Testing the Effectiveness of Your GIPS® Compliance Program

By Amy Jones, CIPM

For investment management firms interested in presenting GIPS compliant investment results the task of establishing and maintaining an effective compliance program can seem daunting. Fortunately, the road to GIPS compliance is well-travelled. The following summary addresses some of the core principles of the GIPS standards and testing procedures that firms should consider in order to evaluate the effectiveness of their GIPS compliance program.

GIPS® Basics

Compliance is voluntary

The Global Investment Performance Standards ("GIPS®") are a set of standardized, ethical principles that provide investment management firms with guidance on how to calculate and report their investment results to prospective clients. Investment managers voluntarily choose to abide by the GIPS standards — compliance is not mandated by any law or regulation. However, achieving compliance with the GIPS standards is not a one-time event, and firms cannot pick and choose when they want to claim compliance. Once a claim of compliance is made, the firm must consistently comply with all of the requirements of the GIPS standards on an ongoing basis.

A multidepartmental initiative

Since GIPS compliance impacts many areas of the firm, several departments are often involved with maintaining and supporting the initiative. Operations, client service, performance, compliance and marketing departments frequently play a role, depending on the firm's size and complexity. The department with the ultimate responsibility varies across firms, but the job tends to fall to the group that has the time and/or most required expertise.

Regardless of which department has tactical responsibility for maintaining compliance with the GIPS standards, the compliance department should be involved in at least an oversight capacity. Periodic internal compliance checks are encouraged in all areas of the firm, including reviewing the effectiveness of the GIPS compliance program. Similar to other annual review testing, the assessment of the GIPS compliance program might be done by compliance personnel, by another department or an independent third party.

GIPS verification ≠ GIPS compliance

Investment management firms often seek third-party review, testing and verification of their GIPS compliance processes and procedures. A verification is conducted on a sample basis and is largely dependent on representations made by the firm to the verifier. A verification report does not ensure that a firm is GIPS compliant. To ensure compliance, the firm must take ownership of their own process and establish internal audit checks and controls that are consistently adhered to.

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The role of the regulators

The Securities and Exchange Commission ("SEC") and other regulatory bodies often review claims of compliance with the GIPS standards to ensure accuracy and that investors are not being misled. During an examination, the SEC may feel it is necessary to perform testing to ensure the firm claiming GIPS standards compliance is, indeed, complying with the requirements of the GIPS standards.

The SEC's Office of Compliance Inspections and Examinations ("OCIE") has indicated that their priorities related to performance reviews include examining the accuracy and completeness of claims about investment objectives and performance. For example, examiners will test hypothetical and back-tested performance, review the use and disclosure made when presenting composite performance, confirm supporting records, and discuss compliance oversight and approval process of advertising materials.

If the SEC found that a firm claiming compliance was not meeting the requirements of the GIPS standards, the firm would be in violation of Rule 206(4)-1 of the Investment Advisers Act of 1940, which governs advertisement by investment advisers.

Compliance Tests

Defining the "firm"

A firm that claims compliance with the GIPS standards must comply with all requirements and on a firm-wide basis. The scope of what constitutes a "firm-wide basis" is ultimately determined by the firm itself, but the GIPS standards do provide guidance: They require that a "firm" is an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business entity.

While the firm definition does not have to be limited to the legal corporate structure or regulatory registration status of the organization, most firms tend to be defined in this manner. The firm definition determines the universe of accounts that must be included in the total firm assets reported for GIPS compliance. Only actual assets managed by the firm can be captured within the firm definition — model and advisory-only assets should not be included.

Consistency with marketing materials

The definition of "firm" used for GIPS compliance must also be consistent with the way the business is typically held out to clients and prospective clients. In other words, the firm should not be described in marketing materials and on websites in one manner while being defined differently for GIPS compliance purposes without clear explanation of the differences. For example, a firm with multiple business units that all fall under one legal entity may decide to have only one of the divisions comply with the GIPS standards. This approach would be acceptable, as long as the division is legitimately held out to the public as a separate business unit that has a distinct market or client type and/or uses a separate and distinct investment process. If this approach is taken, the firm's materials must make clear which divisions claims compliance with the GIPS standards and which do not. It would be inappropriate for the other units to receive the benefit of one division's claim of compliance without achieving compliance themselves.

In addition, the GIPS standards recommend that firms adopt the broadest and most meaningful definition of the firm possible, so careful consideration should be taken when determining how the firm will be defined and if limiting the scope to a particular division is appropriate.

Testing considerations: Firm-wide compliance

1. Confirm that the GIPS standards "firm" definition is consistent with the way the firm is held out to the public. For example, consider how the "firm" is represented on the firm's website, in marketing materials, client reports and in consultant databases.
2. Confirm that advertisements and other materials do not indicate that a particular composite, strategy, or product is "GIPS compliant," but rather that the firm "claims compliance" with the GIPS standards.
3. Confirm that the accounts included in the firm's assets--under-management ("AUM") calculation are appropriate when compared to how the firm is defined for GIPS purposes.
    - Firm AUM should only include assets for accounts that fall within the scope of the firm definition.
    - Ensure that advisory-only assets, including UMA assets, are excluded from total firm AUM that is presented for GIPS compliance purposes.
    - If the firm utilizes leverage, confirm that the firm AUM presented for GIPS compliance purposes is net of leverage. This differs from the instructions outlined in some regulatory filings, which call for AUM gross of leverage.

Documenting policies and procedures

A firm must document all policies and procedures that are established and adhered to for maintaining compliance with the GIPS standards. The firm's GIPS policies and procedures may be maintained in either hardcopy or electronic format. Firms that use a template to create their GIPS policies and procedures must ensure that boilerplate language is customized to address the firm's actual practices.

GIPS policies and procedures are typically outlined in a separate document from the firm's regulatory compliance policies and procedures, but firms should be careful that the two do not conflict. One potential area of overlap is the firm's policy for valuing securities.

Compliance personnel may also want to pay particular attention to the firm's GIPS error-correction policy. Firms are required to outline the policies and procedures the firm follows when errors are discovered that impact GIPS-compliant presentations. A best practice is to document both immaterial and material errors in an error-correction log.

Periodic review of the GIPS policies and procedures — annually, if not more often — is necessary to make sure that the document captures changes at the firm. When new products and strategies are created or new systems are implemented that impact performance calculations, the GIPS policies and procedures should address these changes.

Testing considerations: Documenting policies and procedures

1. Review GIPS policies and procedures to confirm that they reflect the firm's actual practices for maintaining compliance. In addition, confirm that the firm has documented not only the policies, but also the associated procedures.
2. If the firm has started any new business lines — such as managing bundled fee/wrap accounts or becoming an adviser to a pooled investment vehicle — then how performance is calculated for these portfolios, and the books and records maintained to support performance, should be documented. For example, composite presentation disclosures may need to be updated to reflect how net-of-fee returns are calculated.
3. Confirm the firm's error-correction policy addresses how the firm handles both qualitative and quantitative errors. Consider if the policy is adequate by reviewing the error-correction log to confirm the types of errors found and the actions taken.
4. Confirm that the valuation policy and procedures documented in the GIPS manual are true to actual business practices, including the steps taken and hierarchy followed when valuations are not available from the firm's primary sources.

Constructing composites

A composite is an aggregation of all accounts that are managed according to a specific investment mandate, objective, or strategy. A key provision of the GIPS standards is the requirement to include all of the firm's fee-paying discretionary accounts in a composite that is meaningful. For example, if a GIPS-compliant firm managed a global sustainable-dividend strategy, then the firm would need to compile the performance results for all fee-paying discretionary portfolios managed according to the firm's global sustainable-dividend investment process.

Discretionary vs. non-discretionary

But not all the firm's global sustainable-dividend portfolios that meet the legal definition of discretionary may be composite-eligible. Accounts that have client constraints or restrictions that limit the manager's ability to implement the intended strategy may be classified as "non-discretionary" for the purpose of composite construction — these accounts would be excluded from the firm's composites.

The definition of "discretionary" should be applied consistently and should be documented. The firm's GIPS policies and procedures should address common client restrictions such as client-mandated cash balances or socially responsible investment guidelines that limit the manager's discretion and cause an account to be excluded from a composite.

The GIPS standards allow for quite a bit of flexibility in constructing composites, so compliance personnel might consider focusing their internal compliance review on assessing whether the process for constructing composites is objective in order to confirm that it doesn't allow for cherry-picking accounts for inclusion or exclusion.

Administrative or "internal" composites

Creating administrative or "internal" composites — an all-inclusive grouping of non-discretionary accounts — may help a firm to confirm that all accounts have been accounted for, but they should not be treated as official composites for GIPS compliance purposes nor be presented externally. This type of internal composite should be reviewed periodically to confirm that the accounts are not eligible for inclusion in an official composite.

Creating representative composite track records can be a challenge. Firms must consider the most appropriate composite definitions, determine which portfolios satisfy the composite criteria and address portfolios that do not fit neatly into composites. It is important to avoid creating composites that are overly narrow or broad, as these may make the process unnecessarily burdensome and may result in a composite that is not particularly meaningful.

Testing considerations: Constructing composites

1. Interview those who are responsible for composite construction to confirm procedures that are used to determine composite assignment and what situations would cause an account to be ineligible for inclusion.
2. Confirm the audit and review processes that are in place to ensure that composites are accurately constructed, including changes to composite assignment, performance outliers and other events that may affect compliance.
3. Request and review a list of accounts that are not included in composites to confirm appropriateness.
4. Depending on how comfortable the compliance department is with the process, it might be necessary to select a sample of accounts to conduct more detailed testing of the composite construction process.

Compliant presentations

Under the GIPS standards, a "compliant presentation" is a presentation of a composite that contains all the information required by the GIPS standards and may also include additional or supplemental information. The GIPS standards require firms to make every reasonable effort to provide a compliant presentation to all *prospective* clients.

Prospective clients, as defined in the GIPS standards, include any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite. In addition, a prospective client includes existing clients who are provided information for a strategy that is different from their current investment strategy. Investment consultants and other third parties are also generally considered to be prospective clients when they represent investors who qualify to be prospective clients. As long as a prospective client has received a compliant presentation within the previous 12 months, the firm has met this requirement.

Compliance personnel should be aware that this requirement has received increased attention from regulators as of late. Firms should be able to demonstrate that they have a process in place to ensure delivery of compliant presentations.

Testing considerations: Compliant presentations

1. Compliance should have a good understanding of how prospective clients are tracked and understand the processes for delivering the appropriate compliant presentations to prospective clients.
2. It is considered a best practice to have someone from the Compliance Department review compliant presentations at least annually to ensure all requirements have been satisfied. Using a comprehensive GIPS compliance disclosure checklist can be helpful.

Two checklists have been provided:

GIPS Advertising Guidelines Checklist (PDF)

GIPS Compliant Presentation Disclosure Checklist - (PDF)

They are also located in the Resource Library in the GIPS folder.

Maintaining compliance

GIPS compliance is an ongoing process. There are tasks that must be completed on a monthly and annual basis in order to maintain compliance. For example, each month the portfolio returns have to be calculated, composites should be updated and a review of the results and necessary audit checks should be performed. The day-to-day maintenance procedures should either be documented in the GIPS policies and procedures or be separately documented as desktop procedures. At least annually firms should review and update their GIPS policies and procedures, the firm's list of composite descriptions and the firm's GIPS-compliant presentations. More frequent review and updates will be necessary if there are significant changes to the firm's size, product offering and/or systems.

GIPS governance

Throughout the year, the firm might find it necessary to have GIPS governance and oversight meetings to discuss changes to the GIPS standards and/or the firm itself — new products, new systems, changes to composite fee schedules, new account types, or investments in new asset classes are common triggers — and assigning how those changes impact the firm's GIPS compliance program is important. GIPS governance and oversight committee members may include representatives from operations, performance, business development, portfolio management and other internal stakeholders.

Questions Compliance should ask those involved with GIPS compliance:

Who is responsible for the GIPS compliance program?

How do they stay current on applicable rules and regulations related to the GIPS standards and performance advertising?

Who is building and maintaining composites?

What are the policies for assigning accounts to composites? Is the process fairly automated or does it require judgment calls? If subjectivity is involved, how and who makes the final call about which accounts are included in composites and the timing of inclusion?

What audit checks and review process is in place before composite performance is provided to the verifier and/or used in advertising materials?

Who is responsible for ensuring the GIPS-compliant presentations include the necessary disclosures and required statistics? Are multiple people involved in preparing and reviewing the GIPS-compliant presentations?

Are procedures in place to ensure that compliant presentations are provided to every prospective client, as required?

How are prospective clients tracked by the firm? This information would be necessary in the event the firm has to republish materials as a result of correcting a material error.

Stay current

The GIPS standards are updated periodically, new Guidance Statements are released and new Questions & Answers are posted on the GIPS website. Staying on top of changes to the GIPS standards — including changes in the regulatory environment that may impact the firm's claim of GIPS compliance — is important. Firms can monitor the GIPS standards' website, sign up for the GIPS newsletter, attend the GIPS annual conference and subscribe to verifier and GIPS consulting firm email distribution lists to keep updated. Another way to stay connected is to participate in the GIPS Roundtable that is organized by members of the NSCP. The mission of the roundtable is to meet at least quarterly via conference call to collaborate and discuss GIPS compliance and performance advertising related best practices. Contact the NSCP if you are interested in participating.

New GIPS requirement

A new requirement was recently adopted that requires firms that claim compliance with the GIPS standards to submit certain information to CFA Institute on an annual basis. The purpose of this new requirement is to allow CFA Institute to gather information related to the number, location, and types of firms that claim compliance with the GIPS standards. Failure to submit the required information prior to June 30, 2015, and each year thereafter, would cause the firm to be considered out of compliance.

Testing considerations: Maintaining compliance

1. Inquire about the monthly, quarterly and annual processes and controls that are in place to ensure that the firm maintains compliance with the GIPS standards. Discuss if desktop procedures should be maintained to outline, step-by-step, how composites are updated and reviewed and how performance presentations are updated and distributed to prospective clients.
2. Identify the team or individuals responsible for staying on top of changes to the GIPS standards or changes to the regulatory environment that may impact the firm's claim of GIPS compliance.
3. Confirm that the firm has satisfied the new requirement to notify CFA Institute of their claim of compliance prior to the June 30 deadline.

Verification

Many GIPS compliant firms choose to reinforce the credibility of that claim through independent third-party verification. During the verification process, the verifier 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 testing is done on a sample basis and is based on a representation from the firm that the firm is compliant and adhering to all requirements on a consistent basis. Firms that choose to undergo verification will typically set a schedule for having a verification conducted either semi-annually or once a year — while some might even have it conducted each quarter.

It is important to note that verification is *not* an audit and should not be referred to as an audit.

Testing considerations: Verification

1. If the firm chooses to be verified, compliance personnel should confirm that the verification is completed in a timely manner and inquire if the verification is not on schedule.
2. Verifiers and/or GIPS consultants may provide the firm with recommendations that require corrective action or suggestions related to practices that could be improved. The compliance department should periodically review these recommendations and determine what, if any, remedial steps should be taken.
3. Ensure that people at the firm understand the scope and parameters of a GIPS verification so that they don't inaccurately describe it as an "audit" or use other inappropriate terminology. Some firms have received regulatory deficiencies for failing to describe this properly.

Policies and procedures tested on a sample basis

Like the claim of compliance itself, verification is a firm-wide initiative; however, the verifier generally will not review every composite during their verification process. The verifier instead tests consistency of the policies and procedures on a sample basis across the firm. Firms have the option of having the verifier conduct a performance examination on specific composites. Composite performance examinations are done in conjunction with the firm-wide verification. The performance examination testing includes drilling down into that composite's performance track record to affirm whether the underlying valuations, calculation methodologies, and transaction records are accurate and adhere to GIPS requirements.

Responsibility for compliance lies with the firm

Firms that undergo verification should be careful not to make the mistake of relying on the verifier to ensure that the firm is compliant. Instead, the firm must take ownership of their own process and ensure appropriate audit checks and controls are in place and adhered to. Verifiers are required to obtain a representation letter from the firm's management that includes a confirmation that policies and procedures used in establishing and maintaining compliance with the GIPS standards have been consistently applied throughout the periods being verified and that the firm complies with all the requirements of the GIPS standards.

Conclusion

The GIPS standards provide investment management firms with a consistent set of guidelines for reporting firm performance. The decision to adopt the GIPS standards, however, includes an ongoing — and often collaborative — effort. In-house compliance personnel are well-positioned to coordinate that effort, and establish process and documentation guidelines. With a solid testing protocol in place, compliance staff can confirm the right checks and balances are in place, identify weaknesses in the GIPS compliance program, monitor firm changes that might affect compliance, alert internal stakeholders to updates in the GIPS standards, and assist with confirming that the firm remains GIPS-compliant. ✦