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Association for Investment Management and Research
Reference: AIMR-PPS standards – Wrap Fees
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The “New Wrap Fee Guidance” panel at the 6th Annual AIMR-PPS conference was very well done. Karyn Vincent suggested that in light of the three performance conferences held in New York so close to the deadline, comments might be accepted up to a week or so after such deadline. With that in mind we would like to submit the following to the AIMR-PPS Implementation Committee for consideration.

That Nancy Camarata, one of the speakers on the wrap fee panel, had done everything she could to get books and records from some 50+ wrap sponsors for her firm, Bear Stearns Asset Management, and still came up 8 to 12 shy, speaks volumes about where the industry **is** compared to where this guidance statement would like the industry to be.

That the AIMR-PPS subcommittee should continue to work with the Money Management Institute (MMI) and the SEC as they attempt to influence the sponsor arena is very commendable. Placing administrative requirements on investment advisors that would be better placed on wrap sponsors should be avoided, especially since in the current climate, even if the advisor¹ goes to great pains to comply, more often than not the investing public gets something from the sponsor that completely defeats the purpose.

Three areas where the wrap fee guidance statement needs further consideration:

- 1) Making a distinction between wrap programs where the registered investment advisor is merely directing trades to the sponsor and tracking the performance through its own portfolio accounting system (i.e., Morgan Stanley Vision) versus wrap programs where the advisor does not track performance (i.e., Morgan Stanley Access).
- 2) Making a distinction not only in whether presenting performance to a prospective investor or to a prospective wrap sponsor, but also allowing the choice to not present at all, because certainly that choice went into many advisors’ reduced fee negotiations over the past decade, with sponsors contractually assuming responsibility for everything short of stock selection.
- 3) Making a distinction between bundled fee programs where fees **are** inclusive of brokerage fees and other programs where they are not (fixed income strategies, for example, where execution costs continue to be accounted for separately in the buy/sell spreads).

¹ For clarification, the term advisor(s) is used in this letter as a reference to money managers/registered investment advisors, not to be confused with financial consultants/advisors who have a different role in the distribution of wrap performance.

Point One – Theoretical Precedents: Gross vs Net from Advisor to Sponsor

Perhaps the trickiness of complying with the wrap guidance is not because of the trickiness of the quickly evolving wrap industry as much as it is due to the fact that guidance from the first subcommittee more than seven years ago goes against important theoretical precedents. Advisors in the U.S. report both gross and net performance *after* the reduction of execution costs, as execution is one component where the advisor can add or decrease value through broker selection. Custodial fees are not reflected in gross *or* net performance because prospective investors can shop for custodians and negotiate custodial fees completely separate from the arrangement with the advisor. Furthermore, the advisor has no say in what the custodial fees are.

Prospective clients can certainly shop wrap sponsors separate from the advisor, and the advisor has no say in what fee the client pays, nor does the advisor control execution unless trading away from the sponsor, which usually incurs a separate fee.

Theoretically then, there's precedent for allowing wrap performance to be shown by the advisor to prospective wrap sponsors gross of fees. Additionally, if the sponsors prefer to receive the institutional track record rather than a compilation of the performance of other wrap program performance, precedent would dictate that the advisor should be able to provide the prospective sponsor with the requested information.

However, in the best interest of the investing public, and in light of the fact that wrap programs are in essence “unregulated mutual funds” (hence the sponsors push in the past year to have them distinguished as “separately managed accounts”), the SEC (and maybe the NASD?) clearly needs to regulate how the wrap sponsors present performance to the public to assure that the public is getting *net of everything* (analogous to NAV) performance.

Ashland Accounting works with advisors with assets under management below \$50 million and others with assets well over \$50 billion. When the smaller firms try to pull together net-of-everything performance, they call us up and say, “The sponsor said its highest fee is none of our business.” And in fact, the sponsor has a point.

Point Two – Ethics

One Firm or Two?

When discussing the issue of whether to define the firm as one entity or two separate firms, the speakers at the conference suggested that if the advisor chooses to have two separate firms, the advisor wouldn't be able to use the institutional track record linked to the wrap performance. Two conference attendees approached me with the suggestion that of course they could still show performance, because of the precedent already set in the guidance statement on portability of performance: i.e., it's the same team, the historical strategy will be preserved going forward, the institutional books and records are available, and the advisor supports full and fair disclosure regarding the prior performance from the other firm.

There's a fine line between setting ethical standards and codifying regulations that beg loopholes. The bigger picture of full disclosure and fair representation would not be lost if an advisor, deciding to take the two separate firms route, wanted to link the institutional performance (assuming it was representative and useful if the same advisor had decided to define itself as one firm). Under that test, the test of full disclosure and fair representation, the distinction between one firm and two becomes irrelevant.

In fact, allowing an advisor the choice to define itself as two firms is evidence that the subcommittee understands that this guidance statement can create a significant compliance burden for advisors. Perhaps instead of coming up with a choice to avoid the administrative hassle, the guidance statement could meet the industry where it is: if an advisors isn't tracking the performance of certain wrap programs on its system, the advisor isn't getting *paid* to track that performance, and per the SEC, the advisor can't distribute such performance without books and records. Therefore, for now, the Standards could make an allowance even if just until 2005 or 2010 that such accounts don't have to be maintained in a composite, similar to exceptions for non-fee-paying accounts or non-discretionary brokerage accounts that might be managed in the same strategy.

Much more doable than suggesting an advisor split into two firms, the only danger here is that advisors might favor accounts for which they are actually "tracking" performance or they might be showing the public a wrap composite that doesn't include *every single wrap account*. The danger seems benign.

In wrap programs where the advisor isn't tracking performance, the sponsor is doing the marketing to the public. If the advisor is consistently neglecting those accounts, it will be reflected in the performance shown to the investor considering that sponsor/advisor investment. If the neglect is intentional, we have a more serious breach of securities law covered by fair trading rules, which are reviewed/enforced by the SEC during regular advisor examinations.

If the advisor has several wrap programs on its accounting system and would like to present performance for a composite of those accounts, the fact that it includes all and only wrap accounts tracked in-house could easily be disclosed. Advisors could even be required to list the wrap sponsor programs included in the composite. If all else were equal, the performance of accounts not on the system shouldn't be very different from accounts that are on the system. Such an allowance until 2005 or 2010 to prevent firms from taking on split personalities would better preserve the ethics of fair representation and full disclosure.

Consolidated Wrap History or Institutional?

Hands down, if an advisor has a wrap track record, the most ethical performance history to show a prospective wrap sponsor would be the advisor's wrap performance rather than performance of institutional accounts often more than 100 times larger! If I was a wrap sponsor, I would prefer to evaluate gross wrap performance rather than a compilation of net

performance from different programs because there is such a spread in fees between programs. That said, though, there is also a large variance in the overall efficiency of the different sponsors, from execution to notification of new accounts and effective maintenance of the composites in light of mandate changes from the clients. Lack of efficiency can create performance noise.

Perhaps as a sponsor then, I might choose to evaluate the advisor's performance that is completely within the responsibility of the advisor, the institutional performance. I would also be interested in the institutional track record if it was several years longer than the advisor's wrap performance history. Whether or not as a sponsor I could take that performance, which would be very useful in evaluating comparable advisors, and link such institutional performance in presentations to investors and how much disclosure would be adequate for the investing public are critical ethical considerations, all of which are beyond the advisors' control when sponsors are presenting sponsor-generated performance.

Clearly standards for the wrap sponsor are necessary, whether such regulation comes from the SEC or MMI or AIMR (except of course that sponsors can't claim compliance with the AIMR-PPS standards, which are intended to provide guidance for advisors).

Consolidated Wrap History or Unconsolidated?

A delegate at a recent conference suggested an alternative to showing a composite of combined wrap sponsor composites would be to show each sponsor's performance as a line item when presenting to a potential new sponsor relationship. The response was that since advisors don't show "unconsolidated" account-by-account performance in any other composite that this was inconsistent with the Standards and that wrap composites should be "just like any other composite".

Two concerns we had with this response were: 1) Wrap composites already have special considerations within the guidance statement that clearly distinguish them from being "just like any other composite." If the composites are not tracked on the advisor's system, in all fairness, unconsolidated performance for individual sponsor programs is a suggestion worth considering. 2) All in all, advisors need to be able to provide sponsors with requested information, though. What the advisor provides the sponsor to maintain compliance with the AIMR-PPS and what the advisor provides the sponsor that the sponsor actually uses are two very different things. What would be the harm in allowing advisors the choice of presenting unconsolidated sponsor performance to potential sponsors if the advisor has sponsors tracked on different accounting systems/outside the firm or consolidated performance if such performance is all on one system?

As the subcommittee is aware, while the sponsor may require an advisor to be "AIMR-compliant" in order to participate in the program, those same sponsors routinely reject the advisor's compliant presentations. That's important to keep in mind, in so much as the pains (and very real costs) the advisors are going through to maintain compliance are not benefiting the investing public.

Shadow Accounting / Additional Due Diligence?

The AIMR-PPS subcommittees worked with the SEC in the mid-90s and were very successful in receiving a no-action letter allowing them to show mutual funds in composites gross of fees if unnamed. Similar influence in the wrap account area is much needed. Additionally, on the mutual fund front, through conferences and Q&A, advisors are encouraged, as opposed to required, to calculate the true market value performance of mutual funds included in composites rather than working with a grossed-up NAV. Either method is deemed acceptable/ethical, however, allowing advisors to work within the limitations of portfolio accounting systems in place.

At the conference, the comment was made, if the cost of shadow-accounting or due-diligence reconciling is too high, “perhaps it’s a business you want to walk away from”. We have a huge concern here in that several of our clients have more than 40,000 wrap accounts. The advisors accepted reduced fees a decade ago, understanding that the sponsor would be handling the administration of these accounts. Now, the advisor, in order to maintain compliance with the industry’s voluntary professional standards, has new administrative costs to carry, but is not in a position to raise fees to the sponsor’s clients and can’t add 40,000 accounts to its existing accounting system without paying additional per-account charges. This is a serious issue.

Unlike encouraging an advisor to shadow a half dozen mutual funds on the advisor’s accounting system, the per-account cost and the reconciliation process is an enormous burden. Nor is it a question of whether the client might “want to walk away from” this kind of business, as it’s a significant chunk of the advisor’s existing business. The idea of requiring advisors to be responsible for the administration of these portfolios, after they have already accepted reduced fees for years under the premise that the advisor *didn’t* have to carry the administrative costs, seems as un-American as “taxation without representation”.

Wrap performance presented to the public definitely needs regulation regarding what the prior performance reflects, if and when institutional track records can be shown linked/nonlinked, and that the performance *to the public* is analogous to the NAV, showing performance net of all costs to retail investors. While one of the Standards’ goals is to bolster the notion of self-regulation, wrap programs present a problem in that the sponsors are controlling the performance presentations in many if not most instances. AIMR should continue working with the SEC and MMI to influence a policy that serves the best interests of the investing public and addresses the concerns of AIMR’s constituency, the advisor community.

Respectfully submitted,



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