Reconciling the SEC Marketing Rule to the GIPS® Standards for GIPS-Compliant Firms

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The CFA Institute Global Investment Performance Standards (GIPS®) are ethical standards for calculating and presenting investment performance based on the principles of fair representation and full disclosure. They are voluntary industry standards that provide transparency and global comparability in a world where regulations and market practices can differ significantly between jurisdictions. The GIPS standards are developed, maintained, and promoted through the collaboration of individual volunteers from the investment community, CFA Institute, and GIPS Standards Sponsors in over 40 markets. CFA Institute is a global not-for-profit association of investment professionals with the mission of leading the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

As of June 30, 2021, more than 1,800 firms globally claim compliance with the GIPS standards, with a majority of these firms (≈75%) coming from the United States. Each of these firms will therefore need to reconcile their current policies for complying with the GIPS standards to the new SEC Marketing Rule.

Firms that do not currently claim compliance with the GIPS standards may also need to gain an understanding of the GIPS standards. While compliance with the GIPS standards is not required by the Marketing Rule, the GIPS standards clearly influenced the final Marketing Rule – they are mentioned 26 times in the Adopting Release, and the CFA Institute comment letter on the Exposure Draft was cited 69 times.

Background

Firms that claim compliance with the GIPS standards must comply with all of the applicable requirements of the GIPS standards on a firmwide basis. These requirements address how performance must be calculated, for which portfolios, and for which periods. Firms are required to make every reasonable effort to provide a GIPS Report to all prospects. A GIPS Report includes all of the required information for the product (a composite or a pooled fund) the firm is presenting. A GIPS Report will include 10 years of performance and other numerical information, such as total firm assets and the number of portfolios in the composite, and a series of disclosures.

GIPS Reports are standardized marketing materials that typically are not tailored to each individual prospect and would be considered an advertisement for SEC purposes.

This article is based on the current 2020 edition of the GIPS standards. Some terms used in the GIPS standards are different from the terms used in the Marketing Rule, and this article uses the terms that are consistent with the respective source. Finally, as of the date of this article (September 2021), the SEC had issued only two FAQs, addressing early adoption and the speed with which advertisements must be updated after year end. Here are key differences between the GIPS standards and the SEC Marketing Rule that GIPS-compliant firms should know.

1. Use of composite performance.

GIPS Standards: A key concept in the GIPS standards is the use of composites. A composite is an aggregation of one or more portfolios that are managed according to a similar investment mandate, objective, or strategy. When presenting performance of a strategy, a firm must present composite performance. The composite must include all portfolios managed in that strategy. For example, if a firm manages 10 large cap value portfolios, the Large Cap Value Composite must reflect the performance of all 10 large cap value portfolios.

Marketing Rule: The Marketing Rule allows performance of related portfolios to be presented. Related portfolio is defined as a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement. Related performance can be presented:

- For each related portfolio, on a portfolio-by-portfolio basis, or
- For the combination of all related portfolios (a "composite aggregation").

The Marketing Rule allows flexibility when calculating strategy performance. Related performance may exclude related portfolios as long as the performance is not materially higher than if all related portfolios had been included, and the exclusion of any related portfolio does not affect the time periods that are presented.

Reconciliation: Firms that claim compliance with the GIPS standards do not need to make any changes to composite calculation policies. Firms that do not currently claim compliance may choose to present performance for each related portfolio. However, unless the firm manages a very small number of related portfolios for a specific strategy, this will not be practical. Therefore, a firm will need to calculate composite performance, whether it uses performance of the composite aggregation, or instead uses performance that excludes certain related portfolios. As stated in the Adopting Release, the adviser would likely need to calculate the performance of all related portfolios to ensure that the exclusion of certain portfolios meets the Marketing Rule's conditions.

GIPS-compliant firms also need to determine how the Marketing Rule will affect their ability to use representative accounts. Performance of a representative account would be allowed only if is not materially higher than composite performance and it does not affect the time periods presented.

2. Calculating gross returns

GIPS Standards: The GIPS standards require gross returns to reflect the deduction of transaction costs. (Transaction costs are the costs of buying or selling investments and include brokerage commissions and bid-offer spreads. For real estate, private equity, and other private market investments, transaction costs also include all legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing investments but do not include dead deal costs.) If the portfolio invests in underlying pooled funds, gross returns must also reflect the deduction of all fees and expenses, including administrative fees, incurred by these portfolio investments.

Marketing Rule: The Marketing Rule does not require gross returns to reflect the deduction of transaction fees and expenses. It also does not require gross returns to reflect the deduction of fees and expenses incurred by underlying investment vehicles.

Reconciliation: GIPS-compliant firms do not need to make any changes to gross return calculation policies. A firm may choose to calculate returns that meet the SEC requirements for calculating gross returns, which do not reflect the deduction of transaction fees and expenses, but these would be considered a "pure" gross return for GIPS compliance purposes. Pure gross returns may be included in a GIPS Report alongside GIPS-compliant information as supplemental information, but these are not considered proper gross returns and may not be presented as such.

3. Calculating net returns

GIPS Standards: The GIPS standards differentiate calculating net returns for composites versus pooled funds. When calculating net returns for a composite, the GIPS standards require net returns to reflect the deduction of transaction costs and investment management fees. Investment management fees include asset-based fees, performance-based fees, and carried interest. If the portfolio invests in underlying pooled funds, net returns must also reflect the deduction of all fees and expenses incurred by these portfolio investments.

When calculating net returns for a pooled fund for the purpose of presenting pooled fund performance, the GIPS standards require net returns to reflect the deduction of transaction costs and investment management fees, as is required for composite net returns. However, the GIPS standards also require net returns to reflect the deduction of administrative fees and any other fees and expenses charged to the pooled fund. This would be equivalent to a net asset value (NAV)–based return.

Marketing Rule: The Marketing Rule defines net performance as performance results after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio. Net returns must therefore reflect the deduction of advisory fees paid to the adviser, as well as advisory fees paid by underlying investment vehicles. Consistent with the approach to gross returns, the Marketing Rule does not require net returns to reflect the deduction of transaction fees and expenses.

Reconciliation: GIPS-compliant firms do not need to make any changes to net return calculation policies, unless the firm provides custody services. If this is the case, net returns will need to be adjusted to reflect the deduction of custody fees.

4. Conditions for presenting gross and net returns

GIPS Standards: The GIPS standards allow returns included in GIPS Reports to be gross returns, net returns, or both, with one exception. For composites of wrap fee portfolios, the GIPS Report must include net returns that reflect the deduction of the entire wrap fee that a prospect would pay. However, the GIPS standards require firms to comply with all applicable laws and regulations regarding the calculation and presentation of performance. Because GIPS Reports are widely distributed, most firms treat them as advertisements and include net returns to meet current SEC advertising requirements.

With respect to return type, the GIPS standards require firms to present time-weighted returns (TWRs) unless very specific circumstances are met. A TWR is a method of calculating period-by-period returns that reflects the change in value and negates the effects of external cash flows, which are generally client driven. Firms should not be rewarded or penalized for investment decisions outside of their control.

There are some strategies and pooled funds, however, for which the timing and the size of cash flows are controlled by the firm and are part of the investment decision process. In such cases, it is appropriate that performance reflects the results of the investment manager's cash flow timing decisions. A money-weighted return (MWR) is a return for a period that reflects the change in value and the timing and size of external cash flows.

A firm may present MWRs instead of TWRs if the firm has control over the external cash flows into and out of the portfolios in the composite or the pooled fund, and each of the portfolios in the composite have or the pooled fund has at least one of the following characteristics:

- It is closed-end.
- It has a fixed life.
- It has a fixed commitment.
- Illiquid investments are a significant part of the investment strategy.

Marketing Rule: The Marketing Rule requires net returns to be included in all advertisements, and gross returns may also be included in the advertisement. When an advertisement includes both gross and net performance, net performance must be:

- Presented with at least equal prominence to the gross performance.
- In a format designed to facilitate comparison with the gross performance.
- Calculated for the same periods as the gross performance.
- Calculated using the same type of return as the gross performance.
- Calculated using the same methodology as the gross performance.

The Marketing Rule allows an adviser to determine if TWRs or MWRs will be used.

Reconciliation: The GIPS standards do not explicitly require firms to present gross and net returns for the same periods, and also do not address comparability of returns. While it is common practice to present gross and net returns for the same periods and in the same format, in columns side-by-side, firms will need to carefully review GIPS Reports to ensure these requirements are met.

Presenting the same type of gross and net returns should not be an issue for GIPS-compliant firms because firms are not allowed to mix TWRs and MWRs in a GIPS Report.

5. Model investment management fees

GIPS Standards: When calculating net returns, the GIPS standards allow firms to use either actual or model investment management fees. If a model investment management fee is used, the model fee must be appropriate to prospects. For example, if the fee charged to new clients is 1.00%, it would not be appropriate to use a fee of 0.50% to calculate net returns. In addition to being appropriate, net returns that are calculated using a model fee must be equal to or lower than net returns that would have been calculated if actual investment management fees were used. This requirement is consistent with the no-action letter to J.P. Morgan Investment Management, Inc. (May 7, 1996). Net returns using a model fee must be more conservative than net returns that are calculated using actual investment management fees.

Marketing Rule: The Marketing Rule also allows the use of model advisory fees, but it allows two options for model fees:

- Net performance may reflect the deduction of a model fee when doing so results in net returns that are no higher than if actual fees had been deducted, or
- Net performance may reflect the deduction of a model fee that is equal to the highest fee charged to the intended audience to whom the advertisement is disseminated.

Reconciliation: Firms that claim compliance and use model fees will not need to make any changes because the Marketing Rule's first option is consistent with the GIPS standards. Net returns calculated using the Marketing Rule's second option can be used for GIPS Reports only if the net returns are no higher than if actual fees had been used.

6. Non-fee-paying portfolios

GIPS Standards: Firms may manage portfolios that do not pay investment management fees, such as a portfolio that the firm seeds with its own money in order to start a track record. Often these non-fee-paying portfolios are included in composites and are the first portfolio in a composite. When calculating net returns for a composite that includes a non-fee-paying portfolio, and actual investment management fees are used to calculate net returns, the GIPS standards allow the firm to use the actual investment management fee of $0. However, in this situation, the firm must present the percentage of composite assets represented by non-fee-paying portfolios as of each annual period end.

Marketing Rule: The Marketing Rule does not allow this approach. Instead, advisers must apply a model fee to non-fee-paying portfolios when calculating net returns. The model fee can be either the highest fee that was charged historically, or the highest potential fee that the adviser will charge the investors or clients receiving the particular advertisement.

Reconciliation: Firms that calculate composite net returns using actual investment management fees and include non-fee-paying portfolios in composites will need to apply a model fee to those portfolios and recalculate and restate net returns. Alternatively, the firm could apply a model fee to any composite that included one or more non-fee-paying portfolios.

Firms that have opted to present a GIPS Report for individual funds will also need to review these presentations to ensure that there were no periods for which the private fund was not charged a management fee. Often a private fund will be seeded with money from friends and family and no fees are charged. While it is common practice to present net performance that applies a model fee based on a hypothetical investor from Day 1, all firms may not have taken this approach.

7. Time periods

GIPS Standards: When a firm first attains compliance with the GIPS standards, it must present at least a five-year track record, and must subsequently build towards presenting a minimum ten-year compliant track record. The periods for which performance is presented in a GIPS Report depends on which type of return is being presented. GIPS Reports that include time-weighted returns must present annual returns. Therefore, a firm that has claimed compliance for at least 10 years must present 10 annual returns in GIPS Reports. Other returns, such as quarterly or annualized returns, may be presented, but these returns are optional. Common practice is to present annual returns on a calendar year basis.

GIPS Reports that include MWRs must present a single since-inception MWR through the most recent annual period end. Other MWRs may also be presented, and it is common practice to also include since inception MWRs through each annual period end.

The GIPS standards also require that firms update GIPS Reports to include information through the most recent annual period end within 12 months of that annual period end.

Marketing Rule: The Marketing Rule requires all advertisements, except those for private funds, to include performance for one-, five-, and ten-year time periods (the “prescribed periods”). If the relevant portfolio did not exist for a particular prescribed period, then an adviser must present performance for the life of the portfolio. For example, if a composite aggregation has been in existence for seven years, then the adviser must show performance for one-, five-, and seven-year periods. Performance for other periods may also be presented. Performance for the prescribed time periods must be presented with equal prominence in the advertisement.

The Marketing Rule requires that the prescribed time periods must end on a date that is no less recent than the most recent calendar year end.

Reconciliation: Firms that provide GIPS Reports on a standalone basis would need to add returns for the prescribed time periods to GIPS Reports. GIPS Reports that include TWRs would already include the one-year return, so the firm would need to add the five-year and ten-year returns.

The Adopting Release does not specify how the prescribed time periods would be determined for MWRs. Because a MWR makes sense only when the period of the return begins at the inception date, we assume that the prescribed time periods for MWRs would be from inception through the respective 1-, 5- and 10- year period.

We hope there will be clarification on this point.

Many firms do not provide GIPS Reports on a standalone basis and instead include them as part of a pitch book or other marketing materials, which may include returns for the prescribed time periods. In an abundance of caution, however, firms should consider adding returns for the prescribed time periods to all GIPS Reports.

The Marketing Rule does not specify the type of return that must be used for the one-year, five-year, and ten-year returns. GIPS Reports with TWRs could include either annualized returns or cumulative returns for the prescribed time periods. Common practice is to use annualized returns for periods that are greater than one year.

Firms that have less than a 10-year compliant track record may need to include performance for the prescribed time periods outside the GIPS Report because firms may not include non-compliant performance in GIPS Reports.

On April 14, 2021, the SEC issued an FAQ to address how quickly after year end firms will need to update advertisements to include performance through year end. The FAQ states that the staff believe that a reasonable period of time to calculate performance results based on the most recent calendar year end generally would not exceed one month. Firms would therefore need to update performance through calendar year end by the end of January.

8. Predecessor performance

GIPS Standards: The GIPS standards include requirements that must be met for a firm to be able to use performance from a prior firm. The tests, which are applied on a composite-specific or pooled fund–specific basis, include the following:

- Substantially all of the investment decision makers must be employed by the new or acquiring firm (e.g., research department staff, portfolio managers, and other relevant staff);
- The decision-making process must remain substantially intact and independent within the new or acquiring firm; and
- The new or acquiring firm must have records to support the performance.

If the firm wishes to present a continuous track record that combines, or links, the performance from the prior firm and the current firm, there cannot be a break in the track record between the prior firm and the current firm. If there is a break, the new firm cannot present a continuous track record and instead would present separately the performance from the prior firm and the performance at the current firm.

If the firm presents performance from a prior firm, whether linked or not linked, the firm must disclose this fact, including for which periods the performance is from the prior firm.

Marketing Rule: The Marketing Rule refers to performance from a prior firm as predecessor performance and takes a similar approach to the GIPS standards. The following requirements must be met for an adviser to be able to use predecessor performance.

- The person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;
- The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to investors;
- all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods; and
- the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

The Marketing Rule does not differentiate between linked and non-linked performance.

Reconciliation: While the tests related to portfolio management and the strategy of the portfolios are very similar, there are two important differences. First, when considering strategy performance and not performance of an individual pooled fund, the GIPS standards require that performance from the prior firm must be composite performance. A composite must include the performance of all portfolios managed in the composite's strategy. The Marketing Rule takes the same approach that is used in related performance. Predecessor performance must reflect all portfolios that were managed at the predecessor advisor in a substantially similar manner (i.e., a composite aggregation), or the predecessor performance may exclude any portfolio as long as the exclusion does not result in materially higher performance, and the exclusion does not alter the presentation of the prescribed time periods.

The second difference is causing quite a commotion in the industry. Under the GIPS standards, once the portability tests are met for a specific composite or pooled fund, the prior performance becomes that of the current firm and it is treated as the current firm's history. The Marketing Rule takes a different approach and states that the predecessor performance may be used only as long as the person or persons who were primarily responsible for achieving the prior performance results continue to manage accounts at the advertising adviser. Firms would not be able to use predecessor performance if the person(s) who were primarily responsible for managing the portfolios at the predecessor firm no longer manage accounts in the strategy at the new firm. Everyone is standing by for additional guidance on this topic.

Conclusion

In most cases, firms will be able to continue using their GIPS-compliant track records, albeit with modifications. Some firms may need to make more significant changes, including firms that use performance from prior firms. However, future interpretive guidance from the SEC may affect the changes a firm needs to make. The industry is standing by waiting for additional guidance. The next 13 months or so before the compliance date of November 4, 2022 will certainly be interesting. ■
