

# HAS YOUR TRACK RECORD BEEN 'AUDITED'?

ANDREW HALPERIN AND PHILIP DEROSA OF EISNERAMPER DISCUSS THE IMPORTANCE OF PERFORMANCE REPORTING SOLUTIONS IN THE INVESTMENT INDUSTRY



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**A**gainst the backdrop of increasing scrutiny by the investment community and regulators, combined with the challenging capital-raising environment, it has become critical for investment managers to demonstrate the integrity of their reported investment performance statistics. This scrutiny was further buoyed on 9 January 2014, when the SEC's Office of Compliance Inspections and Examinations (OCIE) published its examination priorities for 2014. The OCIE identified marketing and performance as core risks within the Investment Adviser/Investment Company Program.<sup>1</sup>

To that end, engaging a third-party to independently validate performance statistics can yield immeasurable benefits:

- First, investment managers would gain a marketing advantage by abating questions about past performance, thereby enabling the managers to focus on why their investment strategies are likely to continue to be successful in the future.
- Second, it would help investment managers demonstrate the integrity of their performance statistics to regulators by uncovering issues with the accuracy, completeness and disclosures of such statistics in advance of potential regulatory scrutiny.
- Third, it would demonstrate a commitment to best practices and transparency which would instil confidence in investment managers by investors.

Attorney Bertrand Fry, a partner with Pryor Cashman LLP, explains: "When an investment manager's track record comes under regulatory scrutiny, the regulator will focus keenly on the investment manager's data that supports the performance presentation. Under the record-keeping requirements of the Investment Advisers Act of 1940, a registered investment adviser is required to maintain the supporting records for at least five years after the relevant performance presentation is used in marketing. The SEC staff have been clear that in their examinations they will look for records prepared by a third-party (e.g. custodial or brokerage statements) confirming the performance presentation and reports prepared by an independent auditor that verify

the investment manager's advertised performance. Having such records also proves valuable when an investment manager or a portfolio manager seeks to transfer a track record from one fund or fund complex to another. More generally, by involving an independent auditor in the preparation and verification of track record information, an investment manager ensures that it will approach the process with rigour. Some of the determinations to be made when compiling and presenting a track record – e.g. how to present performance net of fees; what items to disclose as potentially having a material effect on the similarity of two accounts' track records – are complex and benefit from the insight and judgment of an independent auditor."

There is no one-size-fits-all solution. The optimal solution will be based on the facts and circumstances of each particular situation. Whether starting a new hedge fund, private equity fund, fund of funds or launching a new strategy as part of a large investment company complex, both emerging and established investment managers are advised to consider the merits of third-party performance reporting engagements, adjusted to fit specific needs. Doing so will better prepare the investment manager when faced with the question: "Has your track record been 'audited'?"

It is important for investment managers to understand the different solutions available to them when engaging a third-party to validate their performance statistics. The following table summarises prevalent options, although additional options may be available, and compares the relative advantages and disadvantages of each across several key factors. ■

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<sup>1</sup> In the release, the OCIE wrote: "The staff will review the accuracy and completeness of advisers' claims about their investment objectives and performance. For example, the staff will review and test hypothetical and back-tested performance, the use and disclosure of composite performance figures, performance record keeping, and compliance oversight of marketing. The staff also expects to review marketing efforts arising out of newly effective rules adopted under the Jumpstart Our Business Startups (JOBS) Act."

\*NB Nancy Grimaldi, a partner in EisnerAmper's financial services group, also contributed to this article

	Compilation	Agreed Upon Procedures (AUP)	Review	Examination	GIPS Examination
What is involved?	The IM determines the performance statistics to be calculated by the accountant.	The IM performs the calculations and determines procedures to be performed by the IA.	The IM performs the calculations. The IA determines the limited procedures to perform.	The IA determines procedures used to assess whether the investment performance schedule materially represents the investment returns of the entity.	The IA performs an examination against a global investment reporting standard.
What does the IM receive?	The accountant issues a report stating he/she compiled the information.	The IA issues a report presenting: <ul style="list-style-type: none"> <li>• procedures performed and</li> <li>• any findings.</li> </ul>	The IA issues a report providing <i>limited assurance</i> ** about the presentation of the performance statistics.	The IA issues a report providing <i>reasonable assurance</i> *** about the presentation of the performance statistics.	The IA issues a report providing <i>reasonable assurance</i> *** whether a firm ("verification") and, if desired, a composite ("performance examination") are in compliance.
Advantages	<p><b>Effort/Complexity:</b> accountant performs calculations; less work for IM</p> <p><b>Marketability:</b> reports can be distributed for general use in marketing materials</p>	<p><b>Effort/Complexity:</b> extent of information provided by IM and procedures performed by IA are flexible/customizable</p>	<p><b>Effort/Complexity:</b> IA's procedures are limited in scope</p> <p><b>Assurance:</b> a level of assurance is provided, unlike a compilation or AUP</p> <p><b>Marketability:</b> reports can be distributed for general use in marketing materials</p>	<p><b>Assurance:</b> higher level of assurance than a review; similar to an audit</p> <p><b>Marketability:</b> reports can be distributed for general use in marketing materials</p>	<p><b>Assurance:</b> provides examination level of assurance, based on an industry standard framework</p> <p><b>Marketability:</b> reports can be distributed for general use in marketing materials</p> <p><b>Standardization:</b> strict adherence to framework is required</p>
Disadvantages	<p><b>Assurance:</b> provides no level of assurance; may be unsatisfactory to some users</p> <p><b>Standardization:</b> performance statistics may be calculated using various methodologies; no standard framework</p>	<p><b>Assurance:</b> provides no level of assurance; may be unsatisfactory to some users</p> <p><b>Marketability:</b> reports are restricted to users who agree to the sufficiency of the procedures</p> <p><b>Standardization:</b> performance statistics may be calculated using various methodologies; no standard framework</p>	<p><b>Standardization:</b> calculation methodologies may be more limited than with a compilation or AUP</p>	<p><b>Effort/Complexity:</b> procedures are usually more complex than AUP or review</p> <p><b>Standardization:</b> calculation methodologies may be more limited than with a compilation or AUP</p>	<p><b>Effort/Complexity:</b> involves more complex and extensive procedures by the IA than other types of engagements; additional work for IM</p>

IA - "Independent Accountant"  
IM - "Investment Manager"

\*\**Limited Assurance Opinion* - IA determines limited procedures to identify whether anything comes to his/her attention indicating the performance statistics are materially misstated

\*\*\**Reasonable Assurance Opinion* - IA determines procedures to assess whether the performance schedule presents, in all material respects, the investment returns of the entity