



Highlights from the 12th Annual GIPS® Standards Conference

The 12th Annual GIPS® Standards Conference (previously the AIMR-PPS® Standards Conference) was held in Chicago on September 27th and 28th. As expected the conference sold out. Highlights from various sessions follow.

SEC Update

The big draw this year was the return of Bill Meck, SEC Senior Assistant Director. Mr. Meck is the person behind the comments on performance in the first ever SEC *ComplianceAlert* letter, and he provided the facts behind the letter. As discussed in detail in our July 2007 newsletter, the letter discusses issues concerning performance and claims of compliance found during the SEC's performance sweep (a sweep is a targeted exam conducted by one SEC office on a particular topic) done by the Philadelphia office. The period covered by the sweep was 2001-2003, and the sweep was begun in 2004. One hundred and fifty managers were identified as the initial pool of candidates for the sweep. From this group firms were eliminated from the pool based on various criteria, including the following factors:

- If the firm managed both institutional accounts and mutual funds in the same strategies so SEC staff could compare the two track records;
- If the firm was recently examined by the SEC and given a clean bill of health; and
- If the firm's performance was only slightly better than the peer group.

The sample was reduced to 31 firms. Of the 31 firms, average AUM was \$13 billion, with the largest firm's AUM at \$90 billion.

The SEC requested the following:

- All RFP responses and consultant questionnaires;
- All advertisements used from 2001-2004;
- Descriptions of the performance calculation processes and written policies and procedures;
- Audit or verification reports;
- List of fair valued securities;
- Composite details for advertised composites; and
- Broker or bank statements.

Out of the 31 firms, the SEC found that only one firm's marketed performance was mate-

rially different from that which was included in its AIMR-PPS verification/examination (given the time period covered by the sweep the AIMR-PPS standards were the standards used by most firms.) They found some calculation errors, including one resulting from a transfer of securities between two accounts that was recorded at original cost versus market value. One firm incorrectly captured dividends from legacy, non-managed assets. The SEC concluded that third party software has increased the accuracy of return calculations. However, the sweep found that many Chief Compliance Officers (CCOs) did not know enough about performance. Mr. Meck said the CCO should be the gatekeeper for information that goes out the door, and posed the question: If the CCO does not know much about performance how can he or she verify the information is accurate?

Out of the 31 firms the following deficiency areas, and the number of firms with the deficiency, were as follows:

- Failure to advertise net returns or other Clover deficiencies (11);
- Past specific recommendations (13);
- Inadequate disclosure of back tested performance (1);
- Use of incorrect returns (12; 9 were immaterial);
- No written policies and procedures (9; 2 claimed AIMR-PPS compliance); and
- Inadequate policies and procedures (5; 5 claimed AIMR-PPS compliance).

Of the 31 firms in the sample, 22 claimed either AIMR-PPS or GIPS compliance. Of the 22 claiming compliance, 21 had some deficiency with respect to the claim of compliance, and 15 of these firms were verified. The firm with no deficiencies was verified.

Mr. Meck provided the Top Ten Deficiencies relating to AIMR-PPS/GIPS compliance:

- 10.) Missing required disclosures related to the use of carve outs;
- 9.) Failing to disclose the number of portfolios in the composite and the market value of the composite;
- 8.) Failing to disclose the fee schedule;
- 7.) Failing to disclose the method used to allocate cash to carve outs;

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- 6.) Failing to disclose that a complete list and description of composites is available upon request;
- 5.) Failing to disclose total firm assets;
- 4.) Not including all (actual, fee-paying, discretionary) accounts in a composite;
- 3.) Websites that include a claim of compliance failed to provide a link to the compliant presentation;
- 2.) Lack of consistency in claiming compliance in advertisements; and
- 1.) Insufficient policies and procedures.

Mr. Meck confirmed that if a firm claims compliance the SEC will test the firm's claim of compliance, but only to see if it's false or misleading. They are "reluctant GIPS Police", as most examiners are not that knowledgeable about the GIPS standards. Staff look at only certain items and do not normally go any further. Some staff, particularly if they are CFA charterholders, will dig deeper into GIPS issues but this is not common practice. Mr. Meck also walked us through the SEC exam testing program, explaining that much of the testing is focused on gaining a general understanding of how the firm calculates and reports performance. Some account-level returns are recalculated for reasonableness, typically using the Modified Dietz method with repricing for cash flows above 10%.

Concluding remarks on this topic were:

- For the most part, departures from the AIMR-PPS/GIPS standards were minor;
- Over the past several years the quality of performance advertising has improved considerably;
- For those firms that were verified, there was no degree of correlation between the degree of compliance and the size or notoriety of the verifier; and
- The quality of the firm's policies and procedures was correlated to the size of the firm and the compliance department.

Finally, Mr. Meck provided an update on SEC activity with respect to performance. There has been very little guidance on performance advertising, with no significant no-action letters since 2004. The area is maturing and there are fewer enforcement cases. Even with this improvement performance advertising is still a critical part of every SEC exam. The future may hold a rewrite of the Advertising Rule, to primarily incorporate the many no-action letters on this topic, but it won't happen soon.

VPS Comments

We welcomed learning the background to the *ComplianceAlert* letter. Based on this presentation, as well as questions and answers on this topic at the conference, we have reached the following conclusions:

- Firms must take seriously their claim of compliance with the GIPS standards, and commit adequate resources and expertise;
- The importance of documenting GIPS policies can't be overstated;
- The threshold for marketing materials to be considered advertising materials by the SEC is quite low. You should assume that all marketing materials, including compliant presentations and one-on-one pitch books, are advertisements and treat them accordingly; and
- The SEC is your friend. Mr. Meck offered his contact information and encouraged anyone to contact him with questions or for copies of documents he mentioned in his speech.

Recordkeeping Guidance Statement

GIPS Provision I.A.1. requires a firm to capture and maintain all information necessary to support a firm's performance presentation and to perform the required calculations. This Guidance Statement (GS) was issued to provide advice about how a firm might meet this requirement and has an effective date of October 31, 2007. What the GS does not do is provide a "magic list" of records that must be maintained. Each firm must decide for itself which records are needed. Either electronic or paper records may be maintained, but the records must be accessible.

As with all provisions of the Standards, before considering GIPS requirements a firm must first meet any regulatory requirement. In the U.S. this guidance does not create a higher burden than what would be required of an SEC registrant. However, unlike the SEC, the GS does give some specific examples of records that a firm should consider maintaining. It is important to note that the word "portfolio" was removed from the name of the GS to reflect that complying with the Standards requires more than maintaining records to support only portfolio-level returns.

While some of this might be quite obvious, different areas for which a firm must maintain records, along with suggested documents, are as follows:

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- **Portfolio-level returns:** bank statements and reconciliations; appraisals and transaction reports; cash flow reports; accrued and earned income reports; and billing information to support net returns;
- **Composite-level returns:** composite membership; account returns and market values; support for the dispersion calculation; and fee information for net returns calculated using model fees;
- **Composite assignment:** composite definitions, focusing on composite inclusion criteria; support for portfolios excluded from all composites; investment management agreements; and client reports and correspondence;
- **Firm-wide claim of compliance:** firm definition details; total firm assets details for each period; list and descriptions of composites; and compliant presentations with supporting information;
- **Policies and procedures:** both current and previous versions of GIPS policies and procedures;
- **Third party service providers:** if third party service providers are used, the firm must ensure the records and information provided and maintained by the service provider meet the requirements of the Standards, and that adequate records are available; and
- **Other records that might help support the claim of compliance:** RFP responses; system and control reports; system manuals, and minutes of the GIPS Committee, if applicable.

Records must be maintained to support all periods presented in the compliant presentations, including both compliant and any allowable non-compliant information. If the firm has been verified a firm may determine that it may reduce the records maintained solely to support or assist with the verification, but verification status has no impact on the firm's recordkeeping requirements.

Finally, if a compliant firm loses records due to a catastrophic event, the firm does not automatically lose its compliant status. The firm should attempt to recapture and reconstruct the records, potentially obtaining the information from clients, custodians, and other third parties that may have duplicate records. If the firm cannot obtain the records, the firm may continue to claim compliance if the lack of records is disclosed, along with the reason for the missing records and the fact that the firm is unable to

duplicate the records. Note that a catastrophic event is defined as an extreme circumstance beyond the control of the manager and would include events such as a flood or earthquake. Events within the control of the firm, such as a change in performance systems, would not qualify as a catastrophic event (although we know that many of you that have been through system conversions would say they should qualify as catastrophic events.)

Mandatory Verification

Currently the GIPS standards state, "Verification is strongly encouraged and is expected to become mandatory at a future date. The IPC will re-evaluate all aspects of mandatory verification by 2010 and provide the industry sufficient time to implement any changes." While not explicitly stated, the intention was to mandate verification in the next version of the GIPS standards (GIPS 2010). The push for mandatory verification has come primarily from the UK, which previously required verification when the UK had their own Country Version of the GIPS standards (CVG). This topic was hotly debated at the recent Executive Committee (EC) meeting in Hong Kong. (The EC has replaced the prior GIPS oversight board, the Investment Performance Council or IPC, referred to above.) The EC agreed that the next draft of the GIPS standards, which is expected to go out for public comment in early 2009, will not mandate verification. Instead, the GIPS claim of compliance will be changed to require disclosure of whether the firm has been verified or not. While the final language has not been determined, it is expected to be something like, "ABC Firm has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). ABC Firm has been verified for the period from January 1, 2001 through December 31, 2006." or "...ABC Firm has not been verified." While this is subject to change in reaction to comments received during the public comment period, as is everything else in the Standards, we are encouraged that this conclusion was reached. We are strong advocates of letting each market determine the value of verification.

Real Estate Quarterly Valuation

Currently a firm that manages real estate must value real estate investments at least once every 12 months. However, as of January 1, 2008 real estate must be valued quarterly. While this is an "internal" valuation versus an external valuation by a third party,

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Performance is all we do.



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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.

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

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even an internal valuation is not a simple process, given the nature of the investments. Currently the GIPS standards do not provide any guidance concerning what steps must be performed in order to satisfy the requirement to do an internal valuation. It was agreed that guidance concerning performing an internal valuation is needed and would be provided in the near term, probably in the form of a Q&A that would be posted to the Q&A Database. If you manage real estate investments stay tuned for more information.

Significant Cash Flows

Significant cash flows (SCF) were discussed, yet again, as there is still confusion concerning this topic. Key points include:

- A firm may adopt, on a composite specific basis, the ability to temporarily remove an account from a composite if it exceeds a level of significance that was previously determined;
- Prior to 1996 if a firm had adopted a SCF policy it was allowed to do so until a Q&A was issued in January 1996 prohibiting this practice;
- After January 1996 a firm was prohibited from adopting such a policy prior to 6/30/02;
- Beginning 6/30/02 a firm may adopt a SCF policy on a prospective basis only, and
- In response to a question asking whether Q&As are authoritative, the definitive answer from Jonathan Boersma, CFA, Executive Director, Global Investment Performance Standards, CFA Institute, and Chair of the conference, was yes.

Additional details on this topic are in the June 2007 edition of VPS Views & News.

GIPS® Standards Workshop to be held in Los Angeles

On December 6th, on behalf of CFA Institute, we will be leading an introductory GIPS workshop at the Hyatt Regency Century Plaza in Los Angeles. This workshop is targeted to performance professionals who are new to the GIPS standards, or those who wish to have a thorough refresher on complying with the

GIPS standards. A similar workshop held in Chicago prior to the GIPS Conference sold out. Registration information is available on CFA Institute's website. As always, we recommend registering early as the workshop typically sells out.