



SEC Speech: Strengthening Examination Oversight

On June 17, 2009, Lori A. Richards, Director, Office of Compliance Inspections and Examinations, with the U.S. Securities and Exchange Commission, gave a speech before the SIFMA Compliance and Legal Division, St. Louis Regional Seminar, The New World of Compliance and Legal, in St. Louis, Missouri. In the speech, titled "Strengthening Examination Oversight: Changes to Regulatory Examination," Ms. Richards described changes made in large part as a result of Madoff and other frauds. Highlights from the six key changes are as follows:

Enhanced Training for Examiners in Fraud Detection Ms. Richards said that examiners will receive more in-depth training on spotting signs of fraud. The SEC, in conjunction with other regulatory agencies will be providing joint training programs that will include case studies, and bringing in experts in fraud detection as well as a former convicted fraudster who will share his story on how he was able to manipulate the system. Ms. Richards said that already more than a third of the SEC staff has signed up for training to become Certified Fraud Examiners.

Enhanced Examiner Expertise in Complex Financial Products, Trading and Other Areas The SEC recognizes that financial markets have become increasingly complex and there are many ways that fraud can be committed. As a result, the SEC is enhancing their expertise in complex financial products. They recently announced the effort to attract people with more specialized industry experience. Examiners will receive training in complex areas such as options, derivatives, trading, anti-money laundering, and financial issues.

Focused Examinations on Firms with Higher Potential Fraud Risk Profiles Ms. Richards said the SEC is now conducting a nationwide exam sweep of firms that have characteristics for higher potential fraud risk. These characteristics include advisers that use an affiliate to maintain custody of advisory client assets; hedge funds that seem to have "smooth" or outlier returns; use of an unknown auditor or no auditor; firms with a disciplinary history; and broker-dealers that sell captive or affiliate hedge funds or limited partnerships.

Improved Tools for Examiners in Detecting Fraud and Leveraging the Work Performed by the Firm's Independent Auditor The SEC will be doing more pre-exam due diligence than in the past. This will include a review of the firm, its employees, and operations. For firms, this means more information will be requested prior to the examination. The SEC is also developing a new fraud module that will focus not only on "red" flag areas, but also "yellow" flag areas. Ms. Richards listed examples of "red" and "yellow" flags as lack of separation of duties/dominant control person; self-custody or use of affiliates for custody/power of attorney over client accounts; aberrational performance claims; lack of independent audit; audit by obscure firm; dire financial condition of a firm or principals; aggressive self-promotions; poor controls over outside business activities; and unusual activity in error or inter-company accounts. Two other tools the SEC plans to use are verifying the existence of assets with independent third-party custodians and with clients, as well as leveraging the work performed by the firm's independent auditor. Ms. Richards also noted that the SEC recently expanded exams of joint or dual registrants, particularly for those advisers that use an affiliated broker-dealer for custody of clients' assets.

Improved Surveillance and Risk-Based Targeting One area the SEC hopes to improve is the ongoing surveillance of firms that present the most risk at a given point in time. To accomplish this, they are working with other staff and regulatory agencies such as FINRA to identify key points and the technology that is needed. The SEC is also seeking more funding to enhance their information systems.

Improved Handling of Tips and Complaints Ms. Richards noted that the SEC receives over 700,000 complaints and tips a year, and is working to find a way to evaluate tips and complaints. They have retained the Center for Enterprise Modernization to provide a comprehensive review of the way they evaluate tips, complaints, and referrals.

You can see the complete version of Ms. Richards' speech [at the SEC's website](#).

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Six New GIPS® Q&As Issued

Six new Question and Answers were recently added to the [GIPS Q&A Database](#). The Q&As are under the broad classifications of Cash, Discretion, General/Miscellaneous, and Valuation. (You can also find them by searching by date, for items added after May 2009.) A summary of each Q&A is below.

Cash This Q&A asks whether a firm may exclude from performance the return from a client-directed cash sweep vehicle that recently “broke” the \$1.00 NAV. The answer is that firms may not exclude the impact of the NAV break. Because the firm chose to have assets invested in cash, the firm must include the impact of the NAV break in both the portfolio and composite returns. The firm must also continue to include the portfolio in the respective composite and must not use the NAV break as a reason for removing the portfolio from the composite.

Discretion This Q&A asks whether an account that has been frozen and cannot be traded on, due to some change in the custodian or prime broker, may be treated as non-discretionary for the time the strategy could not be implemented. A firm would be allowed to temporarily classify a portfolio as non-discretionary and remove the portfolio from the composite, on a prospective basis only. Portfolios may not be removed retrospectively. Once the firm is able to manage the portfolio again on a discretionary basis, it must be re-included in the composite.

General/Miscellaneous There are two new Q&As under this section. The first Q&A asks how a firm should handle a portfolio that either holds securities of companies that go bankrupt or are in default, or has transactions with a counterparty that goes into bankruptcy or defaults. The Q&A also asks if the treatment is the same when the firm has no ability to negotiate the claim; the firm's client is responsible for recovery of the claim; or the recovery takes a lengthy time to resolve. In all instances, the assets and transactions must be valued with any resulting losses included in composite performance. Firms may not treat the bankrupt or defaulted assets as non-discretionary in order to exclude them from performance. Further, firms must determine whether such a situation is a significant event for the impacted composite(s). Significant events that would help a prospective investor interpret the composite's track record are required to be disclosed in the compliant presentation.

The next question under this section asks how a firm should handle securities in portfolios that have become illiquid. The answer is that firms must value illiquid securities with any resulting losses reflected in performance. The portfolio may not be removed from the composite due to illiquid securities, and firms may not claim that illiquid securities result in the portfolio being non-discretionary in order to exclude the portfolio from the respective composite(s). Once again, firms must determine whether the situation results in a significant event that would require disclosure in compliant presentations.

Valuation There are two new Q&As under this section dealing with securities lending income. The first question deals with securities lending where a firm manages portfolios that participate in securities lending and has recognized income related to securities lending in the portfolios' performance. The question asks whether the firm can exclude the impact of a shortfall in the securities lending collateral, when the value of the collateral received was less than the value of the securities that were loaned. Because the firm had previously included the income associated with securities lending, the firm may not exclude the impact of the securities lending collateral shortfall. The firm must also not remove the portfolio from the composite due to the loss on the securities lending collateral.

The second question deals with the flip side of securities lending, in which securities lending is not a part of the strategy, the securities lending arrangement is between the client and the client's custodian, and the firm does not recognize income related to securities lending in the portfolio's performance. In cases where the securities lending decision is directed by the client, not a part of the strategy, and the firm has not included securities lending income in the portfolio's performance, the firm may exclude any impact from the shortfall caused by the securities lending transaction, and the shortfall in related pledged collateral from the performance of the portfolio. (VPS note: One way to handle the negative impact in the difference between the value of the security loaned and the diminished collateral received is to treat the difference as a cash flow/client withdrawal.)

A final note: We would like to remind you that a compliant firm is required to comply with all GIPS guidance, including Q&As (GIPS Provision 0.A.15.)

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2010 Effective Changes vs. 2011 Proposed Changes

Over the past few months we have answered many questions about dates in the GIPS standards. Given the continued confusion, we will review these dates once again.

January 1, 2010 The current version of the GIPS standards includes four changes that will occur effective January 1, 2010. The four changes that become effective January 1, 2010 are:

- cash may no longer be allocated to carve-outs;
- portfolios must be valued at month-end;
- portfolios must be revalued on the date of all “large” cash flows; and
- composites must be calculated at least monthly.

A fifth change that also has an effective date of January 1, 2010 is not in the current version of the GIPS standards but instead is contained in the [GIPS Guidance Statement on Error Correction](#), which was adopted in June 2008. By no later than January 1, 2010, a firm must have established error corrections policies and procedures, and then must follow their established policies. We cov-

ered each of the changes that are effective January 1, 2010 in the [January 2009 VPS Views & News Newsletter](#), with additional analysis on the Error Correction Guidance Statement in our [July 2008 newsletter](#).

January 1, 2011 Separate and distinct from these changes are proposed changes that are included in the next draft of the GIPS standards. As we described in the [March 2009 VPS Views & News Newsletter](#), the GIPS standards are reviewed and updated every five years. The public comment period for the [GIPS 2010 Exposure Draft](#) recently ended and approximately 170 comment letters are posted on the [GIPS standards website](#). Over the next few months CFA Institute staff and various GIPS committees will be analyzing the comments and making any necessary changes to draft. The plan is to issue the updated and finalized next version of the GIPS standards in early 2010. The effective date of the next draft of the GIPS standards is January 1, 2011.

Right now you should be preparing for the definitive January 1, 2010 changes, and standing by for next version of the GIPS standards.

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Highlights from the 2009 VPS Survey

We recently conducted a survey of U.S. and Canadian firms, and took our survey population from the May 26, 2008 issue of *Pensions & Investments*, which listed the top managers of institutional tax-exempt assets. We will post the detailed survey findings on our [website](#) shortly.

This year we focused on soliciting feedback on the proposed changes to the GIPS standards that were reflected in the Exposure Draft. Below we address some of the key points from the survey. Please note that all of the proposed changes are just that - proposed.

Disclosing the firm’s verification status. A firm would be required to disclose if it has been verified by an independent third party, and for which periods. A firm would also be required to explicitly state that it has not been verified. While 87% of respondents agreed with this new disclosure requirement, many firms expressed concern that readers of compliant presentations may not understand what it means that the firm has been verified, and that they might mistakenly believe that a verification report provides assurance on the results of the composite that is being

presented. In fact a verification report disclaims responsibility for the results of any composite.

Change from market value to fair value. Throughout the Standards the concept of using market value has been replaced with fair value. Eighty-seven percent of respondents agreed with the concept, and acknowledged that the world is slowly but surely moving to fair value. However, many firms expressed concern that the proposed fair valuation hierarchy is quite strict and more stringent than that currently required by FAS 157.

Required inclusion of non-fee paying accounts in composites. Eighty-three percent of respondents agreed with the change to no longer allow non-fee paying portfolios to be excluded from composites based simply on the fact that they are non-fee paying. Most agreed that if a portfolio is discretionary it should be included in the appropriate composite(s).

Disclosing the % of the composite that is composed of proprietary assets. While 60% of respondents support this new

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Vincent Performance Services LLC provides consulting and verification services to firms that comply, or wish to comply, with the Global Investment Performance Standards (GIPS®). Our clients range in size from less than \$1 billion of assets under management to over \$500 billion and are located throughout the U.S.

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Highlights from the 2009 VPS Survey

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disclosure, the 40% that do not support it seemed to be primarily concerned that the information would potentially be irrelevant, subject to misinterpretation and confusing.

Disclosing whether actual or model fees are used when presenting net returns. There was wide spread agreement, with 85% of respondents agreeing that it makes good sense to inform a reader exactly how net returns have been calculated.

Prohibition against showing a composite presentation to a prospective client that is known to have less assets than the composite minimum. While 43% of respondents agreed with this new requirement, 57% disagreed. Many

firms expressed concern that such a change would negatively impact their marketing efforts, while others were uncertain as to how they could implement procedures to ensure this requirement was not violated.

Disclosing the 3 year annualized ex-post standard deviation as a measure of risk as of the most recent annual period. Fifty-seven percent of respondents support requiring this new disclosure. Of the 43% who are opposed to this new requirement, 69% said that standard deviation is not a relevant risk measure for all strategies, while 23% think that standard deviation is not an appropriate measure of risk.

Please check our [website](#) shortly for the full survey results.

Boston Again: Mark Your Calendar

The location and timing of the next annual GIPS conference, sponsored by CFA Institute, have been announced. The conference will return to Boston and will be held on September 22-23, 2009. The GIPS Standards workshop will also be offered the day before the conference, on September 21, 2009. Note that these events are from Monday-Wednesday, which is a departure from the norm. Also note that the conference will be a full two

days. Information about the workshop and conference is available on [CFA Institute's website](#). Both the workshop and conference sold out last year, so we encourage you to register early.

For our clients in the Boston area, and those who will be attending the conference, please plan to attend our client dinner on Monday evening, September 21 at [Vinalia Restaurant](#). Details will follow shortly. We hope to see you there!