



The CutterAdvantEdge

Commentary on Investment Systems and Operations

GIPS 2010: Are you Compliant?

GIPS 2010 mandated many new and rigorous requirements for GIPS compliance and, according to a recent CutterBenchmarking survey conducted in early 2011, only 20% of firms responding at the time were compliant with the new requirements. The 20% figure seems low, but given the magnitude of changes to the requirements, it was not surprising to see such a large percentage of firms still working towards compliance.

In order to claim compliance, firms must meet all the requirements of GIPS on a firm-wide basis, and have written policies and procedures that support how the firm meets all of these requirements. Collectively, the GIPS 2010 provisions pertain to the following nine sections: Fundamentals of Compliance, Input data, Calculation Methodology, Composite Construction, Disclosure, Presentation, and Real Estate, Private Equity, and Wrap Fee/Separately Managed Accounts (SMA) portfolios.

Within each provisional section are specific requirements and recommendations. To claim compliance with GIPS, firms must meet all the requirements of the provisions applicable to their respective firm. For example, if a firm does not manage Wrap SMA accounts or Real Estate, they are not bound to the requirements of that section. In addition to the provisions, firms must also comply with all Guidance Statements and Q&A's issued by the GIPS governing committees. Guidance statements are designed to provide firms with additional direction and clarification in handling questions and/or issues that arise within the industry that may not be implicitly covered by the provisions of the Standards. Q&A's address ongoing questions raised by verifiers and industry practitioners with respect to the application of the Standards in the real world. Given this theme of constant evolution, it is critical for a firm claiming compliance to constantly monitor these changes to ensure it is meeting all current requirements of GIPS.

Firms may choose to have an independent 3rd party 'verify' their firm-wide claim of compliance. This process, known as Verification, is recommended by GIPS as it brings additional credibility to the claim of compliance and supports the overall guiding principles of fair representation and full disclosure of the firm's investment performance. Verification assesses whether i. the firm has complied with all the composite construction requirements of the Standards on a firm-wide basis, and ii. the firm's policies and procedures are designed to calculate and present performance in compliance with the Standards. It is not intended to be a forensic audit, or to ensure the accuracy of any composite presentation. It is interesting to note that there was a great deal of recent debate within the industry as to whether or not verification should become mandatory with GIPS 2010. At the end of the day the decision was to let the market drive the need for verification and to leave it as a recommendation. As an aside, GIPS 2010 does include new required disclosure within the claim of compliance explicitly stating whether the firm has or has not been verified.

Why GIPS?

It involves significant cost and effort for a firm to become compliant, maintain compliance, become verified, and license technology solutions to support compliance. So why do firms go to such great lengths to claim compliance with GIPS when it is completely voluntary? The answer is because during the institutional sales and RFP process, consultants searching for asset managers on behalf of clients typically favor firms claiming GIPS compliance over those who do not. Some consultants won't even consider including an asset manager in their search without it. Asset managers also seek GIPS compliance because internally it encourages best practices, aims to increase ethical standards and professionalism, and attempts to improve risk control, business efficiency, and data quality.

The Regulators

Industry regulators like the SEC appear to be increasingly focused on the areas of performance presentation, particularly with firms who claim compliance with GIPS. Post-inspection deficiency letters in this area are not uncommon and pose serious reputational and financial risk to an asset management firm. For example, a 2007 SEC 'performance sweep' of managers in the US uncovered firms claiming compliance who were not. Results indicated that of the 31 firms examined by the SEC, 22 claimed compliance with GIPS and 21 of these had some type of deficiency. Of the 21 firms with deficiencies, 15 were currently verified.

Firms Examined:



Firms Claiming Compliance:



Firms Claiming Compliance & Verified:



Firms Found Compliant by SEC:



In 2007 the SEC examined 31 firms, of which 22 claimed compliance. Of the 22, 15 were also "verified." Ultimately, the SEC confirmed just one firm as GIPS compliant. Today, with expanded GIPS 2010 requirements and tighter SEC inspections, it will be interesting to see if the situation has improved.

The top reasons for non-compliance uncovered during the SEC sweep were:

- Failure to maintain sufficient policies and procedures
- Failure to keep all fee-paying accounts in at least one composite
- Failure to disclose total firm assets
- Failure to disclose that a complete list and description of composites is available upon request
- Failure to disclose the method used for allocating cash to carve-out segments
- Failure to disclose the fee schedule
- Failure to use consistent claims of compliance in advertisements
- Failure to link a claim of compliance on a Web page to a compliant composite presentation
- Failing to disclose the number of portfolios and the amount of assets in composite
- Failure to produce all required disclosures relating to the use of carve-out segments

Recent, well-publicized Ponzi schemes have prompted the SEC, FSA, and other regulatory bodies to focus intensely on improving their examination techniques and their fraud detection procedures for inspections. These regulators are adding qualified resources to their examination and enforcement staff, and many of those will be trained specifically on how to uncover misleading or fraudulent performance claims.

If your firm claims GIPS compliance, you are increasingly likely to be scrutinized by regulators. Given the rigors of GIPS 2010, the many revisions to Guidance Statements, and the frequency of Q&A postings, it is more critical than ever to ensure that your firm is meeting all the current applicable requirements.

During an inspection, the SEC is likely to examine the following for GIPS compliance:

- Your policies and procedures
- Your composite definitions
- Your compliant composite presentations for any of your listed composites
- Your benchmark descriptions
- Your list of discretionary and non-discretionary accounts and the reasons for non-discretion
- Your required disclosures

Purchasing and maintaining multiple systems supporting GIPS compliance can be expensive, with material impact on P&L. The Cutter Associates' Benchmarking survey found that 63% of firms used five or more systems to

support performance measurement, composites, and GIPS compliance. The trend now for vendors is to produce all-in-one performance systems. These new solutions have sophisticated capabilities for producing GIPS compliant results that are transparent to regulators, verifiers, and internal users. Periodically, it is a good idea to compare existing systems architecture with newer solutions to determine whether efficiencies offered by new technology could justify the investment.

GIPS 2010 puts enormous demands on a firm's systems, processes, data and organization. The new fair valuation requirements put pressure on performance support teams because "hard to value" assets must now be included in composites as discretionary accounts. The new risk-related presentation and disclosure requirements are trending into areas previously uncharted by GIPS. Increasingly complex requirements for composite creation, maintenance, and disclosure mean that firms must hire qualified and certified staff to run their GIPS compliance program. Asset managers should not underestimate the rigors and costs of meeting all the new requirements.

In the Numbers

The growing popularity of GIPS and its perceived advantage for Marketing purposes can be seen in results from a survey conducted by ACA Beacon Verification Services, in conjunction with eVestment Alliance. Of 333 asset management firms surveyed, 88% said a primary purpose for pursuing GIPS compliance was to improve their ability to market services to institutional clients. The survey also revealed that 84% of firms claiming compliance were verified by third parties, and 85% of the verified firms said an important driver for the verification was the desire to improve their ability to market their services.

Conclusion

As the asset management, industry and financial markets continue to evolve and expand globally, the GIPS Standards and the requirements for claiming compliance will evolve and expand in parallel. The advent of new complex derivative instruments, hedge funds, and other alternative assets are already driving the need for additional guidance as more and more firms are offering these strategies and wish to include these assets in their firm definitions. The mission of GIPS as a true global standard for calculating and presenting performance results will constantly be challenged. Asset managers need to be prepared to pay constant attention to the changes.

By Barry Finkle, CIPM

Mr. Finkle is co-Chair of the Boston Chapter of the Performance Measurement Networking Group (PMNG), and he is an advisor to the CFA Institute. He served on the May 2011 CIPM Examination Review Panel and holds the Certificate in Investment Performance Measurement (CIPM) sponsored by the CFA Institute. At Cutter Associates, he specializes in consulting on GIPS and Performance Measurement and Attribution. Prior to joining Cutter Associates, Mr. Finkle was Director of GIPS Compliance and Head of Data Governance for Columbia Management.