



# ATTEST **BVS**

Earlier this Fall, Beacon sent a team to the 2008 Annual GIPS Conference. We always feel that this event provides a unique opportunity for us to stay at the forefront of the Standards. We realize that many of you are also interested in these developments, and consequently, this month's edition of our newsletter is devoted to the topics which were covered at the GIPS Conference. As always, the Conference provided interesting perspectives on some very important and timely issues and these are summarized in the following articles.

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## INSIDE THIS ISSUE

GIPS Changes for 2010 and 2011.....	1	SEC Update.....	4
Q&A.....	3		

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## GIPS Changes for 2010 and 2011

The overriding theme of this year's GIPS conference certainly was the proposed changes in the 2010 edition of the GIPS. There are several important upcoming dates to remember. The next edition of the GIPS will be released for a six month comment period in early 2009. The final version of the GIPS will then be released in early 2010 after the GIPS Executive Committee (EC) has had time to make adjustments based on comments received. The Standards will become effective as of the end of 2010. Please note that Standards within the current edition of the GIPS that have an effective date of 1/1/2010 will remain unchanged.

The primary changes effective as of 1/1/2010 are revaluing portfolios at the date of any external large cash flow and the fact that carve-outs MUST

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be managed with their own cash balance (no more hypothetical cash allocation). A less prevalent but important item is that asset-weighting of composite returns must occur at least monthly. Also, it is important to keep in mind that the Error Correction Guidance Statement becomes effective as of 1/1/2010. As we have stressed in earlier newsletters, there is no time like the present to go ahead and establish an error correction policy.

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There are several proposed changes within the next version of the GIPS, and we will highlight the ones we feel are most pertinent. We will be providing clients with an all-inclusive list when the changes become final. On a final note before digging into the changes, the next edition will continue to be referred to as “GIPS 2010” even though the new Standards will not be effective until 1/1/2011. The GIPS EC wants to keep the goal of revising the Standards every five years.



#### **Fundamentals of Compliance (Section 0)**

- The term “Compliant Presentation” will be better defined.
- Firms will have to state in the boilerplate claim of GIPS compliance whether they have been verified and if so, for what periods.
- Showing current clients the applicable Compliant Presentation annually will be recommended.
- “Prospective Client” will be defined.
- There will be clarification on whether information can be supplemental to the Firm as opposed to only a specific composite. This wins the prize for the most heavily debated concept (see Q&A in the following article for a summary of the discussion).
- Firms must not show prospects the Compliant Presentation if the prospect does not meet the minimum composite value threshold, if applicable.

#### **Input Data/Calculation Methodology (Sections 1 and 2)**

- The Standards will move from the concept of market value to fair value. This is already addressed in the Private Equity guidance.
- All managed assets that have a fair value must be included in Firm AUM.
- Recordkeeping will encompass all required statistics (e.g. dispersion, composite assets, etc.) as opposed to just returns.

#### **Composite Construction (Section 3)**

- The Standards will no longer distinguish between fee-paying and non-fee-paying accounts (i.e. non-fee-paying, discretionary accounts must be in a composite prospectively).
- There will be additional requirements for seed accounts in composites.

#### **Disclosure and Presentation (Sections 4 and 5)**

- Firms must disclose if they use actual fees or the highest applicable fee when calculating net of fees returns.
- Firms must disclose treatment of withholding taxes only if material.
- Firms must disclose presence, use, and extent of short positions.
- Firms must disclose material errors for 12 months.
- Firms must show the 3-year annualized standard deviation of composite and benchmark returns.
- If the initial year of a composite’s track record is less than the full year, it must be presented.
- Updating composite presentations quarterly will become a recommendation. (CONTINUED)



We hope this preview of the proposed changes proves to be helpful. We strongly recommend that your firm send comments on the draft when the EC releases it for public comment in 2009, as these are only proposed changes at this point. Also, we strongly recommend that you begin to incorporate the changes once they are finalized in early 2010. Please feel free to call us with any questions.



## Q&A

One of the benefits of the GIPS conference is the Q&A sessions where the attendees can submit any questions they might have. The following are a sampling of some of the most germane issues firms claiming GIPS compliance face today.

### Applying the GIPS Standards to SMA/Wrap Programs

**Q.** Will the SEC accept GIPS allowance to rely on sponsor's recordkeeping?

**A.** Essentially, yes. The firm would still have to keep supporting documents but the audit will likely be more lenient. Also, if wrap performance is similar to non-wrap performance, the SEC is more likely to feel comfortable with reliance on sponsor.

**Q.** In 2010, is it a problem if sponsors do not revalue portfolios for large cash flows?

**A.** Yes, this requirement will also apply to sponsor relationships. It is important for firms to begin discussing this change in calculation methodology with their sponsors to ensure a smooth transition on 1/1/10.

**Q.** If a firm is required to net down wrap performance by the maximum wrap fee but is not privy

to the fee schedule charged by the sponsor, how should a firm go about finding this max wrap fee and what are their options?

**A.** A few options were discussed here. The firm can ask the sponsor what the highest fee charged is, it could try getting this information by surveying some of its clients, and it could look at its sponsor's website. A final option discussed when none of the above produce results is to use the highest maximum fee the firm has ever seen with its sponsors or direct clients (3% was discussed as what a few had seen in the industry as a acceptable maximum for equity portfolios).

### Supplemental Information:

**Q.** Can Supplemental Information be supplemental to the firm, or must it be supplemental to an existing composite presentation?

**A.** Much was discussed on this topic during the Executive Committee open meeting the day preceding the annual conference. Supplemental Information, by definition, is any performance-related information included as part of a compliant presentation that supplements or enhances required or recommended provisions. So, the by-the-book answer to this question is that Supplemental Information cannot be supplemental to the firm. The EC members recognize (CONTINUED)



that there are situations where information that does not meet the definition of Supplemental Information may need to be provided to a prospective investor. For example, a firm presenting a new strategy to a prospect where it does not currently manage actual assets may wish to show model or back-tested performance. We expect Supplemental Information to be more fully clarified with the 2011 revision to the Standards and possibly another term added that allows for usage of information that may not fit the current definition of “supplemental.”

**Q.** The Guidance Statement on Supplemental Information states that firms cannot link model or back-tested performance to actual results. What is meant by the term “link?”

**A.** This topic was also discussed by the EC during the open meeting. Most interpret the term “link” to mean that one cannot geometrically link model and actual results to present a ten year annualized return, for example, when you have

five years of actual performance history and five years of back-tested history. The EC members discussed the idea of “presentational linking” in addition to linking from a calculation perspective. For example, if a firm has model history presented as supplemental information for the period 12/31/00-12/31/05, and actual history shown for the period 1/1/06-present, it could be construed as “presentational linking” if the firm grouped these two performance track records together on the same page without in some way showing the “break” between model and actual performance. More guidance is expected on this topic as well with the next revision.

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## SEC Update

The GIPS conference included a wide array of investment related issues. One of the more interesting topics covered was the SEC Update presented by Gene Gohlke, Associate Director in the Office of Compliance Inspection and Examinations with the U.S. Securities and Exchange Commission. Mr. Gohlke discussed a variety of topics including verification, security valuation, and recordkeeping from the perspective of an SEC auditor.

When investment advisors claim compliance with the GIPS, this claim is subject to testing under an SEC audit. In fact, the SEC has become

more knowledgeable about the GIPS, and within the past year, has even cautioned investment advisors of uncovered deficiencies via the new ComplianceAlert notice. During the session, Mr. Gohlke mentioned that verification adds a level of comfort to the SEC auditor that the firm is indeed GIPS compliant. Furthermore, if the SEC is comfortable with the verification firm’s quality of service, the advisor is likely to be viewed as having less risk of violating the Standards.

Another important and timely topic that was discussed was security valuation and how the SEC determines reasonableness. When (CONTINUED)



an advisor has invested in a security that is thinly traded where market pricing is not readily available, the examiner may choose to review a security with similar characteristics that is currently trading. This will help the auditor determine if the advisor has reasonably valued the thinly traded security.



Lastly, to comply with the SEC recordkeeping requirements, an advisor must maintain all supporting records for all time periods which are presented. The format of the data can be hard

copy or electronic so long as the advisor has the ability to access the data. For example, if an advisor has stored part of its historical data on microfiche, then it must have a microfiche machine to access the data. The alternative is to convert the data into a more current electronic format. Advisors that are involved in wrap programs can rely on their sponsors for recordkeeping support. It is recommended that advisors include this arrangement in their contractual agreements with their wrap sponsor.

Finally, if an advisor is presenting performance that has been ported from a previous firm but does not have the documentation to support the track record, the ported performance must not be linked to the ongoing track record. Rather, if the firm chooses to present this performance, it must be shown as Supplemental Information in order for the firm to remain GIPS compliant. However, when this topic came up in the Q&A portion of the session, it was noted that this situation is viewed as risky from an SEC auditor's perspective, especially if an advisor is presenting very favorable performance.