



Good bye to the AIMR-PPS® Standards

With the new year upon us, many firms are busy completing the annual update of their compliant presentations with 2006 performance data. We thought this would be a good time to go over the final transition from the AIMR-PPS® standards to the GIPS® standards.

To review, once a firm updates the compliant presentation with performance results that begin after December 31, 2005, the firm may no longer claim compliance with the AIMR-PPS standards. For most firms, the transition from the AIMR-PPS to the GIPS standards should not be a difficult task. There have been no changes in the calculation methodology or input requirements. The only "major" changes that are applicable to most firms relate to disclosures in the compliant presentation, as follows:

- Returns must be clearly labeled as gross of fees or net of fees. Ensure the headings in the performance presentation clearly state which returns are shown. To prevent potential regulatory issues we always recommend including both gross and net returns;
- If gross returns reflect the deduction of any fees other than transaction costs and/or net returns reflect the deduction of any fees other than transaction costs and management fees, you must describe which other fees have been deducted;
- You must disclose that additional information regarding calculating and reporting returns is available upon request;
- The presentation must include the composite's description. Currently there is no requirement to disclose the composite's strategy or style, although many firms already do so. A composite description is general information regarding the strategy of the composite; and
- You must disclose which dispersion measure is presented.

Once these disclosure changes have been considered, you should be able to include the GIPS claim of compliance. The compliance statement is "XYZ Firm has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®)." Note that there is no reference to CFA Institute in the GIPS compliance statement.

As you are updating your compliant presentation to adhere to the GIPS standards, it

would be a great time to take a fresh look at your compliant presentations and any advertising that your firms does, including your website. Here are some things to keep in mind:

- There should be no references to the AIMR-PPS standards, anywhere. Once you present performance data after December 31, 2005 you must not make any reference to AIMR-PPS. A firm that previously claimed compliance with the AIMR-PPS standards is granted full reciprocity with the GIPS standards. You may properly state that you claim compliance with the GIPS standards for all periods for which you previously claimed AIMR-PPS compliance.
- Many disclosures previously required by the AIMR-PPS standards are not required under the GIPS standards. The GIPS-required disclosures are listed in section 4.A of the GIPS standards. Of course, your firm may choose to add other disclosures in addition to those that are required. Also note that the GIPS standards specifically state that only required disclosures must be included in compliant presentations. You are not required to provide "negative assurance" on disclosures that are not applicable to the respective composite presentation.
- Review all marketing materials to ensure proper references to the GIPS standards. If you choose to make reference to the GIPS standards in marketing materials, you may do so only by either including a fully compliant presentation or preparing an advertisement following the GIPS Advertising Guidelines. For more information on the GIPS Advertising guidelines, refer to our May 2006 newsletter, available at (http://www.vincentperformance.com/VPS_Views.htm)
- Ensure compliant presentations include all appropriate regulatory disclosures. Have your compliance folks review and approve any updated GIPS presentations; a GIPS-compliant firm must also meet any regulatory requirements.
- Test all links on your website to ensure they do not link to outdated or inaccurate information.

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rate information. We often find old performance information on websites.

While the transition from AIMR-PPS to GIPS is fairly simple, it can be a challenge ensuring that other departments within your firm in-

corporate the changes as well (such as marketing). This final transition calls for a meeting that includes people from performance, marketing and compliance to discuss the transition to the GIPS standards and how it will affect different areas of the firm.

Guidance Statement on GIPS® Performance Examinations Issued

The final Guidance Statement on GIPS® Performance Examinations has been issued with an effective date of December 31, 2006. The purpose of this guidance is to ensure the consistency of the procedures followed for a firm that chooses to have a performance examination conducted on one or more of its composites. While performance examinations are neither recommended nor required under the Standards many parts of the investment management industry require a composite examination to give them comfort that the composite does in fact comply with the GIPS standards.

The purpose of a performance examination (or performance audit) is to test, for a specific composite, whether the firm has constructed and calculated the composite in compliance with the GIPS standards and whether the firm presents the composite in compliance with the GIPS standards. A performance examination requires that the firm be verified successfully on a firm-wide basis before a performance examination can be conducted. In other words, the firm must comply with the composite construction requirements of the GIPS standards and the firm's process and procedures must be designed to calculate performance in compliance with the GIPS standards on a firm-wide basis. A firm may not just have their marketed composites examined and ignore the compliance of their non-marketed composites.

There has been a lot of misunderstanding concerning what work is performed during a verification and what level of comfort is provided by a verification report versus a com-

posite-specific performance examination report. This guidance attempts to address this issue and also describes the minimum procedures that must be performed when conducting a performance examination. Until now only the AIMR-PPS standards included performance examination guidance. No such guidance was previously included in the GIPS standards or any other country-specific standards.

For those firms that have been receiving performance examinations under the AIMR-PPS standards, you should not expect to see any big changes in the work performed by your verifier. The suggested procedures are very similar to the prior AIMR-PPS guidance, as is the suggested language to be included in the verifier's performance examination report.

We know many of you are wondering whether there has been any movement away from obtaining performance examinations towards receiving only a verification. Our experience is that there has been no noticeable change in the scope of the work requested by US firms. We typically see firms request a firm-wide verification, along with a performance examination on key marketed strategies. Of course much of this is driven by the "interesting" questions asked by consultants and databases. Surprisingly, we have also seen increased interest in performance examinations from wrap/SMA managers.

The guidance statement is available on the CFA Institute website at http://www.cfainstitute.org/centre/ips/pdf/guidance_statement_perfexam.pdf.

Addressing Litigation Proceeds (i.e. WorldCom bonds)

We have received many questions lately regarding WorldCom bonds and other payouts resulting from corporate bankruptcy and other litigation proceedings. Many invest-

ment managers have seen their client accounts receive payouts from prior bond holdings that had previously been "written

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Addressing Litigation Proceeds (i.e. WorldCom bonds) (continued)

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off" as a total loss due to bankruptcy. When the litigation proceeds are received, how should the income be reflected for performance reporting purposes?

Should it be classified as a cash flow so that it is not reflected in the client's performance? Or can it be counted as income and therefore reflected in performance?

There is no guidance in the GIPS standards specific to this point. However, we are happy to share our opinion. We believe that if your client participated in the loss that eventually generated the litigation proceeds, while under your watch, and whose performance was negatively impacted by the event, then it would be proper to reflect the litigation proceeds as income. If the account was not under management at the time of the loss then the proceeds should be reflected as a cash flow.

But what if when the loss occurred the client was in the High Yield Composite and

now they are in the Core Fixed Composite, or even the Equity Composite? Should you still reflect the proceeds as income? We're not so sure on this point. Without a doubt the client's return should reflect the income. To be conservative we could argue that because of the composite change the account should not reflect the income in performance. We acknowledge that most firms do not have the ability to calculate more than one return for a client. So if a firm wants to include the income in performance, how can we argue against this? Of course if it would have a material impact on performance, additional disclosures would certainly be justified.

As with any unusual event, we suggest checking in with your verifier to ensure they agree with your treatment. It's always better to address the issue immediately to prevent future historical restatements. We expect lots of fixed income managers will beat the benchmark in December 2006!

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Securities Lending Income

Many clients enter into securities lending arrangements with their custodian banks. In exchange for allowing their securities to be lent the client receives income from the custodian. This income is generally deposited directly into the client's account. How should this income be reflected in performance? The answer is it should not.

A GIPS Q&A on point is included in the 2006 GIPS Handbook on page 91. In response to a question asking if such income should be reflected in the firm's return, the response is as follows:

"The Standards provide comparability of the performance of investment managers by utilizing composites, which are based on investment strategy. Typically, securities lending is not an active part of the portfolio strategy. Therefore, unless the securities lending is a part of the strategy defined and implemented by the investment manager, for purposes of reporting performance for the Standards, securities lending should be treated like a cash flow and should not impact performance results in order to get an accurate representation of the investment manager's ability to implement the intended strategy of the portfolio."

In other words, if you're not responsible for security lending, you don't get the related performance.

Another type of income that should also be treated as a cash flow is commission recapture income. Lately we have seen more accounts receive this income directly into their custodian account. As commission recapture income is a product of negotiations between the client and the brokers, and is not the responsibility of the investment manager, this income also should not be reflected in performance and receipt of any such income should be classified as a cash flow.

We recommend discussing the proper treatment of this income with all of your account reconciliation staff as we often find that there is no consistency in how this income is reflected.

So what do you do if you determine that you have not been properly treating these items as cash flows? First, change your policy immediately on a prospective basis. Next, do an analysis to determine if any impacted composite has been misstated historically. We bet you will find that the impact at the composite level will be quite small. Hopefully you can determine that the change would be immaterial and does not justify restatement. However, once again, you should check in with your verifier and ensure they agree with your conclusion.

**Vincent Performance
Services LLC**

2905 NE Broadway Street
Portland, OR 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 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.

To unsubscribe or change recipient information,
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GIPS Compliance Policy Manual

A firm that claims compliance with the GIPS standards is required to document, in writing, all the policies and procedures it follows throughout the investment performance process for establishing and maintaining compliance with all the requirements of the GIPS standards. While the Standards do not specify exactly what information should be included in the manual, the purpose for documenting policies and procedures is to ensure that the firm has implemented adequate business controls over every stage of the process, from input data to presentation, and supports the validity of the firm's compliance claim. As part of any testing of your firm's claim of GIPS compliance, verifiers and regulators will request a copy of the compliance manual and this will typically be their first exposure to your firm's GIPS compliance environment. If a firm does not have a GIPS Policy Manual that addresses each requirement of the GIPS standards the firm must not claim compliance with the GIPS standards.

The compliance manual should be reviewed on a regular basis to ensure that the documented policies and procedures capture any changes to the Standards and are still rele-

vant and reflect the actual operating environment. We recommend that you view your compliance manual as a "living document" that details not only current policies and procedures, but changes made during all periods for which your firm claims compliance with the GIPS standards. Additionally, you may determine that your firm's compliance manual needs to include more than just information that simply addresses the requirements (i.e. including why the changes were made rather than just that changes were made) as this information may be pertinent to understanding the firm's compliance environment. For example, you may decide that the policy manual should include both a discussion on formula changes over time and the reason for changing the formula.

While it may require a substantial commitment initially to create or enhance your firm's GIPS policy manual, ensuring that it addresses every requirement of the GIPS standards and presents a complete and accurate description of the firm's investment performance process reduces the risk of non-compliance.