



Virtual Annual Investment Industry Seminar

November 17, 2021

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GIPS Update What's New Since GIPS 2020?

Thomas A. Peters
Investment Industry
Group Leader

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Agenda

1. Complying with GIPS
2. Tools
3. Guidance Statements
4. Q&As

Complying with GIPS

- Firms need to comply with ALL of the following (published by the CFA Institute)
 - GIPS Standards – the core rules
 - Guidance Statements – guidance on a topic (such as Benchmarks)
 - Interpretations (such as the GIPS Handbook) – helpful explanations
 - Q&As – guidance for a narrow topic or specific question
- Fun facts
 - GIPS Standards for firms – 126 pages
 - GIPS Handbook – 556 pages



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Guidance Statements, Q&As and Tools

- There are now a lot less of GS and Q&As
- In crafting the GIPS 2020 Standards and the GIPS Handbook, the goal was to incorporate as much as possible and bake it right in.
- This means there are less documents for people to wade through when looking for answers.
- Note that there are two versions of the GIPS Handbook
 - Regular PDF version
 - Searchable HTML version
- Errata? Yep – not a lot, but worth a quick look.
- Many tools to help firms comply. Often overlooked.



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POLL QUESTION



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Tools First

- Why talk about tools first?
- Not often talked about
- Not many people know about them
- Can be useful
- There is a section of the GIPS website dedicated to presenting tools to help firms, asset owners, and verifiers understand and implement GIPS 2020.
 - <https://www.gipsstandards.org/resources/tools/>



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Tools

- GIPS Reports for Firms Comparison Table
 - GIPS 2020 introduced GIPS Pooled Fund Reports, and we still have GIPS Composite Reports
 - GIPS 2020 also increased the ability to use MWR versus TWR
 - Reporting requirements are different for Composite TWR, Composite MWR, Pooled Fund TWR, and Pooled Fund MWR reports. All have slightly different reporting requirements
 - This tool lays the presentation, reporting, and disclosure requirements out side by side.



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Tools

- Advertising Guidelines Comparison for Firms
 - Compares the advertising requirements for Composites, LDPFs, and BDPFs. Have some differences btw them
 - In table format
- Several Supporting Calculations Sections
 - Actual Excel workbooks with formulas
 - Various return calcs – TWR and MWR – many scenarios (with and w/o CFs)
 - Asset weighting portfolios – various methods (Beg period, and weighted flows)
 - Std Dev calcs – dispersion and 3 yr ex-post
 - Very helpful for firms just coming into compliance as well as firms already claiming compliance



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Tools

- Several Supporting Calculations Sections
 - Example for converting annualized XIRR to unannualized SI-IRR

	A	B	C	D	E	F
1	Going from an annualized XIRR to an unannualized SI-IRR					
2					Check calculation	
3		External Cash Flows &			CF's Invested	
4	Dates	Ending Valuation	Explanation		at IRR	
5	1-Sep-20	\$ (1,000,000)	Contribution		\$ (1,023,775)	=B5*(1+B11)^((A7-A5)/(A7-A5))
6	10-Sep-20	\$ (75,000)	Contribution		\$ (76,225)	=B6*(1+B11)^((A7-A6)/(A7-A5))
7	30-Sep-20	\$ 1,100,000	Portfolio value as of 30 September 2020		\$ 1,100,000	=B7
8		34.41%	Calculated annualized return using XIRR		\$ 0	=SUM(E5:E7)
9						
10						
11		2.38%	Unannualized return			
12			= (1+B8)^((A7-A5)/365)-1			
13						

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Tools

- Carve-out Calculations Workbook
 - Carveouts included in composites must include cash and related income.
 - The GIPS Standards do not require a specific calculation methodology for synthetically allocating cash and related income. Firms often struggle with this.
 - Can use BOP weighting with or without CFs
 - Firms can use strategic targets for asset classes or cash weights. Argument here is to do it this way because a stand-alone portfolio would have a target weight (i.e., have 2% cash target for equity accounts).
 - There are many ways to do these calculations and this workbook has 5 different examples.
 - KM preferred method is BOP allocation based on segment weights. Why? It's straightforward and the subcomponents can be added back to get to total for cross-checks. Less subject to criticism.



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Tools

- Model RFP Template

- Template is designed to provide guidance on the right questions for investors to include in RFPs relating to GIPS
- Key elements of GIPS compliance and verification are summarized
- Suggested standardized questions are included. There are 8.
- This was sorely needed. KM has fielded many questions from our manager clients who were frustrated with questions they received in the RFP process.
 - Is the composite compliant? Invalid question and composites can't be compliant
 - AIMR is dead
 - Verification Levels 1 & 2 are dead
 - Verification is explained. Emphases that it doesn't provide assurance on the accuracy of any specific composite. Composite examinations do that.
- Keeping fingers crossed that institutional investors and consultants read this



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Tools

- FINRA Regulatory Notice 20-21 and GIPS
 - GIPS prohibits firms from making statements about partial compliance with the GIPS Standards (Provision 1.A.8) or referring to the calc methodology as being “in accordance,” “in compliance,” or “consistent” with GIPS (Provision 1.A.9)
 - FINRA came out with Reg Notice 20-21 in July 2020 which stated (among other things) “FINRA interprets Rule 2210 to permit the inclusion of IRR if it is calculated in a manner consistent with the Global Investment Performance Standards (GIPS) adopted by the CFA Institute and includes additional GIPS-required metrics such as paid-in capital, committed capital and distributions paid to investors.”
 - This comes into play when alts firms (such as PE) use a broker to act as an agent for their funds. So BDs were asking alt firms to state that their IRRs calcs were done in accordance with GIPS.



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Tools

- FINRA Regulatory Notice 20-21 and GIPS, Continued
 - This posed a problem
 - The TC provided an exception to 1.A.8 and 1.A.9. for this ONE limited circumstance
 - The tools section of the website has an explanatory memo, a checklist for firms to determine if their IRR calcs and disclosures include everything they should, and an explanatory video



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Tools

- Survey Report on US Firms and Distribution of GIPS Reports
 - Conducted by USIPC
 - Who will be responsible for tracking and distributing GIPS reports to prospects?
 - 66% indicated the marketing department will be responsible
 - 56% indicated some form of CRM to track
 - Criteria for determining whether a prospect remains an ongoing prospect
 - Answers varied.
 - 41% indicated that they would not consider to be an ongoing prospect unless interaction in 12 months
 - LDBF – Composite or Pooled Fund Reports?
 - 66% indicated they will continue using composite reports, rather than pooled fund reports
 - Fee Schedules when including pooled funds?
 - 57% indicated that they will maintain one version of the GIPS Composite Report that includes both composite and pooled fund fee schedules.
 - 24% will attach separate exhibits with relevant fee schedules
 - 14% will have multiple versions of the GIPS Reports with different fee schedules



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Guidance Statements

- Archived Guidance Statements – 40+ if you consider multiple versions of the same GS
- What's left?
 - Wrap
 - Verifier Independence
 - Benchmarks
- What's in process?
 - Overlay – tricky subject. TC tried to incorporate key concepts into GIPS 2020 and Handbook, but more guidance is needed



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Wrap GS

- Effective 10/1/21
- What's Wrap?
 - Bundled fee accounts (all in fee)
 - Can't identify pieces of the fee. Lack of visibility.
 - Wrap sponsor has the client relationship
 - Sponsor engages a firm to manage
 - Firms sometimes don't know what total fees are
- Wrap GS has been around for a while. However, it needed to be updated for GIPS 2020



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Wrap GS

- Many of the old provisions are the same
- What's new?
 - Client reporting versus GIPS reporting. The old GS allowed Sponsor-specific composites to be used to meet the requirement to provide a GIPS report to all prospective clients. This doesn't work anymore. Sponsor specific composites are client reporting. Wrap fee composites must include all wrap fee portfolios managed in a specific investment strategy.
 - Wrap reporting requires a net-down by the entire fee. Problem is that managers can't always determine the whole fee. There are now default model fees:
 - 3% for equity composites
 - 1.5% for fixed composites
 - Can still show pure gross as supplemental!



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Wrap GS

- What's new?
 - Unified Managed Account (UMA) guidance.
 - Treat like wrap, or treat like delivering a model?
 - Depends on the UMA program
 - Does the firm have discretion? Does a contract btw UMA sponsor and firm specify?
 - Does the firm implement trades?
 - Or does the firm provide a model?



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POLL QUESTION



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Benchmark GS

- Effective 4/1/21
- Benchmarks are required under GIPS
- GIPS defines a benchmark as a point of reference against which the composite's or pooled fund's returns or risk are compared.
- Much of this was baked into GIPS 2020. This GS is an excellent reference source and is helpful in explaining various areas of benchmarks
- Guidance on using ETFs as benchmarks, custom benchmarks, MWR benchmarks, and more!



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Q&As

- The GIPS TC archived over 250 Q&As
- Goal was to reduce the number of Q&As by including in relevant sections of standards or Handbook.
- There is still a need for some narrow Q&As
- Several new Q&As addressing GIPS 2020 topics have been issued.
 - Many of these have been highlighted in the GIPS newsletter



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Contact the Presenter



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Thomas Peters leads Kreischer Miller's Investment Industry Group. Tom has a wide range of experience providing GIPS, operational due diligence, compliance, and audit services to firms in the investment industry, including investment managers, investment funds, institutional investors, and broker-dealers. Tom has served on several investment performance committees in the industry. He currently serves as a member of the GIPS Technical Committee.



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The next session will begin at 9:20am.



SEC Marketing Rule and the GIPS Standards

Todd Crouthamel
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Agenda

1. What is the new SEC Marketing Rule and who does it apply to?
2. What is an advertisement under the Marketing Rule?
3. Potential areas of conflict between the GIPS Standards and the Marketing Rule



The SEC Marketing Rule

- Marketing Rule and Adopting release were issued in December 2020 with an effective date of May 4, 2021
- Investment Advisors were given an 18 month window to bring their firm into compliance with the rule (November 2022)
 - Early adoption is permitted; however, firms must comply with the rule in its entirety and may not early adopt only parts of the rule



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Who Needs to Comply with the Rule?

- Investment adviser's investment advisory accounts
- 3(c)(1) and 3(c)(7) funds, commonly referred to in the rule as “private funds”
- Investment advisors with principal operations inside the U.S. when advertising to anyone anywhere in the world
- Investment advisors (SEC registered) with principal operations outside the U.S. when advertising to U.S. investors
- Not governed by the Marketing Rule
 - Registered Investment Companies (RICs)
 - Business Development Companies (BDCs)
 - 3(c)(5) funds
 - 3(c)(11) funds
 - Non-U.S. Funds



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What is an Advertisement?

- As defined in the Adopting Release, an advertisement is “Any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance
 - that offers the investment adviser’s investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or
 - That offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser
- Any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly
- Advertisements do not include
 - Extemporaneous, live, or oral communications
 - Information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication
 - A communication that includes hypothetical performance that is provided
 - To a prospective or current investor in a private fund advised by the investment adviser in a one-on-one communication
 - In response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser”



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Are GIPS Reports Advertisements?

- Short answer is generally yes, GIPS Reports *will generally* be considered advertisements under the new Marketing Rule
- Why?
 - Standardized report
 - Includes performance-related information (returns, AUM, number of portfolios, etc.)
 - Distributed to more than one person
- Additionally, any other types of duplicative materials that are standardized and used either separately or inserted into other communications with prospects (i.e., pitchbooks) would fall under the rule



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POLL QUESTION



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Proprietary and Seed Capital Portfolios

- GIPS Standards
 - Firms may include as part of a new composite, begin to build track record
 - Deem it non-discretionary and create new composite upon the management of a fee-paying, discretionary portfolio
- Marketing Rule
 - Needs to be sufficiently capitalized
 - If it's not, could be considered hypothetical performance
 - When hypothetical, additional burden on advisors to make sure recipients have the ability to analyze and understand performance
- Marketing Rule provides more stringent guidelines



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Proprietary and Seed Capital Portfolios – Implications for GPS Compliant Firms

- Firms should perform review composites containing proprietary/seed capital portfolios to determine whether they are sufficiently funded
- May be helpful to look at composites that have minimum asset levels and include proprietary/seed capital portfolios
- If deemed insufficient, performance of proprietary/seed capital account should be excluded from composite or leave and treat in a similar fashion as hypothetical advertisements
- In instances where an account is deemed to have insufficient funding, and it is the only account in the composite, inception date should be delayed until the earlier of
 - capital in proprietary/seed portfolio becomes sufficient; or
 - advisor obtains managed account in the strategy



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Non-Fee-Paying Portfolios

- Non-fee-paying portfolios are defined under the GIPS standards as those portfolios not paying any investment management fees
- Under GIPS, firms are not required to include NFPPs in composites, but may elect to do so on a composite-specific basis
 - When calculating net-of-fee performance, firms can either apply a model fee to the account or include actual investment management fees of \$0
- Under the Marketing Rule, firms are required to deduct a model fee from non-fee-paying portfolios when calculating net performance
 - Highest potential fee that the investment advisor would charge
 - Fee relevant to the anticipated prospect receiving advertisement



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Non-Fee-Paying Portfolios– Implications for GIPS Compliant Firms

- For instances in which NFPPs are included in composites and actual fees are used in calculating NOF returns, firms should apply a relevant model fee in calculating the NOF return
 - Can be applied at the portfolio level or the composite level
- Should be applied to all periods presented, including retroactive changes
 - Would not be considered an error
 - Should disclose change for at least a year or until firm deems it no longer relevant to understanding the performance



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Presenting Gross and Net Returns

- Under the GIPS Standards
 - Firms have the option to present gross returns, net returns, or both
 - GIPS only recommends presenting both gross and net returns
- Marketing Rule requires the presentation of net returns
- When presenting gross returns, the Marketing Rule also requires the presentation of net returns
 - With at least equal prominence to gross returns
 - In a format designed to facilitate comparison with gross returns (i.e., side-by-side comparison)
 - Calculated using the same type of returns and methodology as the gross returns (i.e., time-weighted versus money-weighted)
 - Calculated for the same time periods as the gross returns (i.e., annual, annualized, etc.)



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Presenting Gross and Net Returns – Implications for GIPS Compliant Firms

- When presenting net returns only within a GIPS report, no action necessary
- When presenting gross returns, firms will generally need to update GIPS reports to include:
 - Net returns in at least equal prominence to gross returns and in a format that facilitates comparability
 - Net returns for the same period as gross returns
 - Net returns calculated in a manner consistent with the gross returns



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Presentation of Returns

- Under the GIPS Standards, prescribed time periods include
 - TWRR – at least 5 years of performance, building to 10 year
 - MWRR – SI-IRR annualized through the most recent period end
- Under the Marketing Rule, prescribed time periods include
 - 1-, 5-, and 10- year returns in all advertisements
 - Exception – private funds (no prescribed periods)
 - If performance does not exist for prescribed periods, investment advisors are required to present performance for the life of the portfolio
 - Type of performance presented not specified in rule



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Presentation of Returns – Implications for GIPS Compliant Firms

- Firms may need to add 1-, 5-, and 10-year returns for each series of returns included in their GIPS Reports when treated as an advertisement on a standalone basis (excluding private funds)
- If prescribed period does not exist, firms must include since inception returns in their GIPS Reports (excluding private funds)
- In complying with the GIPS Standards, firms will also be required to include benchmark returns to accompany for each period of composite or pooled fund returns presented
- Returns can be cumulative or annualized



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GIPS Compliant Track Record – Implications for GIPS Compliant Firms

- In conflicting situations, local laws and regulations take precedence
- Firms have 3 options
 - Go back 10 years or since inception if shorter
 - Include the linked performance in the GIPS Report and disclose the conflict between the GIPS standards and local regulations
 - Include the linked performance in materials that are part of the advertisement, but outside of the GIPS Report (i.e., different page)



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POLL QUESTION



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Timeliness of Returns

- GIPS Standards require that GIPS reports be updated within 12 months of the annual period end
 - There is no requirement to present YTD returns or include more frequent returns within a GIPS Report (i.e., quarterly)
- Under the Marketing Rule, prescribed time periods included must end on a date no less frequent than the most recent calendar year-end
 - More frequent performance may be required if circumstance arise that would lead the calendar year-end performance to be misleading
- SEC issued a FAQ on how soon after year-end, calendar year-end performance should be included in advertisements:
 - “The staff believes that a reasonable period of time to calculate performance results based on the most recent calendar year-end generally would not exceed one month.”
 - Interim performance is acceptable during the one-month period following year-end



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Timeliness of Returns – Implications for GIPS Compliant Firms

- Firms may need to update their GIPS Reports that are being distributed to prospects within one month following year-end when distributing as a standalone advertisement
- More recent performance may need to be included in the GIPS Report if circumstances arise that lead the year-end performance presented to be misleading
- Subsequent updates made to GIPS reports based on more up-to-date information could be subject to the firm's error correction policy



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Portability/Predecessor Performance

- Under the GIPS Standards, firms have the option to port and link performance of a new or acquiring firm if certain requirements are met, on composite-specific and/or pooled fund-specific basis
 - If there is a break in performance, but all other conditions are met, performance may be ported, but not linked
- Under the Marketing Rule, firms are prohibited from presenting predecessor performance, unless the following requirements are met:
 - the person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser
 - the accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to investors
 - all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods
 - the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity

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Portability/Predecessor Performance – Implications for GPS Compliant Firms

- Industry is still seeking guidance on how this may impact the presentation of performance of new and acquiring firms
- Potential that firms may no longer be able to advertise prior performance results if the person primarily responsible for the firm leaves (retroactive treatment)



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GIPS Carve-outs and Extracted Performance Summary

- GIPS standards once again permitting the inclusion of carve-outs with allocated cash in composites
- SEC Marketing Rule permits the advertising of extracted performance
- Differences in how both the GIPS Standards and the Marketing Rule define carve-outs or extracted performance (Marketing Rule language)
 - Under the Marketing Rule, extract performance is performance results of a subset of investments extracted from a single portfolio
 - Carve-outs for GIPS standards generally relate to a composite of carve-outs (multiple portfolios)
- Adopting release for the Marketing Rule views a composite of extracts as not reflecting the holdings of any actual investor
 - As a result, would be subject to additional protections that apply to advertisements containing hypothetical performance
- Firms with carve-outs will need to determine whether performance constitutes a composite of extracts and implement the necessary policies and procedures



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Takeaways

- GIPS Reports are subject to the SEC Marketing Rule
- Review your treatment of non-fee-paying accounts
- Review your presentations for compliance with the 1, 5, and 10 or since inception disclosure requirements in the SEC Marketing Rule
- Determine how you will comply with the timeliness of performance requirements (1 month after year end) of the SEC Marketing Rule
- If you have any predecessor performance, review the SEC Marketing Rule to make sure you are still able to present this predecessor performance

The good news is, you have another 11 months.



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Contact the Presenter



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Todd Crouthamel has extensive experience in the investment industry, including providing traditional audit services to investment managers, hedge funds, and broker/dealers, as well as performing custody examinations, in accordance with the Securities and Exchange Commission Rule 206(4)-2. Todd also serves as the leader of Kreischer Miller's Audit and Accounting Practice. In this role, Todd is responsible for managing the resources of the Audit and Accounting Practice including, training and recruiting, budgeting, serving as a resource on technical matters and development and maintenance of compliance policies and procedures.



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Contact the Presenter



Joshua E. Kramer
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Josh has a wide variety of experience within the investment industry, including providing traditional audit and attestation services to investment managers, broker-dealers, and closely-held funds. Josh specializes in the performance of firm-wide verifications and composite examinations for investment managers claiming compliance with the Global Investment Performance Standards (GIPS).

In addition, Josh has assisted investment firms, seeking to make a claim of compliance with the GIPS Standards, in developing sound policies and procedures consistent with widely accepted practices related to the calculation and presentation of investment performance. Josh currently serves as member of the United States Investment Performance Committee (USIPC).

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The next session will begin at 9:40am.



Operational Due Diligence in a Remote Environment

**Jennifer L. Kreischer,
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Agenda

1. What is operational due diligence
2. Due diligence in a remote environment

What is Operational Due Diligence?

- Kreischer Miller helps *investors* who want to understand potential operational and business risks of a using an investment manager
- Kreischer Miller assists *investment managers* looking to understand that proper internal controls are in place and risks are being managed effectively
- Procedures tailored to assess how an investment manager addresses qualitative operational and business risks through things like:
 - Internal controls
 - Design and implementation of systems
 - Oversight of employees



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POLL QUESTION



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Due Diligence in a Remote Environment

- Investments and due diligence must go on
- Adapting to the new environment
 - Investment Managers
 - Due Diligence Professionals
- Regularly update risk assessment for managers
 - Location - as new hotspots emerge, do you know which managers could be affected?
 - Size – smaller managers will be at greater risk
 - Changes in personnel or regulatory profile



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Due Diligence in a Remote Environment

- Gather basic information from your investment managers on impact of remote environment
 - Counterparty exposure
 - Service provider issues
 - Insurance coverage
 - Gather information pertaining to any impact to the front or back office



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Due Diligence in a Remote Environment

- Don't overlook typical updates:
 - Changes in personnel
 - Regulator visits/changes in rules
 - New systems or significant upgrades
 - Change in ownership
- Develop new policies and procedures
 - Some things might not be verifiable
- Understand how things have changed and know that it might not be temporary



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Due Diligence in a Remote Environment

Beyond the Basics – Adapting to the Challenges

- Documentation Review
 - Investment Manager
 - Due Diligence Professional
- Trust but Verify
 - Fundamental component of operational due diligence
 - Even in 2020 some information may not be available electronically
 - Listen and ask more questions



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Due Diligence in a Remote Environment

Beyond the Basics – Adapting to the Challenges

- Interviews
 - Although in-person interviews are preferred, video conferencing is a viable alternative
 - Ask questions of multiple individuals that allow the investment manager to discuss the process through all stages of a transaction
 - Request if information can be shared through screenshots and screen sharing



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Due Diligence in a Remote Environment

Beyond the Basics – Adapting to the Challenges

- Business Continuity and Disaster Recovery
 - Ask about the transition to work-from-home
 - Most BC/DR plans did not address a pandemic
 - Ask about any changes made in response to COVID-19
- Understand that changes may not be temporary
 - Understand the changes. Detail what controls have been put in place



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Due Diligence in a Remote Environment

Beyond the Basics – Adapting to the Challenges

- Understand that changes may not be temporary
 - Change is not just about access and systems; it is about continuing to maintain operational oversight and supervision from a compliance perspective
- Collaboration tools
 - Video conferencing
 - Screen sharing
 - Investor portals



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Contact the Presenter



Jennifer Kreischer, CPA
Senior Consultant, Investment Industry Group
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Jennifer has more than 25 years of experience, including over 10 years as a partner at PricewaterhouseCoopers, providing traditional audit and accounting services as well as financial and operational due diligence. Jennifer leads teams who assist limited partners in assessing operational and business risks at their investment managers, as well as the managers' management of the risk. She consults with financial services businesses on topics including sales, mergers, and succession planning. Jennifer has led teams assisting clients in executing complex investment transactions. These transactions include mergers, acquisitions, debt and equity offerings, registration with the SEC, and joint ventures. Additionally, she led teams implementing Sarbanes-Oley, complex new U.S. GAAP accounting standards, and International Financial Reporting Standards (IFRS). Jennifer has worked with a variety of investment industry clients who manage virtually all asset classes. These clients have been based in North America, Europe, and Asia. Jennifer is a frequent speaker on accounting and due diligence topics. She has presented to industry groups and clients in the U.S. and Europe.



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Trends in Operational Due Diligence

**Dawn M. Levant,
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Agenda

1. Changes and Challenges in Operational Due Diligence
2. Looking Forward

Changes and Challenges in Operational Due Diligence

- Virtual operational due diligence
 - Technology
 - Sensitive information
 - Investor portals
 - NDAs
- Outline of an operational due diligence visit
 - Scheduling
 - More time with the “C-Suite”
 - Multiple days vs. multiple hours
- Larger investment managers vs. smaller investment managers
 - Adaption to the virtual environment



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Changes and Challenges in Operational Due Diligence

- Challenges that are difficult to eliminate
 - Proprietary systems
 - Access to confidential information
 - “Trust but verify”
 - Understanding how the investment process works
 - Hybrid work environments
 - Changes due to COVID-19



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POLL QUESTION



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Operational Due Diligence – Looking Ahead

- Virtual due diligence
 - Travel restrictions
 - Remote vs. hybrid due diligence
- NDAs
 - Impact of ILPA's model NDA
- Regulatory concerns
 - SEC in the United States
 - FCA in the United Kingdom
- Policies and procedures
 - Maintenance and suitability



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Operational Due Diligence – Looking Ahead

- Cybersecurity
 - Drafting provisions in legal agreements
- Environmental, Social, and Governance
 - Understanding the impact to an investor
 - Implementation, monitoring, and reporting
- Vendor management
 - Decision to outsource
 - Conduct due diligence
 - Onboarding
 - Monitoring



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Operational Due Diligence – Looking Ahead

- Fees
 - SEC
 - Why the scrutiny?
 - Improve transparency



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Contact the Presenter



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Dawn is a Chartered Alternative Investment Analyst with more than 20 years of investment industry experience. Dawn performs financial and operational due diligence, including the calculation of management and incentive fees, throughout the United States and Europe to assist investors in understanding the financial and operational risks inherent in their investment managers' operations.



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Break

The next session will begin at 10:20am.



Kreischer Miller Virtual Annual Investment Industry Seminar

SEC and Regulatory Update 2021
Todd Cipperman

A black and white photograph of a Formula 1 pit stop. Several crew members in racing suits and helmets are working on a race car. One person is visible in the foreground, looking towards the camera. The car has the number '1' on its side.

Regulatory Focus

- Active SEC Enforcement
- DoJ criminal penalties
- Form CRS
- Revenue Sharing
- New marketing/advertising rule
- Performance presentations
- Compliance programs
- CCO liability
- Service provider liability
- Cybersecurity
- Private equity and registered fund compliance



Litigation and Enforcement

- SEC Record: \$4.68 Billion
- Whistleblower program expands
- Litigation mistakes
- DoJ and criminal penalties
- Securities markets gatekeepers
- Predecessor liability

Advisers

- Regulation Best Interest and Form CRS
- Revenue Sharing
- Conflicts of Interest
- Fees
- Wrap
- Custody
- Form ADV



Marketing and Advertising

- New marketing/advertising rule
- Misrepresenting investments
- Hypothetical, backtested performance
- Inflating performance
- Exaggerating credentials
- Social media



Compliance

- Inadequate and ineffective compliance programs
- Insufficient compliance resources
- Dual-hat CCOs
- Unqualified CCOs
- CCO liability



Service Provider Liability

- Auditors
- Fund administrators
- Pricing vendors
- Lawyers
- Custodians
- Consultants



Technology and Cyber

- Cybersecurity requirements
- Breaches
- Blockchain and Crypto
- Robos



Other Developments

- Supervision of branch offices and bad brokers
- Compliance problems with private fund managers
- Valuation
- Widespread compliance breakdowns at registered funds
- Cross-trading
- Payment-for-order-flow
- AML and SARs



Practice Tips

- ✓ Hire an enforcement lawyer when you get a subpoena.
- ✓ Prepare/review/revise Form CRS.
- ✓ Do not take compensation other than fees.
- ✓ Get ready for the new marketing/advertising rule.
- ✓ Scrub your performance data.
- ✓ Hire/outsource a professional CCO.
- ✓ Enhance due diligence of prospective clients.
- ✓ Detail services (not) provided.
- ✓ Conduct a cybersecurity assessment.
- ✓ Review Risk Alerts.

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Read and respond to "Our Take" on important industry developments at cipperman.com/blog.



Thank you.

610-687-5320 | cipperman.com

The next session will begin at 10:50am.



Tax Update

**Richard J. Nelson,
Director,
Tax Strategies**

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**Kreischer
Miller**

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Agenda

1. Proposals – What's out/ What's in
2. New Form K-2 and K-3
3. New Carried Interest FAQs
4. Cryptocurrency Update

Disclaimer

This material is provided for general informational and educational purposes only and should not be construed as legal or tax advice. You should not rely on information contained in this presentation to make business or tax decisions without first consulting with your tax advisor. The information contained in this material is subject to change without notice. The presenters undertake no obligation to update this material.



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2021

- A year of uncertainty
- Multiple governmental proposals
- We saw old proposals that have been debated over the years
- We saw new proposals that we have not seen before



Proposals

- The President's campaign proposals
- The President's budget address in April
- The House Ways and Means Committee issued tax elements of the *Build Back Better* agenda
- The most recent proposal was released by the House on October 28th and modified November 4th and 5th
- A vote on the House proposal may happen this week.



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POLL QUESTION



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What's Not in The House Proposal

- **What's not in the latest proposal released by the House:**
 - A corporate income tax rate increase to 26.5%
 - An increase in the top individual rate to 39.6%
 - An increase in the top capital gains rate to 25%
 - Modification of the rules for carried interests in partnership interests held in connection with performance of services
 - A limitation on the section 199A deduction of qualified business income of high-income individuals
 - Changes to rules applicable to grantor trusts
 - Valuation rules for certain transfers of nonbusiness assets
 - Increase in limits on estate tax valuation reduction for certain real property
 - Accelerated termination of temporary increase in the estate and gift unified credit
 - Expansion of the rehabilitation tax credit
 - Making new market tax credit (NMTC) permanent



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What's Not in The House Proposal

- **What's not in the latest proposal released by the House (continued):**
 - Expansion of the rehabilitation tax credit
 - Making new market tax credit (NMTC) permanent
 - A mark-to-market regime for very high-income individuals, trusts, and estates (the so-called “billionaires’ tax”)
 - Reporting of account flows by financial institutions



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Questions

Are they really out?
Should we breathe a sigh of relief?



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What's Next

- The October 28th bill was proposed by the House. It has not yet been voted on.
- If it passes the House, it then goes to the Senate, where there may be further changes.
- Since the final bill voted on by both the House and the Senate must be the same, any changes by the Senate go back to the House.
- Once the bill is passed by both the House and the Senate, it then goes to the president.



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What's in the Latest Proposal

- A surcharge on high income individuals
 - 5% of modified adjusted gross income in excess of \$10 million
 - An additional 3% of modified adjusted gross income in excess of \$25 million
- A surcharge on high income trusts
 - 5% of modified adjusted gross income in excess of \$200,000
 - An additional 3% of modified adjusted gross income in excess of \$500,000
- Increase the state and local tax deduction from \$10,000 to \$80,000
- Application of 3.8% net investment income tax to operating trade or business income. Taxpayers earning more than \$400,000 annually (\$500,000 filing married joint)



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What's in the Latest Proposal

- A 15% corporate minimum tax on financial statement income of corporations with a three-year average income in excess of \$1 billion
- 1% excess tax on stock repurchases by U.S. publicly traded corporations based upon the value of the stock
- Rate changes to international provisions for GILTI (global intangible low taxed income, FDII (foreign derived intangible income) and BEAT (base erosion and anti-abuse tax)



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What's in the Latest Proposal

- Portfolio Interest Exception
 - The proposal provides that any person who owns 10% or more of the total vote or value of the stock of a corporation, the interest for an obligation issue by the corporation is not eligible for the portfolio interest exemption. Currently does not include interest received by a 10% shareholder on an obligation issued by a corporation.
- The special 75% and 100% exclusion rates for the sale of small business C Corporation stock will not apply to Taxpayers with adjusted gross income equal to or exceeding \$400,000 for sales and exchanges after September 13, 2021, subject to a binding contract exception. The 50% exclusion will still apply.



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What's in the Latest Proposal

- Wash Sales – rules prevent owners of stock and other securities from selling the stock at a loss, repurchasing the stock within 30 days, and claiming the loss. The proposal expands the wash sale rules to cover commodities, currencies, and digital assets. The provision would apply to sales and other dispositions beginning after December 31, 2021.

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POLL QUESTION



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BBB Act – New Minimum Distribution Requirements

- Create required minimum distributions for retirement accounts of more than \$10 million. Effective for taxable year beginning after December 31, 2028.
- Prohibit new contributions to large accounts. Effective for taxable years beginning after December 31, 2028.
- Eliminate “backdoor Roth” loopholes. Some provisions effective for taxable years beginning after December 31, 2021 and others not effective until taxable years beginning after December 31, 2031.



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BBB Act – New Minimum Distribution Requirements

- New form of Required Minimum Distribution or “RMD”.
- Provisions would apply if the value of individual retirement accounts, 401(k) plans and other retirement accounts exceed \$10 million.
- Current law requires withdrawals from certain retirement accounts based on age and for Committee inherited IRAs and 401(k) plans.



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BBB Act – New Minimum Distribution Requirements

- The formula is complex, based on factors like account size and type of account (pretax or Roth).
- General concept: accountholders must withdraw 50% of the amount by which prior year total value exceeded \$10 million.
- Larger accounts must also draw down 100% from Roth accounts up to lesser of total value over \$20 million or Roth balances.
- The distributions would only be required for individuals whose income exceeds \$400,000 (\$450,000 for married taxpayers filing jointly and \$425,000 for heads of household).
- Distributions would not be subject to 10% early withdrawal penalty.
- \$10 million and \$20 million thresholds to be indexed for inflation after 2029.



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BBB Act – Restriction on New Contributions to Retirement Plans

- New provisions would prohibit individuals from making more contributions to a Roth IRA or traditional IRA if the total value of their combined retirement accounts (including workplace plans) exceeds \$10 million.
- The provisions will apply to taxpayers once income is over \$400,000 (\$450,000 for married couples and \$425,000 for heads of household).
- A new annual IRS information reporting requirement would be imposed on employer defined contribution plan accounts with aggregate balances exceeding \$2.5 million.



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BBB Act – Backdoor Roth Provisions

- Current law disallows any contributions to Roth accounts for single taxpayers whose annual income exceeds \$140,000 (\$208,000 for married couples filing a joint tax return).
- Individuals who are subject to caps are currently permitted to convert funds in a pre-tax IRA — which doesn't have an income limit — to a Roth IRA.
- Individual must pay income tax on the converted funds.
- Such pre-tax IRAs may hold a substantial sum of money from a 401(k) plan whose funds were rolled over.



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BBB Act – Backdoor Roth Provisions

- New provisions would prohibit any after-tax contributions in 401(k) and other workplace plans and IRAs from being converted to Roth savings. This rule would apply to all income levels starting after December 31, 2021.
- Individuals would be unable to convert pre-tax to Roth savings in IRAs and workplace retirement plans if their taxable income exceeds \$400,000 (\$450,000 for married couples or \$425,000 for heads of household). These provisions would start after December 31, 2031.



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Tax Planning Strategies

- Keep in mind that the effective dates for most of retirement plan provisions do not occur until taxable years beginning after December 31, 2028.
- Look for development of new variations or uses of insurance vehicles to achieve tax deferral of investment gains for assets that would otherwise be held in a qualified retirement plan but for future impact of new \$10 million RMD requirements.
- Consider converting after-tax contributions in 401(k) and other workplace plans and IRAs to Roth savings by December 31, 2021 to avoid change in provisions allowing such transfers going forward.



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POLL QUESTION



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New Schedules K-2 and K-3

- Schedule K-2
 - Schedule K-2 is an extension of Schedule K of Form 1065 and is used to report items of international tax relevance from the operation of a Partnership.
 - Schedule is 19 pages long.
- Schedule K-3
 - Schedule K-3 is an extension of Schedule K-1 of Form 1065 and is generally used to report to partners their share of the items reported on Schedule K-2. Partners must include the information reported on Schedule K-3 on their tax or information returns.
 - Schedule is 20 pages long.



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New Schedules K-2 and K-3

- The partnership need not complete the schedules if the partnership does not have items of international tax relevance (typically, international activities or foreign partners).
- A partnership is only required to complete the relevant portions of Schedules K-2 and K-3, as applicable.
- Schedule K-2 and K-3
 - Instructions: <https://www.irs.gov/pub/irs-dft/i1065s23--dft.pdf>
 - Schedule K-2: <https://www.irs.gov/pub/irs-dft/f1065sk2--dft.pdf>
 - Schedule K-3: <https://www.irs.gov/pub/irs-dft/f1065sk3--dft.pdf>



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Sampling of Items Schedule K-2 and K-3

- Foreign tax credit information
- R&E Expenses
- Distributions from Foreign Partnerships
- Partners deduction with respect to Foreign Derived Intangible Income
- PFIC information
- Information regarding partners interest in foreign corporations
- Partner information for Base Erosion and Anti-Abuse Tax
- Foreign Partner's character and source of income and deductions
- Foreign partner's distributive share of deemed sale items on transfer of partnership interest



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Carried Interest IRS FAQs

- On November 3rd, IRS released detailed reporting directions for certain passthrough entities and taxpayers reporting partnership interests held in connection with performance of services.
- The FAQs provide two sample worksheets and instructions.
- The worksheets are to be used in filing returns after December 31, 2021, in calculating and reporting the amount of net long-term gains of partners holding applicable partnership interests that are recharacterized as short-term capital gains.
- Owner Taxpayers and Pass-Through Entities must apply the final regulations to taxable years beginning on or after January 19, 2021 (the date final regulations were published in the Federal Register).



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Carried Interest Worksheet A

- Worksheet A
 - Applies to pass-through entity which applies the final regulations.
 - Pass-through entity required to attach Worksheet A to the Applicable Partnership Interest (API) holder's K-1
 - Pass-through entity is a partnership, trust, estate, S Corporation or a passive foreign investment company
- A pass-through entity that is not required to and does not choose to apply the final regulations to tax returns filed after December 31, 2021, for a taxable year beginning before January 19, 2021, must attach a worksheet to the API Holder's Schedule K-1 that contains similar information as Worksheet A, and must disclose whether the information was determined under the proposed regulations or another method.



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Carried Interest Worksheet B

- Worksheet B
 - Owner Taxpayer can be an individual, estate or trust who is subject to income tax on the recharacterization amount.
 - For tax returns filed after December 31, 2021 in which the Owner Taxpayer applies the final regulations, Worksheet B must be used to determine the amount of the Owner Taxpayer's Recharacterization Amount. Worksheet B, along with Tables 1 and 2 are to be attached to the Owner Taxpayer's tax return.
- An Owner Taxpayer that is not required to and does not choose to apply the final regulations to tax returns filed after December 31, 2021, for a taxable year beginning before January 19, 2021, must attach worksheets to its return that contain similar information as Worksheet B and Tables 1 and Table 2, and must disclose whether the information was determined under the proposed regulations or another method.



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Carried Interest Forms

- Worksheets
 - Worksheet A <https://www.irs.gov/pub/irs-utl/section-1061-worksheet-a.pdf>
 - Worksheet B <https://www.irs.gov/pub/irs-utl/section-1061-worksheet-b.pdf>
 - Table 1 <https://www.irs.gov/pub/irs-utl/section-1061-table-1.pdf>
 - Table 2 <https://www.irs.gov/pub/irs-utl/section-1061-table-2.pdf>



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Cryptocurrency

- The Infrastructure Investment and Jobs Act imposes new reporting requirements on brokers of cryptocurrency, specifically persons responsible for regularly providing service effectuating transfers of any “digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology.”
- The government is concerned that large amounts of cryptocurrency transactions are not being reported as taxable income. The taxation of that income will help to offset the total cost of the act. Additionally, the penalties imposed on taxpayers for failure to file information returns are extended to apply to this new requirement, helping to raise more revenue.



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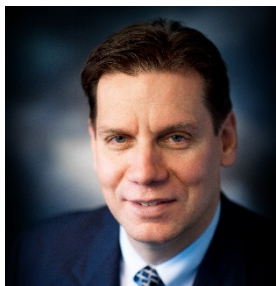
Cryptocurrency

- Currently, cryptocurrency reporting generally is only required in the context of reporting requirements applicable to capital property (which may not be required for transactions under \$600), or where the currency is used as compensation to employees or independent contractors. The act requires reporting of any other transactions where the current rules do not apply.
- The reporting requirements do not take effect until 2023.



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Contact the Presenter



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Rich Nelson has extensive experience providing domestic and international tax planning and services to a variety of middle market companies and entrepreneurial businesses in a number of industries including manufacturing, distribution, real estate, financial, and professional services. He also has significant experience and expertise with high-net-worth individuals, investment companies and pass-through entities and has been involved in federal, state, and local tax audits, settlements, and appeals.

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