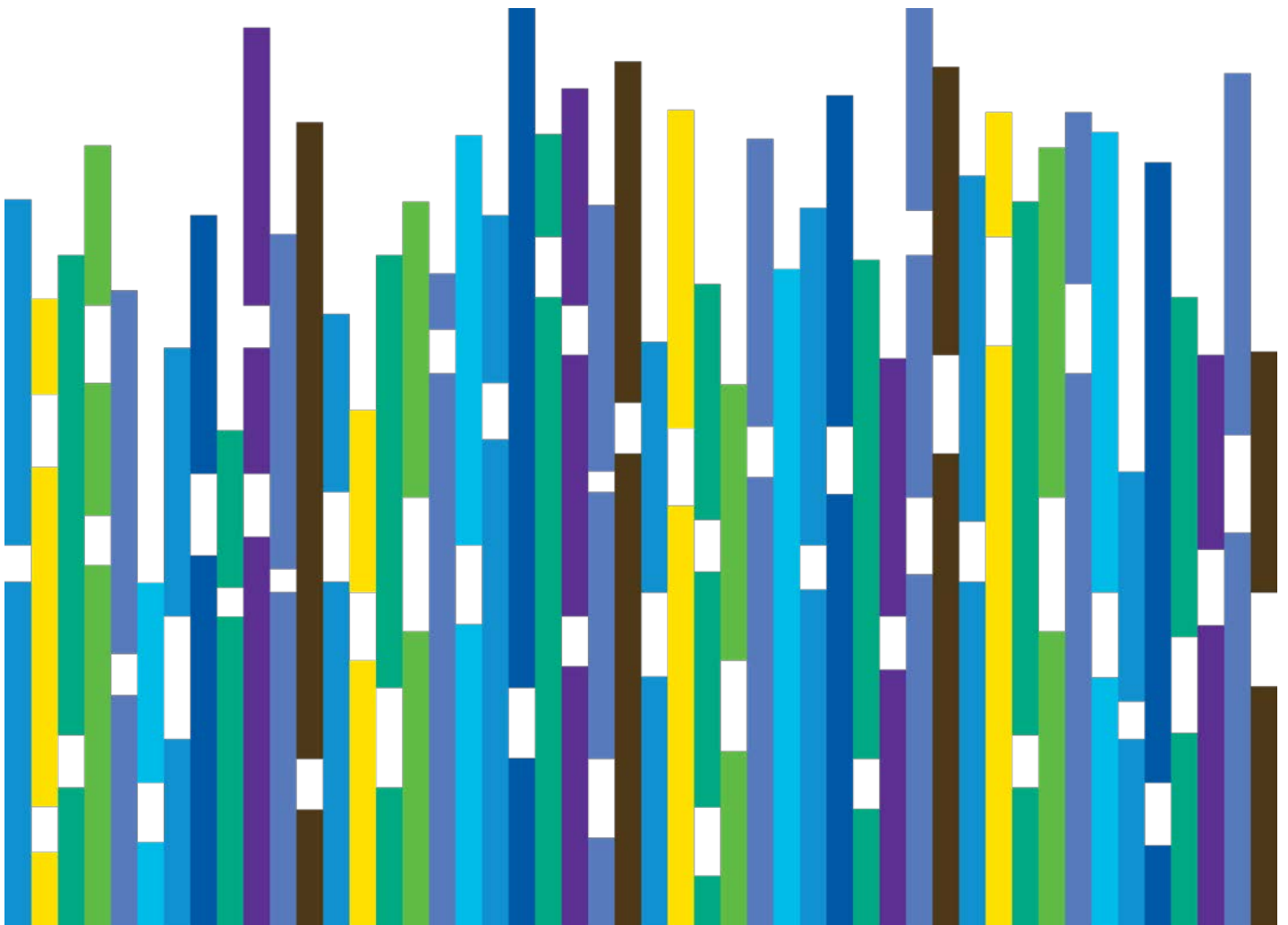


# UMA PORTFOLIOS: WHEN THE GIPS<sup>®</sup> STANDARDS APPLY



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## Introduction

This white paper is intended to help firms that claim compliance with the Global Investment Performance Standards (GIPS) determine whether it is appropriate to include unified managed account (UMA) portfolios in total firm assets or in composites for GIPS compliance purposes. This paper was developed by the United States Investment Performance Committee (USIPC), the United States country sponsor for the GIPS standards. The information outlined in this paper reflects what the authors consider best practices and *is not intended to serve as definitive guidance that must be adhered to by firms that claim compliance with the GIPS standards*. The paper is written from the perspective of the investment manager, not the UMA sponsor. Although a sponsor may separately claim compliance with the GIPS standards, that subject is beyond the scope of this paper. The examples in this paper are for illustrative purposes only and will not be appropriate in all situations; every firm's situation is different, and every firm must consider the nuances of each UMA arrangement to confirm how it relates to the firm's GIPS compliance program.

All references to the GIPS standards throughout the paper are to the 2010 edition of the *Global Investment Performance Standards*, which became effective on 1 January 2011.

## Applying the GIPS Standards to Unified Managed Accounts

Involvement in UMA programs is an exciting growth opportunity for many investment management firms. These programs give firms the opportunity to reach many potential clients while minimizing operational workload and costs. The establishment of UMA programs, however, is not without potential pitfalls and complications, particularly for firms that seek to claim compliance with the GIPS standards.

Guidance within the GIPS standards related to UMA portfolios is limited and must be extrapolated from existing guidance regarding similar products. Thus, GIPS-compliant firms are left with questions about how to proceed, with the main two being the following:

- Should UMA assets be included in the computation of total firm assets for GIPS compliance purposes?
- If included in total firm assets, should UMA assets be considered “discretionary”<sup>1</sup> assets and thus included in composites?

The answers to these questions are not simple and depend on the specific facts and circumstances of the investment manager's UMA programs.

## UMAs and Wrap Fee/SMA Portfolios

Before delving into the various issues associated with UMA portfolios managed by firms claiming GIPS compliance, we should first look at traditional Wrap Fee/Separately Managed Account (SMA) programs, where significantly more guidance is available. Offered by brokerage firms (often referred to as “wrap sponsors”), Wrap Fee/SMA programs give investors access to numerous investment managers through

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<sup>1</sup>Discretion for purposes of GIPS compliance may be different from discretion in the legal sense. Under the GIPS standards, discretion is the ability of a firm to implement its intended strategy.

one platform. An investor selects the investment manager whose strategy appears to best suit her needs, and the investment manager assumes responsibility for managing the investor's account. The investment manager is typically granted full discretion, whereas the wrap sponsor stays involved in the process by providing executive, custodial, and administrative services.

Wrap Fee/SMA sponsors charge a single “wrap” or “bundled” fee for several combined services (e.g., investment management, trading, custodial, and other administrative services). Because the sponsor determines the total fee charged to Wrap Fee/SMA portfolios, a wrap fee is difficult, if not impossible, for the investment manager to separate into its components in order to identify which portion is attributable to a specific service. This difficulty presents an issue for GIPS-compliant firms, because the GIPS standards require that gross-of-fees performance results be reduced by transaction costs. If a firm is unable to segregate the transaction costs from a wrap or bundled fee, the firm must reduce the reported gross-of-fees performance by the entire wrap fee or show only the “pure” gross-of-fees returns (net of no fees) as supplemental information.

Typically, the client's contractual relationship is also with the sponsor; the investment manager is contracted with the sponsor but not directly with the client. In some instances, however, the client may have a dual contract with both the sponsor and the investment manager. In such cases, the investment manager's fee may be charged separately from the bundled fee.

Model delivery programs are a type of Wrap Fee/SMA program in which the investment manager does not direct trades and provides only a model portfolio to the sponsor. In these arrangements, it is usually the sponsor's responsibility to execute trades. From the investment manager's perspective, the service provided is characterized as non-discretionary investment advice because the investment manager does not have control over whether the trades are executed as intended.

UMA programs are similar to Wrap Fee/SMA programs in many ways. Both are technically wrap-fee programs in that a single fee is charged for a combination of services. Both offer investors access to multiple investment managers through a single platform. But UMA programs have the distinguishing characteristic of also offering the ability to combine multiple strategies into a single account. Each Wrap Fee/SMA portfolio requires its own custodial account, but a UMA portfolio may hold securities associated with multiple strategies and investment managers in one custodial account.

The role of the investment manager in UMA programs may also differ from the manager's role in Wrap Fee/SMA programs. Although investment managers generally dictate the strategy to be used for their designated portion of the assets, their trading responsibilities can range from those of a standard Wrap Fee/SMA relationship to those of a model delivery program—or somewhere in between. In a typical UMA program, the investment manager provides a model portfolio to the UMA platform and the responsibility for executing trades is left to the sponsor. In contrast, some UMA programs are set up to give the underlying external managers discretionary authority to enter trades directly on the sponsor's platform, but this setup is not the norm.

Most UMA programs also include an overlay component, whereby another manager (often the sponsor) oversees the overall composition of—and coordinates all activity in—the account. This component includes cash management (i.e., determining how available cash will be distributed among the various investment managers) and asset allocation decisions (i.e., periodically rebalancing or changing the asset allocation to each manager).

## Challenges with UMAs

The challenge for a GIPS-compliant firm that manages UMAs is that UMAs come in different shapes and sizes. Some may be purely discretionary, some may have shared discretion, and some may be model

delivery. Discretion may also be influenced by the presence of an overlay manager who has oversight responsibility for the entire portfolio and may have the authority to override the investment manager's trading directives. Determining the level of discretion is important because it dictates whether the manager must include the program assets in total firm assets or in composite assets for GIPS compliance purposes. Unfortunately, there is no one-size-fits-all approach for UMA programs. Firms must evaluate each program to determine whether its assets must be included in either the GIPS-defined firm assets or the composite assets.

## Determining Discretion for Inclusion in GIPS Total Firm Assets

The GIPS standards state that total firm assets “must be the aggregate fair value of all discretionary and non-discretionary assets managed by the firm. This includes both fee-paying and non-fee-paying portfolios.”<sup>2</sup> Total firm assets include assets for which the firm “has either conditional or unconditional authority to trade the assets”<sup>3</sup> and “exclude assets within advisory-only relationships”<sup>4</sup> (e.g., model delivery).

Many factors should be considered when determining whether to include UMA portfolios in total firm assets. The specifics of the relationship must be thoroughly evaluated to make an appropriate classification. Firms should consider the following when evaluating whether to include UMA portfolios in GIPS-defined total firm assets:

- Review the contract between the sponsor and the firm.
  - A contract between the investment manager and the sponsor indicating that the manager has discretionary authority may suggest that the accounts governed by the contract should be included in total firm assets. Further analysis is probably warranted, however, to assess what level of control the manager actually has. In the case of “dual contracts”—in which the investment manager has a contract with the sponsor and a contract with the client—if the contract with the client specifies that the manager has discretionary authority, this provision supports the inclusion of the accounts in total firm assets. If the manager provides only a model to the sponsor and has no authority for trade execution, the accounts managed through such a program should not be included in total firm assets.
- Determine how trades are effected.
  - UMA portfolios can be included in total firm assets only when the investment manager retains full authority for trade execution. Trade execution is a complicated area—the specific facts and circumstances should be ascertained.
  - In some instances, the investment manager may submit trades to the sponsor's platform but with the sponsor having final approval before execution. The investment manager may retain trading discretion and the portfolios could be included in total firm assets. In assessing such situations, firms must bear in mind that a “substance-over-form” principle should always be applied.
  - Another example is when a firm that does not execute trades has contractual assurance that trades will be executed in a timely manner. If the firm has contractual assurance and receives confirmation of execution, that may indicate a higher level of control by the investment management firm than would typically be the case in an advisory-only scenario. Some firms could include these assets in their total firm assets.

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<sup>2</sup>*Global Investment Performance Standards (GIPS®)* (Charlottesville, VA: CFA Institute, 2010): Provision O.A.13.

<sup>3</sup>*Global Investment Performance Standards (GIPS®) Handbook*, 3rd ed. (Charlottesville, VA: CFA Institute, 2012): 88.

<sup>4</sup>*GIPS Handbook*, 89.

- Our final example is when the sponsor is responsible for all trading and can freely decide to deviate from the manager's trading instructions. Such a relationship should be viewed as advisory only from the investment manager's perspective, and the portfolio should be excluded from the investment manager's total firm assets.
- Determine whether trading decisions are made and whether data are available at the account level.
  - If trading decisions are being made on an account-specific basis, a higher level of discretion may be indicated, warranting inclusion of the portfolios in total firm assets. If the investment manager does not have the necessary data to make these decisions, he is likely to have very limited authority over the accounts and the assets would probably not qualify for inclusion in total firm assets.

## Determining Discretion for Inclusion in Composites

Once a firm has determined which UMA programs, if any, should be included in total firm assets, it must then determine whether the assets qualify for a composite. The GIPS standards provide that “all actual, fee-paying, discretionary portfolios must be included in at least one composite,”<sup>5</sup> including Wrap Fee/SMA portfolios. For purposes of GIPS compliance, discretion is the ability of a firm to implement its intended strategy. If documented client-imposed restrictions significantly hinder a firm from fully implementing its intended strategy, the firm would classify that portfolio as non-discretionary. Non-discretionary portfolios must not be included in a firm's composite.

A firm that determines the UMA assets must be included in GIPS-defined total firm assets may also determine that the UMA assets are non-discretionary for purposes of inclusion in a composite. For example, the investment manager may have access to the sponsor's platform and may be able to execute trades for client portfolios, but the overlay manager may be able to override trading decisions, effectively creating a shared-discretion situation. The overlay manager may also influence the investment manager's ability to implement the intended strategy by moving cash in or out of the portfolio. This scenario can be viewed as similar to non-UMA accounts with client-imposed restrictions. If the sponsor or overlay manager can affect the management of the account, a firm may determine that client-imposed (in this case, sponsor-imposed) restrictions prohibit it from fully implementing its strategy.

## Next Steps

Given the various hurdles that must be cleared before a firm can include UMA portfolios in its total firm assets, the most common approach is to exclude such portfolios. Even in cases in which the firms feel justified in including UMA portfolios in total firm assets, they are frequently found to lack the necessary level of discretion to justify inclusion in composites. But firms that manage UMA portfolios often want to be able to present to prospective clients information about those accounts.

Regarding the presentation of advisory-only assets managed by a firm, that total should not be aggregated with the discretionary and non-discretionary assets; it can be reported separately so long as adequate books and records are maintained. Firms commonly report this information as “assets under advisement,” presented separately from composite assets and total firm assets. Including assets under advisement with total firm assets in presentation materials provides valuable information to prospective clients by conveying the full scope of the assets for which the firm's strategies are being implemented. If a firm elects to do so, assets under advisement can be reported in a GIPS-compliant presentation—but

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<sup>5</sup>*Global Investment Performance Standards*, Provision 3.A.1.

only in addition to total firm assets. In a more finite data environment where only one number can be presented (e.g., consultant databases), the GIPS total firm assets should be shown.

Similarly, performance information on UMA programs that do not qualify as discretionary firm assets could be presented as supplemental information, assuming all supporting records are maintained. If a firm elects to do so, sufficient disclosure should be included in the presentation to describe the investment manager's role and applicable limitations in implementing strategies through UMA platforms.