



SEC Focus on Performance Matters

Within the past few months several of our clients have been inspected by the SEC, or have been notified that the SEC will be there soon. And yes, each of these firms would say that they were long overdue for an inspection. (From our perspective, each of these firms would be considered a very straightforward, easy to understand organization, with no complex firm structure or difficult to understand strategies; in other words, plain vanilla.) Based on our clients' experiences with their inspections, we present a summary of SEC inquiries and comments.

Be ready to hand over your GIPS policies and procedures. A firm that complies with the Global Investment Performance Standards (GIPS®) must document their policies and procedures used in establishing and maintaining compliance with the GIPS standards. (We'll refer to this as the GIPS Manual.) Ensure that all requirements (and any recommendations you have chosen to follow) of the GIPS standards are addressed in the GIPS Manual, or make reference to other policy manuals that may include the information. Too often a firm will focus on only the calculation requirements within the GIPS standards. For example, a firm must make every reasonable effort to provide a compliant presentation to all prospective clients. The GIPS Manual should include all the procedures your firm follows to ensure this requirement is met. This would include how you determine who is considered a prospective client, as well as how you actually deliver the compliant presentation to all prospective clients.

Make sure composite definitions are complete. A composite definition is defined as, "Detailed criteria that determine the assignment of portfolios to composites. Criteria may include investment mandate, style or strategy, asset class, the use of derivatives, leverage and/or hedging, targeted risk metrics, investment constraints or restrictions, and/or portfolio type (e.g. segregated or pooled, taxable versus tax exempt.)" Don't confuse composite definition with composite description. A composite description is general information regarding the investment mandate, objective, or strategy of the composite. The composite description must be disclosed in the compliant presentation, while a composite definition is not a required disclosure. Instead, composite definitions must be made available upon

request. The logical place to maintain composite definitions is in your GIPS Manual. SEC staff have reviewed composite definitions, and have made some pretty detailed comments as to the information they believe should be added to composite definitions, such as targeted cash levels and allowable % differences from the composite's model portfolio. We suggest reviewing composite definitions, to ensure they include all of the details for determining which accounts go in which composites for which periods.

Be ready to provide a complete list of composite descriptions. A firm must provide a complete list of composite descriptions upon request by a prospective client. This list must include all composites that are currently active, as well as any composite that terminated within the past five years. Ensure this list is complete, as you will be asked to provide it.

Be ready to provide a compliant presentation for every composite on your list of composites. A firm must provide a compliant presentation for any composite that is on the firm's list of composites, upon request by a prospective client. SEC staff asked one firm for compliant presentations for every single composite on their list of composites. (The firm had almost 30 composites on their list of composites.) The firm quickly responded to the request, but inadvertently missed the presentation for one composite. SEC staff came back to them and asked for the missing presentation, so they had obviously done a detail review to ensure 100% of the presentations had been provided.

Ensure you disclose which accounts are included in a composite. In the no-action letter issued to Clover Capital Management, Inc. (pub. avail. October 28, 1986) ("Clover"), SEC staff took the position that the presentation of performance without certain accompanying disclosures may be misleading. One of the expected disclosures under Clover is that a firm should disclose, if applicable, that the performance presented relates only to a select group of the firm's clients. Do your composites include only a certain type of account, such as institutional, and exclude others, such as pooled funds? Or include all accounts except wrap fee accounts? If so, you should review compliant

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presentations and ensure composite “populations” are properly described in compliant presentations.

Ensure benchmarks are described. Under Clover, if performance is compared to an index, a firm must disclose all material facts relevant to the comparison. One firm's website included composite returns that were compared to a well known Russell index, but did not describe the index. The SEC found that failing to adequately describe the index may not be consistent with the guidance set forth in Clover. The current 2005 edition of the GIPS standards does not require a firm to disclose the benchmark description, but the 2010 edition of the GIPS standards will require a benchmark disclosure, with one exception. If the benchmark is a readily recognized index or other point of reference, the name alone of the benchmark would suffice. In most cases we do see firms include at least a brief description of even well known indices, such as the S&P 500. If you do not currently do so, we recommend adding a brief description of each benchmark. You will have a good start on transitioning to the 2010 GIPS standards, and you won't have to determine, for GIPS purposes, which benchmarks are considered readily recognizable or not.

Disclose if net returns are net of actual or model fees. When a firm presents net returns in a compliant presentation, the current 2005 edition of the GIPS standards does not require a firm to disclose if net returns are calculated using actual or model fees. The 2010 edition of the GIPS standards does require a firm to disclose if net returns reflect actual or model fees. From an SEC perspective, under Clover an advertisement may be misleading if it compares model or actual results to an index without disclosing all relevant facts relevant to the comparison. SEC staff found that presenting net performance and failing to disclose the use of a model fee may not be consistent with the guidance in Clover. While we believe most firms do already disclose if model fees are used, we recommend reviewing all presentations and adding a disclosure to explain whether actual or model fees are used to calculate net returns. We also recommend describing how the net returns are calculated (e.g., if using actual fees, whether fees are deducted when accrued or paid; if using model fees, what the model fee is, and how often the model fee is deducted). You will also have a jumpstart on transitioning to the 2010 edition of the GIPS standards. See 2010 revised provision 4.A.6.b.

“Disclose if net returns are net of actual or model fees.”

Ensure you can identify all accounts excluded from composites as of a specific date, and provide support for the exclusion. A firm was asked to provide a list of all accounts excluded from composites as of a specific date, which they did. SEC staff subsequently discussed these accounts with the firm, to gain a general understanding of the reasons for exclusion, and then asked the firm to provide supporting documentation to demonstrate the reason for excluding each of the accounts from composites, to prove that each account should not have been included in a composite as of that date. We find that some firms do not actively maintain an excluded account list, but instead must “back into” this list by identifying all accounts within the firm, and then identifying and eliminating all accounts that are in a composite. We recommend actively maintaining an excluded account list, to ensure no account that should be in a composite is missed. Maintaining such a list will also facilitate a periodic review of this list, to ensure no account should be moved into a composite.

Present gross and net returns with equal prominence on your website. In a no-action letter to the Association for Investment Management and Research (pub. avail. Dec. 18, 1996) (“AIMR”), SEC staff agreed that an adviser may present both gross and net returns of a composite, as long as the gross and net returns are shown with equal prominence, in a format designed to facilitate ease of comparison, and sufficient disclosures are included to ensure that the material presented is not misleading. On one firm's website, gross returns were presented versus the benchmark at the top of the web page, while the net returns were shown at the bottom of the same web page in the accompanying disclosures. SEC staff found that presenting the information in this manner did not meet the equal prominence test, and was not in a format designed for ease of comparison. They found this despite the fact that at the top of the page the firm disclosed that the net returns were included in the accompanying disclosures below. SEC staff also made a point of explicitly stating that the website should be considered an advertisement. We recommend reviewing each page of your website, as well as each document that can be accessed on your website, as a stand alone marketing piece, and ensure gross and net returns are shown with equal prominence on each page or document.

We just learned of yet another client that will be examined shortly. Are you ready?

Primer: Large Cash Flows Versus Significant Cash Flows

To help firms understand the changes in the 2010 edition of the GIPS standards, as well as changes with an effective date of January 1, 2010, Q&As continue to be issued. (Remember that a compliant firm must comply with all guidance, including Q&As and guidance statements, and not just the GIPS standards themselves.) Several Q&As were recently issued relating to the requirement to have a large cash flow policy as of January 1, 2010. This requirement has also highlighted the fact that many firms continue to confuse the concept of large cash flows with significant cash flows. We will review the difference between large and significant cash flows, and will also incorporate guidance in the recently issued Q&As.

A **large cash flow** is the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued. Only firms that do not value portfolios daily must adopt a large cash flow policy. If a firm values portfolios daily, they do not need to adopt a large cash flow policy. The typical situation is a firm that values portfolios monthly, and calculates monthly returns using the modified Dietz method whereby cash flows during the month are weighted based on the date during the month when the cash flow occurred. A portfolio that has a large cash flow remains in the composite. The portfolio is still considered discretionary; it is just that the large cash flow makes the portfolio's return that would normally be calculated less accurate.

A **significant cash flow (SCF)** is the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy. In other words, the cash flow is so big that the portfolio is temporarily considered non-discretionary and it is removed from the composite. (A composite can only include discretionary portfolios.) Adopting a SCF policy is optional, and is a composite-specific decision. A firm that maintains 35 composites might have a SCF policy for only one composite.

A large cash flow can be any type of cash flow that is external to the portfolio. It can be client-directed, or done at the direction of the firm if the firm has the ability to move cash between portfolios. Think of a balanced account where the firm is hired to manage a balanced account, and the firm establishes two sub-portfolios (equity and fixed income) and has the authority to move cash between the two sub-portfolios. A SCF can be only a client-directed external cash flow. A cash flow that is at the direction of the firm, such as rebalancing between the equity and fixed

income sub-portfolios of a balanced account, cannot be a significant cash flow. A firm cannot direct cash flows that cause an account to be temporarily removed from the composite.

A large cash flow must be defined as a specific \$ amount or as a percentage of the account's or composite's assets. Common practice is to define large cash flow as greater than either 5 or 10% of an account's beginning of period value. (From our perspective, establishing a large cash flow based on a specific \$ amount does not make sense, as a cash flow of a certain size could have an impact on a small account's return and have no impact at all on a very big account's return. We also don't understand how a firm could establish a level relative to the composite's assets, as until you reach the end of the month you don't know what the composite assets are, if composites are calculated monthly.)

A SCF must be defined as a specific \$ amount or a percentage of portfolio assets (based on the most recent valuation.) Common practice is to define significant cash flow as greater than 25% of an account's value.

The size of both large and significant cash flows must be composite-specific. While the firm could decide to use the same level for all composites at the firm, the firm must first determine that the level is appropriate for all composites. We typically see firms use the same size for large cash flows firm-wide, but decide very carefully whether or not to adopt a significant cash flow policy for a specific composite. A firm also must not establish a small SCF policy so that portfolios with cash flows are always removed from composites so the firm never has to revalue a portfolio mid month.

Once a large or SCF policy is adopted for a composite, the policy must be applied consistently. A portfolio that has a cash flow that is less than the level of large must not be revalued. And a portfolio that has a significant cash flow must be removed from the composite. The impact of cash flows on returns cannot be a factor in either large or significant cash flow policies.

Remember: a large cash flow makes the account be revalued, but it stays in the composite. A significant cash flow makes the account temporarily non-discretionary so it is removed from the composite.

Have we mentioned how difficult it is to establish and maintain a SCF policy? We'll save our comments on this for another day.

"A significant cash flow (SCF) is the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy."

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Three Guidance Statements Issued for Public Comment

As a result of issuing the 2010 edition of the GIPS standards, all guidance statements and other interpretations must be updated to reflect any changes in the GIPS standards themselves. If the changes to a guidance statement are minor, it will be updated and not issued for public comment. This will be true for most guidance statements, so you should expect to see a number of updated guidance statements released in the near future. If the proposed changes to a guidance statement are more significant, it will be issued for public comment. Three guidance statements with significant changes have just been issued for public comment. These guidance statements address Private Equity, Real Estate,

and Verification. The guidance statements are available on the [GIPS standards website](#). Comments must be received no later than November 25, 2010. The expected effective date of the to-be-revised guidance statements is January 1, 2011, which coincides with the effective date of the 2010 edition of the GIPS standards.

For those of you that manage private equity or real estate, there are a few good tidbits included in these guidance statements (e.g. how to handle recallable distributions, and opening the door for using IRR for open end private equity funds.) We will cover highlights from these documents in upcoming newsletters.

Annual GIPS Conference and EC Meeting in San Francisco

The 2010 annual GIPS conference, sponsored by CFA Institute, will be at the Westin Market Street Hotel in San Francisco on September 29-30, 2010. We are also co-instructing the GIPS standards workshop, which is the day before the conference, on September 28, 2010. Note that these events are from Tuesday-Thursday, which is a departure from the norm. Registration information about these events is available on the [GIPS standards website](#).

Most years the conference and the workshop sell

out, so if you plan to attend make sure you register as soon as possible.

The GIPS Executive Committee (EC), the committee responsible for overseeing the GIPS standards, is also meeting in San Francisco. On Tuesday morning, September 28th, the Executive Committee will be holding a meeting that is open to the public. If you are interested in attending this meeting, keep an eye on the [GIPS standards website](#) as you must register to attend this meeting.