GUEST COLUMN

GIPS 2020: Changes on the Horizon for GIPS-Compliant Firms

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CFA Institute's Global Investment Performance Standards (GIPS®) continue to be the most widely endorsed and adopted standard for investment performance reporting around the world. Based on the most recent data from CFA Institute, over 1,600 firms globally claim compliance with the GIPS standards. Demand for compliance remains high in developed economies and has started to extend into emerging markets. However, if that growth is going to continue, the GIPS standards themselves must evolve in order to meet the needs of a changing industry. With that in mind, a new edition of the GIPS standards has been drafted and issued for public comment. The Exposure Draft of the 2020 Global Investment Performance Standards,[1] commonly referred to as "GIPS 2020," reflects an expanded scope and includes new focus areas that had not previously been addressed. The comment window opened on August 31, 2018 and will extend through December 31, 2018, with the final version expected to be approved in mid-2019 and to become effective on January 1, 2020.

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GIPS 2020 represents the most significant restructuring of the GIPS standards since the concept of country-specific versions was removed with the adoption of the 2005 edition. Following is a summary of some of the key proposed changes. Note, however, that this is not a complete list of all the updates reflected in GIPS 2020. The full Exposure Draft includes countless other revisions, additions and modifications compared to the current edition of the GIPS standards, some of which may be particularly relevant to your firm. With that in mind, all GIPS stakeholders should read the Exposure Draft in its entirety. Also keep in mind that all of these items are still subject to change based on public comment.

Funds Exempt from Composite Inclusion Requirements

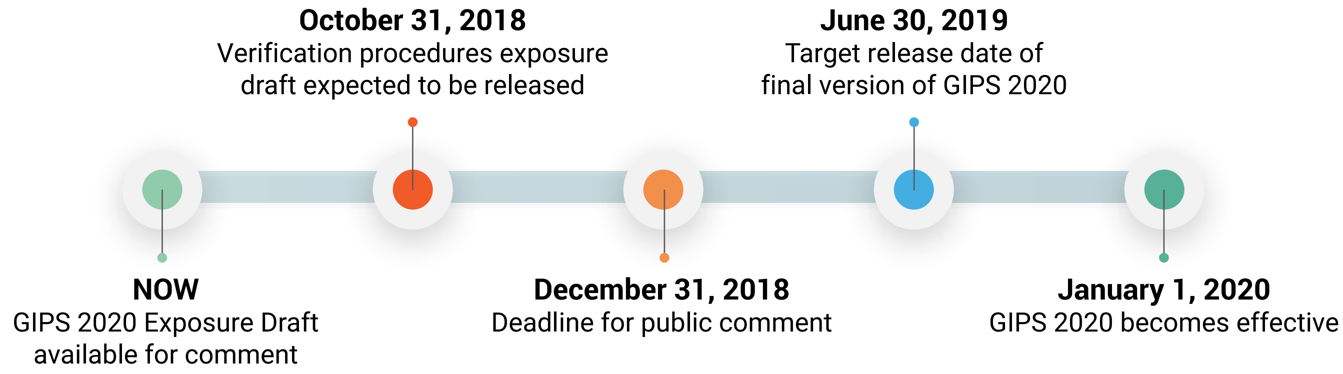
GIPS 2020 proposes a significant departure from one of the fundamental principles of the GIPS standards. To this point, the GIPS standards have always required that all actual, fee-paying, discretionary portfolios—regardless of whether the portfolio was an individual account or pooled investment vehicle—be included in at least one composite. Now, an exception to this requirement is being introduced which would, in certain circumstances, allow pooled funds to no longer be included in composites. If the fund represents a strategy that is being offered to segregated accounts—portfolios owned by a single client, such as separately managed accounts or funds-of-one—then the fund will still need to be captured in a composite. However, if the fund strategy is only offered through pooled investment vehicles that are offered to multiple investors, then the fund would be exempt from composite inclusion—even if multiple funds are managed to the same strategy.

Part of the thought process behind this change is that the use of composites in a firm's marketing efforts is not always the most appropriate approach. If a firm is soliciting investment in a particular pooled fund, it would be confusing and potentially even misleading for the firm to provide prospective investors with a composite comprised of multiple portfolios. Instead, potential investors would be better served if the firm's pooled-fund marketing efforts focused specifically on the vehicles available for investment—the funds themselves.

This change should be viewed positively by most fund managers, as it offers firms flexibility to not create composites for each of their pooled funds if the strategies are not offered as segregated accounts, but

Continued on page 11

GIPS 2020 KEY DATES



does not create an obligation to remove funds from existing composites. Fund managers' obligations under the GIPS standards have not been completely eliminated though. Additional proposed requirements would replace the composite construction obligation for pooled funds, though they are being tailored to more appropriately meet the needs of fund investors.

Product-Specific GIPS Reports

The mechanism for reporting GIPS-compliant information traditionally has been through an instrument referred to in the current edition of the GIPS standards as a "compliant presentation." A GIPS-compliant presentation is specific to a particular composite and includes all information required under the GIPS standards. Now, as the GIPS standards move to more fully embrace pooled investment products, one type of report is not sufficient. To address this, the Exposure Draft outlines two distinct reports designed for different types of product offerings: GIPS Composite Reports and GIPS Pooled Fund Reports. The GIPS Composite Report is essentially just a new name for the traditional GIPS-compliant presentation and will continue to include composite-specific disclosures and statistics. The GIPS Pooled Fund Report, on the other hand, will reflect only information for a particular pooled fund.

To this point, there has been confusion as to what fund managers' responsibilities were with respect to delivering GIPS-compliant presentations to prospective fund investors. This has led to inconsistent practices throughout the industry. The GIPS Pooled Fund Report is being introduced to eliminate this confusion and provide a more appropriate mechanism for communicating GIPS-compliant information to prospective investors in pooled funds. Going forward, it will be clear that prospective pooled fund investors do not need to receive composite information or a GIPS Composite Report, but they may be required to receive a GIPS Pooled Fund Report instead.

If the fund being offered is considered a "limited distribution" fund, then the firm will have an obligation to make every reasonable effort to provide prospective fund investors with a GIPS Pooled Fund Report. A limited distribution pooled fund is characterized in the GIPS 2020 Exposure Draft as a pooled fund that is not publicly available to multiple investors and where the typical marketing practice involves contact between the firm managing the pooled fund and the pooled fund prospective investor—in other words, where the firm has a direct relationship with the fund's prospective investors. In contrast, a broad distribution pooled fund would be a fund that is publicly available to multiple investors and where the typical marketing practice does not involve direct contact between the fund manager and prospective investors. Broad distribution pooled funds include mutual funds, exchange-traded funds, and UCITS funds that are generally offered through wide distribution channels and platforms where contact between the firm and investors is atypical.

For managers of limited distribution funds, the requirement to create and distribute GIPS Pooled Fund Reports is likely a fairly even exchange for the former requirement to create composites to house the funds and to create GIPS-compliant presentations for those composites. The proposed content of the GIPS Pooled Fund Report as outlined in the Exposure Draft is very similar to that of a traditional GIPS-compliant presentation and includes information that firms are typically already including in their fund-specific marketing materials. As a result, it is likely that firms will be able to leverage existing materials to serve as their GIPS Pooled Fund Reports rather than create new materials. However, this proposed requirement could potentially create an additional compliance burden for firms, as they will need

Continued on page 12

to initiate a process for reviewing their fund materials to ensure they meet the GIPS 2020 requirements once they become effective. Additionally, if the private fund strategy is marketed to segregated accounts, it would be necessary for the firm to maintain a GIPS Pooled Fund Report specific to the fund as well as a GIPS Composite Report specific to the strategy.

It should be emphasized that the proposed requirement to provide prospective investors with GIPS Pooled Fund Reports would only apply to limited distribution funds. Prospective investors in broad distribution pooled funds are expected to be exempt from this requirement. As a result, managers of mutual funds and other broadly distributed funds will not need to create customized GIPS reports for each of these vehicles. Instead, these managers will have the option of creating GIPS Pooled Fund Reports, following the revised GIPS Advertising Guidelines (which we will explore further next), or simply not referencing their claim of GIPS compliance in materials specific to these products.

Advertising Guidelines for Pooled Funds

The GIPS Advertising Guidelines provide firms with options for referencing their claim of compliance with the GIPS standards outside of a GIPS Composite Report or GIPS Pooled Fund Report. Like the rest of the GIPS standards, the GIPS Advertising Guidelines are being expanded to go beyond composite reporting. Specifically, the guidance is being divided into sections dedicated to composites, limited distribution funds, broad distribution funds and asset owners. While the GIPS Advertising Guidelines remain voluntary, as firms increasingly want to tout their investment performance and acknowledge their claim of compliance across a variety of media like websites or social networks, it is important to become familiar with the GIPS Advertising Guidelines and the proposed changes.

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The expanded scope of the GIPS Advertising Guidelines is likely most significant for managers of broad distribution pooled funds. The aspects of the revised GIPS Advertising Guidelines related to broad distribution pooled funds were derived primarily from the Guidance Statement on Broadly Distributed Pooled Funds[2] (the "Guidance Statement") that was slated to become effective in January 2018 but was later pushed back. The Guidance Statement would have required GIPS-compliant firms to include specific information in official fund documents or fund-specific marketing materials, including prescribed performance statistics and disclosures. However, with the pending release of the GIPS 2020 Exposure Draft, it was determined that the Guidance Statement should be tabled and reevaluated. Now the content of the Guidance Statement has been reconstituted into the revised GIPS Advertising Guidelines, making the required elements only applicable to firms that voluntarily elect to follow the GIPS Advertising Guidelines. At this point, the Guidance Statement itself should be considered superseded and, pending modification following the adoption of GIPS 2020, no longer viewed as binding.

Expanded Use of Money-Weighted Returns

In private fund management, the GIPS standards have long lagged behind typical business practice when it comes to performance reporting. To date, the GIPS standards require the use of time-weighted rates of return (TWRs) in almost all cases, with the limited exceptions of private equity and closed-end real estate products. Meanwhile, standard industry protocol in reporting private fund results continues to be the use of internal rates of return, now referred to in GIPS 2020 more generally as money-weighted returns (MWRs).

GIPS 2020 would offer more flexibility for presenting MWRs. The requirements will no longer be based solely on asset class. Rather, if certain criteria are met, the firm will have the option of presenting MWRs or TWRs, regardless of the type of assets held. First, the firm must control the timing of cash flows in or out of the portfolio. Secondly, at least one of the following conditions must be met: the vehicle must have a closed-end structure, a fixed life, a fixed commitment, or illiquid investments must be a significant part of the investment strategy. While firms will have discretion over whether TWRs or MWRs are presented in these scenarios, once a method has been selected, the firm must consistently report the same series of returns in their GIPS reports. Switching back and forth between methods in order to present more advantageous performance results will not be acceptable.

This proposal is expected to be well-received, as it is better aligned with standard industry practice and it introduces no required changes for firms, only more options.

Expansion of External Valuation Requirements

As the GIPS standards move to minimize asset-class-specific guidance, requiring different valuation procedures for different types of assets becomes problematic. In particular, real estate currently has very specific requirements

Continued on page 13

for valuation under the current edition of the GIPS standards. At a minimum, real estate investments must have an external valuation completed once every 12 months, though the requirement can be relaxed to as long as 36 months in situations where the client agreement stipulates that less frequent valuations should be performed. The external valuation has to be performed by an independent, external, professionally designated, certified or licensed commercial property valuer or appraiser.

Under GIPS 2020, the external valuation requirement is proposed to be extended to all private market investments—including private equity, infrastructure and other real assets in addition to real estate—and the 36-month exception is being removed so that all external valuations would need to be conducted at least once every 12 months, regardless of what the client has agreed to. However, GIPS 2020 is also proposing to offer two alternative methods of validating the firm's asset valuations rather than requiring a full appraisal every year. Going forward, in lieu of an external valuation, firms will have the option of either relying on a review of valuation inputs and assumptions performed by an external third party or relying on a financial statement audit.

This is likely to be a welcomed relief for real estate managers, as it provides more flexibility with respect to the specific type of assessment conducted and may be less expensive than receiving appraisals across all investments. Additionally, even though it expands the scope of the investments subject to external valuation, this change likely should not create an additional burden for managers of private market investments who typically already receive annual financial statement audits on the vehicles holding these assets—assuming the audit includes an evaluation of the firm's process for determining fair values.

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The Return of Carve-Outs

Back by popular demand, GIPS 2020 is set to reintroduce the option for firms to present composites comprised of carve-outs with allocated cash. Carve-outs are segments of portfolios that are, by themselves, representative of a distinct investment strategy. Typically, carve-outs are based on asset class, geographic region, or industry sector. In 2010, carve-outs were essentially abolished from the GIPS standards when the requirements became so stringent that they were very difficult for firms to adhere to and nearly impossible to apply retroactively. Now, the more onerous requirements enacted in 2010 are proposed to be dialed back. Where currently carve-out segments must be managed separately with their own dedicated cash component, under GIPS 2020 allocating cash to carve-outs on a timely and consistent basis is proposed to again be permitted.

This change should be welcomed by wealth managers, who often view the current approach to carve-outs under the GIPS standards as a barrier to compliance. These firms typically manage portfolio segments individually, but the account setup and maintenance process generally does not allow for cash components to be dedicated to each segment, which makes achieving GIPS compliance difficult. Though these firms could create and maintain composites of balanced portfolios rather than creating carve-outs, that practice often does not align with the firms' marketing efforts, which generally look to highlight the individual asset classes that they manage rather than the combined balanced portfolios, and the process of defining and constructing appropriate balanced composites can be challenging. These managers argue that carve-out results that isolate the individual asset class exposures—which they view as building block components of multi-asset strategies, the combination of which can be customized in a multitude of ways in an effort to meet the client's intended investment objectives—provide more meaningful information to potential clients than presenting the combined performance of a mix of multi-asset-class portfolios with diverse asset allocations that may be very different from the way that a prospect's portfolio would be constructed.

Even if this change is ratified, some hurdles may still exist. Under the current edition of the GIPS standards, managers of multi-asset class portfolios that utilize carve-outs are also required to include the total multi-asset class portfolio in a separate composite, which often necessitates the creation of a number of balanced composites—in other words, including the carve-out segments in composites alone does not satisfy the firm's composite construction obligations. This point is not specifically addressed in the GIPS 2020 Exposure Draft, so it is unclear as to whether this will continue to be the expectation going forward or if additional options will be introduced. Firms that are interested in utilizing carve-outs in the future should consider providing comments on this point and request clarification.

Additionally, a new requirement is introduced in the Exposure Draft which specifies that, while carve-outs and standalone portfolios can be combined in the same composite, standalone portfolios would also need

Continued on page 24

to be assigned to their own dedicated composite that excludes carve-outs. The performance and assets for the composite of standalone portfolios would then need to be included in the GIPS Composite Report for the carve-out composite. This is intended to allow potential clients to evaluate differences between how the composite of carve-outs segments performed relative to the composite of standalone accounts.

Portability Reverts to Optional

Portability is the ability of an investment management firm to present a performance track record that was produced at a separate firm. The rules for portability under the GIPS standards have not materially changed, but one key point has evolved over the years. Under the version of the GIPS Guidance Statement on Performance Record Portability[3] that became effective January 1, 2011, firms have an obligation to present historical track records that satisfy the portability requirements and link them to the ongoing performance history of their firm. However, prior to 2011, firms that met the portability requirements had the option, but not an obligation, to present the track record. GIPS 2020 is now proposing to revert back to this earlier stance, which is more closely aligned with regulatory expectations, at least in the U.S. market, where porting a performance track record is permissible if certain criteria are met, but not required.

Be Sure to Comment

The GIPS 2020 Exposure Draft offers each of us the unique opportunity to help shape the future of investment performance measurement. Whether you agree or disagree with what is being proposed, you are strongly encouraged to express your opinion and submit comments to CFA Institute prior to the December 31st deadline. Comments do not necessarily need to be lengthy or address every point in the draft. In fact, your response can be limited to one specific element of the draft that you have the strongest opinion about. All comments, regardless of length or detail, are read and considered, so if you are passionate about any of these changes—positively or negatively—share your thoughts and have your voice heard. Comments can be submitted to CFA Institute at standards@cfainstitute.org.

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[1]www.gipsstandards.org/standards/Documents/gips_2020_exposure_draft.pdf.

[2]www.gipsstandards.org/standards/Documents/Guidance/gs_pooled_funds.pdf.

[3]www.gipsstandards.org/standards/Documents/Guidance/gs_performance_record_portability_clean.pdf.

Interested members are welcome to join the IAA GIPS Compliance Forum, which is considering the implications of the GIPS 2020 Exposure Draft.