The CCO’s Guide to the GIPS Standards:
Essentials for an Effective Compliance Program

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EXECUTIVE SUMMARY

According to a recent industry survey\(^1\), 75 percent of investment management firms are now compliant with the Global Investment Performance Standards (GIPS\(^\circledR\)). The compliance percentage increases as firm AUM rises. Compliance, in other words, is no longer a differentiator but rather a de facto requirement for firms competing for institutional assets. As adoption of the GIPS standards has grown over the years, ACA has seen an interesting trend: a shift in who takes responsibility for compliance within companies. In the early stages of the Standards’ acceptance, compliance initiatives at firms were driven mostly by people who worked in marketing or business development. GIPS compliance was viewed as a pathway to gaining competitive advantage and market differentiation. Over time, though, the monitoring and maintenance of a GIPS compliance program have shifted gradually to compliance departments.

The shift is occurring “naturally” as a result of several factors. The first one is the current regulatory environment. When the Office of Compliance Inspections and Examinations (“OCIE”), within the U.S. Securities and Exchange Commission (“SEC”) released its 2013 examination priorities list, performance marketing and advertising were near the top. Second, as our clients and prospects have noted, SEC examiners are reviewing claims of GIPS compliance in much greater detail. These individuals are becoming proficient in their GIPS knowledge and their comments have become much more technical and granular. And last, the Standards have grown more complex over the years and will continue to do so as the CFA Institute issues additional guidance, Q&As, and revisions.

Given these factors, compliant firms have a larger need for a dedicated, knowledgeable staff that stays up to date on the Standards. This knowledge is especially important with regard to disseminating performance results. Compliance staff must ensure that marketing materials, pitch books, RFP responses, consultant databases, and any other information made available to prospects or the public meet the GIPS standards presentation and reporting requirements.

In the text that follows, we highlight the areas related to the GIPS standards to which compliance officers should pay close attention. We also offer insight into keeping compliance claims reasonable and sound and, in doing so, mitigating risks that can accompany such claims.

GIPS AND THE SEC

GIPS compliance is voluntary. The CFA Institute has no formal enforcement mechanism. However, in the United States, the SEC and savvy institutional investors act as de facto policing agents for the Standards. Judging by recent deficiency letters, the SEC staff has taken keen interest in this area, making it part of its reviews more and more often. Indeed, the staff takes this position: if a firm markets itself as GIPS compliant and it is not, the action could be viewed as misleading according to Rule 206(4)-1 under the Investment Advisers Act of 1940 (“Advisers Act”).

We have seen other evidence pointing to a stronger SEC focus on the review of GIPS compliance. The CFA Institute, for example, now communicates regularly with SEC staff, responding to questions, providing guidance, and educating the staff on the Standards through periodic training sessions. In addition, according to Carlo di Florio, the OCIE’s former director, the SEC has expanded

its staff to include specialized professionals with direct industry knowledge as part of several department and process reorganizations.\(^2\)

According to di Florio, who spoke at the 2012 GIPS Standards Annual Conference, the trends the SEC sees with respect to deficiencies include:

- smaller firms claiming compliance but not necessarily doing everything right,
- performance record portability (the GIPS and SEC have differing guidance in this area), and
- use of the term “GIPS” in marketing material in ways the SEC could view as misleading.

As the SEC gains expertise in the GIPS standards and starts to confront firms with deficiencies, compliance departments will likely get more involved in their firms’ GIPS compliance programs. For example, it is recommended that compliance officers draft disclosures for marketing materials and advertisements. Today, that means making sure GIPS-compliant presentations include disclosures required by the SEC and by the Standards.

## GIPS COMPLIANCE: FOCUS ON FUNDAMENTALS

The recently released third edition of the GIPS standards handbook (“GIPS Handbook”) runs over 450 pages and provides details on every provision.\(^3\) It also includes guidance statements and Q&As that address topics requiring additional explanation. Given the handbook’s vast amount of information and instruction, starting a GIPS compliance program may seem like a daunting task for a firm. So can maintaining a claim already established. In both cases, we suggest a focus on these six areas:

- GIPS Policies and Procedures
- Definition of the Firm
- Definition of Discretion
- Composite Construction
- Compliant Presentations and Marketing Materials
- Recordkeeping Practices

### GIPS Policies and Procedures

To gain and maintain GIPS compliance, firms first need comprehensive, well-thought-out GIPS policies and procedures. These policies and procedures provide the blueprint for instituting, maintaining, and evidencing compliance claims. GIPS manuals are firm-specific and vary in form and length. The ones we commonly see range between 12 and 25 pages. These manuals are often the first document requested and reviewed by third parties such as verifiers or SEC examiners. A GIPS

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manual that documents policies vaguely and omits procedures will quickly raise a red flag and likely lead to an in-depth review.

An effective GIPS manual, on the other hand, details how the firm complies with every applicable provision of the GIPS standards. It also has a procedure for each policy that describes who will implement the policy, when the implementation will occur, and how the implementation will take place.

As part of the development process, the author who creates this document should solicit feedback and buy-in from all departments affected by GIPS policies and procedures. This is necessary because views on particular topics can vary widely within an organization's groups. For example, regarding materiality thresholds for an error correction policy, the marketing and legal/compliance groups may have disparate opinions on what an investor considers a material error. By having collaborative discussions while drafting the manual, firms can avoid creating irrelevant policies.

As a best practice, we advise our clients to create a GIPS oversight committee where each group affected by their compliance claim is represented. Among other duties, this committee should create the policies and procedures and then review and update them periodically. During its meetings, the committee should also discuss any external or internal changes that affect the firm's compliance claim. GIPS oversight committees typically include members from groups such as compliance, legal, marketing, operations, and portfolio management. All parties involved provide input and buy-in.

We recommend maintaining the GIPS manual as a “live” document. (Although not a requirement, typically firms keep their GIPS manuals separate from other compliance manuals.) The manual should always be current. While changes to policies and procedures should be relatively minimal, firms should review their manuals frequently to keep them up to date. Material strategic or organizational changes, as well as product introductions or discontinuations, will almost always require a revision.

While keeping the manual current is important, it is just as important for firms to maintain all previous versions of this document. This practice creates a permanent history of the document’s evolution and the reasons behind alterations should the firm or third parties want or need to review such changes.

**ACTION ITEMS**

for GIPS Policies and Procedures

☐ Review your draft or active GIPS manual.

☐ Is it up to date? Is it comprehensive and complete?

☐ Is there a procedure for each policy?

☐ Do the policies in place make sense for your firm?

☐ Have changes occurred in areas such as systems, policies, procedures, organizational structure, or personnel that need to be addressed in the manual?

☐ Are the procedures in place being implemented in practice?

☐ Consider creating a GIPS oversight committee that meets periodically to review GIPS-specific issues and that has ultimate responsibility for GIPS policies and procedures.
Definition of the Firm

One of the first decisions involved in becoming compliant is how to define the firm for GIPS purposes. A common misconception regarding the Standards is that firms can claim compliance on only one investment product or strategy. This is not the case. The Standards must be applied on a firm-wide basis. Compliant firms cannot claim compliance for “cherry-picked” strategies. Rather, all assets within the firm must adhere to all provisions of the GIPS standards.

Given this requirement, compliance professionals should ensure that their firms are defined appropriately and fairly. This is of utmost importance. If a firm is not defined properly, issues can arise when determining firm assets under management, constructing composites, and marketing the firm as GIPS-compliant.

One of the key determinants of firm definition is this: how does the firm hold itself out to the public? The Standards require a firm to be defined as “an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity.” A “distinct business entity” is one that “(1) is organizationally and functionally segregated from other units, divisions, departments, or offices; (2) retains discretion over the assets it manages; and (3) has autonomy over the investment decision-making process.” Additionally, there are other factors that may also come into play, including whether the entity has a distinct market or client type or whether it has a separate, distinct investment process compared to other entities within the broader organization.

The Standards suggest that firms adopt the broadest, most meaningful firm definition. In some cases, such as when a firm includes all assets within the legal entity, defining the firm can be simple. In other circumstances, defining the firm is more complex. The latter is common in cases where a parent organization has multiple entities and business lines operating under one brand. If the underlying entities hold themselves out to the public as distinct business entities, it may be appropriate to define the GIPS-compliant firm to only include one of the underlying entities rather than the entire firm at the parent level. Figure 1 illustrates how a firm’s definition options can differ depending on how it is held out to the public.

![Figure 1. Illustration of Firm Definition Options](image-url)

5 – Ibid.
It is important for firms to review their GIPS firm definition periodically. In particular, these reviews should ascertain whether material changes within the organization have altered how the firm is held out to the public. Such changes are typically associated with corporate restructuring or mergers and acquisitions.

**ACTION ITEMS**

for GIPS Firm Definition

- Review your firm definition.
  - Is it consistent with how you market your firm and investment strategies?
  - Has the firm been defined too narrowly or broadly?
- Evaluate any changes in the firm definition.
  - Has the firm undergone restructuring or will it in the near future?
  - Has the firm consolidated or separated any business lines?
  - Are there any new business lines that should be included or excluded from the firm definition (e.g., a hedge fund launch or entry into Wrap programs)?
  - Have any mergers or lift outs occurred that could affect the firm definition?

**Definition of Discretion**

The next key component compliance professionals should be familiar with and review often is how their firms define discretion from a GIPS perspective. A well-thought-out and consistently applied definition of discretion is critical to coming into and maintaining GIPS compliance. The definition of discretion is fundamental to satisfying one of the Standards’ main requirements, specifically, that all actual, fee paying, discretionary accounts must be included in at least one composite.

The GIPS standards define discretion as the firm’s ability to implement its intended strategy. This can differ from the SEC’s definition of discretion. An account may be considered discretionary from an SEC perspective because the manager has trading authority over the account. At the same time, it could be considered non-discretionary from a GIPS perspective as the client has placed restrictions on the account that hinder the manager’s ability to fully implement the intended strategy. Client-imposed constraints can include restricting asset allocation decisions, restricting the purchase or sale of certain securities, imposing specific cash flow requirements, and applying tax considerations.

From a risk perspective, once a firm has created its definition of discretion, it must follow it consistently in all accounts. Firms should be able to use their definition of discretion to easily support instances where they deem certain accounts to be non-discretionary.
ACTION ITEMS
for Definition of Discretion

- Review your firm’s definition of discretion.
  - Have the circumstances that may cause an account to be deemed non-discretionary been clearly and completely documented?
  - Has the policy been applied consistently over time and for all accounts?
- Institute and monitor a process to ensure the appropriate employees understand your firm’s process for determining the discretionary status of portfolios.
- Review accounts not in composites periodically to ensure they are appropriately excluded.
- Review accounts in composites periodically to ensure they are appropriately included and discretionary.
- Institute and monitor a process to ensure you have supporting documentation for non-discretionary accounts.
- Institute and monitor a process to notify appropriate personnel when an account change may affect discretionary status.

Composite Construction

Once a firm has created an appropriate firm definition and identified discretionary accounts using its definition of discretion, the next area the compliance department should know and scrupulously monitor is composite construction. The Standards define a composite as “the aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy and is the primary vehicle for presenting performance to prospective clients.”

Composites form a material component of a firm’s marketing efforts. Consequently, it is important to construct them accurately and fairly. While the Standards offer some leeway regarding composites, compliance professionals should make sure defined composites are reasonable and consistent with their firms’ marketing efforts and with the products and strategies offered.

Well-constructed composites provide prospective investors with a true representation of a manager’s ability to implement a particular strategy. In contrast, allowing composites to be defined too broadly or narrowly can pose unnecessary risk to a firm. For example, say a firm constructs a composite for a strategy that combines accounts that can use leverage with accounts that prohibit leverage. The composite returns in this case would be of little use to a prospective investor that disallows leverage. The risk in this instance comes from this: if the firm does not make clear that some accounts in the composite use leverage, the composite performance could be viewed as misleading from a GIPS and SEC perspective. In this situation, constructing separate composites for these accounts would likely be the most appropriate resolution.

As noted above, the Standards require that composites include all accounts managed according to the same investment mandate, objective, or strategy. They also require portfolios to be added and

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removed from the composite on a timely and consistent basis. In addition, portfolios must not be switched from one composite to another unless the firm can show documented changes to the portfolios' mandates, objectives, or strategies or that it has redefined the composite in a way that makes the switch appropriate. Having these requirements in place ensures the consistency of account additions and removals and prevents a firm from cherry-picking best-performing accounts for a composite at any given time. Adherence to these rules is particularly important because, from a compliance perspective, such cherry-picking could be viewed as misleading.

Of utmost importance for composite construction is periodically reviewing discretionary and non-discretionary portfolios to ensure they have not changed in a way that would alter their classification. For example, non-discretionary accounts should be examined regularly to ensure that restrictions in place have not been lifted. Likewise, discretionary accounts should be inspected to make sure client guidelines have not changed such that the account must be removed from a composite or switched to another.

### ACTION ITEMS for Composite Construction

- **Review your existing composite structure.**
  - Are your composites consistent with the strategies you offer?
  - Do you have too few composites (i.e., too broadly defined) or too many composites (i.e., too narrowly defined)?
  - Would the performance of your composites provide a prospective investor with an accurate and fair depiction of how their account would be managed?

- **Test your composites for proper construction.**
  - Conduct a dispersion analysis of composite accounts for a given year. If the returns are wildly different, this suggests the composite may be defined too broadly or that errors exist in its construction.
  - Select a sample of composite accounts and compare the account holdings to ensure they all have similar securities and/or the holdings are in line with the composite definition.
  - Compare the allocation of accounts within a composite at a high level to ensure they are in line with one another. This comparison could involve allocations to different asset classes if the composite is multi-strategy or it could require a sector allocation review.

### Compliant Presentations and Marketing Materials

One of the most common risks a firm faces when it claims GIPS compliance lies in how it presents performance in compliant presentations and marketing materials. In our experience, in most cases where the SEC cites a firm for a GIPS-related deficiency, the issue relates to marketing materials that omit or provide inadequate disclosures or statistics. A firm's compliant presentation must include all statistics and disclosures required by the Standards. As with any performance-related information disseminated to prospects or the public, compliance departments should review compliant presentations to ensure all required statistics and disclosures are present.
The example below shows what a compliant presentation often looks like.

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**ABC Composite**

**XYZ Investment Management**
**Month Day, Year through Month Day, Year**

<table>
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<tr>
<th>Year</th>
<th>Gross-of-Fees Return (%)</th>
<th>Net-of-Fees Return (%)</th>
<th>Benchmark Return+ (%)</th>
<th>Composite 3-Yr St Dev (%)</th>
<th>Benchmark 3-Yr St Dev (%)</th>
<th>Number of Portfolios</th>
<th>Internal Dispersion (%)</th>
<th>Total Composite Assets (USD mil)</th>
<th>Composite Percentage of Firm Assets (%)</th>
<th>Total Firm Assets</th>
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XYZ Investment Management claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. XYZ has been independently verified for the periods 12/31/02 – 12/31/12. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

**Firm and Composite Information**

XYZ Investment Management is an independent investment management firm that manages equity, balanced, and fixed income portfolios. The firm invests primarily in U.S. stocks and bonds.

The ABC Composite invests in small, mid, and large capitalization common stocks. The minimum account size for inclusion into the ABC Composite is $500,000.

The ABC Composite was created in June 2008. A complete list and description of firm composites is available upon request.

**Benchmark**

†The benchmark is the S&P 500 Index, which is a market-capitalization weighted index containing the 500 most widely held companies (400 industrial, 20 transportation, 40 utility and 40 financial companies) chosen with respect to market size, liquidity, and industry. The volatility of the S&P 500 Index may be materially different from that of the strategy depicted, and the holdings in the strategy may differ significantly from the securities that comprise the S&P 500 Index. The S&P 500 Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee.

**Performance Calculations**

Valuations and returns are computed and stated in U.S. Dollars. Results reflect the reinvestment of dividends and other earnings. Gross-of-fees returns are presented before management and custodial fees, but after all trading expenses and withholding taxes. Net-of-fees returns are calculated using actual management fees that were paid and are presented before custodial fees but after management fees, all trading expenses, and withholding taxes.

The standard management fee for the ABC strategy is 1.25% per annum on the first $1 million USD and 1.00% per annum on additional assets. Additional information regarding ABC’s fees is included in its Part II of Form ADV.

Internal dispersion is calculated using the asset-weighted standard deviation of all accounts included in the composite for the entire year; it is not presented for periods less than one year or when there were five or fewer portfolios in the composite for the entire year. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The standard deviation is not presented for 2003 through 2010 as it is not required for periods prior to 2011. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

**Past performance does not guarantee future results.**

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Provision 0.A.9 of the Standards requires firms to make every reasonable effort to provide their compliant presentations to all prospective clients. A prospective client is defined as “any person or entity that has expressed interest in one of the firm’s composite strategies and qualifies to invest in the composite.”† That is, firms cannot distribute these presentations selectively. We commonly see compliant presentations delivered to prospects during an initial meeting as part of a pitch book.

When providing compliant presentations, firms also should have a system in place to track who receives a presentation, which presentation they receive, and when they receive it. Maintaining this...
The log gives firms an efficient, easily accessible means to demonstrate their adherence to provision 0.A.9. These logs also facilitate any republishing of materials to appropriate prospects and clients should the firm uncover errors that require it to restate performance information. Such tracking can typically be done as part of a firm's existing process to evidence approval and distribution of marketing materials and advertisements.

To help firms market their claim of GIPS compliance, the Standards provide advertising guidelines. Compliance with these guidelines is optional. The performance and disclosure requirements only come into play when an advertisement references a firm as being GIPS compliant.

### ACTION ITEMS

**for Compliant Presentations and Marketing Materials**

- Implement and monitor a process to ensure your firm is complying with provision 0.A.9.
- Train compliance staff to review any information intended for dissemination for adherence to GIPS requirements.
- Referencing sections 4 and 5 of the Standards, review compliant presentations to ensure they contain all required disclosures and statistics.
- Implement tracking to document who receives a presentation, which presentation they receive, and when they receive it.
- If you market your claim of compliance using the GIPS Advertising Guidelines, establish and monitor a review process to ensure these pieces meet all disclosure and presentation requirements.

### Recordkeeping Practices

Good recordkeeping is fundamental to any sound compliance program. The same is true with regard to GIPS compliance. The Standards require firms to capture and maintain the data and information needed to support all items included in their compliant presentations. Since these presentations often take up just a single page, this sounds like an easy task at first. However, when one realizes what it takes to generate the statistics in a compliant presentation, one quickly realizes a much greater effort is needed to satisfy the recordkeeping requirement.

For account and composite-level performance, firms must maintain records sufficient to recalculate portfolio and composite-level returns. For account returns, this information might include portfolio market value reports, transaction summaries showing external cash-flow days and amounts, accrued income reports, and the calculation methodologies used for different time periods. For composites, depending on the calculation methodology used, a firm might have to maintain all historical monthly account returns, monthly account market values, transaction and external cash-flow reports at the composite level, and documentation for portfolios included or excluded for the month being replicated.

One of the best ways compliance officers can test the quality and integrity of their firms' records is to select statistics randomly from the GIPS-compliant presentation and check to see that the data necessary to recreate that particular statistic can be retrieved quickly and easily.

Other areas in addition to the supporting data for compliant presentations often need special attention with regard to recordkeeping. For example, anytime a firm uses spreadsheets to calculate
performance or performance metrics, it should keep underlying records that support the spreadsheet information. Firms should also institute an added review level when they use spreadsheets to reduce the risk of human error. Another area where recordkeeping is important is ported performance. To be specific, firms must maintain all records needed to support performance presented for periods when managers were at another firm. Regulators often pay very close attention to how firms present ported performance, so the recordkeeping for this area should be thoroughly and regularly reviewed.

**ACTION ITEMS**
for Recordkeeping

- Select a random set of statistics from your compliant presentation and check to see how easily the supporting records for these statistics can be obtained.
- Replicate a sample of account and composite-level returns to ensure the underlying records needed are available.
- Scrutinize any ported performance presented to be sure the records on hand support that performance.

**HOW TO STAY CURRENT**

When claiming GIPS compliance, firms must satisfy all applicable requirements, including those disseminated in updates, guidance statements, interpretations, Q&As, and clarifications. These resources are available on the GIPS standards website and in the handbook. Historically, the CFA Institute has reviewed and updated the Standards every five years. Guidance and other interim information, however, is released intermittently. To stay current with changes published by the CFA Institute and the GIPS Executive Committee, firms should periodically review the GIPS standards website (www.gipsstandards.org), read the most recent version of the handbook, and sign up for the GIPS Newsletter as well as our Attest ACA Newsletter.

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