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GIPS 2020 Exposure Draft: What Every Firm Needs to Know

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On August 30, 2018, the CFA Institute released for public comment the GIPS 2020 Exposure Draft (the Exposure Draft or the Proposed Standards),¹ which represents the first significant overhaul of the Global Investment Performance Standards (GIPS) in nearly a decade.² With the comment period for the Exposure Draft now closed, a final version of the Proposed Standards is anticipated in mid-2019, with an effective date of January 1, 2020. Once effective, the Proposed Standards will be applicable to performance periods ending on or after December 31, 2020. As such, firms that currently comply with GIPS will need to prepare performance reports showing 2020 performance in accordance with the Proposed Standards.

GIPS are voluntary ethical standards intended to ensure fair representation and full disclosure in the presentation of investment performance. The objective of GIPS is to establish a single set of standards that facilitate the calculation and presentation of investment performance in a manner that is readily comparable among investment firms, regardless of geographic location and local conventions. GIPS was first published by the CFA Institute in April 1999, although predecessor standards were originally drafted and released by the Association for Investment Management and Research (the predecessor to the CFA Institute) in 1993. Since that

time, the CFA Institute has published several revisions to the Standards, as well as interpretive guidance in the form of Guidance Statements and Q&A responses.

The CFA Institute has stated that an express goal of the Exposure Draft is to facilitate broader adoption among alternative investment managers and other managers of pooled funds. Indeed, most of the significant changes proposed in the Exposure Draft are designed to make GIPS more accessible to managers of private equity, hedge, real estate, private credit, and other limited distribution pooled funds. While broader adoption, if it occurs, will likely be driven by the institutional investor community, the proposed changes to the Standards do address many of the issues that have historically made compliance with prior versions of the Standards difficult for alternatives managers.

Although the Exposure Draft represents a large-scale revision of the existing Standards, this article highlights only those changes that will have the greatest impact on firms that currently claim compliance with GIPS and the likely effect of certain proposed revisions on private fund managers, registered fund managers, and various other types of investment firms. It also highlights certain areas where further clarification is expected prior to the January 1, 2020, effective date.³

GIPS Pooled Fund Reports

- GIPS-compliant presentations, now called GIPS Composite Reports, must be distributed only to separate account clients and prospects.
- There are two new types of reports: GIPS Pooled Fund Reports for the presentation of pooled fund performance, and GIPS Asset Owner Reports for the performance of asset owners.
- A GIPS firm *must* deliver GIPS Pooled Fund Reports to investors in “limited distribution” pooled funds and *may*, but is not required to, publish GIPS Pooled Fund Reports for investors in “broad distribution” pools.

Representing a major shift from the composite-level focus of the existing Standards, GIPS firms will no longer be required to create a composite for an investment strategy if a firm manages only one or more pooled funds according to that strategy. Currently, the Standards require the presentation of performance at the composite level, and if a GIPS firm manages a pooled fund that does not meet any existing composite definition, the firm must create a composite strictly for that pooled fund. Thus, under the current Standards, a firm seeking to advertise GIPS compliance can only present the pooled fund’s performance in accordance with GIPS by presenting the composite performance.

The Exposure Draft proposals divide the existing concept of GIPS-compliant presentations into three categories: (1) presentations of composite performance (GIPS Composite Reports); (2) presentations of pooled fund performance (GIPS Pooled Fund Reports), and (3) presentations of the performance of “asset owners,” a term that generally refers to institutional investors (GIPS Asset Owner Reports). GIPS Composite Reports, GIPS Pooled Fund Reports, and GIPS Asset Owner Reports are together referred to as “GIPS Reports.” The Exposure Draft proposals retain the requirement that GIPS firms include the performance of a pooled fund in a GIPS Composite Report *only if* (1) the fund’s investment strategy meets the

composite definition; and (2) the strategy is also offered in segregated account form.⁴ Thus, GIPS firms are no longer required to create single-fund composites.

A firm’s obligations with respect to the delivery of GIPS Pooled Fund Reports will differ depending on whether the firm is marketing a broad distribution pooled fund or a limited distribution pooled fund, concepts introduced in the Proposed Standards and discussed below. The Proposed Standards require (for firms selling participation in limited distribution pooled funds), or allow (for broad distribution pooled funds) a GIPS firm to prepare and present GIPS Pooled Fund Reports for individual funds.⁵ A “limited distribution pooled fund” is a pooled fund that is not marketed to the public, and for which the typical marketing practice involves direct, one-on-one contact between the firm managing the pooled fund and the prospective investor.⁶ Examples of limited distribution pooled funds include “private funds” offered in the US and alternative investment funds offered in Europe. Under the Proposed Standards, firms that claim GIPS compliance are *required* to prepare and present a GIPS Pooled Fund Report when selling limited distribution pooled funds. A “broad distribution pooled fund” is a pooled fund that is publicly available to multiple investors, for which the typical marketing practice involves no or minimal personal contact between the firm managing the pooled fund and the pooled fund prospective investor.⁷ These funds are typically highly regulated, and examples include mutual funds offered in the US and Undertakings for the Collective Investment in Transferable Securities (UCITS) offered in Europe and Asia. Firms selling broad distribution pooled funds may elect to prepare and present a GIPS Pooled Fund Report. Managers of broad distribution pooled funds may also promote a claim of GIPS compliance without preparing and distributing a GIPS Pooled Fund Report by utilizing a GIPS Advertisement (discussed below) prepared in accordance with the GIPS Advertising Guidelines.

The requirement to prepare a GIPS Pooled Fund Report for each limited distribution pooled

fund and deliver the report to each potential investor raises several interpretive questions. Many private fund managers reach potential investors primarily or exclusively through third-party placement agents. In these arrangements, some potential investors perform due diligence on the manager, but others subscribe for fund interests without ever communicating directly with the manager. It appears that a GIPS firm in this situation would be obligated to deliver a GIPS Pooled Fund Report to some, but not all potential investors. A similar issue arises for managers that distribute funds or share classes that are not clearly “limited distribution” or “broad distribution.” Examples include bank-sponsored collective investment trusts, UCITS marketed in the US pursuant to a private offering exemption, and institutional share classes of mutual funds (I Shares) that are typically marketed in one-on-one meetings.⁸ In these cases, a GIPS firm may need to treat a single fund as a limited distribution fund with respect to certain potential investors, and a broad distribution fund with respect to others. These issues will likely need to be addressed in the final version of the Proposed Standards or in related guidance, and firms should anticipate further clarification.

The content requirements for GIPS Pooled Fund Reports are substantially similar to those for GIPS Composite Reports. These requirements include certain items from the existing Standards as well as the introduction of additional proposals in the Exposure Draft. For example, firms presenting money-weighted returns (discussed below) in either a GIPS Composite Report or a GIPS Pooled Fund Report for portfolios that utilize a subscription line of credit must present specific return information that both includes and excludes the subscription line of credit activity.⁹

GIPS Pooled Fund Reports: Implications for Private Fund Managers

The concept of GIPS Pooled Fund Reports provides a more intuitive structure for the preparation and presentation of pooled fund performance to

potential investors. Fund managers that do not also manage separate accounts may, under the proposed Standards, claim compliance with GIPS and prepare only GIPS Pooled Fund Reports, avoiding the creation of performance composites entirely. Firms that manage private funds and separate accounts side-by-side, by contrast, must continue to include pooled funds in GIPS Composite Reports, and will incur the added obligation to deliver GIPS Pooled Fund Reports to potential fund investors.¹⁰ The proposals related to pooled funds actually impose an incremental burden on such firms, and a manager with several limited distribution pooled funds in a single strategy will ultimately need to prepare several GIPS Reports for that strategy.

Managers should also consider the potential regulatory implications of distributing materials that name a particular fund, rather than present the performance of the fund manager. In the US, there is generally no private right of action under the Investment Advisers Act of 1940, as amended (the Advisers Act), but the Securities Act of 1933, as amended (the 1933 Act), does establish a right of action for purchasers of unregistered securities.¹¹ Consequently, the potential scope of liability arising from errors or material omissions in a GIPS Pooled Fund Report, which would generally be considered a communication made in connection with a securities offering, differs from that of a GIPS Composite Report, which relates to the services provided by an investment manager.¹² Firms will also need to assess whether GIPS Pooled Fund Reports should be distributed only by registered representatives of a broker-dealer, depending on their structure and affiliations.¹³

GIPS Pooled Fund Reports: Implications for Institutional Managers

Due to investor demand, many institutional asset managers already claim GIPS compliance.¹⁴ Although the changes proposed in the Exposure Draft are less relevant for institutional managers than they are for alternative managers, the introduction of GIPS Pooled Fund Reports in the Exposure Draft provides

institutional managers with increased flexibility to meet the needs of their sophisticated investor base. This flexibility comes with the burden of substantial additional compliance obligations for firms that manage pooled funds as well as separate accounts.

Certain investment strategies are better suited for (or can only be implemented in) a pooled vehicle. Under the Exposure Draft, an institutional firm may (or must, for limited distribution pooled funds) provide a potential investor with a GIPS Pooled Fund Report designed specifically for the product in which the prospective investor has expressed interest, rather than a compliant presentation for a composite. As a result, firms that distribute strategies through multiple fund “wrappers” can provide prospective clients with GIPS Pooled Fund Reports that are more representative of the product that the client will invest in. In addition, many diversified asset management firms traditionally have claimed compliance only for the institutional subset of their business. The changes set forth in the Exposure Draft may result in these firms extending the GIPS firm definition and compliance to their entire organizations.

However, this flexibility comes with a substantial incremental burden. Managers with significant existing private fund business likely will need to prepare additional GIPS Reports—one for each fund that is considered a limited distribution pooled fund. For many large institutional managers, this will require the preparation of hundreds of additional GIPS Reports if the firm elects to maintain its claim of compliance. Furthermore, firms that choose to expand GIPS compliance to a broader portion of their firm will likely need to dedicate significant time and resources to bringing all assets into compliance.

Performance Portability

- The presentation of prior firm performance that meets the portability requirements is now optional.
- The one-year limit on bringing any non-compliant assets of an acquired firm or team into GIPS

compliance has been relaxed, affording more time to obtain records and otherwise meet the standards for portability and GIPS compliance.

The Exposure Draft provides much more optionality and flexibility than the current Standards for firms involved in M&A transactions and portfolio management team lift-outs. Currently, if the GIPS portability requirements are satisfied, composite performance from a prior firm or affiliation *must* be linked to performance at the new or acquiring firm. Firms that do seek to link performance may only do so if the existing criteria are met: (1) substantially all of the investment decision makers are employed by the new or acquiring firm; (2) the decision-making process remains substantially intact and independent within the new or acquiring firm; (3) the new or acquiring firm has records that document and support the performance; and (4) there is no break in the track record between the prior firm and the new or acquiring firm. If all four criteria are not met, the past performance record of the acquired firm or team must not be linked to the ongoing performance record of the new firm.

The Exposure Draft reverses this position and makes portability optional, providing that performance *may* be linked if the portability tests are met on a composite-specific or pooled fund-specific basis. This reversal recognizes that, in practice, firms that did not wish to sustain the performance of a particular composite often failed to meet one of the GIPS portability tests. Making portability optional will align the Standards with industry practice, as well as current guidance of US Securities and Exchange Commission (SEC) Staff, which does not require prior firm performance to be linked.¹⁵

Greater flexibility is also provided with respect to the one-year grace period for non-compliant assets. Under current guidance, if a GIPS-compliant firm acquires a non-GIPS-compliant firm, then the acquiring firm has one year from the date of acquisition to bring any non-compliant assets into GIPS

compliance. The Exposure Draft proposes a clarification that the one-year “grace period” applies on a prospective basis only. Under the Exposure Draft, firms are no longer required to ensure that pre-acquisition performance is compliant within one year of an acquisition.¹⁶ For example, three years after an acquisition date, the new firm could purchase records from the prior firm and port the performance at that time. This flexibility will allow an acquiring firm to port only a portion of the track record of the prior firm (for example, the time period for which records are available), which may be a shorter time period than going back to the inception of the strategy at the prior firm. This is consistent with the SEC Staff’s position on portability.¹⁷

Treatment of Carve-Outs

- GIPS-compliant carve-outs no longer must be managed with a dedicated cash balance; cash may now be allocated among carve-outs.
- If a GIPS firm obtains a stand-alone portfolio managed in the same strategy as a carve-out, it must create a separate composite with only stand-alone portfolios.

A “carve-out” is a portion of a portfolio that is representative of an investment strategy distinct from the strategy of the broader portfolio. Under the current standards, the performance of a carve-out may only be included in a composite if the carve-out is managed with its own dedicated cash balance.¹⁸ Consequently, a GIPS firm that manages a blended portfolio could only “carve out” the equity and fixed income portions of the portfolio and include them as distinct portfolios in different composites if each was managed in a separate portfolio at the custodian, with separate cash accounts or in sub-portfolios with a distinct cash balance. In a reversal from prior guidance, the Exposure Draft proposes to permit GIPS firms to allocate cash to carve-outs, which means that, in the prior example, two distinct portfolios for inclusion in different composites could be created

from a single blended account with a shared cash balance.¹⁹ To avoid cherry-picking, a GIPS firm that creates a carve-out with allocated cash for inclusion in a composite must create carve-outs with allocated cash from all portfolios or portfolio segments within the firm managed to the same strategy, and include those carve-outs in the composite. Firms also must disclose the percentage of composite assets represented by carve-outs with allocated cash as of each annual period end.

In addition, once a GIPS firm obtains a stand-alone portfolio managed in the same strategy as the carve-out(s) with allocated cash, the firm must create a composite that includes only the stand-alone portfolio(s). The performance of this stand-alone composite must be presented alongside the performance of the composite including carve-outs with allocated cash in the GIPS Composite Report for that composite. If adopted, the changes to the treatment of carve-outs may make GIPS compliance more attractive to private equity and real estate fund managers that often seek to market new strategies by making reference to the performance of carve-outs of the assets held by prior funds.

Money-Weighted Returns (IRRs) and Subscription Lines of Credit

- Money-weighted returns may be presented for any asset type, provided that the firm controls external cash flows and the strategy exhibits one of the following characteristics: (1) closed-end; (2) fixed life; (3) fixed commitment; or (4) significant illiquid investments.
- Funds or strategies that use subscription lines of credit must present two performance streams: one that reflects the line of credit cash flows, and one based only on investor cash flows.

The Exposure Draft contains several proposals designed to make GIPS more relevant to managers of illiquid assets such as private equity, private credit, and real estate. Many of these provisions

were introduced in prior versions of the Standards and related Guidance Statements as being applicable only to a specific asset class, such as real estate, but the Exposure Draft proposals have been broadened and streamlined to allow the presentation of money-weighted returns for any asset class with certain characteristics.

Under the current Standards, GIPS-compliant presentations may only present time-weighted returns (TWR), subject to two narrow exceptions.²⁰ TWR is a method of calculating period-by-period returns that negates the effects of capital flows, including both cash and investments that enter or exit a portfolio. In recognition of the fact that TWR may not be an appropriate performance measure where, as in private equity, the manager controls the timing of cash flows rather than the manager's clients, the Exposure Draft allows firms greater flexibility for presenting the internal rate of return of a composite or fund—defined in the Exposure Draft as money-weighted returns (MWR). MWR is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows. The Exposure Draft removes the existing asset class guidance and replaces it with a methodology-based standard that is asset class agnostic.

A GIPS firm may now present MWR in GIPS Reports if the firm both controls the external cash flows into a pooled fund or the portfolios within a composite, and the fund or portfolios meet at least one of the following criteria: (1) closed-end; (2) fixed life; (3) fixed commitment; or (4) illiquid investments are a significant part of the investment strategy.²¹ Since-inception MWR are required and must be shown through the most recent year-end period. In addition, if subscription lines of credit are used, firms must present since-inception MWR both including and excluding the subscription line of credit activity through the most recent annual period end.

GIPS Reports will be subject to different performance presentation and disclosure requirements

depending on the decision to present MWR or TWR. For example, firms presenting TWR must disclose the firm's policy for the treatment of "significant cash flows" and what measure of internal dispersion is presented. By contrast, GIPS Reports presenting MWR are not required to disclose significant cash flow policies or internal dispersion, but are required to disclose the frequency of cash flows used in MWR calculations if other than daily.

One of the more controversial proposals in the Exposure Draft is the treatment of subscription lines of credit. Pursuant to the proposals, a firm that uses subscription lines of credit must present two performance streams: one that reflects the line of credit cash flows, and one based only on investor cash flows. This requirement has been introduced to promote transparency and address a perceived lack of consistency in return calculations when lines of credit are used, and may have a significant impact on the stated performance of firms that make use of subscription lines of credit for extended periods.

Estimated Transaction Costs

- Firms may estimate transaction costs if they determine that estimated transaction costs are greater than or equal to actual transaction costs.
- This change obviates the need for special "wrap fee" guidance, and will allow firms to create composites that combine "wrap fee" accounts with traditional separate accounts.

"Transaction costs" are the costs of buying or selling investments, including both traditional trading expenses such as brokerage commissions, exchange fees and taxes, and bid and offer spreads, as well as legal, financial, advisory, and similar costs incurred in private markets transactions.²² Under the current Standards, all returns must be calculated after the deduction of actual trading expenses incurred during the period, and use of estimated trading expenses is not allowed.²³ This presents

difficulties for managers of wrap fee accounts because the portion of the bundled fee attributable to trading expenses often cannot be determined. In a departure from the existing requirement, the Exposure Draft permits firms to use estimated transaction costs if certain requirements are met.²⁴ Notably, firms must be able to determine that estimated transaction costs are greater than or equal to actual transaction costs. In addition, GIPS Reports containing performance measurements including estimated transaction costs must disclose that estimated transaction costs are used, and provide certain details regarding such estimated transaction costs.

Implications for Managers of Wrap Fee Accounts and Separately Managed Accounts

Managers of wrap fee programs will note that the extensive requirements applicable solely to wrap fee and separately managed account portfolios set forth in the Guidance Statement on Wrap Fees/SMA Portfolios do not appear in the Exposure Draft. Instead, the Exposure Draft proposals treat wrap fee composites in a manner similar to any other composite created for purposes of presenting a GIPS Composite Report, with certain minor adjustments to address the treatment of gross- and net-of-fee performance.

The proposal to allow for estimated transaction costs will reduce some of the operational difficulties related to the presentation of gross and net returns of wrap fee accounts by simplifying the treatment of transaction costs. First, the proposed use of estimated transaction costs allows managers of wrap accounts to estimate the gross performance of wrap accounts by estimating the portion of the wrap fee that reflects the transaction costs. In order to do so, a firm likely will need to have a reasonable basis to determine that the estimated transaction costs are lower than the actual transaction costs in the portfolio.²⁵ Second, the Exposure Draft proposes to require that returns presented to a prospective wrap fee client must be calculated net of the entire

wrap fee. Taken together, these changes suggest that a GIPS firm could create a single composite containing both wrap fee accounts and non-wrap fee accounts, and present two performance streams for the same composite: (1) performance based on estimated transaction costs to non-wrap fee clients; and (2) performance reduced by the entire wrap fee to wrap fee clients.

In addition, the Exposure Draft codifies prior guidance that firms may present “pure gross-of-fees” performance (gross-of-fee returns that do not reflect the costs of transactions, commissions, or wrap fees) in a GIPS Composite Report as supplemental information. Another notable change relates to the concept of sponsor-specific composites. The current Standards and interpretive guidance permit firms to create sponsor-specific composites that include only those wrap fee portfolios attributable to a specific sponsor when presenting performance to that sponsor. The Exposure Draft removes the concept of a sponsor-specific wrap fee composite. Although firms may still present sponsor-specific performance, it will be viewed as client reporting rather than composite reporting to a prospective client and thus not subject to GIPS.²⁶ Instead, firms that wish to claim GIPS compliance when presenting performance to a prospective wrap fee client must present a composite that includes all actual wrap fee portfolios (and may include non-wrap portfolios) managed according to the composite strategy, regardless of the wrap fee sponsor.

Valuation Frequency and Assurance

- Private market investments must be valued at least annually through (1) external valuation; (2) an internal valuation subject to external review; or (3) a financial statement audit.

The Exposure Draft includes many changes to the existing valuation requirements in the Standards. For example, although monthly valuations are still required for GIPS Composite Reports, they are not

required for GIPS Pooled Fund Reports. Instead, the Exposure Draft applies many principles of the CFA Institute’s Guidance Statement on Alternative Investment Strategies and Structures²⁷ to GIPS Pooled Fund Reports. A GIPS Pooled Fund Report that presents TWR must value assets at the following times: (1) at least annually; (2) as of the calendar or fiscal year-end; (3) whenever there are subscriptions to or redemptions from the pooled fund; and (4) as of the period end for any period for which performance is calculated.²⁸ GIPS Pooled Fund Reports that present MWR must value assets and calculate returns as of the most recent annual period end of the pooled fund.

By contrast, GIPS Composite Reports using TWR for the portfolios included in the composite must value those portfolios at least monthly. Portfolios must also be valued on the date of all large cash flows. “Large cash flows” must be defined by the firm for each composite, to determine when portfolios in the composite must be valued.²⁹ Firms that present MWR in GIPS Composite Reports must value portfolios at least annually.

Implications for Private Fund Managers

The Exposure Draft also proposes significant changes to the valuation requirements imposed on managers of illiquid assets under the current Standards. Rather than applying disparate standards for the scope and frequency of valuation depending on asset class, the proposed Standards apply consistent valuation requirements to all “private market investments,” which include real estate, private equity, and other investments that are illiquid and not publicly traded. These assets must be valued at least once every 12 months by an external valuation, an internal valuation subject to external review, or a financial statement audit.³⁰ The opportunity to rely on a financial statement audit is a new provision that should greatly reduce the expense of GIPS compliance for many alternative managers. Most US private fund managers already obtain fund-level audits to satisfy investor demand and simplify compliance with Rule 206(4)-2 under the Advisers

Act (the Custody Rule); GIPS firms seeking to rely on audits for these valuation purposes will need to ensure that the assets in question are actually within the scope of the audits, and that audit opinions are not qualified.³¹ These proposals are intended to improve the quality of valuations for all asset classes on a more frequent basis, while acknowledging that this goal may be accomplished by more than one method.

GIPS Advertising Guidelines

- The GIPS Advertising Guidelines have been condensed and streamlined in an effort to reduce content requirements.
- The GIPS Advertising Guidelines may be used by managers of broad distribution funds to advertise GIPS compliance in fund materials in lieu of a GIPS Pooled Fund Report.

The “GIPS Advertising Guidelines” regulate advertisements distributed by GIPS firms and asset owners that already satisfy the applicable requirements of the Standards on a firm-wide or asset owner-wide basis.³² The GIPS Advertising Guidelines do not replace the Standards, nor do they absolve firms from providing GIPS Reports as required by the Standards. Instead, the GIPS Advertising Guidelines govern the content of advertisements disseminated to the general public that contain a claim of GIPS compliance (GIPS Advertisements).

The term “advertisement” is broadly defined in the current Standards as any written material that is distributed to or designed for use in newspapers, magazines, firm brochures, letters, media websites, or other written or electronic material distributed to more than one party, where there is no contact between the firm and the reader of the advertisement.³³ The Exposure Draft clarifies that pooled fund fact sheets and offering documents addressed to more than one pooled fund prospective investor also may constitute GIPS Advertisements, and that firms that choose to present performance in a GIPS Advertisement must use the same return calculation methodology as that used

in the corresponding GIPS Report.³⁴ One-on-one presentations and individual client reporting are not considered advertisements. Consistent with current guidance, an advertisement disseminated by a GIPS firm that does not contain a claim of GIPS compliance or any other reference to GIPS need not comply with the GIPS Advertising Guidelines.

Implications for Registered Fund Managers

As discussed above, the Exposure Draft divides pooled funds into two categories: limited distribution and broad distribution. As a general matter, investment companies registered under the Investment Company Act of 1940, as amended (Registered Funds) conducting a public offering should be treated as broad distribution pools. The Exposure Draft permits, but does not require, firms managing broad distribution pooled funds to market claims of GIPS compliance either in (1) a GIPS Pooled Fund Report that is presented to all prospective investors; or (2) a GIPS Advertisement prepared in accordance with the GIPS Advertising Guidelines.

The role of intermediaries with respect to the distribution of Registered Funds will create complexity and uncertainty. In practice, Registered Fund marketing materials are typically prepared in the name of the fund's distributor rather than the fund's investment manager. Typically a fund's distributor is not within the GIPS firm's definition, and it remains an open issue how and whether intermediaries will be willing to present or provide GIPS Reports or GIPS Advertisements to prospective Registered Fund investors.

Another unsettled issue relates to the treatment of Registered Funds as broad distribution pools. Often, I Shares of Registered Funds are marketed in one-on-one communications in a very different manner than retail shares classes where there is typically no or minimal contact between the firm managing the fund and investors. As noted above, it is unclear under the Exposure Draft whether the I Shares of a Registered Fund would be treated as a limited distribution pooled fund with a separate GIPS Pooled Fund Report. We anticipate that this ambiguity will

be addressed in final guidance, which should clarify the treatment of I Shares and other potential inconsistencies in the definitions as currently proposed (for example, UCITS broadly distributed in Europe but privately placed in the United States).

Total Firm Assets and Advisory Assets

- Firms will be permitted to separately present nondiscretionary "advisory-only" assets in GIPS Reports.

Under the current Standards, a compliant presentation must include a statement of *either* total firm assets (that is, discretionary and nondiscretionary assets) or composite assets as a percentage of total firm assets.³⁵ Under the Exposure Draft, GIPS Reports must include the total firm assets calculated as of each annual period end.³⁶ Although the Exposure Draft does not alter the calculation methodology for total firm assets,³⁷ it does permit firms to separately present "advisory-only" assets (assets for which the firm neither controls the implementation of investment decisions nor has trading authority), so long as such assets are calculated and presented independently from total firm assets. Advisory-only assets include model-delivery, unified managed accounts, and similar arrangements where the firm provides investment recommendations, but does not have investment discretion. The current Standards do not permit firms to present advisory-only assets.

Timeliness of Delivery

- GIPS firms must update the performance presented in a GIPS Report within six months following the most recent year end.

The current Standards are silent regarding how promptly firms must update a GIPS-compliant

presentation. Many GIPS firms currently wait until performance has been verified before distributing updated compliant presentations, which can result in GIPS-compliant presentations with performance that is stale by one to two years in many cases. To address this issue, the Exposure Draft requires firms and asset owners to update the information presented in a GIPS Report within six months following the most recent annual period end.³⁸ The Exposure Draft clarifies that this six month deadline will apply even if the verification process is not complete.³⁹

Requirements for Asset Owners

- New consolidated standards have been developed for the presentation of total fund performance by institutional investors, or “asset owners.”

The current edition of the Standards focuses solely on the performance of investment managers. However, “asset owners,” a term that generally refers to institutional investors such as retirement systems, endowments, foundations, and sovereign wealth funds, may comply with GIPS pursuant to interpretive guidance published by the CFA Institute. Under the Exposure Draft, the application of GIPS to asset owners is codified in the Standards and addressed in sections separate from those relating to firms. These separate, self-contained sections for asset owners are intended to provide a clearer, more user-friendly path for asset owners seeking to comply with the Standards. Asset owners that claim compliance with GIPS will prepare and present a GIPS Asset Owner Report for all “total fund” assets over which they have direct oversight responsibility.⁴⁰ The content requirements of GIPS Asset Owner Reports differ from those required for other GIPS Reports, although much of the flexibility introduced in the Exposure Draft for traditional GIPS firms also extends to GIPS Asset Owner Reports.

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NOTES

- ¹ Exposure Draft of the 2020 Global Investment Performance Standards, CFA Institute (Aug. 30, 2018), https://www.gipsstandards.org/standards/Documents/gips_2020_exposure_draft.pdf (hereinafter Exposure Draft).
- ² The current edition of the Standards was released in 2010 and effective January 1, 2011. Global Investment Performance Standards, CFA Institute, <https://www.cfainstitute.org/ethics/codes/gips-code>.
- ³ By the terms of GIPS, firms and asset owners must comply with all applicable requirements of the Standards, including those found in interpretive guidance such as Guidance Statements and Q&As, most of which were issued after the issuance of the current Standards in 2010. In addition to codifying key requirements set forth in prior interpretive guidance, the Exposure Draft includes certain provisions based on proposed Guidance Statements on Risk, Benchmarks, Overlay Strategies, Supplemental Information, and Verifier Independence that were previously issued for public comment but not finalized.
- ⁴ Exposure Draft Standard 3.A.3. A “segregated account” is defined in the Exposure Draft as a portfolio owned by a single client. In addition to traditional separate accounts, this definition likely encompasses subadvisory relationships, funds of one, and other forms of investment advice distinct from any type of fund offering.
- ⁵ Exposure Draft Standards 1.A.10.b; 1.A.11.
- ⁶ Each GIPS firm that manages pooled funds must maintain a complete list of pooled fund descriptions for all limited distribution pooled funds, and must provide such list to any limited distribution pooled

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fund prospective investor that makes such a request. Exposure Draft Standards 1.A.19.b; 1.A.20.b.

- ⁷ Firms managing broad distribution pooled funds must maintain a complete list of all broad distribution pooled funds, and must provide the list, as well as a pooled fund description to any broad distribution pooled fund prospective investor upon request. Exposure Draft Standards 1.A.19.c; 1.A.20.c.
- ⁸ See Investment Adviser Association, Comment Letter (Dec. 31, 2018) (discussing UCITS broadly offered in the EU but privately placed in the US and mutual funds, ETFs, and closed-end funds with institutional share classes); Investment Company Institute, Comment Letter (Dec. 21, 2018) (discussing mutual funds and ETFs with institutional share classes); Western Asset Management Company, Comment Letter (Dec. 20, 2018) (discussing mutual funds with institutional share classes and UCITS sold publicly in Europe but privately placed in the US); Ivy Investment Management Company, Comment Letter (Dec. 18, 2018) (discussing collective investment trusts and broadly distributed pooled funds with institutional share classes). There may also be confusion with respect to the classification of certain hedge funds that have clone funds distributed to both a broad and limited audience. See Pictet Asset Management, Comment Letter (Dec. 19, 2018).
- ⁹ Exposure Draft Standard 5.A.2.
- ¹⁰ See GIPS Exposure Draft Standards 1.A.10.a. and 1.A.10.b. The potential for this dual obligation is present only with respect to limited distribution pooled funds, for which GIPS Pooled Fund Reports are required. Managers *may*, but are not *required* to, present GIPS Pooled Fund Reports to potential fund investors.
- ¹¹ With respect to the Advisers Act, the Supreme Court held in *Transamerica Mtg. Advisors, Inc. v. Lewis* that no private right of action can be inferred from the anti-fraud provisions of Section 206, which do not expressly provide for a private right of action. *Transamerica Mtg. Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979). Section 12(a) of the 1933 Act establishes

a private right of action for purchasers of unregistered securities. 1933 Act § 12(a)(1) (“[A]ny person who offers or sells a security in violation of section 77e of this title ... shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction...”); § 13 (establishing a one-year limit on actions arising under the 1933 Act from the point at which the discovery of the untrue statement or omission was or should have been made).

- ¹² See 1933 Act § 12(a)(2) (establishing liability for any person who offers or sells a security through a prospectus or oral communication containing a material misstatement or omission). The SEC Staff has stated that certain factual business information about an issuer that does not condition the market for the issuer’s securities can be disseminated widely without such dissemination being deemed a general solicitation. Securities Act Rules: Questions and Answers of General Applicability, Questions 256.24 and 256.25 (Aug. 6, 2015), <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>. However, the SEC Staff has also cautioned that for continuously offered funds the dissemination of performance information would *not* be considered factual business information, and its inclusion in publicly disseminated marketing materials generally would be deemed a general solicitation. *Id.* Consequently, firms should carefully control the distribution of GIPS Pooled Fund Reports for private funds to avoid inadvertent general solicitation.
- ¹³ Section 3(a)(4)(A) of the Exchange Act of 1934, as amended (the Exchange Act), defines a “broker” broadly as any person engaged in the business of effecting transactions in securities for the account of others. In general, an investment adviser’s personnel offering investment advice and services to a client are deemed to act in a “broker” capacity and the adviser’s personnel need not be registered as brokers. By contrast, personnel who market interests in funds generally are deemed to be selling securities rather than providing investment advice, and therefore may be

subject to broker-dealer registration. Many private fund sponsors attempt to rely on Exchange Act Rule 3a4-1, a non-exclusive safe harbor from the broker registration requirements commonly referred to as the “issuer exemption.” However, the issuer exemption is not available for persons affiliated with a broker-dealer. *See* 17 C.F.R. 240.3a4-1(a)(3) (1985). Failure to satisfy the requirements of the Rule 3a4-1 safe harbor does not necessarily mean that broker registration is required, but the determination involves a facts and circumstances analysis and the risk that the SEC or its Staff would reach a different conclusion.

¹⁴ As noted in the Exposure Draft, 85 out of the top 100 asset managers in the world currently claim compliance with GIPS. *See* Exposure Draft at 3; Anju Grover, Out of Top 100 Asset Management Firms Globally, 85 Claim GIPS Compliance, CFA Institute (Feb. 6, 2017), <https://blogs.cfainstitute.org/marketintegrity/2017/02/06/out-of-top-100-asset-management-firms-globally-85-claim-gips-compliance>.

¹⁵ In certain circumstances, the SEC may consider the failure to cite a prior affiliation with and/or the performance of an investment team as a misleading practice in violation of Advisers Act Rule 206(4)-1(a)(5); however, this concern has not historically been the source of significant enforcement activity.

¹⁶ While a firm has an unlimited amount of time to establish that performance from a prior firm is GIPS compliant, it may only actually present the linked prior firm performance: (1) if the prior firm performance is the subject of an unsolicited client request; or (2) once the performance is compliant with GIPS.

¹⁷ *See* Horizon Asset Management, LLC, SEC No-Action Letter (Sept. 13, 1996).

¹⁸ GIPS Standard 3.A.8.

¹⁹ Exposure Draft Standard 3.A.15.

²⁰ Under the existing Standards, GIPS-compliant presentations of private equity composites must present only the internal rate of return, and GIPS-compliant presentations of closed-end real estate composites must present both the internal rate of return and time-weighted returns.

²¹ Exposure Draft Standard 1.A.31.

²² For purposes of GIPS, “transaction costs” will not always align with the reporting of expenses under various regimes or with the allocation of expenses between managers and clients.

²³ GIPS Standard 2.A.4.

²⁴ Exposure Draft Standard 2.A.15.

²⁵ The specific actions a firm must take to demonstrate that it has a “reasonable basis” for this determination are not detailed in the Exposure Draft, and may be further addressed or refined in future guidance.

²⁶ Exposure Draft Standard 3.A.14; Request for Comment #14.

²⁷ Global Investment Performance Standards: Guidance Statement on Alternative Investment Strategies and Structures, CFA Institute (May 18, 2012), https://www.gipsstandards.org/standards/Documents/Guidance/gs_alternative_investment_strategies_and_structure.pdf.

²⁸ Exposure Draft Standard 2.A.27.

²⁹ Pursuant to the current Standards, a “large cash flow” that triggers a valuation requirement is defined as the level at which a firm determines that an external cash flow may distort performance if the portfolio is not valued. Global Investment Performance Standards: Guidance Statement on Calculation Methodology, CFA Institute (Sept. 28, 2010), https://www.gipsstandards.org/standards/Documents/guidance/gs_calculation_methodology_clean.pdf. The Exposure Draft focuses the valuation requirements on the type of return being presented and whether the portfolio is included in a composite or is presented as a standalone pooled fund. Exposure Draft at 8.

³⁰ Exposure Draft Standard 2.A.44.

³¹ The SEC Staff has stated that to use the annual audit exemption in paragraph (b)(4) of the Custody Rule, a private fund’s financial statements must be prepared in accordance with US GAAP, meaning that the audit approach may not be available if the auditor’s opinion includes exceptions to US GAAP.

³² The GIPS Advertising Guidelines are incorporated in the Exposure Draft as Section 13.

- ³³ By contrast, advertisements are defined in Rule 206(4)-1 to include any communication to more than one person regardless of the context.
- ³⁴ Exposure Draft Standards 13.A.5; 13.A.7; 13.A.9.
- ³⁵ GIPS Standard 5.A.1.h.
- ³⁶ Exposure Draft Standards 4.A.1.h.; 5.A.1.g.; 6.A.1.g.; 7.A.1.f.
- ³⁷ The Exposure Draft does clarify that firms may not include committed capital in total firm assets. Exposure Draft Standard 2.A.1.c.
- ³⁸ Exposure Draft Standards 1.A.12; 8.A.12.
- ³⁹ The Exposure Draft also revises the verification guidance, including changing the disclosure that must be included in GIPS Reports for verified firms, although

the decision to seek independent verification would remain voluntary. Substantive verification guidance is contained in the Exposure Draft of the 2020 GIPS Standards for Verifiers, a separate document that compiles existing verification and performance examination guidance from the current Standards, the Guidance Statement on Verification, the Guidance Statement on Performance Examinations, and all relevant Q&As. See Exposure Draft of the 2020 Global Investment Performance Standards for Verifiers, CFA Institute (Oct. 31, 2018), https://www.gipsstandards.org/standards/Documents/gips_2020_verif_exposure_draft.pdf.

- ⁴⁰ Exposure Draft Standard 8.A.10.

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