THE VERIFIER

First Quarter 2005

Guidance Statements Out For Comment

The Investment Performance Council (IPC) recently released five new Guidance Statements for public comment. All five statements are proposed to be effective January 1, 2006. The following are open for comment until February 28, 2005:

Error Correction:

Upon the discovery of an error a firm must evaluate if and how the error should be corrected. The guidance provided in this six page statement should be applied to all types of errors not only errors involving calculations. In order to address the issue of error correction, a firm should first establish the following: written policies and procedures, definition of materiality and an error correction process.

Verifier Independence:

This six page guidance statement addresses the main areas in which conflicts of verifier independence may arise and considerations prior to the acceptance of an engagement. Examples of what may constitute a conflict of interest include the verifier creating source data, establishing policies and procedures, and other situations in which the verifier acts in the capacity of management. Providing clients with spreadsheet templates or compiling disclosures does not necessarily create a conflict of interest, but it's important the client understands and accepts full responsibility for calculation methodologies applied and the origination of disclosures.

The comment period closes **December 31, 2004** for the following:

Leverage and Derivative

This four page statement requires the establishment and maintenance of a leverage policy. It also describes various recommended risk measures (not required) that a firm utilizing leverage could present. The statement provides guidance on how these risk measures should be calculated in a useful thirteen page appendix.

EFFECTIVE JANUARY 1, 2005:

Trade-date accounting required under both AIMR-PPS and the proposed GIPS.

Visit www.cfainstitute.org for more information.

Recordkeeping:

The basic guideline in this useful four page checklist is that a firm must maintain sufficient records that allow for the recalculation of account-level and composite-level returns. Although not explicitly stated in this document, we recommend to our U.S. clients based on past SEC interpretations that third party documents be retained to support the firm's performance whenever available.

SEC Watching Hedge Fund Advisers

Recently, the SEC voted to adopt new Rule 203(b)(3)-2 under the Investment Advisers Act of 1940 ("IA Act") to clarify that investment advisers may not count hedge funds as single clients. Many hedge fund advisers have avoided IA Act registration by relying on Rule 203(b)(3)-1 paragraph (a)(2)(i), which permits advisers to count a legal organization, rather than its owners, as a single client. These advisers would be required to register with the SEC (assuming they have over $25 million in assets under management) by February 1, 2006.

Ashland Checklist

The **four key** steps for hedge fund managers to prepare for registration and to meet ongoing compliance requirements:

1. Establish a timeline for becoming compliant,
2. Establish a Compliance Committee,
3. Become familiar with all requirements of the IA Act / registration,
4. Designate a Chief Compliance Officer.

A firm's compliance officer / department should always approach compliance with an understanding of what business practices the SEC and other law enforcement agencies are scrutinizing. In their reviews of hedge fund managers, the SEC will be taking a "risk based approach". They will be looking particularly for manipulative business practices and conflicts with client interests in trading policies.

At a recent web cast held November 17th, tilted "The Costs of Compliance: Preparing for Hedge Fund Regulation.", the following recommendations were given to hedge fund managers by the panel:

- Review your business practices over the next 14 months, to ensure compliance;
- Those hedge fund managers who fall below $25 million will find that more states will be making the same requirements as the SEC and should prepare to be compliant;
- Firms should register with the SEC voluntarily and "beat them to the punch", given that firms registering at the last minute invite the SEC to look at them with greater scrutiny.

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Guidance Statements

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Wrap Fee/Separately Managed Account (SMA) Performance:

This guidance is the same as the previously issued 2003 wrap guidance regarding options to define a compliant firm to exclude wrap accounts, to exclude non-wrap accounts or to include both, keeping in mind the fundamental principals for the Guidance Statement on Definition of the Firm to be as inclusive as possible.

Recordkeeping

Many firms in SMA programs do not have access to the records needed to substantiate performance. Three options for those firms: 1) conduct due-diligence on the sponsor and place reliance on sponsor calculations, and obtain an agreement with the sponsor to secure access to the underlying records 2) conduct "shadow accounting", by keeping track of SMA accounts internally in addition to using the sponsor system and 3) exclude the SMA division from the firm definition. It is further stated that prior to 1/1/06, with proper disclosure, a firm may link performance without the necessary records. However, this contradicts the U.S. regulatory requirement to maintain records to substantiate presented performance. There is some indication the SEC might support the books and records amnesty period prior to 1/1/06 for wrap program members.

Additionally, and new to this version of the guidance statement, firms may treat an SMA sponsor as one portfolio for the calculation of composite dispersion, which makes recordkeeping for the dispersion calculation more manageable if books and records aren't available internally.

Presentation

Firms have different requirements when presenting SMA performance depending on whether the audience is a prospective or current client.

For prospective clients, the firm must show net performance, net of the entire bundled fee; gross performance can be shown as additional and/or supplemental information only. The firm is required to group the SMA accounts by investment style or strategy and not by specific SMA sponsor. However, firms can present sponsor specific presentations as additional and/or supplemental information. For current clients, the firm can choose to show either net or gross performance, but "pure" gross performance is still considered supplemental information. The firm is also permitted to present sponsor specific presentations to an existing sponsor, and may include the claim of compliance in this presentation as long as they have fulfilled all requirements on a firm wide basis and disclose that this presentation is only for use of the intended sponsor. For further information visit www.cfainstitute.org.

Hedge Funds

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Robert Plaze, Associate Director of Regulation for the Division of Investment Management said, "We would require these new registrants to retain whatever records they do have that support the performance they earned prior to their registration with us, but would excuse them from our recordkeeping rule to the extent that those records are incomplete or otherwise do not meet the requirements of rule 204-2. Once a hedge fund adviser has registered with us, of course, it must comply with our recordkeeping rule going forward," at the annual meeting of the National Society of Compliance Professionals on October 28.

Mr. Plaze also indicated that the compliance date for the newly Adopted Code of Ethics Rule 204A-1 would be extended to February 1, 2005. The original compliance date of January 7, 2005, would not have allowed an adviser's key persons, sufficient time to file their annual holdings reports of December 31, 2004.

The Ashland Corner

Timothy M. Simons, CFA, CFP

Partner

Tim is a frequent speaker on compliance issues for national and regional organizations. This year, Tim was appointed as a member of the GIPS Interpretations Subcommittee of the Investment Performance Council and elected to a three year term on the Board of Directors of the National Society of Compliance Professionals.

Before joining Ashland Partners, Tim was a Chief Compliance Examiner with the Philadelphia District Office of the U.S. Securities and Exchange Commission (SEC), where he supervised and participated in several hundred examinations of Investment Advisers and Investment Companies from 1988 to 2000. He uses that experience to assist clients with SEC compliance issues, advertising, and required disclosures, in addition to verifying investment performance to the AIMR-PPS® and GIPS®.

We are pleased to announce the **2005 Ashland Client Conference ("ACC")**, which will be held in three key locations across the United States:

- Los Angeles — March 21, 2005
- Chicago — June 20, 2005
- New York City — September 19, 2005

This client orientated format will focus on the recent developments and issues surrounding the PPS, as well as give attendees the opportunity to network and discuss other compliance challenges. Presentations will be made by Ashland's senior professionals and other industry experts.

The agenda for the March 2005 conference will be available via our website site www.ashlandpartners.com in the New Year.

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