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Association for Investment Management and Research

Reference: AIMR-PPS standards – Wrap Fees

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VIA E-Mail to standardsetting@aimr.org

We at David L. Babson & Company are pleased to comment on the proposed Guidance Statement on Wrap Fee performance and encourage AIMR to continue to strive for clarity, uniformity and comparability in performance standards.

Responses to Comments Requested

- *Do you support AIMR's effort to clarify the wrap fee provisions of the AIMR-PPS as outlined?*

We are in support of AIMR's efforts to clarify and enhance the wrap fee provisions of the AIMR-PPS.

- *Do you think the requirements for investment management firms to have access to the underlying records are sufficiently explained and the alternatives available to firms to satisfy the requirements are understandable and operable?*

We agree that the wrap sponsor or producer must provide the investment management firm with sufficient underlying records to support performance results. The alternatives available to satisfy the requirements are understandable. However, the use of "shadow accounting" creates a significant burden on the investment manager that is not always commensurate with the benefits gained and is therefore unfeasible in most instances. Reliance on the wrap sponsor or producer to provide accurate performance data, therefore, becomes the most attractive option. However, this reliance is subject to the administrative and systems limitations of the wrap sponsor or producer, which often exceed those limitations of the investment manager. We encourage AIMR and the rest of the investment management community to continue to strive to address the urgent necessity for wrap sponsors or producers to effectively implement systems and administration that will allow for maximum efficiency in the management of wrap fee programs. Wrap sponsors or producers should strongly consider implementing independent review procedures for their wrap program operations, including the engagement of independent auditors to provide reports similar to *A Report on Controls Placed in Operation and Tests of Operating Effectiveness* issued in accordance with the AICPA's Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (as amended by subsequent SAS). Such measures will provide the participants in the wrap fee channel with a greater level of comfort that the systems relied upon for performance reporting are operating effectively.

- *Once a firm acquires one or more wrap fee portfolios for management, should the firm be required to include the performance of the **actual** wrap fee portfolios when presenting performance to prospective wrap fee sponsors and/or clients?*

We understand that the Guiding Principle requiring investment management firms to present actual, rather than simulated, wrap fee performance, is in the spirit of the AIMR-PPS. Because of the unique structure of wrap programs, however, a manager of wrap portfolios, while having discretion over the actual securities invested in the portfolios, does not have discretion over the overall client relationship. The manager can be considered to be "once-removed" from the client. This structure creates several problems in creating a meaningful performance record for actual wrap fee portfolios:

- The risk exists that “nondiscretionary” actions by the client, such as sudden cash withdrawals, will abnormally effect portfolio returns because of the necessity to “cash out” of a portion of the investment strategy. Because of the manager’s position in the hierarchy of the wrap fee portfolio structure, and the systems and administrative limitations of wrap sponsors or producers, such actions may not be effectively communicated to the manager in a way that would make such nondiscretionary actions transparent in relation to the performance of the portfolio.
- Additional nondiscretionary client actions include the manager’s gain or loss of wrap fee portfolios simply by the client’s decision to change broker/dealers (producers). This phenomenon creates extremely frequent inclusions and exclusions in a wrap fee composite based on client decisions that are unrelated to the investment manager.

We expect that because of these conditions associated with the wrap fee platform, there will always be a certain amount of dispersion between wrap fee and direct-channel performance of a similar investment strategy. We encourage all constituents of the wrap fee platform to work towards the minimization of such dispersion through improvement in systems, controls, and overall lines of communication.

- *Is the distinction between pure gross-of-fees, gross-of-fees and net of fees performance clear?*

The explanation of and the distinctions between the above methods of presentation are sufficient.

- *Do you agree with the proposed treatment for a “double hit” of transaction expenses (when creating a simulated wrap fee performance record)?*

We encourage all constituents affected by this proposal to strive to develop and implement systems and procedures necessary to isolate transaction costs so that all actual and simulated performance can be represented properly. The proposed “double hit” treatment also encourages such development, as those firms that cannot accurately isolate transaction costs are in fact penalized with such treatment.

Unfortunately, for the presentation of actual wrap fee performance, investment management firms wishing to show actual gross performance (rather than “pure” gross) must depend on the wrap producer/sponsor and the associated systems and controls. The following is an excerpt from our response to AIMR's Invitation to Comment on the Addition of Fees Provisions and Guidance to the GIPS Standards, dated June 28, 2002:

We agree with AIMR’s statement in the proposed Interpretive Guidance for Fees Provisions that “the investment firm should only be held responsible for those fees that it can control.” In most cases, this results in the presentation of Gross-of-fees returns that include direct Trading Expenses, and, if presented, Net-of-fees returns calculated by deducting the maximum fee applicable to a specific composite. However, the continued proliferation of so-called “wrap” products results in the “blurring” of the lines that delineate which fees an investment firm can in fact control. In certain wrap programs, the calculation and reporting of direct Trading Expenses are controlled by the sponsor of the wrap products and not the investment firm. Implementation of systems that are able to isolate direct Trading Expenses by current wrap sponsors are not at the control of the investment firm and are often behind the current technology cycle. Because of such circumstances, investment firms are forced to present performance net of the entire Bundled fee applicable to the specific wrap program and composite, thereby creating a competitive disadvantage.

Because investment management firms generally provide performance data to the wrap producer/sponsor community rather than the ultimate prospect or client, an element of control is lost over what is ultimately reported to the wrap fee client or prospect. We acknowledge that the ability to present performance in a range of formats (“pure” gross as supplemental information, gross of fees, net of investment management fees only, net of all fees) serves to better educate all constituents of the wrap fee channel. However, because the ultimate client or prospect presentation is usually made by the wrap producer/sponsor and not the investment

management firm, the suggestion that “firms must make every reasonable effort to be sure that the wrap fee performance shown to prospective wrap fee clients is shown net of the entire wrap fee,” although well within the spirit of the Guiding Principles, is often unfeasible. Rather, given performance presentations in a range of formats, it is ultimately up to the wrap producer/sponsor, not the investment management firm, to be sure that the wrap fee performance shown to prospective wrap fee clients is shown net of the entire wrap fee. Therefore, any guidance in the area of wrap fee prospect or client presentation should acknowledge that the wrap sponsor/producer carries a certain burden that would be customarily borne by the investment management firm in a direct-channel environment, rather than placing the entire onus upon the manager.

- *Do you support the 1 July 2003 effective date of the proposed Guidance Statement for Wrap Fee Performance?*

We believe that the effective date should be extended to 1 January 2004 at the earliest to allow the many constituents affected by the proposed Guidance Statement to effectively implement and enhance policies, procedures and systems necessary for compliance. Additionally, because of the nature of the proposal, digestion of comments received by AIMR will most likely preclude such an early effective date.

- *Should AIMR consider any other methods for meeting the objectives of clarifying the wrap fee provisions of the AIMR-PPS standards as set forth above?*

We encourage AIMR and the wrap producer/sponsor community to strive to develop “best practices” guidance in the areas of performance reporting in an effort to maximize efficiency of this rapid-growth platform.

We would be pleased to discuss the comments presented above and, as previously mentioned, applaud AIMR for its efforts in continuing to strive for clarity, uniformity and comparability in presentation of investment performance results.

Sincerely,

Laurence J. S. Grosbaum, CPA, CFA
Director