GIPS® Guidance Statement on Error Correction

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GIPS® Guidance Statement on Error Correction

Introduction

Firms claiming compliance with the Global Investment Performance Standards (GIPS®), or "the Standards," are faced with situations in which errors are discovered that must be specifically addressed. Even with the tightest of controls, errors will occur. Errors can be quantitative and/or qualitative. This Guidance Statement only addresses errors related to GIPS compliant presentations, "compliant presentation(s)" or "presentation(s)". This Guidance Statement does not address errors discovered in advertisements prepared following the GIPS Advertising Guidelines.

Background

For a variety of reasons, an error might occur in a firm's processes that results in errors in, or directly related to, a composite's compliant presentation. An error is defined as any component of a compliant presentation that is missing or inaccurate.

Errors in presentations can result from, but are not limited to, incorrect, incomplete, or missing

- composite returns,
- benchmark returns,
- composite assets,
- firm assets,
- number of portfolios in a composite,
- measure of dispersion, and
- disclosures.

Errors in presentations can be caused by, but are not limited to,

- input data errors,
- prior period adjustments,
- system/spreadsheet calculation errors,
- incorrect assignment of portfolios to composites,
- incorrect timing of inclusion and/or exclusion of portfolios to composites,
- missed trades,
- mishandling of corporate actions,
- software error,
- incorrect treatment of cash flows,
- pricing or exchange rate problems,
- incorrect benchmark returns supplied by the benchmark source,
- incorrectly calculated customized benchmark returns,
- inadequate creation or implementation of policies and procedures, and
- poor internal communication.

Guiding Principles

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Firms must remember that the fundamental principles of the Standards are fair representation and full disclosure. Firms must, therefore, avoid presenting misleading information. The objectives of the Standards include presenting investment performance in a fair, comparable format that provides full disclosure. The Standards were created to ensure accurate and consistent performance data for reporting, record keeping, marketing, and presentations. GIPS provision 0.A.11. requires firms to make every reasonable effort to provide a compliant presentation to all prospective clients.

In addition, GIPS provision 0.A.6 states that firms must document, in writing, their policies and procedures used in establishing and maintaining compliance with all the applicable requirements of the GIPS standards. In that spirit, a firm must establish error correction policies and procedures.

Additionally, firms must follow all local laws regarding error correction, if any.

To deal with errors appropriately, firms must adhere to the following requirements:

- Error correction policies and procedures must be established and then implemented consistently.
- Materiality must be defined in the error correction policies.

With respect to a material error,

- The error must be corrected and disclosed in a corrected presentation.
- Disclosure of the change in the corrected presentation must be included for a minimum of 12 months following the correction of the presentation.
- The corrected presentation must be given to all existing clients that received the erroneous presentation.
- Every reasonable effort must be made to provide the corrected presentation to all prospective clients and other parties that received the erroneous presentation.

The following recommendations have been introduced:

- Error correction policies and procedures should be unambiguous and should include specific steps to discover and correct errors.
- Error correction policies and procedures should include how the corrected presentation will be distributed to all applicable parties.
- Error correction policies and procedures should include procedures for documenting the error and actions taken.

When an error is made, it is important that the firm assess the impact and determine whether the corrective action will meet the guiding principles as described above.

Error Correction Policies and Procedures

A firm’s control procedures are critical to mitigating errors and then identifying errors that do occur. It is important that the firm identify the parties within the organization that are integral to GIPS compliance and ensure that these parties are in communication with each other so that all areas affecting the firm’s compliance with the Standards are addressed in the firm’s error correction policy. There should be a framework within the organization by which material errors in presentations are escalated.

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Error correction policies and procedures must be established and then implemented consistently. A firm should strive to create an unambiguous process that includes specific steps to discover and correct errors.

A firm must define materiality within the scope of its error correction policies and procedures. Once materiality is defined, the firm can decide how to treat errors of varying degrees. The policy should indicate the appropriate course of action given the materiality and nature of the error yet be broad enough to capture various scenarios. Error correction policies and procedures should also include how the corrected presentation will be distributed to all applicable parties as well as procedures for documenting the error and the actions taken. When determining error correction policies and procedures, a firm should consider the following factors:

- the materiality of the error, in absolute and relative terms,
- whether the error is material relative to the benchmark,
- whether returns were overstated or understated,
- the significance of the missing or incorrect disclosures,
- whether the error affects returns over time and/or is a timing issue,
- the period(s) affected by the error,
- if these policies will be applied firmwide or on a composite-specific basis,
- whether erroneous presentations have been provided to prospective clients,
- whether clients have received erroneous presentations,
- whether other parties have received erroneous presentations, and
- whether the firm is legally obligated to correct and/or disclose the corrections.

Definition of Materiality

The size and impact of the error may vary for different asset types (e.g., equities, fixed income, emerging market equities), reporting periods (e.g., monthly, quarterly, or annual returns), and time periods (e.g., prior to a specific date, more than five years ago). Whether an error might affect a prospective client's decision to invest is a key determinant of materiality and the appropriate action necessary to resolve the issue.

Error Correction

Once the investment management firm becomes aware of an error that affects the compliant presentation, the firm must determine how to proceed based on its previously established error correction policies and procedures. The firm generally has four options for how errors might be handled:

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.

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1. Take no action: According to the firm's pre-established error correction policies, the error is deemed to be immaterial and does not require a change to any data or disclosures in the presentation.

2. Correct the presentation with no disclosure of the change: The correction of the error results in a change to one or more items in the presentation, but according to the firm's pre-established error correction policies, these changes are not material and, therefore, do not require disclosure of the change or distribution of the corrected presentation to parties that received the erroneous presentation.

3. Correct the compliant presentation with disclosure of the change and no distribution of the corrected presentation: The correction of the error results in a change to one or more items in the compliant presentation, but according to the firm's pre-established error correction policies, it is not deemed to be a material error. It does, however, require disclosure in a revised presentation.

4. Correct the presentation with disclosure of the change and make every reasonable effort to provide a corrected presentation to all prospective clients and other parties that received the erroneous presentation. According to the firm's pre-established error correction policies, the error is material and, therefore, requires correction and disclosure in a revised presentation. The firm must provide the corrected presentation to all existing clients that received the erroneous presentation. In addition, the firm must make every reasonable effort to provide the corrected presentation to all prospective clients and other parties that received the erroneous presentation, including consultants and verifiers. Disclosure of the change must be included in the respective presentation for a minimum of 12 months following the correction of the presentation.

For example, a basic error correction process involving an incorrect composite return within a compliant presentation may include the following steps:

1. Recalculate the returns and quantify the error.
2. Determine if the error is material based on previously established error correction policies and procedures.
3. Decide which action is the most appropriate based on previously established error correction policies and procedures.
4. Document the original return, the corrected return, and the action taken.

A basic error correction process involving an incorrect disclosure may include the following steps:

1. Compare the composite's existing disclosures with those required in the GIPS standards.
2. Determine if an error has been made and/or whether any disclosures are missing from the presentation.
3. Determine if the error is material based on previously established error correction policies and procedures.
4. Decide which action is the most appropriate based on previously established error correction policies and procedures.
5. Document the original information, the corrected information, and the action taken.

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Effective Date

The effective date of this Guidance Statement is 1 January 2010. Firms must establish error correction policies and procedures by the effective date and then must follow their error correction policies and procedures for any error in a compliant presentation that is identified after 31 December 2009. Firms are strongly encouraged but not required to apply this guidance prior to the effective date.

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Q&A

1. We recently determined that our total firm assets disclosure for the past two years has been incorrectly reported in our compliant presentations, but the rest of the information in our presentations is correct. Does this qualify as an error?

The concept of correcting an error applies to all information included in a compliant presentation and is not limited to errors in composite returns. The firm must treat this as an error and follow the firm's previously established error correction policies and procedures.

2. Our firm has claimed compliance with the GIPS standards for approximately five years. We just took a fresh look at our composite presentations and realized that we inadvertently excluded one of the required disclosures concerning the composite's creation date. We have corrected our presentations and would like some guidance on whether a missing disclosure qualifies as an error.

The lack of a required disclosure is considered an error, and the presentation must be corrected. The firm's error correction policies and procedures should address the materiality and significance of both qualitative and quantitative errors and specify the appropriate course of action. The firm's error correction policies and procedures must be established and then followed consistently.

3. We realized that an account had been included in the wrong composite for the past five years. We have corrected the account's composite assignment and recalculated the composite's returns and related disclosures. We present both gross and net returns in our compliant presentation. Although the annual composite gross returns changed by an immaterial amount for each year, the composite's net annual returns changed quite a bit because this account was a non-fee-paying account. Does this qualify as an error?

Firms must have written policies and procedures for how they handle errors in compliant presentations. Assuming the change in the composite's net annual returns is considered material based on the firm's definition of materiality, the firm must treat this as a correction of an error and follow the firm's previously established error correction policies and procedures.

4. While undergoing our first verification, we noted that we had not consistently calculated asset-weighted standard deviation for our internal risk measure. In two of the past five years, we had calculated an equal-weighted standard deviation and disclosed that an asset-weighted standard deviation was presented. We intend to restate all amounts to reflect the asset-weighted standard deviation because this is the internal dispersion measure we have chosen to present. Does this qualify as an error?

The GIPS standards require firms to present a measure of internal dispersion and do not specify which measure must be used. Both asset-weighted and equal-weighted standard deviation are acceptable measures of internal dispersion. In this instance, the error results

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from an incorrect dispersion measure presented. The firm must treat this as an error and follow the firm's established error correction policies and procedures.

5. We recently determined that our list and description of composites inadvertently excluded five of our cash management composites. We have supplied this list to hundreds of prospective clients over the past few years. Does this qualify as an error?

The offer to provide the list and description of composites is a required disclosure. Therefore, the list and description of composites is directly related to a compliant presentation. The omission of five of the firm's composites from the required list and description of firm composites must be treated as an error, and the firm's established error correction policies and procedures must be followed.

6. Our firm had a software problem that went unnoticed for several months. We recently became aware of the issue and have corrected our composite returns and updated our presentations. We have attempted to identify prospects that relied on the materially incorrect compliant presentation and have provided updated presentations to them. However, we believe there may be others that we are not aware of and/or may have obtained our compliant presentations on the website. Have we handled this process appropriately? What should we do about the incorrect information posted on our website?

Given that the firm has deemed this error "material" according to its error correction policies, the firm must make every reasonable effort to provide the corrected presentation to all prospective clients and other parties that received the incorrect information, including consultants and verifiers. The firm also must ensure that any clients that received the erroneous presentation also receive a corrected copy. The firm's disclosure of the error correction must remain on the presentation for a minimum period of 12 months following the correction of the presentation. The firm should also post the corrected presentation on its website because some parties may have obtained presentations through the firm's website.

7. An error occurred that we had not previously considered when drafting our firm's error correction policies and procedures. Can we change or add to the error correction policies and procedures?

A firm may change its error correction policies and procedures on a prospective basis. A firm should write procedures broadly to retain the flexibility of addressing errors that might not have been considered when originally drafting them. Firms must maintain all policies and procedures (both current and previous versions) that support the claim of compliance.

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<u>Guidance Statement on GIPS Error Correction</u>

8. The GIPS Guidance Statement on Error Correction states that firms must disclose in a compliant presentation any changes resulting from a material error for at least 12 months following the correction of the presentation. Does this mean that we have to disclose that a material error occurred to prospective clients that we know have not received the erroneous presentation?

Firms are not required to disclose the material error in a compliant presentation that is provided to prospective clients that did not receive the erroneous presentation. However, for a minimum of 12 months following the correction of the presentation, if the firm is not able determine if a particular prospective client has received the materially erroneous presentation, then the prospective client must receive the corrected presentation containing disclosure of the material error. This may result in the preparation of two versions of the corrected compliant presentation to be used for a minimum of 12 months following the correction of the presentation.

Date Added: October 2009

9. According to the GIPS Guidance Statement on Error Correction, if we have a material error and correct a compliant presentation, we must make every reasonable effort to provide the corrected presentation to all prospective clients and other parties that received the erroneous presentation. We provided the erroneous presentation to former prospective clients that did not hire us and are no longer interested in hiring us. Are we required to provide the corrected compliant presentation to former prospective clients that are no longer considered prospective clients?

No. A firm is not required to provide a corrected presentation to former prospective clients that did not hire the firm and are no longer considered a prospective client. If a firm wishes to differentiate between current prospective clients and former prospective clients that no longer qualify as current prospective clients, the firm must establish procedures to determine when a prospective client no longer has an interest in or no longer qualifies to invest in the composite strategy in question and therefore no longer is considered a prospective client for that composite strategy. If a firm is not able to differentiate between prospective clients and former prospective clients, the firm must send the corrected presentation to both groups.

Date Added: May 2010