The Exposure Draft of the 2020 GIPS Standards: What You Need to Know

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Speakers

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AGENDA

- Overview of the GIPS Standards
- Goals of CFA Institute for the Exposure Draft of the 2020 GIPS Standards
- Proposed Material Changes to the GIPS Standards
- Impact of the 2020 GIPS Standards Proposals on Market Participants

Overview of the GIPS Standards

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GIPS STANDARDS OVERVIEW

- Voluntary ethical principles for the reporting of investment performance results administered by the CFA Institute

- Purposes of the GIPS Standards:
  - Facilitate apples-to-apples comparison
  - Fair representation & full disclosure
  - Ensure accurate & consistent data
  - Foster industry-wide best practices and self-regulation
  - Enhanced internal controls as well as marketing benefits

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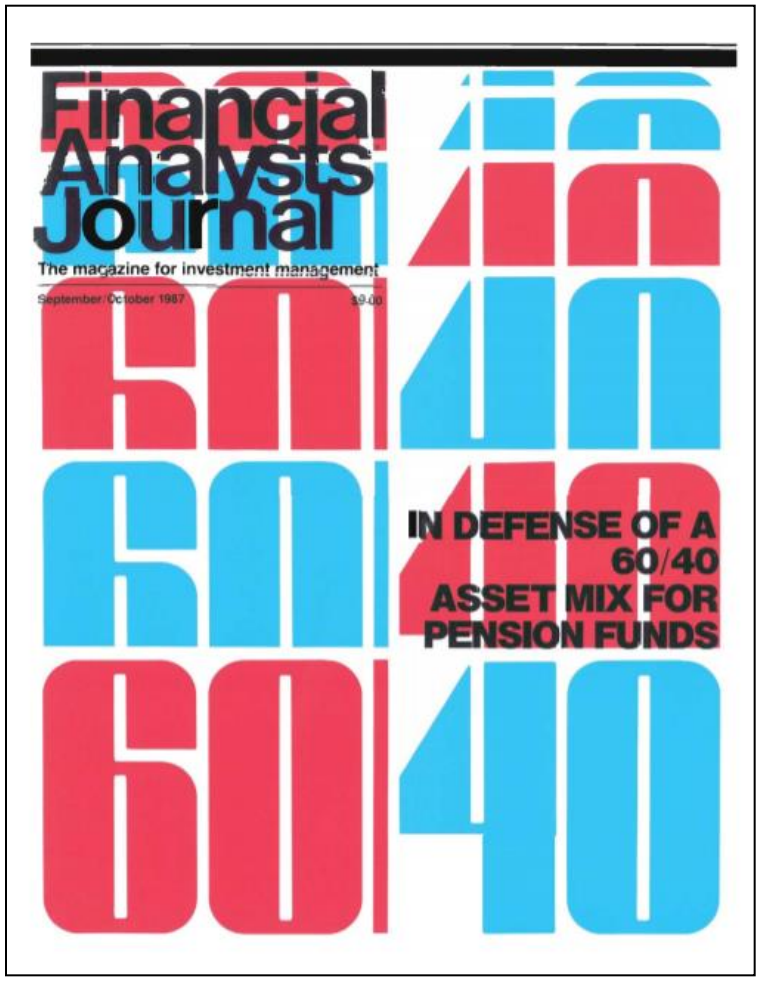
GIPS STANDARDS OVERVIEW

- Two sources of requirements regarding compliance
  - GIPS Standards (last revised and published in 2010)
  - Interpretive Guidance (Guidance Statements, Q&As, GIPS Handbook discussion)
- Fundamentals of compliance:
  - Input data
  - Calculation methodology
  - Composite construction
  - Disclosures
  - Presentation and reporting
  - Detailed policies and procedures, verification (recommended)



Editorial Viewpoint

The FAF Board wishes to emphasize the requirement for full disclosure in the presentation of portfolio performance and considers misrepresentation on this issue to be prohibited under the joint FAF/CFA Code of Ethics and Standards of Professional Conduct, Standard III E (Prohibition Against Misrepresentation of Services).

The FAF Board endorses the basic approach recommended by the Committee for Performance Presentation Standards to be used by investment management organizations and consultants. Adoption of full disclosure standards for performance presentation is considered by the FAF Board to be in the best interest of the investing public.

Comments are invited and should be addressed to the Committee on Performance Presentation Standards, the Financial Analysts Federation, P. O. Box 3726, Charlottesville, VA 22903. An FAF-sponsored seminar on performance is planned for spring 1988.

A Report on Setting Performance Presentation Standards

From The Committee for Performance Presentation Standards (CPPS):
Claude Rosenberg, Jr., Chairman (Rosenberg Capital Management)
R. H. Jeffrey (Jeffion Investment Co.)
Robert Kirby (Capital Guardian)
Dean LeBaron (Batterymarch Financial)
John J. F. Sherrerd (Miller, Anderson & Sherrerd)

I. The Committee for Performance Presentation Standards (CPPS) strongly recommends that the Financial Analysts Federation (FAF) approve, and then disseminate and attempt to place into force, standards for investment management performance presentation. Up to now, this all-important subject has been given little attention; as a result, investment advisers (despite registration with the Securities and Exchange Commission) have been left to their own standards, which have been varied, uneven and, in many instances, outright irresponsible and dishonest. If the investing public is to be treated fairly, and if the investment management industry is to represent the highest ethical and moral standards, a fair and understandable policy must be developed. The CPPS sincerely hopes that the following report provides reasonable guidelines for FAF approval.

II. Those affected by standards

A. This report focuses on standards for "*investment managers*," which obviously includes all registered investment advisers.

B. We hope that *other organizations* and individuals might also be included in this thrust, and urge the FAF to encourage appropriate regulatory authorities to use the standards recommended by the CPPS as a basis for their compliance. The following groups fit into this category:

1. stock brokers acting as "portfolio managers" for clients, particularly those who charge separate (from normal commissions) fees for their management services;
2. mutual funds, where certain presentation practices are very deceptive, but which exist under different jurisdictions;
3. consultants.

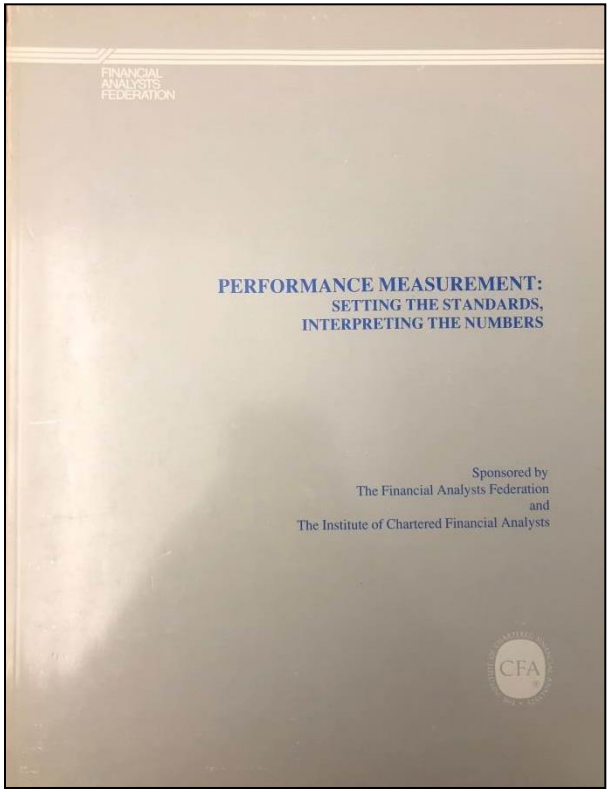
III. Performance calculation

A. *Time-weighted* calculation is the natural method; perhaps the FAF should recommend one preferred formula.

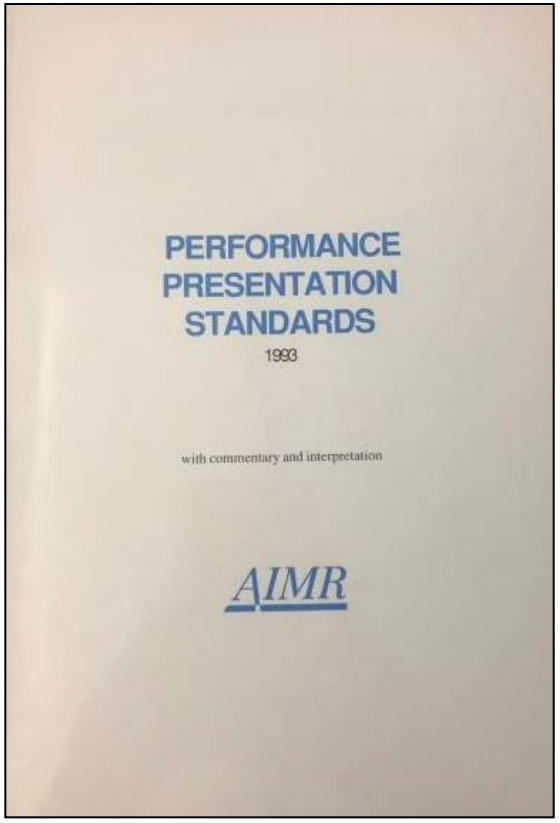
B. *Total return*, including income and capital appreciation, is of course recommended.

C. To allow for the most efficient judgment of manager efficiency, the CPPS recommends that results be presented *before fees*, but with this omission always noted when presenting data. As indicated in V. A. 11., we recommend that pertinent fee information be included with performance presentation.

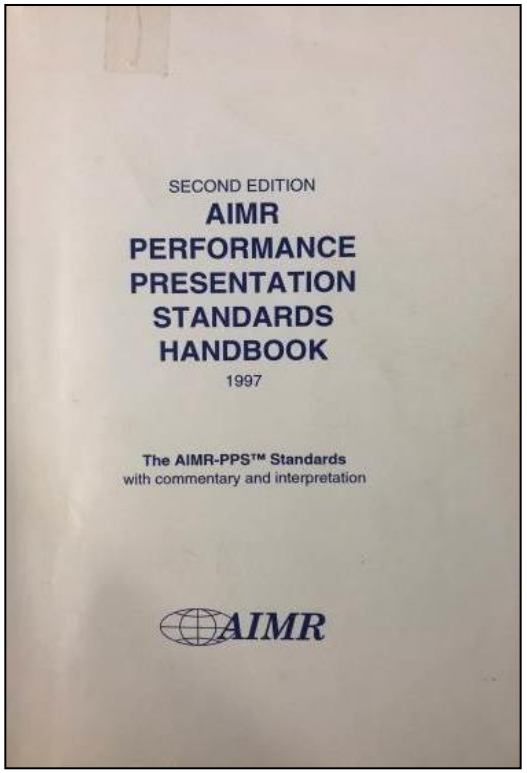
1987



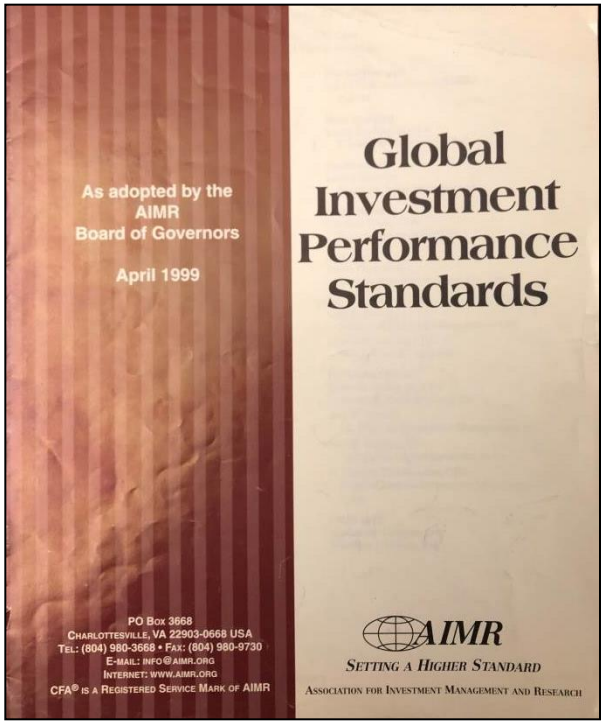
1989



1993



1997



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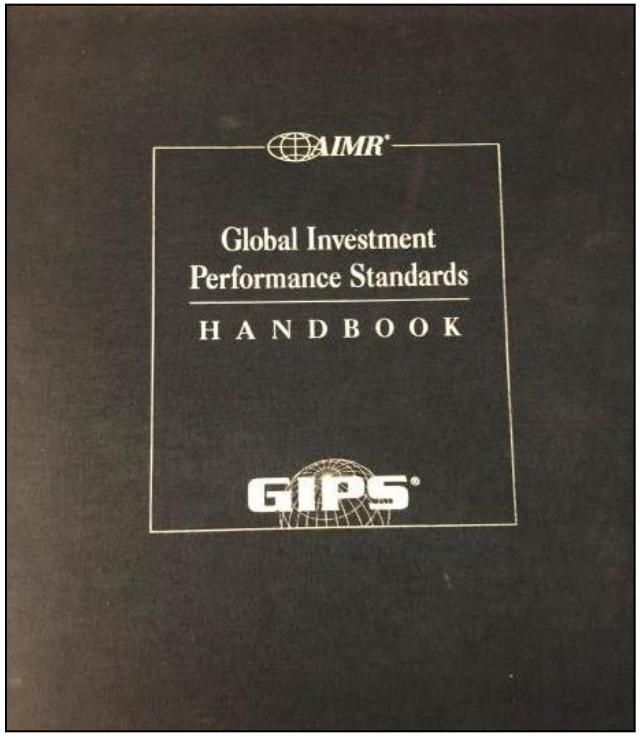

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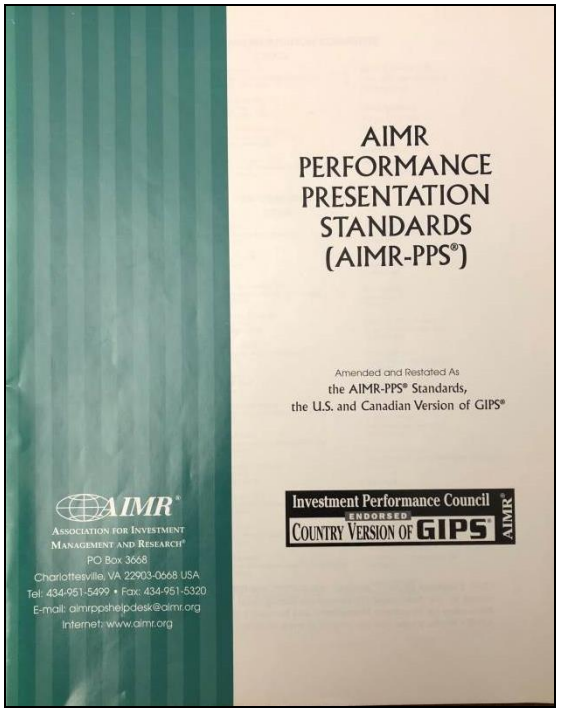

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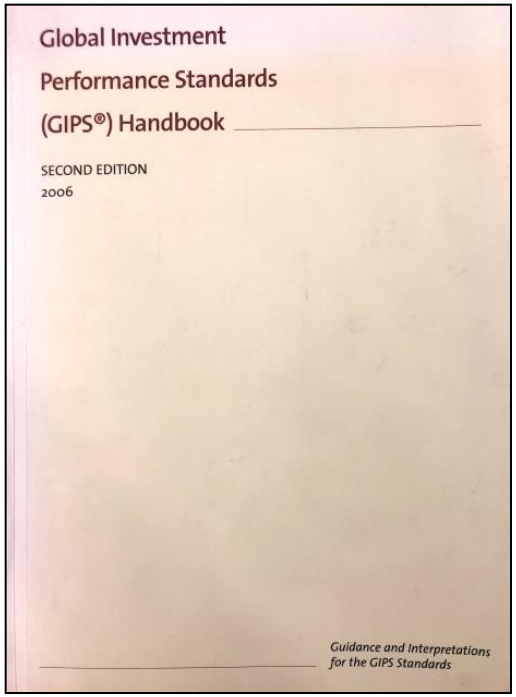

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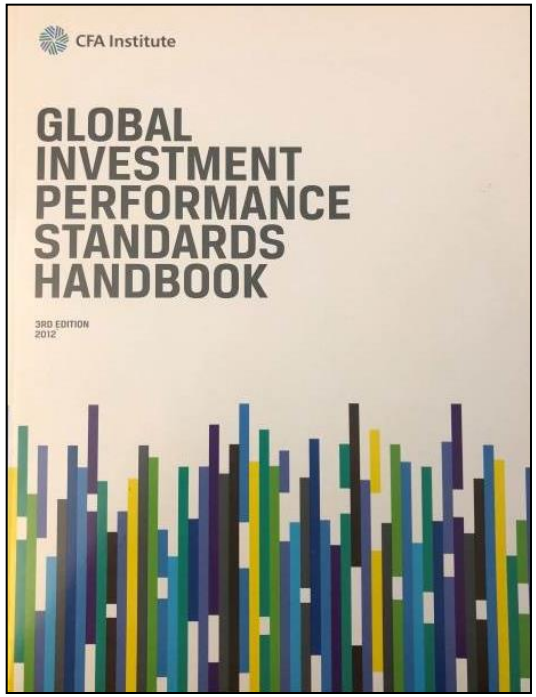
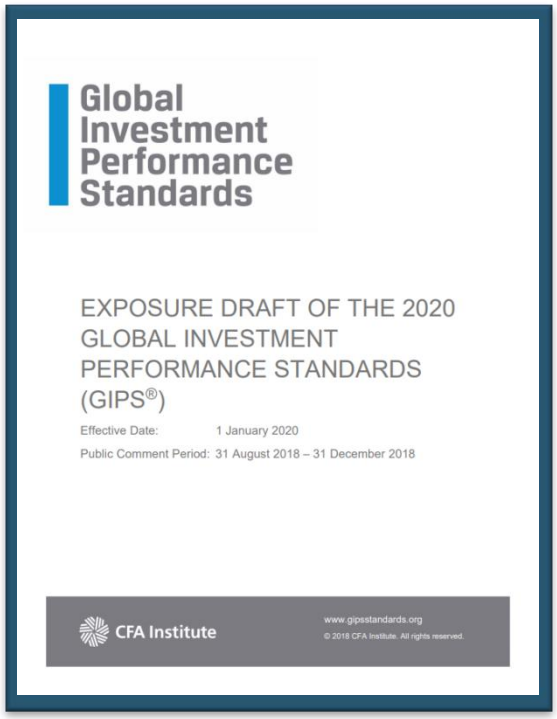


2012



2018

Goals of CFA Institute for the 2020 GIPS Standards

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GIPS STANDARDS TIMELINE

2010
- Release of Current Edition of the GIPS Standards

2018
- Release of the Exposure Draft of the 2020 GIPS Standards
- Comment period open until **December 31, 2018**

2019
- Final version of 2020 edition released **mid-summer 2019**

2020
- 2020 edition effective **January 1, 2020**

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WHY CHANGE THE GIPS STANDARDS?

- Composites are the foundation of the GIPS standards, but composites are not always appropriate for products and vehicles
- Pooled funds do not fit neatly into the current composite construction or GIPS reporting framework
- To make the GIPS standards more relevant for all asset classes, including alternative funds/strategies
- To better address applicability for asset owners
- To consolidate standards that have expanded since 2010

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2020 GIPS STANDARDS CORE PRINCIPLES

- Increasing relevance and adoption by alternative investment managers, fund managers, and private wealth managers
- Increased adoption and demand by asset owners
- Streamline structure of the GIPS standards and remove unnecessary barriers

CURRENT GIPS STANDARDS FRAMEWORK

0 – Fundamentals of Compliance

1 – Input Data

2 – Calculation Methodology

3 – Composite Construction

4 – Disclosure

5 – Presentation & Reporting

6 – Real Estate

7 – Private Equity

8 – Wrap Fee/SMA

Advertising Guidelines

Glossary

NEW FRAMEWORK FOR THE GIPS STANDARDS

General Provisions

1. Fundamentals of Compliance
2. Input Data and Calculation Methodology
3. Composite and Pooled Fund Maintenance

Composite Reports

4. Time-Weighted Returns
5. Money-Weighted Returns

Pooled Fund Reports

6. Time-Weighted Returns
7. Money-Weighted Returns

Asset Owners General Provisions

8. Fundamentals of Compliance
9. Input Data and Calculation Methodology
10. Total Fund and Composite Maintenance

Asset Owner Reports

11. Time-Weighted Returns
12. Money-Weighted Returns

Additional Sections

13. GIPS Advertising Guidelines
14. Glossary

Note: The repetition across these sections is designed for ease of use.

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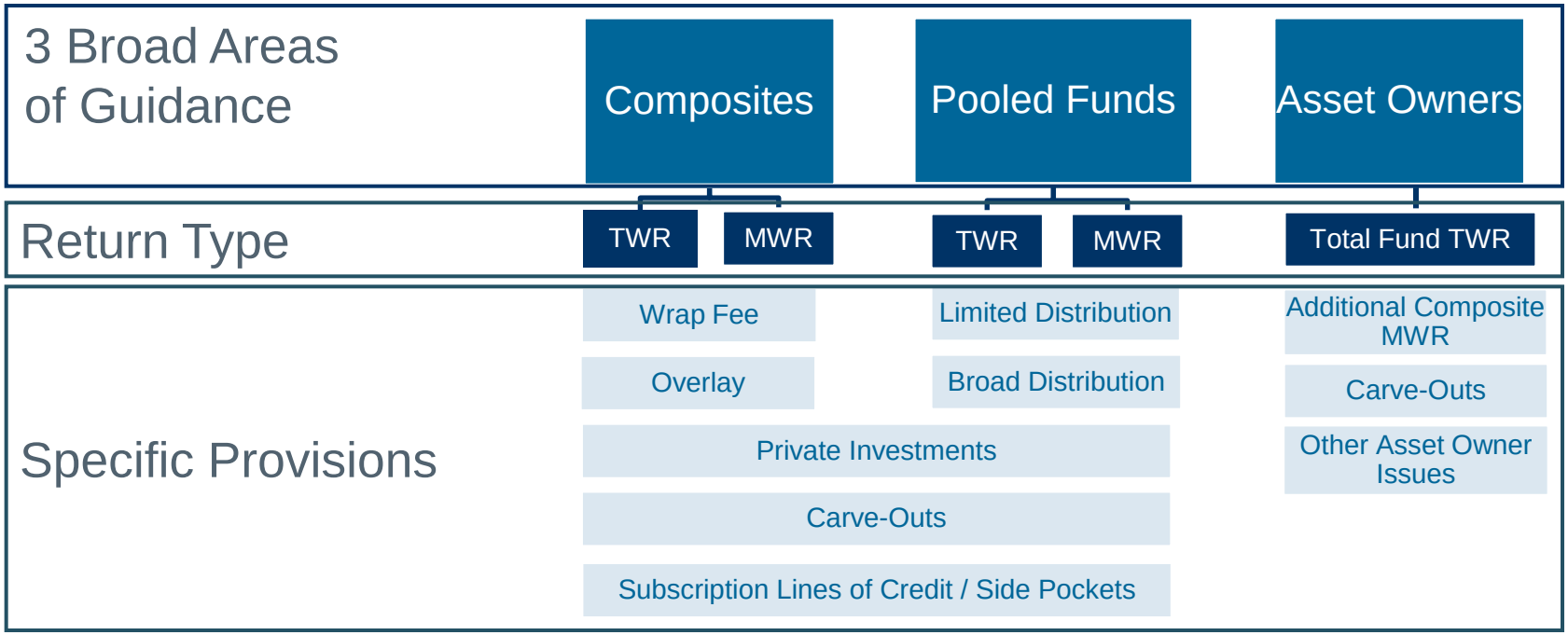
NEW LAYOUT OF THE GIPS STANDARDS



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2020 GIPS STANDARDS IMPACT AREAS

- The following changes are included within the Exposure Draft of the 2020 GIPS Standards

- These are **proposed** changes, but are subject to change

- We are focusing on significant changes, not every change

Proposed Material Changes to the GIPS Standards

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COMPOSITES VS. POOLED FUNDS

- Composites will continue to be required for strategies **offered** in a segregated account format
- What if the strategy is **only** offered through a pooled fund?
  - No longer required to maintain “composites of one” if the strategy is only offered through a pooled fund(s)
- Must continue to include pooled funds in composites with segregated accounts if also marketing the fund’s strategy as a segregated account

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COMPOSITES VS. POOLED FUNDS

What is a pooled fund?

- Multiple investors offered in a fund structure
  - Treatment of “funds of one”
- Two defined types (**this is important!**):
  - Limited Distribution (e.g. LPs, “private funds”)
  - Broad Distribution (e.g. UCITS, mutual funds)
- Limited Distribution Pooled Funds will be required to prepare a GIPS report when presenting the fund to prospective investors
- Broad Distribution Pooled Funds will not be required to maintain a GIPS Report

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MONEY WEIGHTED RETURNS

- Asset-class guidance (RE/PE) has been removed and replaced with methodology-based guidance
- Greater allowance for using money-weighted returns (IRR) rather than time-weighted returns
  - MWRs can be used if the manager controls external cash flows AND at least one of the following is true
    - Closed end
    - Fixed life
    - Fixed commitment
    - Significant part of the investment strategy is in illiquid investments
- This is a significant enhancement, as many strategies are now being offered via commitment-based funds outside of standard private equity funds

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MONEY WEIGHTED RETURNS

- Since-Inception IRR only required to be shown through most recent annual period end
  - Previously RE/PE requirements included showing SI-MWR through each year-end
- If subscription lines of credit are used, must include SI-MWR both with and without the subscription line of credit activity through the most recent annual period end
  - “With” means to include the cash flows, value and associated costs for any Subscription Lines of Credit
    - This shows the return over the whole period your investment was “at risk”

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INTRODUCING THE "GIPS REPORT"

- New name for "GIPS Compliant Presentation"
  - For Composites: GIPS Composite Report
  - For Pooled Fund: GIPS Pooled Fund Report
  - For Asset Owners: GIPS Asset Owner Report
  - (Collectively, **"GIPS Report"**)
- Must make every reasonable effort to
  - Provide GIPS Composite Report to composite prospects
  - **New!** Provide GIPS Pooled Fund Report to all Limited Distribution Pooled Fund prospects

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GIPS POOLED FUND REPORT

- Requires similar statistics and disclosures of a GIPS Composite Report
  - For TWRs: 5 years of annual returns, building to 10 years
  - For MWRs: SI-MWR through most recent period-end
  - Fund assets, firm assets, 3-yr standard deviation (if valued monthly)
  - Must include net returns (reduced by all fund fees & expenses)
    - Actual or highest fee
  - Similar disclosure requirements as in GIPS Composite Report

TOTAL FIRM ASSETS AND ADVISORY-ONLY ASSETS

- Advisory-only assets
  - Include “model-delivery,” “UMA,” or other situations where investment recommendations (e.g. a model) are provided, but firm has no control of investment decisions and no trading authority for assets
- Advisory-only assets can be included in GIPS Report, but not combined or added to firm AUM

	Required	Allowed	Prohibited
Year	**GIPS Firm Assets (A)**	**Advisory-Only Assets (B)**	**“Total Assets” (A+B)**
2017	10 Billion	2 Billion	12 Billion

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ESTIMATED TRANSACTION COSTS

- Transaction costs: costs of buying or selling investments
  - Brokerage commissions
  - Exchange fees/taxes/local regulator fees
  - Bid/offer spreads
- Proposing use of estimated transaction costs in some situations
  - Estimate used is equal to or higher than actual transaction costs
  - This effectively removes much of the wrap fee guidance currently in place

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TRACK RECORD PORTABILITY

- Currently, firms are required to link to performance from a prior firm, if portability tests are met, on a composite-specific basis
- *In the 2020 GIPS standards, firms will be allowed to choose if they will link to performance from a prior firm, if portability tests are met, on a composite-specific or pooled fund-specific basis*
  - Change is a recognition of feedback that firms that do not want to port performance will not meet the criteria
- 2020 GIPS standards clarify the one-year grace period
  - Assets of the acquired non-compliant firm or affiliation must meet all the requirements of the GIPS standards within one year of the acquisition date, on a prospective basis
- No limit on when firms may port history from the prior firm or affiliation
  - Example: If it takes a firm 3 years to get the required records to support prior firm performance, may port the performance at that time

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RETURN OF CARVE OUTS

- Carve out: portion of a portfolio that by itself is representative of a distinct investment strategy
- Cash Treatment Methods
  - Accounted for separately
  - Allocated synthetically on a timely and consistent basis
- Carve out methodology and selection needs to be consistent across firm

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RETURN OF CARVE OUTS

- Must create separate composite for standalone portfolios (once/if they are obtained)
  - Cannot include carve outs in a stand-alone portfolio Composite (*e.g.* cannot link model and actual)
- Additional disclosures
  - Include “carve out” in composite name
  - Methodology for cash allocation
  - Disclose standalone GIPS Composite Report is available upon request
  - Disclose the composite includes carve-outs with allocated cash
- Must present returns and assets of the standalone portfolio composite (but not GIPS Composite Report)

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EXTERNAL VALUATIONS

- Currently, only real estate investments are required to receive an external valuation
  - External valuation at least once every 12 months, with an exception
  - When clients opt out of annual external valuation, external valuations are required once every 36 months
- The 2020 GIPS standards expanded the concept of obtaining independent valuations to private equity, infrastructure, and other real assets, including real estate (i.e., private market investments), and also expanded the types of independent valuations

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EXTERNAL VALUATIONS

- For periods beginning on or after 1 January 2020, at least once every 12 months, private market investments must:
  - Have an external valuation, or
  - Have a valuation review*, or
  - Be subject to a financial statement audit.

*A valuation review is a review of valuation inputs and assumptions performed by an external third party

  - e.g., review by an external party of a firm's internal discounted cash flow calculation for a real estate property

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OTHER GIPS CHANGES

- Asset Owners
  - Institutional investors marketing to external parties must be treated as “Firms” rather than “Asset Owners”
- New GIPS Standards for Verifiers issued as a separate document for public comment in October 2018

Impact of the 2020 GIPS Standards Proposals on Market Participants

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SORTING OUT POOLED FUNDS

- Broad Distribution vs. Limited Distribution Pooled Funds
  - Guidance focuses on whether materials are presented/provided in a one-on-one communication
  - Many outstanding questions
    - Use of Placement Agents
    - Public offering in one jurisdiction, but private in others
    - Presentations to intermediaries/CITs
    - Marketing “I-shares” of mutual funds

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SORTING OUT POOLED FUNDS

- Pooled Fund inclusion in Composites
  - Is the fund's strategy marketed to separate account clients?
    - Yes – Pooled Fund included in Composite
    - No – Pooled Fund "stands alone"
      - No separate Composite report, even for strategies with multiple Pooled Funds

GIPS ADVERTISING GUIDELINES

- Three Options:
  1) Communication with GIPS Report
     - Composite
     - Pooled Fund
  2) Advertisement that complies with Advertising Guidelines
  3) Advertisement that does not reference the GIPS standards (at all)
     - Performance does not need to comply with the GIPS standards (as long as not prohibited)
- Advertisements may include:
  - Website
  - Fact sheets
  - Newspaper/Magazine
  - Social Media
  - PPMs
  - White Papers
  - Ads

REGISTERED FUND MANAGERS – GIPS COMPLIANCE

- Managers of “Broad Distribution Pooled Funds” may promote GIPS compliance in two ways:
  1) GIPS Pooled Fund Report to all prospective investors (not required)
  2) GIPS Advertisement prepared in accordance with GIPS Advertising Guidelines
- Manageable adjustments for existing GIPS firms
  - Broad Distribution Pooled Funds still must be included in Composites if the fund’s strategy is also offered as a separate account
- Questions:
  - Will retail investors grow to recognize the GIPS standards?
  - What about intermediaries?

REGISTERED FUND MANAGERS – DEFERENCE TO LOCAL LAW

- If local laws or regulations mandate specific pooled fund returns, firms must adhere to this methodology
  - If local laws or regulations do not mandate specific periods, pooled fund returns required by local laws or regulations or pooled fund net returns must be presented consistent with certain options
- Key takeaways:
  - 1940 Act / UCITS / similar requirements will prevail
  - Funds sold in multiple jurisdictions may have multiple pooled fund reports!

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INSTITUTIONAL MANAGERS

- Flexibility to present performance through a GIPS Composite Report, GIPS Pooled Fund Report or GIPS Advertisement
  - Allows managers to tailor materials to specific products to better assist investors in making decisions
- Managers that distribute strategies in multiple “wrappers” will prepare additional reports
- Firms that primarily present “strategy” performance will likely continue to do so

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WRAP FEE/SMA PORTFOLIOS

- The concept of sponsor-specific composites has been removed
  - Sponsor-specific performance: practice is now viewed as client reporting rather than composite reporting to a prospective client (and not subject to the GIPS standards)
- Composite performance may be supplemented with “Pure” gross-of-fee returns, but must be clearly labeled and disclosed as such (this is the current requirement)
- Historical performance of non-wrap fee portfolios may still be used to market to wrap fee prospective clients

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HEDGE FUNDS

- Hedge fund managers have stated that composite presentation requirements have disincentivized hedge fund managers from pursuing GIPS compliance
  - Pooled fund managers not selling participation in a composite, they are selling participation in a pooled fund
- Pooled fund reports address this concern, but will hedge fund managers adopt GIPS compliance?
  - Look to the institutional investor community to drive behavior
  - Incremental benefits over annual audit
- In the U.S., fund-specific materials still subject to FINRA rules and '33 Act securities offering rules and guidelines

PRIVATE EQUITY & CREDIT FUNDS

- Exposure draft provides 3 important incentives to private equity/credit managers
  - Pooled fund reports
  - Flexible return calculation options
  - Carve outs
- MWR allows inception-to-date IRR, or any other money-weighted calculation
- Carve-outs
  - Inability to allocate cash has represented a significant disincentive to private equity and private credit managers
  - GIPS compliance will no longer hinder firms from developing new and modified strategies

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PRIVATE EQUITY & CREDIT FUNDS

- Valuation
  - Extension of external valuation requirements to private equity investments may add additional costs for private equity managers
  - Fund audits will only be sufficient if they audit each underlying asset
    - Compare to SEC guidance regarding Custody Rule and SPVs with co-investors
  - Managers will have to weigh costs against the benefits achieved by claiming GIPS compliance

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