



ATTEST **BVS**

Hello everyone and welcome to the September issue of Attest BVS. In this edition we will highlight the recently issued Guidance Statement on Error Correction. This Guidance Statement will go into effect in January 2010 and is more comprehensive than the previously proposed guidance. Since errors are bound to happen at some point, it is imperative to have appropriate policies in line to address them. In addition, this newsletter features an interview that Beacon had with Jonathan Boersma, the Executive Director of the GIPS. We touched on many relevant GIPS-related topics, including the evolution of the marketplace, verification standards, valuation of alternative investments and much more. And lastly, you will find a new segment we will periodically have that will address the GIPS changes which will occur in 2010. As always, please let us know if you have any questions.

INSIDE THIS ISSUE

Error Correction Guidance	1	Countdown to 2010	6
Interview with Jonathan Boersma	3	Congratulations!	6

Error Correction Guidance

On June 18th, 2008 the GIPS Executive Committee adopted the Guidance Statement on Error Correction. Though this guidance has been approved, its provisions are not required until January 1, 2010.

Even though this guidance is not required for another 15 months, Beacon strongly encourages all firms to begin thinking about the way they treat errors and to enact a meaningful error correction policy as soon as possible. With this in mind, we want to take time in this article to summarize the most important aspects of this new guidance.

To be clear, the Guidance Statement on Error Correction only applies to firms' fully compliant GIPS presentations and does not cover errors in advertisements. Error correction encompasses not only errors in return calculation, but also errors to composite or firm assets, dispersion, omitted disclosures, and any other presentation or disclosure error that is deemed to be material. Common sources of errors in these categories include incorrect input data, prior period adjustments, calculation errors, incorrect account inclusion/exclusion, software errors, and much more.

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To deal with these errors appropriately, the Guidance Statement requires that all compliant firms create an error correction policy which will be followed consistently when errors occur. A thorough Error Correction Policy will address the definition of materiality and prescribe the appropriate steps to take dependent upon whether the error is deemed material or not. In creating an error correction policy, there are many factors that a firm should consider. Some of these include:

- The materiality of the error, in absolute and in relative terms
- Whether the error is material in relation to the presented benchmark
- Whether returns were understated or overstated
- The significance of the missing or incorrect disclosure
- The periods affected by the error

This is by no means an exclusive list of criteria worth considering, but rather some of the most important issues that come into play when establishing a policy for error correction. Once these factors have been considered, a firm can go about setting its materiality threshold and establishing the steps to take depending on the classification of the error.



Defining Materiality

This definition is the most important consideration when constructing the policy. When defining this threshold of materiality, we encourage firms to seek input from compliance officers, marketing personnel, and the portfolio managers. Beacon always advises that a firm's definition of materiality should reflect what a prospective investor would consider to be material. The Guidance Statement states that "whether an error might affect a prospective client's decision to invest is a key determinant of materiality."

Now that Materiality is Defined

Once the definition of materiality has been set, the firm must document what it will do when it experiences errors that are both above and below its materiality threshold. Typically there are four ways in which an error can be handled. The first three ways are options firms have when dealing with an immaterial error. The fourth way is what is required by a firm when its error is material

- **Take No Action.** This step will be taken when there is an immaterial error that does not require a change to the data or disclosures on the composite presentation.
- **Correct the Presentation with no Disclosure of the Change.** This option is to be exercised when an error results in a change to a piece of information in the presentation. However, because the error has been deemed immaterial by the firm's error correction policy, the corrected presentation does not need to be redistributed and the error does not need to be disclosed.
- **Correct the Presentation with Disclosure of the Change and no Distribution of Corrected Presentation.** As with the option above, this third option for an immaterial error requires that the information on the presentation be corrected. However, it also requires the (CONTINUED)



extra step of disclosing the nature of the error in a revised presentation.

- **Correct the Presentation with Disclosure of Change and Make Every Reasonable Effort to Provide A Correct Presentation to all Parties that Received the Erroneous Presentation.** This fourth option is required any time a firm experiences a material error. When implementing this option, a firm is obligated to correct the error on the presentation and disclose the change for a minimum of 12 months following the correction. In addition, the firm must send out the revised presentation to all prospective clients, existing clients, consultants, and verifiers who have received the incorrect presentation. It should be noted that inherent in this requirement is the ability of a firm to identify all parties that have received compliant presentations. If a firm does not track its distribution of presentations, we would recommend that it do so immediately.

When a firm encounters an error, we advise the following four-step process:

- Correct the error.
- Compare the correction to the published information to assess whether the error is material.

- The comparison must be made in the context of the predetermined materiality threshold.
- Based on the assessment in step number two, choose the appropriate option from the four listed above.
- Document internally the nature of the error, its materiality, and what actions were taken to correct it.

As mentioned in the opening paragraph, this guidance is not required until January 1, 2010. However, both the GIPS Executive Committee as well as Beacon Verification strongly encourage firms to apply this guidance as soon as practical. To read the Guidance Statement in its entirety, [please click here](#).



Interview with Jonathan Boersma

This month Beacon was privileged to interview Jonathan Boersma, the executive director of the Global Investment Performance Standards. Our question and answer session touched on a wide variety of topics related to the GIPS and their constant evolution. We found this interview to be extremely informative and believe that it offers a unique insight into the issues that affect the GIPS today.

1. Please describe your role and that of the GIPS EC (Executive Committee) in the development and maintenance of the Standards.

The GIPS Executive Committee serves as the decision-making authority for the GIPS standards. It is structured around a broad spectrum of representation across geographical areas as well as industry and investor groups. The EC utilizes subcommittees and working groups to (CONTINUED)



facilitate its ongoing efforts to ensure that the Standards remain effective, useful, and relevant in the investment industry. As the Executive Director, I monitor and oversee the operation of the EC in promoting and maintaining GIPS through alliance with experts in the global investment industry and partnership with GIPS country sponsors.

2. Obviously, the GIPS standards cannot address or anticipate every change in the market in real time. How does the EC cope with the changing market environment and advent of new products and distribution channels?

Certainly the financial services sectors have evolved with changes in the broader market environment—the economy, the regulatory framework, and the forces of globalization. We cannot predict what new products or issues may arise in the future, but we can establish ethical principles that cover a breadth of possibilities. The fundamental principles of fair representation and full disclosure remain applicable throughout the evolution of the industry. We are able to address some issues relatively quickly through the issuance of interpretations—Questions and Answers (Q&As) and Guidance Statements. Over time, we revise the GIPS standards to incorporate additional provisions as needed to ensure the Standards remain current and relevant. We are currently in the midst of that process as we prepare to release a draft of the next version of the Standards.

3. What are the more immediate market trends that the EC is addressing today?

Proper valuation is the primary input into the return calculation. Investors have expressed increasingly concerns over the values of the instruments being held in their portfolios amid the recent sub-prime turmoil. In addition, various regulators and standard setters have issued statements on what constitutes

fair value. We will be proposing that firms be required to use fair values (as opposed to market values) of assets and make additional disclosures for greater transparency. We are also working to provide specific guidance and direction on technical areas such as hedge funds, alternative strategies, real estate, private equity, and risk.

4. CFA Institute does a good job of educating the institutional marketplace. Are there any plans to communicate the benefits of the GIPS standards to retail managers and their prospects?

Investor awareness is an integral part of our long term strategic plan. The retail marketplace presents some unique challenges, but I believe GIPS are relevant and beneficial for retail investors. We are going to be looking at some of the retail-specific issues in the near future and will likely be issuing some guidance. Take mutual funds as an example: I think you can argue that it could be misrepresentative to show a mutual fund investor a composite that includes more than just the fund. The retail space is also already governed by comprehensive regulations in many jurisdictions, so there are many factors to consider. We will continue to deliver educational conferences & workshops to the marketplace, to further enhance the general education of GIPS, and to increase outreach to the retail investors.

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5. When thinking about the future developments in the GIPS, how do technological capabilities, especially in developing countries, factor in to the decision making process?

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Technical considerations are a very important factor. We cannot require firms to do something if the technology is not readily available to support it. One of the ways we handle these types of issues is through the use of recommendations. We view recommendations as best practice that, for one reason or another, cannot be implemented everywhere, all the time, for all asset classes or strategies. Technology may be a limiting factor in some cases, but in general, the metrics and calculations that we require are fairly easy to produce.

6. During your travels and communication with other countries, what kind of reception or reaction do you get regarding the role of the GIPS standards in their markets?

We partner with organizations in other countries to promote the standards and educate the marketplace locally. These Country Sponsors are an important element to our structure and provide local and regional input as we develop and promulgate the GIPS standards. We continue to receive interest from new prospective country sponsor organizations. The EC recently approved National League of the Management Companies in Russia and the Canadian Investment Performance Council as GIPS Country Sponsors, bringing us to 30 Country Sponsors globally. With the continuing globalization of the industry, compliance with the Standards is becoming essential for firms to be competitive. The role of the GIPS standards varies slightly from country to country, but the Standards are universally viewed as best practice and highly regarded.

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7. With what regularity does the CFA Institute communicate with regulatory bodies in the countries that have adopted GIPS? What is your opinion of their view of GIPS?

We, along with our GIPS Country Sponsors, are in regular communications with regulators around the world. We often reach out to regulators to ask their views on certain issues and at the same time, they contact us for input on various issues they are facing. They recognize the benefit of voluntary compliance with the GIPS standards and encourage further development of global best practices.

8. Beyond the Guidance Statements on Verifier Independence and Performance Examinations, do you see any plans by the EC to regulate or create minimum standards for verifiers?

The Verification-Practitioner Subcommittee continues to assess if additional changes are needed in this area. There has been confusion regarding what exactly a verification is and what it is not, as well as what procedures are required to be performed, and so we hope to bring some more clarity to these areas. Obviously, in addition to GIPS authoritative guidance, the verifiers themselves must adhere to their own professional practice standards, and of course the quality of their work is ultimately judged by the market.

9. What plans does the EC have to address alternative investments outside of private equity and real estate, i.e. hedge funds, CLO's, CDOs.

We currently have an alternative investment strategy working group that is examining these issues. In general, the GIPS standards can be applied to hedge funds as is—in fact there are a number of firms already doing so. There are, however, some issues and structures that are unique to these vehicles (e.g., master-feeder structures, (CONTINUED)



side pockets) and we are working on guidance for firms in these areas. Valuation is clearly an issue and while the GIPS standards are not valuation standards, we do recognize that performance standards are meaningless unless there is substance and integrity in the underlying valuations.



10. We are great believers in the CIPM program. What formal role, if any, do you think the CIPM will have in relation to the GIPS?

The CIPM study and exam program meets the industry-wide need for highly qualified, ethically grounded performance professionals. The curriculum covers professional ethics; performance measurement, attribution, and appraisal; and the GIPS standards. The CIPM credential is a highly credible mark of competence, but under the GIPS standards we do not anticipate that verifiers will ever be required to earn it.

Countdown to 2010 – Portfolio Return Calculation

2010 is quickly approaching and with it will come many changes. To ensure that nobody gets caught unaware, we will periodically send out reminders of some of the most significant changes that will be required by the beginning of that year.

This segment's focus is the required portfolio revaluation after all large cash flows. In effect, this requirement will result in firms revaluing portfolios before and after all large cash flows and then linking the sub-period returns to arrive at a monthly return. Many performance measurement systems have the capability to incorporate this requirement seamlessly,

thus the transition should not cause any major disruptions. However, for firms without the capability to value portfolios daily, there must be planned transitions to meet the new requirements. The enhanced calculation will result in a more precise portfolio return than the modified Dietz formula without revaluation. An additional point to note is that it is up to the firm to establish what the large cash flow threshold for the revaluation should be.

We strongly encourage firms to start integrating these changes to ensure a seamless transition. As always, if you have any questions, please contact your verification associate.

Congratulations!

We would like to offer our warmest congratulations to Charlie Stout for achieving the CIPM (Certificate in Investment Performance Measurement) designation!

We at Beacon are strong supporters of the CIPM program. The designation involves a demanding pair of tests which is excellent preparation for the everyday challenges we face as verifiers.