

GIPS GUIDANCE STATEMENT ON BROADLY DISTRIBUTED POOLED FUNDS AND POTENTIAL IMPACTS

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Investment Management Alert

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THE CFA INSTITUTE RECENTLY RELEASED ITS EXPOSURE DRAFT OF THE GUIDANCE STATEMENT ON BROADLY DISTRIBUTED POOLED FUNDS (THE "PROPOSED GUIDANCE") INTENDED FOR FIRMS THAT CLAIM COMPLIANCE WITH THE GLOBAL INVESTMENT PERFORMANCE STANDARDS ("GIPS®" OR "GIPS STANDARDS").^[1]

Once effective, the Proposed Guidance will represent the first comprehensive set of specific guidance to the GIPS Standards relating to pooled funds marketed to the broad public (hereinafter, "funds"), rather than communications that offer advisory strategies. As such, the Proposed Guidance will substantially impact the obligations of many firms that claim GIPS compliance ("GIPS firms").

Market participants have anticipated the Proposed Guidance for several years, with the most recent substantial comments on the topic provided at the 2013 Annual GIPS Standards Conference.^[2]

The Proposed Guidance is expected to be finalized following a public comment period that ends April 29, 2016, and to become effective on January 1, 2017. As discussed below, the Proposed Guidance contains a number of ambiguities and unanswered questions that will need to be resolved through the comment process.

I. CURRENT APPROACH

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] The scope of this obligation is relatively straightforward with respect to the marketing of a firm's advisory services, but firms typically do not deliver a GIPS-compliant performance presentation to prospective fund investors for two primary reasons:

1. Firms typically view the fund itself as the firm's client rather than the prospective fund investors. Consequently, firms may interpret the GIPS Standards to require the delivery of a compliant presentation to the fund or the fund's board, general partner, or managing member, rather than to prospective fund investors. The GIPS Standards' definition of "Prospective Client"^[4] supports this approach, and it makes practical sense, as the fund's sponsor decides whether to hire the firm and

determines the fund's investment strategy. 2. Regulatory standards applicable to the marketing of funds often conflict with the requirements of the GIPS Standards, effectively prohibiting dissemination of GIPS-compliant presentations in fund marketing materials.[5]

Recognizing that funds are an area of confusion for firms that claim compliance with GIPS, the GIPS Executive Committee established a Pooled Fund Working Group[6] with the expectation that the CFA Institute would eventually publish guidance on the application of the GIPS Standards to retail and institutional funds. The Proposed Guidance represents the first major step in those efforts.

II. SUMMARY OF THE PROPOSED GUIDANCE

The scope of the Proposed Guidance is limited. It does not require that GIPS firms provide a fully GIPS-compliant presentation to prospective fund investors[7] or ensure that fund marketing materials meet the requirements of the GIPS Advertising Guidelines. Likewise, the Proposed Guidance does not apply to communications between a GIPS firm and a single prospective investor in a fund managed by the GIPS firm.[8] The Proposed Guidance only applies to situations in which a GIPS firm both (1) manages a broadly distributed fund and (2) is responsible for the creation of the fund's offering documents and/or marketing material distributed to multiple prospective investors.[9]

The Proposed Guidance identifies several disclosure items that must be included in (1) the official fund offering document (the precise structure of which varies among regulators) and (2) all fund-specific marketing materials that present investment performance (collectively, the "Required Items"). The Required Items are:

- A description of the fund's investment mandate, objective, or strategy;
- An indication of the fund's risk, stated as either a qualitative narrative or a quantitative metric, as mandated by the local regulators—if local regulators do not require or prohibit a specific risk measure, the firm may choose which risk measure to present;
- Fund returns calculated according to the methodology and for the time periods required by local laws or regulations (or otherwise in compliance with existing GIPS performance reporting standards if the local laws are silent on any required methodology);
- Benchmark total returns (for the same time periods as the fund) and the benchmark description. If the firm determines that no appropriate benchmark for the fund exists, the reason for the lack of a benchmark (e.g., "no appropriate benchmark exists") must be disclosed; and
- The currency used to express performance.

The Proposed Guidance also recommends, but does not require, that the official fund document and any fund-specific marketing materials include:

- Any sales charges; and
- A "GIPS Pooled Fund Claim of Compliance" in the following form:

- "XXX, the firm managing this pooled fund, claims compliance with the Global Investment Performance Standards (GIPS®). For more information about the GIPS standards, please visit www.gipsstandards.org."

Each Required Item must be included on all official fund documents and fund-specific marketing materials, to the extent permitted by local law. If a firm determines that it cannot satisfy all the requirements of the Proposed Guidance due to regulatory conflicts, the determination must be documented in the firm's policies and procedures.

III. ANALYSIS OF THE PROPOSED GUIDANCE

Scope

The Proposed Guidance characterizes its approach as intentionally "minimalist" due to the complexity of relevant local laws and regulations and the desire to limit the potential regulatory friction that would result from a broader approach. By not requiring a claim of GIPS compliance or the elements of a fully GIPS-compliant performance presentation, the Proposed Guidance alleviates earlier concerns that it would require significant changes in how GIPS firms market fund products and prepare fund documents. Many of the Required Items are already required in official fund documents, such as Key Investor Information Documents of UCITS funds and prospectuses of U.S. registered funds. Consequently, the Proposed Guidance will likely have a greater impact on the content of fund marketing materials in jurisdictions that do not presently require extensive disclosures in their materials.

Impact

The Proposed Guidance provides helpful guidance to GIPS firms on several important issues. For example, GIPS firms covered by the Proposed Guidance will not be required to deliver, or offer to deliver, a GIPS-compliant presentation with official fund document or marketing materials. This is a departure from the Preliminary Draft Guidance Statement discussed at the 2013 GIPS Annual Conference, and it is a welcome clarification for GIPS firms because the delivery of a GIPS-compliant presentation is often at odds with applicable regulatory regimes. For example, the delivery of a GIPS-compliant presentation may represent the provision of "related performance" (which, in the retail context, is prohibited under FINRA Rule 2210).^[10]

The Proposed Guidance also explicitly carves out certain pooled vehicles from its scope. For example, GIPS firms that exclude broadly distributed pooled funds from the firm definition will not be required to comply with the Proposed Guidance. Also, the Proposed Guidance states that GIPS firms need not comply with the Proposed Guidance with respect to hedge funds, real estate funds, and private equity funds. The GIPS Guidance Statements on Alternative Investment Strategies and Structures, Private Equity, and Real Estate govern the marketing of these funds. (Client alert available [here](#).)

Ambiguities and Open Questions

Although the Proposed Guidance clarifies certain obligations of GIPS firms as discussed above, it also contains a number of ambiguities that, unless resolved, may result in practical difficulties in determining when and how the Proposed Guidance applies. Certain of these ambiguities are discussed below.

Firm Involvement– Under the Proposed Guidance, a GIPS firm need only ensure that the Required Items are included in fund marketing materials if the GIPS firm is "responsible for the creation" of the materials. Helpfully, the Proposed Guidance clarifies that GIPS firms are not responsible for marketing material created by a third

party, and that firms typically would not be responsible for marketing materials of funds they sub-advise. In practice, however, fund marketing materials are typically prepared in the name of the fund's distributor (in the United States, a broker-dealer) rather than the fund's investment adviser, and the degree to which an investment adviser is "responsible for the creation" of these materials varies and is unclear in the Proposed Guidance. If the fund's distributor is not within the firm definition, is there no obligation to include the Required Items in marketing materials provided by the distributor? What if the personnel of the distributor are also personnel of the investment adviser that claims GIPS compliance? Similar questions arise outside the broker-dealer context. If a fund management company prepares fund marketing material for a fund sub-advised by an affiliated GIPS firm, does the affiliation between the two entities overcome the presumption that sub-advisers are not "responsible" for the marketing materials? In light of these questions, we would expect that the final guidance statement will clarify what it means for a GIPS firm to be "responsible for the creation" of fund marketing materials.

Covered Funds – The Proposed Guidance, by its terms, addresses only "broadly distributed" funds. This term is not defined, but in context appears to mean any fund "where there is typically no or minimal contact between the firm managing the fund and prospective fund investors." For many funds, including UCITS and U.S. registered funds, the degree of cooperation and information exchange among fund managers, advisers, boards of directors/trustees, and distributors, and the degree of contact between these parties and fund investors, can vary greatly across firms. Elsewhere, the Proposed Guidance states that it applies to funds marketed by a GIPS firm to "more than one investor," but not to hedge funds, real estate funds, and private equity funds—all of which are typically marketed to more than one investor. This definition muddles the plain meaning of "broadly distributed," leaving industry participants uncertain as to whether any, some, or all privately placed products that are offered by general solicitation, such as funds offered under Rule 506(c) of Regulation D, are covered by the Proposed Guidance. We anticipate that the final guidance statement will put a finer point on the application of the term "broadly distributed."

Covered Communications – Marketing communications that are the subject of the Proposed Guidance and that contain "investment performance" must contain the Required Items. However, it is uncertain how broadly "investment performance" should be construed in this context. For example, U.S.-registered fund marketing materials commonly provide rankings from third parties such as Morningstar®, which rate the fund's performance against similar funds. It is likewise common for certain funds to describe the general underwriting standards associated with their investment program, which may include the yield of underlying investments. Although both items tangentially illustrate potential past or future performance, and would likely be considered "Supplemental Information" for GIPS purposes, neither are traditional measures of an investment's return on capital. Absent a precise definition of the term "investment performance" or a conceptual basis to evaluate the meaning of the term in the Proposed Guidance, there is significant uncertainty regarding which marketing materials must contain the Required Items, and which are outside the scope of the Proposed Guidance—an ambiguity we would expect to be addressed in the final guidance statement.

IV. CONCLUSION AND RECOMMENDATIONS

In our view, the Proposed Guidance represents a reasonable approach to pursuing consistency of information across fund offering documents and marketing materials, particularly in jurisdictions with few or no existing standards. However, fundamental questions regarding the scope and application of the Proposed Guidance

could result in GIPS firms interpreting their obligations in different ways, potentially frustrating many of the goals of the Proposed Guidance and of the GIPS Standards themselves. GIPS firms should take advantage of the comment period to ensure that final guidance regarding broadly distributed funds is both practical and free of the ambiguities present in the Proposed Guidance.

Although disclosure of many of the Required Items is already required in official fund documents pursuant to applicable regulations of most developed jurisdictions, firms that claim GIPS compliance will need to analyze the extent to which their offering and marketing materials meet the requirements of any final guidance in all jurisdictions in which they are active. This analysis will depend, among other things, on how the firm defines itself for GIPS purposes, the requirements of existing local regulations, the structure of the firm's management and distribution activities, and those of its affiliates.

If you have any questions regarding these matters or the potential impact of the Proposed Guidance on your firm, please contact any of the authors listed below, or one of the K&L Gates attorneys with whom you work.

To view our Exposure Draft of GIPS Guidance Statement on Widely Distributed Pooled Funds (U.S. Analysis), [click here](#).

Notes:

[1]

http://www.gipsstandards.org/standards/Documents/Guidance/exposure_draft_public_comment_pooled_funds_gs.pdf

[2] <http://www.klgates.com/update-on-gips-guidance-statement-on-pooled-funds-and-potential-impacts---remarks-from-the-gips-standards-2013-annual-conference-10-15-2013/>

[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] Communications that are distributed by a broker-dealer that is a member of the Financial Industry Regulatory Authority, Inc. ("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 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] This group was established in December 2012 with the primary goal of creating, proposing, and publishing the guidance, with the help of the Advisory Team. The Pooled Fund Working Group consists of 12 members from nine countries. It has worked since December 2012 on preliminary steps leading up to drafting a proposed Pooled Fund Guidance Statement. 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.

[7] A fully compliant performance presentation must be provided to prospective pooled fund investors that request one. See GIPS Standards 0.A.11.

[8] These communications are covered by the Guidance Statement on Alternative Investment Strategies and Structures, Private Equity, and Real Estate.

http://www.gipsstandards.org/standards/Documents/Guidance/gs_alternative_investment_strategies_and_structures.pdf

[9] The Proposed Guidance does note, "as in all situations where a firm's performance information is distributed by a third party, the firm should take appropriate measures to ensure that its performance is not misrepresented or used in a misleading fashion."

[10] Although related performance is generally prohibited in the retail context, FINRA has articulated exemptions to the rule for 3(c)(7) funds marketing to "qualified purchasers" and for mutual funds providing information to institutional investors in response to a due diligence request. See K&L Gates Client Alert: FINRA Relaxes Restrictions on Related Performance in Institutional Communications, available at <http://www.klgates.com/finra-relaxes-restrictions-on-related-performance-in-institutional-communications-06-02-2015/>.

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