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By U.S. Mail and Email (standards@cfainstitute.org)

CFA Institute
Global Investment Performance Standards
915 East High Street
Charlottesville, VA 22902

Re: Exposure Draft of GIPS Guidance Statement on Overlay Strategies

Dear Sir or Madam:

Thank you for providing the opportunity to comment on the Global Investment Performance Standards' ("GIPS") Exposure Draft of the GIPS Guidance Statement on Overlay Strategies as proposed by the CFA Institute on August 29, 2017 (the "Exposure Draft" or the "Draft"). Franklin Resources, Inc. is a global investment manager that operates under the name Franklin Templeton Investments ("FTI"). FTI provides investment products and services, including overlay strategies, registered pooled funds, separate account strategies, wrap fee accounts, hedge funds, private equity and other alternative strategies which are offered to retail, institutional and high net worth investors around the world, and has several business entities that claim GIPS compliance. We write today to set forth our views on the Exposure Draft as well as to endorse the comments of the Investment Adviser Association (of which we are a member).

We believe the guidance proposed in the Exposure Draft suffers from a number of serious issues as outlined in detail below. In particular, while the definition of "overlay strategies" in the Exposure Draft is far too broad and vague to be useful, the proposed guidelines are too prescriptive and limited to accommodate the diversity of strategies that are now or will in the future be offered. This results in an inability to apply the Exposure Draft in a significant number of circumstances. As a result, we believe that adoption of the Draft would not only be of questionable value to investors, it would likely cause confusion and result in the presentation of misleading information. And even if the Exposure Draft was workable, it would be extremely burdensome and expensive to comply with. For these reasons, we strongly urge the CFA Institute to abandon this effort and withdraw the Exposure Draft entirely. If the Institute insists on proceeding further, then it should focus its efforts on identifying specific gaps in the current regulatory disclosure framework and making non-binding disclosure recommendations, although we believe that even this is unnecessary given current regulatory requirements for managers on a global basis.

I. The Scope of the Exposure Draft is too Vague to Define a Useful Framework

The difficulty faced by the CFA institute in proposing guidance on overlay strategies is already clearly apparent in the introduction to the Exposure Draft. The Draft states that an "overlay strategy is one in which the management of a certain aspect of an investment strategy is carried out separately from the underlying portfolio." On its face, this definition would capture any situation in which a client hires a third party to manage a portion of its portfolio, either through a managed account, a pooled fund, a single investor fund, or any other type of investment management arrangement that covers only a portion of its total assets. Consequently, any investment product or service would be considered an "overlay" as defined in the Exposure Draft, and because the Draft fails to provide a useful definition of what an overlay strategy is, it would be impossible for firms to comply with this guidance.

For example, managers of alternative investment strategies and multi-asset portfolios, two asset classes that have seen significant growth,[1] would be particularly negatively impacted by the adoption of the Exposure Draft. As an example, many alternative investment managers offer products or strategies intended to profit during market declines, or to generally perform in a way that is negatively correlated to some reference index. These so-called "tail hedging" or "negative correlation" strategies can be packaged in many ways, including as commingled or single-investor private funds, managed accounts, model portfolios or packaged derivative products such as total return swaps. Packaged tail hedging products may be offered in conjunction with investment advice to assist a client in determining how much capital to commit to the strategy as market conditions change. Which of these products or services would qualify as an "overlay" and how is a manager to make that determination?

Another common example is an alternative or multi-asset investment product designed to perform well during periods of rising interest rates. Such a product may be used as a hedge against expected increases in interest rates or inflation, or to neutralize rate-sensitive holdings in other parts of a portfolio, or for any other investment purpose consistent with the product's objectives. Is a strategy of this type an "overlay" just because its management is "carried out separately from the underlying portfolio"? A product like this might be discretionary or non-discretionary, commingled or customized for a single investor, and may reflect the manager's knowledge of its clients' risk exposures, either informally through client review meetings or as an explicit investment objective. The product may be a component of a broader program of portfolio construction advice or management services. It can be designed to achieve its objectives by trading securities or derivatives either directly or through pooled vehicles. Of the many possible combinations outlined above, which ones are "overlays"?

The Exposure Draft also does not address the circumstance in which an overlay is provided to a client as part of a packaged investment solution. This situation is increasingly common for firms such as ours which may utilize the expertise of multiple internal advisory groups in the same client mandate. For example, one advisory group may manage a fixed income portfolio while another provides a currency or interest rate overlay as part of the same client solution. If the overlay strategy is not separately and expressly marketed as an overlay, then the Exposure Draft should not apply to it. It would be extremely costly and burdensome for any GIPS overlay guidance to apply to overlay strategies that are not expressly marketed as such to prospective clients, especially in cases where overlays such as these are managed by a firm's non-GIPS compliant affiliate.

For all of these reasons, adoption of the Exposure Draft would undermine the intended purpose of GIPS of allowing investors to usefully compare the track records of compliant firms. The proposed guidance would only serve to confuse investors. If the goal of the CFA Institute is to support investors by deepening their understanding of overlay strategies, then this Draft fails to accomplish this goal.

[1] For example, alternative investment strategies have seen enormous growth and are now estimated to constitute as much as $6.5 trillion assets under management (Willis Towers Watson Global Alternatives Survey 2017).

II. Proposed Guidelines are Too Prescriptive and Limited

While the definition of "overlay strategy" is extremely vague and problematic as outlined above, the remainder of the Exposure Draft in contrast offers only very narrow and prescriptive rules that are completely unworkable and unnecessary. The Exposure Draft proposes rigid rules and limitations which, although they may at first glance appear workable in the context of the limited examples shown in the Draft, fail to accommodate the vast breadth of strategies that might qualify or be utilized as "overlays" as investment managers are now, or will in the future, offer them. We note that global regulators, including the U.S. Securities and Exchange Commission (the "SEC"), take a principles-based approach to regulating performance advertising. For example, Rule 206(4)-1 under the Investment Advisers Act of 1940 generally prohibits any advertisement "which contains any untrue statement of material fact, or which is otherwise false or misleading." We believe that this principles-based regulatory approach has functioned to protect investors in a useful and meaningful way and that any further "standard setting" by the Institute is not only unnecessary, it would also serve to confuse and mislead investors. Take for example the tail risk or negative correlation strategies discussed above. Sophisticated investors that utilize these strategies may decide on their own how much risk or capital to allocate. This choice may be implemented through an investment in fund share classes that target specified volatility or leverage levels, through managed account agreements permitting different amounts of leverage, or through the purchase of a packaged derivative product with agreed contractual investment guidelines. The manager of a tail risk or negative correlation strategy may therefore be managing the same strategy at many different leverage levels. However, the Exposure Draft provides only three allowable methods for determining the "denominator" of a performance calculation. What is the appropriate denominator in the cases outlined above? The allowable methods may differ depending on the structure through which the strategy is implemented. Because of the rules-based approach taken by the Exposure Draft, a manager may be unable to report the same performance for the exact same strategy offered in different formats or at different levels of fees and expenses. The Exposure Draft may therefore require managers to create composites with no utility or benefit to investors.

As another example, certain derivative strategies may require high levels of notional leverage even though the overall strategy may achieve a low level of volatility and/or require minimal collateral. This can be the case if, for example, the strategy involves taking a long position in one derivative while simultaneously taking a short position in another in order to negate some but not all of the same risk. Another example might be an options strategy that sell options while using the premiums to buy options at a different strike price or on a different but related security. In these cases, total gross "notional exposure" of the strategy may not be a useful metric for purposes of describing total overlay exposure or as the denominator in a performance calculation. In these cases, clients typically would want to understand the performance of the strategy in relation to its risk or capital requirements. Risk may be defined by the strategy's historical or projected volatility, value at risk or some other standardized risk metric. The strategy's capital requirements may simply be the minimum amount of collateral required to be held for its execution, but managers and clients may instead wish to use their discretion in determining a prudent level of capital to devote to the strategy given its risk. Notwithstanding these considerations, the Exposure Draft does not allow any of these methods for performance calculation and in fact expressly prohibits the use of the strategy's collateral as the denominator. As a result of this, for example, the Exposure Draft would punish innovative managers that devise the most efficient strategies – i.e. those strategies that may be implemented with the smallest amount of collateral or capital at risk, and would likely cause managers to abandon the GIPS standards due to their unworkability and lack of meaningful utility.

In these and many other common circumstances, managers will need to present the most appropriate performance calculations to their prospective clients that meet regulatory disclosure requirements. These requirements will depend on the nature of the strategy, the financial instruments that are used in its implementation, and the sophistication of the clients. The production of an additional GIPS-compliant performance presentation limited to the three allowable methods will simply be cause for confusion. In contrast to the narrow, prescriptive approach taken in the Exposure Draft, we believe that the best way for investors to understand these strategies is to have clear, concise, narrative disclosure that is appropriate to the target audience and that explains these nuances. These disclosure requirements are already mandated by our global regulators, as stated above, and further standard-setting in this area by the Institute is unwanted and unnecessary.

A final example of the problems with the Exposure Draft is that it requires that all "absolute return" overlay portfolios with the same risk-return profiles must be included in the same absolute return overlay composite. This is unworkable for many reasons. For example, as discussed above, the exact same investment strategy can be implemented with varying levels of leverage and therefore varying risk-return characteristics. Nevertheless, managers should be permitted to create uniform performance presentations encompassing all of their implementations of the same investment strategy. We believe it is appropriate to normalize these presentations (based on risk, leverage or other means) to reflect prospective client needs and objectives. Therefore it may be appropriate for multiple absolute return strategies with different risk-return profiles to be grouped together in the same composite. As well, there may be many different ways to target the same risk-return profile using fundamentally different strategies. Our regulators have promulgated rules and regulations regarding which track records are appropriate for marketing a given investment strategy. This determination will be nuanced and fact-dependent, and in most cases our regulators will not permit us to market an absolute return strategy by aggregating every other strategy across our firm that happens to have the same risk-return profile on the basis that it would be misleading. Indeed, the Guidance Statement by its terms requires the aggregation of information that would have the end result of misleading investors and running contrary to our regulatory obligations, which certainly cannot be what the CFA Institute intends.

III. The Exposure Draft Does Not Address Investor's Interests

Customized alternative and multi-asset solutions are typically marketed only to sophisticated investors on the understanding that they do not form a complete investment program. These investors are able to decide for themselves what level of risk to accept in any investment strategy. The appropriate way to market an investment strategy may depend on unique, innovative features of that strategy and therefore we do not believe it is possible to enumerate every allowable presentation method. In addition, managers are already under legal obligations to produce fair marketing presentations that are not-misleading, and to offer products and services only to clients they believe are able to understand and accept the risks inherent therein. Therefore, we believe it is appropriate for investment managers to present performance for these innovative strategies in any manner that is fair, clear, not misleading and compliant with applicable laws and regulations. Global regulators already require these standards to be followed, so the CFA Institute's proposal in this area is unnecessary and would do far more harm than good.

For example, while an overlay strategy may generally seek to neutralize a particular risk in a client portfolio, the investment manager may not record with respect to every performance period or cash flow event the exact target exposure or the exact size of the client's underlying portfolio. While these records may exist somewhere within the firm (for example in archived portfolio management records or client meeting notes) they will typically not be integrated with the firm's performance reporting systems. In addition, in many investment management arrangements, target exposures may be general in nature and not specific enough to provide a useful denominator in a performance calculation. The remaining allowable method, using the notional exposure of the strategy itself as the denominator, may be misleading or inappropriate as described above. In these cases the Exposure Draft may leave managers with no allowable method for presenting performance, and the methods deemed useful to clients (and agreed for reporting purposes in their investment management agreements) and acceptable to regulators will not be allowed in the manager's own GIPS-compliant marketing materials regardless of the level of disclosure or investor sophistication. This is an unacceptable result.

IV. Implementation Would be Too Costly Given Questionable Benefits

Even if the recommendations described in the Exposure Draft were beneficial to investors, they do not justify the costs that would have to be borne, especially on diversified investment management firms that may make extensive use of overlays as a component of their broader offering of products and services. From an operational perspective, it can be extremely difficult to adapt a legacy performance management system to comply with the Exposure Draft. This is because the record-keeping obligations imposed by regulators are different from the requirements of the Exposure Draft. Moreover, legacy performance management systems are not designed to track overlay strategies, particularly since the vague definition of "overlay strategies" makes it difficult to identify what is an overlay asset and what should be treated as part of the underlying portfolio. As a result, firms may be required to manually re-create the records required by GIPS, and then manually calculate the GIPS-compliant overly performance presentations. These efforts would be costly and time-consuming, while additional resources would be spent re-programming the firm's performance systems to comply with the new guidance. This could very well be the last straw that causes firms that are GIPS-compliant to abandon these standards completely.

Furthermore, certain aspects of the Exposure Draft appear to apply to overlay strategies that are not separately marketed by firms. For example, the Exposure Draft includes a requirement to report annually a firm's total overlay exposure and total composite overlay exposure. For large, diversified firms such as ours, this would require a review of every portfolio to determine whether any component could be considered an "overlay." We would then be required to establish a policy regarding treatment of collateral, determine an appropriate composite (if any), decide on an allowable performance calculation method and calculate total exposure for each annual period. This massive undertaking (which may require significantly more time for firms than allowed by the Exposure Draft's proposed effective date of January 1, 2019) would result in the calculation of numbers that no client or regulator has yet asked for or considered useful and would be a confusing, misleading, useless and unnecessary paper chase.

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For all of the reasons described above, we do not support the CFA Institute's overlay strategy proposal. As discussed in our February 28, 2017 comment letter on the Exposure Draft of the Guidance Statement on the Use of Supplemental Performance[2], we strongly disagree with any attempt by the CFA Institute to layer additional requirements on top of the comprehensive frameworks already established

[2] See https://www.gipsstandards.org/standards/Documents/Guidance/suppl_info_franklin_resources.pdf.

by regulators. These actions by the CFA Institute would only serve to make our presentations more complex and confusing, and would ultimately harm investors. Investor interests have already been adequately addressed by the regulatory frameworks in which we operate. To the extent that the Institute can specifically identify a gap in already-required disclosures, then it should specify that gap and provide recommended guidance, subject to public comment, to address it.

We appreciate the CFA Institute's consideration of our comments. If you have any questions, please contact the undersigned at (650) 312-2285 or Gregory M. Pomerantz, Corporate Counsel, at (203) 504-1432.

Sincerely,

Alison E. Baur
Deputy General Counsel