

# **Performance Advertising – Reconciling the GIPS® Standards with the Investment Advisers Act of 1940**

## ***United States Investment Performance Committee (USIPC)***

### **Introduction**

This white paper addresses key differences between the Global Investment Performance Standards (GIPS®) and requirements that investment advisers registered with the U.S. Securities and Exchange Commission (“SEC” or the “Commission”) pursuant to the Investment Advisers Act of 1940 (“Advisers Act”) are expected to follow. The term “key differences” used in this document equates to instances where a registered investment adviser (“RIA”) following a GIPS requirement or recommendation would have to follow some additional requirement(s) to adhere to the Advisers Act, no-action letters, or other regulatory releases. This paper is not intended to represent a comprehensive list of all regulatory or GIPS requirements and does not constitute legal advice. In addition, the rules and guidance described in this white paper promulgated by the SEC and/or CFA Institute are subject to change. This white paper is intended as a resource for those RIAs that claim compliance with the GIPS standards and is not an authoritative GIPS Guidance Statement with which firms must comply.

### **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 and were created and sponsored by CFA Institute through the collaboration with the global investment community. Compliance with the GIPS standards is voluntary and is not mandated by any law or regulation, but the SEC or other regulatory organizations may choose to test the legitimacy of a firm’s claim of compliance. In addition, the GIPS standards make it clear that firms that choose to comply must also comply with all applicable laws and regulations regarding the calculation and presentation of performance. In either case, it is clear that the GIPS standards are closely related to local regulatory requirements.

The Advisers Act generally defines an advertisement as any communication addressed to more than one person that offers any investment advisory service with regard to securities.<sup>1</sup> Investment adviser performance advertising and marketing pieces, whether they are used to obtain separate

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<sup>1</sup> Rule 206(4)-1(b).

account clients or pooled investment vehicle investors, should not be misleading.<sup>2</sup> Historically, most of the no-action letters and other guidance referenced by SEC examiners rely on the idea that potential investors should not be misled. During an examination of an RIA, the examiners may choose to assess a firm's adherence to the GIPS standards. It is generally the SEC examiners' view that it is a misleading statement if a non-compliant firm claims compliance with the GIPS standards in an advertisement.

A no-action letter is a letter provided by the SEC to a firm that requests an exception to a particular regulation. The firm explains itself, the regulation, and its intentions, and the SEC responds whether or not it would recommend taking enforcement action given the specifics of the situation. Once released, these letters are made publicly available so that other firms may choose to adhere to them as well. Firms that choose to adhere to a particular no-action letter should ensure that they follow each stipulation in the particular letter, as the relief provided is specific to the facts and circumstances presented. Administrative proceedings are non-judicial determinations of fault or wrongdoing. No-action letters and administrative proceedings that are typically referenced by the SEC staff in relation to performance advertising can be found on the Commission's website at [www.sec.gov](http://www.sec.gov) and include:

#### No-Action Letters

- [Clover Capital Management, Inc. \("Clover"\) – October 28, 1986](#)
- [Investment Company Institute \("ICI"\) – September 23, 1988](#)
- [J.P. Morgan Investment Management, Inc. \("JPMIM"\) – May 7, 1996](#)
- [Horizon Asset Management, LLC \("Horizon"\) – September 13, 1996](#)
- [Jennison Associates, LLC \("Jennison"\) – July 6, 2000](#)
- [Franklin Management, Inc. \("Franklin"\) – December 10, 1998](#)
- [The TCW Group, Inc. \("TCW"\) – November 7, 2008](#)
- [Investment Counsel Association of America, Inc. \("ICAA"\) – March 1, 2004](#)

#### Administrative Proceedings

- [In the Matter of Patricia Owen-Michel \(File No. 3-9107\) – September 27, 1996](#)
- [In the Matter of LBS Capital Management, Inc. \("LBS"\) \(File No. 3-9348\) – July 18, 1997](#)

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<sup>2</sup> Rule 206(4)-1(a)(5) of the Advisers Act makes it a fraudulent, deceptive, or manipulative act to provide advertisements which contain an untrue statement of material fact or which is false or misleading. Rule 206(4)-8 makes it a fraudulent, deceptive, or manipulative act for an investment adviser to make any untrue statement of a material fact or omit to state a material fact to any prospective investor in a pooled investment vehicle.

RIAs are required to establish written policies and procedures to prevent violations of the Advisers Act.<sup>3</sup> Among others, the written policies and procedures should address the accurate creation and maintenance of books and records, valuation, and marketing. Marketing procedures should be tailored to the risk and complexity of the firm.

The Commission generally does not dictate calculation methodology or composite construction requirements but what is generally expected is that the results portrayed are not misleading, that they are accompanied by adequate disclosure, and that calculations are made on a consistent basis. Calculation methodologies should be documented in written policies and procedures.

The following are eleven areas that RIAs should consider in order to adhere to both the SEC requirements and the GIPS standards. This should not be viewed as an exhaustive list, but is intended to address some of the more significant areas of performance advertising.

## **I. Discretion**

The GIPS standards define the term “discretion” somewhat differently than is typically applied by the SEC and investment advisers. RIAs that claim compliance with the GIPS standards should understand that this one term has two different definitions and that discretion from a regulatory perspective does not necessarily equate to discretion from a GIPS compliance perspective.

Specifically, the GIPS standards describe discretion as “the ability of the firm to implement its intended strategy.”<sup>4</sup> Firms have the liberty to make their own assessment as to what is necessary to implement their intended strategies and, therefore, create their own definitions of discretion. Generally, if client-imposed restrictions significantly hinder the firm from implementing its intended strategy for a particular portfolio (for example, liquidity or gain/loss constraints), then the firm may determine that the portfolio is non-discretionary. Under the GIPS standards, portfolios that are considered non-discretionary are prohibited from being included in any composite, while portfolios that are classified as discretionary by the firm must be included in at least one composite.

The SEC definition of discretion is somewhat more direct and prescriptive. In the instructions for filing Form ADV (the SEC’s uniform application for investment adviser registration), the Commission specifies that “your firm has discretionary authority or manages assets on a discretionary basis if it has the authority to decide which securities to purchase and sell for the client.”<sup>5</sup>

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<sup>3</sup> Rule 206(4)-7.

<sup>4</sup> GIPS Guidance Statement on Composite Definition.

<sup>5</sup> Form ADV: General Instructions; OMB Number: 3235-0049.

Because firms are granted the freedom to create their own custom definition of discretion for GIPS compliance purposes, this may lead to conflicts with the regulatory definition. In particular, it is possible that portfolios that satisfy the SEC definition of discretion may not satisfy a firm's internal definition of GIPS discretion. Specifically, a client may grant the adviser the authority to actively manage a portfolio while at the same time imposing highly restrictive guidelines that prevent the full implementation of the adviser's typical investment strategy. In this case, the portfolio would likely satisfy the SEC definition of discretion, but if the firm determined that the portfolio was non-discretionary for GIPS compliance purposes, it would still need to be excluded from all of the firm's composites.

## **II. Representative Account**

In addition to presenting composite results, some GIPS compliant firms choose to include representative account data or performance returns in marketing pieces as "supplemental information".<sup>6</sup> It is important that firms use consistent non-performance based criteria for choosing the representative account (i.e., the performance results achieved by the account should not be a factor in determining whether or not it is "representative"; instead the firm should use objective criteria in the selection process, such as the size of the account or the period of time under management) and that they incorporate the presentation of representative account data into their policies and procedures. Firms should meet each of the relevant requirements of the Clover no-action letter and should ensure that they prominently disclose that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.

## **III. Benchmark Description**

Under the GIPS standards, firms are required to disclose a description of the benchmark used<sup>7</sup> and firms that seek to rely on the Clover no-action letter are required to disclose, if applicable, all material facts relevant to the comparison of firm results to the benchmark.<sup>8</sup> The example given in the Clover no-action letter is a firm that compares results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio. Other composite and index differences that could be material may relate to the level of domestic and international securities, differences in cash positions, or differences in credit quality, duration, and liquidity for fixed income securities. Firms may want to implement policies and procedures to periodically

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<sup>6</sup> As defined in the GIPS standards, supplemental information is any performance-related information included as part of a compliant presentation that supplements or enhances the required and/or recommended provisions of the GIPS standards. See the GIPS Guidance Statement on the Use of Supplemental Information for further information.

<sup>7</sup> Provision 4.A.4 of the 2010 edition of the GIPS standards.

<sup>8</sup> It is currently only a GIPS standards recommendation that firms should disclose material differences between the benchmark and the composite's investment mandate, objective, or strategy (Provision 4.B.3 of the 2010 edition of the GIPS standards).

compare composites to their benchmarks to ensure that the benchmark is appropriate and to ensure that material differences are understood and disclosed.

#### **IV. Net-of-Fees**

There are several disclosures and considerations that are needed for RIAs claiming compliance with the GIPS standards as it relates to the applicability of fees on returns presented in marketing pieces. The GIPS standards recommend that gross-of-fees returns be presented<sup>9</sup> but RIAs generally must present net-of-fees returns if they choose to advertise performance. To satisfy both sets of expectations, many RIAs choose to consistently present both net- and gross-of-fees returns with equal prominence regardless of what would be explicitly required in a specific advertising scenario.

In item number 2 of the Clover no-action letter, the SEC's Division of Investment Management ("Division") stated that Rule 206(4)-1(a)(5) prohibits advertisements that includes model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid. However, the ICI no-action letter references providing gross-of-fees advertisements on a one-on-one basis if the advertisement includes four additional written disclosures.

1. Disclosure that the performance figures do not reflect the deduction of investment advisory fees;
2. Disclosure that the client's return will be reduced by the advisory fees and any other expenses it may incur in the management of its investment advisory account;
3. Disclosure that the investment advisory fees are described in Part II of the adviser's Form ADV; and
4. A representative example (e.g., a table, chart, graph, or narrative), which shows the effect an investment advisory fee, compounded over a period of years, could have on the total value of a client's portfolio.

Many RIAs, including wrap fee/SMA sponsors, choose to present net-of-fees results using a model fee instead of actual fees. Firms claiming compliance with the GIPS standards are required to disclose if model or actual investment management fees were used in the presentation.<sup>10</sup> In these instances, RIAs should ensure that the model fee used is the highest fee charged to any account employing the strategy. Specifically, in the JPMIM no-action letter, the Division stated that it "would not recommend enforcement action to the Commission if JPMIM advertises the composite performance of accounts for which it employs a particular investment

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<sup>9</sup> Provision 5.B.1 of the 2010 edition of the GIPS standards.

<sup>10</sup> Provision 4.A.6 of the 2010 edition of the GIPS standards.

strategy by deducting a model fee equal to the highest fee charged to any account employing that strategy during the performance period.” Firms may want to implement policies and procedures designed to periodically compare model fees used in marketing material to the fees charged to accounts in a composite to ensure compliance with the JPMIM no-action letter.

## **V. Total Return Performance**

While the GIPS standards mandate that total returns (returns that include realized and unrealized gains and losses plus income for the measurement periods) must be used in performance presentations, this is strictly a calculation requirement that is not accompanied by any explicit disclosure requirement. However, the Clover no-action letter suggests that RIAs should disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings. A firm that claims compliance with the GIPS standards and meets the stated calculation requirement may still be found deficient if it does not also include disclosure language in its materials consistent with the Clover no-action letter.

## **VI. Performance Record Portability**

Under certain scenarios, a firm that claims compliance with the GIPS standards is required to present performance results achieved by investment management personnel while they were employed with a prior firm. The GIPS Guidance Statement on Performance Record Portability outlines the criteria that, if met, would require the performance of a past firm or affiliation to be linked to or used to represent the historical performance of a new or acquiring firm if, on a composite-specific basis:

1. Substantially all of the investment decision makers are employed by the new or acquiring firm (*e.g.*, research department staff, portfolio managers, other relevant staff);
2. The decision-making process remains substantially intact and independent within the new or acquiring firm; and
3. The new or acquiring firm has records that document and support the performance.

The firm must also disclose that the performance from a prior firm or affiliation is linked to the performance of the firm.

The SEC has also offered materially similar guidance in regard to performance record portability in the Horizon no-action letter. Of note, where the GIPS standards require the linking of prior firm performance in instances where the portability requirements have been met, the Horizon no-action letter only prescribes the presentation of prior firm performance as a potential option, not

a requirement. In addition, where the GIPS standards require the presentation of composites that represent all accounts managed to a particular investment strategy, Horizon gives flexibility for the omission of certain portfolios if they would not have a material impact on the performance results presented.

The GIPS standards allow firms to report, though not link, non-portable prior firm performance if it is treated as “supplemental information,” provided the new or acquiring firm has all data and information necessary to support the performance. However, RIAs would still need to consider the stipulations outlined in the Horizon no-action letter which could prevent RIAs from presenting the non-portable returns.

## **VII. Model, Hypothetical, Backtested, or Simulated Returns**

The GIPS Guidance Statement on the Use of Supplemental Information states that model, hypothetical, backtested, or simulated returns may be presented as “supplemental information” but must not be linked to actual returns. However, advisers should reference the Clover no-action letter and the Patricia Owen-Michel and LBS Capital Management administrative proceedings, which specify many of the disclosure and reporting details that RIAs should consider. In particular, as discussed in Patricia Owen-Michel and LBS Capital Management proceedings, firms that present backtested results as supplemental information should disclose that the results do not represent the results of actual trading using client assets, but were achieved by means of the retroactive application of a model designed with the benefit of hindsight. As outlined in the Clover no-action letter, advisers that advertise model performance must also prominently disclose the limitations inherent in such results, particularly the fact that model results do not represent actual trading and that they may not reflect the impact that material economic and market factors might have had on the adviser’s decision-making if the adviser were actually managing clients’ money.

Advertisements may need additional disclosures if necessary to keep advertisements from being misleading. Therefore, an adviser must carefully consider the requirements outlined in the Clover no-action letter as well as other administrative proceedings to help ensure the proper disclosures are included, depending on the situation. For example, firms should consider additional disclosure in cases of:

- Material changes to the model portfolio
- Unusual market conditions during the time period portrayed
- Impact of significant securities in the portfolio unrelated to the investment strategy
- Clients following the model portfolio with materially different results

As with the presentation of actual performance results, model or simulated returns must also not be false or misleading.

## **VIII. Past Specific Recommendations**

RIAs regularly provide potential clients with historical performance data. They may also provide their previous security recommendations, which are examples of some of the transactions entered into by their clients. These past specific recommendations are typically used as a way to describe the firm's investment process. According to the GIPS standards, past specific recommendations may be presented as supplemental information.

According to the Clover no-action letter, advisers must not suggest or make claims about the potential for profit without also disclosing the possibility of loss. Many advisers seek to achieve this goal by disclosing in their materials that past performance is not indicative of future results and that there is a potential for loss as well as for profit.

According to Rule 206(4)-1(a)(2) of the Advisers Act, RIAs that choose to present past specific recommendations in advertisements would need to, among other things, provide a list of all securities recommended by the RIA over the past year. However, the Division provided no-action relief for advisers wishing to present past specific recommendations in advertisements without presenting a list of all recommended securities via the Franklin and TCW no-action letters. The Franklin no-action letter permits RIAs to present a sample of past specific recommendations if, among other things, they use the same objective non-performance based criteria to select the specific securities for each quarter and for each investment category and if they do not discuss, directly or indirectly, profits and losses. Many firms choose to list and discuss their ten largest holdings but they are careful not to discuss their profitability directly or indirectly. An indirect discussion of profitability could arise if a firm were to indicate the security's purchase price.

The TCW no-action letter allows firms to present past specific recommendations and discuss profits and losses if, among other things, the RIA meets the requirements outlined in the letter and the RIA calculates, on a consistent basis, each holding's contribution to the account's return and presents at least five of the positive and five of the negative contributors to the account.

## **IX. Advertising Guidelines**

When presenting performance-related information, many firms that claim compliance with GIPS adhere to the GIPS Advertising Guidelines which allows them to provide a subset of the information required for a compliant presentation in advertisements that include the claim of GIPS compliance. For the purposes of the GIPS Advertising Guidelines, an advertisement includes any materials that are distributed to or designed for use in newspapers, magazines, firm brochures, letters, media, websites, or any other written or electronic material addressed to more

than one prospective client.<sup>11</sup> The GIPS Advertising Guidelines specifically exclude one-on-one presentations and individual client reporting from the definition of an advertisement.

RIAs should consider the Clover no-action letter and should note that each of the advertisements listed in the GIPS Advertising Guidelines would necessitate the reporting of net-of-fees returns or both gross- and net-of-fees returns. Firms would not be able to rely on the ICI no-action letter to present gross-of-fees returns as, by definition, the advertisements would not be marketing material presented on a one-on-one basis.

RIAs should also be aware that, in the ICAA no-action letter, the Division stated that it believes that a written communication by an investment adviser that does no more than respond to an unsolicited request by a client, prospective client, or consultant for specific information about the adviser's past specific recommendations is not an advertisement.

## **X. Significant Events**

The Clover no-action letter also stipulates that RIAs should disclose the effect of material market or economic conditions on the results portrayed. Similarly, the GIPS standards require that firms disclose all significant events that would help a prospective client interpret the compliant presentation.<sup>12</sup> The GIPS requirement is generally viewed as addressing firm or composite specific issues that would be relevant to the reader of a compliant presentation, such as the departure of a key portfolio manager. The language in the Clover no-action letter, however, may be viewed as more broadly addressing external factors that may have influenced the results achieved during a particular time period, such as changes in interest rates. Though many firms may not have any relevant issues that would meet either set of criteria, firms with returns skewed by an event that is unlikely to occur in the future (whether due to internal or external factors) should consider discussing the event and the impact on results, if material. For instance, some firms have made additional disclosures when their composites' results were materially impacted by a significant amount of highly profitable initial public offerings.

## **XI. Recordkeeping**

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<sup>11</sup> A "prospective client" is defined in the GIPS standards 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."

<sup>12</sup> Provision 4.A.14 of the 2010 edition of the GIPS standards.

The GIPS Guidance Statement on Recordkeeping Requirements reiterates that all records deemed necessary by the firm must be maintained for each year that is presented in a compliant presentation.<sup>13</sup> The Advisers Act is more descriptive in this area and requires that records be maintained and preserved in an easily accessible place for at least five years (the first two years in an appropriate office of the adviser) from the end of the fiscal year during which the adviser last published or disseminated the communication.

If the underlying data to support the compliant presentation was destroyed because of extreme circumstances beyond the control of the manager and unavailable from other sources, the GIPS Guidance Statement on Recordkeeping Requirements states that the firm may continue to claim compliance and show performance if the lack of records for the unavailable period(s) is disclosed. The disclosure must include the reason why the records are unavailable and state that the firm is unable to duplicate the records. RIAs should note that the Advisers Act does not allow firms to present unsubstantiated performance results. Also, in a no-action letter to Jennison, the Division staff specifically did not, as a matter of policy, provide no-action assurances regarding whether an investment adviser's particular records are sufficient to form the basis for, or demonstrate the calculation of, the investment performance of the adviser's managed accounts or securities recommendations.

The GIPS Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios establishes that certain firms do not maintain or have access to the data necessary to substantiate portfolio-level performance and that, in order to satisfy this requirement of the GIPS standards, firms may choose to "Place reliance on the performance calculated and reported by the wrap fee/SMA sponsor." There is no formal guidance from the SEC stating that firms can rely on wrap fee/SMA sponsors to maintain records to demonstrate performance calculations.

## **Conclusion**

While adhering to the GIPS standards may bring RIAs closer to being compliant with the Advisers Act as it relates to performance advertising, care must be taken to understand the Advisers Act, no-action letters, and associated regulatory releases to ensure all requirements have been met. In many instances, firms may want to seek advice from an attorney or consultant that specializes in RIA performance advertising.

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<sup>13</sup> As defined in the GIPS standards, a "compliant presentation" is a presentation for a composite that contains all the information required by the GIPS standards and may also include additional information or supplemental information.