Vincent Performance Services LLC

VPS Views & News

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July 2007

SEC staff issues first "*ComplianceAlert*" letter

SEC staff recently issued their first *"ComplianceAlert"* letter. The letter is intended to help Chief Compliance Officers ("CCOs") of SEC registrants understand deficiencies and weaknesses SEC examiners have found during compliance examinations. By sharing this information the SEC's intent is to encourage CCOs to review their firm's policies and determine where procedures should be enhanced. The *ComplianceAlert* describes issues found with investment advisers and broker dealers. Below we focus only on the issues found at investment advisers, and deficiencies noted related to performance advertising. Highlights from the SEC's findings and our comments on each item follow.

The SEC found that a majority of the firms that were examined claimed they presented their performance in accordance with the GIPS standards, but only one firm was actually in full compliance. Reading between the lines, we assume the staff is referring to the firms' composite compliant presentations. A GIPS-compliant firm must have the ability to prepare a compliant presentation for all of the firm's composites. The compliant presentation must include, at a minimum, certain required information and disclosures. If a presentation is missing a required disclosure, the firm is improperly claiming compliance. For example, we frequently see presentations that do not disclose the fee schedule that is appropriate to the presentation, as required by GIPS Provision 4.A.12. Instead, we see a disclosure that says something like, "A complete fee schedule is an integral part of a full disclosure presentation and is available in Part II of Form ADV." Referring to the fee schedule does not meet the GIPS disclosure requirement. If you have any question about whether this is a correct interpretation, just refer to the GIPS Q&A database. The following Q&A was added to the database in December 2001:

Question: "Do all disclosures need to be included in a compliant presentation or can they be made available upon request?"

Answer: "A presentation is not compliant without all the required disclosures. Stating that the disclosures are available upon request does not satisfy the requirement of the Standards."

So, we're all clear on that point. We recommend that you review your compliant presentations and make sure you have included all required disclosures. You might also take a fresh look at your disclosures and remove those disclosures that are not required by the SEC or the GIPS standards. We suggest rationalizing why each and every disclosure is included. More is not necessarily better.

But the big news is that in addition to the SEC finding that all but one firm was actually in compliance, most of the firms that were improperly claiming compliance had been verified. Not only did the firm miss something, the verifier didn't catch it either. As a verification firm we know that we do not have control over every process a client follows for complying with the GIPS standards. We could finish a verification and find everything is perfect, but that doesn't mean the client will continue to follow all of the policies and procedures we just tested. Additionally, most verifiers (including us) review a sample of composite presentations. That's why the firm's policies are so important. During the verification your verifier should gain an understanding of your firm's marketing policies and procedures and test a sample of your firm's compliant presentations for accuracy and completeness. Hopefully your firm will continue to follow these procedures once the verification is done.

Speaking of policies and procedures, the SEC found that many firms lacked policies and procedures related to marketing and advertising, or had ineffective procedures, "to ensure the adviser was in compliance with all applicable requirements of the CFA Institute's performance presentation standards (currently called 'Global Investment Performance Standards' or 'GIPS') prior to making a claim of compliance." GIPS Provision 0.A.6. requires a firm to document, in writing, policies and procedures used in establishing and maintaining compliance with all the applicable requirements of the GIPS standards. The SEC's finding supports our long-standing view that a firm should have a detailed and robust GIPS policy manual. We often hear firms say that they have a concise two-page policy manual, and they (and their verifier) think that's just fine. We disagree. Obviously so does the SEC. We don't think all the requirements of the Standards that must be addressed would fit on two pages, never mind including all the procedures a

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firm follows for maintaining and monitoring compliance with the firm's established policies. A detailed GIPS policy manual can be a great tool to help a firm think through and rationalize the procedures they follow.

The letter also said that firms did not have adequate policies to ensure that third-party consultants used compliant presentations. Again, reading between the lines, we assume they are referring to either brokerage firms that offer a firm's products through a dual contract (i.e. fee in lieu) arrangement or a sponsor in a wrap program. In either instance the ultimate end client is still your firm's client, even if you never meet them. You must treat them as a prospective client when you consider GIPS Provision 0.A.11, which states, "Firms must make every reasonable effort to provide a compliant presentation to all prospective clients." So how do you meet this requirement if you are not meeting with prospective clients directly? We recommend the following procedures:

- Provide compliant presentations to all brokers/sponsors at least annually, and ask them to include the presentations in their marketing materials;
- Include the appropriate compliant presentation in the new client welcome package; and
- Post the compliant presentations on your website.

"Firms must make every reasonable effort to provide a compliant presentation to all prospective clients."

GIPS Provision 0.A.11.

We believe that adopting these procedures would meet the requirement to "make every reasonable effort" to provide a compliant presentation to broker/sponsor-referred clients.

Firms also had inadequate procedures addressing the methods used for allocating cash to carved-out segments of balanced accounts. Assuming the comment refers to carve-outs as allowed by the GIPS standards, a firm may carve-out a segment of an account and include it in a composite as long as cash (and cash equivalents) are allocated to the segment. GIPS Provision 3.A.7 requires cash to be allocated "in a timely and consistent manner." The Guidance Statement on the Treatment of Carve-Outs provides guidance on how this might be done. Firms should ensure the following procedures are documented in their GIPS policy manual:

- How the firm determines the carve-outs are managed separately;
- How the firm determines the carve-outs are representative of a stand-alone portfolio managed to the strategy;
- How the firm ensures all similar segments are identified and carved-out and included in the respective composite;
- How the firm allocates cash to the carved-out segments. The exact formula and method used should be documented; and
- If net returns are presented, the method used for calculating net returns for carve-outs. The fee that is used must be representative of the fee that would be paid by an account invested solely in the strategy. For example, assume a balanced account pays a fee of 0.50% while an equity account pays a fee of 0.80%. If an equity segment is carved out of the balanced account and included in an equity composite, the equity carve out's net return must reflect a fee of 0.80% and not 0.50%. Depending on your system and how net returns are calculated, you may not simply allocate a portion of the actual management fee paid to the carve-out unless the fee is in line with the segment composite's fee schedule.

If a composite contains carve-outs you also must disclose the percentage of the composite that is composed of carve-outs. This disclosure must be made as of each period end, for periods beginning after January 1, 2006.

One final point: a "sleeve" is not a carve-out. A segment of an account is a carve-out for GIPS purposes only if cash must be allocated to the segment. If the segment is managed as a sub-portfolio of a larger account and is managed with its own cash, it is not considered a carve-out for GIPS purposes.

Firms did not have adequate policies to require a consistent comparison of composites to appropriate benchmarks. We can think of four possibilities that could be behind this comment:

- Choosing to show a benchmark at some points in time and not at others;
- Choosing to not show a benchmark even though an appropriate benchmark exists;
- Showing a benchmark that does not reflect the composite's strategy, or
- Periodically changing the benchmark that is presented.

We all know that the GIPS standards require disclosure of the appropriate benchmark in the compliant presentation. If no benchmark is presented you must explain why no benchmark is disclosed. You also must disclose if the benchmark presented has changed. But these requirements apply only to GIPS-

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compliant presentations and do not address other performance information that may be presented. Peering into the crystal ball we assume this comment relates to "additional information" that is included in marketing materials. Common practice is to update compliant presentations annually and update other performance information more frequently. (A firm is only required to update the compliant presentations annually but may do so more frequently if they wish.) The GIPS standards won't stop a firm from following any of the practices described above. We can't imagine any instance where it would be appropriate to report additional information using a benchmark that is different from the benchmark used, or that should be used, in the compliant presentation. However, as with all requirements, we recommend documenting the policies your firm follows for selecting and reporting benchmarks.

Firms also had inadequate policies for ensuring accurate composite descriptions. The GIPS standards define a composite description as, "general information regarding the strategy of the composite. A description may be more abbreviated than the composite definition but includes all salient features of the composite." A compliant presentation must include the composite description (GIPS Provision 4.A.20.) Composite descriptions also must be included on the firm's list and description of composites, which must be provided upon request (GIPS Provision 0.A.12.) So what is an accurate composite description? It depends. We'd suggest considering the following key factors:

- The type of accounts included in the composite, if relevant (institutional versus wrap, or taxable versus tax-exempt);
- If non-fee paying accounts are included;
- If carve-outs are included;
- If the composite has a minimum size for inclusion;
- The strategy followed by the accounts in the composite;
- If leverage and/or derivatives are used by the accounts in the composite;
- Key characteristics of the strategy, such as the number of holdings, duration, quality, or asset allocation; and
- The benchmark selected, if an important strategy factor.

A composite description does not have to be lengthy. Most can be written in two or three sentences. Appendix B of the GIPS standards includes sample composite descriptions and the longest description is three sentences. Note that none of the sample descriptions include the words "actual, fee paying, discretionary" when describing the accounts in the composite. You are not required to do so either.

Don't confuse a composite description with a composite definition. A composite definition is much longer as it includes detailed criteria for determining which accounts to include in the composite (e.g. when new accounts are included). Composite definitions must be included in the GIPS policies.

SEC staff also noted limited instances where firms inappropriately advertised a prior firm's track record as its own. The GIPS standards have very specific tests for portability (GIPS Provision 5.A.4.). A firm may link to the track record of a past firm or affiliation if:

- "Substantially all the investment decision makers are employed by the new firm, (e.g. research department, portfolio managers, and other relevant staff);
- The staff and decision-making process remain intact and independent within the new firm; and
- The new firm has records that document and support the reported performance."

If all three tests are met a firm may link to the prior track record, with appropriate disclosures. Our experience is that unless it's a friendly acquisition the records requirement is rarely met. Remember that only an entire composite is portable, not a carve-out of certain accounts within the composite, therefore records must be available for all accounts within the composite (including accounts that terminated previously) and not just those that follow the portfolio manager to the new firm. If it's one PM joining a new firm, it would be a rare instance where the case could be made that the PM was the one and only person at the prior firm who was involved with making investment decisions. If a firm does not meet all of the portability tests the firm still may be able to show the prior track record as long as it is clearly labeled as supplemental information and it is not "linked" to the ongoing track record.

Of course the firm must also meet any SEC rules regarding portability. Remember the typical view from the SEC concerning portability, whether performance is linked or not: No records, no performance.

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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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The letter did not focus only on bad practices as it did include some examples of policies in place at firms that had "fewer" deficiencies. While the letter stops short of saying that a firm should have these policies in place, we think firms should look to those policies as best practice and adopt those that are appropriate for their firm.

A "good" procedure includes having, "a multi-review process among an adviser's performance group, portfolio managers, and marketing group for the accuracy of marketing materials prior to their use." The more eyes that see marketing materials and ensure their accuracy, the better.

Another good practice is to review outlier returns on a monthly basis, to compare returns of account within a composite to each other and to the benchmark. We do this as part of our verification testing and recommend our clients do the same. While problems with performance calculations may be identified, the test is much more valuable for identifying accounts that are potentially included in the wrong composite. Don't just look at each month in isolation: the big clue is typically when it's the same account that is the outlier month after month. This can be a challenge if composites are calculated using the aggregate method. We strongly recommend reviewing individual monthly account returns within a composite, even if it is difficult to gather the information. Otherwise it's like looking at the forest through the trees. For this procedure to work you need to be looking at the leaves on the trees.

The "good" firms have a composite committee to review all accounts at least quarterly, to ensure proper composite construction and maintenance. We also recommend having portfolio managers sign off on each of their composites and the accounts they manage at least quarterly. The information they approve should include the accounts in (and excluded from) their composites as well as account-level returns.

So, what does all of this mean? A GIPS-compliant firm should take seriously the requirement to document the policies the firm follows for maintaining GIPS compliance. Of course the firm must then actually follow their policies. If a firm is trying to do the right thing and comply with all requirements of the GIPS standards, detailed GIPS policies and procedures can only help; they can't hurt.