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3 October 2018

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A Face-Lift for GIPS:

CFA Institute Publishes Proposed Revisions to the GIPS Standards in the GIPS 2020 Exposure Draft

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I. Executive Summary

On August 30, 2018 the CFA Institute released for public comment the GIPS 2020 Exposure Draft (the "**Exposure Draft**"),[1] which proposes significant changes to the current Global Investment Performance Standards ("**GIPS**" or the "**Standards**").[2] The CFA Institute will accept comments on the Exposure Draft through December 31, 2018. A final version of the revised Standards is expected to be adopted in mid-2019, with an effective date of January 1, 2020. Firms claiming GIPS compliance will need to prepare performance reports for periods ending on or after December 31, 2020 in accordance with the revised Standards.[3]

a. What are GIPS?

GIPS are voluntary ethical standards intended to ensure fair representation and full disclosure in the presentation of investment performance. The objective of GIPS is to establish a single set of global investment performance standards that facilitate calculation and presentation of investment performance that is readily comparable among investment firms, regardless of geographic location and local conventions. Thousands of investment management firms representing more than 40 different countries claim compliance with GIPS, including 85 of the 100 largest global asset management firms.[4]

The CFA Institute, a global not-for-profit association of investment professionals, published the first version of GIPS in April 1999, although the foundation for GIPS was first established by the Association for Investment Management and Research (the predecessor of the CFA Institute) in 1987. Since that time, the CFA Institute has published several revisions to the Standards, as well as interpretative guidance in the form of Guidance Statements and Questions & Answer responses.

b. Why did the CFA Institute prepare and publish the Exposure Draft?

Although a majority of the largest asset managers in the world claim compliance with GIPS, there has not been widespread adoption among alternative investment managers and other managers of pooled funds. Many of the revisions proposed in the Exposure Draft are

[1] https://www.gipsstandards.org/standards/Documents/gips_2020_exposure_draft.pdf.
[2] https://www.cfainstitute.org/ethics/codes/gips-code.
[3] GIPS® is a registered trademark owned by CFA Institute.
[4] https://www.gipsstandards.org/compliance/Documents/a_guide_for_asset_owners.pdf

designed to facilitate broader adoption of GIPS by these managers.[5] The proposed revisions are intended to ensure that GIPS is relevant and applicable to all asset managers, regardless of structure, client type, asset class, or investment strategy, by removing certain limitations inherent in the current "one-size fits all" composite-based approach.

Under the revised Standards, firms will be subject to different requirements and performance measurements based on product type or asset class. For example, GIPS firms that market certain pooled funds must present fund performance rather than composite performance. Certain current requirements that impose burdensome restrictions on the presentation of performance, such as the treatment of carve-outs and valuation of private market assets, have been relaxed. Many of these revisions are intended to encourage alternative investment managers (including private equity and real estate managers) to adopt the Standards.

Firms that currently claim GIPS compliance will also notice that many of the "new" provisions proposed by the Exposure Draft appear familiar; certain requirements previously imposed through interpretative guidance have been incorporated into the Standards themselves.

c. *What are some prominent changes to the current Standards proposed in the Exposure Draft?*

- *Introduction of Pooled Fund Reports*. Under the current Standards, firms must present the composite performance of all discretionary, fee-paying portfolios managed according to the same investment strategy. If a pooled fund does not meet the definition of an existing composite, the manager must create a single-fund composite that contains only the pooled fund. By contrast, the Exposure Draft proposals require managers of "limited distribution pooled funds" (*e.g.*, U. S. private funds and AIFs) to present performance reports at the pooled fund level, thus removing the burden of creating a composite and presenting composite performance for a single fund. Investment managers of broad distribution pooled funds (*e.g.*, U.S. registered funds and UCITs) *may*, but are not required to, present the performance of such funds in a pooled fund report.
- *Portability*. Linking the performance of an acquired firm or investment team to performance at the new firm is optional under the Exposure Draft proposals. This represents a break from the long-standing requirement that the past performance of a firm or investment team acquired by a GIPS firm be linked to its performance at the new firm if certain criteria are met. In addition, the Exposure Draft relaxes the current requirement that any non-compliant assets of an acquired firm or team be brought into compliance within one year of the acquisition.
- *Carve-Outs*. The Exposure Draft proposals permit firms to prepare GIPS-compliant performance presentations for "carve-out" strategies, even if the carve-out strategy is not managed separately with its own cash balance. Under the Exposure Draft proposals, firms may allocate cash to carve-outs, but must do so for all carve-outs within the same strategy. Notably, this revision will facilitate GIPS compliance for private equity, real

[5] Many of the proposed changes reflect the codification of principles first introduced in Guidance Statements and a May 2017 consultation paper issued by the CFA Institute. *See* GIPS 20/20 Consultation Paper at https://www.gipsstandards.org/standards/documents/guidance/gips_2020_consultation_paper.pdf ; *see also* http://www.klgates.com/calm-before-the-storm-investment-advisers-face-changes-to-the-advertising-rule-gips-and-performance-portability-standards-05-23-2018/.

estate, and private wealth managers seeking to show the performance of only a portion of their portfolios (*e.g.*, the performance of European investments in a global portfolio, or the performance of fixed income assets in a balanced portfolio). Once a firm obtains a stand-alone portfolio managed in such strategy, it must create a composite containing only the stand-alone portfolios.

- *Money-Weighted Returns*. Under the current Standards, GIPS presentations in general may only present time-weighted returns ("**TWR**"). The Exposure Draft proposals would allow firms to present an internal rate of return, which is defined in the proposal as a "money-weighted return" ("**MWR**"), if the manager controls external cash flows into a pooled fund (or all portfolios of a composite), and meets certain other criteria.
- *Valuation.* Under the current Standards, valuation frequency depends on both the underlying asset class of a composite and the portfolio type. Under the Exposure Draft proposals, the required frequency of valuation depends primarily on the type of return being presented (TWR or MWR) and whether the portfolio is included in a composite or is presented as a stand-alone pooled fund. In addition, the Exposure Draft requires that all private market investments have an external valuation, a valuation review, or be subject to a financial statement audit on an annual basis.
- *Asset Owners*. Although both investment firms and institutional investors, or "asset owners," may comply with GIPS, the current Standards address compliance solely in the context of firms. The Exposure Draft proposals set forth requirements for asset owners that are distinct from those applicable to firms.

d. How do the Exposure Draft proposals effect GIPS Advertisements?

The "**GIPS Advertising Guidelines**" allow GIPS firms to include a claim of GIPS compliance in advertisements that do not satisfy the full requirements of GIPS reports. The term "advertisement" is broadly defined as any written material, other than one-on-one presentations and individual client reporting, distributed to more than one party. The Exposure Draft proposals clarify that pooled fund fact sheets and offering documents addressed to more than one pooled fund prospective investor may constitute GIPS advertisements. Firms that include performance in a GIPS advertisement must present the same return calculation methodology as that used in the corresponding GIPS report.

e. Are there any other revisions firms should become familiar with?

Yes. This summary highlights only certain major revisions to the Standards contained in the Exposure Draft proposals. Firms that presently claim GIPS compliance, as well as firms considering GIPS compliance in the future, should carefully review the Exposure Draft to understand the full extent of the proposed revisions. The remainder of this alert reviews many of the proposed revisions in greater depth, as well as the likely effect of those revisions on private fund managers, registered fund managers, and various other types of investment firms.

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II. Material Changes Proposed by the Exposure Draft

a. Introduction of GIPS Pooled Fund Reports

One of the most significant changes to the Standards set forth in the Exposure Draft is the introduction of pooled fund reports. The current Standards require presentation of composite performance at the strategy level. Presently, all products (including pooled funds) that meet a particular composite's definition must be included in that composite for purposes of calculating composite performance and generating a GIPS-compliant presentation. If a GIPS firm manages a pooled fund that does not meet any existing composite definition, the firm *must* create a composite containing solely the pooled fund, and the only way that the firm can present the pooled fund's performance with a claim of GIPS compliance is by presenting the composite performance.

The Exposure Draft proposals divide the existing concept of GIPS-compliant presentations for firms into two categories: (i) presentation of composite performance ("**GIPS Composite Reports**"); and (ii) presentation of pooled fund performance ("**GIPS Pooled Fund Reports**"). In the Exposure Draft, GIPS Composite Reports, GIPS Pooled Fund Reports, and GIPS Asset Owner Reports (discussed below) are together referred to as "**GIPS Reports**". The Exposure Draft proposals retain the requirement that GIPS firms include the performance of a pooled fund in a GIPS Composite Report if the fund's investment strategy meets the composite definition. However, only pooled funds that are managed in a strategy that is also offered in a separate account form need to be included in a composite. Thus, GIPS firms are no longer required to create single-fund composites. The revised Standards also require (for firms selling participation in limited distribution pooled funds), or allow (for broad distribution pooled funds) a GIPS firm to prepare and present GIPS Pooled Fund Reports for individual funds.

A "limited distribution pooled fund" is a pooled fund that is not marketed to the public for investment by multiple investors, and for which the typical marketing practice involves direct, one-on-one contact between the firm managing the pooled fund and the prospective investor. Examples of limited distribution pooled funds include "private funds" offered in the U.S. and AIFs offered in Europe. Firms are *required* to prepare and present a GIPS Pooled Fund Report when selling limited distribution pooled funds

By contrast, firms selling broad distribution pooled funds may *elect* to prepare and present a GIPS Pooled Fund Report. A "broad distribution pooled fund" is a pooled fund that is publicly available to multiple investors, for which the typical marketing practice involves no or minimal personal contact between the firm managing the pooled fund and the pooled fund prospective investor. These funds are typically highly regulated, and examples include mutual funds offered in the U.S. and UCITS offered in Europe and Asia. Managers of broad distribution pooled funds may also promote a claim of GIPS compliance without preparing and distributing a GIPS Pooled Fund Report by preparing a GIPS Advertisement (discussed below) prepared in accordance with the GIPS Advertising Guidelines.

Each GIPS firm that manages pooled funds must maintain a complete list of pooled fund descriptions for all limited distribution pooled funds, and must provide such list to any limited distribution pooled fund prospective investor that makes such a request. Firms managing broad distribution pooled funds must maintain a complete list of all broad distribution pooled funds, and must provide the list to any broad distribution pooled fund prospective investor upon request. Firms must also provide the pooled fund description for any broad distribution pooled fund to any broad distribution pooled fund prospective investor that makes such request. Terminated pooled funds must be kept on both the limited distribution pooled fund list and the broad distribution pooled fund list (as appropriate) for at least five years following the pooled fund termination date.

The performance presentation requirements for GIPS Pooled Fund Reports are substantially similar to those for GIPS Composite Reports. The similar requirements include both retention of requirements under the existing standards and the introduction of additional requirements proposed in the Exposure Draft. For example, firms presenting money-weighted returns (described below) in either a GIPS Composite Report or a GIPS Pooled Fund Report of portfolios that utilize a subscription line of credit must present specific information that both includes and excludes the effect of the subscription line of credit. However, the proposed revisions to the Standards also incorporate certain required and recommended performance measurements applicable only to composites versus pooled funds. These varied requirements are largely driven largely by the inherent differences in preparing and displaying composite performance as opposed to pooled fund performance. For instance, only GIPS Composite Reports presenting TWR are required to present a measure of internal dispersion of individual portfolio returns for each annual period.

b. Portability of Performance

Linking the performance of an acquired firm or investment team to performance at a new firm has been made optional under the Exposure Draft proposals. This represents a break from the current requirement that such performance be linked if, on a composite-specific basis, certain criteria are met. However, firms that do seek to link performance may only do so if the existing criteria are met: (i) substantially all of the investment decision makers are employed by the new or acquiring firm; (ii) the decision-making process remains substantially intact and independent within the new or acquiring firm; (iii) the new or acquiring firm has records that document and support the performance; and (iv) there must not be a break in the track record between the prior firm and the new or acquiring firm. If all four criteria are not met, the past performance record of the acquired firm or team must not be linked to the ongoing performance record of the new firm. As under the current Standards, the performance of the acquired firm or team may be presented as supplemental information as long as the acquiring firm has records that document and support the performance.

In addition, the Exposure Draft relaxes the existing requirement that any non-compliant assets of an acquired firm or team be brought into compliance within one year of the acquisition. Under the proposed revisions, the one-year compliance period will apply only for periods after the acquisition (*i.e.*, on a prospective basis). There will be no limitation on when firms may port performance history from the prior firm.

c. Treatment of Carve-Outs

A “carve-out” is a portion of a portfolio that is representative of an investment strategy that is distinct from the strategy of the broader portfolio. Under the current standards, the performance of a carve-out may only be included in a composite if the carve-out is managed with its own dedicated cash balance. Consequently, a GIPS firm that manages a blended portfolio could only “carve out” the equity and fixed income portions of the portfolio and include them as distinct portfolios in different composites if each is managed in a separate portfolio at the custodian, with separate cash accounts or in sub-portfolios with a distinct cash balance. In a reversal from prior guidance, the Exposure Draft proposals will permit GIPS firms to allocate cash to carve-outs, which means that, in the prior example, two distinct portfolios for inclusion in different composites could be created from a single blended account with a shared cash balance. To avoid cherry-picking, a GIPS firm that creates a carve-out with allocated cash for inclusion in a composite must create carve-outs with allocated cash from *all* portfolios or portfolio segments within the firm managed to the same strategy, and include those carve-outs in the composite. Firms also must disclose the percentage of composite assets represented by carve-outs with allocated cash as of each annual period end.

In addition, once a GIPS firm obtains a stand-alone portfolio managed in the same strategy as the carve-out(s) with allocated cash, the firm must create a composite that includes only the stand-alone portfolio(s). The performance of this stand-alone composite must be presented alongside the performance of the composite including carve-outs with allocated cash in the GIPS Composite Report for that composite.

If adopted, the changes to the treatment of carve-outs may make GIPS compliance more attractive to private equity and real estate fund managers that often seek to market new strategies by reference to the performance of carve-outs of the assets held by prior funds.

d. Time-Weighted and Money-Weighted Returns

Under the current Standards, GIPS-compliant presentations may only present TWR, subject to two narrow exceptions.[6] TWR is a method of calculating period-by-period returns that negates the effects of capital flows, including both cash and investments that enter or exit a portfolio. In recognition of the fact that TWR may not be an appropriate performance measure where, as in private equity, a firm controls the timing of cash flows, the Exposure Draft proposals allow firms greater flexibility for presenting the internal rate of return of a composite or fund, which is defined in the Exposure Draft as MWR. MWR is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows. Under the current Standards, firms may only present MWR for certain asset classes. The Exposure Draft proposals remove this asset-class guidance and replace it with a methodology-based guidance that is asset-class agnostic.

A GIPS firm may now present MWR in GIPS Reports if the firm both controls the external cash flows into a pooled fund or the portfolios within a composite, and the fund or portfolios meet at least one of the following criteria: (i) closed-end; (ii) fixed life; (iii) fixed commitment; or (iv) illiquid investments are a significant part of the investment strategy. Since-inception MWR are required, and must be shown through the most recent year-end period. In addition, if subscription lines of credit are used, firms must present since-inception MWR both including and excluding the subscription line of credit activity through the most recent annual period end.

GIPS Reports will be subject to different performance presentation requirements depending on the decision to present MWR or TWR, and the decision will also affect the required

[6] GIPS presentations of private equity composites must present only the internal rate of return. In addition, GIPS presentations of closed-end real estate composites must present both the internal rate of return and time-weighted returns.

disclosures. For example, firms presenting TWR must disclose the firm's policy for the treatment of "significant cash flows" and what measure of internal dispersion is presented. By contrast, GIPS Reports presenting MWR are not required to disclose significant cash flow policies or internal dispersion, but they are required to disclose the frequency of cash flows used in MWR calculations if it is other than daily.

e. *Estimated Transaction Costs*

"Transaction costs" are the costs of buying or selling investments, including both traditional trading expenses such as brokerage commissions, exchange fees and taxes, and bid and offer spreads, as well as legal, financial, advisory, and similar costs incurred in private markets transactions. Under the current Standards, all returns must be calculated after the deduction of actual trading expenses incurred during the period, and use of estimated trading expenses is not allowed. In a departure from this existing requirement, the Exposure Draft proposals permit firms to use *estimated* transaction costs if certain requirements are met. Notably, firms must be able to determine that estimated transaction costs are greater than or equal to actual transaction costs. If a firm calculating gross returns cannot estimate transaction costs or if actual transaction costs cannot be segregated from a bundled fee, firms must reduce returns by the entire bundled fee or the portion of the bundled fee that includes the transaction costs.[7] For firms calculating net returns, the returns must be reduced by the entire bundled fee or the portion of the bundled fee that includes transaction costs and the investment management fees.

In addition, GIPS Reports containing performance measurements including estimated transaction costs must disclose that estimated transaction costs are used, and provide certain details regarding the estimated transaction costs that are used.

f. *Presentation of Total Firm Assets and Advisory Assets*

Under the Exposure Draft proposals, GIPS Reports must include the total firm assets as of each annual period end. Currently, firms may choose between presenting either total firm assets or composite assets as a percentage of the total firm assets.

In addition, the Exposure Draft proposals permit firms to present "advisory-only" assets that are not actually managed by the firm, as long as such assets are calculated and presented separately from total firm assets. Advisory-only assets include model-delivery, unified managed accounts, and similar situations where the firm provides investment recommendations, but has no control of investment decisions and no trading authority for assets. While the proposals uphold the existing requirement that total firm assets include both discretionary and non-discretionary assets managed by the firm, the current Standards do not permit firms to present advisory-only assets.

The Exposure Draft also clarifies that firms may not include committed capital in total firm assets.

[7] "Bundled fee" is defined in the Exposure Draft as a fee that combines multiple fees into to one total or "bundled" fee. A wrap fee is a type of bundled fee, but a bundled fee is not necessarily a wrap fee.

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g. *Valuation Frequency and Assurance*

The Exposure Draft includes many changes to the existing valuation requirements in the Standards. For example, GIPS Pooled Fund Reports are not required to perform monthly valuations, which are required for GIPS Composite Reports. Instead, the Exposure Draft Proposals apply many principles of the CFA Institute's Alternative Investment Guidance Statement to GIPS Pooled Fund Reports. A GIPS Pooled Fund Report that presents TWR must value assets at the following times: (i) at least annually; (ii) as of the calendar or fiscal year-end; (iii) whenever there are subscriptions to or redemptions from the pooled fund; and (iv) as of the period end for any period for which performance is calculated. GIPS Pooled Fund Reports that present MWR must value assets and calculate returns as of the most recent annual period end of the pooled fund.

GIPS Composite Reports using TWR for the portfolios included in the composite must value those portfolios at least monthly. Portfolios must also be valued on the date of all large cash flows. "Large cash flows" must be defined for each composite to determine when portfolios in the composite must be valued. Firms that present MWR in GIPS Composite Reports must value portfolios at least annually.

Under the current Standards, only real estate investments are required to receive annual external valuations. The Exposure Draft extends annual external valuation requirements to all private market investments (*e.g.*, private equity, infrastructure, and other real assets). In addition, the proposals allow firms managing private market investments to meet this requirement through valuation options other than external valuations. Instead, firms may seek a valuation review of private market investments, including a review of valuation inputs and assumptions performed by an external third party. Firms may also meet the valuation requirement by subjecting private market investments to a financial statement audit. These proposals are intended to improve the quality of valuations for additional asset classes on a more frequent basis, while acknowledging that this goal may be accomplished by more than one method.

h. *Changes to GIPS Advertising Guidelines*

The "**GIPS Advertising Guidelines**" regulate advertisements distributed by GIPS firms and asset owners that already satisfy the applicable requirements of the Standards on a firm-wide or asset-owner wide basis. The GIPS Advertising Guidelines do not replace the Standards, nor do they absolve firms from presenting GIPS Reports as required by the Standards. Instead, the Advertising Guidelines govern the content of advertisements disseminated to the general public that contain a claim of GIPS compliance ("**GIPS Advertisements**").

The term "advertisement" is broadly defined in the current Standards as any written material that is distributed to or designed for use in newspapers, magazines, firm brochures, letters, media websites, or other written or electronic material distributed to more than one party, and there is no contact between the firm and the reader of the advertisement. The Exposure Draft proposals clarify that pooled fund fact sheets and offering documents addressed to more than one pooled fund prospective investor also may constitute GIPS Advertisements, and that firms that choose to present performance in a GIPS Advertisement must use the same return calculation methodology as that used in the corresponding GIPS Report. One-on-one presentations and individual client reporting are not considered advertisements.

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Broad distribution pooled funds may claim compliance in GIPS Advertisements without the creation of a GIPS Pooled Fund Report. The Exposure Draft proposals include detailed requirements for managers of broad distribution pooled funds regarding the creation and presentation of pooled fund performance in GIPS Advertisements. Many of these new requirements were taken from the CFA Institute's Broadly Distributed Pooled Funds Guidance Statement.

Consistent with current guidance, an advertisement disseminated by a GIPS firm that does not contain a claim of GIPS compliance or any other reference to GIPS need not comply with the GIPS Advertising Guidelines.

i. Codification of Interpretive Guidance

The CFA Institute frequently provides guidance to firms pursuing GIPS compliance through the publication of Guidance Statements and Questions & Answers responses. In many cases, this interpretive guidance has the practical effect of expanding and revising the Standards, and provides vital insight for firms seeking compliance. Firms and asset owners must comply with all applicable GIPS requirements, *including* those found in interpretive guidance such as Guidance Statements and Q&As.

Many of the current requirements that firms must satisfy to achieve GIPS compliance are set forth in interpretative guidance written after the issuance of the current Standards in 2010. The Exposure Draft proposals codify key requirements set forth in prior interpretative guidance as new provisions in the revised Standards. In addition, proposed Guidance Statements on Risk, Benchmarks, Overlay Strategies, Supplemental Information, and Verifier Independence have been issued for public comment but not yet finalized. The Exposure Draft proposals include certain provisions based on industry comments to these proposed Guidance Statements.

j. Verification and Timeliness of Delivery

The current Standards are silent regarding how promptly firms must update a GIPS presentation. Many GIPS firms presently wait until their performance has been verified before distributing updated compliant presentations, which can result in GIPS-compliant presentations with performance that is stale by more than two years. To address this issue, the Exposure Draft proposals require firms and asset owners to update the information presented in a GIPS Report within six months following the most recent annual period end. The Exposure Draft clarifies that this six month deadline will apply even if the verification process is not complete.

The Exposure Draft proposals will revise the verification disclosure that must be included in GIPS Reports for verified firms and asset owners to reflect the new proposed language for verification reports. However, substantive verification guidance is not yet finalized, and is expected to be issued for public comment in late October, 2018. Although the decision to seek independent verification remains voluntary, firms and asset owners that choose to pursue verification must create policies and procedures for determining that the verifier is independent from the firm or asset owner.

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k. Requirements for Asset Owners

The current edition of the Standards focuses solely on firms, although both firms and "asset owners," which generally refers to institutional investors such as retirement systems, endowments, foundations, and sovereign wealth funds, may comply with GIPS pursuant to interpretive guidance published by the CFA Institute. Under the proposed Exposure Draft, the application of GIPS to asset owners is codified in the Standards and addressed in sections separate from those relating to firms, providing asset owners with specialized requirements. Asset owners that claim compliance with GIPS will prepare and present a GIPS Asset Owner Report, rather than a GIPS Pooled Fund Report or GIPS Composite Report, for all "total fund" assets over which they have direct oversight responsibility. The new term "total fund" refers to a pool of assets managed by an asset owner according to a specific investment mandate, which is typically composed of multiple asset classes. The performance measurement requirements of GIPS Asset Owner Reports differ from those required for other GIPS Reports, although much of the flexibility introduced in the Exposure Draft proposals for firms also extend to GIPS Asset Owner Reports.

III. Effect of the Proposed Revisions Certain Investment Managers and Transactions

a. Managers of Private Funds

The CFA Institute has stated that an express goal of publishing the Exposure Draft is to facilitate broader adoption among alternative investment managers and other managers of pooled funds. Indeed, most of the significant changes to the Standards proposed in the Exposure Draft are designed to make GIPS more accessible to managers of private equity, hedge, real estate, private credit, and other "limited distribution pooled funds." While broader adoption, if it occurs, will likely be driven by the institutional investor community, the proposed changes to the Standards do address many of the issues that have made compliance with prior versions of the Standards difficult for many alternatives managers.

GIPS Pooled Fund Reports

First and foremost, the concept of GIPS Pooled Fund Reports provides a more intuitive structure for the preparation and presentation of pooled fund performance to potential investors. As noted in the preface to the Exposure Draft, pooled fund managers do not sell participations in a composite, they sell participations in an individual fund. This development is most helpful to fund managers that do not also manage separate accounts. These managers may, under the proposed Standards, claim compliance with GIPS and prepare *only* GIPS Pooled Fund Reports. On the other hand, firms that manage private funds *and* separate accounts side-by-side will continue to include pooled funds in GIPS Composite Reports, and will incur the added obligation to deliver GIPS Pooled Fund Reports to potential fund investors. This will impose an incremental burden on such firms, and a manager with several pooled funds in a single strategy will ultimately need to prepare several GIPS Reports for the strategy.

The requirement to prepare a GIPS Pooled Fund Report for each limited distribution pooled fund and deliver the report to each potential investor also raises several open questions. Many private fund managers reach potential investors primarily or exclusively through third-party placement agents. In these arrangements, some potential investors perform due diligence on the manager, but others subscribe for fund interests without ever communicating directly with the manager. It appears that a GIPS firm in this situation would be obligated to deliver a GIPS Pooled Fund Report to some, but not all potential investors. A similar issue arises for managers that distribute funds or share classes that are not clearly "limited distribution" or "broad distribution." Examples include bank-sponsored collective investment trusts, UCITS marketed in the U.S. pursuant to a private offering exemption, and institutional share classes of mutual funds ("**I Shares**") that are typically marketed in one-on-one meetings. In these cases, a GIPS firm may need to treat a single fund as a limited distribution fund with respect to certain potential investors, and a broad distribution fund with respect to others. These issues will likely need to be addressed in the final version of the revised Standards or in related guidance, and affected GIPS firms may consider raising these issues during the comment period.

Managers should also consider the potential regulatory implications of distributing materials that name a particular fund, rather than present the performance of its investment adviser. In the U.S., there is generally no private right of action under the Investment Advisers Act of 1940, as amended ("**Advisers Act**"), but the Securities Act of 1933, as amended, does establish a right of action for purchasers of unregistered securities. Consequently, the potential scope of liability arising from errors or material omissions in a GIPS Pooled Fund Report, which technically relates to a securities offering, differs from that of a GIPS Composite Report, which relates to the services provided by an investment adviser. Firms will also need to assess whether GIPS Pooled Fund Reports should be distributed only by registered representatives of a broker-dealer, depending on their structure and affiliations.

Money-Weighted Returns and Valuation

The Exposure Draft also contains several proposals designed to make GIPS more relevant to managers of illiquid assets such as private equity, private credit, and real estate. Many of these provisions were introduced in prior versions of the Standards and related Guidance Statements as being applicable only to a specific asset class, such as real estate, but the Exposure Draft proposals have been broadened and streamlined to apply consistently to the management of any asset class with certain characteristics.

Any GIPS firm may present MWR (an internal rate of return) in a GIPS Report if the firm both controls external cash flows and the fund or portfolio(s) in question exhibits at least one of the following criteria: (i) closed-end; (ii) fixed life; (iii) fixed commitment; or (iv) illiquid investments are a significant part of the investment strategy. A GIPS firm with funds or portfolios that meet this threshold requirement may present MWR performance, but must do so according certain standards designed to ensure comparability across GIPS firms. For example, since-inception MWR is required, must be shown through the most recent year-end period, and must include the performance of side pockets. One requirement that alternatives managers should pay close attention to is the treatment of subscription lines of credit. Pursuant to the proposals, a firm that uses subscription lines of credit must present two performance streams: one that reflects the line of credit cash flows, and one based only on investor cash flows. This requirement has been introduced to promote transparency and address a perceived lack of consistency in return calculations when lines of credit are used, and may have a significant impact on the stated performance of firms that make use of subscription lines of credit for extended periods.

The Exposure Draft also proposes significant changes to the valuation requirements imposed on managers of illiquid assets under the current Standards. Rather than applying disparate standards for the scope and frequency of valuation depending on asset class, the proposed Standards apply consistent valuation requirements to all "private market investments," which include real estate, private equity, and other investments that are illiquid and not publicly traded. These assets must be valued at least once every 12 months by an external valuation, an internal valuation subject to external review, or a financial statement audit. The opportunity to rely on a financial statement audit is a new provision that should greatly reduce the expense of GIPS compliance for many alternative managers. Most U.S. private fund managers already obtain fund-level audits to satisfy investor demand and simplify compliance with the Custody Rule under the Advisers Act; GIPS firms seeking to rely on audits for these valuation purposes will need to ensure that the assets in question are actually within the scope of the audits, and that audit opinions are not qualified.

b. Registered Fund Managers

As discussed above, the Exposure Draft divides pooled funds into two categories: limited distribution and broad distribution. As a general matter, investment companies registered under the Investment Company Act of 1940, as amended ("**Registered Funds**") conducting a public offering should be treated as broad distribution pools. The Exposure Draft permits, but does not require, firms managing broad distribution pooled funds to market claims of GIPS compliance either in (1) a GIPS Pooled Fund Report that is presented to all prospective investors or (2) a GIPS Advertisement prepared in accordance with the GIPS Advertising Guidelines.

Given the fact that most retail investors do not recognize GIPS, there is currently little to no market pressure for claims of GIPS compliance in registered fund marketing materials. Until (and if) this changes, it seems unlikely that registered fund managers will take advantage of the GIPS Pooled Fund Reports or the GIPS Advertising Guidelines revisions proposed in the Exposure Draft. On the other hand, registered fund managers may in the future be incentivized to market GIPS compliance if intermediaries begin to sell participation in funds based on GIPS compliance.

The role of intermediaries with respect to the distribution of Registered Funds also creates complexity and uncertainty. In practice, registered fund marketing materials are typically prepared in the name of the fund's distributor rather than the fund's investment adviser. Typically a fund's distributor is not within the firm's definition, and it remains an open issue how and whether intermediaries will be willing to present or provide GIPS Reports or GIPS Advertisements to prospective registered fund investors.

Another unsettled issue relates to the treatment of Registered Funds as broad distribution pools. Often I Shares of Registered Funds are marketed in one-on-one communications in a very different manner than retail shares classes where there is typically no or minimal contact between the firm managing the fund and investors. As noted above, it is unclear under the Exposure Draft proposals whether I Shares of a fund would be treated as a limited distribution pooled fund with its own GIPS Pooled Fund Report. We anticipate that this ambiguity will be an active area for comment and that the final guidance will put a finer point on this issue and clarify the treatment of I Shares and other potential inconsistencies in the definitions (*e.g.*, UCITS broadly distributed in Europe but privately placed in the United States).

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c. Institutional Managers

Due to investor demand, most institutional asset managers already claim GIPS compliance. Unlike the substantial Exposure Draft changes designed to expand GIPS compliance among alternative and pooled fund managers, the changes for institutional managers are less significant. We expect that firms that primarily present "strategy" performance to separate account prospects will likely continue to do so without substantial changes to their current practices. However, while the proposed changes for institutional managers are not as ground-breaking as for alternative managers, the Exposure Draft does provide institutional managers with increased flexibility to meet the needs of their sophisticated investor base.

Strategies are often not one size fits all, and certain strategies are better suited for (or can only be implemented in) a pooled vehicle. Under the Exposure Draft, a firm may (or must, depending on the type of pooled fund) provide a potential investor with a GIPS Pooled Fund Report designed specifically for the product in which the prospective investor has expressed interest rather than a compliant-presentation for a composite. As a result, firms that distribute strategies through multiple fund "wrappers" likely will need to prepare additional GIPS Reports.

In addition, many diversified asset management firms traditionally have claimed compliance only for the institutional subset of their business. The changes set forth in the Exposure Draft may result in these firms extending the GIPS firm definition and compliance to their entire organizations. If so, these firms will likely need to dedicate significant time and resources to bring all assets into compliance.

d. Firm Mergers and Acquisitions (M&A) and Team Lift-Outs

The Exposure Draft provides much more optionality and flexibility than the current Standards for firms involved in M&A transactions and conducting team lift-outs. Currently, if the GIPS portability tests are met, composite performance from a prior firm or affiliation <u>must</u> be linked to performance at the new or acquiring firm. The rationale is that a firm should not be allowed to exclude poor prior performance. The Exposure Draft reverses this position and makes portability optional, providing that performance <u>may</u> be linked if the portability tests are met on a composite-specific or pooled fund-specific basis. This reversal is in recognition of the practical application of the current Standards and that firms that did not wish to port performance of a particular composite would fail to meet one of the GIPS portability tests. Making portability optional will align the Standards with industry practice as well as current U.S. Securities and Exchange Commission guidance, which does not require prior firm performance to be linked.

Greater flexibility is provided with respect to the one-year "grace period" for non-compliant assets. Under current guidance, if a GIPS-compliant firm acquires a non-GIPS-compliant firm, then the acquiring firm has one year from the date of acquisition to bring any non-compliant assets into compliance. The Exposure Draft proposes a clarification that the one-year "grace period" applies on a prospective basis only. In other words, the one-year period applies to the assets at the new firm only. As such, there is no one-year limit on porting the performance achieved at a prior firm. For example, three years after an acquisition date, the new firm could purchase records from the prior firm and port the performance at that time. This flexibility will allow an acquiring firm to port only a portion of the track record of the prior firm (e.g., the time period for which records are available), which may be a shorter time

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period than going back to the inception of the strategy at the prior firm. This is consistent with the SEC staff's position on portability.

e. Managers of Wrap Fee Accounts and Separately Managed Accounts

Managers of wrap fee programs will note that the extensive requirements applicable solely to wrap fee and separately managed account portfolios set forth in the Guidance Statement on Wrap Fees/SMA Portfolios do not appear in the Exposure Draft. Instead, the Exposure Draft proposals treat wrap fee composites in a manner similar to any other composite created for purposes of presenting a GIPS Composite Report, with certain adjustments to address the treatment of gross- and net-of-fee performance. As a result of these Exposure Draft proposals, managers may now present wrap fee accounts and institutional accounts in the same composite.

Under existing guidance, an initial wrap fee composite could be constructed by presenting the gross-of-fee performance of non-wrap portfolios, and presenting net performance by deducting the gross performance by the highest total wrap fee charged to the end client. Under this arrangement, gross-of-fee performance already reflects the deduction of actual trading expenses, so the net performance is generally lower than the recipient would have actually obtained. The current guidance also presents several options for integrating prior non-wrap performance with the performance of new wrap fee accounts.

The Exposure Draft proposals may reduce some of these operational difficulties around the presentation of gross and net returns of wrap fee accounts by simplifying the treatment of transaction costs. First, the proposed use of estimated transaction costs allows managers of wrap accounts to estimate the gross performance of wrap accounts by estimating the portion of the wrap fee that reflects the transaction costs. In order to do so, the firm likely will need to have a reasonable basis to determine that the estimated transaction costs are lower than the actual transaction costs in the portfolio, which may difficult in this context. Second, the Exposure Draft proposes to require that returns presented to a prospective wrap fee client must be calculated net of the entire wrap fee. These two changes together suggest that a GIPS firm could create a single composite containing both wrap fee accounts and non-wrap fee accounts, and present two performance streams for the same composite: (i) performance based on estimated transaction costs to non-wrap fee clients, and (ii) performance reduced by the entire wrap fee to wrap fee clients.

In addition, the Exposure Draft codifies prior guidance that firms may present "pure gross-of-fees" performance (gross-of-fee returns that do not reflect transaction or commission costs) in a GIPS Composite Report as supplemental information.

Another notable change relates to the concept of sponsor-specific composites. The current Standards and interpretive guidance permit firms to create sponsor-specific composites that include only those wrap fee portfolios attributable to a specific sponsor when presenting performance to that sponsor. The Exposure Draft proposals remove the concept of a sponsor-specific wrap fee composite; although firms may still present sponsor-specific performance, it will be viewed as client reporting rather than composite reporting to a prospective client, and thus not subject to GIPS. Instead, firms that wish to claim GIPS compliance when presenting performance to a prospective wrap fee client must present a composite that includes all actual wrap fee portfolios (and may include non-wrap portfolios) managed according to the composite strategy, regardless of the wrap fee sponsor.

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f. Asset Owners

An "asset owner" is an entity that manages investments, either directly and/or through the use of external managers, on behalf of participants, beneficiaries or an organization itself. Traditional "asset owners" include pension funds, endowments, and foundations; and other institutional investors such as sovereign wealth funds and family offices may seek to comply with GIPS in their capacity as "asset owners." However, under both current guidance and the Exposure Draft, if an asset owner markets to prospective clients, the part of the organization that does so will be subject to the requirements for firms.

Asset owners are generally accountable to a board of trustees or similar body with responsibility for oversight. Although many asset owners require their external investment managers to comply with GIPS, asset owners themselves typically do not claim GIPS compliance in their own reports to their board or beneficiaries. However, an asset owner with discretion over investment assets, either directly or by having discretion to hire or fire external investment managers, may choose to claim compliance with GIPS.

Asset owners may elect to claim GIPS compliance for a number of reasons. With increased public scrutiny of certain asset owners, such as public pension plans, compliance with the Standards may signal to stakeholders (such as plan participants, beneficiaries or the general public) that an asset owner is committed to following universal standards regarding performance calculation and reporting, adhering to accepted best practices and establishing enhanced internal policies and procedures and controls. An asset owner also may seek to claim GIPS compliance to demonstrate its performance to the oversight body in a manner that is comparable to other asset owners that also claim compliance with the Standards, for benchmarking purposes.

Notably, California Public Employees' Retirement System (CalPERS) announced its adoption of the GIPS Standards in March 2018. As the largest defined-benefit public pension plan in the U.S., other public pension plans often look to CalPERS as an example, and other public plans may seek to claim compliance with GIPS if they decide to follow CalPERS' lead in this respect. The Exposure Draft, which includes separate, self-contained sections for asset owners, is intended to provide a clearer, more user-friendly path for asset owners seeking to comply with the Standards.

The adoption of GIPS 2020 and expected amendments to the Security and Exchange Commission's Advertising Rule will have a significant impact on the marketing activities of global asset managers in the coming years. Visit our Marketing Resource Center to stay informed of regulatory and marketplace developments and learn how K&L Gates' practical insights can help you navigate these changes.

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