

The CFA Institute Consultation on the Exposure Draft of the 2010 Global Investment Performance Standards (GIPS)

A response by

UK Investment Performance Committee (UKIPC)

June 2009

Pre-amble

1. UKIPC is the UK country sponsor of GIPS and is sponsored by the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds. In addition to its sponsors, its membership includes the Association of Consulting Actuaries, the Association of Private Client Investment Managers and Stockbrokers, the British Venture Capital Association, CFA UK, the Society of Pension Consultants, the Investment Property Forum, Software Suppliers, Investment Performance Measurers and GIPS Verifiers.
2. Between these members is represented the great majority of institutional investment in the UK together with a significant section of the private client market.

Introduction

3. UKIPC welcomes the opportunity to comment on the exposure draft believing that maintaining the relevance and validity of the standard in today's rapidly evolving financial market place is essential. UKIPC has through its active membership of GIPS working sub-committees, helped in contributing ideas and suggestions to the draft. This response concentrates on the broad issues raised by the proposals and will only deal with detailed wording or drafting points where necessary.

Overarching comments

4. The updating and partial re-writing of the Standard is helpful in improving consistency across GIPS and in aiding clarity to the reader. UKIPC compliments both the working sub Committees involved and the staff at the CFA Institute in successfully completing this significant task.
5. In this consultative version of GIPS 2010, valuation issues and concerns have clearly moved a long way up the agenda. It has been publically stated that GIPS is not intended to be a valuation standard. Whilst that may be the intention, UKIPC believes that this is not the result. Clearly for certain asset classes (eg most

public equities and bonds), valuation can be derived from prices obtained in an active and transparent trading market. But for many other asset classes, this is not the case. For assets such as private equity, venture capital and hedge funds and real estate this is far from the case. For such asset classes the importance of reliable valuation methodology becomes a key part of calculating the investment performance results. To ensure credibility a sound and widely recognised consensus set of valuation principles becomes essential. Accepted valuation principals are available from recognised industry bodies, in some areas the local regulator also has clear rules regarding valuation - both are in common use within their respective industries. It is suggested that GIPS should require use of such principals and for firms to state which set of principals have been used. In this way GIPS need not concern itself with valuation detail and the GIPS standard can be made less prescriptive and a little shorter.

6. Risk – while it is recognised that fuller risk guidance will be forthcoming, there is some disappointment that the much anticipated risk principles are exceedingly light-touch, so much so that it is difficult to see how the single required risk measure assists the prospective client in forming a balanced investment decision. Furthermore, where there is a requirement for a more generic description of risk, the catch-all nature of what is being currently suggested in GIPS 2010 could leave the investment manager vulnerable to possible litigation if the future investment outcome in some way does match client expectations. Where appropriate, we have suggested further risk disclosure that would more fully assist prospective clients. We firmly believe that firms should be required to produce risk measures for all periods for which performance is presented, whether this be simply the minimum required by the Standards or additional periods that the firm elects to present. Arguments over theory and practise are dealt with in the respective section. As prospective clients and consultants frequently engage in their own analysis it has been suggested that a statement should be made to the effect that ‘all monthly returns underlying the composite and the benchmarks presented should be made available on request’.

Detailed Comments

(References are as used in the consultation document)

0. Fundamentals of Compliance

0.A.2 Prospective Clients – *this is a very wide term which UKIPC suggests is not sufficiently well covered in the glossary. The relationship could span the range from formal relationships to the very casual. A tighter alternative wording is suggested in the response made under Appendix E – GIPS Glossary.*

0.A.7 Do you agree with including disclosure of the firm’s verification status in the claim of compliance?



UKIPC strongly supports the disclosure of the firm's verification status. For investors the UKIPC has long supported mandatory third party verification (MV) believing in the important reassurance that verification offers to investors and clients. UKIPC has also called for MV to be re-considered when planning commences for GIPS 2015. It is therefore vital to get this disclosure right and resist calls to weaken the requirement – such calls are not made with the interests of clients and investors in mind. There is however one glaring deficiency in the current proposals since the name of the verifying company is not disclosed. In the light of more recent financial scandals (eg Madoff) investors need to know who has carried out the verification. If investors see a firm name that perhaps is not known to them then they are in effect put on notice to carry out some further due diligence checks. This disclosure should apply equally to advertising presentations. Because there may be concerns in some markets that the term 'verification' is ambiguous (and could pose risk if users of the Firm's reporting misinterpret what the service provide) it may be appropriate to suggest a clarifying statement around verification eg saying 'verification as defined under the GIPS Standards'. This would require GIPS to include an effective description of what GIPS verification is and what it is not.

0.A.7 Do you agree with the classification of a current verification being within the last 24 months?

Yes. The phraseology is arguably a little loose and there could be some misunderstanding of when the 24 months runs from; the draft would benefit from clarification and tighter language on this point.

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

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

At first sight, these statements might be regarded as rather obvious. However they leave all those involved with GIPS in no doubt of the standard required. The language used is clear and direct and is strongly supported. From the perspective of GIPS compliance enforcement by a regulator or country sponsor both statements are highly valuable. It is suggested that this does not rule out the practical use of materiality when interpreting its application for some minor misdemeanour or transgression.

0.B.2 Firms should provide to each existing client, on an annual basis, a compliant presentation for the composite(s) in which the client's portfolio is included.

In practice this does not often seem to happen with many firms showing a marked reluctance to provide compliant presentations. In order to strengthen the recommendation it is suggested that it should be made explicit, and to encourage pro-active provision, that such information must be provided if requested by the client.

- 0.B.3 Firms should comply with the recommendations of the GIPS standards, including recommendations included in any updated information. Guidance Statements, interpretations, Questions & Answers (Q & A's), and clarifications published by CFA Institute and the GIPS Executive Committee, which will be made available via the GIPS website (www.gipsstandards.org) as well as the GIPS Handbook.

This is a new proposal that is welcomed.

1. Input Data

- 1.A Do you agree with the change from market value to fair value?

It is recognised that Fair Value is a fundamental principle applied in International Financial Reporting Standards (IFRS). UKIPC accepts the use of "Fair Value" as a more recent and appropriate proxy for "Market Value" but in doing so we advance the following notes of caution:

- Despite being enshrined within IFRS, GIPS 2010 ought to recognise (and does not based on what is drafted in appendix D) that IFRS is not widely adopted in Asia, the US and nor is it comprehensively applied by investment funds in Europe, since the EU regulation to mandate the use of IFRS applied only to "listed companies" (which some funds there are many that are not). Globally, there will be substantial application of local Generally Accepted Accounting Principles ('GAAP') for the foreseeable future despite the presence of many global convergence initiatives. While UK GAAP is well known to have very few material divergences with IFRS, this is not fully the case with the US and certainly not the case with Asia.*
- The financial market crisis is forcing some not inconsiderable rethinking of both the validity and breadth of the application of fair value in accounting practice under such banners as "how fair is fair value?" While the Fair Value concept looks set to withstand this, GIPS 2010 needs to reflect that the long envisaged endgame of universal endorsement of Fair Value is, at this point in time, much less of a 'fait accompli'.*

Accordingly, we propose that (in a similar fashion to the provisions on allocating benchmarks to composites), Firms should be required to apply fair value principles to their portfolio accounting but where they do not are required to disclose and justify such actions.

We expect there to be two primary 'valid cases' for non-application:

- 1. Where fair value principles are not required to be applied in the GAAP mandated by the legally binding constitution of a fund*
- 2. Where fair value principles are applicable but not followed because the fair value cannot be reliably determined.*

UKIPC believes it is important that the 2010 GIPS recognises and allows for this practical reality.

2. Calculation Methodology

2.A.1 Total returns must be used.

Agreed

2.A.2 Time-weighted rates of return that adjust for external cash flows must be used. Periodic returns must be geometrically linked. External cash flows must be treated in a consistent manner with the firm's documented composite specific policy, Firms must define large cash flow for each composite to determine when the portfolio in that composite are to be revalued for calculating performance.

Supported

3. Composite Construction

3.A.1 Do you agree with requiring the inclusion of non-fee paying discretionary portfolios in composites?

Yes from a fixed date going forwards.

3.A.9 Do you agree with changing 3.A.9 from a recommendation to a requirement?

No this seems unnecessary and does not benefit the investor. In practice there are many circumstances in which this requirement would be impossible to apply. For example the ultimate investor is not always known or disclosed and the amount of the proposed investment is not always fully decided on in advance of any presentation or tender.

4. Disclosure

- 4.A Should firms be allowed to remove certain disclosures after a defined period of time? If so, which disclosures would be eligible for removal and after what period of time?

Yes this is a sensible proposal. UKIPC favours 10 years as that is a period of time already used in relation to historical data within GIPS. However there would be no problem with allowing a shorter period (five years) at the discretion of the Firm where the early removal can be justified on grounds of insignificance to the prospective client.

- 4.A.5 Do you agree with the inclusion of short positions in provision 4.A.5?

In principle we agree with this requirement but would look for further guidance on practical issues such as, but not limited to, the conditions on which materiality might be assessed and whether this requirement would be retrospective in application as this would be a significant undertaking.

We also think that the alternative use of the terms composite "definition", "description" and "strategy" could be tidied up so that one term is used throughout if applicable.

It is understood that both the FSA (UK) and the SEC (US) are consulting on short positions. It would seem likely therefore that GIPS proposed provision might have to be adjusted or fine tuned as a result of any relevant conclusions from these studies.

- 4.A.20 Do you agree with requiring the disclosure of key characteristics and risks in the composite description?

Once again yes in principle but the catch-all nature of the requirement is one of the areas that is exceedingly sensitive to managers. We suggest striking "including risks" and inserting the term "principal risks" immediately following "key characteristics".

- 4.A.28 Firms must disclose, for a minimum of 12 months, any change to the compliant presentation due to a correction of a material error.

There is a sense that this requirement will encourage firms to adopt a high materiality threshold to avoid displaying their "dirty washing" to prospective clients. There might be a case for differentiating between those that received the originally (erroneous) compliant presentation (irrespective of whether they are now an existing client) and future prospective clients who would in theory

be untroubled by a past error. It is agreed that error disclosure should not be necessary for longer than a year and that for new or prospective clients it is unnecessary.

4.A.29 Do you agree with the inclusion of a standard deviation disclosure?

Yes this is sensible and is supported but should be extended to provide further information to assist the prospective client. We would suggest that the standard deviation measure for both composite and benchmark be extended to include any period (>3 years) for which performance figures are presented in the compliant presentation, We also suggest that SD be presented alongside for each of the discrete annual periods presented and although recognising the apparent mismatch between annual performance figures and three year SD, it is industry-wide practise amongst managers and consultants to require and present information on this basis.

5. Presentation and Reporting

5.A.5 Is it appropriate to discontinue disclosure 5.A.5 for periods after 1 January 2011?

Yes

5.A.8 Do you agree with the requirement to present the percentage of the composite assets composed of proprietary assets?

UKIPC supports the need to identify proprietary assets in any composite, which is envisaged as seed capital. The term proprietary assets is regarded as confusing and the glossary definition is not very helpful. The term should include any assets run on behalf of shareholders e.g. insurance company funds, as well as seed capital. These should be disclosed in any composite.

6. Real Estate

6.A.2 Do you agree that real estate investments must be valued by an independent external appraiser every 12 months beginning 1 January 2012?

Yes supported. This is of course an industry issue, going far beyond GIPS but as far as GIPS is concerned, the need is to seek uniformity of approach from a performance measurement viewpoint and in doing so, to avoid having other than the minimum of definitions which may be slightly different and therefore being capable of opening up different interpretations. However the current proposal in GIPS leaves the way open for these valuations to be carried out on different assets in the portfolio at different points in the time period

concerned. UKIPC believes that all assets should be valued at the same date. This is in any case already widespread global best practice. The UKIPC would support an aspiration proposal that in five years time the valuation frequency should increase to become quarterly.

- 6.A.5 Do you agree with the additional requirements and recommendations for closed-end real estate funds as defined?

Yes as a recommendation and not a requirement. The use of the "since inception internal rate of return" is undoubtedly appropriate for so-called opportunity funds in the real estate sector. These are funds set up to exploit a particular value strategy for a fixed period of years, to produce high returns and accept risk at the higher end of the accepted spectrum. But, in many cases, it is not appropriate. In many closed ended funds, the objective is to gain strategic exposure to a market sector, not with a particular aim of timing entry.

- 6.A.15 Do you agree that component returns must be disclosed, and that the method described in provision 6.A.9.b will no longer be acceptable for periods beginning 1 January 2011?

Yes

8. Wrap Fees/Separately Managed Accounts (SMA)

- 8.A.6 Is it appropriate and/or necessary to include provision 8.A.6, which addresses presenting performance to existing clients, in the GIPS standards?

This is an issue for the USA – it is almost unknown in the UK.

- 8.A.6 Should firms be allowed to present a "sponsor-specific composite" as opposed to a "style-specific composite"?

UKIPC has no view.

III. Verification

- B.1 Should specific verification procedures be included for GIPS provisions 0.A.16 and 0.A.17?

No.

Appendix D - GIPS Valuation Principles



Q1 Do you agree with the requirements and recommendations in the GIPS Valuation Principles below?

No. The GIPS Valuation Principles in Appendix D in their current form will create far more problems than they are intending to solve and impinge on the general credibility of the GIPS Standards if released without amendment. The current climate only serves to raise the stakes involved in getting this area of the guidance right. The principal concerns of UKIPC are as follows:

- The guidance is too detailed and more complicated than necessary. This breaches our central claim, which must remain sacred, that GIPS is not a prescriptive standard. In addition to accounting standards, GIPS already contains (via the VC, RE and AI guidance statements) plenty of guidance on 'hard to value assets'. The extensive prescription listed in Appendix D almost seems to imply that challenging valuations requiring hierarchies and "observable inputs" are the base case when it is patently not so for the vast majority of compliant (and aspiring to be compliant) Firms.*
- This area of guidance raises the conceptual issue of how the GIPS Standards should interact with parallel standards of best practice, such as accounting standards or the International Private Equity Valuation Committee (IPEVC) guidance. UKIPC believes the approach of including certain provisions on a selective basis creates a number of practical problems and these should be avoided by interlocking rather than overlapping with the existing guidance from the expert bodies in those disciplines.*
- As indicated above, the proposed provisions (and some of the guidance in the alternative investments guidance statement) draw from the patchwork quilt of global and national accounting standards on a selective basis without considering the extent to which they are applied and required on a global basis. While great strides have been achieved, a performance standard which assumes universal application of IFRS in portfolio accounting is being unrealistic..*

The result will be considerable confusion, not only across the large parts of the world where such concepts remain in their infancy and are not well recognised by prospective clients but even within Europe where IFRS is not applied to many investment funds. The help desk would need to recruit considerable accounting and valuation expertise to handle this, and we believe this is best avoided from the start by cross referring the detailed guidance and leaving queries over its merits and application to the accounting standards boards that conceived them.

Leaving aside the points about prescription and interaction, there should be enough clarity by 2015 to conclude whether the concepts will be recognisable to the vast majority of the GIPS compliance constituency and for this reason it might be a useful input to that draft, or preferably to a full guidance statement on the topic. Currently, this fundamental 'recognition' test is not satisfied and makes the guidance unworkable.

Assuming (quite correctly in the view of UKIPC) that the degree of prescription and interaction with parallel guidance matters, we propose that Appendix D of 2010 GIPS be redrafted along the lines of the enclosed Appendix One to this letter. This proposal reduces the level of detail and complexity, transfers responsibility for the principles required back to the accounting standards boards who have written them already and presents a realistic framework to take account of the 'work in progress' that is the global convergence of accounting standards.

Finally, in creating the proposed redraft of Appendix D (below) we point the way to a possible removal of this section in its entirety, bringing the relevant principles (which are not many) into the main body of the Standards. In doing so, we do not reject the notion that there is considerable clamour for additional clarifying guidance on valuation, which has increased considerably as a result of the financial crisis. However, we believe the production of an "Accounting and Valuation" guidance statement between the 2010 and 2015 versions of GIPS (at a time when global accounting standards convergence will be substantially completed) represents a far better solution as opposed to over burdening the 2010 draft with a form and content of prescriptions that in some cases run contrary to the founding principles which have made GIPS such a successful global standard.

Appendix E - GIPS Glossary

Q1 Do you agree with the definition of prospective client? If not, how should it be defined?

It is suggested that prospective client be defined as:

- a). *Any person or entity that qualifies to invest in a composite strategy and has expressed an interest in, or discussed the possibility of, forming a client-firm relationship with respect to any of the firm's strategies.*
- b). *Even when no client-firm relationship ensues, a person or entity that has had discussions with a firm or expressed interest in any of the firm's*

strategies should be regarded as a prospective client for a period of 12 months following the last expression of interest or discussion.

- c). Existing clients may also qualify as prospective clients in respect to any strategy that is different to their current investment strategy.*
- d). Investment Consultants and other advisory persons or entities fall within the definition of prospective client whether they are acting in their own capacity and/ or representing potential investors who satisfy any of the above definitions.*

Appendix One – Specific comments and proposed amendments to GIPS valuation guidance and relevant provisions

Main body of GIPS

1A2

To be technically correct, this should say “.....PORTFOLIOS MUST be based on FAIR VALUE accounting principles [in accordance with the GIPS valuation principles in appendix D”]

1B1

This recommendation is a moot point. According to accounting standards which have adopted the principles of FAIR VALUE, obtaining them from a “qualified independent external third party” is often not possible for perfectly normal reasons. In fact, it is only in Real Estate that this is considered to be the standard approach. This provision should therefore be a requirement of the main Real Estate guidance only and not part of section 1 of the main GIPS.

Overall, we believe that the question of the most relevant valuation source for a given asset class is not matter GIPS can easily prescribe on, and perhaps nor should we attempt to do so. There is considerable coverage of this topic by both accounting and trade body best practice standards (HFWG, IPEVC, RICS etc) which should be cross referred to rather than partially replicated.

1A5, 1A6, 1B2 and 1B3

All of these provisions could be covered by a single requirement stipulating that “Portfolio accounting for assets (including investments), liabilities, income and expenses must follow the accruals basis”. This principle is already well entrenched in accounting standards throughout the world and to a far greater extent than the concept of using FAIR VALUE”

Section 4A – Additional provisions

I. Given the comments we have made about the non universal application of FAIR VALUE, and to a lesser extent, ACCRUAL ACCOUNTING, we propose the inclusion of the following requirement:

“Where the accounting policies of PORTFOLIOS are contrary to or in conflict with the accounting principles of FAIR VALUE and the ACCRUALS BASIS, the composite report should disclose the nature, extent and justification for such departures.”

II The 4B2 recommendation is an important provision that we believe should be given greater prominence in light of both the financial market turmoil and the general trend towards greater complexity in investment products. It also needs to be linked to the specific guidance already given in GIPS covering most types of investment that are "hard to value". Suggest that section 4A include the following as a draft provision:

"Where investment valuations are not based on quoted or published prices and do not fall within the scope of sections 6 or 7 of the GIPS Standards, Firms should disclose how they determine the FAIR VALUE of such investments in accordance with applicable accounting standards".

III Linking to Appendix D4 (as per the Exposure Draft):

"Where changes in the policies, procedures and methodologies used to value portfolio investments have occurred that are material to the composite performance record, the nature and extent of such changes MUST be disclosed in the composite report as well as the date such changes became effective"

GIPS 2010 Appendix D

Paragraph 2 of the introduction is a concern. Large parts of the world will not be applying IFRS for the first time before 2011 and this will not necessarily apply to investment funds, even in Europe where IFRS is perhaps most well entrenched. We suggest this paragraph be removed because the following proposal for the provisions of Appendix D is an alternative to 'cutting and pasting' selected provisions from IFRS and US GAAP on the grounds that GIPS should not proscribe detailed accounting guidance.

The definition of FAIR VALUE is appropriate.

Below is a suggestion of how the provisions could be simplified, condensed and linked into the relevant underlying accounting guidance.

1. For periods beginning on or after 1 January 2011, PORTFOLIOS MUST be based on FAIR VALUE *accounting principles* (Provision 1A2). For the majority of portfolios, FAIR VALUE will be determined with reference to observable quoted market prices. If such inputs do not exist for the purposes of valuing PORTFOLIO investments, the Firm should follow the guidance on how FAIR VALUE should be determined contained within the accounting standards (commonly known as Generally Accepted Accounting Principles ('GAAP')) applicable to the portfolio.

2. *In accordance with provisions OA16 and 4A9, Firms must comply with all applicable laws and regulations concerning portfolio accounting and investment valuation. Where such rules differ from the requirements of the GIPS Standards, Firms must disclose the nature and extent of the departure.*

(Designed to cover 2 and 3)

3. *In accordance with OA6, FIRMS MUST document their valuation policies, procedures and methodologies. Material changes to how investments are valued MUST also be documented.*

4. Provision D5 should be kept in its current form

Provisions 6 and 7 are covered by the cross reference to “applicable accounting standards” which for a very large number of investment funds might not be IFRS or US GAAP. It also sits better with the ‘compliance of with local law and regulations’ disclosure requirement. For example in large parts of Asia or even ‘Anglo Saxon model’ countries like Canada, portfolios are not legally allowed to follow the above standards and must follow local GAAP. To keep the current prescription could prevent Firms in these countries from becoming GIPS compliant.

Provisions 8 and 9 are picked up above in additional provisions II and III respectively suggested for section 4A. Provisions 10 and 11 are needlessly replicating guidance already spelled out in the main body. Comments on these are provided above.