



ACA'S SPRING 2015 COMPLIANCE CONFERENCE

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SEC vs GIPS[®] REQUIREMENTS

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Agenda

- SEC regulatory framework
- GIPS standards
- Key SEC vs. GIPS issues
- GIPS disclosure requirements in Guidance Statements
- Q&A

SEC Regulatory Framework

- SEC creates the rules implementing the federal securities laws
- Issues guidance on rules; sources include:
 - Rule releases
 - No-action letters and other guidance
 - Enforcement actions
- Goal is to prohibit fraud through regulation

The GIPS Standards

- The Global Investment Performance Standards (GIPS®) are a set of voluntary standards developed by CFA Institute, in partnership with other organizations worldwide
 - The GIPS standards have been adopted by over 30 local country sponsors
- Claiming compliance is voluntary, but
 - In the U.S., claiming compliance with the GIPS standards is required by many clients, sponsors and consultants

SEC Advertising Guidance

- One rule – Rule 206(4)-1
 - Falls under Advisers Act anti-fraud provision
 - Anti-Fraud Catchall - No misrepresentations; no omissions of material facts; no false or misleading statements
 - No testimonials
 - Limited past specific recommendations, or “Cherry Picking”
 - Restrictions on graphs and charts and tools to make investments decisions

SEC Advertising Guidance

- Key No-Action Letters:
 - Investment Counsel Association of America: Advertisement definition
 - Clover Capital: Prohibited advertisements
 - ICI II: One-on-one presentation of performance
 - JP Morgan: May advertise composite performance using model fees if equal to highest fee charged
 - Horizon Asset Management: Portability of performance (includes predecessor performance)

SEC Advertising Guidance

- Key No-Action Letters:
 - Cambiar: Client lists
 - Franklin and The TCW Group: Past Specific Recommendations (client letters, representative accounts, best and worst performing holdings)

Performance Advertising - SEC

- What is an advertisement?
 - Rule definition: Any notice, circular, letter or other written communication addressed to more than one person
 - Practical definition: Any communication intended to solicit business
- Advertising rule falls under anti-fraud provision of Advisers Act
 - SEC focus on disclosure
- Investment adviser advertising cannot be false or misleading, must be fair and balanced

Performance Advertising – GIPS

- The GIPS standards are focused on presenting performance to prospective clients
- Firms must make every reasonable effort to provide a compliant presentation to all prospective clients. Firms must not choose to whom they present a compliant presentation. As long as a prospective client has received a compliant presentation within the previous 12 months, the firm has met this requirement

What is a Compliant Presentation?

- A presentation for a composite that contains all the information required by the GIPS standards and may also include additional information or supplemental information
- Typically includes a table with numerical information and a series of disclosures

**Sample 1 Investment Firm
Balanced Growth Composite
1 January 2002 through 31 December 2011**

Year	Composite Gross Return (%)	Composite Net Return (%)	Benchmark Return (%)	3 Yr St Dev Composite (%)	3 Yr St Dev Benchmark (%)	Number of Portfolios	Internal Dispersion	Composite Assets (\$ M)	Firm Assets (\$ M)
2002	-10.5	-11.4	-11.8			26	4.5	165	236
2003	16.3	15.1	13.2			32	2.0	235	346
2004	7.5	6.4	8.9			38	5.7	344	529
2005	1.8	0.8	0.3			45	2.8	445	695
2006	11.2	10.1	12.2			48	3.1	520	839
2007	6.1	5.0	7.1			49	2.8	505	1,014
2008	-21.3	-22.1	-24.9			44	2.9	475	964
2009	16.5	15.3	14.7			47	3.1	493	983
2010	10.6	9.5	13.0			51	3.5	549	1,114
2011	2.7	1.7	0.4	7.1	7.4	54	2.5	575	1,236

Sample 1 Investment Firm claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 1 Investment Firm has been independently verified for the periods from 1 January 2000 through 31 December 2010. The verification report is available upon request. Verification assesses whether 1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and 2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Notes:

1. Sample 1 Investment Firm is a balanced portfolio investment manager that invests solely in US based securities. Sample 1 Investment Firm is defined as an independent investment management firm that is not affiliated with any parent organization. Policies for valuing portfolios, calculating and reporting performance results, and preparing compliant presentations are available.
2. The Balanced Growth Composite includes all institutional balanced portfolios that invest in large cap US equities and investment grade bonds to provide long-term capital growth and rising income from a well diversified strategy. While the strategy allows for equity exposure in the range of 50–70%, the typical allocation is between 55–65%. Only portfolios greater than \$5 million are included in the composite.
3. The custom benchmark is 60% YYY US Equity Index and 40% ZZZ US Aggregate Bond Index. which

Who is a Prospective Client?

Any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite. Existing clients may also qualify as prospective clients for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as prospective clients if they represent investors that qualify as prospective clients

Compliant Presentations

- Common practice is to treat compliant presentations (CP) as “SEC advertisements”
 - Which returns are presented
 - Which disclosures are included

GIPS Advertising Guidelines

- Allow a firm to state it complies with the GIPS standards in something other than a fully compliant presentation
- Advertising Guidelines do not replace the GIPS standards
- Complying with the GIPS Advertising Guidelines is voluntary

GIPS Advertising Guidelines

- In an advertisement, a firm has three options
 - Include an ad prepared in accordance with the GIPS Advertising Guidelines
 - Include a compliant presentation
 - Do not mention the GIPS standards
- Regardless of the option selected in any advertisements, the firm still has the compliant presentation delivery obligation

Applicability

SEC

- Applies to prospects and clients
- Disclosure and content may vary based on the audience; more leeway with “sophisticated” clients
- Use of composite performance
 - Few rules, though changing composite may signal cherry picking
 - SEC interested in composite maintenance controls

GIPS standards

- Use of composite performance is required
- Only obligation is to make every reasonable effort to provide a CP to all prospective clients
 - And to ongoing prospective clients at least once every 12 months
- Not required to provide a CP to current clients
 - Current clients can qualify as prospective clients for a different strategy

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Net vs. Gross Returns

SEC

- Net required in advertisements
- Gross ok alongside net with equal prominence
- Gross ok in one-on-one presentations - private meeting with sophisticated prospect (including groups) - opportunity to ask questions
- If using gross only, need disclosure about the effect of fees on performance

GIPS standards

- Either gross or net returns may be presented in CPs
 - Gross is recommended to allow for better comparability between firms
- But must also comply with any applicable laws and regulations regarding the calculations and presentation of performance
- Therefore common practice is to include both gross and net returns in CPs

Net Returns

SEC

- May deduct actual advisory fee paid by client, or adviser's highest standard fee
- Disclose basis used to deduct fee

GIPS standards

- If use model fees, net returns must be lower than net returns calculated using actual fees
- Common practice is to use model fees
 - Deduct 1/12th of the highest tier of the applicable fee schedule from the monthly gross composite return
- Must disclose if net returns are calculated using actual or model fees, and if performance fees are reflected in the net returns

Timeliness of Returns

SEC

- Can't be false or misleading
- Use current returns
- Can't cherry pick
- No hard and fast rules – tread carefully

GIPS standards

- Only annual returns must be included in CPs
- Must update CPs at least annually
 - May update more frequently
- No guidance as to how soon after year end/other period end new returns must be included

Composite vs. Fund Returns

SEC

- No hard and fast rules, but antifraud focus on cherry picking
- While composite performance provides more flexibility, may show fund performance so long as prospect is eligible to invest
- Need thoughtful / required disclosures

GIPS standards

- Must determine if marketing a fund or composite strategy
- If marketing a fund, provide fund information
- If marketing a composite strategy, must provide the appropriate composite's CP

AUM/Firm Assets

SEC

- Form ADV Part 1: Regulatory AUM (RAUM)
- May use another reasonable method for other uses (including ADV Part 2A); may differ from RAUM
- Discretionary v. non-discretionary assets

GIPS standards

- Must disclose total firm assets as of each annual period end
- Total firm assets includes:
 - All portfolios for which the firm has conditional or unconditional trading authority
 - Discretionary and non-discretionary portfolios
 - Fee-paying and non-fee-paying portfolios
- Total firm assets excludes
 - Portfolios without trading authority
 - Model portfolios
- Must not double count assets

Disclosures – RAUM

ADV Part 1 (RAUM)

- Securities Portfolios: must include
 - Family or proprietary accounts
 - No-fee accounts
 - Foreign accounts
- Cannot deduct indebtedness/liabilities
- Continuous and regular supervisory and management services

Prior ADV Part 1 AUM

- Securities Portfolios: may include
 - Family or proprietary accounts
 - No-fee accounts
- Accounts of non-US persons

Definition of Firm

SEC

- No requirement to disclose
- SEC requires disclaimer in Form ADV 2A if say, “Get Rich Advisers, Inc. is an SEC-registered adviser...”
- Disclaimer: SEC registration does not imply a certain level of skill or training

GIPS standards

- Must disclose the definition of the firm in CPs
- Becoming more common to include the SEC disclaimer in CPs and other marketing materials that mention SEC registration

Supplemental Information

SEC

- GIPS term
- If included in marketing materials, all SEC guidance applies

GIPS standards

- Supplemental information is any performance or performance-related information included as part of a CP that supplements or enhances the required and/or recommended provisions of the GIPS standards
- Must not contradict or conflict with the GIPS standards
- Must be clearly labeled and identified as supplemental to a specific CP

Representative Accounts

SEC

- Can raise past specific recommendation issues
- TCW Group no-action letter
- No “cherry picking”
 - Equal number of holdings (at least 5) on each side, plus weight and % contribution
 - Objective methodology and consistent presentation across periods
 - Equal prominence
- Disclosures

GIPS standards

- Considered supplemental information
- Subject only to the requirement to not present performance or performance-related information that is false or misleading

Recordkeeping Requirements

SEC

- Performance: must maintain info to support performance calculations forever
- Other records: varies, generally 5 years for advisers, 6 years for mutual funds
- Custody statements
 - If receive, need to keep
 - Paper vs. electronic

GIPS standards

- Must maintain records to support all information included in compliant presentation, including supplemental information
- Once information is deleted from a CP, no longer required to maintain those records
- But SEC requirements trump GIPS requirements

Policies and Procedures

SEC

- Firms required to adopt and implement policies and procedures reasonably designed to prevent violations of applicable rules
- Key: policies need to be customized around firm's actual business practices

GIPS standards

- Firms must document all of their policies and procedures used in establishing and maintaining compliance with the GIPS standards
- Includes ensuring the existence and ownership of client assets
- Must apply them consistently

Error Correction - SEC

- No official rule – fiduciary responsibilities and anti-fraud expectations apply
- Traditional SEC focus on error correction directed towards investment and trading errors
- In performance advertising context, SEC focus is on anti-fraud principles
- Client reporting and disclosure obligations need to be assessed

Error Correction - GIPS

- Obligation is to provide a CP to all prospective clients: assumption is that the information included in the CP is correct
- Firms must establish an error correction policy to address how to handle errors in CPs and other directly-related materials (e.g., the list of composite descriptions)
- Does not apply to other marketing materials, including advertisements in which the firm claims compliance following the GIPS Advertising Guidelines

Error Correction

SEC

- Duty to disclose restatement? Consider:
 - Fiduciary duty
 - Anti-fraud provisions
- Self-reporting considerations

GIPS standards

- Material errors must be disclosed in the corrected CP for at least 12 months
- Corrected CP (with material error disclosure) must be provided to all prospective clients that received the erroneous CP

Portability

SEC

- General principle: Investment performance is earned by a firm, not an individual
- Allowable under certain conditions
- Cannot be misleading
- May encounter record ownership issues
- Horizon Asset Management no-action letter

GIPS standards

- General principle: same as SEC
- Very strict requirements for being able to port a composite's track record from a prior firm and link it to performance at the new firm
- Unless it is a friendly acquisition, portability tests probably will not be met

GIPS Disclosure Requirements in Guidance Statements

Calculation Methodology (Jan. 1, 2011)

- Changes in methodology discloseable without regard to materiality
- Treatment of withholding taxes if material
- Policies on valuation, calculation of performance and preparation of compliant presentations available on request (vs additional information)

Composite Definition (Jan. 1, 2011)

- Disclose minimum asset level for inclusion in composite and any changes
- Disclose composite creation date and any redefinition of composite (and date, description and reason)

Error Correction (Jan. 1, 2011)

- Disclosure of errors – for 12 months following correction
- Policies and Procedures on error correction (including errors involving missing disclosures)

Performance Portability (Jan. 1, 2011)

- Disclose if ported performance is linked
- Disclose use of sub-advisors and relevant periods
- Disclose key changes (i.e., changes of control, key people)

Recordkeeping (Jan. 1, 2011)

- Disclose use of performance despite unavoidable destruction of backup & reasons why records unavailable

GIPS Disclosure Requirements in Guidance Statements

Definition of the Firm (Jan. 1, 2011)

- Disclose definition of Firm
- If multiple subsumed entities, must list
- Date, reasons and description of any redefinition
- Use of sub-advisers

Fees (Jan. 1, 2011)

- Disclose applicable fee schedule
- With gross, whether any fees or expenses (other than trading costs) are deducted
- With net, what fees are netted, if model or actual fees are used, if returns are net any performance fees
- Bundled fees

Treatment of Carve-Outs (Jan. 1, 2011)

- Disclose percent of composite assets carved out

Wrap Fee/SMA Portfolios (Jan. 1, 2011)

- Composite with SMA and non-SMA accounts with additional disclosure
- Disclose that SMA performance includes pre-SMA performance (and periods)
- Gross/Net information
- Sponsor specific – if gross, must say internal use

GIPS Disclosure Requirements in Guidance Statements

Alternative Investment Strategies and Structures (Oct. 1, 2012)

- Evaluate “need for increased disclosure” of complex strategies
- With new strategy with no appropriate composite, disclose that firm does not currently manage the specific strategy
- Disclose if composite’s valuation hierarchy materially differs from GIPS Valuation Principles
- Disclose use of subjective unobservable inputs for valuing investments if material
- Disclose if pricing has been performed internally
- Disclose if firm opts out of monthly valuations
- For composites with investments that do not lend themselves to monthly valuations and in which the underlying fund is open to client cash flows only on a less frequent (e.g., quarterly) basis, disclose that the three-year annualized ex-post standard deviation is not presented for the composite (and benchmark if applicable) because monthly returns for the composite (benchmark) are not available
- Disclose if using estimates to fair value and percentage of assets valued using estimates

GIPS Disclosure Requirements in Guidance Statements

Alternative Investment Strategies and Structures (Oct. 1, 2012)

- Disclose if a portfolio or fund in the composite creates a side pocket
- Disclose “all significant events” (e.g., events related market, composite or the firm”)
- Disclose “presence, use, and extent of leverage, derivatives, and/or short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks”
- Disclose if illiquid securities are a significant part of the strategy or if there is a strategic intent to invest in illiquid investments
- Disclose the benchmark description
- If firm determines that no appropriate benchmark exists, disclose why none is presented
- If firm uses a custom benchmark or combination of benchmarks, disclose the benchmark components, weights, and rebalancing process
- Disclose if firm presents portfolio or composite performance eliminating “cross-investments”

Questions

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