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Guidance Statement on Verifier Independence

Introduction:

The GIPS standards define verification as the review of an investment management firm's performance measurement processes and procedures by an independent third-party "verifier," where the phrase "independent third-party" generally means that neither the verification firm (or verifier) nor the investment management firm (also known as a verification client) has a direct conflict of interest. A direct conflict of interest exists when an independence issue between the investment management firm and the verification firm cannot be managed effectively, i.e., the conflict is not "cured." The purpose of this Guidance Statement is to guide investment management firms and their (potential) verification firms in the process of determining if independence issues exist between them.

A verification firm is selected and appointed by the investment management firm; the investment management firm must retain the ultimate responsibility for the decisions made. The GIPS standards do not contain specific qualification requirements for a verifier, other than the verifier must be an independent third party. The self-regulatory nature of the GIPS standards necessitates a strong commitment to ethical integrity on the part of the investment management firm as well as the verification firm. Verification provides substantial benefit not only to the investment management firm whose policies and processes are verified, but also to the prospective investor relying on the performance information presented by the investment management firm.

This Guidance Statement serves as minimum guidance. It is not intended to replace or supersede any applicable independence guidance for a verification firm that is subject to its existing professional independence guidance. If any conflicts exist between this guidance and the verification firm's professional independence guidance, verification firms must follow their professional independence guidance and disclose the conflict to the investment management firm (verification client).

Defining Independent:

Defining the term "independent" is not a simple process. Crucial to the verification process is the assumption by all interested parties that the verifier (for purposes of this document, used interchangeably with verification firm or verification unit (of a larger/parent firm)), performs its service in an unbiased manner and is not verifying its own work.

When considering a verification engagement, the investment management firm and the verification firm must determine any known independence issues existing between the two organizations. Both the investment management firm and the verification firm should create their own policies and procedures that address independence. As part of its evaluation process, each firm should consider policies and procedures used by the other organization to address independence. For example, if an investment management firm is contemplating hiring a verification firm which offers additional products and services that the investment management firm could or does utilize, the investment management firm must understand how the verification unit achieves independence within the parent organization as well as with the investment management firm. A verifier must disclose to the investment management firm the services known to the verifier that other units of the verification firm may be providing to the investment management firm. During the process of determining if any independence issues exist, both the investment management firm and the verification firm should be cognizant of actual (existing in fact) as well as perceived (potentially viewed as) independence issues. Each organization's self-examination of independence should always keep in mind the following question: 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 potentially be changed if the prospective client knew about other existing relationships between the investment management firm and the verification firm?

For verifiers that provide services in addition to verification services, it may prove difficult for the verification unit to identify other services (especially highly sensitive or confidential services) provided to the investment management firm by other units of the verification firm without input/notification from the investment management firm. However, the investment management firm itself may be aware of services being provided by other units of the verification firm to the investment management firm. The investment management firm must then be responsible for deciding whether a service provided by the verification firm – ***but unknown to its verification unit*** – results in an independence issue.

Potential independence issues must be disclosed by the verification firm and the investment management firm to each other. Additionally, because disclosure alone does not “cure” the independence issue, the firms must then determine if the identified independence issues can be managed such that independence is achieved. It may be helpful for both the verification firm and the investment management firm to consider independence as a continuum. At one extreme of the continuum is a verification firm with no relationships with the investment management firm. At the other extreme is a verification firm with existing relationships with the investment management firm, such that if the investment management firm's verification were performed by the verification firm, the independence issue could not be appropriately managed and independence not achieved. The investment management firm and the verification firm must determine where their relationship is on this continuum and if it is appropriate to proceed with the verification engagement.

The firms should document their conclusions. If the appointment of the verification firm by the investment management firm continues beyond the initial verification, the firms should reassess independence prior to each verification engagement.

Guiding Principles:

- The verification firm and its employees must be independent from its verification clients;
- The verification firm must consider any independence guidance for their profession, if applicable;
- To the best of their ability, the verification firm and the verification client (investment management firm) must consider their entire relationship when analyzing potential independence issues;
- The verification firm has an obligation to discuss with the verification client their analysis of potential independence issues and how they will be managed;
- The verification firm and the verification client must reach a conclusion regarding the verification firm's independence;
- Determining independence is the responsibility of both the verification client and the verification firm; however, the verification client (investment management firm) must retain the ultimate responsibility for the decisions made; and,
- 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.

Assessment of Verifier Independence:

In addition to verification services, verification firms may provide additional services and products to its verification clients. The verification firm must be cognizant of its role as advisor on issues relating to compliance with the GIPS standards, which may include being a performance measurer to the verification client prior to the verification. Potential independence issues should be mitigated; existing independence issues must be "cured." Because each situation is unique, the following are suggested considerations. While not definitive, these considerations are provided to assist verification firms to more precisely define the types of services and products that may result in a potential independence issue.

1. What services/products that a verification firm might provide to a verification client should be considered when determining their status with regard to independence?
2. Are there other issues a verification firm should consider when determining their status with regard to independence?

1. What services/products that a verification firm might provide to a verification client should be considered when determining their status with regard to independence?

A verification firm can provide consulting to a verification client, including both GIPS- and non-GIPS-related services. However, when the verification unit of the verification firm provides GIPS-related services, members of the verification unit must not step into a management role or

undertake any management function. Further, the verification unit must not perform (or have performed in the past) any services which would result in their reporting on their own work product and decisions or calling their own work into question during the verification. While certain tasks may be outsourced to external service providers, responsibility for the fair representation and full disclosure of a performance presentation that adheres to the GIPS standards remains with the investment management firm.

Examples of services that, if performed by the verifier, may not create an independence issue include:

- Participating as an advisor to the compliance project management team;
- Participating in the identification of issues that hinder an investment management firm's compliance;
- Educating investment management firm personnel about the GIPS standards and the compliance process;
- Providing advice on compliance issues as they arise as long as the advice does not include making decisions on these issues for the investment management firm;
- Providing generic samples of client presentations;
- Providing compliance checklists;
- Providing formulas and calculation examples;
- Providing training on performance-related topics; and
- Reviewing results of performance-system conversion testing.

Examples of services that, if performed by the verifier, create or may create an independence issue include:

- Functioning as a member of the investment management firm's compliance project management team, with responsibility for performing management tasks (e.g., compositing portfolios, defining policies, etc.);
- Acting as the project manager for the investment management firm's compliance project management team, with management decision authority;
- Making decisions about compliance issues for the investment management firm. (The verifier should only offer suggestions and present options which the investment management firm may consider when making their decisions.);
- Creating source data for the calculation of performance returns;
- Providing templates for performance calculation, if the verification client does not assume full responsibility for the calculation methodology;
- Assigning accounts to composites;
- Collating or creating the underlying data required to calculate account-level returns;
- Calculating account-level returns;
- Calculating composite-level returns;
- Preparing compliant presentations;
- Establishing policies and procedures; and
- Functioning as a data warehouse for the performance data on behalf of the investment management firm. The verifier can maintain data duplicated for its own purposes but this data must not serve as the investment management firm's primary data source.

2. Are there other issues a verifier should consider when determining their status with regard to independence?

Other issues that are not directly related to verification services or GIPS compliance may impact a verifier's independence. For example, activities where the verification firm serves as an advocate for the verification client may impair independence. A verifier should consider their personal and financial relationships with their clients and consider whether they are, in fact, independent or could be influenced by such relationships. Mere disclosure of a personal or financial relationship does not "cure" the independence issue.

Effective Date

Verification and investment management firms must follow the principles discussed herein for all verification engagements commencing after 1 January 2006.

Applications:

1. How much time and effort must the verification firm expend in order to identify all other services provided to a verification client?

Both the verifier and the verification client need to expend such time as is reasonable for them to, independently and jointly, satisfy themselves that none of the **known** relationships between the two organizations will impair the independence of the verifier. This is a continuing joint obligation and does not just apply on the first appointment of the verifier.

From a practical point of view, the inclusion of the word "**known**" is an essential qualifier, as both the verifier and verification client may have a business relationship which is confidential to all but a selected few. For example, a verification firm may serve in an advisory role in a corporate acquisition/sale, which would not be disclosed under any circumstances to the employees involved with the verification appointment of either the investment firm or the verification firm.

2. As defined in the Guidance Statement on Verifier Independence, what are "management functions?"

In the context of this Guidance Statement, "management functions" are tasks and responsibilities that are directly related to the GIPS-compliance process. Management functions include, but are not limited to:

- Identifying all portfolios of the firm;
- Assigning accounts to composites;
- Determining firm definition;
- Determining discretion definition and/or status;
- Creating composite criteria;

- Establishing policies and procedures;
- Calculating account- and composite-level returns; and
- Preparing compliant composite presentations.

3. *Is there a formal process for reporting conflicts of interest?*

No, there is no formal process for reporting conflicts of interest. If a verifier determines that a conflict of interest prevents them from accepting a verification engagement or continuing to provide verification services to a client, the verification firm should inform the client immediately of such conflict. The verifier and the client should also discuss if a newly discovered conflict extends to historic periods, which may require that any previously issued verification reports be recalled, (i.e., the investment firm must cease making any claims of verification for the period the conflict existed). If, in the future, the investment management firm is verified for that period by an independent third-party, the investment management firm may again claim that it was verified for that period.

4. *If the verification firm provides a spreadsheet template to a verification client to help in the calculation of asset-weighted standard deviations for inclusion in a composite presentation, does that create an independence issue?*

Merely providing a spreadsheet template to a verification client that includes calculation examples does not automatically create an independence issue, as long as the client assumes full responsibility for the calculation methodology.

5. *Can a verification firm participate in the process of selecting a new performance measurement system for a verification client?*

Yes, as long as the verification firm's assistance is limited to making recommendations and suggestions, with the final decision being made solely by the verification client. The verification firm must not receive any monetary or non-monetary compensation from the systems providers for their review or recommendation.

6. *Can a verification firm participate in the process of implementing a new performance measurement system for a verification client?*

Yes, a verification firm may participate in the process of implementing a new performance measurement system for a verification client, but the verification firm must be careful to not undertake management functions. The verifier must **not** have final responsibility for data conversion and reconciliation functions.

7. *In addition to performing a firmwide verification, our verifier also performs a Performance Examination on one composite. The Performance Examination report will include a compliant presentation for the one examined composite. Can the verifier produce the compliant presentation for this composite?*

The verifier may not assume the responsibility for creating or producing a composite presentation for the investment management firm. The investment management firm must first provide a compliant presentation to the verifier. Once the Performance Examination is completed (based on the composite presentation provided by the investment management firm), the verifier may reformat/redesign the data from the compliant presentation in a separate document to be provided to the investment firm as part of its Performance Examination Report. Simply performing word processing and duplication functions does not impact the verifier's independence.

8. *Our investment management firm has used the same verification firm for the last five years. We recently discovered that an employee of the verification firm is related to a portfolio manager our firm hired this year. Will our firm be able to continue to use the verification firm for our annual verification next year?*

Both firms must take measures to ensure that the verification firm's employee maintains independence if that employee is used for the investment management firm's verification. If the employee is not a member of the verification unit, there may not be an issue. However, if the employee is in charge of the verification project for the investment management firm and, for example, is the spouse of the recently-hired investment manager, the independence issues must be evaluated.