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Year-End Review & Testing Considerations for GIPS® Compliant Firms

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As the end of the year fast approaches, now is a good time for firms that claim compliance with the Global Investment Performance Standards (GIPS®) to look under the hood of their GIPS-compliance program to make sure they are ready for 2018. Following are some of the things these firms should consider:

Review Your GIPS Polices & Procedures

A key aspect of compliance with the GIPS standards is that firms are required to document policies and procedures designed to establish and maintain compliance. The firm's policies and procedures should address all requirements of the GIPS standards and outline how the firm is actively meeting those requirements. As the GIPS standards are being expanded and revised on a regular basis, the firm's GIPS policies and procedures need to be updated to address any changes, which may come in the form of new or revised guidance statements or Q&As published on the GIPS website[1] or through a complete redraft of the standards, as is expected in 2020. It is also a good practice for certain employees of the firm to subscribe to the GIPS newsletter and email alerts[2] and to regularly review the GIPS website for new content.

Your firm's GIPS policies and procedures also need to keep up with changes within your firm. Developments at your firm that may impact your GIPS policies and procedures include:

- Changes in the organizational structure, such as mergers or acquisitions, that may impact the firm definition.
- Changes to valuation or accounting practices.
- New systems being utilized for portfolio accounting or composite construction, which may use different methodologies than those that are described in the policies and procedures.
- New products being offered by your firm that utilize calculation methodologies other than those described in your policies and procedures. For example, a firm that has traditionally only managed separate accounts and calculated performance using monthly intervals may start managing a mutual fund that calculates performance based on daily NAVs.
- Changes to strategies or products offered by your firm that may impact your error correction policy. For example, different materiality thresholds may be necessary for private equity strategies that use an internal rate-of-return (IRR) for return calculations rather than a time-weighted rate-of-return (TWRR).

Review Your List of Composite Descriptions

Firms that claim compliance with the GIPS standards are required to maintain and make available to prospective clients a complete list of composite descriptions that includes all active composites as well as composites that have terminated within the last five years. The "descriptions" included in the list should include general information regarding the investment mandate, objective, or strategy of the composite. If any of that information has changed since the last update, the list will need to be revised. Common items that may need to be updated include:

- Adding newly created composites to the list.
- Potentially removing any composites that terminated more than five years ago.
- Confirming that the language used to describe the investment strategy is consistent with other materials published by the firm.
- Ensuring that any composite redefinitions (i.e., changes to the rules governing which accounts are included in the composite) are properly reflected.
- Noting changes to composite benchmarks.

Review Your Composites

Most firms have a process for maintaining and updating their composites throughout the course of the year, which should include performing routine checks to validate the accuracy of

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1. www.gipsstandards.org
2. www.gipsstandards.org/news/Pages/newsletter.aspx

composite construction. However, it is also a good practice to conduct a more extensive annual review prior to publishing final composite results and updating presentation materials. This can also help you to prepare for verification, if your firm chooses to receive a GIPS compliance verification from an independent third party.

- Throughout the course of the year, many firms look at performance outliers – accounts whose performance results deviate significantly from the rest of the composite – on a monthly basis. Additionally, we recommend looking at performance outliers over the course of the full year. Issues and patterns that may not have been evident when looking at isolated periods may come to light.
- Review all changes to composite membership throughout the year – new accounts, terminated accounts, and strategy changes – and confirm that all changes are consistent with the firm's policies and are supported by appropriate documentation.
- If the firm has established minimum account size rules for composite inclusion, ensure that all accounts below the minimum are properly excluded.
- If the firm has adopted a significant cash flow policy, ensure that it is being applied consistently.
- Review all accounts that are classified as non-discretionary for GIPS compliance purposes to ensure that their exclusion from composites is appropriate. When doing so, you should also confirm that the definition of discretion outlined in the firm's GIPS policies and procedures is consistent with the firm's actual practice of determining whether an account is eligible for composite inclusion.

The personnel responsible for maintaining composites on an ongoing basis may conduct this review or it might be conducted in conjunction with others who are less involved with the process. For example, portfolio managers should periodically review composite membership for the strategies and portfolios they manage.

Review Net-of-Fees Calculations

The GIPS standards provide multiple options for calculating net-of-fees composite returns. Whichever option you choose, care must be taken to ensure the fees being applied are appropriate. Routine follow-up checks are often necessary.

- If net-of-fees results are calculated based on actual management fees, confirm if any accounts in the composite pay fees from outside of the account, such as a separate brokerage account or by check. If the account's performance is not adjusted to reflect these management fees, the composite's net-of-fees return could be overstated.
- In addition, for accounts in the composite that the custodian debits the management fee, review the custodian's data feeds to confirm that management fees are reflected as performance impacting transactions. This review is particularly important for custodian relationships that are new to the firm, though periodically reviewing all custodians' classification of fee transactions is important.
- If model fees are used to calculate net-of-fees returns, confirm that the fee applied is the highest fee being charged to any account in the composite. In no case should the use of a model fee result in net-of-fees returns that are higher than those that would have been calculated if actual fees had been used.
- For accounts charged a bundled fee, confirm that the entire bundled fee is deducted.

Finalize Your Total Firm Assets

Total firm assets must include all discretionary and non-discretionary assets for which the firm has investment management responsibility. Firms are required to report total firm assets (or the particular composite's assets as a percentage of the total firm assets) in their GIPS-compliant presentations as of each year end. For some firms, compiling total firm assets is a straightforward exercise; for others, it can be more of a challenge. Generally, it comes down to the complexity of the firm definition – in some cases it may overlap across multiple legal entities, while in others the firm definition may only encompass a small division within a large organization. In any event, total firm assets must be consistent with the scope of the definition of the firm and not include any accounts that are outside of that scope.

Other items to keep in mind related to total firm assets:

- Be sure that advisory-only assets – assets for which the firm does not have authority to execute trades – are excluded from total firm assets. This would include model-delivery and, in most instances, unified managed account (UMA) portfolios.
- If any of the firm's strategies employ leverage, ensure that total firm assets (as well as composite assets) are presented net of leverage and not grossed up as if the leverage did not exist.
- Once total firm assets are properly compiled, they should be reconciled back to the firm's composite membership to confirm that all discretionary, fee-paying accounts are included in at least one composite and that non-discretionary accounts are properly excluded.

Update Your GIPS-Compliant Presentations

Once composites have been updated and total firm assets have been compiled, you can begin the process of updating your GIPS-compliant presentations. A GIPS-compliant presentation is a presentation for a composite that includes all information required by the GIPS standards. At a minimum, firms are required to update their GIPS-compliant presentations on an annual basis, which generally takes place shortly following year end. While it may appear that adding the most recent year's annual returns to the presentation and updating a few other statistics is all this entails, there are many other elements of the presentation that are subject to change over time and may require attention to ensure that the presentations remain complete and accurate. Following are some of the items that should be considered when updating compliant presentations:

- Ensure the composite description presented is consistent with the one noted in the firm's list of composite descriptions.
- Ensure that benchmark names and descriptions are consistent with those published by the index provider, keeping in mind that index names tend to change from time-to-time (e.g., Lehman indices changed to Barclays indices, then later changed to Bloomberg Barclays indices).

- If the composite benchmark has changed, include disclosure explaining why the change occurred.
- For composites with blended benchmarks, ensure the weightings noted for the component indices are accurate as of year end.
- Review and confirm that fee schedules and disclosures related to fees are accurate. Consider comparing the composite fee schedule with the strategy fee schedule outlined in Part 2 of Form ADV for consistency. Also, ensure that disclosures related to the use of model or actual fees to calculate net-of-fees performance are accurate.
- Confirm if the composite includes any non-fee-paying accounts. If so, update the percentage of composite assets represented by non-fee-paying portfolios as of year end.
- If the composite includes accounts that pay bundled fees, update the percentage of composites assets represented by portfolios with bundled fees as of year end.
- When initially creating a presentation for a new composite, confirm if the composite has an initial period of less than a full year. If so, include composite returns in the presentation from inception through the initial annual period end.
- Ensure disclosures regarding the use of leverage, derivatives and short positions sufficiently detail the risks associated with the use of these tools. This disclosure can be qualitative, quantitative, or both.
- Ensure any significant events impacting the composite (e.g., a change in lead portfolio manager) are properly disclosed.

GIPS Program Governance and Oversight

A good practice is for firms to establish a GIPS working group or committee, comprised of personnel who are responsible for maintaining the firm's GIPS compliance program as well as representatives from different departments who are not involved in the day-to-day process. This group should meet at least annually to discuss and review items related to GIPS compliance that may impact the firm on a macro level. Such items would include:

- Changes to the GIPS standards and how these changes may impact your firm.
- Changes in investment management style or process and how they may impact composites.
- Any changes in laws or regulations regarding the calculation and presentation of performance and how such changes could impact the firm's GIPS-compliance program.

Other potential compliance oversight functions that may be necessary include:

- Confirming the process for ensuring that GIPS-compliant presentations are distributed to all prospective clients is working effectively.
- Providing internal education to various groups that are impacted by GIPS compliance to ensure that all stakeholders throughout the organization understand the value of and the obligations created by claiming compliance with the GIPS standards.

Conclusion

Compliance with the GIPS standards is not a one-time exercise that, once completed, can be permanently checked off a firm's to-do list. Maintaining GIPS compliance is a continuous effort that has many moving parts and involves extensive coordination throughout a firm. Year end is the perfect time to revisit your GIPS compliance program to ensure it continues to function as intended.