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2020 GIPS® STANDARDS

– Key Insights from Exposure Draft & Commentary

On August 31, 2018, the CFA Institute published the 2020 GIPS® Standards Exposure Draft. This Exposure Draft represents the intended changes to the GIPS® Standards, which were last updated in 2010. The investment management community was given until December 31, 2018 to provide their thoughts on the proposed changes, specifically to elicit feedback on 47 questions for comment.

Over 100 responses were sent to the CFA Institute, with 81 being made public. The GIPS® Executive Committee will now review those comments and make any final changes before publishing the 2020 GIPS® Standards by June 30, 2019. Effective January 1, 2020, firms wishing to claim compliance with GIPS® will need to adhere to the 2020 GIPS® Standards in their 2020 calendar year (i.e. January 1, 2021) presentations.

While the 2020 GIPS® Standards are by no means final yet, investment managers and asset owners are already preparing for the expected changes. We note some of the important points below.

Highlighted Proposed Changes from 2010 GIPS® Standards to 2020 GIPS® Standards

Division of Standards by Investor Type

Previously, the GIPS® Standards were holistically presented, with notations prescribing which pieces of The Standards applied to which particular investor type. This was noted as causing confusion for many adopters or would-be adopters, unsure of what aspects of The Standards applied to them. To simplify this, The Standards are being presented in segregated form for the 3 main intended audiences: traditional separate account managers, pooled funds, and asset owners. Sections 1-7 outline standards for (investment management) firms, while Sections 8-12 outline standards for asset owners. Section 13 applies to both firms and asset owners.

Money-Weighted Returns vs TWR/IRR

A major hurdle to gaining adoption of GIPS® Standards by alternative investment managers, such as closed-end Real Estate funds and Private Equity funds, was the focus on Time-Weighted Returns (TWR) and Internal Rate of Return (IRR) calculations for performance presentations. To allow more flexibility, the 2020 Exposure Draft proposes allowing for closed-end fund managers to present Money-Weighted Returns (MWR). To be allowed to present MWR, a closed-end fund manager needs to demonstrate control of the external cash flows for the portfolios and also meet at least one of four additional criteria, such as a fixed life.

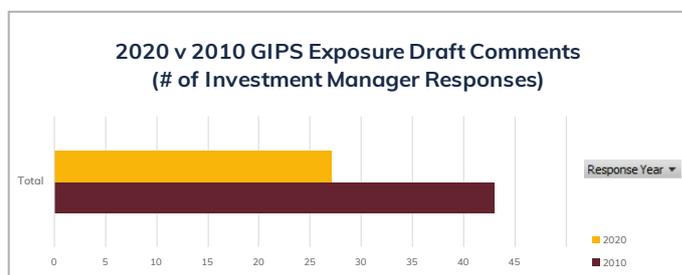
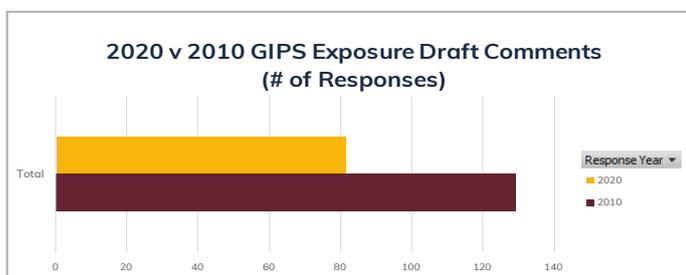
Valuation Frequency Changes

For the 2010 GIPS® Standards, asset valuation frequency was based on the underlying asset class of a composite. This meant that most investments, except for illiquid assets such as private equity funds, real estate portfolios, and other alternative investment strategy funds, were required to be valued monthly and at the time of large cash flows. For 2020 GIPS® Standards, it has been proposed that the valuation frequency is based on the type of returns presented (TWR v. MWR). Additionally, Asset Owners have pushed for extending the external valuation requirement for Real Estate investments to include private equity and other real assets. Therefore, the Exposure Draft proposes that all private market instruments require either an external valuation, a valuation review, or a financial statement audit at least every 12 months, to allow flexibility towards improved valuation quality.

Industry Response from Commentary Period

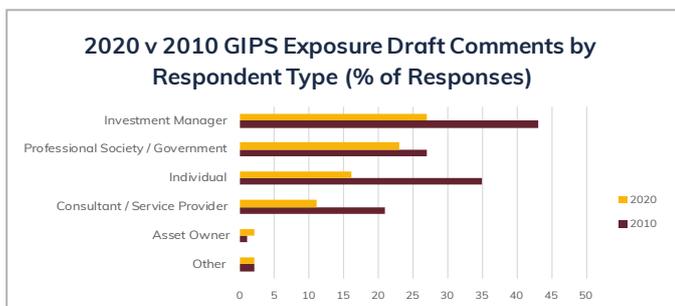
Lower Response Rate than for 2010 Exposure Draft

When commentary was last sought for the 2010 GIPS® Standards Exposure Draft, 129 public responses were received. For the 2020 GIPS® Standards Exposure Draft, only 81 public responses were received. It is important to highlight that the request for commentary seeks both agreement and/or criticism with the proposed standards. Of note is the lower response rate from Investment Managers, from 43 responses in the 2010 Exposure Draft to only 27 responses in the 2020 Draft. This may indicate that fewer investment managers have reviewed the latest Exposure Draft, or that they are expecting other entities to handle the work of commentary on the proposals.



Changing Dynamics of Respondent Type

The largest segment of respondents for both the 2020 and the 2010 Exposure Draft came from Investment Managers. The next two segments are Professional Societies / Government Agencies and Individuals. Interestingly for the 2020 draft, Professional Societies / Government Agencies have provided a proportionately larger response than Individuals. Consultants / Service Providers also supplied relatively less responses for 2020 than for 2010, with Asset Owners and Other respondents (including Wealth



Management) increasing their share of responses for the 2020 draft. Market participants should find it comforting that a larger share of commentary is coming from Professional Societies and Government Agencies, and less from Individuals, as these organized bodies have already undergone extensive internal discussions amongst their members to

present a cohesive view of their opinions on the Exposure Draft.

Key Areas of Industry Opposition

Timeliness for Updating Presentations

The Exposure Draft has proposed that firms should update their annual compliant presentations within 6 months of year-end. Currently some managers wait 12 months or more to update compliant presentations, under the argument that they are waiting for verification of their returns to be completed. Numerous investment managers (AXA, Glenmede, Lasalle, and WAMCO), consultants (ACA and Spaulding) and others have responded that, while a requirement timeframe is needed, a 6-month timeline may be too aggressive, especially for alternative investment funds, with 12 months being a more reasonable target for updates. However, other investment managers (including American Century, RBC, and Wells Fargo) have argued that 6 months is acceptable or even too generous, some suggesting quarterly updates.

Usage of Money-Weighting Reports for Cash Flow Controlled Funds

The switch from TWR/IRR to MWR was highlighted as one of the main changes to closed-end funds from 2010 GIPS® Standards. The criteria proposed by the Executive Committee is that the manager must have control of the cash flows, and 1 of 4 additional criteria must also exist, such as illiquid investments being a significant part of the investment strategy. Responses from Acadian Asset, AXA, Lasalle, WAMCO and others indicate that the manager having control of cash flows is the only necessary criteria for whether MWR should be allowed, which was also raised in the earlier Consultation Paper. Additionally, if the criteria is required, firms feel that illiquids being “a significant part” of the strategy needs a more precise definition.

Standards and Reporting Differentiation Between Limited Distribution and Broad Distribution Pooled Funds

The Exposure Draft proposes two different classes of Pooled Funds; Limited Distribution Pooled Funds (typically sold one-on-one to investors for a specific fund class) and Broad Distribution Pooled Funds (sold to the public at large, with the firm not necessarily knowing the investor). With this distinction, the proposed standards are that a separate “GIPS Pooled Fund Report”, similar to a “GIPS Composite Report”, be provided to prospective Limited Distribution Pooled Fund investors. Broad Distribution Pooled Funds are not required to provide this report but can if they wish, or they can create a “GIPS Advertisement”. Feedback from some managers (including Acadian Asset, AXA, Franklin Templeton, T.Rowe, WAMCO, and Wells Fargo), has been that this distinction, and requisite “GIPS Pooled Fund Report”, are unnecessary and create onerous reporting requirements.

What Should Firms Expect with 2020 GIPS® Standards?

Change is Coming, Prepare for the Extra Costs

It's worth noting that much research, analysis, and discussion by the GIPS® Executive Committee and other collaborators went into the 2020 GIPS® Standards Exposure Draft. That's not to say things can't change. However, in the absence of significant opposition raised in commentary, the Exposure Draft will likely resemble the final 2020 GIPS® Standards. Regardless of the specifics, change is coming.

For firms compliant with 2010 GIPS® Standards, they must perform gap analysis to determine necessary changes to their current processes to comply with the new standards effective January 1, 2020.

For firms not already compliant with GIPS®, a component of the 2020 changes are to encourage more firms to become GIPS® compliant. As asset owners seek to claim compliance, this has a trickle-down effect, increasing the demand that asset owners' sub-adviser firms are also GIPS® compliant. Firms that have held out on adopting GIPS® will be under increased pressure to become compliant as asset owners themselves adopt GIPS®.

Proposals to enhance the frequency of valuations, timeliness of presentations, clarity of disclosures, etc. will also increase demand for valuation, verification, legal, regulatory, and other services, which all have additional costs for compliant firms. Therefore, those firms wishing to maintain or claim GIPS® compliance should begin preparing for how to integrate the standards outlined in the Exposure Draft and start budgeting for these additional costs.



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