

INVESTMENT PERFORMANCE COUNCIL ADOPTION OF THE GUIDANCE STATEMENT ON THE TREATMENT OF SIGNIFICANT CASH FLOWS

SUMMARY: In July 2001, the Association for Investment Management and Research (AIMR[®]) released for public comment the proposed Guidance Statement on the Treatment of Significant Cash Flows.

The Guidance Statement on the Treatment of Significant Cash Flows provides clarification to the Global Investment Performance Standards (GIPS[®]) relating to when an investment manager can remove a portfolio from a composite due to significant cash flows.

ADDITIONAL INFORMATION: For further information on the Guidance Statement on the Treatment of Significant Cash Flows, contact AIMR's Professional Standards and Advocacy department via facsimile at 434-951-5320, via e-mail at gips-info@aimr.org, or at 560 Ray C. Hunt Drive, P.O. Box 3668, Charlottesville, VA 22903-3668.

I. PURPOSE OF GUIDANCE STATEMENTS

Guidance Statements are developed to respond to questions that raise new and novel issues that are beyond the scope of the simple application of the Standards and/or require additional interpretation and clarification. They incorporate all of the applicable existing interpretations that have been published on a subject in an effort to consolidate all related information and add clarification.

II. SUMMARY OF COMMENTS

In general, most of the comments received during the public comment period were in support of the objectives of the Guidance Statement. Below is a summary of the comments received along with the changes generated by the comments. The firm or individual making each comment is indicated using the following abbreviations:

CAPS: Karyn Vincent, CFA; CAPS, Inc.

HSBC: Colin Kay; HSBC Global Fund Services Limited

PwC: Peter McNamara and Kelvin Laing-Williams; PricewaterhouseCoopers

SAAJ: The Security Analysts Association of Japan

TRPA: T. Rowe Price Associates, Inc.

UBS: Robert Clarke, CFA, William McCoy, CFA, and Paul Weller; UBS Asset Management

SPECIFIC COMMENTS ON THE PROPOSED GUIDANCE STATEMENT ON THE TREATMENT OF SIGNIFICANT CASH FLOWS

1. Responses to Specific Questions Posed in the Invitation to Comment

The Invitation to Comment document that accompanied the original proposal included specific questions related to the proposal. The questions and responses are as follow:

- a. Should firms only be allowed to remove portfolios from composites that are invested in less-liquid asset classes?

Comment: We do not consider that this Guidance should be restricted to less-liquid asset classes because either the Guidance or the firms themselves would need to define what constitutes a liquid investment. This is likely to prove impractical, as the notion of what is liquid can change over time and may vary according to the investment strategy adopted, even for different strategies in respect of similar investments (e.g. an index tracker of liquid equities may find cash flows more distorting than an active strategy in the same equities). (PwC)

- b. Should there be any consideration given to asset classes that have liquid futures markets by which firms can gain immediate exposure?

Comment: This decision should be left up to the firm. Many clients restrict the use of futures. (PwC, HSBC, UBS)

- c. Should Significant Cash Flows be defined according to the size of composite assets rather than size of the portfolio assets?

Comment: The size of the cash flow relative to either the portfolio or the composite as a whole should both be allowable measures in determining its significance. Utilizing composite assets could avoid the need to adjust for cash flows in portfolios when the overall impact on composite performance is not material. However, firms should consider the potential impact on composite dispersion when defining significance in terms of composite assets rather than portfolios. (PwC)

Comment: The level of “significance” should be base on a percentage of the portfolio assets. Cash flows that are small as a percentage of the composite assets, yet large relative to portfolio assets may skew the portfolio return and, therefore, increase composite dispersion. (CAPS, TRPA, HSBC, UBS)

- d. Should Significant Cash Flows be defined according to an absolute monetary value for each asset class? (e.g., £10 million for emerging markets equities) If so, how should these levels be determined?

Comment: The level of “significance” should be base on a percentage of the portfolio assets. Cash flows that are small relative to the absolute monetary value, yet large relative to portfolio assets may skew the portfolio return and, therefore, increase composite dispersion. (HSBC, PwC, UBS)

- e. Should firms be required to disclose any additional information regarding their Significant Cash Flow policy?

Comment: Firm’s composite presentations should be required to disclose the firm's policy on the removal of accounts due to significant cash flows, and the number of "removal events" for that composite during the period for which compliant results are being presented. (HSBC)

- f. When should this Guidance Statement become effective?

*Comment: 1 January 2002 (CAPS)
1 July 2002 (PwC)
1 January 2003 (HSBC)*

2. General Comments on the Guidance Statement

Comment: Since there are no provisions in the GIPS standards themselves regarding the treatment of significant cash flows, we think it is inappropriate from the viewpoint of compliance. Guidance Statements should exist only when there are no relevant provisions in the GIPS standards. We understand the purpose of the Guidance Statement is to respond to questions arising from important issues with respect to how to apply the GIPS standards, not to incorporate additional requirements in the guidance. Accordingly, we think draft GIPS requirements and recommendations for the treatment of significant cash flows should be proposed together with the Guidance Statement and adopted through due process established by the IPC. (SAAJ)

GIPS provision 3.A.5. states “Portfolios must not be switched from one composite to another unless documented changes in client guidelines or the redefinition of the composite make switching appropriate. The historical record of the portfolio must remain with the appropriate composite.” This Guidance Statement adds clarification to this provision by addressing under what circumstances a portfolio may be removed from a composite. This Guidance Statement does not introduce new requirements to the Standards that firms must consider when claiming compliance. It simply offers a relaxation of provision 3.A.5., but lists specific rules that must be followed and disclosures that must be made if firms choose to follow this guidance.

Revision: None.

Comment: The Guidance Statement does not adequately address the role of verifiers on this issue. Verifying the application of this Guidance Statement adds to the responsibilities and costs of verifiers. (UBS)

This Verification Subcommittee of the Investment Performance Council determined this guidance was no different than any other guidance that is issued on the application of the Standards. The impact on cost will depend on how each firm implements the guidance and how the verification fee that is negotiated between the client and the verifier is structured. The Subcommittee did note that the documentation required under the guidance statement would simplify the verification exercise.

Revision: None.

3. Comments on “Cash Flow Definition” Section

The original proposal defined a "cash flow" as an external flow of cash and/or securities (capital additions or withdrawals) that is client initiated and may be defined as a single flow or as an aggregation of a number for flows within a stated period of time. The proposal also indicated that the guidance must not be applied to transfers of assets between asset classes within a portfolio or manager initiated cash flows.

Comment: There is no detail in the Guidance Statement as to how transfers of securities should be treated and whether any aspects of a cash flow policy can differ based on whether a flow is comprised of cash and/or securities. For example, it can be difficult to define what constitutes “significant” when securities are transferred, when conceivably the liquidity of the securities transferred and their similarity to the composite strategy may be of more importance than either the monetary value or the liquidity of the composite’s investments/strategy. (PwC)

While this is a possibility, it would require defining when a security is “illiquid”. These types of situations illustrate the usefulness of using a Temporary New Account structure.

Revision: None.

Comment: The Guidance Statement does not address client requests to raise cash over extended periods for a cumulative withdrawal. Client instructions may be received many months in advance of the cash out-flow. This type of event significantly restricts the firm’s ability to implement the intended strategy. This may, in fact, negate the firm’s discretion to the extent that the portfolio should be classified as non-discretionary. In this situation, the portfolio should be excluded from the composite beyond the standard grace period, assuming written client instruction is obtained. (TRPA)

In this case it seems that it may be appropriate to classify the portfolio as non-discretionary if the firm is truly not able to implement its strategy. The Guidance Statement on Composite Definition includes client cash flow requirements as an example of a client restriction that could be cause for classifying a portfolio as non-discretionary.

Revision: *Added reference to discretion section of Guidance Statement on Composite Definition.*

Comment: *The Guidance Statement states that “The “cash flow” may be defined by the firm as a single flow or an aggregate of a number of flows within a stated period of time.” The Guidance should indicate and discuss allowable definitions for “stated period of time” to remove inconsistency and subjectivity as far as possible. (PwC)*

In general, the Standards are written so as to not be overly prescriptive. Just as firms must define what “Significant” means, so they must also determine the period of time whereby multiple smaller flows have the cumulative effect of one Significant flow. The length of time will depend on the asset class and the size and frequency of flows

Revision: *None.*

Comment: *The Guidance states that “transfer of assets between asset classes within a portfolio or manager initiated flows must not be used to move portfolios out of a composite on a temporary basis.” Generally, we agree with this statement, but we also consider that there should be an exception in the case of carve outs, allowing the removal of portfolios, even if the manager made the asset allocation decision. (PwC)*

The purpose of this Guidance Statement is to allow firms to remove portfolios from a composite due to circumstances that are beyond the firm’s control (i.e., client driven cash flow that are so large that the firm cannot implement its strategy quickly enough so as not to cause a disturbance in the portfolio returns). Allowing firms to remove carve-out segments due to the firm’s actions (i.e., a strategic change in the asset allocation) would violate the fundamental principles of the Standards.

Revision: *None.*

4. Comments on “Temporary Removal of Portfolios with Significant Cash Flows” Section

The original proposal gave firms the ability to remove portfolios from a composite if it experienced a significant cash flow, provided certain policies and procedures were followed and certain disclosures were made.

Comment: The Guidance Statement should emphasize that firms must implement this guidance on a firm-wide basis and then select criteria for each composite. (PwC, CAPS)

All of the required disclosures and policies established in this Guidance Statement are applicable at the composite level as opposed to the firm level. It does not seem necessary to require firms to establish policies and definitions for all of the firm's composites if the firm does not wish to apply this guidance to all of its composites (e.g., single portfolio composites).

Revision: ***None.***

Comment: The Guidance Statement should emphasize the fact that if the application of this guidance leads to all portfolios being removed from the composite (e.g., a single portfolio composite), there will be a break in the composite performance record and the two periods cannot be linked. (PwC, CAPS)

This is an important point, especially for single portfolio composites. If a composite were to lose all its member portfolios, there would be a break in the performance record. Firms that have composites with only a few portfolios should strongly consider either defining Significance at a very high level or possibly determining that the Significant Cash Flows policy is not applicable to that composite. If a composite loses all of its member portfolios, whether that is due to Significant Cash Flows, termination, or some other reason, the performance record stops. If portfolios are later added to that composite, the two periods cannot be linked.

Revision: ***Added discussion of the implications of removing all of a composite's member portfolios due to Significant Cash Flows.***

Comment: The Guidance Statement should clarify if firms that are initially claiming compliance can apply this guidance historically when coming into compliance. (PwC)

This Guidance Statement is effective as of 30 June 2002. Firms can apply this Guidance for periods after that date. Firms cannot apply this Guidance to periods prior to the Effective Date.

Revision: ***Clarified applicability of the Guidance Statement.***

Comment: The Guidance Statement should recommend that firms review their policy regarding significant cash flows if the firm finds that it is frequently removing portfolios from composites. (PwC)

The Guidance Statement states that it is expected that removal of portfolios due to Significant Cash Flows will be an infrequent occurrence for composites invested in larger, more liquid asset classes. The suggested comment strengthens this statement.

Revision: *Added recommendation for firms to review their policy if it finds that it is frequently removing portfolios due to Significant Cash Flows.*

Comment: *The proposal makes reference to the grace period of new portfolios for the purposes of bringing an excluded portfolio back into the composite. This section should also indicate the timing of when a firm can initially exclude a portfolio from the composite under its cash flow policy. We believe that the timing must be consistent with the firm's policy for terminated accounts. (PwC)*

The GIPS standards require that “Terminated portfolios must be included in the historical record of the appropriate composites up to the last full measurement period that the portfolio was under management.” Similarly, portfolios that are removed due to Significant Cash Flows must be removed as of the beginning of the period in which the flow occurred.

Revision: *Clarified when a portfolio must be removed.*

Comment: *We believe that a new portfolio is different from a portfolio that has experienced a significant cash flow, and thus should not be treated in the same manner. A new portfolio will typically start with 100% cash, or a portfolio of securities that may need to be completely changed. Time is needed to invest the entire portfolio, and a Grace Period allows a firm to invest the portfolio in the intended style. In contrast, a portfolio with a significant cash flow is already invested in the style. For a certain period, the portfolio will be impacted by the significant cash flow, resulting in a temporary non-fully discretionary status. However, the time period needed to handle the significant cash flow is typically much shorter than that needed to invest a new portfolio. Following the Grace Period re-inclusion rule may result in excluding the portfolio for longer periods than is necessary to not impact the composite.*

We would rather see a firm re-include a portfolio as soon as possible, and minimize the amount of time it is excluded from the composite. We suggest that the Guidance Statement be changed to allow a firm to exclude a portfolio only for the period in which the significant cash flow occurred. (CAPS)

The amount of time needed to invest a cash flow will depend on the asset class, strategy, and size of the cash flow. If a portfolio receives a 150% cash flow, it is reasonable to assume that it would take as much time, if not more, to invest this new cash than it did to invest the original portfolio. Limiting the exclusion to the period in which a Significant Cash Flow occurred would have a negative impact if the cash flow were received near the end of the period. Requiring

firms to return portfolios “as soon as possible” allows for a degree of subjectivity. Requiring portfolios to be returns according to the Grace Period policy removes this subjectivity and reinforces the consistency of application.

Revision: ***None.***

5. Comments on “Disclosure” Section

The original proposal included a number of required disclosures that must be made and certainly documentation that must be kept if firms elect to apply this guidance.

Comment: Items 4 and 5 in the documentation section should be combined such that a firm is only required to document any significant cash flow in accordance with its cash flow policy. That is, if the policy defines significance according to the size of the portfolio, the required documentation should be of the amount as a percentage of the portfolio, if the policy is based on composite size, the documentation should be of the cash flow as a percentage of the composite. (PwC)

Comment: We suggest removing the requirement to document the cash flow’s percentage of composite assets, as it has no bearing on the temporary removal of a portfolio. The information would also not be useful, and might be misleading, as the cash flow may be a very significant percentage of the portfolio, but a completely insignificant percentage of the composite, if the composite is very large and the portfolio is very small. (CAPS)

Comment: The documentation of a cash flow’s percentage of composite assets would add little incremental value to the reader and would place an unreasonable administrative burden on the firm. (TRPA)

The documentation of the cash flow as a percentage of composite assets can give some indication of the size of the flow relative to the asset class. While composite assets do not necessarily give an indication of the size and liquidity of the asset class, it does provide another point of reference. The reason for removing portfolios because of significant cash flows is not because the portfolio return is different from that of the composite; in fact, the Guidance Statement states that this guidance cannot be applied after the fact (i.e., when the portfolio and composite returns are known). The purpose is rather that portfolios can be removed because it takes time to implement the firm’s strategy and, therefore, the portfolio is not representative of the composite strategy. In larger, more liquid asset classes, it should take less time to implement the strategy, and should, therefore, be less of a disruption in the portfolio’s return. However, because the measure of Significance is based on portfolio assets, firms should not be required to also document the cash flow as a percentage of composite assets.

Revision: ***Removed requirement to document the cash flow as a percentage of composite assets.***

Comment: Item 4 in the disclosures section states that disclosure is required if policies have been amended. This should be extended so that firms must also indicate the reason for the amendments. (PwC)

While the rationale for an amendment provides valuable information, simply requiring firms to disclose any amendments to its policy provides a prompt to prospective clients to ask for the rationale.

Revision: *None.*

Comment: The Disclosures section states that “upon request, firms must disclose to clients the number of times portfolios were removed in a given period, the number of portfolios removed and the amount of assets represented by the portfolios affected by the application of these policies to the composite.” This should either be a recommended disclosure or this should be deleted from the guidance.

The focus on clients receiving this information is misplaced. If it is recommended, this information should be disclosed to all users of the report(s), including prospects and consultants. The phrase “given period” is too vague. This information should be disclosed on an annual basis. (PwC)

Comment: Firms should be required to disclose that this information is available upon request; otherwise prospective clients would not know that the information is available. (CAPS)

Firms must disclose that this information is available upon request.

Revision: *Added required disclosure that additional details regarding Significant Cash Flows are available upon request.*

Comment: Firms should simply be required to disclose the firm’s policy with respect to significant cash flows and the number of removal events during the period presented. (HSBC)

The number of removal events is a piece of information that is available upon request and firms are not required to disclose this information on each composite presentation.

Revision: *None.*

Comment: The concept of significant cash flows and the resultant effect on composite performance is less understood by the recipients of the performance presentations, as compared to the performance measurement practitioners. The increased length and complexity of disclosures leads to less comprehension and therefore could minimize their effectiveness and value added. (UBS)

These disclosures present an opportunity to educate clients and discuss with them issues such as asset class liquidity.

Revision: *None.*

6. Comments on “Temporary New Accounts” Section

The original proposal included a section discussing the use of Temporary New Accounts as an alternative method for handling significant cash flows. The proposal indicated that the Temporary New Account method is expected to be required as of 1 January 2010 provided the necessary technology exists.

Comment: The use of Temporary New Accounts is the best solution for the treatment of significant cash flows. (UBS, CAPS)

The use of Temporary New Accounts remains the preferred method for handling Significant Cash Flows because it isolates the effect of the flow yet allows the remaining portion of the portfolio to stay in the composite. However, since there are very few software systems that are capable of this functionality, it does not seem practical to require the use of Temporary New Accounts at this time. It is expected that Temporary New Accounts will be required for the treatment of Significant Cash Flows in 2010.

Revision: *None.*

Comment: The proposal states that in the temporary new account cash inflow example described in the Guidance, “the funds would remain in the temporary new account until invested in line with the manager’s standard policy for the mandate and then be transferred to the main account.” However, as the Guidance simply refers to the cash inflow example provided, it is not clear whether the firm has discretion over when a new temporary account established from a cash inflow must be closed out (i.e., once the account is appropriately invested) or, for example, if it may be treated consistently with the firm’s policy for new portfolios. A discussion as to any valuation considerations and/or requirements upon the transfer of the temporary new account to the existing portfolio also may be helpful. (PwC)

As the name implies, Temporary New Accounts are temporary. Once cash flows have been invested or divested, these Temporary New Accounts would be closed. In the case of cash inflows, once the cash is invested, the securities would be added to the existing portfolio and the Temporary New Account would be closed. In the case of cash out-flows, once the cash has been distributed the Temporary New Account would be closed. It is expected that additional guidance will be issued in the future when Temporary New Accounts become required.

Revision: **None.**

Comment: The Guidance states that with respect to outflows "the account would reflect the withdrawal of funds and/or securities as a cash outflow of the portfolio, and the performance figures would be calculated to include this cash outflow at the date of transfer to the temporary account. Similar to inflows, there is no discussion as to any valuation considerations upon the establishment of the temporary new account. It is also not clear whether firms would have the option of accounting for the cash outflow as of the beginning of the period and not necessarily the date of withdrawal. In addition, we note that the example provided only makes reference to a cash flow taking place at the end of a month. More realistic examples with single and multiple flows taking place during the month could also be provided. (PwC)

Accounting for cash out-flows would take place at the time of notification and/or identification of the securities to be sold. It is expected that additional guidance will be issued in the future when Temporary New Accounts become required.

Revision: **None.**

Comment: The proposal indicates that beginning January 1, 2010 the use of temporary new accounts may be required. We support the eventual prohibition of temporarily removing portfolios from composites due to large cash flows. The Guidance should indicate that the use of temporary new accounts is expected to be a recommendation starting January 1, 2010 if feasible and cost effective. (PwC)

The expectation is that Temporary New Accounts will become a requirement, not a recommendation. When considering new requirements, the cost and feasibility of the changes play an important role in the deliberations.

Revision: **Added reference to consideration of cost and feasibility.**

III. Guidance Statement on the Treatment of Significant Cash Flows (REVISED)

Adoption Date: 13 March 2002

Effective Date: 30 June 2002

Retroactive: No

INVESTMENT PERFORMANCE COUNCIL (IPC)

Guidance Statement on the Treatment of Significant Cash Flows

Dealing with large external cash flows in a portfolio is a common struggle for most investment managers. These large flows, of cash and/or securities, can make a significant impact on investment strategy implementation and, thus, on a portfolio's and composite's performance. Accordingly, this Guidance Statement clarifies the issues related to the treatment of significant cash flows under the Global Investment Performance Standards (GIPS®).

Background

GIPS Section II.3.A.3 requires that composites include new portfolios on a timely and consistent basis after the portfolio comes under management - unless specifically mandated by the client (e.g., a client mandates a schedule of initial cash flows over several time periods and can prolong the length of time needed to implement the strategy). The GIPS standards were developed with the understanding that new portfolios may require a period of time (a "grace period") for a firm to fully implement the intended investment management strategy. During the grace period, the portfolio is not required to be included in a composite. The necessary length of this grace period may vary from composite to composite, depending on a number of factors that impact the implementation of an investment strategy. It is also reasonable that when cash flows to a portfolio are significantly large, the same process that governs the introduction of a new portfolio into a composite should apply.

Cash Flow Definition

For the purposes of this guidance statement, a "cash flow" is an external flow of cash and/or securities (*capital additions or withdrawals*) that is client initiated. Transfers of assets between asset classes within a portfolio or manager initiated flows must not be used to move portfolios out of composites on a temporary basis. The "cash flow" may be defined by the firm as a single flow or an aggregate of a number of flows within a stated period of time. In cases of multiple cash flows over an extended period of time, firms should refer to the Discretion section of the Guidance Statement on Composite Definition and consider whether the portfolio should be classified as non-discretionary.

Significant Cash Flows

Firms that wish to remove portfolios in cases of Significant Cash Flows must define what is meant by "significant" on a composite-by-composite basis. The definition may be influenced by the characteristics of the asset class(es) within the strategy, such as asset market liquidity, market volatility, and/or by the trading capabilities of the investment manager. (For instance, a Significant Cash Flow may be considered 10% of a portfolio's market value for an Emerging Market Fixed-Income composite but may be in excess of 50% of a portfolio's market value for a more liquid composite, such as European Equities). In theory, the determination of significance should primarily be based on the liquidity of the asset class and the investment strategy employed. Because of the dynamic nature of global markets and the inherent subjectivity involved, it is impractical to establish absolute levels of significance for each asset class. Theoretically, cash flows that are relatively small on a composite level, but relatively large on a portfolio level, can potentially distort the portfolio's performance and skew the measure of composite dispersion. The measure of significance must be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of portfolio assets (based on the most recent valuation).

Temporary Removal of Entire Portfolios with Significant Cash Flows

Provided the provisions below are met, firms are permitted to temporarily remove portfolios from composites if the firm believes that Significant Cash Flows can disrupt the implementation of the investment style and strategy for a portfolio. Firms must establish criteria (i.e., policy and definition) on a composite-by-composite basis. Firms are encouraged to establish Significant Cash Flow policies and definitions for all of its composites, but are not required to do so.

The temporary removal of a portfolio from the composite is similar to the grace period permitted for a new portfolio while the intended strategy is implemented. Firms must remove portfolios as of the beginning of the period in which the Significant Cash Flow occurs. In this respect, the portfolio is treated similarly to a terminated portfolio. Portfolios that are temporarily removed from composites due to Significant Cash Flows must be returned to their respective composite according to the firm's policy defining the grace period for new portfolios. The firm is required to define this grace period, and may do so on a firm wide or composite-by-composite basis.

Grace period policies, as well as definitions and policies concerning Significant Cash Flows, must be established and documented for each composite by the firm before they are implemented (preferably at the time each composite is created) and firms must not retroactively apply these policies to restate performance. Once implemented, the firm must consistently apply these policies (i.e., if a cash flow in a portfolio occurs that meets the definition of significant for that composite, the portfolio must be removed according to the guidelines). Firms must not remove portfolios on an ex-post basis (after the fact) when it can be determined whether the cash flow has helped or hurt performance. It should be noted that the removal of a portfolio due to a Significant Cash Flow will not affect the specific portfolio's performance history. The definitions and policies for Significant Cash Flows and Grace Periods for new or cash flow-impacted portfolios can be amended, but the amendments must not be applied retroactively. It is expected that the removal of portfolios due to Significant Cash Flows will be an infrequent occurrence, particularly in composites that are invested in the larger, most liquid asset classes. Firms are recommended to periodically review their policies regarding Significant Cash Flows,

especially if firms find that they are frequently removing portfolios due to Significant Cash Flows.

It is important to note that if all of a composite's portfolios were removed during one or more periods due to Significant Cash Flows, there would be a break in the composite performance record. Firms that have composites with only a few portfolios should strongly consider either defining the measure of significance at a very high level or possibly determining that a Significant Cash Flows policy is not appropriate for that composite. If a composite loses all of its member portfolios (whether that is due to Significant Cash Flows, portfolio termination, or some other reason), the performance record stops. If portfolios are later added to that composite, the two periods cannot be linked.

It is also important to note that removing a portfolio due to a Significant Cash Flow removes the portfolio when transaction costs are expected to be high. The intent of this Guidance Statement is not to allow firms to "hide" transaction costs, but rather to remove the potentially more disruptive effects that occur as a result of a Significant Cash Flow.

Documentation

Firms must document each time a portfolio moves into or out of a composite. Documentation should be part of the firm's record keeping process and, at a minimum, must include:

1. the date,
2. the amount of the cash flow,
3. if the cash flow is moving into or out of the portfolio, and
4. the amount of the cash flow as a percentage of the most recent portfolio market value.

Documentation will allow third-parties to easily determine whether firms have followed their grace period policy and definition of Significant Cash Flow.

Firms must document their definitions and policies regarding Significant Cash Flows, including the definition of the Grace Period and measure of Significance. Firms must also document any amendments that are made to the definitions or policies.

Disclosures

If a firm wishes to make use of the option to remove portfolios when Significant Cash Flows occur, then it must disclose the following items in each composite presentation:

1. how the firm defines a "Significant Cash Flow" for that composite,
2. the grace period for the composite,
3. if the definitions, policies, or grace periods for handling Significant Cash Flows have been amended, and
4. that additional information regarding the treatment of Significant Cash Flows is available upon request.

Upon request, firms must disclose to clients the number of times portfolios were removed during a given period, the number of portfolios removed, and the amount of assets represented by the portfolios affected by the application of these policies to the composite.

Temporary New Accounts

The use of Temporary New Accounts remains the most direct method for dealing with Significant Cash Flows. Under this methodology, when Significant Cash Flows occur in a portfolio, the firm may treat these cash flows as temporary "new" accounts. For example, if a Significant Cash Flow is withdrawn from a portfolio at the end of the month, the firm would move the necessary cash and/or securities into a Temporary New Account for liquidation and/or distribution to the client. In most cases Temporary New Accounts would not be included in any composite. The account would reflect the withdrawal of funds and/or securities as a cash outflow of the account, and the performance figures would be calculated to include this cash outflow at the date of transfer to the temporary account. The Temporary New Account would receive the funds and/or securities as a cash inflow. The assets would remain in this account until the funds are distributed. The same principles would hold true with a cash inflow. In this example, the funds would remain in the temporary account until invested in line with the manager's standard policy for the mandate and then be transferred to the main account.

Firms that are currently able to use a Temporary New Account methodology are encouraged to continue to do so. However, technology at the present time does not readily allow for the use of this method. It is anticipated that the Investment Performance Council (IPC) will adopt a requirement to use Temporary New Accounts to handle significant cash flows beginning January 1, 2010, provided that the technology and programming required exists and is not cost prohibitive. At that time, it is expected that the removal of portfolios due to significant cash flows will no longer be allowed. The firm's policy for the use of Temporary New Accounts must be defined and consistently applied in the same manner as the policy for the temporary exclusion of an account from a composite.

Effective Date

These changes are effective 30 June 2002. Firms must not apply these guidelines prior to the implementation date of the firm's policy and these guidelines must not be used to retroactively restate performance. Firms currently coming into compliance must not apply this guidance to composite performance for periods prior to 30 June 2002.