Global Investment Performance Standards

GIPS ERROR CORRECTION SURVEY

Executive Summary

About the Survey

In 2014, the United States Investment Performance Committee (USIPC), in conjunction with CFA Institute, conducted a survey to seek input on error correction policies and procedures used by firms that comply with the Global Investment Performance Standards (GIPS®). The purpose of this survey was to inform the investment industry on how firms develop and administer their GIPS standards compliance programs with respect to such policies and procedures. This executive summary analyzes the results of the survey, outlines what can be learned from it, and suggests best practices for firms to consider.

The GIPS Guidance Statement on Error Correction (the "Guidance Statement") requires firms that claim compliance with the GIPS standards to document and consistently follow policies and procedures to address errors related to compliant presentations. Under the GIPS standards, a compliant presentation is a presentation for a composite that contains all the information required by the GIPS standards and may also include additional or supplemental information. The Guidance Statement does not specifically address errors discovered in materials prepared by the firm other than compliant presentations.

Rates of GIPS Compliance

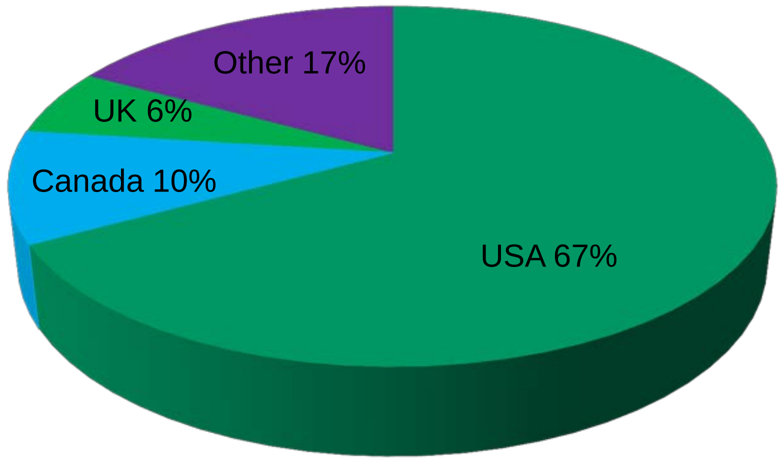
As an initial screening question, respondents were asked whether their firm claimed compliance with the GIPS standards (because the rest of the survey was only applicable to firms that actually claim compliance). Seventy-four percent of the 302 total respondents indicated that their firm claimed compliance, which is fairly consistent with statistics reported in other industry surveys (such as a 2014 survey conducted by eVestment and ACA Performance Services in which 72% of respondents indicated that their firm claimed compliance with the GIPS standards). Currently, surveys such as this provide the only indicators of overall rates of compliance because there are no comprehensive statistics available on the subject; however, that should change in the near future with the new requirement that GIPS-compliant firms must notify CFA Institute of their claim of compliance on an annual basis. CFA Institute may publish summary statistics of reported rates compliance, which would provide the industry with some additional transparency around how broadly accepted the GIPS standards have become.

Demographics

To provide the proper context for how these results will be interpreted, the following demographic information was gathered:

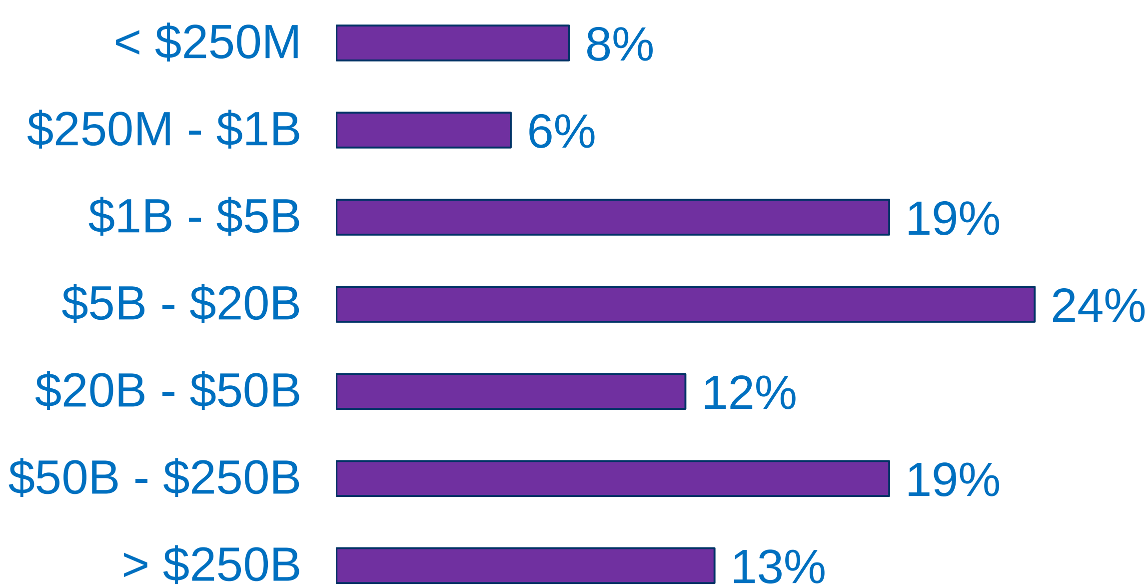
- 67% of the responses came from the United States, 10% from Canada, 6% from the United Kingdom, with the remaining 17% broadly distributed with no one region accounting for more than 2%.

BREAKDOWN OF RESPONSES BY COUNTRY



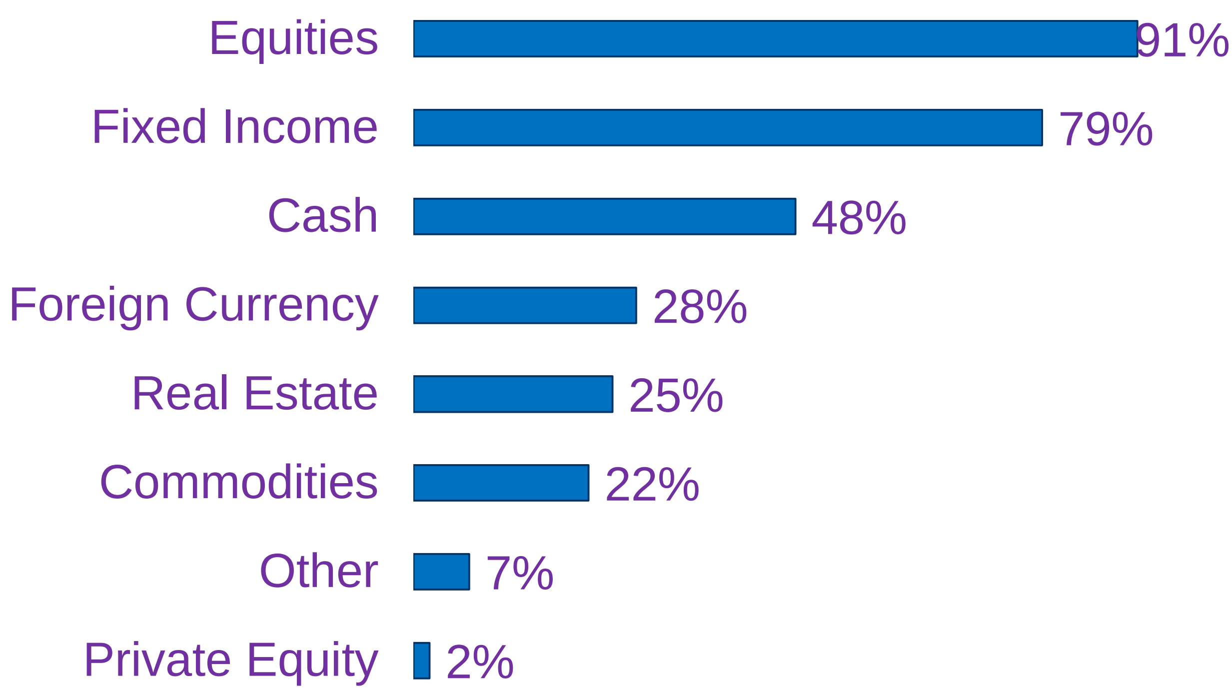
86% of respondents represented firms with more than $1 billion in assets under management (AUM), with the remaining 14% managing less than $1 billion. Nearly one-quarter of respondents (24%) reported AUM of between $5 billion and $20 billion.

GIPS ASSETS UNDER MANAGEMENT



- Respondents were also asked to specify which assets classes were managed by their firm. The overwhelming majority (91%) indicated that they managed equities. The second highest total (79%) was garnered by fixed income. A distant third was cash (48%). A minority of the respondents indicated that they managed foreign currency (28%), real estate (25%), commodities (22%) or private equity (2%).

ASSET CLASSES MANAGED BY FIRMS

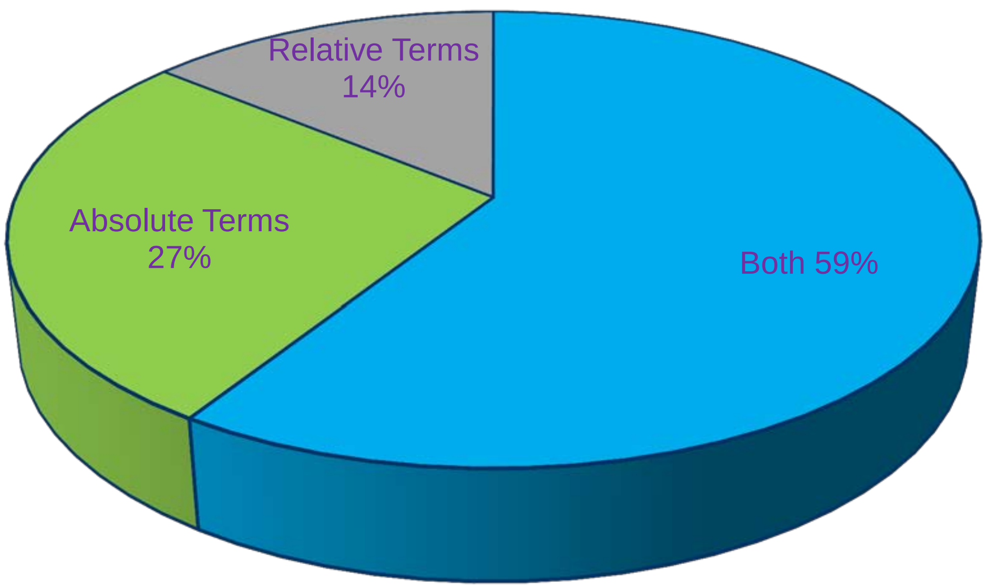


Assessment of Materiality

The Guidance Statement on Error Correction requires firms to define materiality in their error correction policies. As an aspect of this, the Guidance Statement recommends that firms assess materiality both in absolute and relative terms. When evaluating a change to performance results, an absolute assessment would be based on the number of basis points that a return moved as the result of correcting an error. On the other hand, a relative assessment would evaluate the percentage change to the return relative to the figure previously presented or potentially some other variable, like a benchmark return. For example, if an error were corrected that caused a composite return for a period to change from 1.00% to 0.75%, the absolute change would be 25 basis points (0.75% – 1.00% = -0.25%) while the change relative to the originally published figure would be 25% (0.75%/1.00% -1 = -25%).

To learn more about how this is applied in practice, respondents were asked whether they evaluated performance errors in absolute terms, relative terms, or a combination of the two. Twenty-seven percent of respondents indicated that they evaluated errors solely on an absolute basis, 14% solely on a relative basis, while 59% used a combination of the two.

EVALUATION OF PERFORMANCE ERRORS



The indication from the survey that the majority of firms use a combined absolute and relative assessment of materiality reveals that many firms are implementing fairly sophisticated error correction policies. Applying both absolute and relative thresholds may make the policy more complicated than necessary for some firms, but for others utilizing both can help the firm to make a more accurate assessment of materiality.

As an example, consider a composite that reported an annual return of 1% for a given year. In this scenario, an error that moves performance by 25 basis points could be considered fairly material given that it also changed the reported return by 25% in relative terms. On the other hand, consider a different strategy that reported an annual return of 30%. A similar 25 basis points error likely would not be considered as material, as its relative impact would represent only a 0.83% change from the originally published figure. By looking at the error from both an absolute and relative perspective, we can better assess the significance of the error.

Some contest that the use of a relative threshold in one's error correction policy may not be appropriate in an environment in which clients are primarily concerned about outperformance or underperformance compared to a benchmark. If so, the firm may want to incorporate the relative change to the composite's excess return or alpha as a component of its error correction policy. In doing so, the firm could ensure that the materiality of errors affecting these figures is properly assessed.

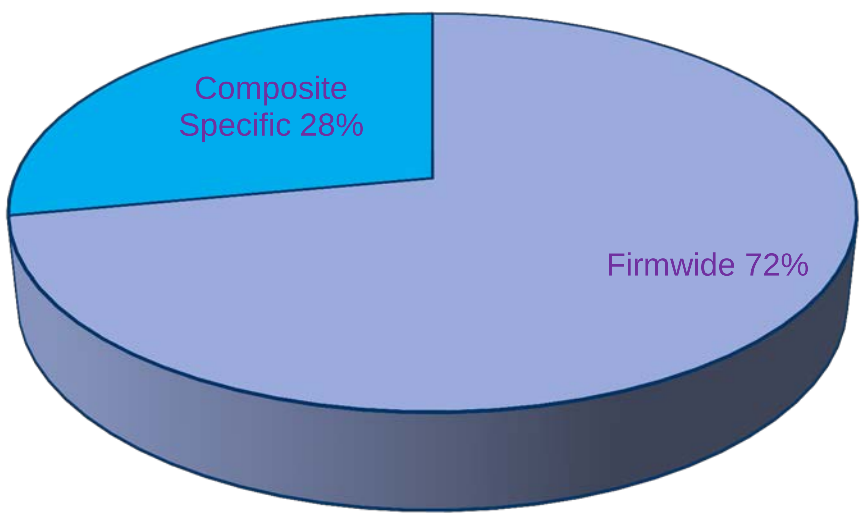
Another relative assessment that some firms make when determining the materiality of an error is how the correction affects the composite's ranking within pier universes. For example, if a correction changes the tier in which the composite had been ranked, the error may be considered more material.

As a best practice, we believe firms should consider incorporating a combination of absolute thresholds and some type of relative thresholds into their error correction policies for assessing materiality.

Firm-Wide vs. Composite-Specific Policies

Survey respondents were asked whether they applied their firm's error correction policy on a composite-specific or firm-wide basis, and 72% responded that they had one policy for the entire firm.

APPLICATION OF ERROR CORRECTION POLICY



The Guidance Statement does not specify whether firms should implement a standard error correction policy for their entire firm, or one that varies for different composites or strategies. However, it does outline that "the size and impact of the error may vary for different asset types (e.g., equities, fixed income, emerging markets equities)." With this in mind, firms should consider incorporating into their policies different composite- or asset class-specific materiality concepts, depending on the types of strategies they manage.

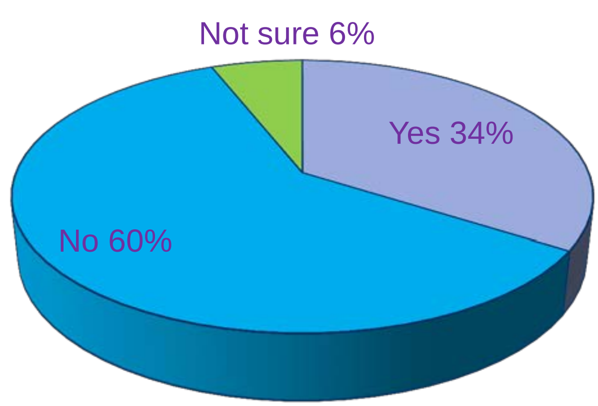
In the opinion of the USIPC, it would be difficult and potentially problematic to prescribe definitive thresholds for assessing the materiality of errors across all strategies to which the entire industry would be expected to adhere (e.g., requiring all firms to implement the same materiality threshold for errors affecting equity composites). Rather, we feel that these thresholds should be determined by each firm individually because different types of investors (e.g., institutional vs. retail) have different views on what constitutes a material change.

Firms should take the time to implement an objective policy that will take into consideration on a composite-specific basis what a prospective investor would consider material with respect to that specific composite.

Overstatements vs. Understatements

Respondents were asked whether their firm's error correction policies assess materiality for errors affecting performance returns differently depending on whether an error resulted in performance being overstated or understated. For example, if an error were identified that led to previously reported results being understated, the firm may consider such an error less material than an error that led to overstated results (e.g., composite performance changed by the same number of basis points). Only 34% of survey respondents reported that their policies looked at these two differently**.**

ASSESSMENT OF MATERALITY DIFFERENT IF ERROR UNDERSTATED OR OVERSTATED?



While not required, the Guidance Statement does encourage firms to consider incorporating into their error correction policy considerations whether returns are overstated or understated. There are two factors to consider:

1. Whether an error that leads to a positive restatement would have impacted a prospective investor's decision-making process in a negative manner. If anything, it would make the prospect more likely to invest, in which case it should be at the firm's discretion whether they want to redistribute the results.
2. Whether an error that leads to a positive restatement may still illustrate to prospective investors that the firm potentially has inadequate controls around its performance reporting process. Electing to not

correct errors that are in favor of the manager may also lead to data inconsistencies if underlying records are updated but the compliant presentation is not.

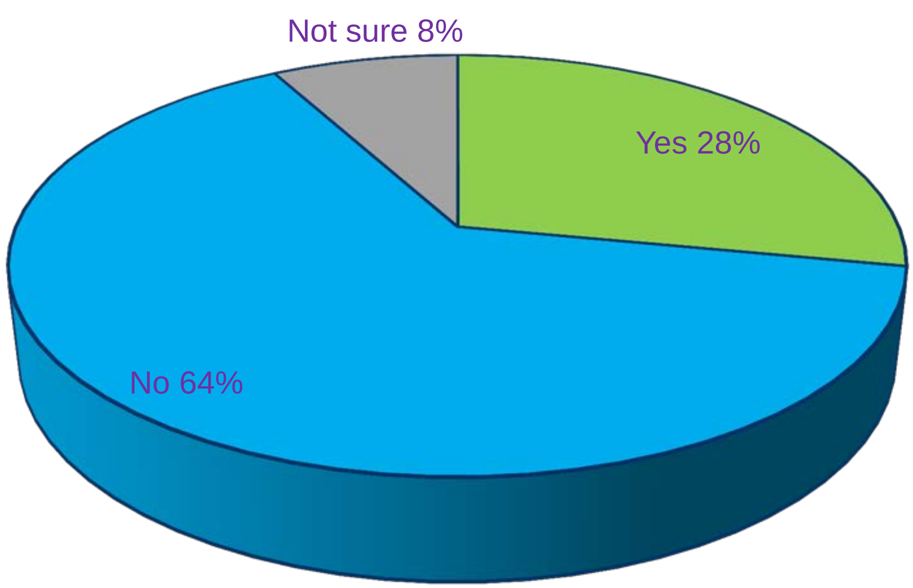
Both of these perspectives are valid and it is up the firm to determine which they agree with and wish to incorporate into their policy. However, firms would be wise to implement policies that require redistribution of compliant presentations only in situations where it is determined that a prospective client's investment decision making process may have been adversely impacted.

Recent vs. Historical Time Periods

The Guidance Statement also indicates that the time periods affected may play a role in determining materiality. For example, a firm could initiate tighter materiality thresholds for more recent time periods and higher thresholds for historical time periods (e.g., more than five years ago). The thought process involved with incorporating different time periods into the firm's policy is based on the idea that prospective investors are more concerned with a strategy's most recent performance track record and that changes to prior years may have less of an impact on an investor's decision-making process. While we believe this argument is valid and the affected time periods could be a factor in determining materiality, firms must be careful not to dismiss historical errors that are identified. For example, if the firm reports trailing returns (e.g., annualized or cumulative since inception results) historical errors could have an equal or greater impact on such results than errors in more recent time periods.

Only 28% of the respondents to the survey indicated that they look at more recent results differently than historical results.

ASSESSMENT OF MATERIALITY FOR DIFFERENT TIME PERIODS



As a best practice, we believe all errors should be assessed in a similar manner but that it may be appropriate to implement slightly different materiality thresholds for historical errors.

Materiality Thresholds

The survey asked respondents to select the error correction thresholds that their firm uses for annual composite returns for each asset class that they manage. The percentage of respondents within each range is outlined in the table below.

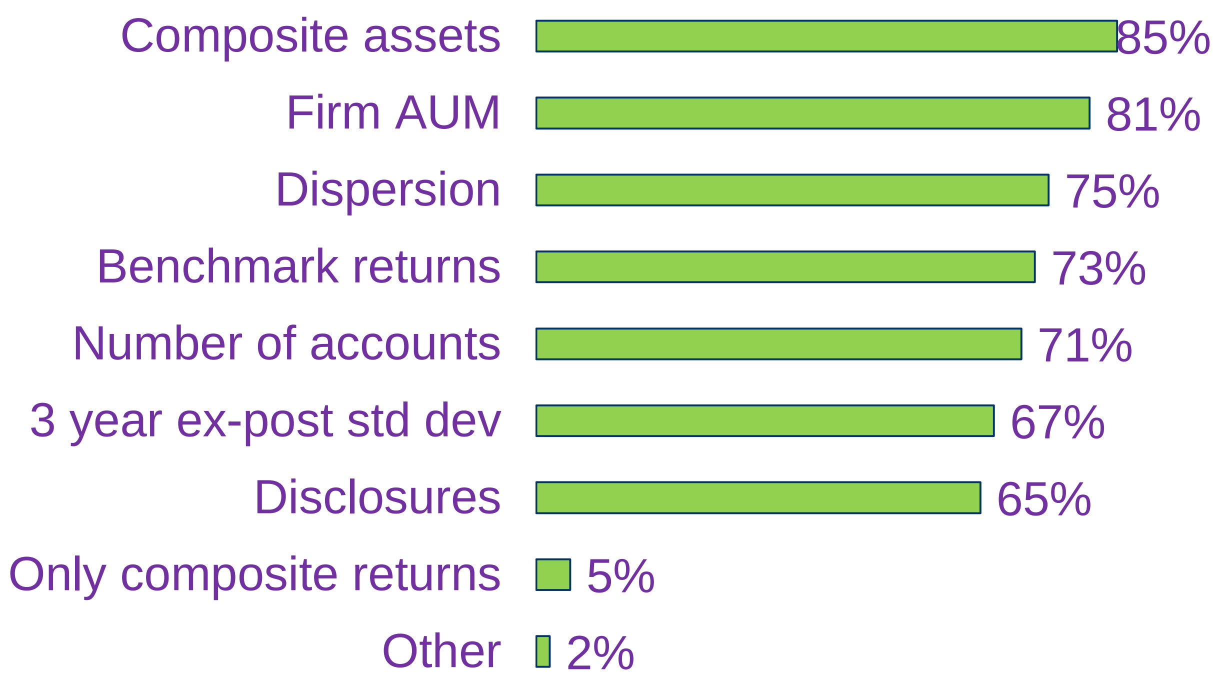
Asset Class	< 5 bps	5-10 bps	11-50 bps	51-100 bps	101-200 bps	> 200 bps
Cash	16%	30%	**34%**	14%	4%	2%
Equities	7%	18%	**41%**	26%	8%	1%
Fixed Income	9%	23%	**47%**	17%	3%	1%
Commodities	8%	4%	**48%**	24%	16%	0%
Foreign Currency	19%	**33%**	26%	15%	4%	4%
Private Equity	13%	13%	26%	**30%**	13%	4%
Real Estate	15%	15%	**41%**	22%	7%	0%
Other	0%	**44%**	33%	11%	11%	0%

The highest reporting range for most asset classes was 11-50 basis points, with foreign currency falling slightly lower and private equity slightly higher. In total, however, the results appear to be fairly broadly distributed. We believe this supports the viewpoint that there is not a one-size-fits-all error correction policy that could be implemented for all firms. **Rather, error correction policies should be written with the individual firm in mind, focusing on the products that they manage, the historical performance of their strategies, and the expectations of their client base.** Based on the range of responses received, this appears to reflect actual practice.

Statistics Other Than Composite Returns

The survey also asked which statistics other than composite returns are addressed in the firm's error correction policy. The response rates are outlined in the table below.

STATISTICS ADDRESSED BY MATERIALITY POLICY OTHER THAN COMPOSITE RETURNS



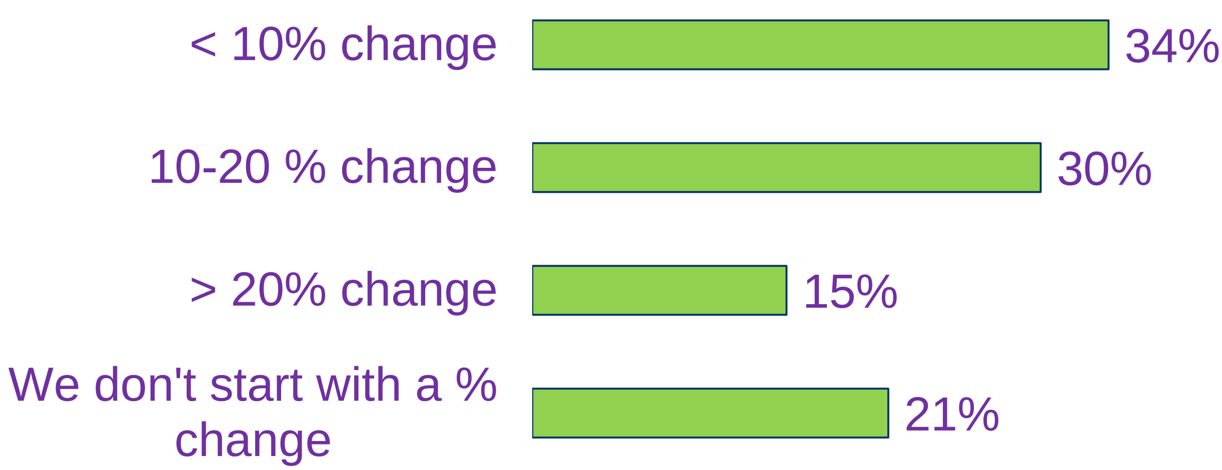
The Guidance Statement defines an error as "any component of a compliant presentation that is missing or inaccurate." With this in mind, a firm's error correction policy should actually address all statistics as well as disclosures required by the GIPS standards — though the survey results indicate that this is not necessarily consistently done by all firms. **The policy does not necessarily need to include a quantitative assessment of materiality for each of these items, but each should be addressed in the policy in some capacity.**

We recognize that it would be difficult to establish objective policies for every statistic and disclosure in a compliant presentation. However, the firm's policies should be prescriptive in how changes to each item will be addressed. For example, rather than outlining specific quantitative thresholds, a firm's policy could specify that changes to dispersion, composite AUM, and missing disclosures will be reviewed on a case-by-case basis by a particular group or team in order to assess materiality. In addition, as issues like this are identified, the firm should establish a precedent for resolution and document it in their policies and procedures.

Assessing Changes to Firm AUM

The survey also asked for more information on a particular nonperformance statistic: changes in firm AUM. Specifically, respondents were asked what their initial screen was for assessing materiality for errors in firm AUM. Thirty-four percent indicated that they start their assessment of materiality on changes of less than 10%, 30% on changes ranging between 10%-20%, and 15% required a change higher than 20%. Interestingly, 21% of the respondents indicated that they do not start their assessment of materiality with a percentage threshold, implying that they use a qualitative determination of materiality for AUM changes. This approach is supported by the Guidance Statement, which indicates that errors can be quantitative or qualitative, though it is a bit surprising to see firms making a purely qualitative assessment when assessing a numerical error. Though it is not clear from the survey responses, perhaps these firms that use a purely qualitative approach in determining materiality have developed their policy to focus on the mere fact that an error occurred and would resolve the error in the same manner, regardless of its severity.

INITIAL SCREENING FOR ASSESSING MATERIALITY FOR ERRORS IN FIRM AUM



Whether the assessment made is purely quantitative, purely qualitative, or a combination of the two, error correction policies should consider changes to statistics reported in compliant presentations, such as firm AUM.

Distribution of Compliant Presentations

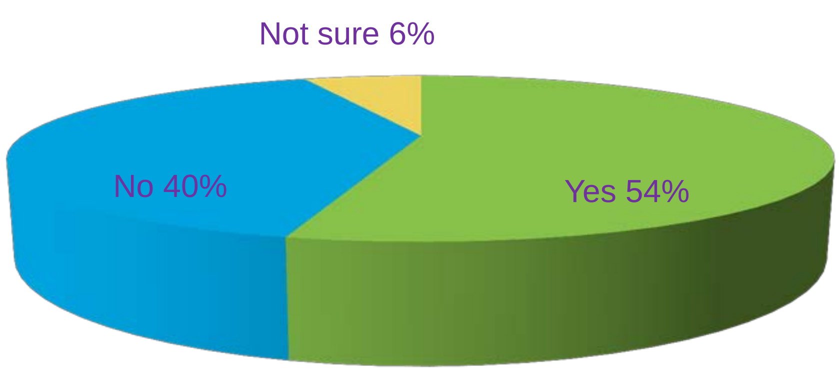
When a material error is identified, the Guidance Statement requires firms to make every reasonable effort to provide a corrected compliant presentation to all prospective clients and other parties that received the erroneous compliant presentation. This implies that the firm should have a process in place for tracking which parties are receiving compliant presentations, though this is not an explicit requirement of the GIPS standards. The survey asked respondents if their firms did, in fact, have a process for tracking who received compliant presentations — 83% indicated that they did. Keep in mind that there are many different types of communications through which a firm would be required to deliver a compliant presentation, including pitch books delivered to prospective clients, responses to requests for proposals (RFPs), and performance submissions to consultant databases.

While it is certainly a best practice and a positive indicator that so many firms have implemented a program to track the distribution of compliant presentations, for large organizations with extensive marketing practices this can be a difficult proposition. For example, for firms that publish compliant presentations on websites, it may be difficult, if not impossible, for the firm to identify every individual who viewed a copy of an erroneous presentation on the site.

In such scenarios, it is advisable for the firm's policy to, at minimum, identify the communication channels through which compliant presentations are typically distributed and to determine internal points of contact that would be accessed if a material effort necessitated redistribution. The firm should also have a process in place for identifying who was considered a prospective client at the time of the correction and who became a client during the period in which the erroneous presentation was distributed to ensure that these parties receive the corrected presentation.

Involvement of Oversight Committee in Assessing and Determining Materiality of Errors

The Guidance Statement outlines the need for an organizational framework for escalating material errors in compliant presentations. Along those lines, many firms have established oversight committees or other groups within their firm that evaluate and, in some cases, make the final determination with respect to how to assess a material error. To assess how widespread this practice is, survey respondents were asked whether their firm has a group, such as a GIPS oversight committee, that helps assess and determine the materiality for errors that occur. Fifty-four percent of the responses indicated that their firm did involve a committee in this process.



We see pros and cons to having an oversight committee involved in evaluating errors.
First, this practice can help ensure that all key stakeholders are involved in and aware of decisions made related to error correction. The team responsible for GIPS standards compliance at the firm typically has little or no direct interaction with clients, so involving client-facing personnel in this process can bring a better understanding of the type and degree of changes to compliant presentations that would actually be material to clients and prospective clients.

On the other hand, we believe that firms should be cautious about giving too much control to oversight committees. Doing so can lead to a subjective and inconsistent error correction process, which would be contrary to the spirit of the GIPS standards.

In many instances, the USIPC believes that a firm's error correction policy should be able to stand alone in specifying the action needed, given a specific situation. However, oversight committees can add an important layer of governance to the process and can also serve a valuable role when evaluating subjective errors. Ultimately, each firm needs to make its own determination regarding the most appropriate process for its organization.

Levels of Materiality

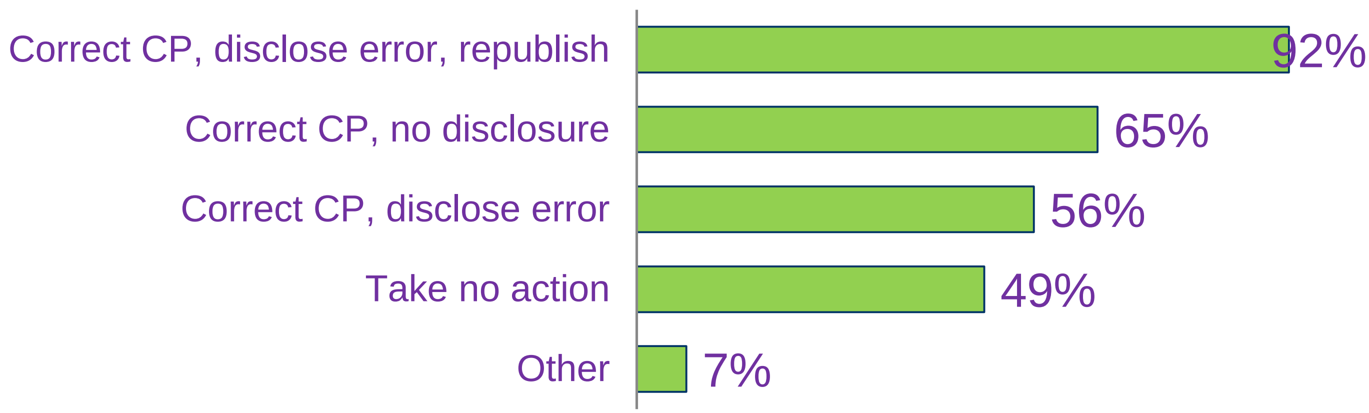
The Guidance Statement outlines four options that a firm generally has for handling errors:

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 without 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 compliant presentation.

A firm's error correction policy should incorporate some of these options, though not necessarily all. Technically, the Guidance Statement only requires firms to establish a policy for identifying and correcting material errors. That means that the correction of immaterial errors is not explicitly mandated and, as a result, the fourth option outlined above could be the only level of materiality established by the firm (though doing so would necessitate redistribution whenever an error is identified).

Survey respondents were asked which of these levels had been incorporated into their policy. Ninety-two percent of respondents said their policies set a materiality threshold at which compliant presentations would be redistributed; 65% said their policy required updating the presentation without additional disclosure; 56% had a minimum level for correcting the presentation with disclosure; and 49% set a threshold to establish when no action would be taken. In practice, we typically see firms incorporating at least two of the four materiality levels (and often all four) into their error correction policies.

OPTIONS INCORPORATED INTO FIRM'S ERROR CORRECTION PROCEDURES



For some firms, only implementing two levels of materiality may be perfectly sufficient. However, incorporating additional levels is likely warranted for firms that offer complex products or have extensive marketing initiatives.

Conclusion

It is ultimately up to each firm to determine how simple or complex they want to make their error correction policies. Factors to consider would include the size of the organization, the types of investment strategies offered by the firm, the volume of compliant presentations created and published by the firm, and the number of distribution channels utilized by the firm. A key consideration should also be the bandwidth available to dedicate to the process. For example, a small firm with limited resources would not be advised to implement a complex process that requires significant monitoring and oversight.

In addition, there are several best practices associated with error correction that firms should consider:

- Implementing an operational process that would proactively look for errors
- Maintaining an error correction log which includes support for the assessment and determination of materiality
- Involving multiple parties in reviewing errors
- Incorporating a reporting mechanism for communicating to a broader committee or group when errors occur
- Implementing procedures for tracking who has received compliant presentations and tracking who has received updated compliant presentations when material errors occur
- Implementing controls to prevent similar errors from occurring in the future once errors are identified

Key Considerations

- There is no one-size-fits-all error correction policy.
- A firm's process for assessing the materiality of an error may be relatively straightforward or very complex. It is up to the firm to decide which approach is most appropriate.
- Firms need to consider what a prospective investor would consider as material and establish appropriate thresholds with that in mind.
- Above all else, firms that claim compliance with the GIPS standards must abide by the fundamental principles of fair representation and full disclosure.