PRINCIPLES FOR INVESTMENT REPORTING

SECOND EDITION

CFA Institute

CFA Institute is the global association of investment professionals that sets the standard for professional excellence. We are a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community.

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PRINCIPLES FOR INVESTMENT REPORTING

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I. PREFACE

Clear, trustworthy investment reporting continues to be the most valuable tool for communicating investment information. Whether you utilize this information as an investor or as a financial professional, it is what you don't know that can be the most damaging. In today's complex investment marketplace, there is a need for a tool set of guidelines to advance the next stage of evolution for investment reporting.

Currently, there is no general, global industry guidance to address the lack of transparency that can occur when providing investment reporting to asset owners. The widely implemented Global Investment Performance Standards (GIPS®) can be seen as guidelines addressing a number of transparency issues with respect to performance measurement and presentation, but it addresses the transparency issue primarily from a prospective client's point of view. For existing clients, we observe the same situation that prospective clients experienced prior to GIPS standards and its predecessors. The Principles for Investment Reporting specifically address reporting to existing clients, whereas the GIPS standards address presentation primarily to prospective clients.

Various examples of inadequate investment reporting have been uncovered as a result of the financial crisis, (e.g., unvalued holdings, inappropriate pricing, lack of disclosure of counterparty risks, not presenting the effective exposure of leveraged instruments). These gaps in the industry's practices need to be closed. The fact that investment reporting often only reflects the provider's perspective raises a question whether such investment reporting meets all clients' expectations or needs. If not, closing this gap is possibly one of the biggest challenges for the investment reporting industry in the future.

The Principles for Investment Reporting facilitate a dialogue between the preparers of investment reporting (e.g., investment management firms, custodians) and the intended users of the investment report (e.g., investors, portfolio managers). The goal is to harmonize the understanding and needs of both investment report creators and those for whom the report is intended.

Investment reporting today has to include coverage of more complex securities and instruments, such as structured products, derivatives, and multilayered products and is therefore becoming more and more complex. There is often a lack of understanding of many important technical reporting concepts by clients, which often leads to expectations that currently are not or cannot be met.

The purpose of the Principles for Investment Reporting is not to restrict or define which elements should be in a report but to address that having created a report, it should include sufficient information or indicate where the information can be readily obtained so that the recipient understands the contents of the report and the reasons behind the selection presented.

The first edition outlined the key Principles and promised a second edition that would contain a series of recommendations. While this is the second edition, the recommendations are included in a separate document titled "Guidance to Effective Investment Reporting" (EIR), and is presented as an extension of Principles for Investment Reporting. The second edition of the Principles, for all practical purposes, contains the same information as the first edition.

EIR introduces the recommendations that support the qualities that relate to each principle. By implementing the recommendations of EIR, the dialogue is facilitated that enables the preparer to understand the user's requirements and enables the user to understand the ability of the preparer regarding the specification of the report. The conclusions from the dialogue are documented and combined into an EIR document that therefore contains the specifications for the EIR that will be delivered to the specific user. The recommendations indicate preferences for the information that is to be included in a report and how that information is to be presented. That information is considered to be the minimum that is to be included in the dialogue that occurs between the preparer and the user.

II. WHY PRINCIPLES FOR INVESTMENT REPORTING ARE NEEDED

Currently, no general, globally accepted industry practices address the lack of transparency and clarity that can occur when firms report investment information to their existing clients. The well-established GIPS standards address a number of transparency issues but primarily with respect to performance measurement and presentation for prospective clients. Existing clients throughout the financial industry—not only those dealing with investment management firms—are in a situation similar to that of prospective clients before the development of the performance presentation standards culminating in the GIPS standards.

There are six key areas where reporting today is lacking:

Transparency and clarity

Examples:

- Unvalued holdings or holdings valued on the basis of stale prices that are not disclosed
- Inappropriate pricing and the use of prices based on in-house assumptions that are not disclosed or visible
- Lack of adequate disclosure of risks
- No presentation of the true exposure of leveraged instruments
- Unclear assumptions, calculations, and underlying data used in the construction of the information users are shown

Client perspective

Examples:

- Presenting time-weighted returns reflecting the asset manager's performance but not presenting the money-weighted return that shows the impact of client-driven capital flow decisions
- Providing only gross-of-fees return—which, again, indicates the manager's performance but ignores the management fees that will be paid or have been paid by the asset owner, which will lower the return the asset owner actually obtains

When any report is provided, it is crucial that the user be able to determine what component parts make up the information provided. For instance, a net-of-fees return must be accompanied by an indication of the fees it is "net" of; the label by itself is inadequate. In situations where the interaction with the client is streamlined, such as in non-advisory relationships, it is key that the limited amount of information that is transmitted to the client be presented with the clarity and transparency that lets the user understand precisely what is being presented.

In such a case, the labels should indicate not only what is included, but also what is excluded and any assumptions or process specifics, such as cutoff dates, accruals, corrections, or changes to prior data.

Fee transparency

Wherever a fee applies or could apply that is under the control of the financial entity preparing the report, the report needs to be transparent as to (1) which fees are being applied and for what service, (2) the calculation used to set the fee, (3) the amount charged, and (4) the impact of the fee on the investment portfolio (i.e., is it separately invoiced, deducted from the account, included in the net-of-fees and/or gross-of-fees return, or not included in any returns; is it reflected in the final value being presented?).

Examples:

- Transaction fees, advisory fees, asset servicing and administrative fees, and management fees (performance fees and fixed or variable fee schedules) may be applicable to the total asset base or to individual holdings.
- Transaction fees are incurred through the trading of assets; thus, high turnover equates to high transaction costs.
- Asset selection subjects users to commissions, incentives, issuance fees, purchase fees, redemption fees, exchange fees, and loads (e.g., front-end, back-end, level, low loads) related to specific holdings.
- Periodic fees, such as management fees and account maintenance fees, may have breakpoints where, depending on the amounts involved and client eligibility, the level of fees changes. The various combinations and permutations of (1) type of asset, (2) time held, and (3) existence of waivers, reimbursements, and recoupments may also determine the fee applied.
- Some fee structures include return targets that must be met, sometimes over a specific time frame, before the fee can be levied, but information on progression toward the targets is not always provided.
- Fees that are being accrued and the progression toward any performance-based fees should also be disclosed but typically are not.

Fees charged to or incurred by an investor will impact the investor's return by a material amount over the long term. Further, the structure of fees and incentives may influence asset selection and the management of investments and, therefore, impact both the gross-of-fees return as well as an associated net-of-fees return.

Ultimately, the client should be able to aggregate the fees from all the reports from the various providers of financial services for the client's assets and clearly see the cost of managing or administering those assets.

Improving the transparency of fees is one of the biggest challenges in investment reporting because of the various systems and data that are required to track what can be "hidden," embedded, "rolled up," holdings based, transaction based, and portfolio based. Transparency of fees is of paramount importance, however, not only to asset owners but also to policymakers and regulators.

Treatment of complex technical issues

Examples:

- Inconsistent treatment of structured products, derivatives, and multilayered products and their response to less stable markets
- No consideration of the impact of complex products on the risk profile as well as return of a portfolio
- Lack of interfaces between decision-support tools and accounting records, holdings files, asset characteristic databases, and reference data to enable firms to produce a non-contradictory, consistent, and comprehensive report

In addition, the quality of investment reporting differs significantly among providers, and it may differ among various levels of service offered to clients. More data, disclosure, footnotes, etc., do not necessarily produce the clearest, most transparent, unambiguous report. Indeed, more minutiae may produce the most confusing report.

Understanding between preparers and users

A number of reviews and surveys of clients have identified at least two major problems: (1) preparers have little knowledge and understanding of investment reporting principles and (2) preparers lack the ability to meet the reporting needs of clients.

Addressing these needs would be a substantial move toward reestablishing and building trust between clients and the reporting entities. Rebuilding trust will encourage investors to refocus on securing their financial future in partnership with investment professionals.

Anticipation of regulatory trends

Regulatory authorities are already reviewing the content of investment reporting. Several directives regulate some aspects of the reporting and communication to investors. It is now up to the industry to anticipate what may come next in this trend and determine how to self-regulate investment reporting.

III. BACKGROUND AND DEFINITIONS

The Principles for Investment Reporting represent the work of CFA Institute and its Investment Reporting Working Group (IRWG). CFA Institute is a global not-for-profit association of investment professionals with the mission to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. CFA Institute has a long-standing history of and commitment to establishing a broadly accepted ethical standard for calculating and presenting investment performance, predominantly for prospective clients, based on the principles of fair representation and full disclosure.

Beginning in 2011, the working group set out to establish a concise and comprehensive set of principles for investment reporting for the purpose of providing customers and clients of financial institutions with a definitive guide to complete, consistent, and transparent reporting.

The intentions are for the Principles to become recognized guidance for investment reporting globally and to promote the notion of full, accurate, and transparent disclosure and communication between all financial institutions or their agents and investment clients. The Principles reflect the three points below.

Investment reporting is a subset of client reporting in the investment management industry

In addition, it is a fundamental component of a comprehensive due diligence process.

Investment reporting is defined in the Principles as the preparation and presentation of investment information, including:

- the investments made,
- the results achieved,
- the risks taken, and
- the management and maintenance fees incurred.

This definition applies to reports that are produced for non-advisory relationships and for advisory relationships. Investment reporting is considered to include not only the output but also the processing of the inputs, the creation of the reports, the communication between the preparer and the user, and the policies and procedures followed for these elements.

In the Principles, investment reporting focuses on current exposures of the investments, which includes reports on asset allocation, performance, tax status, risk, etc., but does not include reports designed purely for accounting, tax, and regulatory purposes (e.g., tax lot reporting, annual reports).

The Principles are separate from the well-established GIPS standards

The discussions, Principles, and conclusions herein are not part of the GIPS standards.

The Principles are flexible

Many types of financial firms create investment reports, which cover various aspects of assets—holdings, transactions, performance, and portfolio analysis, to mention a few—and report on the assets from a management, custody, administrative, or consultative perspective. The Principles must be applicable to all of these providers of investment reporting and be of value to the users of the reports. The structure of the Principles is flexible so that preparers can support it fully for the client base that the preparer has defined and expand the client base definition as the preparer's ability and client demand develop.

IV. STAKEHOLDERS

The Principles are intended to apply globally and can accommodate several types of stakeholders, all of whom will benefit from a comprehensive approach for preparers and users of investment reporting. Stakeholders include both the preparers and the intended users of investment reporting, such as:

- asset management companies;
- mutual fund administrators;
- custodians;
- administrators;
- prime brokers;
- investment consultants; and
- asset owners.

The report request could be made by the user or could be made by an intermediary. The request could be to supply the information to the user directly or to consolidate it with other information and pass it on to the user.

In the preparation of a report, knowing who the intended user(s) of the report is (are) can aid in determining the information and the disclosures that should be included to ensure transparency and clarity. When preparers are aware of the role they are undertaking in providing investment information, the transparency of the report is enhanced and thus also the potential for effective investment decisions.

The stakeholder who is a preparer should recognize that the perspective of the intended user may be different from that of the initial recipient. For example, fee information that may be irrelevant or even unavailable to a custodian would be relevant when presenting a report to the asset owner.

At such times, the preparer will have to disclose that they do not have access to certain information (e.g., certain fees and costs that have not been included) and disclose the limits of the information that is available.

This principles-based approach is intended to be flexible and accommodating for investment reporting globally and for many types of preparers. The Principles require a number of actions that the preparer must follow, however, if the investment reporting is to be of the necessary quality.

V. OBJECTIVES

The objectives of the Principles are:

- to highlight the importance of reporting as feedback into the investment management process,
- to ensure that the user's preferences are reflected in the information contained in the report,
- to increase communication and education between the preparers and recipients of investment reporting,
- to document policies, procedures, controls, and preferences of the asset owner for report content and to make the documents available upon request,
- to provide guidance on the minimum content necessary for full, fair, transparent, and effective investment reporting,
- to promote consistency while accommodating and disclosing differences,

- to provide assurance to intended users of investment reporting that the preparers who follow the Principles adhere to high ethical standards,
- to provide guidance on methodologies for preparers and intended users,
- to promote strong and consistent internal processes for preparers of investment reporting, and
- to anticipate those aspects of investment reporting for which regulation may be considered necessary and complement existing regulations.

VI. THE FIVE PRINCIPLES FOR INVESTMENT REPORTING

There are five principles for investment reporting that must be followed and also aspects of reporting that are recommended to be followed.

1. Communication occurs between the preparer and the user as to the purpose of and need for investment reporting

Communication between a preparer and the intended user is a key component that leads to the production of a report that meets the objectives of the Principles. The Principles require periodic communication so that changes in the recipient's needs and the provider's capabilities can be incorporated into the production of a report that continues to be useful to the user, to be understandable, and to follow the Principles.

The communication is expected to introduce the user to the practices and principles of investment reporting and the components that the Principles indicate should be discussed with the intended user so that the user can make an informed decision about the information the user wishes to have in the report. The expectation is that the value users derive from the communication will encourage them to ask for reporting that follows the Principles from other preparers and in additional reports.

As indicated in the Principles, a specific discussion must be conducted with the intended user about the content of the investment report, and the conclusion must be documented. Following are some guidelines of how the communication process might be undertaken:

Format

The communication could take many formats, as long as it provides an opportunity for the client to question the preparer, although not necessarily directly or in real time. The format must also enable the client to make informed decisions from the options presented. Examples of formats that support this include face-to-face meetings, phone calls, web-based tools, written internet discussions, interactive question-and-answer sessions with online help, and traditional paper-based or e-mail exchanges.

Content

The communication should cover all the information that is recommended for inclusion by the Principles so that the recommendations and alternatives the preparer may need to disclose can be discussed and so that the client's preferences are understood. The two key aspects of the communication are (1) to ensure that the preparer informs the user about the purpose of the pieces of information and explains what each piece of information conveys and (2) to allow the user to go through the Principles and recommendations, ask for further details if needed, and indicate preferences. For both recommendations and alternatives, the preparer should make sure the user has adequate information to understand why the information is being presented and what it conveys. Where options are offered, the preparer must ensure that each option is presented in a full and fair manner so that the user can make an unbiased, informed choice.

The Principles outline the minimum that should be included in the communication and do not restrict either the preparer or the client from discussing additional content that the preparer can provide or that the client wishes to have.

The discussion between the user and preparer should also cover the frequency of reviews. The frequency of the communication must be sufficient for changes in the client's needs and the preparer's ability to be discussed and incorporated into reports in a timely manner.

Effective investment reporting reflects the following qualities:

i. Active communication occurs between the preparer and the user of the investment report, and all decisions about content of the report from this communication are documented by the preparer in, or as part of, a client agreement that is reviewed periodically by both parties.
ii. The purpose of the investment report and the reasons for its content and production are transparent and clearly stated.
iii. The investment report provides information on changes in the investment strategy or investment style.

2. Control processes, policies, and procedures are documented and followed

The Principles require that the policies, procedures, and control processes that support the report preparation and error correction exist, are documented, and are available if requested by a report user.

Effective investment reporting reflects the following qualities:

i. The investment report is timely and accurate.
ii. The investment report complies with all applicable laws and regulations.
iii. Data quality is defined and managed according to transparent criteria, and control processes are defined, documented, and made available on request.
iv. Methodologies used for the production of the data in the report are disclosed or made available on request.
v. The preparer consistently adheres to the processes that are documented and makes them available on request.
vi. The preparer follows an error-correction policy, which is available on request, discloses material errors affecting information included on prior investment reports, and the definition of "material" is agreed with the user.
vii. The preparer has a policy for handling potential conflicts of interests—especially concerning the provision of investment information to third parties to whom this information may be advantageous. Where conflicts of interest exist, they are declared. Segregation of duties is sufficient that a fair and accurate representation of the assets to be reported occurs.
viii. Production and control processes are periodically reviewed.

3. Client preferences are reflected in the investment report documentation

The conclusion of the communication between the preparer and user about the user's preferences must be documented and must be accessible to the report preparers for regular maintenance.

Monitoring

The documentation must be regularly reviewed and updated to ensure that it reflects changes in the user's requirements or in the preparer's capabilities (including the ability to include the Principles recommendations). User and preparer changes that arise from the periodic reviews are to be incorporated into the documentation and reflected in the reports.

Once the client has selected the information the client wishes to see in the report, information not selected does not need to be disclosed or referred to or appear in the report. During the periodic reviews, however, all information recommended by the Principles (or the preparer's alternatives) must be communicated to ensure that the client has considered all options should they wish to make changes to their preferences.

Effective investment reporting reflects the following qualities:

i. The design of the investment report reflects what the preparer and user agreed.
ii. The intended user or audience of the investment report and the expected use of the information are considered when the preparer designs the report.

4. Clear and transparent presentation of investment risks and results

Investment reporting is more than showing investment results. The risk that is inherent in the investments must be made known to the investor and any changes to risks and the level of risk should be disclosed; risk exists in most investments and is associated with the generation of return. The report should disclose significant risks associated with specific assets, significant risks that arise from aspects of the strategy, and the overall level of risk in the assets being reported.

When information in the report is being sourced from a third party (e.g., return data supplied by third-party fund administrators, benchmark or universe data, analytics, market reference data), the source of that information should be disclosed as part of the report. Preparers should indicate whether any reconciliation or independent validation of the data being accepted from the third party takes place.

Effective investment reporting reflects the following qualities:

i. Historical information presented in the investment report is not changed without disclosure to the user.
ii. The investment report is a fair representation of the investments made, results achieved, risks taken, and costs incurred.
iii. The investment report is relevant and appropriate for the purpose stated and the assets and investment strategies being presented.
iv. The investment report provides the user of the report with appropriate comparative data—such as index data, a customized benchmark, peer group data, or a GIPS composite—to allow the user to assess the relative performance of the investments.

v. The investment report provides information on investment risks that have been experienced and are expected, including changes to assumptions previously adopted.
vi. The impact of taxes in general and the impact of taxes on performance are, where germane, reflected in the investment report.

5. Comprehensive fee disclosure

All fees charged to the user by the preparer, or under the control of the preparer or the financial organization on whose behalf the preparer is working, must be included in the report. Fees are a critical component of investment results, and the user must be able to see and understand the impact of fees. Comprehensive disclosure of fees includes: fees that are being accrued, an indication of fees that will be incurred upon reaching targets, and the current position of the relevant assets relative to those targets.

Fees incurred at the security or asset level as well as fees incurred at the portfolio level must be disclosed.

Effective investment reporting reflects the following quality:

i. The investment report is transparent regarding the fees and remuneration (e.g., commissions, referral fees) to be received by the preparer of the investment report and by third parties, such as custodians, investment management companies, or consultants, relating to the management or administration of the assets being reported.

VII. PRINCIPLES FOR INVESTMENT REPORTING AND GUIDANCE TO EFFECTIVE INVESTMENT REPORTING

The purpose of the Principles and EIR is not to define or restrict every element that should be in a report but, rather, to stress that a report must contain enough information, or an indication of where such information can be obtained, that the recipient can understand the content of the report and the reasons behind the inclusion of the information in the report. This should allow the user to make better-informed decisions having read the report.

The Principles do not attempt to define the content, methodology, data, etc., that must be included in an investment report. The investment report should reflect the conclusions of the discussion between the preparer and the user about the specific needs and circumstances of the user and the capabilities of the preparer with the Principles being used to facilitate the dialogue between the preparers of investment reporting (e.g., investment management firms, custodians) and the users of the investment reports (e.g., investors, portfolio managers).

EIR contains a series of specific recommendations that support each quality that, in aggregate, form the Principles. By following all the recommendations indicated in EIR, coupled with adopting the concepts addressed in the Principles, an effective investment report will be produced. EIR introduces the defined client base and bases, the recommendations that apply both to the generic ability of the preparer and the user-specific requirements. EIR defines the EIR document and describes the documentation that it contains. EIR presents the EIR statements and the circumstances in which they can be used and also contains the recommendation regarding the use of a third party to provide assurance.

The Future of Finance initiative is a long-term global effort to shape a trustworthy, forward-thinking financial industry that better serves society. It provides the tools to motivate and empower the world of finance to promote fairness, improved understanding, and personal integrity. Its success is driven by ongoing input from an advisory council of prominent global leaders and others in the financial community.

We invite you to learn more about current and upcoming Future of Finance initiatives, impact stories, and ways you can get involved.

THE FUTURE OF FINANCE STARTS WITH YOU

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