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Association for Investment Management and Research
Reference: AIMR-PPS standards – Wrap Fees
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To the members of the AIMR-PPS Implementation Committee,

We would like to begin by thanking you for your work in drafting guidance aimed at clarifying the original AIMR-PPS wrap fee provisions. Further, we appreciate the opportunity to comment on the proposed guidance. We hope that the following comments are useful as you once again reconsider the guidance and move to finalize it.

Defining Wrap Fee Portfolios

The “Introduction” and “Definition of Wrap Fee Portfolios” sections of the proposed Guidance Statement on Wrap Fee Performance (Wrap Fee GS) include references to wrap fee portfolios followed by a parenthetical statement indicating that wrap fee portfolios are “also known as managed accounts.” We would recommend this language be more carefully defined or changed. The SEC specifically states that “‘managed account programs’...generally are *not* considered wrap fee programs.” (Regulation of Investment Advisors, 2.02[3][f])¹ Given this definition, the intended scope of the Wrap Fee GS (those accounts for which “the calculation of gross-of-fees results does not reflect the deduction of actual trading expenses”), and given the fact that based on the individual fee structures in place wrap, managed and even traditional separate accounts may qualify as “wrap” according to the Wrap Fee GS, we would like to see the language clarified.

One easy alternative would be the term “Bundled Fee” which is used in the “Proposed Fees Provisions for the GIPS Standards.” For even greater clarity the committee might consider “Bundled-fee-in-lieu-of-discrete-fees,” though we recognize this is unwieldy. We would additionally recommend the inclusion of an explicit statement which explains that in addition to wrap fee portfolios, some managed and traditional separate accounts may qualify as wrap fee portfolios for the purposes of the AIMR-PPS, depending on their fee structures. Along with this acknowledgement, we further suggest a recommendation or warning to managers that they must carefully review the actual fee structures of their accounts when determining composite membership rather than relying on the name of the sponsor’s program or the type of the account.

¹ *Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisors, 2001 ed., (St. Paul, MN: West Group, 2001) 2.02[3][f].*

Clarifying the Scope of the Wrap Fee Portfolio Definition

In the crucial “Scope of Guidance Statement on Wrap Fee Performance” section, the proposed Wrap Fee GS asserts “the fundamental principles of this guidance statement must be applied in all cases where the calculation of gross-of-fee results does not reflect the deduction of actual trading expenses.” As a guiding principle this statement goes a long way in helping managers discern which accounts qualify as “wrap” and which do not. However, this statement bears further clarification as it does not adequately address the complex reality of applying this standard. While we do understand it is not the purpose or goal of the Implementation Committee to provide explicit guidance for every conceivable specific situation, we do request further clarification to address the situations outlined below as we believe it is critical to ensure the uniform interpretation and application of the Wrap Fee GS.

The “Interpretive Guidance for Fees Provisions” states: “Trading Expenses can be direct, as in the case of brokerage commissions, or indirect, as in the case of a bid/ask spread.” The obvious challenge in applying this definition in conjunction with the principle set forth regarding the definition of wrap accounts is that while a fee is charged in lieu of commissions for equity accounts, our understanding is that all bond trades include a spread. Strictly applying the defining wrap principle in question, then, would mean that no accounts holding bonds would qualify as wrap. Conversely, if it were to be determined that spreads did not actually “count” as a trading expense, then virtually all bond accounts would qualify as wrap accounts.

The “Interpretive Guidance for Fees Provisions” further states: “Direct Trading Expenses include brokerage commissions and any other regulatory fee, duty, and/or tax (e.g., stamp duty, SEC fee, etc.) associated with an individual transaction.” This definition combined with the defining wrap-fee account principle presents another contradiction. While it is only a matter of pennies for most of our trades, SEC fees are being deducted from trades made in our wrap-fee accounts. By strict definition, then, none of our wrap fee accounts would actually qualify as wrap since the returns would not be “pure gross of fee” due to the deduction of the SEC fee trading expense.

Clarifying Methodology for Reporting to Non-Wrap Fee Prospects & Sponsors

We would like to ask the committee to consider clarifying the language of the Wrap Fee GS in two more locations. First, in the “Reporting to Non-Wrap Fee Prospective Clients” section the Wrap Fee GS asserts that “If transaction costs are not determinable (which is generally the case), a firm must use the net-of-fees returns for calculating the composite gross-of-fees return.” We have assumed the intention is that managers would “add back in” the amount of their management fees (as these are likely to be known) and have the option of adding back the amount of the custody portion of the fees, should the actual

custody fees be determinable. We believe clarification of the committee's actual intentions with regard to this matter would strengthen the guidance on this subject.

Second, in "Comprehensive Case Study 5" we believe the answer provided to question 5.A.2. also requires clarification. AAA is presented as having two options for deducting the "highest applicable wrap fee" from the performance of their institutional composite, the first being to deduct "the highest wrap fee that is charged by AAA to a portfolio of a similar style." As we read it, this option refers to the "partial net-of-fees" approach a manager can use when presenting wrap performance for a sponsor's use only. If this is the case, we suggest the answer to 5.A.2. be expanded to include an indication that this is the option being described and cautioning that AAA would need to have the partial net-of-fees returns clearly labeled, as required, and that the entire wrap fee would have to be deducted before the performance could be shown to end wrap prospects. If we have misinterpreted the answer presented, let our confusion stand as further argument for the need for clarification.

Establishing Wrap Fee Composites and Reporting Wrap Fee Performance

On the subject of establishing a wrap fee track record for investment managers with no prior history of managing wrap assets, we commend the committee for their creative solution to this practical problem. Likewise, we greatly appreciate and endorse the committee's proposed options for defining wrap fee composites once a firm begins to manage actual wrap fee portfolios. Further, we are grateful for the great care taken by the committee to address the varied requirements and options for presenting wrap fee performance to different audiences. All these provisions – which clearly represent a tremendous amount of rigorous thinking on these complex issues – provide much needed clarification of the standards and serve to equip managers with effective guidelines for initiating and defining wrap fee composites, as well as for establishing external communication standards for wrap fee presentations.

Accountability for End-Client Presentations

The "Presenting Wrap Fee Performance" section of the Wrap Fee GS very accurately asserts "the typical wrap fee relationship involves the transfer of marketing and reporting control from the investment management firm to the wrap fee sponsor." Because of the uniform truth of this statement we heartily endorse the mandate that firms "adopt a conservative approach when reporting performance to a wrap fee sponsor." At the same time, we harbor some serious concern over the extent to which the Wrap Fee GS attempts to hold investment managers responsible for ensuring that end-clients (sponsor clients) receive fully compliant presentations. Practically speaking, as the "hired help" investment managers are not in a position to dictate to sponsors how and what the sponsors will report to their end clients and prospects. Contrary to the assumption made that sponsors will use the manager's net-of-fees performance returns "to market to

prospective clients (end users),” sponsors may well choose to calculate and report their own return information, bypassing the investment manager’s performance report altogether. The investment managers cannot prevent this. Nor can the manager prevent a sponsor from selectively utilizing data from the manager’s fully compliant presentation (e.g. stripping out the net-of-fees returns and most or all of the disclosures). This dilemma is not unique to wrap fee programs, of course. It is very common for a manager to supply a fully compliant presentation to a consultant only to have the consultant turn around and provide his/her prospect with “summarized” information that includes an assurance that the manager’s composite is “Level I and Level II compliant.”

The introduction to the Wrap Fee GS concludes with the following paragraph:

Because the standards were created for the ultimate benefit of the users of investment management services, this Guidance Statement focuses on the need for the prospective wrap fee clients to receive all necessary performance information in order to fairly represent a wrap fee product.

We fully support this aspiration and believe managers should strive to promote the fair, full representation of wrap fee products, but the reality of the sponsor/investment manager relationship causes us to question if, perhaps, this stated intent establishes an impossible standard for managers, who like anyone else, cannot control the actions of the others. This stated, we are not suggesting that any guidance necessarily be changed or reworded. Instead, we are advocating that the committee strongly consider adding an acknowledgement that, ultimately, managers cannot control what sponsors show to end-prospects where the managers are not directly involved in the presentation of the material. We further suggest that such an acknowledgement immediately follow the last sentence of the “Gross-of-fees versus Net-of-fees performance” section. Our intent with this suggestion is not to contradict the aim of the guidance, but to assure managers that the committee and AIMR are indeed well aware of the reality faced by managers and are not mandating an unattainable feat but are establishing an achievable high standard.

Timing and Challenges of Guidance Statement Implementation

With respect to the proposed implementation date of the Wrap Fee GS, we would strongly suggest a graduated implementation as detailed below in our proposed modifications/additions to the wrap fee provisions.

Our deep concern about the timing of the implementation stems from the enormous complexity of satisfying the underlying records requirements that already exist in the standards, as well as the practical matter of current system limitations, combined with the nature of the sponsor/investment manager relationship. The Wrap Fee GS very accurately acknowledges that investment management firms “do not maintain or have access to the data necessary to substantiate performance.” Yet the expectation clearly

established is that investment management firms will satisfy requirements 1.A.1. of the standards (“All data and information necessary to support a firm’s performance presentation and to perform the required calculations must be captured and maintained.”) for all their wrap-fee portfolios. We heartily agree that 100% documentation should be the desired goal and should be vigorously pursued. However, the two proposed alternatives for achieving this goal are unfortunately impractical at present. While shadow accounting offers the better safeguard of a firm’s compliance, it is universally acknowledged as an excessively expensive undertaking – so much so, in fact, as to represent for some firms an insurmountable deterrent to pursuing wrap fee business. If a firm does choose to “bite the bullet” and utilize shadow accounting, there is still no assurance they will be able to fully satisfy requirement 1.A.1. because they may or may not have access to the complete account information necessary for an accurate “shadow.”

Utilizing sponsor-calculated performance information is an unreliable, largely untenable option at present. While sponsors generally require investment managers to be compliant with the AIMR-PPS in order to be included on their sponsor platforms, they typically lack an understanding of what is required of them to help the managers they have hired remain compliant – which is perfectly understandable since they are not themselves subject to the standards. Furthermore, the sponsors have no incentive to help managers obtain the data required since, from their perspective, the investment manager is little more than a vendor of services. Who among us would respond, in a timely manner no less, to demands from a vendor for extensive support and data feeds? Additionally, sponsors view their client data as proprietary, and as a vendor (who is also a potential competitor), investment management firms are not in a position to negotiate open, ready access to sponsor-client data.

Of course, while all these obstacles do exist, there are some sponsors making definite efforts to help investment managers collect the data they need to maintain compliance with the AIMR-PPS. However, even when sponsors are willing to provide the necessary information, systems and data incompatibilities can, and often do, still make it costly or impossible to fully satisfy requirement 1.A.1., and potentially other requirements set forth by the standards. It is our understanding, though, that the sponsor community is taking steps to address standardization issues within their industry. We are confident these efforts will ultimately benefit all concerned, including investment management firms attempting to manage wrap assets while maintaining their compliance and their profitability.

In the meantime, the obstacles outlined above present very real threats to the attainment and ongoing maintenance of compliance with the AIMR-PPS for firms managing wrap assets. While we recognize and greatly appreciate the tremendous value offered by the AIMR-PPS as a catalyst for change in our industry, we are very concerned that the effect of a near-term implementation of the Wrap Fee GS as it is currently proposed will be to discourage firms who are legitimately compliant, and who vigilantly maintain their

compliance, from pursuing wrap business, allowing the wrap marketplace to be dominated by firms making false claims of compliance. We know that it has never been the goal of the AIMR-PPS to dictate the types of business investment managers choose to pursue, and that it is not the intention of the proposed Wrap Fee GS to discourage managers from pursuing wrap fee business. At the same time, we were alarmed but not surprised by the acknowledgement by a member of the panel leading the discussion of the Wrap Fee GS at the recent AIMR-PPS conference in New York that she has audit clients who are seriously considering walking away from wrap business because of the costs associated and the serious threat to their compliance with the standards. This statement confirmed our exact concerns. Of course it is also possible that given the choice between maintaining compliance and accepting a large wrap relationship, a firm may opt to recant its claims of compliance and accept the lucrative deal. (And it is well within the prerogative of any wrap sponsor to hire a manager who is not in compliance with the standards.) Being strong advocates of the AIMR-PPS, we believe such a choice – particularly if it became a trend – would be very damaging to the long-term credibility of the standards and therefore the industry as a whole.

Since the SEC already provides strict requirements for investment managers with respect to the documentation required for client accounts, and since the standards already mandate firms claiming compliance with the standards must also “comply with the local law or regulation” (Introduction C.1.10.i.), we believe a viable alternative to the proposed timing of the implementation of the Wrap Fee GS is to allow the current government regulation to “stand in the gap” while the wrap industry is allowed to evolve further. It is not our intention to open the door for firms to become lazy about the collection and maintenance of “all data and information necessary to support...[their] performance presentations and to perform the required calculations.” (1.A.1.) In fact, we have tried to suggest an interim solution and disclosure requirements which we hope, if adopted, will provide real incentive to managers to strive for 100% documentation and full compliance with 1.A.1. for all their wrap portfolios, while also providing useful information to the recipients of wrap fee performance presentations. We firmly believe the guidance set forth by the Wrap Fee GS represents the best, most appropriate ultimate goal for the AIMR-PPS with regard to wrap fee accounts. Our suggestions are made simply to allow reputable, compliant investment management firms who are willing to incur the costs associated with being a trail-blazer in this yet “untamed” segment of the industry to pursue wrap business without necessarily sacrificing their compliance.

Proposed modifications/additions to the wrap fee provisions (underlined sections):

1.A.1. All data and information necessary to support a firm’s performance presentations and to perform the required calculations must be captured and maintained. Refer to 8.A.4. for a temporary exception for wrap-fee portfolios only.

8.A.4. Firms must be diligent and continuously make every reasonable effort to comply fully with requirement 1.A.1. for all wrap fee portfolios. Where firms are absolutely unable to obtain sufficient documentation, they must categorize the wrap fee portfolios in question as “disqualified.”¹ Disqualified portfolios may not be included in any composite except for a sponsor-specific composite to be used only to present performance to the sponsor from whom adequate documentation is not available. This sponsor-specific composite may not include a claim of compliance. Firms are strongly cautioned to ensure they continue to comply with all local law or regulation with respect to the maintenance of sufficient records and documentation for client portfolios. If a firm has categorized any portfolio(s) as disqualified, the firm must disclose in all wrap fee presentations the following items: a) the existence of disqualified portfolios and b) the percentage of its total wrap fee business the disqualified portfolios represent. After December 31, 2005² it will no longer be permissible to classify any portfolios as “disqualified” and firms will have to comply fully with requirement 1.A.1.

¹ Disqualified accounts are distinctly different than non-discretionary and non-supervised accounts. Disqualified accounts are strictly defined as fully discretionary wrap-fee style accounts that would be included in a wrap composite if the manager were able to obtain the necessary data to satisfy requirement 1.A.1.

² This date is presented as a placeholder more than a suggestion, and it is only a guess at what might be an appropriate time frame. We would strongly recommend the solicitation of input from members of the sponsor, investment management, and financial services software communities for the final determination of a realistic phase-out date for this proposed temporary provision.

Assuming the inclusion of our proposed modifications, we support the proposed July 1, 2003 effective date for the Wrap Fee GS.

In conclusion, we would like to thank the Implementation Committee for providing thorough guidance on what can be considered a very gray subject matter and for providing us the opportunity to comment on the proposed guidance. We greatly appreciate your tireless efforts to further the AIMR-PPS standards and ensure their continued practicality, rigor and relevance. Please contact us with any questions on our above comments.

Sincerely,

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