Best Practices for Creating and Maintaining Policies and Procedures for Complying with the Global Investment Performance Standards (GIPS®)

United States Investment Performance Committee (USIPC)
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Introduction

This white paper is intended to assist firms with establishing and maintaining policies and procedures for claiming compliance with the Global Investment Performance Standards (GIPS®). The paper was developed by the United States Investment Performance Committee (USIPC), the United States country sponsor for the GIPS standards. The information outlined in this paper reflects what the authors consider to be best practices and *is not intended to serve as definitive guidance that must be adhered to by firms that claim compliance with the GIPS standards*. The examples included are provided for illustrative purposes only and will not be appropriate in all situations; every firm is different and must develop their own policies and procedures with their specific needs in mind.

All references to the GIPS standards throughout the paper relate to the 2010 edition of the GIPS standards, which became effective on 1 January, 2011.

Background

The GIPS standards are the industry accepted standard for calculating and presenting investment performance results to prospective clients. The GIPS standards promote fair representation and full disclosure of investment performance. The GIPS standards were created by and are sponsored by CFA Institute through the collaboration of the global investment community. Only firms or organizations that manage actual assets may claim compliance with the GIPS standards In order to claim compliance, initially firms must comply with all requirements of the GIPS standards for a minimum of five years or since the firm's inception, and an additional year of performance each year must be presented, building up to a minimum of ten years of GIPS-compliant performance.

One of the fundamental requirements of the GIPS standards is that firms must document their policies and procedures used in establishing and maintaining compliance. A firm must document all of the policies and procedures it follows for meeting the applicable requirements of the GIPS standards, as well as any recommendations the firm has chosen to adopt. There is no requirement to create and document policies and procedures to comply with provisions or other requirements of the GIPS standards that do not apply to the firm. However, firms must actively make a determination about the applicability of all the provisions or other requirements of the GIPS standards and document their policies and procedures accordingly. It is recommended that firms review all requirements of the GIPS standards on an annual basis to determine if changes in the requirements or changes in the firm's investment strategies warrant changes to existing policies and procedures.

The firm's policies and procedures should help ensure that the institutional memory of how and why things were done in the past is not lost and serve as an important guide to capture how things are done currently. The document should be a useful training tool for new employees, educating them and providing guidelines to support day-to-day operations and processes.

It is important to emphasize that the firm must document both their policies <u>*and*</u> their procedures for adhering to the GIPS standards. For clarification:

- A policy can be defined as the principles that are used to determine decisions and actions.
- In contrast, a procedure is the course of action that must be followed to implement a policy consistently.

Simply stating the requirements of the GIPS standards in policies and procedures will not be sufficient in many areas. Although there are some cases where an affirmation of the requirement may be appropriate from a policy perspective, the firm's procedures should go into more detail as to how the firm ensures the policy is followed.

Once a firm establishes its policies and procedures, those policies and procedures must be consistently applied. However, issues may arise where the firm must make decisions that are not directly addressed by existing policies and procedures. These decisions should be documented so that they can be used as precedent to be followed consistently going forward.

Policies and procedures should be reviewed on a regular basis to determine if they should be changed or improved, but it is not expected that they will change frequently. A firm must not change a policy solely to improve performance or to present the firm in a better light. Furthermore, retroactive changes to policies and procedures should be avoided. Even in the absence of an immediate need to update the document due to changes to the GIPS standards, there should be a thorough review and approval by the person(s) responsible for maintaining compliance with the GIPS standards on at least an annual basis.

Firms must maintain both current and any previous versions of their policies and procedures. In the case of a significant change in policies, firms should consider creating a document history page or moving the old policy to an appendix so that it can be easily obtained if there is a need to review historical composite construction criteria. It is also advisable to document the reason for the change.

Policies and procedures are created for each firm that claims compliance with the GIPS standards. Policies and procedures can differ by firm due to various business decisions made by the firm, including investment strategies employed, calculation and valuation methods utilized, and systems developed or purchased by the organization. In addition, some firms find it most effective to create separate policy and procedure documents for different lines of business, even if the different areas or divisions are included in the definition of the firm. For example, the area of the firm that handles wrap fee / separately managed account (SMA) portfolios might use a different portfolio accounting system, have different composite construction rules, or include significantly different disclosures because of the nature of the portfolios. A firm with diverse lines of business should carefully consider what makes sense for them.

The firm should also carefully consider the potential audiences who may be reviewing or testing their policies and procedures. In each compliant presentation (a presentation for a composite that contains all of the information required by the GIPS standards), firms must disclose the availability of policies for valuing portfolios, calculating performance, and preparing compliant presentations. If requested by a prospective client, these policies must be provided. In addition, policies and procedures are often requested and reviewed by regulators in order to confirm the validity of the firm's claim of compliance. Also, if the firm wishes to be verified, the verifier is obligated to obtain a copy of the firm's policies and procedures used in establishing and maintaining compliance with the GIPS standards and to ensure that all applicable policies and procedures are properly included and adequately documented. Therefore, the firm should attempt to make their policies and procedures as clear and unambiguous as possible so that they can be easily interpreted by any of these outside parties.

The firm's policies and procedures can be outlined in separate documents or combined into one consolidated manual. Further, policies and procedures can be documented in either hardcopy or electronic format. Many firms also chose to create detailed step-by-step "desktop procedures" (separate from formal policies and procedures) to help employees consistently complete ongoing tasks.

Policies and Procedures: Core Elements

The following items should be addressed in any firm's GIPS policies and procedures, though the order and details will vary by firm. Many firms organize their policies and procedures to follow the order of the provisions in the GIPS standards or may expand their policies and procedures beyond these core elements. Firms are also reminded that the provisions of the GIPS standards do not address all that is required of a firm that claims compliance, as firms must also adhere to any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee.

The core elements addressed in this paper are as follows:

I. Definition of the firm
II. Firm assets
III. Definition of discretion
IV. Composite definitions
V. Composite construction
VI. Portfolio valuation and accounting methodologies
VII. Portfolio valuation frequency
VIII. Portfolio performance calculations
IX. Composite performance calculations
X. Treatment of fees
XI. Developing compliant presentations
XII. Distributing compliant presentations
XIII. Record retention
XIV. Error correction
XV. Maintaining compliance

For each of these areas, the paper provides a brief summary of the relevant provisions within the GIPS standards followed by a sample policy as well as procedures and additional points for firms to consider. Please note that this paper is only intended to focus on what the authors consider to be the core requirements and recommendations of the GIPS standards and the sections that they feel apply to most firms. In addition to the core elements described here, the GIPS standards also include guidance dedicated to private equity, real estate, wrap fee / SMA portfolios, and other topics that, though beyond the scope of this paper, must still be addressed in firms' policies and procedures where applicable.

I. Definition of the firm

The GIPS standards must be applied on a firm-wide basis. The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined. Once the definition of the firm is clearly established, all actual, fee-paying, discretionary portfolios that have been part of the defined firm at any time during the period for which the firm claims compliance must be placed in composites.

Firms must be defined as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity. Firms are recommended to define the firm as broadly as possible, encompassing all of the relevant locations, departments, and functional areas so that a prospective client is given enough information about the investment strategies being managed and the firm as a whole.

If a firm chooses to present non-compliant performance, they may do so for periods prior to January 1, 2000, but the firm must disclose which periods are not in compliance.

Refer to the Guidance Statement on Definition of the Firm for additional information.

Example policy:

Effective January 1, 2003, the firm is defined as follows:

- *XYZ Asset Management is an SEC registered investment adviser that provides a broad array of investment management services to investors around the world. XYZ Asset Management is an independent investment management firm that is not affiliated with any parent organization.*

The firm has complied with the GIPS standards since its inception on January 1, 2003.

Procedures to consider:

- The firm should outline procedures for monitoring acquisitions or other significant changes to the business and evaluating whether there is an impact to how the firm is holding itself out to the public.

Helpful hints:

- If there are any complexities in defining the firm, the firm should outline the rationale for the firm definition.
- Note that if the firm is defined in a way that leaves out one or more divisions or areas, the assets from those divisions or areas cannot be included in the firm assets.
- If there have been any historical organizational changes at the firm, those changes should be outlined in the firm's policies and procedures and should potentially be disclosed in the firm definition.
- The effective date of firm-wide compliance with the GIPS standards should be indicated in the firm's policies and procedures.
- Any periods of and reasons for non-compliance should also be noted in the firm's policies and procedures.

II. Firm assets

For periods beginning on or after January 1, 2011, total firm assets must be the aggregate fair value of all discretionary and non-discretionary assets managed by the firm. This includes both fee-paying and non-fee-paying portfolios. For periods prior to January 1, 2011, total firm assets must be the aggregate of the market value of all discretionary and non-discretionary assets under management within the defined firm.

Firms must document policies and procedures for ensuring the existence and ownership of client assets. In addition, firms must create and document policies and procedures to ensure that the firm's composites and total firm assets properly reflect only actual assets managed by the firm. Firms are prohibited from double-counting assets when calculating total firm assets. Firms must also consider any laws and regulations with regard to ensuring the existence and ownership of client assets.

Example policy:

> *Effective January 1, 2011, total firm assets are the aggregate fair value of all discretionary and non-discretionary assets managed by the firm, including both fee-paying and non-fee-paying accounts as well as assets delegated to sub-advisors. Prior to January 1, 2011, total firm assets were the aggregate market value of all discretionary and non-discretionary assets managed by the firm.*
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> *Only actual assets managed by the firm are included in total firm assets. Simulated, model or hypothetical portfolios are not included in firm assets.*
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> *In certain instances, assets may be captured in more than one portfolio (e.g., separate account portfolios that invest in pooled investment vehicles managed by the firm). When this occurs, the portion of portfolio assets that are invested in other firm portfolios are backed out when calculating total firms assets in order to avoid double-counting.*

Procedures to consider:

- In order to ensure the existence and ownership of client assets, the firm should obtain custodian statements, broker statements, and trade confirmations and perform timely reconciliations between the firm's records and the custodian's or broker's records.
- Firms that manage pooled funds that are subject to third-party audits on at least an annual basis may want to consider such audits as part of their validation procedure.

- Firms should document how firm assets are calculated, including how model portfolios and/or double counting of assets are identified and removed from total firm assets.

Helpful hints:

- Certain investment types (e.g., limited partnership interests, derivatives, real estate and private equity) may require alternate documentation to establish the ownership and existence of client assets, as custody and broker records may not exist.
- For firms that include portfolios in more than one composite or that manage portfolios that invest in the firm's pooled funds, care must be taken to ensure assets are not counted more than once in total firm assets.

III. Definition of discretion

Discretion is the ability of the firm to implement its intended strategy. What makes a portfolio discretionary or non-discretionary may be unique to a firm's business and, therefore, each firm must document its own definition of discretion. The firm's definition of discretion establishes criteria to judge which portfolios should be included in a composite to accurately reflect the application of the firm's investment strategy. Discretionary, fee-paying portfolios must be included in at least one of the firm's composites, while non-discretionary portfolios must not be included in any of the firm's composites. Non-fee paying portfolios may be included in a composite; however, if included, firms must present the percentage of composite assets represented by non-fee-paying portfolios as of each annual period-end in the compliant presentation. Ideally, discretion is defined at the firm level, but it may be defined at the composite level or by asset class.

Please refer to the Guidance Statement on Composite Definition for additional information.

Example policy:

Portfolios are generally considered to be discretionary if the client has granted the firm authority to manage the portfolio according to the specified strategy without imposing material restrictions.

Portfolios are considered to be non-discretionary when significant client-imposed investment and/or trading restrictions prevent the portfolio from being managed in substantially the same manner as other portfolios with a similar strategy. Examples of client-imposed restrictions that may cause a portfolio to be classified as non-discretionary include, but are not limited to:

- *Restrictions on trading activities*

- *Material restrictions on trading partners*
- *Restrictions on cash allocations*
- *Tax considerations (e.g., gain/loss restrictions, harvesting or gifting of securities)*
- *Restrictions on the sale or purchase of certain securities, sectors, or regions*
- *Risk constraints (e.g., duration, tracking error)*
- *Cash flow requirements*
- *Legal restrictions*

Procedures to consider:

- Firms must apply their definition of discretion consistently over time. To ensure this, firms must review each of their portfolios (both discretionary and non-discretionary) on a regular basis to determine whether any portfolios must be re-classified. The firm should document how this review process is conducted, including each of the steps involved.
- Firms should establish procedures to review investment guidelines and amendments to guidelines to determine if any restrictions impede the portfolio manager's ability to implement their strategy.

Helpful hints:

- Firms must maintain records to support why a portfolio was assigned to a specific composite or was excluded from all composites. Keeping an ongoing log of the rationale behind each portfolio's discretionary classification would help meet this requirement.
- Though non-discretionary portfolios are not permitted to be included in composites, firms may group some or all of the firm's non-discretionary portfolios together to simplify composite administration. According to the GIPS standards, this is not a composite and must not be included on the firm's list of composite descriptions.
- Firms should be aware of the difference between "discretion" as it pertains to the GIPS standards and the terms typically used in the legal sense (the authority to decide which securities to purchase and sell). A portfolio may satisfy the legal definition of discretion, but may not meet the firm's internal definition of discretion for GIPS compliance purposes.
- The treatment of temporary restrictions, if applicable, should also be documented. For example, the firm may decide that portfolios that impose client-directed trading restrictions lasting longer than a specified number of days will be considered temporarily non-discretionary until the restriction is lifted.

IV. Composite definitions

A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. All actual, fee-paying, discretionary portfolios must be included in at least one composite. Although non-fee-paying discretionary portfolios may be included in a composite, non-discretionary portfolios must not be included in composites. Composites must include all portfolios within the firm definition that meet the composite definition.

Composite definitions (the detailed criteria that determine the assignment of portfolios to composites) must be documented in the firm's policies and procedures. Composite descriptions (the general information regarding the investment mandate, objective, or strategy of the composite) must be disclosed in compliant presentations. Composite descriptions may be more abbreviated than composite definitions, but still must include all key features of the composite and must include enough information to allow a prospective client to understand the key characteristics of the composite's investment mandate, objective, or strategy.

Firms must provide a complete list of composite descriptions to any prospective client that makes such a request. Terminated composites must be included on the list for at least five years after the composite termination date.

Refer to Appendix C of the 2010 edition of the GIPS standards for a sample list of composite descriptions.

Example policy:

> *All actual, fee-paying, discretionary portfolios are included in at least one composite. Non-discretionary portfolios, as well as non-fee-paying portfolios, are not included in composites. Composites include only actual assets managed by the firm. Simulated or back-tested portfolios are not included in composites or linked with actual performance returns.*
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> *Composites are defined according to investment mandate, objective or strategy. Composites include all discretionary, fee-paying portfolios that meet the composite definition.*
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> *A list of detailed composite definitions is included within these policies and procedures as Appendix A. The firm also maintains a complete list of composite descriptions, including all composites that have closed within the past five years. The firm's list of composite descriptions is provided to any client or prospective client who requests it.*

Procedures to consider:

- Portfolio managers and marketing departments should be consulted to appropriately define composites by investment mandate, objective, or strategy. Since the investment objectives documented in investment management agreements will be utilized to support the inclusion of portfolios in composites, these should also be consistent with the firm's definition of the strategy.

- The firm should document procedures for maintaining the list of composite descriptions, as well as the process for responding to requests for copies of the list. Note that firms must include terminated composites on the firm's list of composite descriptions for at least five years after the composite termination date.

Helpful hints:

- Composite definitions should identify key characteristics, including risks specific to the composite, minimum portfolio size (if any), and benchmarks.
- Take care in setting composite definitions. Too broad a definition may cause unwanted dispersion, while too narrow a definition may cause portfolios to be excluded even though they are not materially different from others included in the composite. Note that composite definitions also correlate to composite assets under management; a broad definition captures larger amounts of assets than a more narrow definition.

V. Composite construction

Composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. Terminated portfolios must be included in the historical performance of the composite up to the last full measurement period that each portfolio was under management. Portfolios must not be switched from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes it appropriate. The historical performance of portfolios that terminate or switch composites must remain with the original composite.

Firms may establish minimum asset levels for portfolios to be included in composites. The purpose of a minimum asset level should be to exclude portfolios from the composite that are too small to be representative of the intended strategy. If the firm sets a minimum asset level for portfolios to be included in a composite, the firm must not include portfolios below the minimum asset level in that composite. Minimums can vary by composite.

Firms that wish to remove portfolios from composites in cases of significant cash flows must define "significant" on an ex-ante, composite-specific basis and must consistently follow the composite-specific policy. The GIPS standards define a significant cash flow as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy, thereby causing the portfolio to no longer be representative of the composite strategy. Portfolios that experience a significant cash flow are temporarily removed from the composite. Firms may also seek to minimize the impact of significant cash flows through the use of temporary new accounts.

Example policy:

Composites include new portfolios at the beginning of the first full month under management. Terminated portfolios are included in the historical performance of appropriate composites through the last full month under management. Portfolios that switch composites due to strategy changes are removed from composites at the end of the last month under the old mandate and are eligible for re-inclusion in composites at the beginning of the first full month after the change.

Some (but not all) of the firm's composites have established minimum asset levels for portfolios to be included or policies for temporarily removing portfolios that experience significant cash flows. These minimum asset levels and significant cash flow policies are outlined in the firm's composite definitions, outlined in Appendix A.

Procedures to consider:

- Firms should establish procedures to ensure that all fee-paying discretionary portfolios are assigned to the appropriate composites. This should include periodic evaluations of the full list of portfolios within the scope of the firm definition, validating the discretionary status and composite assignment (if applicable) for each portfolio, and reconciling between the portfolios in composites and total firm assets.
- Firms should monitor new and terminated portfolios, as well as strategy changes. Firms should have procedures to be notified of these events and could build exception reports to track these items. Procedures should also address the necessary communication of client directed portfolio changes from those responsible for interacting directly with clients to those responsible for maintaining composites.
- Composite dispersion should be monitored and an outlier analysis could be performed to analyze the appropriateness of the inclusion of portfolios in each composite.
- Firms should establish procedures for reviewing portfolios that may fall below prescribed minimum asset levels or experience significant cash flows and removing such portfolios from composites on a consistent basis.

Helpful hints:

- Firms should consider a grace period policy prior to including portfolios in composites based on when a portfolio manager can fully implement the intended investment mandate, objective or strategy. The grace period may vary by composite.
- If there is an unusual delay before including a new portfolio in a composite, it is good practice to document the reasons for the delay.
- Closed portfolios should be excluded from composites based on the date the firm was instructed to change the implementation of the portfolio's strategy such that it was no

longer discretionary, as opposed to the date the portfolio was liquidated or the assets were transferred from the firm.

- For portfolios that move from one composite to another, firms should consider how often they will review the composites and/or portfolios for changes and whether portfolios that change mandate follow the same composite inclusion rules as new portfolios.
- Firms should carefully consider whether or not a minimum asset level for inclusion in a composite is necessary for their business. The establishment of a minimum portfolio size for marketing or sales purposes does not necessarily mean that the firm must establish a minimum asset level for composite inclusion. Though a firm may choose not to manage portfolios below a certain size as a business decision that does not necessarily mean that the strategy could not be implemented for portfolios below that limit. Firms should also note that composites with few portfolios could potentially terminate the composite performance if all portfolios fall below the minimum asset level.
- Some firms confuse Significant Cash Flow policies with Large Cash Flow valuation requirements. A Significant Cash Flow policy, if used, should be an amount that impedes the ability to apply the intended investment strategy. Large Cash Flows are normally a much lower level and are relevant to achieving accurate performance for the portfolio. Definitions of each are available in the GIPS standards glossary.
- Even with procedures in place to help ensure that changes in the management of a portfolio are communicated to the team responsible for compliance with the GIPS standards, it is good practice to have portfolio or relationship managers review and sign off on the composite assignment of portfolios on at least an annual basis if not more often. A quarterly review would be best practice.

VI. Portfolio valuation and accounting methodologies

Beginning January 1, 2011, firms must value portfolios in accordance with the GIPS Valuation Principles and the following definition of fair value:

> Fair value is defined as the amount at which an investment could be exchanged in a current arm's length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation must be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation must represent the firm's best estimate of the market value. Fair value must include accrued income.

Valuations should be obtained from a qualified independent third party.

For periods prior to January 1, 2011, the GIPS standards require the use of market value, which is defined as the current price at which investors buy or sell securities at a given time, in order to best identify the fair economic value of the firm's portfolios.

For periods beginning on or after January, 1 2011, firms must disclose the use of subjective unobservable inputs if they are material to the composite.

Trade date accounting (rather than settlement date) must be used for all periods after January 1, 2005. Accrual accounting must be used for fixed-income securities and all other investments that earn interest income. Accrual accounting should be used for dividends (as of the ex-dividend date).

Refer to the GIPS Valuation Principles in Chapter II of the 2010 edition of the GIPS standards for additional information.

Example policy:

> *Valuations are generally obtained from qualified independent third-parties in accordance with the firm's valuation hierarchy. The firm's valuations hierarchy does not materially differ from the recommended hierarchy in the GIPS Valuation Principles. The firm generally only invests in securities that are traded in active markets, valuation inputs are objective, and where market prices for identical securities are readily available. However, if the aggregation of portfolio investments valued using subjective unobservable inputs in a composite strategy is greater than 10%, the use of these inputs will be disclosed in the compliant presentation.*
>
> *Valuation Hierarchy:*
>
> a. *Investments must be valued using objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available. If not available, then investments should be valued using;*
> b. *Objective, observable quoted market prices for similar investments in active markets. If not available or appropriate, then investments should be valued using;*
> c. *Quoted prices for identical or similar investments in markets that are not active (markets in which there are few transactions for the investment, the prices are not current, or price quotations vary substantially over time and/or between market makers). If not available or appropriate, then investments should be valued based on;*
> d. *Market-based inputs, other than quoted prices, that are observable for the investment. If not available or appropriate, then investments should be valued based on;*

e. *Subjective unobservable inputs for the investment where markets are not active at the measurement date. Unobservable inputs should only be used to measure fair value to the extent that observable inputs and prices are not available or appropriate.*

Trade date accounting is used for all periods. Accrual accounting is used for fixed income securities and all other investments that earn interest income. Accrued income is included in beginning and ending portfolio market values when calculating performance. Dividends are accrued as of the ex-dividend date.

Procedures to consider:

- The firm may choose to establish a valuation policy documented outside of the firm's GIPS policies and procedures. Such a policy could detail valuation procedures for specific asset classes or securities.
- Firms should consider having a valuation oversight committee to ensure that valuations of portfolio investments have integrity and fairly reflect their value.
- When the firm regularly receives or calculates multiple valuations for one portfolio (e.g., internal valuations compared to those received from the custodian or a fund administrator), the firm should determine which will be the official valuation source for that portfolio and use that source consistently.
- Firms should establish a regular review of the use of subjective, unobservable inputs to determine if these investments are material to each of their composite strategies.
- Firms' accruals should be verified through timely reconciliations between the firm's records and the custodian's records.

Helpful hints:

- Firms that typically invest only in liquid securities in active markets should still consider addressing in their policies and procedures potential scenarios where markets suddenly become illiquid and objective, observable investment prices are unavailable.

VII. *Portfolio valuation frequency*

The GIPS standards have gradually increased the minimum required frequency of portfolio valuation from quarterly (prior to 2001), to monthly (from the beginning of 2001 to the end of 2009), then to as of each calendar month end or the last business day of the month as well as on the date of all large cash flows (beginning in 2010). A large cash flow, which is to be defined by the firm for each composite, is the level at which the firm determines that an external cash flow (cash or investments that enter or exit a portfolio) may distort performance if the portfolio is not valued at the time of the cash flow. Firms must define the amount in terms of the value of the cash/asset flow or in terms of a percentage of portfolio assets or the composite assets. Firms must also determine if a large cash flow is a single external cash flow or an aggregate of a number of external cash flows within a stated period of time.

Example policy:

Portfolios are valued on the last business day of each month and on the date of all large external cash flows. The firm has defined a "large" cash flow as a single external cash flow (contribution or withdrawal of cash or investments) equal to or greater than 5% of the beginning-of-month value of the portfolio. The definition of large cash flow has been applied consistently across all composites.

Procedures to consider:

- Some firms may have difficulty obtaining accurate valuations more frequently than monthly. Since firms are required to revalue portfolios on the date of all large external cash flows as of January 1, 2010, the firm's procedures related to the frequency of portfolio valuation should address how and from where the firm will obtain intra-month valuations when necessary.
- If not automated, firms should describe how large cash flows are identified.

Helpful hints:

- The firm may establish valuation policies that differ on a composite-by-composite basis. Depending on the nature of the firm's business, having different valuation policies for different composites or account types may not be practical.
- The firm's composite-specific valuation policy may also differentiate between account types within the composite. For example, if a composite contains mutual funds and separate accounts, the firm's policy may be to value the mutual funds daily while the separate accounts are only priced at month-end and on the date of all large cash flows.
- The firm must follow the composite-specific valuation policy consistently. If a portfolio incurs an external cash flow that is less than the defined large cash flow threshold, then the firm must not value the portfolio for return calculation purposes.

VIII. Portfolio performance calculations

The GIPS standards mandate the use of certain calculation methodologies to facilitate comparability. Firms must calculate time-weighted rates of return that adjust for external cash flows. Total returns including both realized and unrealized gains and losses must be used and returns from cash and cash equivalents held in portfolios must be included in all return calculations. In addition, all returns must be calculated after the deduction of the actual trading expenses incurred during the period. Returns should be calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes should be accrued.

Example policy:

All performance results are total returns, including both realized and unrealized gains and losses plus income. Portfolio performance results are calculated on a monthly basis using the Modified Dietz method. Sub-period calculations are performed during periods where large cash flows occur. Sub-period returns are geometrically linked to arrive at monthly, quarterly, and annual returns. Cash flows are assumed to occur at the beginning of the day. Returns for cash and cash equivalents held in portfolios are included in all return calculations. All returns are calculated after the deduction of actual trading expenses incurred during the period. When applicable, performance is calculated net of non-reclaimable withholding taxes on income and capital gains.

Procedures to consider:

- The firm's procedures related to portfolio return calculations should address the systems used and whether the calculations are performed internally or by an outside vendor. Note that even if the firm has outsourced portfolio calculations, the firm is still responsible for the accuracy of the calculations and for ensuring adherence to the GIPS standards. If a third-party is engaged to perform portfolio-level performance calculations, it is important to review a sample of portfolios on a regular basis to verify the calculations.
- Firms should consider establishing procedures to periodically compare portfolio performance to composite performance to assist in identifying outliers that could indicate valuation, cash flow, or calculation issues.

Helpful hints:

- It may be helpful to include formulas and definitions in the firm's policies to explain the methodologies used, including indicating if any details have changed over time.
- The firm's policies should indicate how cash flows are treated (e.g., accounted for as of the beginning or end of day) and that a consistent methodology is applied.
- Policies for converting returns into different currencies should also be outlined, if applicable.

IX. Composite performance calculations

The composite return is the asset-weighted average of the performance of all portfolios in the composite. Firms must document the methodologies used and the frequency for asset-weighting portfolio returns when calculating composite returns. Similar to the portfolio valuation requirements, the GIPS standards have gradually increased the minimum required frequency for asset-weighting portfolio returns in order to calculate composite results. Quarterly composite calculations are permitted for periods prior to January 1, 2010; subsequently, composite returns must be calculated at least monthly.

Example policy:

> *Composite returns are calculated on a monthly basis by asset-weighting portfolio returns using beginning of month valuations. Consistent beginning and ending valuation dates are used for all periods. Monthly composite performance results are geometrically linked to obtain quarterly and annual results.*

Procedures to consider:

- The firm's procedures related to composite performance calculations should address the systems used, weighting methods (i.e., using beginning-of-period values or a method that reflects both beginning-of-period values and external cash flows), and the frequency for which calculations are performed.

Helpful hints:

- Firms should understand and test the methodologies used to calculate composite performance, particularly if third-party systems or vendors are being utilized.
- It may be helpful to include formulas and definitions to explain the methodologies used, including indicating if any details have changed over time.

X. Treatment of fees

A fee-paying portfolio incurs investment management fees, which are fees paid to the firm for the management of the portfolio. These investment management fees are typically asset based (a percentage of assets), performance based (based on the performance of the portfolio on an absolute basis or relative to a benchmark), or a combination of the two, but may take different forms as well.

The firm's policies and procedures should describe the methods used to calculate gross-of-fees and net-of-fees performance results. The GIPS standards define gross-of-fees performance as the return on investments reduced by any trading expenses incurred during the period. Net-of-fees performance is defined as the gross-of-fees return reduced by investment management fees (including performance-based fees and carried interest). The GIPS standards recommend presenting gross-of-fees returns. If net-of-fees returns are presented, investment management fees should be accrued.

Refer to the Guidance Statement on Fees for additional information.

Example policy:

Gross-of-fees composite performance figures do not reflect the deduction of investment advisory fees but have been reduced by all transaction costs. Net-of-fees composite performance figures typically reflect the deduction of actual investment advisory fees (including performance based fees), transaction costs, and, in certain instances, other expenses, which may include custodial and administrative fees. Investment management fees are accrued on a monthly basis.

In some instances, model fees are applied at the composite level to calculate net-of-fees results. When model fees are applied, the highest investment management fee incurred by portfolios in the composite is deducted from the monthly gross-of-fees composite return to calculate a net-of-fees return.

Procedures to consider:

- The firm should specify systems and formulas used in their policies and procedures.
- If actual fees are used, the firm should outline a process for validating that fees are accurately recorded.
- If model fees are used, the firm should detail how it confirms that the resulting net-of-fees returns are no higher than those that would have been calculated if actual fees had been used.
- Procedures should address the calculation of performance-based fees, if any.

Helpful hints:

- The treatment of fees is one area in particular where firms should consider the impact of local laws and regulations in addition to the GIPS standards. The firm should also consider the expectations of prospective clients and consultants in determining whether or not gross-of-fees or net-of-fees returns will be distributed. Regardless of which return a firm chooses to present, the firm should consider having both gross-of-fees and net-of-fees returns readily available as prospects may ask for either.
- Some account-holders choose to pay a fee based on a percentage of assets in lieu of per share commissions. Firms with these types of clients should be sure to include these trading costs in their calculation of gross-of-fees results.
- If model fees are used, firms should address how changes to a fee schedule are handled.

XI. Developing Compliant Presentations

A compliant presentation is defined as a presentation for a composite that contains all the information required by the GIPS standards and may also include additional information and supplemental information.

The following must be included in a compliant presentation (not a comprehensive list):

- At least five years of GIPS compliant performance (or since the firm's or composite's inception date). After five years, the firm must present an additional year of performance each year, building up to a minimum of 10 years of GIPS compliant performance.
- Annual composite returns that are clearly identified as gross-of-fees or net-of-fees.
- Annual benchmark returns that reflect the investment mandate, objective, or strategy of the composite.
- Number of portfolios as of each annual period end unless the composite contains 5 or fewer portfolios.
- Composite assets as of each annual period end.
- Either total firm assets or composite assets as a percentage of total firm assets as of each annual period end.
- A measure of internal dispersion of individual portfolio returns for each annual period unless the composite contains five or fewer portfolios for the full year.
- For periods ending on or after January 1, 2011, the three-year annualized ex-post standard deviation (using monthly returns) of both the composite and the benchmark as of each annual period end. An additional ex-post risk measure must be shown if standard deviation is not relevant or appropriate for the strategy.
- All applicable required disclosures.

For examples of compliant presentations, refer to the samples included in Appendix A of the 2010 edition of the GIPS standards.

Example policy:

> *Annual gross-of-fees and net-of-fees composite returns since inception are included in each compliant presentation. Initial periods shorter than a year are also presented, when applicable. The number of portfolios, composite assets, and total firm assets are presented as of each annual period end. The asset-weighted standard deviation of portfolio returns is presented as a measure of internal dispersion.*
>
> *At least one benchmark that reflects the strategy is presented on each composite, but a second or third benchmark may also be presented if deemed appropriate. If the firm*

believes that no appropriate benchmark exists, no benchmark will be presented and the reason will be disclosed in the compliant presentation.

All applicable, required disclosures are included in each compliant presentation and reviewed annually for changes or updates.

Procedures to consider:

- Firms should establish procedures for updating compliant presentations on at least an annual basis, though the recommended frequency is quarterly.
- Firms should establish procedures for reviewing and ensuring the accuracy of compliant presentations and that all required information is properly included. It is recommended that the firm maintain checklists or other relevant procedural documents for ensuring the completeness and accuracy of compliant presentations either as part of the firm's policies and procedures or as separate documents.
- Since the GIPS standards also require adherence to applicable laws and regulations regarding the calculation and presentation of investment performance results, firms should have procedures in place to help ensure that all marketing material has been reviewed for both regulatory requirements and compliance with the GIPS standards before it is approved for use.

Helpful hints:

- It may be helpful to include formulas to explain the firm's methodologies for internal dispersion and three year ex-post standard deviation.

XII. Distributing Compliant Presentations

Firms claiming compliance with the GIPS standards must make every reasonable effort to provide all prospective clients with a compliant presentation. The firm must not choose to which prospective clients it presents a compliant presentation. Firms must also establish policies and procedures for determining when an interested party becomes a prospective client.

Additionally, firms may choose to reference their claim of compliance with the GIPS standards in advertising materials. If so, the firm must follow the GIPS Advertising Guidelines or include a compliant presentation in the advertisement. The GIPS Advertising Guidelines provide firms with options for advertising performance when mentioning the firm's claim of compliance. The GIPS Advertising Guidelines do not replace the GIPS standards, nor do they absolve firms from presenting a compliant presentation as required by the GIPS standards. When following the GIPS Advertising Guidelines, the firm must meet specific reporting requirements, including referencing how a prospective client can obtain a compliant presentation and/or the firm's list of composite descriptions. If a firm chooses to utilize the GIPS Advertising Guidelines in certain situations rather than provide a compliant presentation, that fact should be noted in the firm's policies and procedures.

Example policy:

A prospective client is defined as any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite. Existing clients may also qualify as prospective clients for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as prospective clients if they represent investors that qualify as prospective clients. A person or entity will no longer be deemed a "prospective client" if after six months there is no longer communication with the prospective client or they no longer express interest in the composite strategy.

When initially distributing composite performance information to a prospective client, materials are always accompanied by a compliant presentation. Subsequent marketing presentations or requests for proposals (RFP) will typically also include a compliant presentation. At a minimum, all prospective clients that continue to be solicited after twelve months have passed will be provided with an updated compliant presentation. In addition, the firm will provide a compliant presentation to any client or prospective client upon request.

On occasion, the firm may refer to its claim of compliance with the GIPS standards in abbreviated advertisements. In these instances, the advertisement will be prepared in accordance with the GIPS Advertising Guidelines. A compliant presentation will generally not be included in the advertisement but will be made available upon request.

Procedures to consider:

- Firms must establish procedures for determining when an interested party becomes a prospective client and ensuring that the prospect receives a compliant presentation. An interested party becomes a prospective client when two tests are met. First, the interested party must have expressed interest in a specific composite strategy or strategies. Second, the firm must have determined that the interested party qualifies to invest in the respective composite strategy.
- Firms should implement procedures to monitor that all prospective clients have been provided with a compliant presentation within the last 12 months at a minimum, if the firm decides not to provide one more frequently at every touch point along the way. Best practice is to create a log to track all prospective clients.

- Firms may consider having the compliance department review and approve new compliant presentations or advertisements with performance information prior to dissemination, as well as when any subsequent changes are made to the presentations.
- Firms may want to compare returns in compliant presentations to returns in other advertisements, including responses to requests for proposals and consultant databases, to ensure stale or inaccurate information is not being distributed.

Helpful hints:

- Some prospective clients remain prospective clients for extended periods of time. Once a firm has provided a compliant presentation to a prospective client, the firm must provide an updated compliant presentation at least once every twelve months if the prospective client is still a prospective client.
- If a firm provides performance information to an investment consultant or a database, these entities qualify as prospective clients and they must receive the appropriate compliant presentation(s). They must also receive an updated compliant presentation at least once every twelve months.
- When a current client expresses interest in a strategy of the firm that the client is not already invested in, the client becomes a prospect for that strategy and, therefore, must receive a compliant presentation for the corresponding composite.
- Firms are encouraged to schedule regular internal training to keep the parties integral to the GIPS compliance process up-to-date on the requirements and changes within the GIPS standards, particularly as it relates to the distribution of compliant presentations as a wide range of departments and individuals may play a part in that process.

XIII. Record retention

Firms must have policies and procedures for capturing and maintaining all data and information necessary to support all items included in its compliant presentations. Although most firms are looking for a very precise list of the minimum supporting documents that must be maintained to support all parts of the compliant presentation, including the ability to recalculate the firm's performance history, there is not a single list of records that will suffice in all situations. Each firm must determine for itself which records must be maintained.

The Guidance Statement on Recordkeeping Requirements includes a list of records that firms should consider maintaining to meet this requirement.

Example policy:

The firm maintains documentation necessary to support information included in performance presentation materials in accordance with the Guidance Statement on Recordkeeping Requirements, Rule 204-2 under the Investment Advisers Act of 1940, and the firm's record retention policy.

Procedures to consider:

- The firm's procedures should outline who is responsible for maintaining required records and data, as well as how and where such information is stored and for how long.

Helpful hints:

- Above all else, a firm must comply with all applicable laws and regulations regarding the calculation and presentation of performance, including any recordkeeping requirements.
- Original hard copy documents are not required to be maintained. Firms can rely on electronic scans of paper documents in order to satisfy the recordkeeping requirements.
- Make sure that those involved in the legal/compliance area of the firm and those involved in compliance with the GIPS standards agree on data retention requirements and that responsibility is clearly defined. This should include records to support all aspects of a performance presentation, including supplemental information.

XIV. Error Correction

A firm must establish policies and procedures to ensure that it does not knowingly distribute performance and performance-related information that includes false or misleading information. However, for a variety of reasons, an error might occur in a firm's processes that results in errors in, or directly related to, a composite's compliant presentation. An error is defined as any component of a compliant presentation that is missing or inaccurate. Firms are required to document policies and procedures for addressing errors in compliant presentations.

The error correction policy must encompass not only errors in return calculation, but also errors to composite or firm assets, dispersion, omitted disclosures, and any other presentation or disclosure error that is deemed to be material. Changes in returns, along with other factors, are to be considered when evaluating materiality, such as absolute and relative change, whether it helped or hurt performance, change relative to the benchmark as well as how long ago the error occurred.

Refer to the Guidance Statement on Error Correction for additional information.

Example policy:

Since error correction policies will vary greatly from one firm to another, it is not reasonable to provide one example policy that would be applicable to a wide audience. Please refer to the requirements in the Guidance Statement on Error Correction as well as the considerations provided below.

Procedures to consider:

- The firm should create a procedure for documenting any error identified. Such documentation would include the date of the error, the cause of the error, the level of materiality, how the error was ultimately addressed, and actions taken to prevent similar errors in the future.
- The firm should establish procedures for tracking which compliant presentation(s) were provided to which prospective clients and when. Doing so will allow the firm to know who must receive a corrected compliant presentation in case the firm subsequently determines a previously distributed compliant presentation includes a material error. Such procedures will also allow the firm to determine when ongoing prospective clients must receive an updated compliant presentation.
- The firm should also consider implementing procedures for identifying potential errors, such as reviewing composites and performance advertising materials on a regular basis.

Helpful hints:

- Materiality must be defined and documented within the scope of the firm's error correction policy. In developing criteria for assessing the materiality of an error, keep in mind a key determinant of materiality: Could the error potentially change a prospective client's decision to invest?
- Consider how material the error is within the context of the entire compliant presentation. A number of immaterial errors in a presentation may add up to a material error when considering the presentation as a whole. In addition, both current and prior time periods should be considered.
- Remember that even a very small error may be material if it moves a composite from outperforming to underperforming its benchmark's return.
- Materiality thresholds may differ across asset classes (equities, fixed income, emerging markets, etc.), reporting frequency (monthly, quarterly or annual results), and time periods (more recent results may be considered more material than historical results, in some contexts).
- Consider a higher materiality threshold for volatile equity styles and a lower threshold for less volatile fixed income strategies.
- A number of disclosures required in a compliant presentation involve an offer to provide information, such as the firm's list of composite descriptions. Since the offer is a required

disclosure, the information provided in response to the offer (in this case, the list of composite descriptions) is directly related to a compliant presentation. Therefore, any error in the provided information must be treated as an error and the firm's error correction policies and procedures must be followed.

- It is wise to include in your error correction policies and procedures ways to deal with subjective or unanticipated issues. Keep in mind that the process for evaluating materiality should not be unduly influenced by the marketing/sales team or by those involved in preparing presentations. Consider establishing an Error Correction Committee with representation that includes the team responsible for compliance with the GIPS standards and those involved in regulatory compliance.

XV. Maintaining Compliance

Firms must create policies and procedures to monitor and identify changes to all of the updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee.

Firms must create policies and procedures to ensure that they adhere to all applicable laws and regulations regarding the calculation and presentation of performance. Firms must also have policies and procedures to identify and monitor changes and additions to laws and regulations regarding the calculation and presentation of performance.

Example policy:

The firm has a dedicated resource knowledgeable about the GIPS standards to manage the firm's GIPS Compliance Team. This individual has been tasked with all aspects of maintaining the firm's claim of compliance. The firm also receives third-party verification on an annual basis.

In order to stay informed of any new guidance, interpretations, or changes to the GIPS standards and laws and regulations, members of the GIPS Compliance Team:

- *Regularly attend industry conferences, including the GIPS Standards Annual Conference.*
- *Participate in webinars and other online training programs offered by industry leaders.*
- *Subscribe to newsletters and email alerts from CFA Institute related to the GIPS standards.*

- *Have completed or are candidates in the Certificate in Investment Performance Measurement (CIPM) certification program, which emphasizes knowledge of performance measurement, attribution, ethics, and the GIPS standards.*
- *Formed a Performance Advisory Council which consists of members from Compliance, Operations, Risk and Marketing and meets on a regular basis to discuss the firm's application of the GIPS standards and any other performance-related topics.*
- *Utilizes the firm's verification service provider for interpretations and applications of the GIPS standards.*

Procedures to consider:

- The firm should outline steps taken to ensure awareness of all changes to the GIPS standards, as well as Guidance Statements, interpretations, Q&As and other clarifications to the GIPS standards.
- The firm should also outline steps taken to ensure awareness of applicable laws and regulations that could impact the firm's claim of compliance.

Helpful hints:

- Consider at least two or more of the firm's staff subscribe to the GIPS Newsletter.
- As new guidance and interpretations are issued, consider their impact on the firm's existing policies and procedures and adjust accordingly. The GIPS standards are constantly evolving so a compliant firm's policies and procedures must continue to evolve as well.
- Identify a group or individual at the firm who is responsible for maintaining the policies and procedures as well as ensuring that all applicable requirements are being followed.
- If the firm engages industry experts (either consultants or verifiers) to keep them abreast of the changes to the GIPS standards, this should be highlighted in the firm's policy.

Conclusion

Sound and practical policies and procedures are the foundation of an accurate claim of GIPS compliance. Creating policies and procedures may require working with several departments such as accounting, compliance, legal, and portfolio management, among others. In addition, it is important to keep in mind that firms must have the ability to implement a policy that they decide to document. The firm needs to assess the resources available to them (time, systems, etc.) when determining what policies and procedures are feasible for their organization.

For more information on the GIPS standards, please refer to www.gipsstandards.org.