GPS INSIGHTS

October 2023

HIGHLIGHTS FROM THE 2023 GIPS® STANDARDS ANNUAL CONFERENCE

The 27th Annual Global Investment Performance Standards (GIPS®) Conference was held in Chicago, Illinois on October 17-18, 2023. The conference brought over 400 delegates from 17 countries to learn about changes to the GIPS standards, share challenges with complying with the SEC Marketing Rule, and to connect with their fellow investment performance measurement and compliance professionals.

Conference Recap

The conference kicked off with a session highlighting the impact on performance advertisements since the SEC Marketing Rule (the "Rule") was put into effect almost a year ago. The session was led by Michael McGrath, CFA, a Partner with Dechert; Robert Shapiro, Assistant Director, SEC Division of Investment Management; Karyn Vincent, CFA, CIPM, the Senior Head of Global Industry Standards at CFA Institute; and Krista Harvey, CFA, CIPM, Director, Global Industry Standards at CFA Institute. While their views and opinions were consistent with the expectations that practitioners have heard this past year, there were some clarifying details shared that surprised some of the attendees. Key highlights and takeaways from this session are outlined in the "*SEC State of the Union*" section below.

The next session highlighted the latest trends for managing back/middle office performance functions including 1) outsourcing the function to a third-party to perform on the service provider's platform, 2) hiring a third-party service provider to be responsible for the function utilizing the investment firm's technology (commonly referred to as "Managed Services"), and 3) insourcing, where the function is performed by the investment firm's in-house team. Cost considerations, achieving greater operational efficiencies, and access to technology and expertise that meet business needs were the three top reasons cited for hiring third-party support.

As the conference progressed, Jill Banaszak, Global Head of Omni Success at eVestment highlighted how institutional investors and their consultants use database information to identify and screen for potential managers. Mrs. Banaszak highlighted the most frequently used data screens; interestingly, none of which relate to performance. In the past three years, Diversity & Inclusion (D&I) screens have increased by 400%. She noted that D&I factors are now included in over 10% of all consultant and asset owner screening activity in eVestment. Further illustrating the importance of D&I, 100% of the top 10 consultants that are using eVestment are factoring this into their screens. Mrs. Banaszak suggested that if your firm does not address questions related to D&I, many consultants and investors screen your firm out. ESG also continues to be a hot topic and a popular screen on consultant databases. In fact, eVestment recently launched an analytics tool that helps investors research ESG considerations and verify statements pertaining to ESG using holdings provided by investments managers. She concluded the session by explaining how managers are missing out on opportunities, revealing top missed screens: 1) screens pertaining to qualitative data, like how firms utilize derivative securities and 2) portfolio team details identifying what makes a firm or the portfolio management team stand out and differentiate themselves from others.

Several sessions touched on the use of internal rate of return (IRR), given recent regulations that require firms to calculate these return metrics, including the newly issued Quarterly Statement Rule for Private Funds, FINRA Regulatory Notice 20-21, and the SEC Marketing Rule. These sessions were packed with information and kept conference attendees engaged. A key take-away from the question-and-answer portion of the session on the Private Fund Adviser Quarterly Statement Rule was the realization that since the proposed Quarterly Statement Rule for Private Funds requires firms to show since inception IRRs after there are two quarters of P/L, the SI-IRRs presented for these periods will likely be heavily distorted due to the short time frame. It will be interesting to see how this plays out; if the SEC will address this in follow-up guidance or if firms will add disclosure to explain the issues related to calculating IRR for periods shorter than a year.

Other conference sessions included a deep dive into how performance calculation requirements will be impacted under the Private Fund Adviser Rule and a GIPS standards update. Key highlights and takeaways from these sessions are outlined below.

SEC State of the Union - Marketing Rule Update, Enforcement Cases & Lessons Learned

We're approaching one year since the SEC Marketing Rule became effective on November 4, 2022. Given the recent enforcement cases citing failure to comply with the new rules, it is no surprise that this was, again, a major topic of discussion at this year's GIPS Standards Annual Conference.

- Robert Shapiro, an Assistant Director in the Division of Investment Management at the SEC, touched on the nine enforcement actions that came in September, shortly after the first enforcement case in August 2023. All ten cases involved the use of hypothetical performance metrics spanning multiple issues including hypothetical performance that was presented on publicly available websites, materials that contained misleading statements, advertisements that made improper disclosures, or where firms failed to adopt and implement policies and procedures around the use and dissemination of hypothetical performance. It is apparent that the SEC is taking this very seriously by conducting focused examinations and digging into whether investment managers have adequate policies and procedures in place that outline and define the use of hypothetical performance. However, it's not enough for firms to have documented policies and procedures; the SEC is also taking into consideration whether documented policies and procedures are *appropriate* given what the firm presents and what the Marketing Rule stipulates. There is a clear obligation for firms to establish and document policies and ensure that hypothetical performance is only shown to those whom the performance is relevant.

- Another deep concern expressed was whether investors in the retail space, who may be less sophisticated investors, are able to adequately interpret hypothetical performance. In all instances where a firm presents hypothetical performance, the firm must ensure the audience can understand it and that the materials contain complete and accurate disclosure related to the assumptions used, and related risks and limitations. In some circumstances, disclosure might not be enough, and firms will need to remove hypothetical performance from their materials depending on the intended audience.
- Last year at the conference, there was much discussion around attribution and whether it was deemed to be "related performance" for purposes of the Rule. This year, session panelists discussed this again and specified that certain portfolio characteristics do not need to be presented net-of-fees ("NOF"), but the determination will depend on what the information is intended to convey. Panelists acknowledged that if an investor is expected to take away from the materials an understanding of what the investment or portfolio has returned, then the information would be considered performance and must be presented NOF. In other words, if an investor could look at the information and could infer what he or she likely would have earned or what was earned, then it needs to be presented NOF. Panelists agreed that sector returns are clearly performance and, if presented, the returns need to be NOF; however, attribution effects do not convey the amount of money generated by the investment, so presenting NOF would not be required.
- Many firms are calculating investment-level net returns for the first time given the clarification that was provided in the SEC's FAQ released earlier this year. The panelists discussed this FAQ and noted that firms who present investment-level returns need to choose a methodology they believe is reasonable and not misleading. Mr. Shapiro noted that he does not expect the SEC to provide guidance on how firms should approach the calculation and instead firms need to utilize a methodology they believe is reasonable and not misleading. This has been frustrating for some as firms are finding that each methodology has its flaws. The panelists discussed calculating net IRRs using the ratio method and other alternative methods.

Calculating Investment-Level Net Returns

The SEC has not indicated a methodology or specific approach for calculating investment-level net returns. Applying a model fee is the most common approach that firms are taking to calculate extracted performance net-of-fees. Determining what model fee is most appropriate is the challenging part. In response to the SEC's FAQ, CFA Institute created two spreadsheets to help firms with the calculations. The files from CFA Institute are available by clicking here. Regardless of the methodology the firm elects, disclosures about the methodology used and assumptions need to be made clear in the advertisement.

- Whether or not dividend yield should be considered "performance" has been a gray area. Some of the panelists, including Mr. Shapiro, shared their conclusion on this issue, assertively stating that dividend yield needs to be classified as performance, while others in the industry do not share the same view. Mr. Shapiro acknowledged that the SEC values advocacy and conversation surrounding these controversial topics and encouraged firms to approach the SEC with their questions and comments as this dialogue can impact the SEC's opinions and future guidance.
- In addition to presenting composite returns, it is common practice within the industry to present a representative account's return stream. An argument was made that this could be a form of "related performance," especially if a firm was presenting statistics using the returns of multiple representative accounts linked together to illustrate a continuous return stream. However, if a firm is combining multiple representative accounts for the purpose of showing *portfolio characteristics*, then it would not be considered performance. Alternatively, the panelists agreed that combining multiple representative accounts for the purpose of illustrating a track record *would* be considered hypothetical performance, as it does not represent an actual portfolio or the composite.
- As the industry continues to evolve, moving towards net returns being the gold standard, it is surprising that database providers are slow to follow suit. It is not uncommon for some databases to request that managers upload only their gross-of-fees track records. Mr. Shapiro acknowledged that advisory firms cannot control the information that databases are requesting but believes firms are responsible for making a best effort attempt to get the required information to investors. He hopes that as the market continues to adjust, that databases will evolve and adjust too. In the meantime, he recommended that firms simply do their best when updating databases. Firms should not put themselves at a disadvantage; the best practice would be to load in the requested performance and answer all the required questions, while also including disclosure to add clarification, if needed. For example, if only gross performance is uploaded, firms should include disclosure to direct the reader where they can review net performance.

SEC Adopted New Private Fund Adviser Rules

In August 2023, the SEC adopted new Private Fund Adviser rules, including a requirement to prepare and distribute to fund investors a quarterly statement that includes information about fees, expenses, and performance. The rules are set to go into effect November 13, 2023, with a compliance date for the quarterly statement rule of March 14, 2025. There was much discussion around the upcoming requirements for private fund advisors, particularly as recent lawsuits filed by private fund industry associations attempt to challenge the validity and enforcement of the new rules. Is history repeating itself? We're reminded of the court's interpretation and decision to overturn the SEC's proposed Hedge Fund Rule back in 2006, which closed the door on greater oversight over hedge funds and left it to Congress to determine if increased oversight and regulation of hedge funds was needed. Since we don't know what the future will hold, advisors must prepare for these rules as if the lawsuits did not exist.

The panelists focused on the quarterly reporting aspects of the Private Fund Adviser Rules ("PFA Rules"). They compared the differences in the terminology as well as the requirements under the PFA Rules, the SEC Marketing Rule and the GIPS standards. The rules have different objectives given the requirements related to quarterly statements under the PFA Rules are focused on reporting requirements for current investors and the SEC Marketing Rule and GIPS standards are requirements appliable to prospective investors. Firms will need to update policies, checklists and potentially perform additional calculations to ensure that all provisions are addressed.

Your Input is Needed – Guidance Statement for OCIO Strategies Exposure Draft

An entire session was dedicated to the Exposure Draft of the Guidance Statement for OCIO Strategies that is currently available for public comment. OCIOs ("Outsourced Chief Investment Officers") provide investment advice and investment management services on an outsourced basis for Total OCIO portfolios of institutional investors, such as pension funds, endowments, and foundations.

Consultants have been asking for more comparability across performance materials produced by OCIOs, but the existing GIPS standards were not originally written taking OCIOs into consideration. CFA Institute created a working group in 2022 to address these concerns. The outcome of the working group's efforts is a draft guidance statement that is dedicated to firms managing OCIO strategies. Under the exposure draft, if a firm offers or manages Total OCIO Portfolios as segregated accounts, this will require a firm that claims compliance with the GIPS standards to create composites that meet the required OCIO composite structure which separates strategies into two buckets based on the portfolio's strategic allocation to certain types of assets: Liability-Focused or Total Return. Liability-Focused strategies are managed with an objective to meet a liability stream for some or all of the client's assets and its assets will be classified as either liability-hedging or growth assets (e.g., pension funds). Total Return strategies are managed with a total return objective and no liability matching and their assets will be classified as either risk-mitigating or growth assets (e.g., endowments and foundations). Each of those two main buckets are then broken down further into risk categories (Aggressive, Moderately Aggressive, Moderate, Moderately Conservative & Conservative) based on the mix of assets. Firms must establish policies and procedures for determining how assets are classified. This is the first time that the GIPS standards have been this prescriptive in how firms are required to construct composites.

You can find the Exposure Draft of the Guidance Statement for OCIO Strategies here. The period for public comment will close on November 20, 2023.

GIPS Standards Update

There were two sessions dedicated to providing an update on the GIPS standards. It was announced that 1,753 firms have currently reported to CFA Institute that they are adhering to the GIPS standards. The top 5 markets include the United States, United Kingdom, Canada, Switzerland, and Japan. New markets added in 2023 include Israel and Sweden. According to Pension & Investments data, 24 of the top 25 global firms claim GIPS compliance, as do 90 of the top 100 global firms.

CFA Institute future projects:

- After-tax standards for U.S. firms
- Guidance for verifiers when conducting a verification
- Best practices for calculating attribution
- Calculating performance when a trade error occurs

Finally, the following new and revised guidance statements were discussed in detail:

- Guidance Statement on Benchmarks for Firms (Revised)
- Guidance Statement on Firms Managing Only Broad Distribution Pooled Funds (Exposure Draft)
- Guidance Statement for OCIO Strategies (Exposure Draft)
- Guidance Statement on Composites for Fiduciary Management Providers to UK Pension Schemes (Exposure Draft)

GIPS Standards Conference Digital Package

For those who were not able to attend the GIPS Standards Conference, CFA Institute has made available a digital content package which contains all the resources and session recordings from the conference, plus additional content. Those who are interested in purchasing the digital content can register for access on the CFA Institute website. The conference session recordings and resources will be available for on-demand viewing from October 30th-December 31st.

GROWING THE GUARDIAN PERFORMANCE SOLUTIONS (GPS) TEAM

We are thrilled to announce the addition of two talented team members, Laura Richardson and Cameron Cheney. They are set to play integral roles in GPS' continued pursuit to bring a depth of expertise and knowledge to our clients' challenges and projects.

Laura Richardson works as a Compliance Consultant. With over 25 years in the investment management industry, Laura has a wealth of knowledge in performance measurement, systems management and applying the GIPS standards. She has experience working with several asset classes and account types, including equities, fixed income, mutual funds, private wealth accounts, sub-advisory accounts, wrap accounts and UMA accounts.

Cameron Cheney works as a Process Management Specialist. Cameron has experience in project management, refining operational processes to incorporate automation and documenting procedures to ensure consistency.

ABOUT US

Guardian Performance Solutions LLC (GPS) is a specialty compliance consulting firm dedicated to providing customized solutions to the investment management industry with the objective of supporting firms to achieve and maintain compliance with the Global Investment Performance Standards (GIPS®) and the SEC Marketing Rule. Because GPS does not provide verification services, GPS is free from independence concerns and can take a hands-on approach to developing and managing an adviser's performance advertising program, which may include reviewing marketing materials, drafting disclosures, constructing composites, calculating, and validating performance results, and writing compliance policies and procedures. Additional information can be found at www.GuardianPerformanceSolutions.com.