Global Investment Performance Standards

GIPS® 20/20

CONSULTATION PAPER

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CFA Institute

www.gipsstandards.org

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Introduction

The mission of the CFA Institute GIPS® Executive Committee is to

> *Promote ethics and integrity and instill trust through the use of the Global Investment Performance Standards by achieving*
>
> - *universal demand for compliance by asset owners,*
> - *universal adoption by asset managers, and*
> - *universal support from regulators*
>
> *for the ultimate benefit of the global investment community.*

In order to achieve this mission, it is necessary for the Global Investment Performance Standards (GIPS) to be relevant and applicable to all asset managers, regardless of structure, client type, asset class, or investment strategy. Although part or all of 85 out of the top 100 asset managers in the world are GIPS compliant, there has not been widespread adoption among alternative investment managers and managers of pooled funds. The GIPS standards in their current form can be improved to facilitate such adoption. We must, therefore, examine the underlying causes and respond by updating, revising, and reimagining the GIPS standards. We are calling this project GIPS 20/20, to reflect that not only do we hope to have the project completed by 2020 but, more importantly, this is our vision for the future.

The GIPS 20/20 project offers an opportunity for the industry to reflect and provide input on how the GIPS standards can support the industry for the benefit of investors. It is also an opportunity to learn about challenging issues that investment managers and asset owners are facing that we should consider as we look forward to 2020. Some of the ideas are evolutionary and others are revolutionary. We encourage you to take a step back and, with an open mind, consider how things should be, rather than how things have always been done. Our goal is to move the industry forward and, at the same time, streamline the GIPS standards ensuring they are as relevant and straightforward as possible.

The goals for this consultation paper are to provide our thinking on important potential changes and to elicit your feedback. Your input on these ideas and issues will help shape the GIPS 20/20 Exposure Draft, which we expect to publish in early 2018 for a 90-day comment period. Please provide your comments on this consultation paper by (16 July 2017). Comments can be sent to (standards@cfainstitute.org).

1. Structure

The GIPS standards as they are now focus primarily on the use of composites, which are the aggregation of individual portfolios managed to the same strategy. Although this is useful in situations where firms are presenting strategies to prospective clients who are interested in having the firm manage a separate account, when firms are selling participation in an individual pooled fund, composite reporting may not be relevant or appropriate. There needs to be clear guidance on situations where the firm is not selling a composite strategy but instead is selling participation in a pooled fund. There is another fundamental difference between how composite performance is presented by investment managers and asset owners. Investment managers have prospective clients and asset owners do not, and asset owners primarily report performance to their oversight boards.

Therefore, we are planning to structure the 20/20 edition of the GIPS standards differently. We believe that the relationship between the party presenting performance (i.e., the investment manager or asset owner) and the receiver of the information (i.e., prospective client, prospective pooled fund investor, or oversight board) is the defining criterion regarding how performance should be presented. Our thinking is to organize the GIPS standards into three "pillars," based on the following:

- *One to one*—composite performance is appropriate. This pillar is where the investment manager has an individual, one-to-one relationship with the client. For example, a typical institutional separate account would fall under this category. This type of relationship is usually characterized by the client's ability to have input into the management of their portfolio (e.g., specific risk constraints, liquidity level), resulting in a customized, client-specific portfolio. This pillar will have many of the same requirements and recommendations currently seen in the GIPS standards.
- *One to many*—fund performance is appropriate. This pillar is where the investment manager is selling participation in a specific pooled fund. This pillar will expand on the concepts currently in the Guidance Statement on Broadly Distributed Pooled Funds and include guidance for all pooled funds, including limited distribution pooled funds, as well as closed-end, fixed life, fixed commitment portfolios where investment managers control the cash flows.
- *One to none*—for asset owners that have no prospective clients. This pillar will have many of the same requirements and recommendations in the Guidance Statement on the Application of the GIPS Standards to Asset Owners.

Question 1: Do you agree with the pillars concept? If so, should there be any other pillars?

2. Pooled Funds

One of our goals with the 20/20 edition is to better accommodate the presentation of pooled fund performance versus composite performance. We have begun to apply this concept with the recently issued Guidance Statement on Broadly Distributed Pooled Funds. GIPS 20/20 will expand on the concepts in this Guidance Statement.

Currently firms are required to make every reasonable effort to provide a compliant presentation to all prospective clients. Firms will still be required to do so when they are marketing a composite strategy. In GIPS 20/20, we are proposing that firms managing any type of pooled fund would be required to present to prospective investors in those funds a pooled fund report that would include only the pooled fund's information. The information required to be included in a pooled fund report will depend on whether the pooled fund is typically broadly distributed or not and whether it is a closed-end, fixed life, fixed commitment fund where the investment manager controls the cash flows. The fund report information may differ from the information included in a composite compliant presentation. We believe that the performance of a single fund that is presented to prospective investors should be required to be presented net of all fees and expenses because this reflects the pooled fund client experience. In addition to presenting returns that are net of all fees and expenses, firms may choose to present gross-of-fees returns as permitted by regulatory requirements.

Pooled funds would still be required to be included in the appropriate composite according to the investment mandate, objective, or strategy if they meet the composite definition. However, firms would not be required to create single-fund composites simply to meet the requirement that "all fee-paying discretionary portfolios must be included in at least one composite." Firms would be required to create a list of all composite and pooled fund descriptions.

Question 2: Do you agree with the proposed treatment of pooled funds?

3. Asset-Class-Specific Guidance

Currently the GIPS standards have specific provisions and guidance on private equity, real estate, alternative investment strategies and structures, and wrap fee/separately managed account (SMA) portfolios. We propose reducing the number of asset-class-specific guidance wherever possible. For example, many of the requirements for private equity and closed-end real estate funds are very similar. These requirements were created as a result of the investment structure (e.g., closed-end limited partnership) rather than the specific asset class. The current private equity and real estate closed-end fund provisions could be consolidated and could include other strategies that use a similar investment structure.

Question 3: Do you agree that asset-class-specific guidance should be consolidated where possible?

4. Time-Weighted Rates of Return vs. Internal Rates of Return

We would like to eliminate the current approach in which the return required to be used is based on the underlying investments in the portfolio, and instead, base the calculation methodology decision on the portfolio structure. For open-end funds and composites with separate accounts, time-weighted rates of return (TWRR) would be required. For closed-end, fixed life, fixed commitment funds, for which the investment manager controls the cash flows, firms would be allowed to present internal rates of return (IRR) or TWRR. Once a firm determines which methodology is more appropriate, it would create a policy and apply it consistently to the pooled fund or composite. This change would allow the GIPS standards to be more readily adopted by firms that offer fixed life, fixed commitment products where the investment manager controls the cash flows.

Question 4a: Do you agree with the proposal that firms should be allowed to choose whether to present IRRs or TWRRs for any closed-end, fixed life, fixed commitments fund where the firm controls the timing of the cash flows?

Question 4b: What criteria should be required for a firm to be allowed to present an IRR versus TWRR?

5. Valuation Frequency

For time-weighted rates of return, the more frequent the valuation and performance calculation, the more accurate the return. The requirement at this time is that firms calculating TWRRs must value portfolios monthly and at the time of all large cash flows. We have heard from some firms that valuing at the time of large cash flows means that they must have the ability to value daily anyway and that they moved to daily valuation years ago. That said, we remember the concerns that some firms had in 2010 about being able to value daily. These concerns brought us to the current requirement to value monthly and at the time of large cash flows.

When calculating IRRs, we are proposing that portfolios would be required to be valued annually. We are also proposing that firms would be required to value portfolios whenever performance is calculated and reported to prospective clients or prospective fund investors. For example, if a firm is calculating IRRs through 30 June, the firm must value the portfolio as of 30 June.

Question 5a: For calculating TWRR, do you believe that valuing monthly and at the time of all large cash flow suffices?

Question 5b: For calculating IRR, do you agree with the proposed valuation frequency for all portfolios regardless of the underlying investment or asset class?

6. Distribution of Composite Compliant Presentations and Pooled Fund Reports to Existing Clients

The GIPS standards have always been focused primarily on the prospective client relationship and the information that must be provided to prospective clients. Currently, investment management firms are required to make every reasonable effort to provide a compliant presentation to all prospective clients. No GIPS-compliant information is required to be provided to existing clients.

In the situation where investment managers of closed-end, fixed life, fixed commitment funds are raising capital for a new fund, there is typically no fund track record available to present because the fund has not yet begun investing. Therefore, the GIPS-compliant fund report with a performance track record would never be seen by the investors in that fund if the requirement is limited to prospective clients.

Also, once a prospective client becomes an existing client under the current requirements, they would never again be required to receive a GIPS-compliant presentation of the composite's performance track record. Although an existing client has initially made the decision to invest with an investment management firm, it is constantly evaluating that decision and determining whether to add, withdraw, or continue investing at the same level. An existing client is effectively always a prospective client. The same is true for existing pooled fund investors.

We believe that GIPS-compliant information should be provided to existing clients/pooled fund investors as well as prospective clients/pooled fund investors. We, therefore, are proposing that investment management firms should be required to make every reasonable effort to provide the composite compliant presentation or pooled fund report to existing clients/investors in the composite/pooled fund on an annual basis. Alternatively, we are considering proposing that investment management firms make an offer to provide a composite compliant presentation or pooled fund report to existing clients/pooled fund investors on an annual basis.

Question 6a: Do you agree that firms should be required to provide a pooled fund report to investors in the pooled fund on an annual basis?

Question 6b: Do you agree that firms should be required to provide a compliant presentation to existing clients in the composite on an annual basis?

Question 6c: Do you agree that firms should be required to make an offer to provide a composite compliant presentation or pooled fund report to existing clients or pooled fund investors on an annual basis?

7. Total Firm Assets

We recognize that advisory assets are becoming a larger part of the investment management industry. These assets include unified managed accounts (UMAs), model portfolios, and advisory-only portfolios. Currently these assets are not included in GIPS total firm assets. The underlying portfolios in overlay strategies that are not managed by the firm are also excluded from total firm assets. We are considering whether these assets should be included in compliant presentations differently by creating a new category of assets that includes assets managed, advised, and overlaid. We are also considering whether this information should be required or recommended to be included in compliant presentations.

Question 7a: Do you agree with creating a new category of assets as described above?

Question 7b: Which assets should be included in this new category of assets (e.g., UMAs, models, overlay, and advisory-only portfolios)?

Question 7c: Should firms be recommended or required to report this new category of assets as well as total firm assets in compliant presentations?

8. Non-Fee-Paying Portfolios

Currently only actual, fee paying, discretionary portfolios must be included in a composite. Firms may choose to include or exclude non-fee-paying portfolios from composites. We are considering removing the "fee-paying" criterion, so that all actual discretionary portfolios must be included in a composite. Doing so would ensure that composites include all portfolios managed according to a specific strategy.

Question 8a: Do you agree with no longer allowing firms to exclude non-fee-paying portfolios from composites based solely on fee-paying status?

Question 8b: How should non-fee-paying portfolios be treated for net-of-fees calculations?

9. References to the Firm's Claim of Compliance

Currently firms can state that they claim compliance with the GIPS standards in only three ways: in a compliant presentation, in an advertisement that is prepared in accordance with the GIPS Advertising Guidelines, and in a GIPS Pooled Fund Claim of Compliance that is included in the official pooled fund document or fund-specific marketing material for a broadly distributed pooled fund. We are considering expanding how firms can demonstrate that they are in compliance beyond the three ways allowed now. It is important that firms be able to state that they are GIPS-compliant in more than just these three ways. Including a statement that the firm claims compliance with the GIPS standards in more marketing materials would help to increase awareness of the GIPS standards.

Question 9: Do you agree that firms should have more flexibility to state that the firm complies with the GIPS standards?

10. Timeliness and Frequency of Compliant Presentations

As previously discussed, firms must make every reasonable effort to provide a compliant presentation to all prospective clients. Currently, there is no guidance on the timeliness of the compliant presentation. Some firms are distributing compliant presentations that are not current (e.g., in September 2016, providing prospective clients with compliant presentations that include annual returns through December 2014). We understand that some firms are reluctant to update compliant presentations until the firm's verification is complete. We are considering requiring firms to provide compliant presentations to prospective clients on a timely basis that include more current performance.

Question 10a: Do you agree with requiring firms to update compliant presentations on a timely basis?

Question 10b: How current should the information be required to be in a compliant presentation?

11. Estimated Trading Expenses

Currently, all returns must be calculated after the deduction of actual trading expenses incurred during the period and estimated trading expenses are not allowed. When the GIPS standards were originally created, trading expenses were generally higher than they are now and were more standardized. Today, trading expenses can be charged in a variety of ways and may not be under the control of the firm. Indeed, in some instances, firms may not have the ability to determine how or where trading expenses are charged. We, therefore, are considering allowing firms to use estimated trading expenses, if returns are equal to or lower than those that would have been calculated if actual trading expenses had been used. We would expect firms to determine the estimated trading expense rate based on other portfolios managed by the firm that do pay them.

Allowing estimated trading expenses may eliminate the need for specific wrap fee/SMA requirements and recommendations.

Question 11: Do you agree with allowing firms to use estimated trading expenses?

12. Compliant Presentation Numerical Information and Disclosures

Firms are required to include certain numerical information and disclosures in compliant presentations. We hope to eliminate any items that are not particularly helpful or informative.

We would also like to consider whether there are other items that should be required to be included in compliant presentations (e.g., attribution information or asset allocation).

In addition, we are considering whether there are disclosures that are only relevant for a certain length of time (e.g., five years) and should be allowed to be removed from compliant presentations because they are no longer relevant.

Question 12a: Which existing numerical information and disclosure requirements, if any, should be removed?

Question 12b: Is there any information not currently required that should be required in compliant presentations?

Question 12c: Are there any disclosures that can be discontinued after a certain period-of-time?

13. General

Question 13: Are there other issues that are important for us to address as part of the GIPS 20/20 project (e.g., private wealth, outsourced CIO, model/hypothetical performance, carve-outs and “building blocks”)?