GUEST COLUMN

GIPS® Establishing New Standards for Pooled Funds

By Arin Stancil, CFA, CIPM*

Introduction

The Global Investment Performance Standards ("GIPS®") are based on the fundamental principles of full disclosure and fair representation of investment performance results. To achieve this objective, the GIPS standards create a framework for firms that choose to comply. This framework includes prescribed methodologies that firms must use when calculating performance and a standardized list of statistics and disclosures that must be included in presentation materials. What the GIPS standards do not offer is comprehensive guidance that can be universally applied to all scenarios. Many complex issues have yet to be fully addressed within the scope of the GIPS standards and, therefore, are still open to interpretation and future clarification. One of those key areas has been the application of the GIPS standards to pooled investment vehicles, such as mutual funds and hedge funds. That has now changed, at least to a degree, with the adoption of the Guidance Statement on Broadly Distributed Pooled Funds (the "Guidance Statement"). While the Guidance Statement does not address every question related to pooled funds, it does answer some of the most pressing ones and sets the stage for the development of further guidance.

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Background

Before we get into the new guidance and what it means for firms that comply with the GIPS standards, let's first explore how the GIPS standards have historically addressed pooled funds. Traditionally, rather than focusing on specific investment vehicles or products, the GIPS standards have been developed around the concept of "composites." A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The GIPS standards require that all actual, fee-paying, discretionary portfolios managed by a firm that claims compliance must be included in at least one composite. The purpose of this requirement is to ensure that performance information provided to prospective investors includes all portfolios that the firm has historically managed to the investment strategy under consideration and does not isolate individual portfolios that may have performed better than the rest. In considering which portfolios must meet this composite inclusion requirement, the GIPS standards are agnostic with respect to the type of investment vehicle. A "portfolio" could be any individually managed group of investments, including separately managed accounts or any type of pooled fund.

In constructing composites, firms have some flexibility in determining how their composites will be structured and how they wish to characterize their investment strategies. In particular, the firm can choose how narrowly or broadly to define their composites. Broadly defined composites will naturally result in larger composites with more dispersion, while narrowly defined composites will yield smaller composites with tighter dispersion. Part of this decision process relates to pooled funds and whether they will be included in the same composites as separate accounts. Firms can decide what approach is appropriate for their particular composites based on their investment process.

Because of this flexibility, as well as the lack of specific guidance in the GIPS standards related to pooled funds, the treatment of pooled funds by GIPS-compliant firms has varied. However, based on information scattered across a few provisions and Q&As within the current edition of the GIPS standards and outlined in the Guidance Statement on Composite Definition, GIPS-compliant firms that manage pooled funds firms can decipher some general guidelines:

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- **It would generally be difficult to build an argument that a typical pooled fund could be considered non-discretionary for GIPS-compliance purposes.** In a pooled fund, investor assets are managed collectively to a single objective that is determined by the investment manager. Because of this structure, individual investors typically have little or no ability to initiate restrictions – they only have the ability to accept the strategy as offered through the fund by purchasing shares or not. As a result, a firm that claims compliance with the GIPS standards and includes pooled funds within its firm definition would need to include those funds in composites.

- **Pooled funds and separate accounts can be segregated into different composites.** In order for a firm to create composites that only include pooled funds, the composite definitions should identify differences in the application of the investment strategy due to the pooled fund structure, such as increased liquidity needs or the ability to invest in a more broadly diversified mix of assets.

- **Alternatively, pooled funds and separate accounts may also be included in the same composite.** The firm could define their composites broadly enough to combine separate accounts and pooled funds. This would be appropriate as long as the investment vehicle structure does not have a significant impact on the implementation of the investment strategy.

- **Firms that comply with the GIPS standards must have a process for delivering compliant presentations to prospective clients, but this requirement does not necessarily apply to pooled funds.** Guidance within the GIPS standards has been unclear as to whether firms are obligated to provide prospective pooled fund investors with what is referred to as a "compliant presentation"—a presentation for a particular composite that meets all of the reporting requirements of the GIPS standards. However, debate continues as to whether providing composite information to pooled fund investors is appropriate, and some argue that investors in pooled funds should not qualify as prospective clients, either of which would negate the need for fund managers to adhere to this requirement. It was this issue that essentially led to the creation of the Guidance Statement on Broadly Distributed Pooled Funds.

Broadly Distributed Pooled Funds Guidance

After years of development involving multiple committees and volunteers from across the investment management industry, an exposure draft of the Guidance Statement on Broadly Distributed Pooled Funds was released for a 90-day public comment period in January 2016. The comment period produced 39 comment letters, including a response from the IAA, which can be viewed on the IAA website under Publications >> Comment Letters. The comments were all carefully considered, the guidance was revised, and the final Guidance Statement was ultimately adopted in March 2017 with a scheduled effective date of January 2018.

In addressing the question related to the distribution of compliant presentations, the Guidance Statement makes it clear that if a firm meets the requirements outlined therein, the firm would have no further obligation to provide a typical compliant presentation to prospective investors in pooled funds. It must be noted, however, that this easement is limited to what the document defines as "broadly distributed" pooled funds. The Guidance Statement does not attempt to address a firm's obligations related to other types of funds, only those considered broadly distributed, which includes funds that meet the following three requirements:

1. The fund is publicly available to multiple investors—though there is no minimum number of investors necessary for a pooled fund to qualify as broadly distributed.

2. The typical marketing practice for the fund involves no or minimal contact between the firm marketing the pooled fund and the prospective pooled fund investors—however, the fund may be marketed directly to investors in one-off scenarios.

3. The firm both manages the fund and has the ability to influence the fund's official documents or marketing materials—note that firms may influence the content of such documents without necessarily being involved directly in their creation.

Clearly this is a fairly limiting definition, as it leaves a number of pooled funds—particularly hedge funds and other private funds—off the table awaiting further guidance. However, it does encompass a vast number of fund types, including '40-Act mutual funds and UCITS funds.

Due to the extensive legal and regulatory requirements that many of these products are already subject to, the Guidance Statement intentionally takes a light-touch approach in terms of introducing new requirements. In all, the Guidance Statement only requires four items to be included in either an official pooled fund document or fund-specific marketing material prepared by the firm for prospective pooled fund investors. It is also highly likely that these items are already being included in the firm's materials, as they are typically required by regulations that the funds would be subject to—as was intended by the writers of the paper. Specifically, the required items are:

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1. A description of the fund's investment mandate, objective, or strategy.
2. An indication of the risks that the fund may expose an investor to, either as a qualitative narrative or quantitative metric.
3. Fund returns calculated according to the methodology and for the time periods required by local laws and regulations. The Guidance Statement outlines default methodologies and time periods, but these would only be applicable in the event that no local regulatory requirement exists.
4. The currency used to express performance, which may be conveyed by a currency symbol or be implied by the investment focus of the fund. For example, a U.S.-based fund that only invests in U.S. dollar-denominated securities would be assumed to have performance expressed in U.S. dollars unless stated otherwise.

The Guidance Statement also offers a "safe harbor" provision designed to minimize the perceived burden imposed by the guidance on fund managers that claim compliance. It outlines that CFA Institute intends to review the requirements imposed by legal and/or regulatory regimes around the world and make available a list of the regimes whose requirements overlap with the requirements of the Guidance Statement. Firms subject to those regulatory regimes would be considered to have also met the requirements of the Guidance Statement and would not need to take further action. Though the safe-harbor list has yet to be published, it is fully expected that the list will include U.S. regulatory agencies like the SEC and FINRA.

What's Next?

The Guidance Statement on Broadly Distributed Pooled Funds serves as an initial step by the GIPS standards to better address pooled funds and, more broadly, incorporate product marketing as opposed to just strategy marketing.

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However, it is not the final step. The introduction to the Guidance Statement describes the guidance as "a bridge between the 2010 edition of the GIPS standards and GIPS 20/20." GIPS 20/20 is a project that CFA Institute and the GIPS Executive Committee are undertaking that will serve as the next evolutionary step for the GIPS standards. Essentially, GIPS 20/20 will be the next complete edition of the GIPS standards and, in order to keep the GIPS standards relevant and robust, there are several significant changes that are being considered. In order to stimulate discussion with the industry on these potential changes as early in the process as possible, the GIPS Executive Committee issued a GIPS 20/20 Consultation Paper that outlines the items being considered. One of the proposals that the Consultation Paper addresses is an expansion of the guidance related to pooled funds in order to encompass all types of pooled funds, not just those that are "broadly distributed" as defined in the Guidance Statement. The Consultation Paper also outlines three specific items that are being considered:

- Introducing a requirement to provide a "pooled fund report" to prospective investors in pooled funds, rather than a standard GIPS-compliant composite presentation. What would be required to be included in such a report is, at this point, unclear.
- Eliminating the requirement for firms to create single-fund composites simply to meet the requirement that all fee-paying discretionary portfolios must be included in at least one composite.
- Firms may also be required to create a list of "pooled fund descriptions" in addition to the existing requirement to maintain a complete list of composite descriptions.

The window to provide comments on the Consultation Paper ended on July 16, 2017, but interested parties will also have another opportunity to provide feedback when a full exposure draft of GIPS 20/20 is issued for public comment, which is expected in the early part of 2018.

What Should Firms Do Now?

Firms that manage pooled funds and claim compliance with the GIPS standards should start preparing to meet the requirements of the Guidance Statement on Broadly Distributed Pooled Funds in advance of the January 2018 effective date. As noted, for firms that are subject to developed regulatory regimes, the increased burden should be minimal. Firms are also encouraged, but not required, to apply the new guidance prior to the effective date. That means firms can place reliance on the guidance now to support why they would not provide GIPS-compliant presentations to prospective investors in broadly distributed pooled funds, which should be viewed as a positive outcome for firms who may have been viewed as deficient in this area in the past.

Firms would also be advised to review the GIPS 20/20 Consultation Paper and evaluate how the proposed changes could impact them. They should then look for the release of the exposure draft of GIPS 20/20 and consider responding by preparing a comment letter with the

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IAA or individually. Public comment is the mechanism through which we can all have input into the future development of the GIPS standards, so anyone who has ideas as to how the GIPS standards could be improved or has suggestions for topics that would benefit from further guidance would be encouraged to submit a comment.

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