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INVESTMENTS

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Jonathan Boersma, CFA

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CFA Institute

Centre for Financial Market Integrity

Reference: Global Investment Performance Standards (GIPS®) 2010 Exposure Draft

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Dear Mr. Boersma:

Franklin Templeton Investments is a global investment management firm that has always been committed to ensuring the highest ethical standards in the manner that it provides its services to its clients and reports its performance to clients, shareholders, and prospective investors. The firm has extended its compliance with the Global Investment Performance Standards (GIPS®) in recent years, to the point where now seven firms within the global organization claim compliance with GIPS, including Franklin, Templeton, Franklin Templeton Real Estate Advisors, Bissett Investment Management in Canada, two wrap fee divisions (Templeton Portfolio Advisors and Franklin Portfolio Advisors), and Franklin Templeton Investments Japan, Ltd., serving Japanese clients. Work is in progress to make Franklin Templeton Investment Trust Management Company in Korea GIPS compliant as well.

With this as background, Franklin Templeton has reviewed the Exposure Draft for GIPS® 2010 and would like to offer the following comments.

### **Fundamentals of Compliance**

*Requirement 0.A.7: Change in claim of compliance between firms that are currently verified, those that are not currently verified, and those that have not been verified.*

*[Also applies to Appendix C – GIPS Advertising Guidelines, Requirement B.3.]*

The 2010 Exposure Draft is proposing that there be three variants of the compliance legend: one for firms that are currently verified (within the last 24 months), one for firms that are not currently verified (more than 24 months ago), and one for firms that have not been verified. The first two variants both include the dates for which the firm has been verified. Franklin Templeton believes that, since the dates for which the firm has been verified are included in compliance legend, it seems superfluous to have a different legend for firms that are currently verified vs. those that were verified at an earlier date – the dates clearly indicate how current the verification is, so the reader can easily deduce if the verification is current or not by just examining the dates. It would seem more appropriate to indicate an “expiration date” for verification. If a firm was verified seven years ago but not since that time, one might ask what the relevance of saying the firm was verified for those old dates. Since the minimum period for compliance for a new firm is five years, we might suggest that verification expires after five years. We would recommend that a firm can state that it has been verified and provide the dates if the verification occurred within the last five years of reported performance. Otherwise, the firm would have to state that the firm has not been verified within the last five years, even if the firm has a 10 year record and the verification occurred eight years ago. There should be two variants of the compliance legend, then, not three, in our opinion. One indicating that the firm has been verified if that verification covered a period within the last five calendar years of performance reported. If the firm has not been verified within the last five years, the firm would state in the compliance legend that it has not been verified within the last five years. Franklin Templeton believes the same approach should be applied to the claim of compliance legend for advertisements, as specified in Appendix C – GIPS Advertising Guidelines.

*Requirement 0.A.12: Firms must provide a complete list and description of the firm's composites to any existing or prospective client that makes a request.*

Franklin Templeton agrees with the notion of extending the requirement to provide a list and description of the firm's composites to any existing (previously just a recommendation) or prospective (was required previously) client. We note, however, that "prospective client" is a defined term (previously, it was undefined) and the definition in the glossary seems very broad: "Any person or entity that qualifies to invest in a composite strategy (e.g. has assets above the composite minimum asset level) and has expressed interest in one of the firm's strategies". The term "expressing interest" seems so all-inclusive as to include any person or entity, including competitors, journalists, commentators, data vendors, and the like. The phrase "that qualifies to invest in a composite strategy (e.g. has assets above the composite minimum...)" may be intended to exclude journalists and other individuals or entities that just want information and are not bona fide prospects that are candidates for actually committing funds to the strategy. Nevertheless, we would rephrase the definition to say "...and has expressed interest in committing funds to one of the firm's strategies". This would more clearly exclude competitors, journalists, and the like.

There is another issue that Franklin Templeton would like to raise with respect to supplying a complete list and description of the firm's composites. Franklin Templeton has a number of "firms" as defined for GIPS purposes across its global organization. Many of those firms have mutual funds as well as separate accounts. Franklin, for example, has hundreds of mutual funds, and many of those funds are one-off in nature, i.e. their strategies are relatively unique and are not offered to institutional investors, only to prospective new shareholders who would purchase more shares of the same funds. In some cases, we do have institutional separate accounts that are managed similarly to mutual funds, so that mutual funds can be included in the same composite as the separate accounts, but in many cases, the mutual funds are in what we would call single account mutual fund composites.

A classic instance of this is our family of municipal bond funds. Franklin Templeton has a municipal bond fund for almost every state in the union. Sometimes, we have more than one fund for the same state, but with different strategies (California has six different municipal bond strategies). Every one of these mutual funds must, according to GIPS be in a composite, and since every one of the funds is different, they are each in a single account composite. When we sell more shares of a mutual fund, we use a prospectus and are required to meet FINRA (formerly NASD) guidelines in our marketing materials (and according to local laws and regulations we can only show net-of-fees performance). We would not use a composite to sell more shares of a fund.

The relevance of a complete list and description of composites is questionable for a firm that has hundreds of mutual funds with a lot of one-off strategies, where, for purposes of selling shares of the fund, it would not be appropriate, and would in fact be against local regulation, to use a composite to attract more shareholders to the funds. The message here is that the GIPS standards are very definitely separate account centric. They were not written with large mutual fund organizations in mind – a word search indicates that the word "mutual fund" does not even appear anywhere in the body of the GIPS standards (it does appear once in Appendix C, which relates to the Advertising Guidelines).

To address this issue, Franklin Templeton has its list of composites in two parts: One list includes all the composites that are used for representing the track record of strategies that we are looking to attract new mandates for, which includes some single account mutual fund composites where we are looking to attract new separate account mandates managed in a similar manner to the mutual funds. Another list is a list of single account mutual fund composites, which numbers in the hundreds, none of which are used for representing our performance to prospective new separate account clients. We note the availability of this second list in our "additional information" footnote within our GIPS compliant performance presentations. The description for these composites is the investment objective as in the prospectus. In the case of these hundreds of "composites", we are again looking only to sell more shares of the respective funds in those single account composites, which requires that we follow SEC and FINRA /NASD rules, including having a current prospectus. Two different verifiers have approved the use of this concept for Franklin Templeton. Using a "composite" for the purpose of selling more shares in the fund would be against local regulation, so including such composites in a single list with the other composites we have where we *are* looking to sell the track record, not a particular fund, would be confusing and detrimental to our efforts to attract separate account mandates. The GIPS Executive Council has issued no guidance on this that we are aware of, other than to say that there should be no distinction between "marketed" composites and "non-marketed

composites”. The reality is, firms like ours have hundreds of mutual funds where using a composite would be against local regulation. This cries out for better guidance.

*Requirement 0.A.16: Firms must comply with all applicable laws and regulations regarding the calculation and reporting of returns.*

*Requirement 0.A.17: Firms must not present performance or performance related information that is false or misleading.*

These two requirements state what has been implicit previously in the standards, and it certainly seems desirable to make these important concepts more explicit. With respect to the second requirement listed above (0.A.17), however, the requirement not to present performance that is false or misleading is very broad and open-ended, with no guidance as to what would constitute false and misleading. It may be appropriate to append the phrase “in any material respect, as determined by local laws and regulations” to the words “false and misleading”, so that one person’s claim that something is “misleading”, which local laws and regulations may not consider as such, does not jeopardize the claim of compliance.

### **Input Data**

*Requirement 1.A.1: All data and information necessary to support all items included in a compliant presentation must be captured and maintained.*

Previously, this requirement focused on just the performance presentation and the related calculations. Now, the requirement seems to cover ALL items in a compliant presentation, including (potentially) supplemental information or other information that may not be required to be presented. Franklin Templeton has some legacy funds that go back 20, 30 or even 50+ years. The firm does not claim compliance that far back, but may elect to show portfolio characteristics for the earlier period, or risk statistics, or other supplemental information for the more recent period for which we do claim compliance such as peer group data where we don’t have direct access to the underlying data. This broadening of the records requirement could inhibit the presentation of supplemental information and work against providing useful additional data to the client.

*Requirement 1.A.2: Use of fair valuation beginning 1 January 2011, vs. market value.*

Switching from market value to fair value is a fairly profound change that has important implications, particularly since it comes at a time when GIPS is seeking to be more inclusive of the type of assets that would be considered part of the “firm” – assets such as proprietary (captive) assets, and potentially fine art or collectibles (which a wealth management firm serving high net worth individuals may find itself managing in addition to more traditional assets). “Fair value” has gotten a lot of attention recently, as distressed prices for assets like real estate or real estate related securities may be forcing firms to mark down assets whose market value may previously have been determined using valuations that were not indicative of distressed pricing (an analogy would be – should a fire sale for a foreclosed home reduce the value of homes in the same neighborhood that are not in foreclosure and whose owners can easily service the debt). Getting a “fair value” for illiquid assets that don’t trade can be problematic – going to three brokers to get a “market value” may not be sufficient to determine true “fair value”, which may require getting an independent appraisal. In addition, the concept of fair value may be well recognized in markets such as the United States and Europe, but it may not as familiar in some of the 30 or countries that have now adopted GIPS, or countries now seeking to adopt GIPS. The 2010 Exposure Draft does include a substantially revised Appendix D that describes GIPS Valuation Principles, so that should help increase familiarity with the notion of fair value. Nevertheless, Franklin Templeton is concerned about moving to fair value at the same time as the definition of assets that must be included in a firm definition is being broadened (proprietary assets, non-fee-paying assets, and real or physical assets that may be under the supervision of the firm). We believe it may be premature to move to fair value for all asset types, and that it would be more appropriate to let firms continue to use market value, but have the flexibility to use fair value, with appropriate disclosure as to when and how it is applied, and for what assets.

## Calculation Methodology

*Requirement 2.A.2: Firms must define large cash flow for each composite to determine when the portfolios in the composite are to be revalued for calculating performance.*

Previously, this standard read that for periods after 1 January 2005, firms must use approximated rates of return that adjust for daily-weighted external cash flows (e.g. Modified Dietz) and, for periods after 1 January 2010, firms must value portfolios on the date of all large external cash flows. The 2005 requirement is clearly moot by the time the 2010 Exposure Draft is released, and even the 1 January 2010 will likely have passed. What is confusing about the new wording, however, is that it is not clear that the definition of large cash flow corresponds to when the portfolio must be revalued. Moreover, the standard references large EXTERNAL cash flows in its first sentence, but then reverts to just “large cash flow” without the word external in the second sentence. This seems to be intentional since what used to be “large external cash flow” in the glossary has been changed to just “large cash flow”. There is a footnote to 2.A.2 that references the two dates excluded from this standard. This seems awkward and buries the second date which we think should be restored to the standard itself.

To clarify this requirement, Franklin Templeton would advise rewording the new sentence added to this requirement as follows (using the convention of capitalizing defined terms used in the actual draft). Restoring the 2010 date ensures continuity with what the previous version of GIPS had required. Given that the earlier 2005 date is moot, that date can remain in a footnote.

*Effective 1 January 2010, FIRMS MUST define LARGE EXTERNAL CASH FLOW for each COMPOSITE and revalue the PORTFOLIOS in that COMPOSITE on the date of any such LARGE EXTERNAL CASH FLOWS.*

We would *not* recommend deleting EXTERNAL from the term in the standard or in the glossary, since firms may treat internal (inter-segment) cash flows differently from external cash flows. For purposes of this standard, the key requirement is that portfolios must be revalued on the date of any large EXTERNAL cash flow, as defined. We would not recommend that the requirement to revalue portfolios be extended to large INTERNAL cash flows, which would only impact segment returns, not total returns. This extension is implied by the current wording in the 2010 Exposure Draft.

## Composite Construction

*Requirement 3.A.1: All actual discretionary portfolios must be included in at least one composite.*

The 2010 Exposure Draft eliminated the word “fee-paying” so as to be more inclusive, requiring now that fee-paying and non-fee-paying accounts must be included in a firm’s composites. Previously, firms had the option of including non-fee-paying assets in composites, and had to disclose what percentage of composites is represented by non-fee-paying assets (the latter requirement still remains). A question that comes up with respect to non-fee-paying assets is, what about corporate assets (of the investment manager) being put to work in strategies that are specific to the firm’s corporate needs, not strategies that are intended to be offered to outside clients? While it makes sense to require that non-fee-paying accounts in strategies that are offered to clients be included in composites, it is not reasonable to require corporate assets invested in firm-managed funds intended solely for corporate purposes (i.e. not strategies that are also offered externally) to be included in composites. A related issue (see comment on standard 5.A.8 below) is the requirement to disclose the percentage of assets in a composite represented by proprietary assets, which is defined to include seed capital that an investment management firm may contribute to kick off a new fund. This also seems unreasonable. One possible avenue to reduce the impact of requirement 3.A.1 is to define “non-fee-paying portfolios” as portfolios in strategies that are offered to clients (or intended for clients) but for which no fees are currently being charged due to such factors as fee waivers or regulatory impediments (such as firms not being able to charge themselves a fee on captive funds). As for accounts with fee waivers, such accounts would become fee-paying once the fee waiver had ended. For accounts with captive funds that are offered to or intended for clients where regulatory requirements prevent the firm from charging itself a fee (true for SEC-registered commingled accounts), the account would become fee-paying as soon as an external, fee-paying client bought into the fund. This would exclude corporate assets invested in strategies that are not intended for clients but only for specific corporate purposes. It might be argued that such portfolios

could be excluded according to the current 2010 Exposure Draft by virtue of being deemed “non-discretionary”, but an exclusion for corporate assets nonetheless seems advisable. One final note on this requirement: we would not recommend burying the previous requirement that, prior to 1 January 2011, all actual fee-paying discretionary composites must be included in at least one composite. We would restore that language to the actual standard.

*Requirement 3.A.6: For periods beginning on or after January 1, 2010, carve-outs must not be included in composites unless the carve-out is actually managed separately with its own cash balance.*

Franklin Templeton agrees with the ending, as of 1 January 2010, the use of carve-outs where a cash allocation method was applied (instead of the carve-out having its own cash balance). The current 2010 Exposure Draft includes a reference to the previous standard that allowed the use of carve-outs if cash was allocated in a timely and consistent manner only in a footnote. We believe that language should be restored to the standard itself, to better highlight the change in the requirement. In addition, we believe that clarification will be required in a guidance statement to address issues such as can a firm still apply the old approach (allocating cash to carve-outs) after 1 January 2010 as supplemental information? Or does the prohibition to using this approach in a GIPS compliant presentation also extend to not using the approach supplementally to the GIPS compliant presentation? This gets into the broader question of what is supplemental information and what standards apply to the use of supplemental information. To avoid confusion, and reduce pressure from Sales or Marketing to continue to maintain composites, prohibiting the use of carve-outs using a cash allocation method should be implemented, in our opinion, even as supplemental information.

*Requirement 3.A.9: Firms must not present a composite to a prospective client known to have a portfolio with assets less than the composite’s minimum asset level.*

Franklin Templeton agrees with upgrading this from a recommendation to a requirement. One important point here, however, is that the firm does not always know the size of the portfolio or the prospective client. The language seeks to address this by the phrase “known to have a portfolio with assets less than the composite’s minimum asset level”. We would prefer, however, that the requirement state that firms must not MARKET (which is the work used in the current recommendation) a composite to a prospective client, which is different from saying a firm can’t show or PRESENT the composite. In addition, there may be instances where we are considering offering a new strategy in our wrap-fee division (where minimums are typically small) that replicates a strategy that we currently have in our institutional division (defined to be a separate firm). In this case, it would be our intent to have a low minimum typical of our wrap-fee division if we were to launch this new strategy, but in the interim we would like to be able to show a prospective wrap-fee client a performance presentation that complies with the GIPS standards for the same strategy offered by the institutional firm (which would have a higher minimum, typical of the mandates that we offer to institutional prospective clients). We assume that, since it would be our intent to have a low minimum for the wrap-fee strategy that replicates the institutional strategy, the wording of this standard would not preclude us from doing this. If that is *not* a correct assumption, then we would have a problem with this requirement.

## **Disclosures**

The 2010 Exposure Draft asks the question: should firms be allowed to remove certain disclosures after a defined period of time and, if so, which disclosures would be eligible for removal and after what period of time? Currently, only Requirement 4.A.28, relating to the disclosure of any change to the compliant presentation due to correction of a material error, has a reference to how long that disclosure is required, in that case for a minimum of 12 months. While on the face of it there may be some merit to allowing some disclosure requirements to expire, in practice it may be somewhat unwieldy, considering that there are (in the new draft) 29 different disclosure requirements. Applying varying expiration dates for different disclosures would be cumbersome to describe, resulting in the addition of many dates to the language. Having said that, Franklin Templeton would agree with the recommendation we have seen from Vincent Performance Services, which is to apply a 3 year sunset policy for the following disclosures:

- 4.A.19: significant events.
- 4.A.21: firm redefinition.

- 4.A.23: composite name change.
- 5.A.6.b: benchmark change when the entire historical record is replaced.

*Requirement 4.A.5: Firms must disclose the presence, use and extent of leverage, derivatives and/or short positions if material....*

Franklin Templeton supports the requirement to extend this requirement to short positions, in addition to the use and extent of leverage and derivatives.

*Requirement 4.A.7: Firms must disclose relevant details of the treatment of withholding tax on dividends, interest income, and capital gains, if material. Firms must disclose if benchmark returns are net of withholding tax.*

Franklin Templeton supports adding the term “if material” to the first sentence of this requirement, as in many instances withholding tax considerations are not material to the return of accounts or composites. Unfortunately, the benefit of adding “if material” to the first sentence is offset by the new disclosure to disclose if the benchmark returns are net of withholding tax (where the materiality threshold is *not* mentioned). Just as withholding taxes may not be material to portfolios, they may not be material to benchmarks either. MSCI is very public about its treatment of withholding taxes, and offers two different series that treat withholding taxes differently. Other index vendors are not so public as to how they handle withholding taxes, or how material the treatment of withholding taxes is to their indices. We would make the second sentence in this standard a recommendation (disclosing if benchmark returns are net of withholding tax), not a requirement.

*Disclosure 4.A.10: For any performance presented for periods prior to 1 January 2000 that does not comply with the GIPS standards, firms must disclose the period of non-compliance.*

Franklin Templeton supports the elimination from this requirement the phrase “...and how the presentation is not in compliance with the standards”. At the time this standard was originally written, 1 January 2000 was five years prior to the adoption date of the current GIPS standards. By the time the 2010 Exposure Draft is finalized and effective, on 1 January 2011, that 2000 date will be more than 10 years old, and most firms don’t present more than 10 years anyway. What does need to be addressed, however, as more firms around the world adopt the GIPS standards, some in countries that have only recently adopted GIPS, is what to do about presenting performance prior to 5 years ago from the effective date of 2010 GIPS. Firms that have recently decided to adopt GIPS only have to go back 5 years initially, then they will need to add one more year going forward until they have 10 years of compliant history. This means many firms will be starting their track record in 2005 or even 2006. What can newly compliant firms show for performance prior to the last five years ended 2010 or 2011? Does this standard preclude the showing of non-compliant performance after 1 January 2000? Can firms that recently adopted GIPS show performance prior to the minimum five years for GIPS as supplemental information if they state that the prior record is not GIPS compliant? Just as a provision was made for showing performance more than the minimum five years in the 2005 standards (which meant prior to 1 January 2000), some provision ought to be made for what newly compliant firms can do prior to 2005 in the 2010 standards. Firms in Korea, for example, were not thinking about GIPS in 2003, but Korea recently adopted GIPS and now many firms in Korea are seeking to achieve GIPS compliance for the first time. They may have issues preventing them from claiming full GIPS compliance for their track record prior to five years ago, but they have performance to show for that earlier period. If they make their best effort to create composites, or use representative accounts for certain strategies vs. composites, can they show such performance as supplemental information with appropriate disclosure? Franklin Templeton, which has an office in Korea that is now seeking GIPS compliance, believes that some accommodation is needed for allowing firms that have recently adopted GIPS to show prior period performance as supplemental information.

*Requirement 4.A.16: When presenting net-of-fees returns, firms must disclose:...b) if model or actual investment management fees are used and c) if returns are net of performance-based fees.*

Franklin Templeton supports adding the requirement to disclose if model or actual investment management fees are used, but simply stating that model fees are used without describing what the calculation method is would be relatively uninformative. The disclosure should add a brief description of the model fee calculation, e.g. the standard fee schedule with applicable breakpoints is utilized against the gross-of-fees returns. A side issue here is

that there is a legal argument that, in the U.S. jurisdiction, the SEC staff issued a no-action letter indicating its belief that the highest applicable fee should be utilized, implying that breakpoints should not be used. This issue would need to be addressed in a guidance statement, not in the body of the standards, but it highlights the importance of knowing what the calculation method is for the “model” fee. This requirement also includes, in part c), the need to disclose if returns are net of performance-based fees. Again, a brief description (without getting into unnecessary detail) may be appropriate for the performance-based fee as well, such as the composite includes accounts with a performance-based fee “tied to outperforming the S&P 500 over a set time period”. Again, a guidance statement seems necessary here, as it would be burdensome and impractical to include details of each performance-based fee, which may differ account by account within the same composite.

*Requirement 4.A.20: Firms must disclose the composite description, which must include sufficient information to allow a prospective client to understand the key characteristics of the composite strategy, including risks.*

This requirement used to state that firms must disclose the composite description, period. Now, sufficient information to allow a prospect to understand the key characteristics of the strategy, including risks, must be included. Given recent volatility and the increased awareness that investors have with respect to the need to understand risks, this new requirement is consistent with getting better risk disclosure, although there is a danger that firms could use a “laundry list” approach to enumerating all possible risks, which is what regulatory requirements tend to elicit (such as in mutual fund prospectuses) and which is not what we think the CFA Institute is looking for. Care must be taken, therefore, to provide appropriate guidance on this (and other) risk disclosures through a Guidance Statement that would emphasize the importance of focusing only on material risks that are directly associated with the strategy of the composite. This Guidance Statement (to be released, hopefully, well before the implementation date of the 2010 Standards) should provide examples of the kinds of risks that should be addressed, including credit risk, interest rate risk, liquidity risk, and the like.

*Requirement 4.A.21: If a firm is redefined, the firm must disclose the date, nature, and reason for the redefinition.*

The word “nature” was added to this requirement. Franklin Templeton is not sure what is intended by adding that word, and it seems to us that simply stating the reason for the redefinition is sufficient for this requirement. We would discourage adding the word “nature” to this requirement.

*Requirement 4.A.29: Firms must disclose the 3-year annualized ex-post standard deviation...for the composite and for the benchmark, as of the most recent annual period presented.*

Franklin Templeton generally supports adding this new requirement to show the 3-year standard deviation for the composite and the benchmark, and we appreciate the fact that the requirement is only for the most recent period. We also appreciate that the proposal to present this same information as of each annual period (not just the most recent period) is a recommendation, not a requirement. We are presuming here that the 3-year standard deviation would be calculated on the same basis as the returns that are shown, i.e. if gross returns are shown, then the 3-year standard deviation would be based on gross returns, and if net returns are shown, then it would be based on net. We would recommend making this explicit in the standard. We would add that it may be appropriate, in addition to requiring the 3-year annualized ex-post standard deviation that firms also show the three year annualized return for the same 36 month period. That way, the 3-year standard deviation figure can be compared more directly to the 3-year annualized return. An editorial suggestion we have here is that the requirement for the most recent period appears under Disclosures, whereas the recommendation to show the same information as of each annual period appears under Presentation and Reporting. The requirement and the related recommendation ought to appear in the same section and not in different sections. We would suggest that the appropriate section is Presentation and Reporting, not Disclosures, not only because the recommendation to present the 3-year annualized standard deviation for all periods presented is there, but because, for those instances where firms may believe that other measures of risk are more appropriate, they could take advantage of the additional recommendation in this same section to show other relevant composite-level risk measures. We would also recommend that an example be shown in the appendix that includes displaying how the 3-year standard deviation would be displayed, including how it can be made clear if the figure is based on gross or net returns.

## Presentation and Reporting

*Requirement 5.A.1: Requirement to include the first partial period in composite presentations.*

Franklin Templeton supports this change, and is already doing it in its composite performance presentations.

*Requirement 5.A.4: Performance portability.*

The 2010 Exposure Draft has revised 5.A.4.a. to state that the performance track records of a past firm (changed to lower case from FIRM, meaning the current firm claiming compliance) or affiliation must be linked to or used to represent the historical record of a new firm *on a composite-specific basis* (emphasis added, as this was added to the standard) if certain conditions were met. Franklin Templeton agrees with this change, to make the language more composite-specific vs. applying only to the entire firm being acquired.

Another change relates to Standard 5.A.4.a.ii where “staff and decision-making process remain intact” was revised to “decision-making process remains substantially intact”. The key people that need to move to the new firm are the decision-makers. “Staff” was too all-inclusive and not critical to the investment process, and adding “substantially” brings home the point that just the key decision makers need to be present in the new firm. Franklin Templeton agrees with this change.

The requirement that substantially all the assets from the past firm’s composite transfer to the new firm was eliminated. This test represented a high hurdle for many firms, and did not really relate to whether or not a given strategy had continuity of management. We support this change as well.

The final change to this requirement is that the one year grace period for when a compliant firm acquires, or is acquired, by a non-compliant firm, has been modified to apply even if both firms start out as compliant. Merging two firms can lead to operational issues related to combining assets, personnel, and composites, so giving the merged firm a year of grace to sort things out seems appropriate.

*Requirement 5.A.8: For periods after 1 January 2011, firms must present, as of the end of each annual period, the percentage of the composite assets represented by proprietary assets.*

Proprietary assets are defined in the glossary as “assets owned by the firm, the firm’s management, or the firm’s parent company”. Franklin Templeton fails to see the relevance of why this new requirement has been added. The source of funding for a strategy is not important to the success of a strategy. In addition, firm assets may include assets that are purely for corporate purposes and are not intended to be in strategies that will be offered to external clients. Such assets do not belong in composites, in our opinion. We would classify them as non-discretionary accounts managed for specialized purposes, or would even suggest that they be excluded from the firm definition. A particularly onerous implication of this standard is that seed capital used to kick off a new mutual fund is defined as “proprietary assets”, which means that we as a firm would need to track the size of the initial seed capital for a new fund, which typically remains with the fund for a potentially lengthy period of time, until the account gets to be of sufficient size and/or the parent firm has other higher priority use for its capital. Franklin Templeton strongly opposes this requirement, which seems totally unnecessary, offers little benefit to the client, and would be onerous operationally to implement.

*Recommendation 5.B.6: Firms should update compliant presentations quarterly.*

Franklin Templeton agrees with this recommendation, and believes that it deserves to stay only a recommendation. Recent market volatility makes it appropriate for firms to present their GIPS compliant presentation more frequently than just annually. At our firm, we already generate quarterly composite presentations for the composites we emphasize and are seeking to market. We would not want to see this as a requirement, which would force the firm to generate more composite presentations, including for composites with just a single mutual fund in it where we don’t use the composite for marketing but rather the prospectus and NASD / FINRA approved marketing materials.

## Real Estate and Private Equity

In the current 2005 GIPS, there are separate sections on Real Estate and Private Equity. In those sections, there is little reference to a type of investment that combines elements of both asset classes: investment through private equity in closed-end real estate funds. Franklin Templeton has a firm, Franklin Templeton Real Estate Investment Advisors, which invests in closed-end real estate funds in a fund of funds structure that we manage. Since our investment in these funds is in the form of private equity, we have taken the position that the private equity standards take precedence and that the private equity rules apply. Since we are not investing directly in real estate, only indirectly through equity investment in closed-end real estate funds, we do not believe that the real estate GIPS requirements articulated in Section 6 apply, only the private equity requirements articulated in Section 7. We also note the equity investment in closed-end funds is not mentioned in the preamble to Section 6, neither in the 2005 version of GIPS, nor the 2010 Exposure Draft.

What is surprising, therefore, about the 2010 Exposure Draft is that, in the body of Section 6, after not mentioning closed-end real estate funds in the preamble, the Exposure Draft suddenly starts citing “additional requirements” or “additional recommendations” for closed-end real estate funds (which we interpret to include private equity investment in such funds). The complete list of such additional requirements or recommendations is as follows, all of which generally parallel the requirements and recommendations for private equity (including revisions to those standards in the 2010 Exposure Draft), but with more recent effective dates:

*Requirement 6.A.6: The annualized since inception internal rate of return (SI-IRR) must be calculated using the period-end valuation of the composite as a terminal value. For periods beginning on or after 1 January 2011, SI-IRR must be calculated using daily cash flows.*

*Recommendation 6.B.2: For periods beginning prior to 1 January 2011, the annualized SI-IRR should be calculated using daily cash flows.*

*Requirement 6.A.7: Each composite must be defined by investment strategy and vintage year. These classifications must remain consistent throughout the life of the composite.*

*Requirement 6.A.11: Firms must disclose the period of non-compliance when presenting non-GIPS-complaint annualized SI-IRRs and must meet the disclosure requirements for non-compliant performance.*

*Requirement 6.A.12: Firms must disclose the periods of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods beginning prior to 1 January 2011.*

*Requirement 6.A.13: Firms must disclose the vintage year of the composite and how the vintage year was defined.*

*Requirement 6.A.14: Firms must disclose the final realization (liquidation) date of all closed composites.*

*Requirement 6.A.17: Firms must present net-of-fees annualized SI-IRR of the composite for each year since the composite inception and firms must present at least 5 years of performance (or a record since firm or composite inception if the firm or composite has been in existence less than 5 years) that meets the requirements of the GIPS standards. When the initial period is less than a full year, firms must present net-of-fees annualized SI-IRR from composite inception through the initial year end.*

*Requirement 6.A.18: If gross-of-fees annualized SI-IRR is presented, firms must present gross-of-fees annualized SI-IRR of the composite for each year since the composite inception and firms must present at least 5 years of performance (or a record since firm or composite inception if the firm or composite has been in existence less than 5 years) that meets the requirements of the GIPS standards. When the initial period is less than a full year and gross-of-fees performance is presented, firms must present gross-of-fees annualized SI-IRR from composite inception through the initial year end.*

*Requirement 6.A.19: Firms must present, as of each period end:*

- a. *Total composite since inception committed capital.*
- b. *Total composite since inception paid-in capital (cumulative drawdown).*
- c. *Total composite since inception cumulative invested capital.*
- d. *Total composite since inception cumulative distributions.*

*Requirement 6.A.20: Firms must present, as of each period end:*

- a. *Total Value to Paid-in Capital (Investment Multiple or TVPI).*
- b. *Cumulative Distributions to Paid-in Capital (Realization Multiple or DPI)*
- c. *Paid-in Capital to Committed Capital (PIC Multiple).*
- d. *Residual Value to Paid-in Capital (RVPI).*

*Recommendation 6.B.6: Firms should present gross-of-fees annualized SI-IRR for each year since composite inception.*

By noting that these are additional requirements or recommendations, the Exposure Draft is saying that closed-end private equity real estate funds must meet all the requirements of Section 6 in addition to requirements that closely parallel the private equity requirements of Section 7. As indirect investors in real estate through a fund of funds structure (where the firm makes private equity investments in closed-end real estate funds managed by others), we do not have ready access to the information required to meet the requirements of Section 6, only the managers of the funds we invest in have such access. It would be extremely burdensome on us, and any other investor in closed-end real estate funds through a fund of funds structure, to expect us to meet the requirements of BOTH sections. We are willing to abide by the requirements of Section 7 for our fund of fund investments and have done so for our private equity real estate composites. We strongly urge the CFA Institute to be more explicit in the preamble of these two sections that private equity real estate investments in a fund of funds structure fall under the private equity requirements, *not* the real estate requirements. Only investment managers that invest directly in real estate (i.e. the managers that manage the closed-end real estate funds we invest in through a fund of funds structure) and offer a fund that invests in real estate directly should need to abide by the real estate provisions in Section 6. Moreover, we believe strongly that overlaying private equity provisions to closed-end funds that invest directly in real estate should NOT be written into the GIPS standards (as opposed to private equity investments in closed-end funds, where we believe only the private equity standards should apply). As a result, Franklin Templeton believes strongly that ALL of the provisions itemized above should be DELETED from Section 6.

Regarding the Private Equity provisions specifically, articulated in Section 7, Franklin Templeton sees in the preamble to that section that the provisions of Section 7 apply to private equity investment “*other than*” (emphasis added) a) private equity open-end funds and evergreen funds, which must follow the main GIPS provisions for time-weighted returns (Sections 1 through 5) and b) “closed-end real estate funds (which must follow Section II.6)”. The latter statement conflicts with statements that appear on a number of occasions in Section 6 that “the following provision(s) is/are an additional requirement / recommendation for closed-end real estate funds”. There seems to be a dichotomy within the standards about closed-end real estate funds: are they covered only in Section 6 in the 2010 Exposure Draft (as the preamble to Section 7 states) or are they covered by Section 6 but *in addition* have all the additional requirements / recommendations embedded in Section 6 that parallel Section 7? This is very confusing. And do closed-end real estate funds include private equity investments in closed-end real estate funds through a fund of funds structure? This is not clearly articulated. Franklin Templeton believes, as noted previously, that private equity investments in closed-end real estate funds should be considered private equity and should *only* need to follow the private equity requirements and recommendations as articulated in Section 7.

With respect to the issue of closed-end vs. open-end private equity investments, Franklin Templeton believes strongly that open-end private equity investments are more suited for the private equity standards than for the main provisions of GIPS (Sections 1 through 5) covering traditional asset classes. Franklin Templeton has a few instances where clients may elect, in a fund of funds structure, to make additional contributions to a fund of funds, to make up for return of capital as older investments in the fund of funds wind down. Such investments do not lend themselves to monthly valuations. Franklin Templeton is frankly unable to meet the main provisions of GIPS for its private equity real estate fund of funds accounts, so we have taken the position that accounts that have a closed-end

flavor but where the client elects to make an additional investment on an infrequent basis to maintain a certain level of investment in the fund of funds should be treated as a closed-end investment, not an open-end one.

With this as a backdrop, Franklin Templeton has the following comments on specific private equity provisions.

*Requirement 7.A.1: For periods beginning on or after 1 January 2011, private equity investments must be valued at fair value at least annually in accordance with the GIPS Valuation Principles in Appendix D.*

The standard references in footnote 1 the requirement prior to 1 January 2011, whereby private equity investments must be valued according to the GIPS Private Equity Valuation Principles in Appendix D of the 2005 version of the GIPS standards. Editorially speaking, Franklin Templeton believes that the prior requirement should legitimately be in the body of the standard, so that the reader does not have to reference a footnote in fine print for the previous standard.

*Requirement 7.A.4: For periods beginning on or after 1 January 2011, the annualized SI-IRR must be calculated using daily cash flows and the period-end valuation of the composite as a terminal value.*

Again, as in Requirement 7.A.1, the previous requirement in the 2005 version of GIPS (which allowed daily or monthly cash flows) is referenced in a footnote (2) rather than being in the body of the standard. We believe it is easier to appreciate the change if the previous requirement was stated in the body of the standard. We agree that using daily cash flows (in effect, using the XIRR function in Excel, which accomplishes this) is appropriate for this asset class.

*Requirement 7.A.9: For funds of funds, all discretionary investments must be included in at least one composite defined by investment strategy and/or vintage year.*

This appears to be the first reference to fund of funds in the standards. Franklin Templeton would suggest that the fund of funds vehicle should be more specifically addressed prior to this, particularly in the preamble to the private equity section. As a firm, we have not looked differently at fund of funds structures vs. other private equity investments, so we are not sure why the 2010 Exposure Draft has elected to allow composites to be defined based on investment strategy and/or vintage year, vs. both investment strategy and vintage year for all other private equity structures. Perhaps it is based on the notion that, in a fund of funds structure, there could be funds that are in different stages of the investment cycle – commitment stage, investment stage, or harvest stage, so that defining fund of funds composites by vintage year may not be appropriate. As firm, we would support building in flexibility to the standards, as different firms may have different views on this, so being able to choose is preferable than being forced to go with both strategy and vintage year for every composite.

Requirement 7.A.10: Firms must disclose the vintage year of the composite and how the vintage year is defined.

Vintage year may be defined as the year of closing, of first commitment or of first capital drawdown against that commitment. It is appropriate that firms should be required to state upon which basis they are defining vintage year.

*Requirement 7.A.16: Firms must disclose if a valuation basis other than fair value was used for periods beginning prior to 1 January 2011.*

This standard previously allowed valuation methods other than fair value and required that firms must justify why fair value was not applicable. Firms that took advantage of this provision were also required to disclose the carrying value of non-fair value investments relative to the total fund, the number of holdings valued on a non-fair value basis, and the absolute value of the non-fair value investments. The emphasis now on fair value has eliminated these alternatives to fair valuation, which may be onerous to private equity managers. Private equity investments, particularly in the early stages of their life cycle, are difficult to appraise. The previous version of this standard offered some flexibility when fair value was just not possible. Franklin Templeton is concerned that private equity investments will be difficult to assign a fair value to in the early period after initial investment.

*Requirement 7.A.19: Firms must disclose any period of non-compliance and must meet the disclosure requirements for non-compliant performance.*

This is a new standard not in the 2005 version of GIPS. It is not clear what is intended by this new disclosure. Is there still a minimum period of five years in order for a claim of compliance to be valid? So, would the period of non-compliance have to be beyond the minimum five years? What are the disclosure requirements for non-compliant performance and where are these articulated in the standards? As a firm, Franklin Templeton is confused as to what this new requirement is trying to achieve.

*Requirement 7.A.20 and 7.A. 21: Reporting SI-IRRs for the first partial year of performance in addition to the current requirement to report the first full calendar year.*

While Franklin Templeton supports reporting the first partial year of performance for traditional assets using time-weighted returns and meeting the requirements articulated in the main sections of GIPS (Sections 1 through 5) for such accounts, the firm does not support doing this for private equity accounts as well, since in the very early stages of private equity investments, it is difficult to calculate a meaningful performance figure. Private equity investments need time to convert committed capital to real investments that are able to generate a return. The real test of private equity comes during the investment stage, after the first year or so of initial capital drawdowns. Performance during the drawdown period is not particularly meaningful. Franklin Templeton advises against implementing this requirement, for either net-of-fees returns (7.A.20) or, if presented, gross-of-fees returns (7.A.21).

*Requirement 7.A.22: Firms must present as of each period end:*

- a. Total composite since inception paid-in capital (cumulative drawdown),
- b. Total composite since inception distributions.

*Requirement 7.A.23: For periods beginning on or after 1 January 2011, firms must present as of each period end:*

- a. Total composite since inception committed capital,
- b. Total composite since inception amount realized [defined as proceeds from the liquidation of investments].

Eliminated from Requirement 7.A.22 is the need to report total invested capital for each period, replaced by a new requirement in 7.A.23 to report the amount realized from the liquidation of investments. Franklin Templeton does not understand the rationale for eliminating the reporting of invested capital, which would seem to be an important figure to disclose. The amount realized from liquidation seems to be a useful number as well, but not necessarily more important than invested capital. We would recommend keeping invested capital as a requirement, and making the disclosure of amount realized as a recommendation.

*Requirement 7.A.25: The time period used to calculate the annualized SI-IRR for the benchmark must be the same as the vintage year of the composite and must reflect the investment strategy represented by the composite.*

This requirement was previously written in terms of IF a benchmark was shown, the annualized SI-IRR for the benchmark must be presented for the same time periods for which the composite is presented. If no benchmark is shown, the presentation must explain why no benchmark is disclosed. The new standard has no flexibility to not show a benchmark if none is available. Franklin Templeton strongly believes that it is difficult to create a benchmark for a private equity strategy if no benchmark provider offers one, which is the case for many strategies. Being forced to create a benchmark when none may exist will be very onerous for many firms, including Franklin Templeton.

#### **Wrap-Fee / Separately Managed Accounts (SMA)**

The wrap-fee / SMA section, previously in a Guidance Statement separate from the 2005 GIPS standards themselves, are now incorporated as Section 8 in the 2010 Exposure Draft. The Guidance Statement (dated 10 August 2005, effective 1 January 2006) and the new 2010 Exposure Draft both mandate that firms must present

performance to wrap fee / SMA prospective clients (defined to include wrap fee / SMA sponsors as well as end clients of the wrap fee / SMA sponsors) net of the entire wrap fee. No provision in the standards themselves is made for showing gross-of-fees performance, neither in the 2005 version or Section 8 (in the Guidance Statement) or in the 2010 Exposure Draft (in the standards themselves). The wording in the 2010 Exposure Draft of the relevant requirement is as follows:

*Requirement 8.A.5: When firms present performance to a wrap fee / SMA prospective client, performance must be shown net of the entire wrap fee.*

In the Guidance Statement issued in 2005, there is discussion about “pure” gross-of-fees performance, defined to returns gross of all expenses, including trading expenses. Firms may want to show “pure” gross-of-fees returns when they are not able to break out actual trading expenses for purposes of calculating trading gross-of-fees returns that include the impact of trading expenses. The Guidance Statement says that “pure” gross of fees returns may be shown as supplemental information – in fact, the example in the Guidance Statement includes “pure” gross-of-fees returns in a column adjacent to net-of-fees returns. Given that discussion and noting the example in the Guidance Statement, Franklin Templeton believes strongly that a reference to the ability to show “pure” gross-of-fees returns as supplemental information ought to be incorporated into the body of the standards, rather than buried in the Guidance Statement (which officially is still part of the standards). This would include adding a definition for “pure” gross-of-fees returns in to the glossary (it is not there now). One way to reword this requirement would be as follows:

*Requirement 8.A.5: When firms present performance to a wrap fee / SMA prospective client, performance must be shown net of the entire wrap fee. Gross-of-fees returns or, if the actual direct trading expenses cannot be identified and segregated from the wrap fee, “pure” gross-of-fees returns, may be shown as supplemental information to a compliant presentation, so long as net-of-fees returns are also presented with equal or greater prominence. “Pure” gross-of-fees returns must be clearly labeled and defined as excluding trading expenses whenever such returns are presented.*

This language would ensure that “pure” gross-of-fees is shown only when traditional gross can not be, and ensures that it is shown only as supplemental information and only with appropriate disclosure that “pure” gross-of-fees excludes trading expenses. Generally, “pure” gross-of-fees would be shown to sponsors, so that sponsors may evaluate the investment advisers they use for their wrap-fee /SMA programs and compare them without the wrap-fee added on, which typically is controlled by the sponsor, not the investment adviser. In some instances, firms like Franklin Templeton offer separate account management where, instead of the end client signing only with the sponsor and appointing Franklin Templeton as discretionary investment adviser (with Franklin Templeton signing a contract with the sponsor), we as a firm offer separate account management directly to end clients, who sign dual contracts – one with us, and one with the sponsor/custodian, where the securities would be held. In this case, we may show “pure” gross-of-fees performance directly to end clients, so they can evaluate us before fees (which we don’t control) and compare us to other sponsor programs, where the fees may be different. For these reasons, having the ability to show performance both net and before the wrap-fee is important.

As a final point here, we would recommend that, since the term “pure” gross-of-fees would be referenced in the body of the standards, it would also need to be added to the glossary, as follows:

“PURE” GROSS-OF-FEES  
RETURN

The return on assets before all expenses, including  
TRADING EXPENSES, incurred during the period.

*Requirement 8.A.6: When firms present composite performance to an existing wrap fee / SMA sponsor, which includes only that sponsor's wrap fee / SMA portfolios (resulting in a "sponsor-specific composite"):*

- *Firms must disclose the name of the wrap fee / SMA sponsor represented by the sponsor-specific composite; and*
- *If the sponsor-specific composite compliant presentation is intended for the purpose of generating wrap fee / SMA business and does not include presentation net of the entire wrap fee, the compliant presentation must disclose that the named sponsor-specific compliant presentation is only for the use of the named wrap fee / SMA sponsor.*

While Franklin Templeton has not seen a lot of demand for sponsor-specific composites, we believe that it is appropriate to allow the presentation of sponsor-specific composites with appropriate disclosures as articulated in the standard above. When a Wrap Fee / SMA sponsor seeks to evaluate how well a particular investment manager has done for one of their programs, it stands to reason that the sponsor would want to see how well the investment manager has done for just their portfolios. Moreover, a sponsor may want to compare how a firm has done for that sponsor, compared to how well the firm has done for *all* sponsors for the same mandate, as indicated by the "style-specific" composite.

Franklin Templeton does believe it should not be a requirement to offer sponsor-specific composites, since the work associated with doing so, in addition to providing style-specific composites, can be very great. If a firm has 5 different styles, and five sponsors for each style, the firm has to maintain 25 sponsor-specific composites, a multiple of just the 5 style-specific composites required under GIPS for compliance with the standards.

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This concludes our comments. Thank you for considering these points.



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