

SEC Enforcement of GIPS® Compliance: A Closer Look

By Amy Jones, CIPM, and Arin Stancil, CFA, CIPM

A robust GIPS compliance program should include: 1) documented GIPS policies and procedures that are tailored and specific to the firm, 2) a review process for composite construction and performance calculations, 3) marketing controls to ensure appropriate disclosures and performance results are being properly included in advertisements and other marketing materials, 4) compliance oversight (internal or external) involved with reviewing the overall process and 5) procedures for maintaining compliance going forward, including staying current with respect to changes to the GIPS standards and/or regulatory requirements.

Amy Jones, CIPM is the Founder and Principal at Guardian Performance Solutions LLC, a specialty compliance consulting firm dedicated to assisting investment advisory firms to implement, maintain and manage compliance with the Global Investment Performance Standards (GIPS®) as well as reviewing performance advertising materials for adherence with SEC requirements. Mrs. Jones is a recipient of the Certificate in Investment Performance Measurement (CIPM), a credential awarded by CFA Institute that focuses on performance evaluation and the GIPS standards.



Arin Stancil, CFA, CIPM is a Managing Director and Principal at Guardian Performance Solutions LLC. Mr. Stancil has been working with the GIPS standards for the past fourteen years as a verifier, consultant, and practitioner. He has earned the right to use the Chartered Financial Analyst (CFA) designation as well as the Certificate in Investment Performance Measurement (CIPM). Mr. Stancil is also a member of the United States Investment Performance Committee (USIPC), the official local sponsoring organization for the GIPS standards in the United States.



Introduction

The Global Investment Performance Standards (“GIPS®”) are a set of standardized, industry-wide 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, once a firm makes the decision to publicly claim compliance with the GIPS standards, strict adherence is required. A firm cannot make a partial claim of compliance with the GIPS standards, or comply in some instances but not others. If a firm claims compliance, it must do so consistently and completely.

Regulators like the Securities and Exchange Commission (“SEC”) often review claims of compliance with the GIPS standards to ensure that they are accurate and that investors are not being misled. The recent enforcement action against ZPR Investment Management, Inc. (“ZPRIM”) and its founder, Max E. Zavanelli, serves as a testament to the level of attention and seriousness that the SEC gives to potentially false claims of GIPS compliance.

In May 2014, an administrative law judge (“ALJ”) issued an Initial Decision¹ against ZPRIM which focused predominately on misrepresentations regarding compliance with the GIPS standards in magazine advertisements and investment newsletters. These misrepresentations were determined to be violations of the Investment Advisers Act of 1940 (“Advisers Act”) and, as a result, the firm was censured, issued a cease-and-desist order, and fined \$250,000 in civil penalties. Additionally,

©2014, Amy Jones and Arin Stancil

Mr. Zavanelli was determined to be personally liable for these violations as an aider and abettor and, as a result, was individually fined \$660,000 and permanently barred from the industry.

The case is particularly significant because of its extensive focus on the GIPS standards and the fact that it resulted in what are likely the most significant penalties ever imposed for violations limited almost exclusively to failure to comply with the GIPS standards. In exploring the case further though, we found that there were several other relevant aspects to this case and lessons to be learned by all investment advisers, regardless of whether they claim compliance with the GIPS standards.

GIPS Standards

The GIPS standards were first adopted in 1999 based on the idea that global standardization of investment performance reporting would give investors around the world the additional transparency necessary to compare and evaluate investment managers and make more educated investment decisions. The GIPS standards are based on the fundamental principles of full disclosure and fair representation of investment performance results.

The GIPS standards are quite extensive and, while a complete outline of the details associated with achieving compliance is beyond the scope of this article, there are some specific aspects of the GIPS standards that are relevant to

The case is particularly significant because of its extensive focus on the GIPS standards and the fact that it resulted in what are likely the most significant penalties ever imposed for violations limited almost exclusively to failure to comply with the GIPS standards.

this discussion and should be understood before we proceed:

- Compliance with the GIPS standards can only be achieved on a firm-wide basis by an investment firm, subsidiary, or division that is held out to the public as a distinct business entity.² The manner in which the “firm” is defined is the foundation for GIPS compliance. Individual portfolios, funds or composites (or the performance results thereof) do not themselves comply with the GIPS standards and, as a result, cannot be reported as “in compliance.” Only

when a comfort level has been achieved that the firm as a whole has adhered to all of the requirements of the GIPS standards (and has a process in place to ensure continued adherence) can the firm publicly “claim” compliance.

- A key component of the GIPS standards is the concept of a “composite.” A composite is an aggregate of one or more portfolios managed according to a similar investment mandate, objective, or strategy.³ The performance for the composite is then used to represent – in a transparent and comprehensive manner – how the investment strategy performed historically. The GIPS standards require all actual, fee-paying, discretionary portfolios managed by the firm to be included in at least one composite.⁴
 - There is a common misperception that the GIPS standards are strictly “performance standards” and, therefore, if the prescribed calculation methodologies are properly followed, then the firm can represent that it is “GIPS compliant.” In reality, there are many more aspects to the GIPS standards beyond the performance calculations. Ultimately, the accuracy of a claim of GIPS compliance depends not just on how performance results are calculated, but on how those results are communicated to the investing public. In particular, the GIPS standards have detailed requirements that address disclosure and performance information that must be provided to prospective clients. In addition, all firms that claim GIPS compliance must document policies and procedures for establishing and maintaining compliance with the GIPS standards.⁵
- The GIPS standards are very specific that, in order to claim compliance, “Firms must comply with all requirements of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipstandards.org) as well as in the *GIPS Handbook*.”⁶ What that means is that firms cannot pick-and-choose which parts of the GIPS standards they want to follow. Either they comply completely, or they do not comply at all. In fact, a firm that is not in compliance with the GIPS standards should not make any references to the GIPS standards in the context of reporting performance or performance presentations.

“GIPS®” is a trademark owned by CFA Institute and it is only authorized for use by firms that claim compliance.

- Verification, as defined in the GIPS standards, is the “process by which an independent 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.”⁷ Verification does not ensure the accuracy of any specific composite presentation nor is it considered equivalent to an audit. Verification is encouraged, but not required in order to claim compliance with GIPS standards.
- As noted earlier, compliance with the GIPS standards is voluntary. However, GIPS compliance is generally expected in many markets in order for investment management firms to win new mandates, especially those that serve the institutional marketplace. Since GIPS compliance is often seen as an essential ingredient that can make or break a firm’s marketing efforts, regulators tend to look at claims of compliance closely. One reason for this scrutiny is the possibility that clients and prospective clients are placing reliance on the firm’s claim of GIPS compliance and, therefore, making the claim is helping the firm to acquire new business or to retain existing business. If a firm’s claim is found to be false, then the claim of GIPS compliance itself could be considered a misleading statement and, as a result, a violation of the anti-fraud provisions in Section 206 of the Advisers Act.

Advertising Claims of GIPS Compliance

The means by which firms that claim compliance with the GIPS standards communicate their claim to the investing public is typically through the distribution of what is referred to as a “Compliant Presentation.” A Compliant Presentation is a presentation for a specific composite that contains all of the disclosures and statistical information required by the GIPS standards.⁸ A Compliant Presentation for a single composite will usually cover a full page and, in some instances, may require two pages. At a minimum, a Compliant Presentation will include:

- Five years of annual composite performance results and
- Corresponding benchmark returns,
- The number of accounts included in the composite and the value of composite assets as of each year-end.

- The total assets managed by the firm *or* the percentage of firm assets represented by the composite.
- Dispersion and volatility measures.
- Various disclosures including a description of the composite, the definition of the firm, details regarding the calculation methodologies used, and specific language regarding the firm’s claim of compliance with the GIPS standards.

Firms that claim compliance with the GIPS standards are required to “make every reasonable effort to provide a Compliant Presentation to all prospective clients”⁹ though there is no requirement to provide these presentations to existing clients or to other parties that the firm does not consider to be prospective clients. Prospective clients, as defined in the GIPS standards, are limited to “any person or entity that has expressed interest in one of the firm’s composite strategies and qualifies to invest in the composite”¹⁰ and, as a result, there are many potential situations where a firm may interact with groups or individuals who do not meet this definition but where the firm may want to acknowledge their claim of GIPS compliance. The GIPS Advertising Guidelines were designed to address scenarios like this.

The GIPS Advertising Guidelines allow firms to state that they claim compliance with the GIPS standards in something other than a Compliant Presentation. Firms are not required to produce advertisements that reference their claim of GIPS compliance – they can choose to remain silent on the topic in any particular piece. However, if the firm chooses to reference its claim of compliance in an advertisement, it must follow the GIPS Advertising Guidelines or include a Compliant Presentation in the advertisement. The GIPS Advertising Guidelines do not replace the GIPS standards, nor do they absolve firms from providing a Compliant Presentation when required to do so by the GIPS standards.¹¹

For the purposes of the GIPS Advertising Guidelines, an advertisement “includes any materials that are distributed to or designed for use in newspapers, magazines, firm brochures, letters, media, websites, or any other written or electronic material addressed to more than one prospective client. Any written material, other than one-on-one presentations and individual client reporting, distributed to maintain existing clients or solicit new clients for a firm is considered an advertisement.”

The GIPS Advertising Guidelines require that all advertisements that include a claim of compliance with the GIPS standards disclose the following:

- The definition of the “firm” making the claim of compliance.
- How a prospective client can obtain a Compliant Presentation and/or the firm’s complete list of composite descriptions.
- The GIPS compliance statement for advertisements: “[Firm Name] claims compliance with the Global Investment Performance Standards (GIPS).”

In addition, advertisements that follow the GIPS Advertising Guidelines that include performance must also disclose:

- The description of the composite.
- Whether returns are presented gross-of-fees or net-of-fees.
- A total return benchmark for the same periods that composite returns are presented, along with a description of the benchmark. If the firm determines that no appropriate benchmark for the composite exists, a disclosure must be included explaining why no benchmark is presented.
- The currency used to express performance.
- The presence, use, and extent of leverage, derivatives, and short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks.
- Periods that do not comply with the GIPS standards (if applicable).
- If the advertisement conforms to laws and/or regulations that conflict with the requirements of the GIPS standards (typically not applicable for advisers in the United States).

As for the performance information presented, the advertisement must include one of the following options:

- One-, three-, and five-year annualized composite returns through the most recent period with the period-end date clearly identified. If the composite has been in existence for less than five years, the composite’s annualized return since inception must be presented.
- Period-to-date composite returns in addition to one-, three-, and five-year annualized composite returns through the same time period as presented in the corresponding Compliant Presentation (typically, the most recent calendar year-end) with the period-end date clearly identified. If the

composite has been in existence for less than five years, the composite’s annualized return since inception must be.

- Period-to-date composite returns in addition to five years of annual composite returns (or for each annual period since the composite inception if the composite has been in existence less than five years) with the period-end date clearly identified. The annual returns must be calculated through the same period of time as presented in the corresponding Compliant Presentation.

Identified Performance Advertising Deficiencies

As outlined in the Initial Decision, ZPRIM was found by the SEC to have a series of deficiencies over a number of years and in multiple performance advertisements related to the GIPS standards and the GIPS Advertising Guidelines. These issues included:

- Failure to include performance results for time periods required by the GIPS Advertising Guidelines in advertisements that referenced the firm’s claim of compliance with the GIPS standards. To compound this issue, it was suggested that ZPRIM had opportunistically chosen reporting periods in which the firm’s composite outperformed its benchmark and that, had the performance periods required by the GIPS Advertising Guidelines been included, in at least some instances the advertisements would have shown that the composite actually underperformed compared to its benchmark.
- Failure to include specific disclosures required by the GIPS Advertising Guidelines in advertisements that referenced the firm’s claim of compliance with the GIPS standards, such as the currency used to express performance and how an interested party could obtain a Compliant Presentation.
- Including claims in advertisements that returns had been “audited” instead of more accurately referencing that the firm had been “verified.” (We found this item to be particularly interesting, as we have seen many firms over the years use these terms interchangeably as if they were synonymous. In this case, the SEC has clearly indicated that this practice is not appropriate.)
- Including statements indicating that “all numbers are GIPS compliant” rather than properly indicating that the firm “claims compliance” with the GIPS standards.

- The inclusion of “carve-out” results (i.e., asset class segment returns) in at least one composite without adequate disclosure.

One particularly interesting point is that the SEC did not actually allege that any of the returns that ZPRIM had advertised were inaccurate. The deficiencies primarily centered on the presentation of performance results for selective time periods and missing GIPS disclosures, issues that, had the firm not claimed GIPS compliance, likely would not have been as problematic. Further, the presentation materials in

The conclusion may have been very different had ZPRIM and Mr. Zavanelli been responsive to the regulator’s concerns, acknowledged their errors, taken corrective action, and handled the process with humility.

question were found not to have produced a single new client for the firm, indicating that no investors actually placed reliance on the ads. However, the ALJ concluded that “whether customers actually relied on ZPRIM’s GIPS compliance is not a defense” and went on to state that “the issue is whether the advertisements were materially misleading, not whether anyone was actually misled.”

The case also emphasizes the basic necessity for investment management firms to claim compliance with the GIPS standards in order to acquire new clients, both through the ALJ’s comments and the actions of ZPRIM. In the Initial Decision, the ALJ noted that “GIPS has become almost mandatory for firms seeking institutional investors.” Mr. Zavanelli apparently agreed with this sentiment as demonstrated by his insistence that the firm’s claim of compliance not be removed from the advertisements that were brought into question in the case, even when space limitations demanded that other disclosures be removed. Mr. Zavanelli apparently did not recognize the need to meet all of the requirements of the GIPS standards in the firm’s advertisements, but he did recognize the importance of claiming compliance.

Selective Reliance on Experts

Firms often rely on the technical expertise, knowledge and experience of a performance measurement expert, verifier or

compliance consultant to understand the requirements of the GIPS standards. Firms who hire experts and profess to rely on their opinions should not disregard feedback that is provided, even when it is not exactly what the firm wants to hear. The Initial Decision outlined that ZPRIM had employed the services of a GIPS verification firm for a number of years and relied on this verifier not only to conduct GIPS verifications periodically, but also to serve as the firm’s “GIPS expert.” It was noted that the verifier repeatedly identified issues with ZPRIM’s performance advertisements and brought them to the firm’s attention, but Mr. Zavanelli “recklessly chose to ignore” their advice when it contradicted his views.

While not acting upon the counsel of their verifier, ZPRIM still apparently relied on the verification as evidence that they were GIPS compliant. However, as the ALJ outlined in a footnote in the Initial Decision, “ZPRIM cannot point simply to verification reports to substantiate compliance. Verifiers can only base their decision to verify on what the firm discloses to them. If a firm, like ZPRIM, withholds non-compliant advertisements from the verifier, there is no opportunity to judge the firm’s full universe of compliance.” We could not agree more with this sentiment. Verification does not confirm GIPS compliance – it merely validates that the firm has a control structure in place in order to facilitate compliance. A verification is also conducted as of a particular point in time and is largely dependent on representations made by the firm to the verifier.

Disregard for the GIPS Standards

The Initial Decision also outlined a situation where Mr. Zavanelli publicly criticized the GIPS standards. He wrote an article in the firm’s December 2009 newsletter in which he challenged the appropriateness of asset-weighting portfolio returns (a requirement of GIPS compliant composite construction) as an appropriate way of reflecting whether an asset manager has added value. He also explicitly stated in the article that the “investment report you are now reading is not GIPS compliant.” Since a GIPS compliant firm cannot be in compliance only part of the time and, therefore, is precluded from distributing materials that are not compliant, by making this statement Mr. Zavanelli was implying that ZPRIM was actually not in compliance with the GIPS standards.

These comments were further exacerbated by the fact that Mr. Zavanelli later testified that he was “the closest thing to an expert” on the GIPS standards that ZPRIM had (other than their verifier) and that “he believed himself better qualified on GIPS than the Commission’s staff.” Based on these comments and Mr. Zavanelli’s perceived knowledge of the topic, it would be reasonable to conclude that he should have known the ramifications of his comments regarding non-compliance. He, in effect, gave the appearance that he knowingly violated the GIPS standards. Mr. Zavanelli also admitted that he was responsible for ensuring ZPRIM’s marketing materials were GIPS compliant and for making all claims of GIPS compliance on ZPRIM’s behalf, which led to the finding that he was personally responsible for the violations.

As part of his defense, Mr. Zavanelli attempted to argue that his newsletter should not be considered an advertisement because it was not being provided to prospective clients – it was sent to clients and “members of the investment community.” This argument lacked merit, however, because the definition of “advertisement” outlined in the GIPS standards clearly extends not only to materials sent to prospective clients but also to those designed to maintain existing clients. In addition, the SEC has repeatedly taken a broad view of what constitutes a performance advertisement and has also considered materials designed to maintain existing clients to fall within that scope.¹²

Responding to Regulator’s Requests

The Initial Decision also painted a picture that ZPRIM was not completely forthcoming with the information they provided to SEC examiners. When the SEC’s examination initially commenced in 2009, among the materials requested were all email communications from certain members of the firm; however, ZPRIM elected to exclude from their response correspondence that was sent through the company’s internal cloud-based electronic portal. ZPRIM felt that the content of the portal was not subject to the SEC’s request, though it was later learned that Mr. Zavanelli used the portal as his primary method of communicating with his employees. Though ZPRIM acknowledged the existence of the portal in their initial response, the SEC staff did not initially recognize the significance of this portal and the information being withheld until 2013 when preparing a witness for testimony during the trial.

After this finding, ZPRIM was made to produce approximately 860,000 documents from the portal and ZPRIM email system. In the ALJ’s opinion, it was clear that one of the reasons the portal was used was to avoid scrutiny from the SEC. In one of the emails sent through the portal in 2001, Mr. Zavanelli stated that certain communications should be maintained within the portal to keep them away from the “prying eyes of the SEC Monster.” The ALJ also concluded that ZPRIM “deliberately withheld records in the First ZPR Portal after being requested to provide them, and intentionally misdirected examiners and investigators.”

Though the Initial Decision did not mention any significant violations of the Advisers Act that were identified through the review of the information in ZPRIM’s portal, the apparently deliberate attempt by the firm to hide these records seemed to become a significant issue in the case and likely contributed to the significance of the penalties that were imposed. This should serve as an example to other advisers for the need to respond to regulatory requests in an honest, transparent, and comprehensive manner in order to avoid the appearance of misconduct.

Role of the CCO

This case also served to illustrate the need for investment advisers to employ qualified, experienced compliance professionals. A reoccurring theme throughout the Initial Decision was a demonstrated lack of compliance oversight. ZPRIM reportedly did not have anyone designated as the firm’s Chief Compliance Officer (“CCO”) until 2006 when Mr. Zavanelli’s ex-wife was assigned the role. Mr. Zavanelli assumed the role of CCO himself in 2009 following the SEC’s examination and concerns were expressed that his ex-wife was “not particularly capable.” Mr. Zavanelli’s son then assumed the role in 2011, though he conceded under testimony that he was not an experienced compliance officer. At no time, it seems, did ZPRIM ever employ an experienced CCO, nor was the CCO particularly involved in the GIPS compliance process.

The implementation of robust compliance controls, particularly with respect to the firm’s marketing communications, could have helped to alleviate many of the issues uncovered in the case. At many firms, the primary responsibility for GIPS compliance resides outside of the compliance department (typically, it is relegated to operations, performance, or even marketing); however, regardless of who “owns” GIPS compliance, having compliance

oversight involved in the process is critical. Someone from the compliance group who is separate from the marketing and sales teams should be involved with reviewing advertising materials, including confirming that all required GIPS disclosures and statistical information are included where appropriate. Many firms refer to disclosure checklists as part of their process to help ensure these requirements are being met.

Conduct with Regulators

Another aspect of this case that appears to have played a significant role in the outcome was the manner in which Mr. Zavanelli conducted himself throughout the process. In fact, the Initial Decision actually includes a section dedicated specifically to “Max Zavanelli’s Demeanor,” which was described as “extraordinarily poor.”

He was described throughout the Initial Decision as:

- “repeatedly disrespectful to Division counsel,”
- “combative,”
- “defensive,”
- “discursive,”
- “uncooperative,”
- providing “non-responsive answers” that were “largely irrelevant,” and
- giving testimony that was “confusing, inconsistent, and evasive.”

The way Mr. Zavanelli conducted himself appears to have had an impact on the severe judgment passed on him and his company. His combative nature and professed knowledge of

the GIPS standards seemed to give the impression (real or not) that he acted willfully and with intent and awareness of his wrongdoing.

Conclusion

The violations detailed in the case were the result of ZPRIM not adhering to all the requirements of the GIPS standards; however, the outcome and penalties levied do not appear to be purely the result of GIPS deficiencies. The withholding of requested records and the conduct of Mr. Zavanelli throughout the proceedings clearly played a key role. The conclusion may have been very different had ZPRIM and Mr. Zavanelli been responsive to the regulator’s concerns, acknowledged their errors, taken corrective action, and handled the process with humility.

Firms that are currently claiming compliance with the GIPS standards or are considering doing so in the future should find this case instructive. As long as the firm can demonstrate that the firm’s GIPS compliance program includes the appropriate framework necessary to meet all the requirements outlined in the GIPS standards and the program is being consistently adhered to, situations like the one that ZPRIM found themselves in should be easily avoidable.

Regardless of the issue, if the SEC expresses to an adviser that something is an issue that needs to be addressed, then the firm should take those concerns very seriously. Advisers can demonstrate this by correcting known deficiencies, establishing a control structure to mitigate the risk of deficiencies occurring again, and ensure the process has independent oversight.

ENDNOTES

¹ <https://www.sec.gov/alj/aljdec/2014/id602ce.pdf>

² GIPS Provision 0.A.12, Global Investment Performance Standards (GIPS), 2010 Edition.

³ Section V. Glossary, Global Investment Performance Standards (GIPS), 2010 Edition.

⁴ GIPS Provision 3.A.1, Global Investment Performance Standards (GIPS), 2010 Edition.

⁵ GIPS Provision 0.A.5, Global Investment Performance Standards (GIPS), 2010 Edition.

6 GIPS Provision 0.A.1., Global Investment Performance Standards (GIPS), 2010 Edition.

⁶ GIPS Provision 0.A.1., Global Investment Performance Standards (GIPS), 2010 Edition.

⁷ Section V. Glossary, Global Investment Performance Standards (GIPS), 2010 Edition.

⁸ Section V. Glossary, Global Investment Performance Standards (GIPS), 2010 Edition.

⁹ GIPS Provision 0.A.9., Global Investment Performance Standards (GIPS), 2010 Edition.

10 Section V. Glossary, Global Investment Performance Standards (GIPS), 2010 Edition.

¹⁰ Section V. Glossary, Global Investment Performance Standards (GIPS), 2010 Edition.

¹¹ Section III. GIPS Advertising Guidelines, Global Investment Performance Standards (GIPS), 2010 Edition.

¹² Munder Capital Management, SEC No-Action Letter (pub. avail. May 17, 1996)

This article is reprinted with permission from *Practical Compliance and Risk Management for the Securities Industry*, a professional journal published by Wolters Kluwer Financial Services, Inc. This article may not be further re-published without permission from Wolters Kluwer Financial Services, Inc. For more information on this journal or to order a subscription to *Practical Compliance and Risk Management for the Securities Industry*, go to pcrmj.com or call 866-220-0297