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GIPS 2010: What Every Firm Needs to Know Now (and how to react)

By Michael S. Caccese and
Rebecca O'Brien Radford

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On January 1, 2011, the Chartered Financial Analyst (CFA) Institute's 2010 revisions (2010 Revisions) to the Global Investment Performance Standards (GIPS) went into effect. The 2010 Revisions reflect the joint cooperation with the 32 country sponsor organizations that help develop and promote the adoption of the GIPS standards and represent an update to the 2005 version (2005 Standards), the second version since their introduction in 1999.

The 2010 Revisions are applicable to performance presentations that include performance for periods on or after January 1, 2011, so firms claiming compliance may not have to alter their Composite presentations until they begin presenting 2011 performance. Firms may adopt selected new or revised requirements of the 2010 Revisions earlier than is required. However, firms must not stop adhering to selected requirements of the 2005 edition of the GIPS standards that have been removed in the 2010 Revisions without adopting all of the requirements of the 2010 Revisions.[1]

Among the most notable changes to the GIPS standards include:

(1) Requiring firms to disclose their verification status;
(2) Requiring firm assets to be "fair valued"'; and
(3) Requiring firms to present three year annualized standard deviation for each Composite and its benchmark.

The 2010 Revisions only reflect changes to the GIPS standards.[2] In late 2010, the CFA Institute issued revised GIPS Guidance Statements (Guidance Statements) to conform to the 2010 Revisions, but conforming changes to the Explanation of the Provisions of the GIPS Standards and Verification (Explanations) have not yet been issued.[3] It is the authors' position that except to the extent that the 2010 Revisions are inconsistent with the Explanations, the principles and guidance provided in the Explanations continue to reflect the CFA Institute's views on GIPS compliance.

Although there have been numerous modifications, deletions, and additions to the current version of the GIPS standards, this article highlights only the most important changes applicable to traditional asset classes[4] that will impact firms currently claiming compliance with the GIPS standards. It also provides some guidance as to actions that may be necessary for firms to comply with the 2010 Revisions.[5] In Part 2 of this article, to appear in an upcoming issue of *The Investment Lawyer*, we will highlight certain additional key changes and include a checklist that summarizes the key requirements under the GIPS standards, as amended by the 2010 Revisions.

Mr. Caccese and Ms. Radford are partners in the Boston office of K&L Gates LLP.

Mr. Caccese works extensively with investment firms on compliance issues, including all of the GIPS and AIMR standards. He was previously the General Counsel to CFA Institute and was responsible for overseeing the development of the AIMR-PPS, GIPS and other standards governing the investment management profession and investment firms. He can be reached at 617.261.3133 and michael.caccese@klgates.com.

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General Compliance

Claims of Compliance

Action Required: Ensure that, if the firm does not meet all the requirements of the GIPS standards, the firm does not make any statement that may indicate partial compliance with the GIPS standards.

This Revision serves more as a reinforcement than a substantive change. The GIPS standards make clear that firms that do not claim compliance should not, in any way, refer to GIPS or partial compliance with the GIPS standards. In this manner, the GIPS standards are an all or nothing set of standards. Firms must fully comply on a firm-wide basis with all of the GIPS standards in order to claim compliance. There is no such thing as "partial" compliance. The 2010 Revisions have made changes to the required claim of compliance disclosures, discussed in the Disclosures section of this article.

Compliant Presentation Delivery Requirement

Action Required: Firms must make every reasonable effort to provide a compliant presentation to all prospective clients.[6]

While this standard has not changed, the Revisions have introduced definitions of "Compliant Presentation" and "Prospective Client." "Compliant Presentation" is defined as "[a] presentation for a Composite that contains all the information required by the GIPS standards and may also include additional information or supplemental information."[7]

This definition will hardly draw a surprising reaction from compliant firms since compliant presentations have always been viewed in this light. The more significant definition is that of a "Prospective Client." The Revisions' definition states that a prospective client is:

"[a]ny person or entity that has expressed interest in one of the Firm's Composite strategies and *qualifies to invest in the Composite*. Existing clients may also qualify as Prospective Clients for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as Prospective Clients if they represent investors that qualify as Prospective Clients."[8]

The 2005 Standards' requirement was broader in that it allowed firms to determine their own definition of "Prospective Investor."[9] On the other hand, the new definition of "Prospective Investor" is narrower and affords firms less flexibility in determining to whom they are required to provide compliant presentations.

Compliance Statement and Verification

The basic claim of compliance statement has been slightly changed, and for firms that have not been verified, only this slight change to their compliance statements must be made.[10] More significantly, however, the Revisions require firms to make specific disclosures regarding verification. Specifically, firms that have been verified must include a specific statement that is set forth in the 2010 Revisions[11] explaining what it means to be verified. Further, to the extent that a performance examination has been conducted, the firm must include an additional statement explaining that verification and performance reports are available upon request.[12] Firms that have not been verified must so state.[13] Claims of compliance may only be used in compliant presentations.[14]

Verification and Performance Examinations

Action Required: Ensure that verification is performed by a qualified independent third-party verifier.[15]

The burden of ensuring that a verifier is "qualified and independent" is imposed on the firm claiming compliance. Although the 2010 Revisions do not define "qualified independent third-party verifier," the more well-known and widely used verifiers would likely satisfy the "qualified" requirement, and the firm should confirm that there is no affiliation between the firm and the verifier that may call into question the "independent third party" requirement.

Valuation

Total Firm Assets

Action Required: For periods beginning on or after January 1, 2011 determine total firm assets using the aggregate *fair value* of all discretionary and non-discretionary assets managed by the firm, including fee-paying and non-fee paying portfolios.

Under the 2005 Standards, total firm assets were required to include the aggregate of the *market value* of all discretionary and non-discretionary assets under management within the defined firm.[16] Market value is the current price at which investors buy or sell securities at a given time, and excludes investments/assets for which there is no "market value" and to which the GIPS standards could not be applied.[17] The Revisions now require that total firm assets must be determined based on fair value. "Fair value" is defined as:

"[t]he amount at which an investment could be exchanged in a current arm's length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation must be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation must represent the Firm's best estimate of the Market Value. Fair Value must include accrued income."[18]

For periods prior to January 1, 2011, firms must continue to value portfolios based on market value.[19]

GIPS Valuation Principles

Action Required: Portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles.[20]

In the 2010 Revisions, the CFA Institute issued the GIPS Valuation Principles (Valuation Principles). For firms that primarily invest in liquid securities and active markets, the Valuation Principles will have little effect on their GIPS valuation policies and procedures since objective, observable, unadjusted quoted market prices for identical investments will be available. For firms that invest in illiquid investments for which there is no active market, the CFA Institute's objective is to align the GIPS approach to valuation with the concepts promoted by the International Accounting Standards Board and the Financial Accounting Standards Board, as well as other organizations.[21]

The Valuation Principles require that firms value securities consistent with the definition of fair value and that firms establish and consistently apply a hierarchy of factors for valuing illiquid securities.[22] The Valuation Principles also include a recommended hierarchy of factors for firms to use in fair valuing their investments.

Composite-Specific Valuation Policy, Large Cash Flows and Significant Cash Flows

Action Required: Beginning January 1, 2010, firms must set and implement a Composite-specific valuation policy, including "large cash flow" thresholds, and value portfolios in accordance with such policies and on the date of all large cash flows.[23]

As anticipated, the Revisions confirm the requirement that firms value portfolios on the date of all large cash flows.[24] However, the Revisions provide additional guidance for firms to consider when determining their Composite-specific large cash flow amount. The Revisions define "Large Cash Flow" as "the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued."[25] Firms must define their large cash flow amount either (1) in terms of the value of cash/asset flow or (2) in terms of a percentage of the portfolio assets or the Composite assets. The amount of assets that constitutes a large cash flow may vary across a firm's Composites, depending on the strategy, asset class and size of a particular Composite or portfolio. Firms are prohibited from valuing portfolios more frequently than required by the appropriate Composite valuation policy.[26]

Action Required: For firms that wish to remove portfolios from Composites upon a Significant Cash Flow, firms must define "significant" on a forward-looking, Composite-specific basis and must consistently follow the Composite-specific policy.[27] If the firm has adopted a significant cash flow policy for a specific Composite, the firm must now disclose the definition of significant cash flow for that Composite and for which periods.[28]

The 2010 Revisions have taken this concept from the Guidance Statement on the Treatment of Significant Cash Flows (Revised) and incorporated it directly into the GIPS standards. The Revisions emphasize that "significant" must be defined on a Composite-specific basis in advance of the receipt of any cash flows to which the firm's significant cash flow policy will be applied. To allow firms to determine "significant" on an ad-hoc or retroactive basis would not be consistent with the CFA Institute's goal of full and fair performance calculation and presentation.

The 2010 Revisions include concepts of "Significant Cash Flow" and "Large Cash Flow." A Significant Cash Flow is a client-initiated in- or outflow of assets/securities that allows for a portfolio or part of a portfolio to be removed from the Composite if the Significant Cash Flow prevents the adviser from implementing the strategy. In contrast, a Large Cash Flow does not have to be client-initiated and is an in- or outflow of assets/securities that triggers a requirement to value a portfolio or Composite on the date such Large Cash Flow occurs. Although the two concepts are different and relate to two separate GIPS concepts, they are similar in that each must be defined on a Composite-specific basis.

Risk

Composite Definition

Action Required: Composites must be defined according to *investment mandate*, objective or strategy. Composites must include all portfolios that meet the Composite definition.[29]

Like many of the 2010 Revisions, the changes to this requirement reinforce existing GIPS concepts. The Revisions add "investment mandate" to the factors upon which a Composite may be defined. Additionally, the new definition of "Composite Definition" now includes a list of acceptable criteria that may be used to assign portfolios to Composites, derived from the Guidance Statement on Composite Definition.[30] Benchmarks are not included in the definition, but are still included in the Guidance Statement. In the Exposure Draft of the 2010 changes, the CFA Institute included a revision to the definition of "Composite Definition" that would have required disclosure of key risks, similar to that which you would see in a disclosure document.[31] Although the CFA Institute removed the proposed risk disclosure requirement in the 2010 Revisions, the examples provided in the definition include prospectus-type risk disclosure.

Standard Deviation

Action Required: For periods ending on or after January 1, 2011, as of each annual period end, firms must present the three year annualized ex-post standard deviation (using monthly returns) of both the Composite and the benchmark or an additional three year ex-post risk measure for the Composite and the benchmark if the ex-post standard deviation is not relevant or appropriate.

As part of the CFA Institute's emphasis on risk disclosure, the 2010 Revisions require firms to disclose Composite risk by reporting the three-year annualized ex-post standard deviation, using monthly returns, of both the Composite and the benchmark, for each annual period.[32] If the firm determines that the three-year ex-post standard deviation is not a relevant or appropriate risk measure for the Composite, the firm must disclose an additional three year ex-post risk measure for the benchmark (if available and appropriate) and the Composite that is relevant and/or appropriate.[33] When calculating the ex-post risk measure, the GIPS standards require that firms use the same measurement periods for the Composite and benchmark.[34]

Disclosure

Firms must disclose if the three-year annualized ex-post standard deviation of the Composite and/or benchmark is not presented because 36 monthly returns are not available.[35] Additionally, if the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate, the firm must describe why it is not relevant or appropriate, the additional risk measure presented, and why the alternative risk measure was selected.[36]

Materiality

A number of disclosures incorporate the concept of "materiality." The insertion of a materiality standard will be a welcome sight for firms to which certain of these disclosure requirements never had much relevance or applicability. However, with this newfound flexibility comes the ambiguity surrounding the meaning of "material." Unlike that which is required in firms' GIPS Error Correction Policies,[37] there is no requirement to define materiality in the context of these disclosures. However, firms should consider making documented determinations about whether or not, and why, they deem certain disclosure unnecessary due to immateriality. In our view, a prudent approach would be to follow the SEC standard of materiality[38] since investment advisers in the United States are obligated to comply with the Investment Advisers Act of 1940's general anti-fraud provision. We believe this to be the appropriate standard, especially in the absence of concrete guidance from the CFA institute. Importantly, the factors used in making materiality determinations should be applied consistently.

Valuation Hierarchy

Action Required: Firms must disclose if the Composite's valuation hierarchy *materially differs* from the recommended hierarchy in the GIPS Valuation Principles.[39]

Although the hierarchy in the 2010 Revisions is only a recommendation, firms are required to disclose if there are any material differences between the hierarchy they establish and apply and the recommended hierarchy in the Valuation Principles.[40] The firm need not, however, identify or explain the material differences.

Similarly, firms must disclose the use of subjective, unobservable inputs for valuing portfolio investments (as described in the Valuation Principles) if the portfolio investments valued using these inputs are *material* to the Composite.[41] As explained above, this disclosure may have little to no effect on firms that engage primarily in exchange-traded equities, but will require additional disclosure for firms that invest in less liquid investments.

Action Required: Firms must make disclosures regarding short investing, if material.

In addition to disclosing the presence, use, and extent of leverage or derivatives *if material*, firms must now disclose the presence, use, and extent of short investing, *if material*.[42] This addition seems appropriate given the unlimited cap on losses for short sales and the CFA Institute's reinvigorated emphasis on risk disclosure.

Treatment of Withholding Taxes

Under the new standards, firms need only disclose relevant details of the treatment of withholding taxes on dividends, interest income and capital gains *if material*.[43] If the information is available, firms must also disclose if the benchmark returns are net of withholding taxes.[44]

Differences among Portfolios within a Composite and the Composite and the Benchmark

Beginning on or after January 1, 2011, firms must disclose and describe any known *material differences* in exchange rates *and valuation sources* used among the portfolios within a Composite and between the Composite and the benchmark.[45] As with withholding, short sales, and leverage, among other things, the GIPS Standards include the concept of materiality, and such determinations should be made in the same manner as described above.

Performance Calculation

Periodic Geometric Linking

Action Required: Firms must geometrically link sub-period as well as periodic returns.[46] Previously, firms were only required to geometrically link periodic returns.[47]

Partial Period Performance

Action Required: For Composites with an inception date on or after January 1, 2011 with an initial period less than a full year, firms must show performance from the inception date through the initial annual period end.[48] For Composites with a termination date on or after January 1, 2011, firms must present performance from the last annual period end through the Composite termination date.[49]

The 2010 Revisions require that firms present initial partial year returns at the front and back ends of a Composite's life. Under the 2005 Standards, firms were permitted to show performance for these partial year periods but were not required to do so.[50] The new requirement is, in part, aimed at removing the ability of an adviser to cherry pick performance for partial year periods.

Additional Changes to Disclosure Requirements

The new standards contain additions to and modifications of the 2005 Standards' disclosure requirements.

Benchmarks

Firms must now disclose the benchmark description.[51] A "benchmark description" is defined as "[g]eneral information regarding the investments, structure, and/or characteristics of the benchmark. The description must include the key features of the benchmark, or the name of the benchmark for a readily recognized index."[52] For "readily recognized" indices, simply identifying the benchmark by name may be sufficient as a benchmark description. Firms should keep in mind, however, that local laws or regulations may require a more detailed description to provide investors with sufficient information to compare firm and benchmark performance.

Firms must now disclose if the benchmark returns are net of withholding taxes (if this information is available).[53] Previously, firms were required only to disclose the tax basis of the benchmark if the benchmark was net of taxes.

If there has been a change in the benchmark, firms must now provide a description of the change in addition to the date and reason for the change.[54]

For custom benchmarks, each component and the weight assigned to each component must be disclosed.[55] This does not present a change from the 2005 Standards; rather, this disclosure requirement has been deleted from the Presentation and Reporting section and inserted as a Required Disclosure.

Net-of-Fee Returns

When presenting net-of-fee returns, firms now must disclose if model or actual investment management fees are used and if returns are net of any performance-based fees.[56] "Investment Management Fee" has been (and continues to be under the 2010 Revisions) defined to include performance-based fees, but specific disclosure of whether a particular Composite strategy charges performance-based fees was not previously required.

Provision of Policies upon Request

In addition to offering policies for calculating performance, firms must now disclose that policies for valuing portfolios and preparing compliant presentations are available upon request. Policies for "preparing compliant presentations" is a fairly broad term and appears to include all of a firm's GIPS policies and procedures, given the definition of "Compliant Presentation."[57]

Non-Compliant Performance

While firms must continue to disclose the periods of non-compliance for any performance presented for periods prior to January 1, 2000 that does not comply with the GIPS standards, firms no longer need to disclose how the presentation is not in compliance with the GIPS standards.[58]

Wrap Fee/Separately Managed Account (SMA) Portfolios

Applicability

The 2010 Revisions clarify the applicability of the SMA requirements. The 2010 Revisions indicate that the SMA provisions apply to all SMA portfolios where there are bundled fees and the SMA sponsor serves as an intermediary between the firm and the end user of the investment services.[59] The revisions expressly provide that the provisions do not apply:

(1) To portfolios defined as other types of bundled fee portfolios;
(2) To model portfolios that are provided by a firm to an SMA sponsor if the firm does not have discretionary portfolio management responsibility for the individual SMA portfolio; or
(3) Where a firm or overlay manager in a multiple strategy portfolio or similar program does not have discretion over such portfolios.[60]

GIPS Advertising Guidelines[61]

Requirement to Comply with GIPS

Action Required: Advertisements (that is, other than one-on-one presentations) that do not include or make reference to a firm's claim of GIPS compliance, whether or not performance is presented, do not need to comply with GIPS presentation and disclosure requirements.[62]

This is a point of clarification by the CFA Institute. If a firm does not intend to advertise its claim of compliance or show firm performance, the GIPS standards will not force the firm to show performance or advertise its claim of GIPS compliance. For example, if a firm intends to distribute a market commentary letter to potential clients, in a non one-on-one situation, that discusses the market environment but does not mention the firm's claim of GIPS compliance, GIPS will not require the firm to present performance or make disclosures in a GIPS-compliant manner.

If a firm does choose to advertise its claim of compliance in an advertisement, the advertisement must comply with, at a minimum, the GIPS Advertising Guidelines (Guidelines).[63] In this regard, the requirements of the Guidelines are bifurcated depending on whether or not the advertisement contains performance. Specifically, for advertisements that do not contain performance, the Guidelines require only non-performance-related disclosures.[64] On the other hand, advertisements that do present performance are subject to additional performance-related presentation and disclosure requirements.[65]

Definition of the Firm

Action Required: Under the 2010 Revisions, all advertisements that include a claim of GIPS compliance must include the firm definition.[66]

This subtle change will not have an impact on firms that used the firm definition to satisfy the requirement of the 2005 Standards to describe the firm. For those firms that included a short description that falls short of the formal definition of the firm, this change will require a change to their advertisement disclosures.

Annualized Returns

Action Required: Firms may include one-, three-, and five-year annualized returns through the most recent period.

Previously, returns had to be calculated and presented through the same period of time as presented in the firm's corresponding GIPS-compliant presentation.

Short Positions

Action Required: Firms must disclose the presence, use and extent of leverage, derivatives *and short positions* in advertisements, *if material*.

This change mirrors that of new GIPS Standard 4.A.13 in fully compliant presentation disclosures. Under the new standards firms must disclose the presence, use, and extent of leverage, derivatives *and short positions*, *if material*, and must include a description of the frequency of use and characteristics of the instruments sufficient to identify risks.[67] Here again the CFA Institute has added a materiality requirement that may prove to be both a benefit and a burden to many firms.

Conflicts with Local Law

Action Required: If the advertisement conforms to laws and/or regulations that conflict with the requirements of the GIPS standards and/or Advertising Guidelines, firms must disclose this fact and disclose the manner in which the laws and regulations conflict with the GIPS standards and/or Advertising Guidelines.[68] Previously, this was not applicable to advertisements.

Conclusion

Most of the new requirements under the 2010 Revisions became effective January 1, 2011. The authors recommend that firms claiming GIPS compliance should begin implementing the new changes in advance of presenting performance in 2011 so that they are prepared once they are required to show 2011 performance. Part 2 of this article, appearing in an upcoming issue of *The Investment Lawyer*, contains further information regarding the 2010 Revisions.

Notes

1. GIPS Q&A Database, Early Adoption, May 2010.

2. *See* pp.15-63 of the GIPS Handbook, Second Edition (2006) (the Handbook).

3. *See* pp.65-162 of the Handbook.

4. The 2010 revision includes both real estate and private equity. The specific revisions applicable to these two alternative asset classes are not addressed in this article.

5. Unless otherwise defined, capitalized terms shall have the meanings ascribed to such terms in the 2010 Revisions.

6. GIPS Standard 0.A.9.

7. GIPS Glossary, "Compliant Presentation."

8. GIPS Glossary, "Prospective Client" (emphasis added).

9. GIPS Handbook, Section 0.A.11. *See also* GIPS Handbook, Explanations, p.73.

10. "[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards."

11. GIPS Standard 4.A.1. Firms that are verified must make the above claim of compliance accompanied by the following: "[Insert name of firm] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request. Verification assesses whether (1) the firm has complied with all the Composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific Composite presentation."

12. GIPS Standard 4.A.1. "The [insert name of Composite] Composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request."

13. GIPS Standard 4.A.1.

14. *Id*.

15. GIPS Verification, IV.A.1.

16. GIPS Handbook, Section 0.A.3.

17. GIPS Handbook, Guidance Statement on Definition of the Firm (Revised).

18. GIPS Glossary, "Fair Value."

19. GIPS Standard 0.A.13.

20. GIPS Standard 1.A.2. *See* "Fundamentals of Compliance—Total Firm Assets" for a definition of fair value.

21. GIPS Standards, Principles, II.

22. GIPS Standards, Principles, II.B.5.

23. These new requirements are included in the Handbook with the January 1, 2010 effective date clearly stated. Accordingly, advisory firms have had ample notice that these changes would be implemented and the 2010 Revisions did not alter the indicated effective date.

24. GIPS Standard 1.A.3.

25. GIPS Glossary, "Large Cash Flow."

26. GIPS Standard 1.A.3(c).

27. GIPS Standard 3.A.10.

28. GIPS Standard 4.A.32. To the extent that a Composite's significant cash flow policy requires the removal of an entire portfolio in the event of a significant cash flow, the 2005 Standards already required firms to make fairly detailed disclosures, including the definition of "significant." The new disclosure, however, requires disclosure of a firm's Composite-specific definition of "significant" regardless of whether the entire portfolio may be removed.

29. GIPS Standard 3.A.4.

30. GIPS Glossary, "Composite Definition."

31. The GIPS 2010 Exposure Draft included a requirement to include in the Composite description sufficient information to allow a prospective investor to understand the key risks of the Composite strategy. *See* Exposure Draft of the

2010 Global Investment Performance Standards, 4.A.20 and Glossary, "Composite Description."

32. GIPS Standard 5.A.2.a.

33. GIPS Standard 5.A.2.b.

34. *Id*.

35. GIPS Standard 4.A.33.

36. GIPS Standard 4.A.34.

37. *See* GIPS Guidance Statement on Error Correction.

38. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

39. GIPS Standard 4.A.28 (Emphasis added). *See* Note on Materiality, below. The 2010 Revisions do not require a firm to disclose *how* its valuation hierarchy differs from the recommended hierarchy in the GIPS Valuation Principles.

40. GIPS Standards, Principles, II.B.8.

41. GIPS Standard 4.A.27 (emphasis added). *See* Note on Materiality, below.

42. GIPS Standard 4.A.27. *See* Note on Materiality, below.

43. GIPS Standard 4.A.20 (emphasis added). *See* Note on Materiality, below.

44. GIPS Standard 4.A.20.

45. GIPS Standard 4.A.21 (emphasis added).

46. GIPS Standard 2.A.2.

47. GIPS Handbook, Section 2.A.2.

48. GIPS Standard 5.A.1.c.

49. GIPS Standard 5.A.1.d. The 2010 Revisions define "Composite Termination Date" as "[t]he date that the last Portfolio exits a Composite."

50. *See* GIPS Standard 4.A.1.

51. GIPS Standard 4.A.4.

52. GIPS Glossary, "Benchmark."

53. GIPS Standard 4.A.20.

54. GIPS Standard 4.A.30.

55. GIPS Standard 4.A.31.

56. GIPS Standards 4.A.6.b and 4.A.6.c.

57. GIPS Standards, Glossary (defining "Compliant Presentation" as "[a] presentation for a Composite that contains all the information Required by the GIPS standards and may also include additional information or supplemental information…").

58. GIPS Standard 4.A.15.

59. GIPS Standard 8.

60. *Id*.

61. The GIPS Advertising Guidelines defines an "advertisement" as any material "distributed to or designed for use in newspapers, magazines, firm brochures, letters, media, websites, or any other written or electronic material addressed to more than one prospective client. Any written material, other than one-on-one presentations and individual client reporting, distributed to maintain existing clients or solicit new clients for a firm is considered an advertisement."

62. GIPS Advertising Guidelines, III.B.

63. The firm may comply with the full GIPS requirements in lieu of complying with the Guidelines.

64. GIPS Advertising Guidelines, III.B.

65. *Id*.

66. GIPS Advertising Guidelines, III.B.1.

67. GIPS Advertising Guidelines, III.B.11. *See* Note on Materiality, above.

68. GIPS Advertising Guidelines, III.B.13.

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There have been numerous modifications, deletions, and additions to the current version of the GIPS® standards, many of which were discussed in the first installment of this article. As a continuation of the first installment, this article highlights a few key additional changes applicable to traditional asset classes[1] that will impact firms currently claiming compliance with the GIPS® standards and provides some guidance as to actions that may be necessary for firms to comply with the 2010 Revisions.[2] Additionally, included at the end of this article is a checklist that summarizes the key requirements under the GIPS® standards, as amended by the 2010 Revisions.

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The authors would also like to acknowledge the assistance of K&L Gates Associate Douglas Y. Charton for his contributions to this article.

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Other Changes

Policies and Procedures: Custody

Action Required: Document policies and procedures used in establishing and maintaining compliance with the GIPS® standards, *including ensuring the existence and ownership of client assets*.[3]

Contrary to the actual language, the CFA Institute issued guidance on this new requirement indicating that the aim of the requirement was not to prevent Madoff-like scandals but rather to ensure that only actual, discre-

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tionary assets (as opposed to hypothetical or model portfolios) managed by the firm are included in Composites.[4] Accordingly, a firm's policies and procedures may include requirements that the firm obtain custodian or broker statements, trade confirmations or other documentation to establish the ownership and existence of client assets.[5]

The CFA's guidance leaves much unanswered for GIPS® firms that are non-discretionary managers and firms that manage alternative assets including privately offered assets, loans and certain derivatives. Since the standard is applicable to client assets, and makes no distinction between discretionary and non-discretionary assets, both of which are included in a firm's total assets for GIPS® purposes, the firm is required to ensure that non-discretionary client assets are in existence and owned by the firm's clients. In such a situation, the manager will not necessarily receive brokerage or custody statements. Similarly, if a firm has discretion over privately offered securities, it is virtually impossible for the firm to comply with Standard 0.A.5 without receiving a copy of the subscription agreement, some other form that evidences ownership, or audited financial statements.

Accordingly, for liquid assets over which a firm has discretion, the firm should be able to satisfy Standard 0.A.5 by including in its policies and procedures the requirement to reconcile the firm's records with statements from the client's custodian or broker. As to non-discretionary or privately offered securities, until the CFA Institute gives clearer guidance it is hard to determine how a firm may comply with this new requirement. Firms may have to simply rely upon representations made by the client that the assets (whether discretionary or non-discretionary) exist and are owned by the client if other reasonable methods of establishing existence and ownership (for example, auditor's report, subscription agreements, loan documents, ISDAs or other non-publicly traded instruments signed by the client) are not readily available.

Recordkeeping

Action Required: Capture and maintain all data and information necessary to support *all items* included in a compliant presentation, including supplemental and additional information included as part of the compliant presentation.[6]

The 2005 Standards only required firms to capture and maintain data and information necessary to support the performance presentation and to perform the required calculations.[7] As of January 1, 2011, firms are subject to broader recordkeeping requirements under GIPS®. Many advisers, particularly those registered with the United States Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, as amended (Advisers Act), are already subject to fairly broad recordkeeping requirements.[8] However, firms claiming compliance should not simply assume that compliance with local laws and regulations will suffice for GIPS® purposes. Firms should confirm that their current record retention procedures are sufficient to back up the information presented in compliant presentations. To the extent changes are required, firms should be sure to revise their GIPS® policies and procedures to reflect the heightened recordkeeping policies.

Carve-Outs

Action Required: For periods beginning on or after January 1, 2010, firms may only include a carve-out in a Composite if the carve-out is managed separately with its own cash balance.[9] This provision may require firms to adjust the way in which they manage portfolios within a Composite if they wish to continue to carve out the performance of certain segments. At a minimum, firms should amend their Composite construction policies and procedures regarding carve-outs to reflect this change in the GIPS® standards.

This is not a new concept as the 2005 Standards included this provision and served as fair warning to firms that firms would be required to come into compliance as of January 1, 2010. Prior to January 1, 2010, a carve-out was previously defined simply as a single or multiple asset class segment of a multiple asset class portfolio and firms were permitted to allocate cash to the carve-out returns as long as they did so in a timely and consistent manner and disclosed the allocation policy.[10] To reflect the new rule, the Revisions define "Carve-Out" as "[a] portion of a Portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multiple-strategy Portfolio managed to a broader mandate…"[11] For periods beginning on or after January 1, 2010, cash allocation to carve-outs is no longer permitted under GIPS®, but all carve-out performance with cash allocations prior to January 1, 2010 must be left unchanged, and the firm must disclose the historical inclusion of carve-outs and the period of inclusion.[12] Also, firms are no longer required to disclose prospectively the percentage of Composite assets represented by carve-outs.

Portability

Action Required: Firms must judge portability on a Composite-specific basis and must link past performance when the decision making process has remained *substantially* intact and independent within the new firm (and all of the other portability requirements are met).

The presentation and reporting requirements related to portability contained in the 2010 Revisions now make clear that portability is judged on a Composite-specific basis.[13] The implication is that for newly hired managers that have managed multiple strategies, just because one Composite strategy meets the portability standards does not necessarily mean the rest will. Moreover, under the 2010 Revisions portability requirements may be satisfied as long as the decision-making process remains *substantially* intact and independent within the new or acquiring firm.[14] The insertion of the word "substantially" provides flexibility and clarity that the investment decision-making process does not need to be a mirror image of what it was at the prior firm.

It is also important to note that for mergers, the test requiring that substantially all of the assets from the acquired firm transfer to the new acquiring firm has been eliminated.

Additionally, under the 2010 Revisions the one-year grace period to bring non-compliant portable performance into compliance with GIPS® applies to a firm acquiring another firm *or affiliation*.[15] As a result, a firm that acquires one or more portfolio managers as part of a "lift out" has one year to bring the performance of such portfolio managers into compliance with GIPS®.

Conclusion

As mentioned in the first installment of this article, most of the new requirements under the 2010 Revisions became effective January 1, 2011. We recommend that firms claiming GIPS® compliance should begin implementing the new changes in advance of presenting performance in 2011 so that they are prepared once they are required to show 2011 performance. The 2010 Revisions reflect a fine-tuning of the GIPS® standards more than an overhaul of new compliance requirements. However, the SEC will take note of the 2010 Revisions and will continue[16] to scrutinize firms' claims of compliance to ensure that such claims are legitimate and valid.

ADVERTISING CHECKLIST: GLOBAL INVESTMENT PERFORMANCE STANDARDS

A. GIPS® COMPLIANCE. Once a firm has met all the requirements of the GIPS® standards, the firm must adhere to the following:

- ☐ Disclose compliance with GIPS® using **one** of the following statements (*note: the claim of compliance can only be used in a compliant presentation*):[17]

1. For firms that are verified:

"[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. [Insert name of firm] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS®standards. Verification does not ensure the accuracy of any specific composite presentation."

OR

2. For Composites of a verified firm that have also had a performance examination:

"[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS®standards. [Insert name of firm] has been independently verified for the periods [insert dates].

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS®standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS®standards. The [insert name of composite] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request."

OR

3. For firms that have not been verified:

"[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS®standards. [Insert name of firm] has not been independently verified."

- *If the firm is jointly marketing with other firms*, the firm claiming GIPS®compliance must be clearly defined and separate relative to other firms being marketed and the advertisement must be clear as to which firm claims GIPS®compliance.

- Firms <u>*must*</u>

1. Make every reasonable effort to provide a compliant presentation to all prospective clients.[18] (*Note: as long as a prospective client received a compliant presentation within the past 12 months, the firm has met this requirement*)

2. Provide the following, upon request, to a prospective client: (i) a complete list of Composite descriptions; and (ii) a compliant presentation for any Composite listed on the firm's list of Composite descriptions.

3. Satisfy the input data, calculation methodology and Composite construction requirements under the GIPS®standards.

B. PRESENTATION AND REPORTING—FULL GIPS® PRESENTATION

1. For each Composite presented, the following items must be reported:

- At least five years of performance (or since firm or Composite inception if firm or Composite is in existence for less than five years); after five years of performance, must present an additional year of performance building up to a minimum of 10 years of GIPS®-compliant performance. (*Note: If the firm is converting from AIMR-PPS to GIPS®, a full 10 years of compliant performance must be presented.*)
- Composite returns for each annual period, *clearly identified* as gross-of-fees or net-of-fees.
- The total return for the benchmark(s) that reflects the Composite mandate, objective or strategy must be presented for each annual period.
- Number of portfolios in the Composite as of each annual period end, *except if* the Composite contains five or fewer portfolios at period end, in which case the number of portfolios is not required.
- Composite assets as of each annual period end.
- Either:

1. Total firm assets as of each annual period end,

OR

2. Composite assets as a percentage of total firm assets as of each annual period end.

- Measure of internal dispersion of individual portfolio returns for each annual period, *except if* Composite has five portfolios or less for the full year, in which case an internal measure of dispersion is not required.

2. **Non-Compliant Returns**. Firms may link non-GIPS® compliant performance to GIPS®compliant performance provided that only GIPS®-compliant performance is presented for periods beginning on or after January 1, 2000 (that is, firms may link returns for periods ending on or before January 1, 2000 but they may not link returns for periods ending on or after January 1, 2000).

3. **Returns of Less than One Year.** Returns of portfolios and Composites for periods of less than one year must not be annualized.

4. **Carve-Outs**. For periods beginning on or after January 1, 2006 and ending prior to January 1, 2011, if a Composite includes carve-outs the presentation must include the percentage of the Composite that is composed of carve-outs as of each annual period end. This information need not be shown for periods ending on or after January 1, 2011.

> ***Note:*** For periods beginning on or after January 1, 2010 carve-outs must not be included in a Composite unless the carve-out is managed separately with its own cash balance. For periods prior to January 1, 2010, if carve-outs were included in a Composite, cash must have been allocated to the carve-out in a timely and consistent manner.

5. **Non-Fee Paying Portfolios**. If Composite contains any non-fee paying portfolios, the presentation must present as of each annual period end, the percentage of Composite assets represented by non-fee paying portfolios.

6. **Bundled Fees**. If Composite includes portfolios with bundled fees, the presentation must include the percentage of Composite assets represented by portfolios with bundled fees as of each annual period end.

7. **Portability**.

- Performance track records of past firm or affiliation must be linked if:
  - Substantially all investment decision-makers are employed by the new firm;
  - The decision-making process remains substantially intact and independent within the new firm; and
  - New firm has supporting documents for the performance.

Note: If a compliant firm acquires or is acquired by a non-compliant firm, the acquiring firm has one year to bring non-compliant assets into compliance.

- Must disclose that performance results from past firm are linked to performance record of new firm.

8. **Composites showing performance for periods ending on or after January 1, 2011:**

- *For Composites with an inception date of January 1, 2011 or after*: If the initial period is less than a full year, performance must be shown from the inception date through the initial annual period end.
- *For Composites with a termination date of January 1, 2011 or after:* Performance from the last annual period end through the Composite termination date must be shown.

Risk. For Composites showing performance for periods ending on or after January 1, 2011, firms must show:

- The three-year annualized ex-post standard deviation (using monthly returns) of both the Composite and the benchmark as of each annual period end).

AND

- *If the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate*, the firm must show an additional three-year ex-post risk measure for the benchmark (if available and appropriate) and the Composite. (*Note: the periodicity of the Composite and the benchmark must be identical when calculating the ex-post risk measure.*)

9. **Misleading Information**. The following types of information are deemed to be misleading and unrepresentative, and may NOT be presented unless specifically requested by a prospective or current client in a one-on-one presentation:

- Model, hypothetical, backtested or simulated results *linked* to actual performance returns.
- Non-portable performance from a prior firm *linked* to current ongoing performance.

C. DISCLOSURES—FULL GIPS® PRESENTATION

- **General Information about the firm:**
  - **Firm Definition.** Must disclose firm definition used to determine total firm assets and firm-wide compliance.
  - **Firm Redefinition.** If firm redefined, must disclose date of, description of, and reason for redefinition.
  - **List of Composites**. Must disclose availability of a complete list and description of all firm Composites.

- **General Information about the Composite:**
  - **Composite Description**. Must disclose the Composite description (that is, general information regarding the Composite strategy).
  - **Composite Redefinition.** If Composite redefined, must disclose date of, description of and reason for change. Changes to Composite are not permitted to be applied retroactively.
  - **Composite Name Change.** Must disclose any changes to name of Composite.
  - **Composite Creation Date**. Must disclose the Composite creation date.
  - **Minimum Asset Levels.** Must disclose minimum asset level (if any) below which portfolios are not included in a Composite, and any changes to the minimum asset level.

- **Fees:**
  - **Gross-of-Fee Performance.** Disclose if any other fees are deducted in addition to the trading expenses.

- Net-of-fee Performance. Disclose:
  - If any other fees are deducted in addition to the investment management fees and trading expenses;
  - If model or actual investment management fees are used; and
  - If returns are net of any performance-based fees.
  - **Fee Schedule.** Must disclose fee schedule appropriate to presentation.
  - **Currency.** Disclose the currency used to express performance.
  - **Dispersion Measures.** Must specify which dispersion measure is presented.
  - **Calculation Policies.** Must disclose that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
  - **Leverage and Derivatives.** Must disclose presence, use, and extent of leverage, derivatives, and short positions, if material, including description of frequency of use and characteristics of the instruments sufficient to identify risks.
  - **Significant Events.** Must disclose all significant events that would help a prospective client interpret the compliant presentation.
  - **Noncompliant Periods.** If performance presented prior to January 1, 2000 does not comply with GIPS®, must disclose period of non-compliance.
  - **Withholding Tax.** Must disclose relevant details of treatment of withholding tax on dividends, interest income, and capital gains, if material.

- **Exchange Rates.**
  - *For periods beginning on or after January 1, 2011*, must disclose and describe any known material differences in exchange

rates or valuation sources used among portfolios within a Composite and between Composite and benchmark.
- *For periods prior to January 1, 2011*, must disclose and describe any known inconsistencies in exchange rates used among portfolios within a Composite and between Composite and benchmark.
- **Local Law.** If local laws and regulations differ from GIPS®, must disclose that presentation adheres to local laws and disclose manner in which law conflicts with GIPS®.
- **Carve-outs.** For periods prior to January 1, 2010, if carve-outs are included in a Composite, must disclose the policy used to allocate cash to carve-outs. (*Note: for periods beginning on or after January 1, 2010, carve-outs can only be included in a Composite if the carve out is managed separately with its own cash balance.*)
- **Bundled Fees.** If Composite contains portfolios with bundled fees, must disclose the types of fees that are included in the bundled fee.
- **Subadvisers.** *For periods beginning on or after January 1, 2006*, disclose use of subadviser and periods subadviser was used.

- **Valuation.**
  - **Month-End Valuations.** *For periods prior to January 1, 2010,* must disclose if any portfolios were not valued at calendar month end or on the last business day of the month.
  - **Use of Subjective Inputs.** *For periods beginning on or after January 1, 2011*, must disclose use of subjective unobservable inputs for valuing portfolio investments if the portfolio investments valued using subjective unobservable inputs are material to the Composite.[19]
  - **Valuation Hierarchy.** *For periods beginning on or after January 1, 2011,* must disclose if the Composite's valuation hierarchy materially differs from the recommended valuation hierarchy in the GIPS®valuation Principles.

- **Benchmarks:**
  - Must disclose the benchmark description.
  - Must disclose if benchmark returns are net of withholding taxes, if this information is available.
  - If no benchmark is shown, must disclose why no benchmark is presented.
  - If the firm changes benchmark, must disclose date of, description of, and reason for change.
  - If a custom benchmark or combination of multiple benchmarks is used, must disclose the benchmark components, weights and rebalancing process.
  - Must disclose if the three-year annualized ex-post standard deviation of the benchmark is not presented because 36 monthly returns are not available.
  - **Significant Cash Flow.** If the firm has adopted a significant cash flow policy for the Composite, must disclose how the firm defines significant cash flow and for which periods.

- **Risk:**
  - Must disclose if the three-year annualized ex-post standard deviation of the Composite is not presented because 36 monthly returns are not available.
  - If the three-year annualized ex-post standard deviation is not relevant or appropriate, must (1) describe why the ex-post standard deviation is not relevant or appropriate; and (2) describe the additional risk measure presented and why it was selected.
  - **Linked Performance**. Must disclose if performance from a past firm or affiliation is linked to the performance of the firm.

D. SUPPLEMENTAL INFORMATION

1. Supplemental information is any performance-related information included as part of a compliant performance presentation that supplements or enhances the required and/or recommended disclosure and presentation provisions of GIPS®.

2. Supplemental information may be shown so long as the supplemental information:

 - Satisfies the spirit and principles of the GIPS®standards (that is, fair representation and full disclosure);
 - Does not contradict or conflict with information provided in the compliant Composite presentation; and
 - Is clearly labeled and identified as supplemental to a specific Composite presentation (for example, "as provided on page 11" or "as provided on 15 March 20XX).

3. A fully compliant presentation must be provided prior (within the past 12 months) to or must accompany the supplemental information.

E. GIPS® ADVERTISING GUIDELINES

1. **General Requirements**. All advertisements that include a claim of compliance with the GIPS® standards must include:

 - The definition of the firm;
 - How a prospective client can obtain a compliant presentation and/or the firm's list of Composite descriptions; and
 - The GIPS®Advertising Guidelines compliance statement: "[xxx] claims compliance with the Global Investment Performance Standards (GIPS®)."

2. **Performance Information**. If the advertisement includes a claim of GIPS®compliance *and* performance results, the following information must be taken/derived from a presentation that adheres to requirements of the GIPS®standards:

 - **Composite Description.** Must disclose description of the strategy of the Composite.
 - **Performance Returns.** Present Composite total returns according to *one* of the following:
 - One-, three-, and five-year annualized Composite returns through the most recent period with the period-end date clearly identified. Returns for periods of less than one year cannot be annualized. *(Note: if the Composite has been in existence for less than five years, must also present the annualized return since the Composite inception date.)*
 - Period-to-date Composite returns in addition to one-, three-, and five-year annualized Composite returns through the same period of time as presented in the corresponding compliant presentation with the period end date clearly identified. Returns for periods of less than one year cannot be annualized. *(Note: if the Composite has been in existence for less than five years, firms must also present the annualized returns since the Composite inception date.)*
 - Period-to-date Composite returns in addition to five years of annual Composite returns (or for each annual period since the Composite inception date if the Composite has been in existence for less than five years) with the period end date clearly identified. The annual returns must be calculated through the same period of time as presented in the corresponding compliant presentation.
 - **Gross/Net Returns.** Must disclose whether performance is gross and/or net of advisory fees.
 - **Benchmarks.**
 - Must disclose total return for the benchmark for the same periods for which the Composite return is presented. (*Note: benchmark must be the same benchmark return presented in corresponding GIPS® presentation*).
 - The benchmark description.
 - If no benchmark is shown, must disclose why.
 - **Currency.** Must disclose currency used to express returns.
 - **Leverage and Derivatives.** Must disclose description of use and extent of leverage, derivatives, and short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks.

□ **Noncompliant Information.** If presenting noncompliant performance information before January 1, 2000, must disclose period(s) of noncompliance.

□ **Local Laws/Regulations.** Must disclose if advertisement conforms with laws/regulations that conflict with the GIPS® standards or the Advertising Guidelines and disclose the manner in which the laws/regulations conflict with the GIPS® standards or Advertising Guidelines.

Notes

1. The 2010 Revision includes both real estate and private equity. The specific revisions applicable to these two alternative asset classes are not addressed in this article.

2. Unless otherwise defined, capitalized terms shall have the meanings ascribed to such terms in the 2010 Revisions.

3. GIPS®Standard 0.A.5 (emphasis added).

4. GIPS®Q&A Database, Fundamentals of Compliance, May 2010.

5. *Id*.

6. GIPS®Standard 1.A.1.

7. GIPS®Handbook, Section 1.A.1.

8. *See* Rule 204-2 under the Advisers Act.

9. GIPS®Standard 3.A.8.

10. GIPS®Handbook, Section 3.A.7.

11. GIPS®Glossary, "Carve-Out."

12. GIPS®Handbook, Guidance Statement on the Treatment of Carve-Outs (Revised).

13. GIPS®Standard 5.A.8.a.

14. GIPS®Standard 5.A.8.a.ii.

15. GIPS®Standard 5.8.b.

16 The SEC has taken enforcement action against firms falsely claiming GIPS®compliance. *See In re Stan D. Kiefer & Associates and Stanley D. Kiefer*, SEC Release No. IA-2023 (Mar. 22, 2002); *see also*, *In re Schield Management Company et al.*, SEC Release No. IA-1872 (May 31, 2000).

17. A compliant presentation is a presentation for a Composite that contains all the information required by the GIPS®standards and may also include additional information or supplemental information.

18. Prospective client is defined broadly to include "any person or entity that has expressed interest in one of the firm's composite strategies and is qualified to invest in the composite. Existing clients may also qualify as prospective clients for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as prospective clients if they represent investors that qualify as prospective clients."

19. Subjective unobservable inputs should only be used to measure fair value of portfolio investments if observable inputs and prices are not available or appropriate. Unobservable inputs reflect the firm's own assumptions about the assumptions that market participants would use in pricing the investment and should be developed based on the best information available under the circumstances.

K&L|GATES

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