# PART One

# Explanation of the GIPS Standards

CHAPTER 1

# Fundamentals of Compliance

The institutional investor searching for a new investment manager will consider many factors before making a choice. The manager's reputation, the breadth of the firm's offerings, and the manager's fee schedule all play a role in this decision. While past performance cannot guarantee future results, this information provides valuable insight about an investment manager. One factor that is almost always considered in a search is the investment manager's historical track record. With only a few exceptions, investment managers have historically had minimal, if any, regulations or guidance that instructs the firm on how to calculate and report investment performance to prospective investors. The Global Investment Performance Standards (GIPS®), administered by CFA Institute, fill that void.

## SCOPE OF THE GIPS STANDARDS

The Global Investment Performance Standards are a set of voluntary standards for calculating and reporting investment performance to a prospective investor. Institutional investors, such as pension plans and endowments, will often consider hiring only managers who have calculated and presented their performance in compliance with the GIPS standards. The GIPS standards provide investors with assurance that performance records are comparable and that they are prepared based on the ethical principles of fair representation and full disclosure.

The GIPS standards do not attempt to address every performance measurement issue that a money manager may face. For example, the GIPS standards are not intended to govern performance presented as part of internal reporting within the investment management firm or for client reporting to existing clients. The GIPS standards are primarily concerned with marketing performance history to prospective clients.

There is no global law that requires a firm to comply with the GIPS standards. (But if an investment manager claims compliance, the local regulator can and often does test that claim.) The GIPS standards are a form of industry self-regulation. An investment manager that chooses to comply with the GIPS standards must comply with all of the applicable *requirements* of the GIPS standards on a firmwide basis. The GIPS standards also include a series of *recommendations* that are considered industry best practices. A firm that complies with the GIPS standards may select which, if any, of these recommendations the firm will adopt and follow.

## HISTORY OF THE GIPS STANDARDS

Several decades ago, the Association for Investment Management and Research (AIMR®, now known as CFA Institute) recognized the need for performance standards. In 1987, the AIMR Performance Presentation Standards (AIMR-PPS®) were issued and over the next decade became widely adopted in the United States, primarily by managers of institutional assets. At the same time, other countries were beginning to take notice of these standards. Recognizing that the AIMR-PPS standards were directed mainly at the U.S. and Canadian markets, several countries used the AIMR-PPS standards as a starting point and tailored them for local use. To facilitate the ability of money managers to do business across borders and address the proliferation of country-specific standards, in 1995 AIMR undertook the process of creating a set of performance standards that could be used by all firms globally. The end result of this effort was the issuance of the first edition of the GIPS standards in February 1999.

Several countries adopted the GIPS standards as their local standard as issued, making no changes. However, other countries that already had their own standards were hesitant to replace their current standards with the GIPS standards, particularly if the local standards had been widely adopted and extensively interpreted, as was the case in the United States and Canada. To take the first step toward unifying the different standards used globally, a concept of *Country Versions of GIPS* (CVG) was created. Each CVG would have as its core the GIPS standards themselves, but would allow for additional requirements and recommendations over and above those included in the GIPS standards. In 2000, the AIMR-PPS standards became a CVG. The process to become a CVG was quite simple for the AIMR-PPS standards, since the GIPS standards were primarily based on the concepts in the AIMR-PPS standards.

When the GIPS standards were originally created, it was agreed that they would be reviewed and updated every five years. This first five-year review resulted in the issuance of the 2005 edition of the GIPS standards in February of that year. This edition began the process of eliminating all CVGs as a key step toward meeting the stated goal of having one standard for performance calculation and presentation used globally. Firms that complied with a CVG could continue to do so until they reported performance for any period after December 31, 2005. Once a firm reported performance for subsequent periods, the firm was required to transition from CVG-based reporting to reporting in compliance with the GIPS standards.

To facilitate convergence to one global standard, the GIPS standards provided full reciprocity for historical periods. For example, a firm that previously complied with the AIMR-PPS standards and transitioned to the GIPS standards in 2006 could state that the firm complied with the GIPS standards for all periods and make no reference to prior compliance with the AIMR-PPS standards. Reciprocity allowed firms throughout the world to remove references to local standards from their presentations and to speak only about the GIPS standards.

The next five-year update was completed in January 2010 when the 2010 edition of the GIPS standards was issued. The 2010 edition has an effective date of January 1, 2011. Compliant presentations that include any performance results for periods beginning on or after January 1, 2011 must comply with the presentation and disclosure requirements of the 2010 edition. All input and calculation data requirements must be followed beginning on that date. (Unless explicitly stated otherwise, this book references and provides guidance for the 2010 edition of the GIPS standards.)

To facilitate global acceptance and adoption of the GIPS standards, local sponsoring organizations serve as "Country Sponsors" of the GIPS standards. Country Sponsors, such as The Securities Analysts Association of Japan, promote the GIPS standards in their local market, and provide feedback and input on country-specific concerns. As of December 2010, over 30 Country Sponsors have adopted the GIPS standards as their local standard. A current list of Country Sponsors is available on the GIPS standards web site (www.gipsstandards.org). In accordance with standard CFA Institute practice, for governance purposes Country Sponsors are pooled into three geographic areas: Americas; EMEA (Europe, Middle East, and Africa); and Asia Pacific.

## GOVERNANCE OF THE GIPS STANDARDS

CFA Institute is an investments industry association that is best known as the administrator of the CFA and CIPM exams. The Chartered Financial Analyst® (CFA®) designation is a key credential for anyone in the investment management industry. The Certificate in Investment Performance Measurement (CIPM) program has a narrower focus on the investment performance

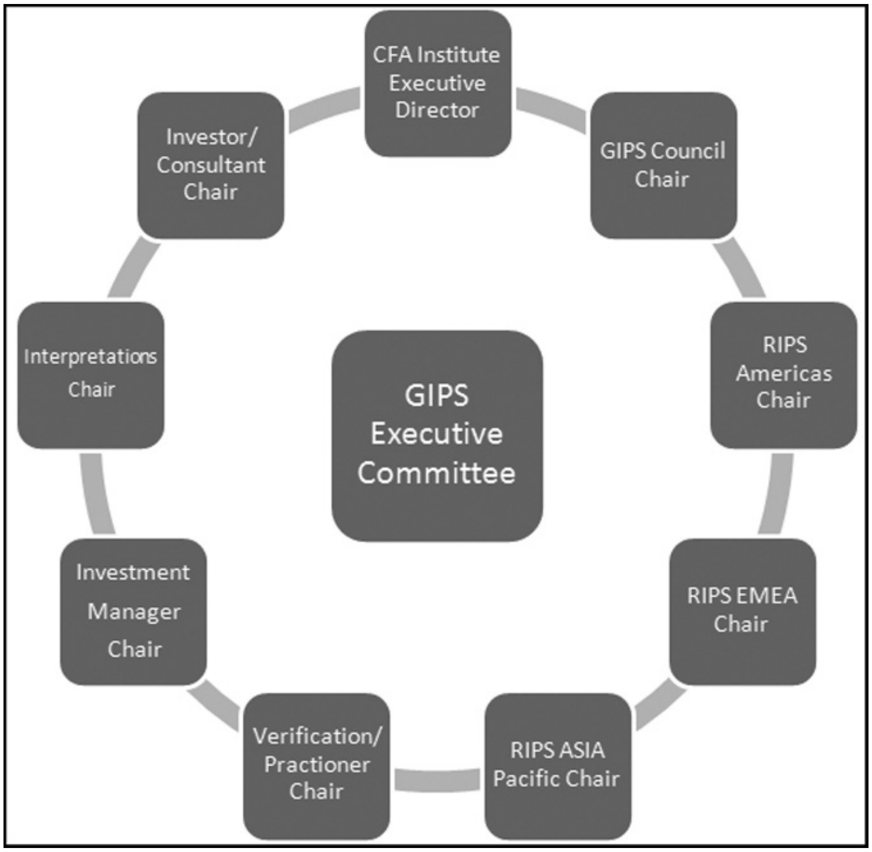


**FIGURE 1.1** GIPS Standards Executive Committee

field. CFA Institute has ultimate responsibility for the GIPS standards and funds a permanent staff to promote and enhance the GIPS standards. CFA Institute recruits volunteers from a variety of constituents to guide and enhance the GIPS standards.

The *Executive Committee* (EC) serves as the decision-making authority for the GIPS standards. The EC, which functions as the equivalent to a company's Board of Directors, includes nine "seats" and is organized according to the structure illustrated in Figure 1.1.

Four of the nine seats (Investor/Consultant, Interpretations, Investment Manager, and Verification/Practitioner) are appointed by CFA Institute. Four seats represent Country Sponsors through the global *Regional Investment Performance Subcommittees* (RIPS) and the GIPS Council, and are

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elected by Country Sponsors. (The GIPS Council includes a representative from each Country Sponsor.) The ninth seat is held by the CFA Institute Executive Director of the GIPS standards.

With the exception of the CFA Institute Executive Director seat, which is a permanent position, all seats have term limits. The GIPS Council Chair seat rotates every two years, and rotates between the three geographical segments. All other seats are elected or appointed for four-year terms.

Each EC member chairs a subcommittee, and each subcommittee is supported by a CFA staff liaison. The subcommittees and CFA staff members do much of the detailed work required to maintain and improve the GIPS standards. Subcommittees and working groups are created as needed. For example, a working group of private equity specialists was created to oversee the update of the private equity guidance for the 2010 edition. The continued success of the GIPS standards globally is directly related to the active participation by committed and engaged volunteers and Country Sponsor organizations.

## ORGANIZATION OF THE GIPS STANDARDS

Firms must comply with all requirements of the GIPS standards, as well as any interpretive guidance. This body of knowledge includes the GIPS standards, a series of Questions & Answers addressing narrow issues, and Guidance Statements, which are topical papers addressing issues more broadly. A firm must comply with the GIPS standards themselves as well as Q&As, Guidance Statements, and any other guidance issued by CFA Institute and the GIPS Executive Committee.

All guidance is available at the GIPS standards web site. Guidance is updated periodically, and CFA Institute notifies practitioners and other interested parties of changes via e-mail alerts.

The GIPS standards themselves are collected in a booklet that is organized into five chapters and three appendixes (see Table 1.1). Each provision, which represents either a requirement or a recommendation, has a number that references a section in Chapter I. (For example, Provision 0.A.4 states that the GIPS standards must be applied on a firmwide basis, and is included in Section 0.) The glossary in Chapter V defines the specific meaning of key words used in the GIPS standards. These terms are printed in the GIPS standards in SMALL CAPITAL LETTERS.

Each section of Chapter I contains both requirements and recommendations. All firms must comply with all of the applicable requirements within Sections 0 to 5 of Chapter I. A firm may choose, however, which recommendations it will follow. In the past, recommendations were viewed as

**TABLE 1.1** Organization of the GIPS Standards

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|---|---|
| Chapter I, Section 0 | Fundamentals of Compliance |
| Chapter I, Section 1 | Input Data |
| Chapter I, Section 2 | Calculation Methodology |
| Chapter I, Section 3 | Composite Construction |
| Chapter I, Section 4 | Disclosure |
| Chapter I, Section 5 | Presentation and Reporting |
| Chapter I, Section 6 | Real Estate |
| Chapter I, Section 7 | Private Equity |
| Chapter I, Section 8 | Wrap Fee/Separately Managed Account (SMA) Portfolios |
| Chapter II | GIPS Valuation Principles |
| Chapter III | GIPS Advertising Guidelines |
| Chapter IV | Verification |
| Chapter V | Glossary |
| Appendix A | Sample Compliant Presentations |
| Appendix B | Sample Advertisements |
| Appendix C | Sample List of Composite Descriptions |

provisions that were likely to become requirements in future editions of the GIPS standards. This may have been true when the GIPS standards and their predecessor standards were new. However, given the maturity of the GIPS standards, this is no longer the case and we should view the recommendations as simply best practices.

## FUNDAMENTALS OF COMPLIANCE

The Fundamentals of Compliance section (Section 0) was first included in the 2005 edition of the GIPS standards. Several of the provisions within this section were added to explicitly state what had been implicit and to remove any doubt about the responsibilities of a compliant firm. Other provisions within Section 0 speak to overarching principles of the GIPS standards. The following text explains the key provisions of Section 0.

### Firmwide Compliance

An organization that chooses to comply with the GIPS standards must comply on a firmwide basis. *Firm* is used throughout this book to refer to an organization that has chosen to comply with the GIPS standards. Defining

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the firm is the first step in the GIPS compliance process. Chapter 2 of this book provides guidance on defining the firm.

### Complete Compliance

An organization that does not claim compliance with the GIPS standards can make no reference to the GIPS standards. Investment managers cannot state that they are in "partial compliance" with the GIPS standards or are "in compliance with the GIPS standards except for...." There is no ability to partially comply with the GIPS standards. An organization either fully complies with the GIPS standards or does not comply at all.

### Use of Composites

The GIPS standards are predicated on the use of composites. A composite is an entity representing a collection of all portfolios managed according to a particular style or strategy. We use composites to recognize that most investment firms manage multiple portfolios on behalf of multiple clients. However, portfolios managed according to the same strategy could still achieve a different return. One of the key notions underpinning the GIPS standards is that the requirement to use composites prevents a firm from "cherry picking" the best-performing portfolio for a strategy and using that portfolio's performance to represent the strategy's track record. A prospective client should be able to review the fairest possible representation of a firm's track record. This would take into account not just selected portfolios but all portfolios managed according to a specific strategy.

Composites must include only "actual" portfolios. The performance of *model* or *hypothetical* portfolios may be presented as supplemental information but may not be combined with the performance of actual portfolios. All actual, fee-paying, discretionary portfolios must be included in a composite. Chapter 2 provides a discussion on composite construction.

### Policies and Procedures

A firm must document all policies and procedures that it has adopted for attaining and maintaining compliance with the GIPS standards. Firms combine these policies and procedures into a firm-specific document that is commonly named the *GIPS Manual*. GIPS Manual is the term that is used in this book to refer to these policies and procedures. A firm's GIPS Manual must address all requirements of the GIPS standards, as well as any recommendations of the GIPS standards that the firm has opted to follow. While many GIPS-related policies and procedures are included in the GIPS Manual, the firm may also choose to make reference to policies and procedures that are maintained elsewhere. For example, a firm may have pricing and other valuation policies already documented in a separate pricing manual. The firm could replicate this information in the GIPS Manual or simply refer to the pricing manual.

A common mistake is that firms document only policies, and not procedures. A firm must document not only policies that the firm has adopted but also the procedures by which those policies are applied. A policy can be thought of as a statement describing what the firm has selected to do with respect to a specific requirement. A sample policy is: "New portfolios are included in the respective composite after the first full month under management." Procedures are the steps the firm takes to ensure the firm follows the established policy. Some of the procedures to ensure new portfolios are included in composites at the correct time, in accordance with the firm's policy, could include:

- The Performance Measurement department is included on all notifications of new clients.
- For each new account, the assigned Relationship Manager completes a New Account Form, summarizing the account's mandate, benchmark, restrictions, expected funding amount and date, and so forth. The New Account Form is provided to all interested parties, including the Performance Measurement department.
- Upon receipt of the New Account Form, the Performance Measurement department determines which composite(s) the account should be assigned to.

Clearly articulated and detailed policies and procedures can be an invaluable tool for a firm to efficiently comply with the GIPS standards. A robust GIPS Manual can also serve as a powerful first line of defense when dealing with regulators. For example, in the United States, the Securities and Exchange Commission (SEC) oversees most managers of institutional assets. As part of its inspection program, the SEC may perform testing to determine whether a firm that claims compliance with the GIPS standards is actually in compliance with the GIPS standards. In 2007, the SEC issued the results of a series of examinations that were specifically focused on performance and advertising. A number of firms included in this "sweep" exam claimed compliance with the GIPS standards or the predecessor AIMR-PPS standards, but the SEC determined that a number of these firms had claimed compliance improperly. The top two deficiencies cited by the SEC were inadequate documentation of policies and procedures or a complete lack of policies and

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procedures. The regulatory risk alone should provide motivation for a firm to ensure the GIPS Manual is complete and as robust as possible.

### Compliance with All Laws and Regulations

The 2010 edition of the GIPS standards includes a new Provision 0.A.2: "Firms must comply with all applicable laws and regulations regarding the calculation and presentation of performance." This makes explicit what has always been implicit in the GIPS standards. The GIPS standards have had a long-standing requirement for a firm to disclose any conflicts between the GIPS standards and applicable laws and/or regulations.

Firms claiming GIPS compliance cannot ignore regulatory requirements that go beyond the GIPS standards. Instead, a firm must consider both the GIPS standards and all applicable regulatory requirements. For example, the GIPS standards allow a firm to present a prospective client with gross-of-management fee returns only, net-of-management fee returns only, or both gross and net returns. If a firm that is registered with the SEC chooses to present only gross returns in materials provided to a prospective client in a one-on-one meeting, four additional disclosures, commonly referred to as the *ICI II disclosures* (see *Investment Company Institute*, SEC No-Action Letter (pub. avail. September 23, 1988)), must be included for SEC purposes. (No-action letters are issued by the SEC in response to questions asking if certain practices would be allowed.) Personnel responsible for GIPS compliance should work in tandem with the firm's legal and compliance personnel to ensure all regulatory requirements are met.

### No False or Misleading Performance

Provision 0.A.3, new in the 2010 edition of the GIPS standards, states: "Firms must not present performance or performance-related information that is false or misleading." This new provision is a direct result of industry events over the time period when the GIPS standards were being updated. Several firms that were discovered to be Ponzi schemes or that were reporting fictitious assets under management had falsely claimed compliance with the GIPS standards. While adding this provision will not stop an unscrupulous firm from claiming compliance, it clearly articulates the high ethical standards that investment firms claiming GIPS compliance are expected to uphold.

### Provide a Compliant Presentation

A firm that claims compliance with the GIPS standards must make every reasonable effort to provide a compliant presentation to all prospective clients. A compliant presentation is a composite-specific report that includes all statistical data and disclosures required by the GIPS standards. Chapter 6 describes the information that must be included in a compliant presentation. A prospective client is a person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite.

### List of Composite Descriptions

One of the required disclosures that must be included in a compliant presentation is an offer to provide a list of composite descriptions. A composite description is general information about the composite's strategy (for example, "This composite represents the performance of all portfolios managed according to the firm's U.S. Active Equity Strategy and benchmarked to the S&P 500 Index"). This list must include all composites managed by the firm, whether a composite is marketed or not, as well as all composites that terminated within the past five years. Provision 0.A.10 requires a firm to provide the complete list of composite descriptions if requested to do so by a prospective client.

Once a firm provides the list of composite descriptions to a prospective client, the prospective client might wish to see a compliant presentation for another composite. Provision 0.A.11 requires a firm to provide a compliant presentation for any composite included on the firm's list of composite descriptions, if requested to do so by a prospective client. This includes any composite that terminated within the past five years.

While prospective clients rarely request to see the list of composite descriptions or ask for additional compliant presentations, the firm's verifier, and regulators, will ask for these items. In the United States, these items are standard requests made by the SEC when examining investment managers that claim compliance with the GIPS standards.

## SUMMARY

This chapter described what the GIPS standards are and why they came to be, the basic tenets of GIPS compliance, and how the GIPS standards are governed by CFA Institute and volunteers representing the needs of institutional investors and the investment managers that serve them.

The GIPS standards are voluntary. If a firm chooses to claim compliance with the GIPS standards, the firm must comply with *all* of the required guidance. Failure to do so may subject the firm to regulatory scrutiny. The following chapters provide detailed guidance for complying with the GIPS standards.