. Overall, firms should consider the utility of such a new definition, and whether or not a more granular approach to totaling assets may be preferable.

- **Non-Fee-Paying Portfolios:** Under the current GIPS Standards, only actual fee-paying, discretionary portfolios are required to be included in composites, but firms are permitted, in their discretion, to include non-fee-paying portfolios in composites. The Consultation Paper notes that the Executive Committee is considering requiring that all discretionary portfolios be included in a composite, regardless of whether they are fee paying.

Considerations: The Consultation Paper seeks input from industry participants on whether non-fee-paying portfolios should be included in composites and, if so, how such portfolios should be treated for net-of-fees calculations. While it may be appropriate and beneficial to do so, there are practical considerations that will need to be addressed by the Executive Committee in developing its guidance. For example, the inclusion of incubator accounts, which are typically non-fee-paying accounts designed to test strategies that have not yet been offered to external customers, would be of little value to prospective customers and should be excluded from such a requirement. Additionally, non-fee-paying portfolios may be comprised of assets managed on behalf of the manager's organization and the inclusion of such portfolios in a composite may not be meaningful to prospective investors. Alternatively, firms should consider whether to recommend to the Executive Committee that firms be required to apply a model fee (perhaps based on the average of the other portfolios in the composite) to the non-fee-paying portfolio(s) before it is included in the composite in order to reflect net-of-fee performance. Currently, if non-fee-paying portfolios are included, the percentage of the composite they represent is required to be included.

- **References to the Firm's Claim of Compliance:** Under the current GIPS Standards, firms are only permitted to state their GIPS claim of compliance under specified circumstances. *Specifically*, firms are only permitted to make claims of GIPS compliance in GIPS-compliant presentations, GIPS advertisements, and the standardized pooled fund claim of compliance. The Executive Committee is seeking input from the industry as to whether it would be appropriate to permit firms more flexibility in the manner in which they can claim compliance.

Considerations: In responding to the request, commenters should consider how and where claims of compliance would be beneficial from a marketing or operational standpoint. Additionally, firms should consider whether such additional claims of compliance would be meaningful to potential investors and whether there is any benefit to a GIPS-compliant firm or to potential investors in expanding the flexibility of firms to market that they are GIPS-compliant or whether such marketing only will serve to increase the visibility of GIPS more generally.

- **Timeliness and Frequency of GIPS-Compliant Presentations:** Under the current GIPS Standards, firms must make every reasonable effort to provide a GIPS-compliant performance presentation to all prospective clients; however, there is no guidance in GIPS as to the timeliness of the presentation. The Executive Committee is considering including a requirement in the 2020 version of GIPS that firms provide GIPS-compliant presentations on a timely basis to ensure the performance provided is current.

Considerations: In order to illustrate the timeliness issue, the Consultation Paper presents an extreme example in which the current GIPS-compliant presentation's performance is almost two years old. In our experience, this is not consistent with industry practice. There are legitimate reasons for firms to delay updating their GIPS-compliant presentations, including waiting until the firm verification or relevant composite examination is complete. In responding to this Proposal, firms should be mindful of these legitimate reasons for delay and stress to the Executive Committee that an unduly restrictive timeliness requirement may impact the accuracy of the information presented. In our experience, most firms use the most current data that is available to them in preparing their annual presentation and generally are not presenting data that is much beyond 12 months, and as such, the implementation of a timeliness requirement may have little, if any, material impact on current practices.

- **Estimated Trading Expenses:** Under the current GIPS Standards, performance **information** is required to be presented after the deduction of actual trading expenses. The Executive Committee is considering whether to permit firms to use estimated trading expenses under certain circumstances. As proposed, estimated trading expenses would only be permitted where their use would result in returns that are equal to or lower than if actual trading expenses had been used. The Consultation Paper also notes that permitting the use of estimated trading expenses may eliminate the need for wrap fee/SMA-specific requirements.

Considerations: By allowing estimated trading expenses and potentially eliminating the need for separate wrap fee/SMA guidance, this Proposal furthers the Executive Committee's initiative to streamline the GIPS Standards across asset classes and product lines. As firms consider whether to provide comments on this Proposal, they should be mindful of whether it is practical or even possible to generate estimated trading expenses in the manner that is contemplated. Specifically, as crafted, the Proposal would only permit the use of estimated expenses in circumstances where the returns would be equal to or less than if actual trading expenses were used. This would require that the firm would have knowledge of what actual trading expenses were and, if this were the case, there would be no need to use the estimated trading expenses in the first place.

- **GIPS-Compliant Presentation Numerical Information and Disclosures:** As part of the GIPS 20/20 initiative, the Consultation Paper asks for industry input on whether to eliminate any items of numerical information or disclosure currently required in GIPS-compliant presentations that are not particularly helpful or informative.

Considerations: In considering a response to this request, firms should review their current disclosures and asses the utility of such information and the related burdens of maintaining or producing such information to determine which may no longer be necessary. For example, maintaining disclosure relating to the portability of composite information, at least for a specified time period, appears to be beneficial to potential clients in understanding a firm's track record; however, maintaining disclosure relating to the date of a benchmark change or a name change of the composite or the firm diminishes in value over time and is arguably of little value to potential clients.

- **General:** The Consultation Paper also seeks general industry comment on any other aspects of the GIPS Standards that industry **participants** believe should be reevaluated as part of the GIPS 20/20 initiative. If the proposed revisions to the GIPS Standards as set forth in the Consultation Paper are implemented, many of the existing guidance statements will also need significant updating to align with the new GIPS Standards, and firms should take this opportunity to comment on any issues or concerns with the guidance statements in their current form. Moreover, firms may want to suggest that it would be helpful for the CFA Institute to publish its views with respect to industry practices on certain matters, including hypothetical or model performance, and attribution analysis.

NOTES:

[1] https://www.gipsstandards.org/standards/Documents/Guidance/gips_2020_consultation_paper.pdf.

[2] Guidance Statement on the Application of the GIPS Standards to Asset Owners, https://www.gipsstandards.org/standards/Documents/Guidance/gs_asset_owners.pdf.

[3] Guidance Statement on Broadly Distributed Pooled Funds, https://www.gipsstandards.org/standards/Documents/Guidance/gs_pooled_funds.pdf.

[4] *See* Exposure Draft of the Guidance Statement on Broadly Distributed Pooled Funds, https://www.gipsstandards.org/standards/Documents/Guidance/exposure_draft_public_comment_pooled_funds_gs.pdf, and GIPS Guidance Statement on Broadly Distributed Pooled Funds and Potential Impacts, http://www.klgates.com/gips-guidance-statement-on-broadly-distributed-pooled-funds-and-potential-impacts-02-22-2016/.

[5] Guidance Statement on Alternative Strategies and Structures, https://www.gipsstandards.org/standards/Documents/Guidance/gs_alternative_investment_strategies_and_structures.pdf.

[6] https://www.gipsstandards.org/standards/Documents/Guidance/gs_calculation_methodology_clean.pdf.

