



Spotlight on Verifier Independence

A firm that claims compliance with the Global Investment Performance Standards (GIPS®) may voluntarily choose to be verified. Verification is the review of an investment management firm's performance measurement processes and procedures by an independent third party "verifier." Verification tests:

- Whether the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and
- Whether the firm's processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards.

Under the current GIPS standards, firms are strongly encouraged to be verified, as this adds credibility to a firm's claim of compliance. There has been much discussion concerning whether verification would eventually be mandatory, as was strongly desired by several countries that joined the one standard, GIPS bandwagon in 2005. However, as there was still a lot of concern that requiring verification would not be appropriate for all types of firms in all markets, the compromise position currently proposed is to require firms to disclose their verification status as part of the firm's claim of compliance with the GIPS standards.

While the topic of verification itself has been widely and hotly debated, there has been little debate over the term "independent" with respect to verifiers. In the current provisions and related verification guidance in the GIPS standards, the term "independent" is used many times. But within the GIPS standards themselves there is no definition for what it means for a verifier to be independent. This issue was addressed first in the Guidance Statement for Verification, which was issued in March 2002. This document did not provide much guidance with respect to defining independence, but it did hammer home the point that the verifier must be independent of the verification client. Subsequently, in October 2005, the Guidance Statement on Verifier Independence was issued to further address this topic. This guidance states, "Defining the term 'independent' is not a simple process. Crucial to the verification process is the assumption by all interested parties that the

verifier performs its services in an unbiased manner and is not verifying its own work." The Guidance Statement provides a variety of factors that should be considered when determining whether the verification firm is independent of the verification client. The guidance attempts to address the sometimes complex and multi-faceted relationship an investment firm could have with its verification firm, such as when a very large accounting firm provides verification services to a very large investment management firm. But, the guidance clearly states that a verifier cannot verify its own work. Contemplating the verifier's provision of other GIPS-related services to a verification client, the guidance states, "Verifiers must not:

- Step into a management role,
- Undertake any management function or a decision-making role relative to the implementation of and compliance with the GIPS standards, or
- Be in a position to verify their own work."

We think the most important statement in the Guidance Statement is as follows. "If a prospective client of the investment management firm places reliance on the verification firm's report, could the prospective client's perception of the value of the verification report be changed if the prospective client knew about other existing relationships between the investment management firm and the verification firm?"

While we think this guidance is quite clear, we believe there has been some liberal interpretation of what other services a verification firm may provide to their verification client. More than once we have been asked if we can provide composite creation and calculation services, and then do the verification. We unequivocally say no, that the independence requirements would forbid us from doing that. Sure, we could set up a different company with a different name and have that company calculate the composite results, but if this is done just to create the appearance of independence, we believe the facts remain the same. We could not do both the composite calculations and the verification, even under two different firm names. Yet we continue to hear about other

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firms doing exactly this, and wondered if we were being too conservative in our view. We discussed this topic with Jonathan Boersma, CFA, Executive Director, Global Investment Performance Standards, of the CFA Institute Centre for Financial Market Integrity, Yoh Kuwabara, Chairperson of the GIPS Verification/Practitioner Subcommittee, and David Spaulding, President of The Spaulding Group, Inc.

VPS: Jonathan Boersma (JB), thank you for taking the time to speak with us. As you know, the topic of verifier independence is near and dear to us. Looking ahead to the next version of the GIPS standards, do you believe the proposed change to the GIPS compliance statement, where firms will be required to disclose their verification status, will cause firms to more closely look at verifier qualifications, including independence?

JB: As previously disclosed in November 2007, the GIPS Executive Committee decided not to pursue mandatory verification for firms claiming compliance with the GIPS standards. Instead, the draft of the next version of the Standards will include a revised compliance statement that will propose specific language indicating whether the firm has, or has not, been verified. We hope that this new disclosure will call increased attention to the firm's verification status. Qualifications and independence considerations remain key considerations when choosing the verifier, but I think this proposed change will highlight these issues even more.

VPS: In your own words, what does the term "independent" mean when used in the context of the requirement that verification must be performed by an independent third party?

JB: Well, first it is important to point out that everyone believes independence is an important topic and that the verifier must be an independent party. I don't think there has ever been any doubt about that. However, the meaning of the word independent and the specific accompanying rules are where the challenges lie. We find that as we debate various scenarios regarding independence, there are a lot of different views as to what exactly it means to be independent. We are not attempting to duplicate the work that any regulators have done in this area, but rather wish to implement a global set of minimum independence requirements and guidance that is both fair and ethical, as independence rules on verification do not exist on a global basis.

As you know the current Guidance Statement on Verifier Independence does not include a specific definition of independence but rather includes guidance to help assess independence and to determine if an issue or violation exists. We certainly do not want the work of any verification firm to be clouded by the influence of any relationships they or their employees have with the entity being verified. This clearly will diminish the credibility of the verification and the reputation of each of the parties involved. When assessing independence, both the firm and their verifier should pause and consider whether another party, such as a user of the verification report, would come to the same conclusion if they knew all the facts and circumstances being addressed. If such knowledge would change the user's perception of the verification then it is safe to say that you are probably not independent and the verifier may need to walk away from the relationship. I am not saying all cases are easy to assess, but there needs to be a minimum framework in place so that users of GIPS presentations can feel comfortable in assuming the verification work was performed independently. Both the verification firm and the investment management firm really need to have strong policies and procedures in place regarding independence.

The bottom line for me is that "independent" is the opposite of "dependent". So if any of the work of the verifier is dependent on any other work that has been performed for the client, then there is an independence issue.

VPS: Do you think the language surrounding verifier independence should be strengthened?

JB: The whole notion of independence and verifier qualifications have been hot topics since the inception of the Standards. These are items that we continue to spend a lot of time thinking about and have had some discussions with the GIPS Executive Committee regarding where we are at this point. As the verification process has evolved verifiers have gotten more creative in how they structure themselves and we need to be on top of that. I can tell you that CFA Institute staff and the Verification/Practitioner Subcommittee are presently reviewing these issues as part of the GIPS 2010 process. If the conclusion is that our current guidance needs to be revised, we will do so. I think everyone would agree now that the three Verification Guidance Statements have been out for awhile, and there are certain items

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*Jonathan Boersma
CFA Institute*

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that we probably need to clarify. We are intent on making all the GIPS provisions and guidance clearer and we will not hesitate to strengthen them if deemed appropriate.

VPS: The guidance statement says that a verification firm must not verify its own work. What does that mean?

JB: A verifier cannot possibly be independent if they were to verify any of their own work or conclusions. The key point here is that a verifier cannot perform management functions. The list of items that would be considered management functions is probably unlimited and we do a reasonably good job of articulating those in the guidance statement, but perhaps it would be clearer if I provide some examples. If the verifier were to create the firm's GIPS policies and procedures they would not be independent. Similarly if the verifier were to determine composite assignments, calculate account performance, composite performance, determine valuations or prepare the compliant presentations they would not be independent as well. This doesn't mean they couldn't provide these services. However, they would not be able to perform the verification for that particular firm.

We then spoke with Yoh Kuwabara, Chairperson of the GIPS Verification/Practitioner Subcommittee.

VPS: Yoh Kuwabara (YK), the subcommittee you chair, the Verification/Practitioner Subcommittee, was responsible for creating the idea that the claim of compliance should be modified, as opposed to moving to mandatory verification. Did the topic of independence play a part in your decision?

YK: Throughout my experience as a verifier over the years, as well as working with various people who are knowledgeable of the market, I learned that there are differences among verification practices being undertaken by individual verifiers and market expectations of verification in individual countries. In addition, each country is on a different point of the learning curve. So, I thought it was not realistic to ask all managers in all countries to get verified in order to claim GIPS compliance.

Having said that, it doesn't mean verification isn't valuable. Undertaking verification will add confidence in the firm's claim of compliance, and increase the consistency and quality of the GIPS compliant presentations it makes.

No matter how verification is designed or defined, independence is always a very basic

and most important issue in that any attestation opined by an individual or entity who is not independent of the firm is just nonsense. Being not independent is not merely a weakness for the verifier. Rather, it is the clear sign that the verifier should refrain from conducting verification work and issuing an opinion letter.

To answer your question, unless I am specifically asked about independence, I have not focused on this issue as it is very obvious to me, and I'm sure to you as well, that verifiers should be independent of their clients.

VPS: In the U.S., we would call something that is so obvious a "no brainer." As the leader of the verification practice at Ernst & Young in Japan, do you encounter issues related to independence in your work?

YK: I'd say yes, fortunately or unfortunately. Just looking back the past year, I had a couple of occasions where we had to decline offers from prospective client firms due to our independence problems with those firms. The more lines of services we provide to one client firm, the more chance there could be where we cannot be independent of the firm. The issue of independence should be assessed not only from certain substance or fact, but also from appearance i.e., how we'd be viewed by others if we do this work for this client with whom we have this and that relationships.

On the other hand, I recently witnessed a case where in my honest opinion the issue of independence was not taken care of. Please understand that I don't have any preoccupation about other verification firms and no intention to interrupt their business promotion activities.

In one country that is near Japan, and where GIPS compliance has just started, a group of professional service providers under a strategic alliance are promoting one-stop shopping services to the investment management firms. According to their pitch book, the packaged services they jointly provide include GIPS compliance consultation, IT solutions for composite maintenance and/or performance calculations, and GIPS verification.

I looked into the Guidance Statement on Verifier Independence very closely, but couldn't find a clear statement banning the practice that came to my attention, which is most likely a loophole, I believe.

VPS: We agree. While the existing guidance provides a framework for assessing independence, it seems that some firms have

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Jonathan Boersma
CFA Institute

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taken the approach that if the guidance statement doesn't specifically prohibit a certain practice then it must be OK. As this guidance is more of a principles-based approach versus a rules-based approach, this does not seem like the right interpretation of the guidance to us. We can't help but think that prospective clients would have a very different view about the value of the verification report if they also knew that the verification firm priced the portfolios in the composites, assigned the accounts to composites, calculated the composites, and then prepared the presentations. But, given some of the practices we see, we would expect to see, as you say, a closing of some of these loopholes. How would you respond if a prospective client asked you to calculate composites and then do the verification?

YK: I'd say explicitly that, "We can either calculate composites or do the verification, but cannot do both definitely because we cannot verify our own work."

So, just to beat a dead horse, we talked with one of our industry colleagues, David Spaulding, President of The Spaulding Group.

VPS: David Spaulding (DS), your firm provides both consulting and verification services. How much attention does your firm pay to independence? Do you follow the same standard when you do work outside the US?

DS: We are sticklers for independence and make it clear to our clients and prospects that we cannot "cross the line" if we're engaged as a consultant. We believe that one's objectivity is potentially jeopardized if they are also providing consulting and tell our clients that we will not be able to serve as their verifier should our independence be

compromised. Our policy is consistent both domestically and globally. Just as the standards are global, the rules for verifiers are global, too. To take advantage, for example, of a less sophisticated market would run totally in conflict with the standards.

VPS: How would you respond if a prospective client asked you to get them into compliance, to go in and create and calculate composites, and then do the verification?

DS: The request to "get them into compliance" is one that clearly crosses the line of independence, and therefore we couldn't also do the verification; we could do one or the other but not both.

VPS: Here's an idea. Let's establish the Dave and Karyn Composite Calculation Company, and you and I can each own 50%. That company can do the composite calculations. Then, we can take turns doing the verifications for the clients of this company using our existing companies. Does this sound like a good plan?

DS: Of course! (oh, and I appreciate the top billing). Seriously, this would be an example of "crossing the line" and compromising independence. Using an affiliate doesn't obviate a verifier's obligations to remain independent.

VPS: We couldn't agree more. Thank you.

To conclude, we believe we all share the same view: that in keeping with the "spirit" of the Standards a verifier must be independent both in fact and in appearance. This means that just because there isn't a rule specifically prohibiting a verifier from doing something doesn't mean a verifier can do so without violating the principals of independence. We expect and hope to see more clarity on this topic in the future.

"We can either calculate composites or do the verification, but cannot do both definitely because we cannot verify our own work."

*Yoh Kuwabara
Ernst & Young*

Error Correction Guidance Statement Issued

A firm that claims compliance with the GIPS standards is required to make every reasonable effort to provide a compliant presentation to all prospective clients (GIPS Provision 0.A.11.) Inherent in this requirement is the assumption that the information included in the GIPS compliant presentations is correct and accurate. However, as we all know that errors are a fact of life, what happens when you have provided a compliant presentation that is later determined to be incorrect? The GIPS® Guidance Statement on Error Correction, which was recently finalized and issued, provides guidance on

this topic. Note that this guidance does not differ greatly from the old AIMR-PPS guidance. (See the June 2007 edition of **VPS Views & News** for more information). If you had established procedures to follow the old AIMR-PPS Q&A, you won't have much work to do. Key points from the final guidance statement follow.

The Error Correction Guidance Statement applies only to errors related to GIPS-compliant presentations. Just to make sure we are all on the same page,

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when we refer to the compliant presentation, we mean the composite presentation that includes the “chart” with annual returns, benchmark returns, the number of accounts in the composite, etc, along with the accompanying disclosures, including the GIPS claim of compliance. This guidance applies only to errors in the compliant presentation, or other directly-related materials. Other directly-related materials would include information that is referenced in the compliant presentation, such as the list and description of composites. The guidance statement does not apply to errors that appear in advertisements in which the firm claims compliance following the GIPS Advertising Guidelines, or errors in any other marketing materials.

An error is defined as any component of a compliant presentation that is missing or inaccurate. Errors are not limited to mistakes with composite returns. An error could result from a missing disclosure, an incorrect firm assets number, or any other incorrect or missing item included in the compliant presentation.

Error correction policies and procedures must be established and then implemented consistently. In the past, a firm could handle errors on a case by case basis. However, now a firm must establish procedures for how errors will be handled and then must follow the established procedures.

Materiality must be defined in the error correction policies. A firm must take specific steps if the error is material, so a firm must establish policies for determining what qualifies as a material error. However, materiality is a difficult issue to tackle. Materiality, like beauty, is in the eyes of the beholder, and can be dependent on so many things. For example, a 2 bps change in a quarterly composite return would probably be an immaterial change for an equity manager, but it could be considered material by a fixed income or passive manager. Each firm will need to decide for itself what represents a material error, and will need to determine a variety of materiality measures. The guidance statement says that a key determinant of materiality is whether the error might affect a prospective client’s decision to invest with your firm. Keeping this in mind, we’d suggest considering the following when determining a materiality threshold for errors in composite returns:

- **Determine over which period the error will be assessed.** Will you

measure an error relative to a monthly, quarterly, annual, or annualized return?

- **Include a “relative” component to your assessment.** Don’t just consider the absolute size of the error. Consider the error relative to the original composite return. A 10 bp change on an annual return of 20% is very different from a 10 bp change on a 2% annual return.
- **Take a fresh look at your composite presentations and think about how materiality would be assessed for each and every item in the presentation.** The more “stuff” you put in the compliant presentation and the more frequently you update the presentation, the more opportunities you have for an error. For example, the GIPS standards require presentations to be updated annually. You may update the presentation more frequently if you wish, to include year to date returns. But each time you update that presentation you are putting a stake in the ground and opening yourself up to potential errors. Also, if you include a myriad of cumulative and annualized returns, each of those could potentially be wrong. What if you discover an error from 2004? You have now reported incorrect annualized returns for multiple periods for several years. Instead of assessing whether one annual return has a material error, you now have many returns to assess.

A firm generally has four options for how errors will be handled. The four options are as follows:

1. Take no action.
2. Correct the compliant presentation with no disclosure of the change.
3. Correct the compliant presentation with disclosure of the change and no distribution of the corrected presentation.
4. Correct the compliant presentation with disclosure of the change and make every reasonable effort to provide a corrected compliant presentation to all prospective clients and other parties that received the erroneous presentation.

The type and materiality of the error will determine which option you will follow. We see option 3 as the most commonly followed procedure. Option 4 is the biggie, and you must include any disclosure related to the error in the compliant presentation for at least 12 months.

“Error correction policies must be established and then implemented consistently.”

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Vincent Performance Services LLC provides GIPS verification and consulting services to investment managers of all sizes and complexity located throughout the world. We are committed to delivering unsurpassed service based on a real understanding of the issues and a genuine enthusiasm for what we do.

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The notion of disclosing that the compliant presentation includes preliminary information is gone. This idea was included in the draft that went out for public comment but it is not included in the final version. Of course you can still include a disclosure stating that the results are preliminary, but that does not relieve you of your responsibility to apply your firm's error correction policies if an error occurs.

Ensure you have the ability to identify who received your compliant presentations. Most firms have the ability to identify who received the compliant presentations that are pro-

vided as part of the standard pitch book. If you don't, now is the time to start tracking this distribution. And don't forget about any advertisements or postings on your website that may have included compliant presentations. If you don't know who received the compliant presentation, how can you begin to attempt to provide the corrected presentation to everyone who received an incorrect presentation?

Effective Date is January 1, 2010. A firm must have policies in place by January 1, 2010 and must apply the established procedures to any error that is identified as of that date. Early adoption is strongly encouraged.

Register Now for the Annual GIPS Conference

The next annual GIPS conference, sponsored by CFA Institute, will be held on September 25th and 26th, at the Westin Copley Place in Boston. This conference is the must attend event for many of us in the performance world. The day before the conference, on September 24th, we will be co-instructing an introductory GIPS workshop. This workshop is targeted to performance professionals who are new to the GIPS standards, or wish to have a thorough refresher on

complying with the GIPS standards.

Registration information is on the GIPS standards website www.gipsstandards.org. We recommend registering early as both the conference and the workshop sold out last year.

Also, we will be hosting a dinner for our clients on Wednesday, September 24th. If you are attending the conference or are in the Boston area please plan on attending. Details to follow soon.