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Practice Group:

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Update on GIPS Guidance Statement on Pooled Funds and Potential Impacts - Remarks from the GIPS Standards 2013 Annual Conference

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At the Global Investment Performance Standards (“GIPS®”, or “GIPS Standards”) 2013 Annual Conference, held Sept. 19th and 20th in Boston, MA, speakers Annie Lo (CFA Institute) and Ann Putallaz (AFP Consulting, LLC) and moderator Jonathan Boersma (CFA Institute, Executive Director of GIPS) hosted a panel session entitled: *Still Swimming in the Deep End: Developing Guidance for Pooled Funds*. The conference session’s purpose was to update the investment management industry on the CFA Institute’s progress in developing additional guidance with respect to applying the GIPS Standards to pooled funds. Such guidance has not yet been finalized; however the GIPS Executive Committee’s (“EC”) intended approach would significantly impact pooled fund managers that claim compliance with GIPS. The EC’s approach would dramatically impact how firms satisfy their obligation to deliver a compliant presentation to all prospective clients and how firms advertise pooled fund products.

I. Current Approach

By way of background, firms that claim compliance with the GIPS Standards are required to make every reasonable effort to deliver a compliant presentation to all prospective clients.³ Firms currently do not typically deliver a compliant presentation to prospective pooled fund investors for two primary reasons:

- A firm may interpret the GIPS Standards to require the firm to deliver a compliant presentation to the fund or the fund’s board/general partner/managing member rather than to prospective fund investors. This is a common approach whereby the firm views the fund itself as the firm’s client rather than prospective fund investors. In addition, the GIPS Standards’ definition of “Prospective Client”⁴ supports this approach, and the approach makes practical sense, as the fund or its board/general partner/managing member decides whether to hire the firm and directs the firm to manage the fund in accordance with the composite strategy being marketed.
- Alternatively, a firm may not deliver a compliant presentation to prospective fund investors because applicable regulatory requirements prevent the firm from doing so.⁵

II. Pooled Fund Guidance Statement Background and Proposed Approach

Recognizing that pooled funds are an area of confusion for firms that claim compliance with GIPS, the EC established the Pooled Fund Working Group⁶ in December 2012 with the primary goal of creating, proposing and, with the help of the Advisory Team,⁷ eventually publishing guidance on applying the GIPS Standards to retail and institutional pooled funds. The Pooled Fund Working Group has completed an initial draft of the proposed Pooled Fund Guidance Statement (the “Preliminary Draft

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Guidance Statement”). While the Preliminary Draft Guidance Statement has not yet been published for public comment, and many details and technical issues remain unresolved, the panel discussion provided some insight into the ways that the Preliminary Guidance Statement intends to address some of the problem areas encountered by firms when applying the GIPS Standards to pooled funds, which is summarized below.

The Preliminary Draft Guidance Statement deems, for GIPS compliance purposes, prospective pooled fund investors to be “prospective clients” of a firm. Recognizing that GIPS guidance for pooled funds must allow for complexities such as applicable regulatory requirements, the Preliminary Draft Guidance Statement provides an exception from the compliant presentation delivery requirement and will permit firms managing pooled funds to *either*: (1) deliver a fully-compliant GIPS presentation to all prospective pooled fund investors; *or* (2) follow the GIPS Advertising Guidelines. The GIPS Advertising Guidelines require that all advertisements that include a claim of compliance with the GIPS Standards disclose: the definition of the firm; how prospective clients can obtain a compliant presentation and/or the firm’s list of composite descriptions; and a prescribed GIPS compliance statement for advertisements. In addition, the GIPS Advertising Guidelines require a firm to disclose the composite description, composite total returns calculated in accordance of one of three prescribed methods, whether returns are gross or net-of-fees, benchmark description and total returns for the benchmark, and currency used to express performance, but only if an advertisement includes both (1) a claim of compliance with GIPS; *and* (2) performance information.

Currently, if an advertisement does not include a claim of GIPS compliance, the advertisement is not subject to the GIPS Advertising Guidelines. Therefore, it appears that if a fund’s offering materials and related marketing materials do not refer to GIPS and include performance data, a firm would not be required to deliver a GIPS compliant presentation to prospective pooled fund investors.⁸ We expect that the Pooled Fund Guidance Statement, when published, will clarify this point. The Preliminary Draft Guidance Statement also requires firms to include information required by the GIPS Advertising Guidelines in the fund’s official document (*e.g.*, the offering memorandum, the prospectus in the U.S. or KIID in the U.K.). If local law prohibits the fund’s official document from including such performance information, however, the Preliminary Draft Guidance Statement requires a firm to include such information in all other fund marketing materials prepared by the firm.

III. Impact of the Proposed Approach

While much remains uncertain, it is clear that the approach contemplated by the Preliminary Draft Guidance Statement represents a substantial and fundamental departure from the current GIPS Standards. This approach would require firms to treat individual prospective fund investors/shareholders as the firms’ prospective clients. This is a significant departure from current industry practice and raises concerns regarding whether information such as composite performance and other composite strategies managed by the firm is relevant information for prospective fund investors.

In addition, the Preliminary Draft Guidance Statement inserts the GIPS Standards front-and-center into all pooled fund advertising materials and official fund documents (such as prospectuses) unless an exception is available, though it is not clear to what extent this will be the case if such materials do not include both a claim of compliance with GIPS and performance data. This would require firms to significantly change how they market their pooled fund products and prepare official fund documents, including promptly stickering pooled fund offering documents to include performance information calculated in accordance with the GIPS Standards. In addition, firms would need significant

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additional guidance regarding how to apply the GIPS Advertising Guidelines to their pooled funds, as there are many practical complications to consider.

IV. Recommendations

A proposed Pooled Fund Guidance Statement may be released for public comment as early as the first half of 2014; however, the proposed provisions and guidance could change substantially from the Preliminary Draft Guidance Statement. Until more concrete guidance is issued, firms claiming compliance with GIPS should continue applying their current approach with respect to pooled fund products (either treating funds or fund boards/general partners/managing members as prospective clients or determining that applicable regulations prohibit firms from delivering compliant presentations to individual fund investors). If and when the proposed Pooled Fund Guidance Statement is published for public comment, the industry should be prepared to be actively involved in the comment period to help ensure that any final guidance is practical and clarifies as many ambiguities as possible.

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³ See, GIPS Standard 0.A.9.

⁴ The GIPS Standards define "Prospective Client" as: "Any 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."

⁵ By way of background, communications that are distributed by a broker-dealer that is a member of the Financial Industry Regulatory Authority ("FINRA"), such as communications regarding registered funds and many private funds, are subject to FINRA's communications rules and related guidance. Pursuant to FINRA guidance, related performance information may only be presented in communications marketing section 3(c)(7) funds where the member ensures that all recipients of such communications are "qualified

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purchasers". See, NASD Interpretive Letter to Davis Polk & Wardwell (Dec. 30, 2003). Composite/strategy performance data included in a GIPS compliant presentation inherently constitutes related performance (unless the fund being marketed is the only fund in the composite). Applicable law in other jurisdictions may impose similar or conflicting requirements.

⁶ The Pooled Fund Working Group consists of 12 members from 9 countries. It has worked since December 2012 on preliminary steps leading up to drafting a proposed Pooled Fund Guidance Statement.

⁷ The Advisory Team consists of 27 members from 10 countries. It has consulted with the Pooled Fund Working Group during the initial drafting process and provided comments and insight on the initial draft of the proposed Pooled Fund Guidance Statement.

⁸ In the authors' view, it seems likely that the Pooled Fund Guidance Statement will not permit firms to continue to "opt-out" of the GIPS Advertising Guidelines with respect to pooled fund offering documents and marketing materials that do not include a claim of GIPS compliance. As a result, firms that do not deliver a GIPS-compliant presentation to all prospective pooled fund investors would be required to comply with the GIPS Advertising Guidelines with respect to pooled fund offering documents and marketing materials and include performance calculated in accordance with the GIPS Advertising Guidelines in such materials regardless of whether such materials include a claim of compliance with GIPS.

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