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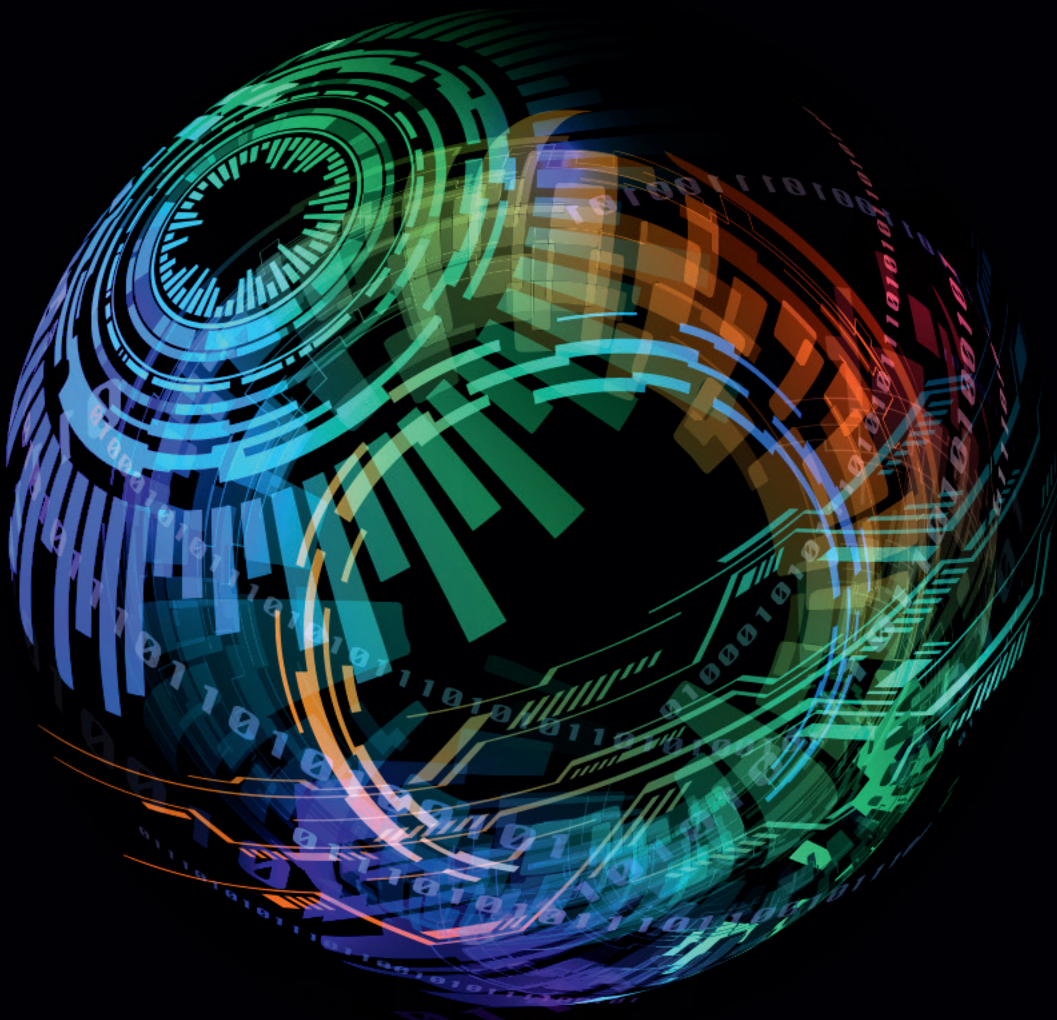


GIPS® 20/20: The way forward

Analyzing industry feedback on the performance standards

Deloitte Center *for* Financial Services

Contents

Seizing the collaboration opportunity

Investment management (IM) firms are constantly on the lookout for changing trends that create opportunities in the capital markets. A different kind of change is currently underway for many investment managers: revision of the Global Investment Performance Standards (GIPS) in 2020.

Developed by the CFA Institute, the voluntary performance-reporting standards aim at calculating and presenting investment performance on the principles of transparency and fair representation. These standards were designed to help investors make an "apples to apples" comparison of fund performance while making an investment decision, easing the selection process. As a result, most investors believe they can place greater confidence and trust in the performance presentations of GIPS-compliant firms.

As of February 2018, more than 1,650 firms across 40 countries claim compliance with the current GIPS standards.[1] For investment managers, the GIPS standards can provide an advantage by helping them compete for new assets globally.[2] In fact, maintaining policies and procedures for GIPS compliance typically strengthens the internal controls and governance processes for IM firms. This often helps IM firms focus more on client expectations and strategic fit during due diligence reviews, instead of performance data integrity.

The collaborative approach for performance standards development is a key to their wide acceptance. This collaboration is driven by the GIPS Executive Committee (details in sidebar), which encourages industry participants to provide feedback at various stages of the development process. Along with having industry representatives on the GIPS subcommittees, industry feedback and responses are sought via comment letters, panel discussions, and conferences. With fewer than two years to go for the revised standards, the CFA Institute initiated a 90-day comment period on the "GIPS® 20/20 Consultation Paper" (which is the precursor to draft standards) in May 2017.[3] Once the comment letters were received, the GIPS Executive Committee conducted in-depth analysis and review of the letters to assess the industry feedback on key proposals.[4]

The May 2017 Consultation Paper aims to increase the number of GIPS-compliant firms among alternative and pooled fund investment managers.[5] These changes may be subtle, but they represent an important transition for the industry, warranting a detailed analysis of the comment letters. The analysis (summarized in this report) indicates that the industry participants have agreed in principle with most proposals but appear to be seeking greater clarity and guidance on specific cases. This report highlights the industry participants' feedback concerning each GIPS® 20/20 proposal. It also analyzes the feedback and provides an expected outcome for each proposal, based on insights gleaned from the comment letters.

The GIPS Executive Committee and GIPS sponsors

The **GIPS Executive Committee** has multiple objectives: to achieve universal compliance for asset owners, adoption by asset managers, and support from IM regulators. Representatives from all industry stakeholders—asset owners, investment managers, and market regulators—constitute this committee. The Executive Committee also organizes subcommittees (including asset owner, interpretations, investment manager, and verification) to facilitate the involvement of all GIPS sponsors and key stakeholders in the ongoing oversight of the standards.[6]

GIPS sponsors are local organizations, such as United States Investment Performance Committee (USIPC) and UK Investment Performance Committee (UKIPC), which support continuous development of the performance standards. More than 40 GIPS sponsors provide an important link between the GIPS Executive Committee and local markets. They ensure that the local practices and regulations of investment managers are considered while developing the GIPS standards.[7]

Sensing investment managers' feedback on GIPS 20/20 proposals

Multiple industry stakeholders have provided feedback on the Consultation Paper to shape the upcoming standards (see figure 1). While just 19 IM firms have provided detailed views on the 11 proposals, these firms control aggregate assets under management (AUM) representing approximately 5 percent of the global total (worth more than $4.3 trillion).[8] Additionally, 15 GIPS country sponsors (responsible for developing and promoting the GIPS standards in the respective country), 5 industry associations, and 12 individuals have provided their feedback. The responses carry a global flavor, coming from a range of geographies including the United States, Europe, Asia, Africa, and Australia.

The following section highlights the broader differences in opinion received. Further analysis provides indications of which proposals may proceed with minimal change and which would likely be overhauled in the next draft.

Deloitte analysis methodology: The "GIPS® 20/20 Consultation Paper" comment letters are publicly available. Each of these comment letters provides the respondent's feedback on some or all of 13 questions.

The opinions in the comment letters have been classified as either "agree" or "disagree" based on the details of the response. In some cases where participants have asked for more clarity or suggested alternative solutions, the responses have been classified as agree or disagree based on the tone of the comment and the conviction expressed. In cases where respondents have not provided any feedback, the response has been considered as "not applicable" and has not been considered for further analysis.

Industry associations represent the opinions of investment managers and provide a unified voice to IM firms. Accordingly, we have grouped their responses to understand the overall industry opinion. Our team arrived at the expected inclusion status based on the strength and frequency of the comments.

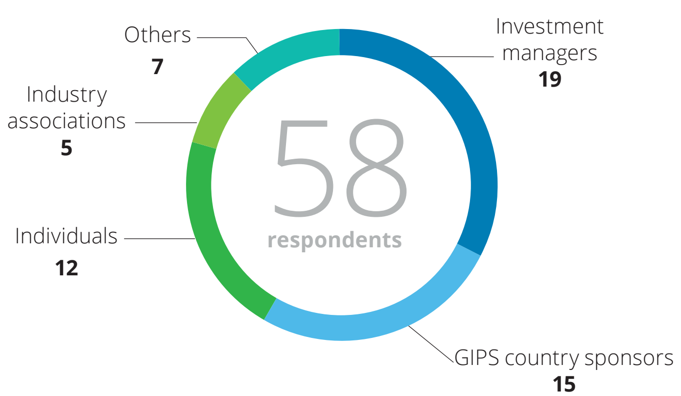
Only opinionated responses have been considered for calculating the percentage of agreeing and disagreeing responses for a specific proposal. Responses not providing comments have been ignored.

Degree of impact of proposed GIPS 20/20 standards has been determined based on the deviation from current standards and the associated burden for IM firms. The six proposals scrutinized in detail would have a high impact on IM firms per the above criteria.

Figure 1. Respondent demographics

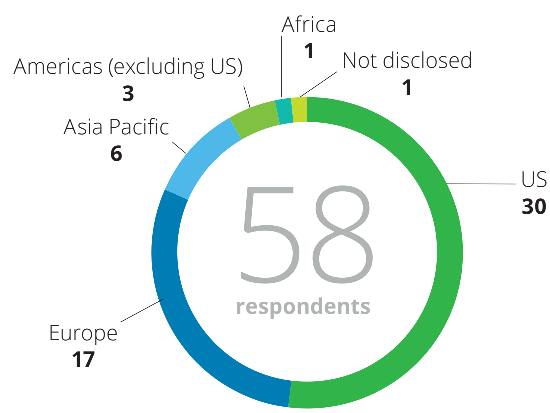
By industry role

IM firms and GIPS country sponsors have been at the forefront in providing feedback



By geography

Respondents from US and Europe accounted for 81% of total

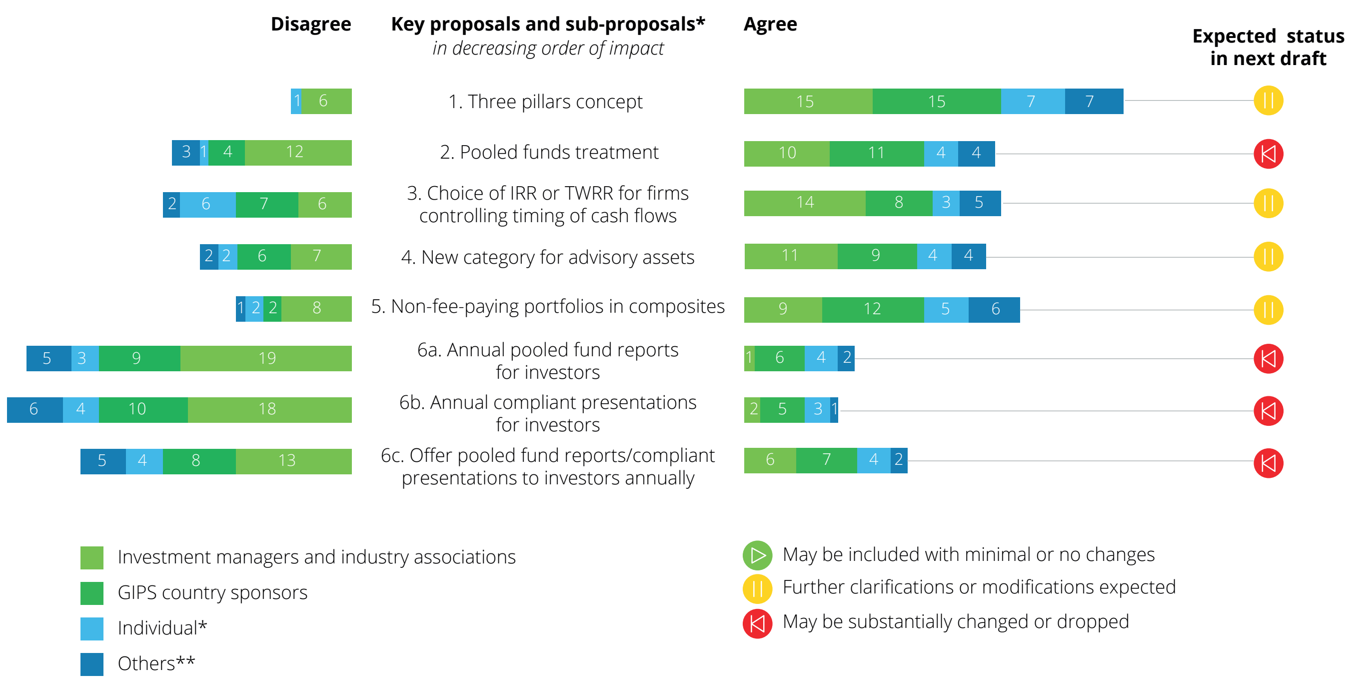


Source: Comment letters on "GIPS 20/20 Consultation Paper" and Deloitte Center for Financial Services analysis.

Feedback and expected outcome for high-impact proposals

Six high-impact GIPS proposals warrant a closer look. These proposals would significantly change the current standards and widen their application. Let's look at how these proposals are being received by the industry.

Figure 2. Responses to high-impact GIPS 20/20 proposals and sub-proposals, and their expected inclusion status



Note: The order and numbers for each proposal are in the decreasing order of impact and may not be in line with the order presented and questions posed in the GIPS 20/20 Consultation Paper. Details of proposals and sub-proposals and their expected way forward are explained in the following section.

*Individual responses include those submitted by professionals in a personal capacity

**Others include audit, tax, and advisory service providers; compliance software vendors; GIPS verification service providers; GIPS consultancy firms; and anonymous respondents

Source: Comment letters on "GIPS 20/20 Consultation Paper" and Deloitte Center for Financial Services analysis.

1. Three pillars concept

The three pillars concept recommends that performance presentations be based on the relationship between the parties presenting and receiving information. The standards would be organized into three pillars:[9]

- ***One-to-one***—Where one-to-one relationship exists between the investment manager and the client (for example, institutional separate account).
- ***One-to-many***—Where an investment manager sells participation in pooled funds (for example, mutual fund).
- ***One-to-none***—Where asset owners do not have any prospective clients (for example, sovereign wealth funds).

The three pillars concept would adjust the reporting standards to match the type of investment relationship. Accordingly, composite performance should be presented for one-to-one relationships, whereas fund performance should be presented for one-to-many relationships. The feedback on this proposal is moderately positive, with 71 percent of IM firms and industry associations (IM firms' perspective) agreeing with the proposal. However, many respondents are seeking additional clarifications, especially for the real estate and advisory asset classes. These clarifications aim to make the pillars structure well-defined, exhaustive, and free from overlaps, so that each reporting relationship is unambiguously covered by the standards. Further, the Investment Company Institute (ICI) is recommending exclusion of regulated funds from the purview of these additional reporting requirements.

Three pillars concept

The way forward:

The CFA Institute is paying close attention to the feedback and is adjusting the proposed standards. The fine-tuned GIPS 20/20 exposure draft is scheduled to be released in Q3 2018.[10] This draft will likely provide further guidance for classification of assets in the three pillars structure. An additional pillar could be added to the structure for advisory services such as outsourced chief investment officer (OCIO) and sub-advisers who do not actively manage portfolios.

2. Pooled funds treatment

The Consultation Paper proposes the following treatment for pooled funds:[11]

- A "pooled fund report" should be provided to prospective clients instead of a composite presentation.
- Performance should be presented net of all fees and expenses; gross returns may be presented to satisfy regulatory requirements.
- Single-fund composites need not be created for funds with a unique strategy.
- A list of all composites and pooled fund descriptions must be maintained.

IM firms' perspective is leaning toward disagreement (55 percent). Further, the proposal has received divergent responses from IM firms of varying size. IM firms with fewer than $100 billion in AUM agree with the proposal but have asked for clarifications regarding the content of the pooled fund presentation and treatment of different asset and share classes. On the other hand, IM firms with more than $100 billion in AUM have raised concerns over additional compliance burdens. The combination of the three pillars concept and proposed pooled funds treatment may result in discontinuity in the historical track record of composites. The pillars concept proposes that presenting composite performance for one-to-one relationships and fund performance for one-to-many relationships is appropriate. For example, if a new pooled fund is created following the same strategy as that of a poorly performing existing separate account, the poor track record of the separate account would not be presented to the prospective client.

Additionally, IM firms offering different share classes of pooled funds to distinct investors, such as retail, institutional, or private banking clients, may need to consider each share class as a separate fund owing to the differences in fees (as shown above for the pooled funds treatment). IM firms and industry associations have urged the GIPS Executive Committee to consider local regulations before finalizing the standards. One IM firm has suggested that the provision to create a list of all composites and pooled fund descriptions runs the risk of being construed as an advertisement by the U.S. Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA).[12] Consequently, additional advertising disclosures may be needed.

Pooled funds treatment

The way forward:

The proposal may be substantially modified to accommodate different jurisdictional regulations across the globe. The additional cost burden highlighted by large IM firms (AUM more than $100 billion) may also lead to a notable and considerable rethinking of the current proposal.

3. Choice of IRR or TWRR for firms controlling timing of cash flows

This proposal provides a choice to IM firms that control cash flows for closed-ended, fixed-life, fixed-commitment funds to present either internal rate of return (IRR) or time-weighted rate of return (TWRR). The majority (70 percent) of IM firms and industry associations have agreed with the proposal. However, there is a difference of opinion among them. Investment managers (87 percent) are in favor of being allowed to choose the appropriate method, whereas most (60 percent) industry associations have recommended that IRR be the primary method for closed-ended funds. Requiring all closed-ended funds to use IRR would make performance comparison easier. Moreover, IM firms suggest (see figure 3) that control over timing of cash flows should determine the calculation method for performance presentation. The ICI recommends the exclusion of regulated funds, as the performance reporting requirements are specific and detailed in many jurisdictions.

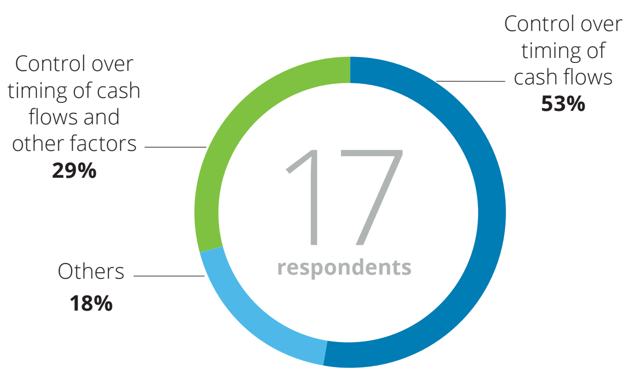
Choice of IRR or TWRR for firms controlling timing of cash flows

The way forward:

Because ICI has some pointed recommendations on this proposal, consideration of local regulations is likely to be added to lower burden on already regulated funds.Specific guidance for choosing the performance calculation method along with criteria could also be introduced.

Figure 3. Criteria to present IRR

An IM firm's control over timing of cash flows is the single largest parameter favored to present IRR, according to 82% of respondents.



Others includes firm's discretion, IRR as primary metric, and TWRR as core metric.
Excludes respondents who did not provide any comments.

Source: Comment letters on "GIPS 20/20 Consultation Paper" and Deloitte Center for Financial Services analysis.

4. Creating a new advisory assets category

In light of the fact that advisory assets represent a considerable portion of the IM industry, the Consultation Paper proposes to create a new category of assets. It would include managed, overlaid, and advised assets, such as unified managed accounts, advisory-only portfolios, and model portfolios. IM firms' perspective is in favor (61 percent) of the proposed new advisory assets category (see figure 2). However, most of the IM firms and industry associations (72 percent; see figure 4) suggest that this should only be a recommendation or presented as supplemental information in compliant presentations. Some firms have also asked for clarifications and clear definitions so that the provision can be implemented without any ambiguity.

Creating a new advisory assets category

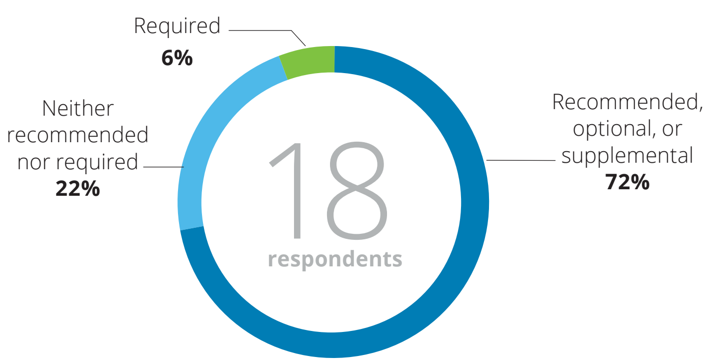
The way forward:

Given the feedback, we expect clarifications on the new asset categories to be included in the exposure draft along with a softening of the reporting requirement to "recommendation."

Figure 4. Reporting requirement for new advisory assets category

New advisory assets category

72% of respondents favor allowing reporting of new advisory assets category and total firm assets in compliant presentations as a recommendation or supplemental information, if the new category is created.



Excludes respondents who did not provide any comments.

Source: Comment letters on "GIPS 20/20 Consultation Paper" and Deloitte Center for Financial Services analysis.

5. Including non-fee-paying portfolios in composites

This proposal requires firms to include non-fee-paying portfolios in composites in contrast to the discretion offered to firms earlier. Based on the responses from IM firms, there is no clear consensus on this proposal, with 53 percent agreeing. Those in favor have stated that fee-paying status does not restrict a portfolio manager from applying a strategy to the portfolio and hence should be included. However, those against the proposal have advocated that firms should continue to have discretion to include these portfolios in composites. Some firms have communicated that they are in the best position to gauge the meaningfulness of a portfolio to investors. Further, the value added by such calculations may not be worth the additional effort required.

Including non-fee-paying portfolios in composites

The way forward:

Given the mixed opinion received from IM firm respondents, the CFA Institute is likely to engage in extended discussions with IM firms to redesign the proposal. Considerable rethinking would likely be required to take the proposal forward.

6a. Provide pooled fund report to investors annually

6b. Provide compliant presentation to investors annually

6c. Make an offer to provide pooled fund reports or compliant presentations to investors annually

This proposal asks IM firms to provide pooled fund reports or compliant presentations to existing investors annually. Both of the suggestions have received overwhelmingly negative responses, with 95 percent of IM firms and 90 percent of industry association respondents expressing their disagreement. Alternatively, it proposes IM firms should make an offer to present these documents to investors on an annual basis. More than two-thirds (68 percent) of the IM firms and industry associations have opposed this provision as well. Investors receive regular performance reports based on local regulation or in accordance with their governing agreement with IM firms. Some respondents note that additional reporting requirements imposed by GIPS 20/20 may be duplicative. Some local jurisdictions may also prohibit this additional reporting. Moreover, the additional reports may also confuse the investors who may not understand the objective of these reports.

Provide pooled fund reports or compliant presentations to existing investors annually

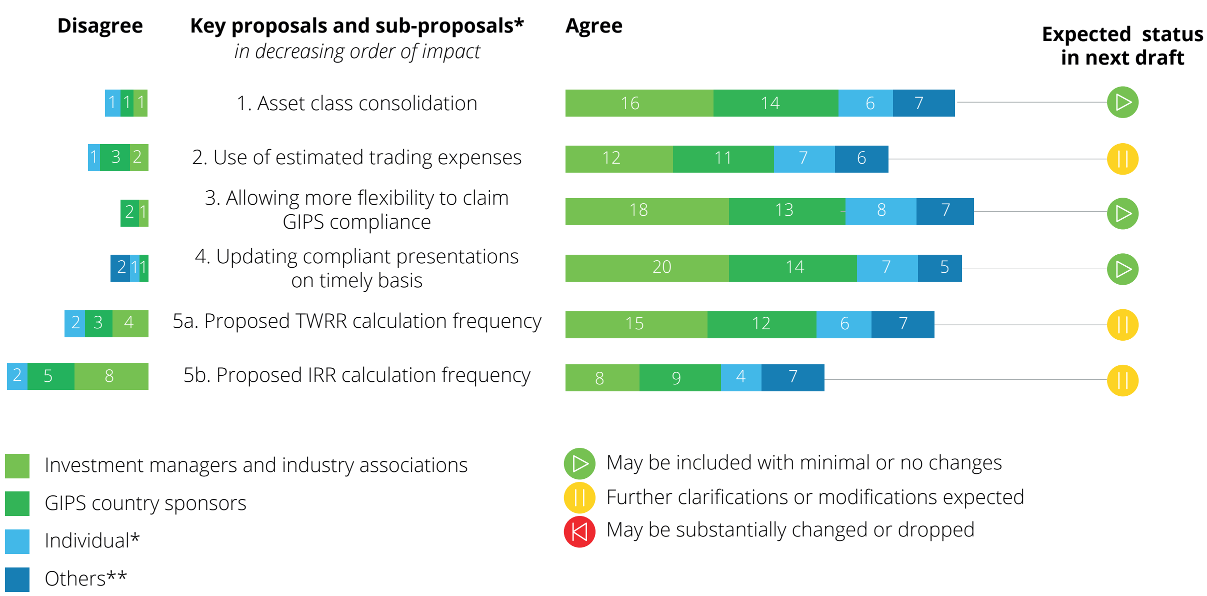
The way forward:

This proposal is likely to be significantly modified based on the feedback. Both versions of the annual reporting proposal may become a recommendation rather than a requirement. Alternatively, these requirements could be completely dropped.

Feedback and expected outcome for medium-to-low-impact proposals

The remaining five proposals are expected to have medium-to-low impact on the reporting and compliance functions of IM firms.

Figure 5. Responses to other GIPS 20/20 proposals and sub-proposals and their expected inclusion status



Note: The order and numbers for each proposal are in the decreasing order of impact and may not be in line with the order presented and questions posed in the GIPS 20/20 Consultation Paper. Details of proposals and sub-proposals and their expected way forward are explained in the following section.

*Individual responses include those submitted by professionals in a personal capacity

**Others include audit, tax, and advisory service providers; compliance software vendors; GIPS verification service providers; GIPS consultancy firms; and anonymous respondents

Source: Comment letters on "GIPS 20/20 Consultation Paper" and Deloitte Center for Financial Services analysis.

1. Consolidation of asset-class-specific guidance

The current GIPS standards include specific provisions and guidance for asset classes such as real estate, private equity, and alternative investment strategies and structures. The Consultation Paper proposes to reduce asset-class-specific guidance as much as possible. This proposal garnered 94 percent positive feedback from IM firms and industry associations. The lone dissenting opinion from a large US-based IM firm was concerned about losing the unique characteristics of asset classes.

2. Use of estimated trading expenses

Firms may be allowed to use estimated trading expenses in returns calculations. Estimated expenses can be used on the condition that the calculated returns are lower than or equal to returns calculated using actual trading expenses. More than 85 percent of the IM firms and industry associations have responded positively to the proposal, along with suggestions that estimations be accompanied with appropriate disclosures and explanation of calculation methodology.

3. Allowing more flexibility to claim GIPS compliance

The proposal aims to let IM firms claim GIPS compliance through additional means apart from the three ways allowed currently:[13]

- Compliant presentation with a claim of compliance
- Advertisements prepared per the GIPS Advertising Guidelines
- GIPS Pooled Fund Claim of Compliance included in pooled fund document or marketing material

This proposal has received overwhelmingly positive response (95 percent) from the perspective of IM firms. The respondents have suggested other means for claiming compliance, such as on company websites, additional marketing materials, and databases.

4. Timely updates to compliant presentations

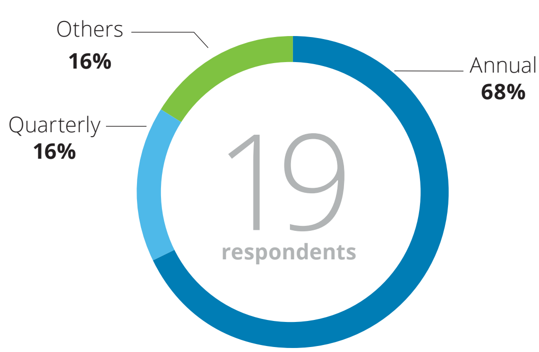
This proposal requires that the compliant presentation be updated at regular intervals so that the data presented to prospective investors is recent. The proposal has received 100 percent agreement from IM firms' perspective so that performance presented to prospective investors is current and relevant. The majority of respondents (68 percent) have also suggested that the data provided in these compliant presentations be updated on an annual basis (see figure 6).

5a. Proposed TWRR calculation frequency

The Consultation Paper proposes that the frequency of TWRR calculation should be monthly and at the time of large cash flows. The proposal is favorable (79 percent) from IM firms' perspective. However, some of the respondents (32 percent) have suggested that the valuation frequency should take asset class into consideration. They suggest less-liquid asset classes (private equity or real estate) can have an infrequent calculation period, such as quarterly calculations as required currently. Some respondents have also asked for more clarity to define large cash flows.

Figure 6. Recency of data in compliant presentations

Of respondents, 68% suggest that data in compliant presentations should be updated annually.



Others includes "Based on firm's valuation ability," "Most recently available," and "Quarterly non-verified returns or 18 months of verified returns." Excludes respondents who did not provide any comments.

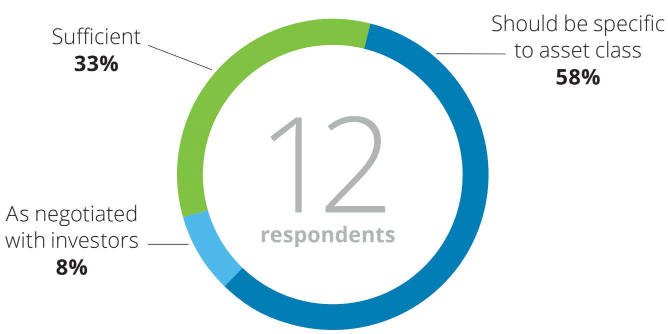
Source: Comment letters on "GIPS 20/20 Consultation Paper" and Deloitte Center for Financial Services analysis.

5b. Proposed IRR calculation frequency

The Consultation Paper proposes that IRR be calculated annually and at times when performance is calculated and presented to prospective clients or investors. The calculation frequency is agnostic to the underlying investment or asset class. The suggested frequency has received a mixed response, with more than half (58 percent; see figure 7) of IM firms and industry associations in agreement. The proponents suggest that the frequency is sufficient and in line with the annual updates made to compliant presentations. On the other hand, those against the proposal have suggested that the calculation frequency should consider the asset class so that a suitable frequency to each asset class (private equity and real estate) may be determined.

Figure 7. Responses to proposed IRR calculation frequency

Of respondents, 58% believe that IRR valuation frequency should be dependent upon asset class.



Sum does not add up to 100% due to rounding of numbers.
Excludes respondents who did not provide any comments.

Source: Comment letters on "GIPS 20/20 Consultation Paper" and Deloitte Center for Financial Services analysis.

Studying the comment letters indicates varying degrees of agreement among industry participants on the proposals and sub-proposals. Given the divergence of opinion, keeping a close track of the changes is recommended as firms transition to planning and prioritization.

Medium-to-low impact Proposals

The way forward:

Many of the low- and medium-impact proposals received strong, positive feedback from the perspective of IM firms. Three of the five proposals—asset-class consolidation, timely updates to compliant presentations, and flexibility to claim GIPS compliance—receiving more than 90 percent support are likely to be adopted without significant change in the next draft of the standards. A key reason for the positive feedback from IM firms and industry associations is the provision of greater compliance options and more flexibility being offered to IM firms. Other proposals—use of estimated trading expenses and proposed calculation frequency for IRR and TWRR—receiving overall positive feedback from IM firms and industry associations are likely to be modified in the next draft. While the proposal allowing use of estimated trading expenses could be modified to require inclusion of disclosures and methodology of estimation, the one concerning TWRR calculation frequency is likely to include asset-class-specific guidance for products with infrequent NAV calculations, such as private equity and real estate.

Next steps for investment managers in the GIPS 20/20 journey

Although the GIPS standards are voluntary, this comment period creates the opportunity for sensing and influencing as outlined in Deloitte's regulatory-ready organization[14] framework in figure 8. Consisting of three stages, the framework follows a life-cycle approach to respond effectively to changes in regulatory and compliance standards. The approach begins with the sensing and influencing stage, followed by planning and prioritization for the firm response, and implementing the compliance change management program. For investment managers, the sensing and influencing stage provides an opportunity to voice their opinion and help shape the upcoming standards.

The first stage of sensing and influencing for the GIPS 20/20 standards is closer to the finish line. Investment managers that missed out on the previous window can utilize the upcoming Q3 2018 exposure draft to help shape the performance standards. Some proposals are likely to be adopted with minimal change, while others are more uncertain. Much of the uncertainty will likely be reduced in the fall of 2018, when the revised guidelines are published.

After sensing and influencing comes planning and prioritizing, followed by implementing. The planning phase is important because IM firms face differing levels of changes to maintain or achieve GIPS compliance depending on their operating models. Coordinating the GIPS-driven process and technology changes with the overall technology modernization plan can represent a challenge for some IM firms. Figuring out how these initiatives can dovetail or complement one another may present difficulty, but can also provide value. Even though GIPS compliance is a voluntary standard, it is considered important by many. Since planning and marshalling resources may take significant time prior to implementation, IM firms should consider starting now to prevent having to play catch-up.

Figure 8. The three stages of a regulatory-ready organization

Source: Deloitte Center for Financial Services analysis.

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Endnotes

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