



Highlights from the 2011 GIPS® Standards Annual Conference-Part I

The 2011 GIPS® Standards Annual Conference was held in Chicago on October 27-28. The conference was hosted by Jonathan Boersma, Executive Director, Global Investment Performance Standards, CFA Institute. Highlights from three sessions follow. We will cover other sessions in future newsletters.

Conference Welcome

Jonathan Boersma started the conference with a list of the five top GIPS standards priorities for the GIPS Executive Committee ("EC"). (Working alongside CFA Institute staff, the EC serves as the decision-making authority for the GIPS standards.) The top five topics for which GIPS guidance will be created and/or expanded are 1) applying the GIPS standards to mutual funds/pooled funds; 2) defining and measuring risk; 3) supplemental information and how it should be treated; 4) overlay strategies; and 5) portability issues. Mr. Boersma welcomed any suggestions from the GIPS community about other issues that should be addressed.

Staying Current: Review of Recently Issued Guidance and Interpretations

Karyn Vincent, former Chair of the Interpretations Subcommittee, reviewed some of the GIPS technical changes or clarifications that took effect over the past year.

Must establish procedures for meeting the compliant presentation ("CP")

delivery obligation: A compliant firm must make every reasonable effort to provide a CP to all prospective clients. To meet this requirement, firms must therefore establish procedures to determine:

- When a prospect becomes a prospective client;
- How the CP is delivered to prospective clients;
- How ongoing prospective clients are tracked; and
- How CPs are provided to ongoing prospective clients (this includes databases, consultants, and wrap sponsors) at least once every 12 months.

Error correction: The Guidance Statement on Error Correction requires firms to establish procedures for handling errors that appear in CPs. An error is defined as any component of a CP that is missing or inaccur-

rate, and errors are not limited to mistakes with composite returns. An error could result from a misstated internal risk measure, an incorrect firm assets total, or any other erroneous item in a CP. An error could also occur when a required item is missing from a CP. In the case of a material error, the firm must:

- Correct the error in the CP;
- Disclose the change in the CP;
- Provide the corrected CP to everyone that received the incorrect CP and is still considered a prospective client, or has since become a client of the firm.

When the Error Correction Guidance Statement was updated, it was modified to reflect guidance included in previously issued Q&As, clarifying that:

- Firms do not have to provide the corrected CP to former prospective clients that are no longer considered prospective clients; and
- Firms may prepare a version of the CP that does not include disclosure of the material error change that is provided to new prospective clients who did not previously receive the erroneous CP.

Track delivery of CPs: Firms must be able to track who received which version of a CP. Why? If the firm determines that a CP that was distributed to prospective clients includes a material error, the firm must know who received the incorrect CP so the firm can provide the corrected CP.

Life after carve-outs: As of January 1, 2010, a firm may no longer allocate cash to a carve-out and include that carve-out (with allocated cash) in a composite. (A carve-out is a portion of a portfolio that is, by itself, representative of a distinct investment strategy, e.g., the equity portion of a balanced account.) As of January 1, 2010, a carve-out must have its own cash balance. Because of the complexity associated with establishing multiple cash accounts for one portfolio, or the operational difficulty with creating proper stand-alone sub-portfolios, many firms chose to not create carve-outs with their own cash balances and include in composites only true stand-alone portfolios as of January 1, 2010. In most instances the size of these composites greatly decreased, and

(Continued on page 2)

Highlights from the 2011 GIPS® Standards Annual Conference-Part I

(Continued from page 1)

many firms were not pleased with the marketing reaction to the greatly diminished composite sizes. Firms may find it helpful to include carve-out information, such as equity-only returns, in the CP as supplemental information. An often overlooked **GIPS Q&A** (see the carve-out category) was issued in December 2009 that shows how this information can be incorporated into a CP.

Internal dispersion versus external dispersion: Since the inception of the GIPS standards, firms have been required to disclose a measure of dispersion of the annual returns of those portfolios included in the composite for the full year. This is a measure of internal dispersion, as it measures how similarly portfolios within the composite have been managed. The most commonly used measure of internal dispersion is standard deviation, on either an asset weighted or equal weighted basis. Other dispersion measures, such as high/low, can also be used. Contrast this internal dispersion measure with new provision 5.A.2, which requires, for periods ending on or after January 1, 2011, the three-year annualized ex-post standard deviation of the composite and the benchmark, as of each annual period end. Assuming annual returns are presented as of December 31 in compliant presentations, the first three-year standard deviations must be presented as of December 31, 2011. This is a measure of external dispersion, as it measures the variability of the monthly composite returns and benchmark returns over the three year period. Some firms have been confused by the use of standard deviation in two different dispersion measures. The chart below summarizes the differences between the two measures.

<u>Internal standard deviation</u>	<u>External standard deviation</u>
<ul style="list-style-type: none"> • Calculation inputs are the annual returns of those portfolios included in the composite for the full annual period. • Must be presented for each annual period included in the compliant presentation. 	<ul style="list-style-type: none"> • Calculation inputs are the monthly returns of the composite and the benchmark for the most recent 36 months. • Must be presented for each annual period ended after January 1, 2011 included in the compliant presentation.

Pension plan sponsors can comply with the GIPS standards: Any firm that manages actual, discretionary assets may choose to comply with the GIPS standards. This includes pension plan sponsors, foundations, and endowments. Pension plan sponsors are beginning to claim compliance. Unlike invest-

ment management firms that typically claim compliance to help the firm’s marketing efforts, plan sponsors typically do so as claiming compliance provides credibility to the performance that is calculated and reported to various stakeholders. [**VPS note:** A **Plan Sponsor Booklet** is available on the GIPS standards website.]

Ensuring the existence and ownership of client assets: Provision 0.A.5 was modified in the 2010 edition of the GIPS standards to explicitly require firms to establish policies and procedures to ensure the existence and ownership of client assets. In most instances firms meet this requirement by documenting their already established procedures for reconciling to custodian and/or broker positions. Firms that have investment types that are not held at a custodian bank, such as direct real estate or private equity investments, need to establish other procedures to ensure this requirement is met.

Fair value: Prior to January 1, 2011, assets for which a market value was not available were excluded from firm assets, and therefore the portfolios that hold these assets were not eligible for composite inclusion. As of January 1, 2011, these assets must be included in firm assets, and the portfolios that hold these assets must be considered for inclusion in a composite. (If a portfolio is discretionary and fee-paying, it must be included in a composite.) This is true for prospective periods only.

Significant cash flows: Portfolios may experience client-directed cash flows that are big enough to temporarily prevent the firm from implementing the composite strategy, thus making the portfolio non-discretionary.

If a firm wishes to temporarily remove such portfolios from composites, the firm must adopt, on a composite-specific basis, a significant cash flow (“SCF”) policy. The level of significance must be determined as either a specific monetary amount, or a percentage of portfolio assets. A firm may not consider the impact of the SCF on returns. Once a SCF policy is adopted for a specific composite, all portfolios that experience a SCF must be removed from the composite in accordance with the firm’s policies. Contrast a SCF policy with a large cash flow policy. For portfolios that are not valued daily, a large cash flow is an external cash flow that is big enough to distort the monthly return, therefore the firm breaks the month into sub-periods and revalues the portfolio during the

(Continued on page 3)

Highlights from the 2011 GIPS® Standards Annual Conference-Part I

(Continued from page 2)

month at the time of the large cash flow. Performance for periods before and after the large cash flow are linked together to calculate the monthly return. The chart to the right summarizes the differences between the two types of cash flows.

A question and answer session followed the presentation. Some of the concepts discussed in this session follow:

Q: Can you establish a policy whereby the significant cash flow policy is temporarily suspended if the number of accounts in a composite drops below a certain number?

A: No. Once a significant cash flow policy is established, it must be applied consistently. The number of accounts in a composite has no impact on whether or not a cash flow is big enough to cause an account to be considered non-discretionary temporarily.

Q: Recently a Q&A was issued stating that when calculating monthly composite returns using the aggregate method, new portfolios must have a full month of performance in order to be included in the composite calculation. Is this new guidance?

A: No, this is not new guidance. Whether a firm is using the aggregate method or another method, only portfolios that have a full month of performance are included in the monthly composite calculation. The population of portfolios that is included in the monthly composite calculation does not change based on the method used to calculate composite returns.

Q: What is the process for developing new guidance for the GIPS standards?

A: Each issue passes through various committees involved with GIPS governance, including the Interpretations Subcommittee and other technical groups, before it is finally approved by the GIPS Executive Committee. **[VPS note:** Most new GIPS guidance is created through Guidance Statements. The GIPS standards website includes information about the **Guidance Statement creation process.**]

Q: How should a firm prove the existence of client assets?

A: Firms should maintain records to prove that reconciliations between the custodian's positions and the firm's positions are completed. For client accounts where a hard copy custodian statement is received, the firm should maintain these custodian statements. **[VPS note:** For SEC purposes, if a firm receives hard copy custodian state-

Significant Cash Flow

- Client-directed cash flow that causes the firm to alter the way the portfolio is managed.
- Portfolio is temporarily removed from the composite.

Large Cash Flow

- Cash flow that triggers a re-valuation of the portfolio (if not valued daily) during the month.
- Portfolio remains in the composite.

ments, the firm is obligated to keep them.]

Q: Do procedures for defining a prospective client go into the GIPS policy manual?

A: A firm must document all applicable policies and procedures used to maintain GIPS compliance. This would include policies and procedures for defining prospective clients. However, a firm does not have to gather all of the policies and procedures into one document. While a firm could do so, a firm could also refer to other documents that include policies and procedures related to GIPS compliance. For example, a firm might refer to the valuation procedures that are maintained by the Operations Department, and does not need to replicate those valuation policies in the GIPS manual.

Q: If multiple benchmarks are presented in a compliant presentation, must the firm present the 3-year annualized ex-post standard deviation for all of the benchmarks presented in the compliant presentation?

A: To date no guidance has been issued explicitly addressing this issue. Therefore, in the absence of guidance on this point, firms must present the 3-year annualized ex-post standard deviation for all benchmarks presented in the compliant presentation.

Q: For new composites with less than 36-months of performance, does a firm have to include a disclosure as to why the 3-year annualized ex-post standard deviation is not presented?

A: Yes. For annual periods ended after January 1, 2011, a firm is required to disclose why the 3-year annualized ex-post standard deviation is not presented for the composite or the benchmark even if it is obvious that it is not presented because there are not yet 36 months of composite returns.

Q: Can a firm present the 3-year annualized ex-post standard deviation of the composite and benchmark for annual periods ended prior to January 1, 2011?

A: Yes. Firms are required to present the 3-year annualized ex-post standard deviation

(Continued on page 4)

Highlights from the 2011 GIPS® Standards Annual Conference-Part I

(Continued from page 3)

for all annual periods that end after January 1, 2011. It is recommended that firms present the 3-year annualized ex-post standard deviation for annual periods ended prior to January 1, 2011, but it is not required.

Q: In order to meet the portability requirements of the GIPS standards, a firm must have sufficient records to support the performance track record that is being ported. What is considered sufficient records?

A. The GIPS standards do not define which records must be maintained to support a composite history that is ported from a prior firm. The GIPS standards also do not specify exactly which records must be maintained to support a non-ported composite. The **Guidance Statement on Record-keeping Requirements** provides general guidance as to which records a firm should consider keeping to support the various components of a composite and its related compliant presentation. This guidance would also apply to a ported history. When considering a ported history, a firm must have records to support the composite's track record, which would include both the composite-level returns and underlying account-level returns.

Regulatory Update

Matthew D. Harris, Exam Manager from the Chicago office of the U.S. Securities and Exchange Commission, provided an update on the regulatory landscape. As is customary, no slides were made available for his presentation, so everything that follows is from notes taken during the session.

With respect to the GIPS standards, Mr. Harris acknowledge that compliance with the GIPS standards is voluntary and not required. Nonetheless, he noted that more firms are claiming compliance in order to be able to check the compliant box in RFPs. As a result, the SEC wants to make sure that if a firm is claiming compliance with the GIPS standards, the claim is accurate and not misleading. The SEC continues to see firms reference AIMR and NASD rather than GIPS and FINRA, respectively.

Mr. Harris discussed the two most frequent findings related to GIPS compliance in recent exams. First, some firms were claiming to comply with the GIPS standards in RFPs and marketing materials, but they were not meeting the disclosure and presentation requirements of the GIPS standards. Second, the SEC noted a lack of independence with the verifier, where the verifier had participated in shaping procedures, creating com-

posites and providing calculation support. Mr. Harris asked, rhetorically, how can a verification firm be independent if they participated in such activities? **[VPS note:** The key fact to keep in mind is that the verifier must not be in a position to test its own work, therefore a verifier cannot undertake any decision-making role relative to a firm's implementation of and compliance with the GIPS standards.]

Mr. Harris said other areas of concern are valuation, standard deviation, policies and procedures manuals, and benchmark selection.

With respect to valuations, he noted that there is greater potential for conflicts when firms use internal valuations as opposed to independent, third party valuations. When internal valuations are used, the SEC will look to see that a reasonable process for determining internal valuations is in place, that the firm follows its established process, and that disclosures about valuations provide enough detail so clients will understand this process.

Mr. Harris stated that there is a concern that firms are showing standard deviation as the internal risk measure when it may not be an appropriate risk measure. **[VPS note:** Provision 5.A.1.i requires firms to show a measure of internal dispersion for each annual period when the composite includes more than five portfolios for the entire year. Determining which measure of internal dispersion will be shown is left to the firm. Options include, but are not limited to, high and low annual portfolio returns; the range between the highest and lowest annual portfolios returns; and standard deviation of annual portfolio returns on either an asset-weighted or equal-weighted basis. Mr. Harris did not state what would make standard deviation an inappropriate measure of internal dispersion. We assume he was making the point that standard deviation is a statistical measure and, in order to make this measure meaningful, there must be a large enough number of portfolios in the composite, otherwise the measure is not meaningful and may even be misleading.]

The SEC will also check to see whether firms have a current GIPS policies and procedure manual. The policy manual should include all relevant and current procedures and should reflect changes to procedures over time. **[VPS note:** The GIPS standards require firms to maintain both current and prior versions of policies and procedures that support a firm's claim of compliance.

(Continued on page 5)

“When considering a ported history, a firm must have records to support the composite's track record, which would include both the composite-level returns and underlying account-level returns.”

Highlights from the 2011 GIPS® Standards Annual Conference-Part I

(Continued from page 4)

When a change is made to a policy or procedure, we recommend documenting the change, and the effective date of the change, within the manual so that the current manual includes both prior and current policies and procedures. If you are ever asked why you did something different historically, you will be able to substantiate that you were following your procedures that were in place at that time.] The SEC will also look for proof that the firm actually followed its established policies and procedures.

The final additional area of concern mentioned was benchmark selection. Mr. Harris noted that firms should select benchmarks that provide a reasonable comparison for the composite and are helpful to prospective clients. Benchmarks should not be selected simply because they are well known if they don't provide an appropriate comparison.

Mr. Harris finished up his comments related to the GIPS standards by stating that the SEC has not issued any noteworthy no-action letters.

Mr. Harris then turned to recent SEC initiatives. The SEC has been conducting procedures to identify significant performance outliers, looking for performance that is different from peers or that may indicate data manipulation, such as smoothing of returns. He said that firms should be able to explain why their performance is different from their peers using key risk measures and attribution.

The SEC is also gathering information on the use of derivatives by funds. This includes the types of derivatives and how they are being used, including the impact on portfolio diversification requirements and concentration limits.

Mr. Harris then described how the SEC has been busy with various tasks related to the Dodd-Frank legislation, including Section 619. **[VPS note:** Section 619 is the so-called "Volcker Rule," which prohibits depository and banking type institutions from engaging in short-term proprietary trading and also prohibits them from having certain relationships with hedge funds or private equity funds.] In particular, the SEC is looking at how to define and exempt some trading activities, record keeping requirements, and reporting of quantitative data (profits/losses, etc.)

Another area of Dodd-Frank legislation the SEC has been working on is the Whistleblower program. **[VPS Note:** This is covered under Section 922 of the Dodd-Frank

Act.]. The SEC has enhanced its tips/complaints system. The system now centralizes all calls and assigns complaints to the correct region, but complaints can be accessed by any office, allowing the SEC to look at patterns. The SEC has received 25,000 tips/complaints so far this year.

Mr. Harris noted one of the big recent changes has been to the investment advisor examination program. Mid-size investment advisors, those with assets between \$25 and \$100 million, will be required to transition to state registration unless the adviser operates in 15 or more states, or state registration is unavailable; Minnesota, New York and Wyoming do not allow for state registration. The SEC realizes that assets under management fluctuate, so they have added a plus or minus \$10 million buffer to the \$100 million mark.

The SEC estimates that approximately 25% of the 11,600 firms currently registered with the SEC will fall under the transition to state registration rules, but these firms represent only approximately \$150 to \$200 billion in assets. While the number of SEC-registered firms will greatly decrease, the total amount of assets subject to SEC oversight will decrease by a very small percentage.

Another significant change is that many more hedge funds and private equity funds will now be required to register with the SEC. **[VPS note:** The Dodd-Frank Act eliminates the widely-used exemption that was primarily based on the number of clients of the firm.] When figuring asset size, firms will be required to use gross assets instead of net assets. Grossing up for leverage will capture more investment advisers.

Mr. Harris stated that as a result of all the changes, the investment adviser population will change and the complexity of firms under SEC oversight will increase dramatically. The increased complexity, combined with structural changes within the SEC, will result in the SEC issuing a new examination handbook for examiners, which should allow for greater consistency during examinations. The SEC exam staff will also coordinate more exams that will include experts from other SEC departments. Due to the increased complexity of firms being examined, the SEC is working on increasing internal skill sets and is hiring more people with expertise in certain areas. They are also creating specialized working groups for complex products/topics and are bringing Exam Managers out of their offices and back into the exam process.

(Continued on page 6)

"The SEC estimates that approximately 25% of the 11,600 firms currently registered with the SEC will fall under the transition to state registration rules, but these firms represent only approximately \$150 to \$200 billion in assets."

**Vincent Performance
Services LLC**
2014 NE Broadway Street
Portland, Oregon 97232

Phone: 503-288-2704
Fax: 503-548-4435
Email: info@vincentperformance.com

Performance is all we do.



Vincent Performance
Services LLC

WWW.VINCENTPERFORMANCE.COM

Vincent Performance Services LLC provides consulting and verification services to investment managers of all sizes and complexity located throughout the world. We are committed to delivering unsurpassed service based on a real understanding of the issues and a genuine enthusiasm for what we do.

Additional information about our services and expertise can be found at www.vincentperformance.com

To unsubscribe or change recipient information, please send an email to

info@vincentperformance.com

Highlights from the 2011 GIPS® Standards Annual Conference-Part I

(Continued from page 5)

Mr. Harris described how the SEC determines which firms will be examined. The selection process now is risk based and is no longer on a time period, or cyclical, basis. The SEC will look at SEC filings and websites for “risk flags.” These risk flags will help determine the scope and reasons for performing the exam, but they will not limit the areas the SEC will examine. SEC staff will also look for additional red flags once they start an exam.

Finally, Mr. Harris explained that complaints about investment advisers are now being tracked in a centralized database, which allows the SEC to organize data so that they can determine who to examine given the limited resources, as well as the types of issues that are occurring.

Here are some of the questions and answers during the Q&A section:

Q: Which types of penalties are assessed due to shortcomings in a firm’s compliance with the GIPS standards?

A: Most of the findings related to a firm’s claim of compliance with the GIPS standards were technical in nature, where there was no intent to mislead. In such a situation, firms are typically issued a deficiency letter to which they must respond. **[VPS note:** The September 2010 edition of **VPS Views & News** includes an article named “SEC Focus on

Performance Matters,” in which we describe SEC requests and comments based on the experience of several of our clients that were recently examined.]

Q: When the SEC identifies shortfalls in a firm’s claim of compliance, and the firm is verified, does the SEC hold the verifier accountable?

A: When the SEC identifies shortfalls in a firm’s GIPS compliance, the SEC’s focus is on the firm and not the verifier. The SEC does not have jurisdiction over the verifier, but is concerned about verifier independence.

Q: What can firms do to prepare for an SEC visit?

A: Firms should ensure they are doing the following:

- Maintaining a complete and updated policies and procedures manual;
- Maintaining completed checklists or other proof that the policies and procedures were consistently applied; and
- If the firm is examined, making all staff available to the SEC, and not just compliance personnel.

* * * * *

We will continue with highlights from other sessions in future editions of the newsletter.