

How to Negotiate the New SMA Guidance Statement Maze

MMI 2006 Annual Convention
March 15-16, 2006



John K. Forst
Deputy General Counsel
Lord, Abbett & Co. LLC



Michael S. Caccese
Partner
Kirkpatrick & Lockhart Nicholson Graham LLP

Highlights of Changes to the 2006 Global Investment Performance Standards



History

History of Wrap Fee/SMA Guidance

- 1995: Wrap Fee provisions 1st in AIMR-PPS standards – Many questions about how to apply
- 2002: Circulated guidance for public comment
- 2003: Received 57 comments (most critical of approach)
- 2004: Oct – 2nd draft circulated for comment within GIPS framework (no longer just US/AIMR-PPS issue)
- 2004: Dec – comment period closed; received 20 comments (most repeating same issues)
- 2005: Aug – GIPS Provisions and Guidance adopted
- 2006: Jan – Must comply with new guidance

Key Provisions

- Definition of Firm
- Recordkeeping
- Composite Composition – including the use of historic performance records
- Performance Presentation
- Effective Date

Key Provisions

Definition of Firm

Single organization could = single “Firm” OR multiple “Firms”

Why Important?

- Claim of GIPS compliance extends to all business units included in the “Firm”
- Assets/Number of Clients
- Performance



Key Provisions

Firm Definition – Considerations

- Holding Out
 - Segregation from other units
 - Discretion over assets
- “Should have” autonomy over the “investment decision making process” (although not required)
- Use of GIPS Track Record
- Non-GIPS compliant “Firm” – not subject to GIPS

Key Provisions

Recordkeeping

- Under the Guidance Statement, a firm does not need records supporting performance prior to January 1, 2006 in order to claim GIPS compliance
- Beginning January 1, 2006, firm must:
 - Implement shadow accounting, OR
 - Rely on sponsors' records (+due diligence)
- Wrap Fee/SMA Account Identity – Choices
 - Each investor OR each separate sponsor's program
- Consider application of SEC recordkeeping requirements (Rule 204-2)

Key Provisions

Performance Presentations – Investor

- Prospect: 1st time Performance is shown
 - Style defined composite
 - Net-of-fees: reduce by entire wrap fee
- Existing: Once an agreement is in place
 - Net-of-Fees: reduce by trading expenses and investment management fees
 - Gross-of-Fees: reduce by trading expenses
 - If expenses can't be unbundled, may be equal to net-of-fees
 - Can add back fees except for trading
 - Client specific performance

Key Provisions

Performance Presentations – Sponsor

- Prospect: 1st time Performance is shown
 - Must show ‘style defined’ composite
 - Must show net of wrap fee
 - May show gross/pure gross, etc. – supplemental
- Existing: Once an agreement is in place
 - May show gross or net
 - Can also show “pure gross” – supplemental
 - May show ‘sponsor-specific’ composite
 - If Gross Only – must limit to sponsor use, not investor

Key Provisions

Effective Date: January 1, 2006

Commencing January 1, 2006

- Firms must comply with Guidance Statement – prospectively

For performance periods prior to January 1, 2006

- Firm may link non-compliant performance (with disclosure)

Resources

Available Resources

- Website – (<http://www.cfainstitute.org/cfacentre/ips/>)
- GIPS Standards (Revised in February 2005)
- GIPS Handbook (revisions coming this fall)
- CGIPS Program (beginning in 2006)
- Helpdesk – Q&As (gips@cfainstitute.org)
- E-mail Alert list (standards@cfainstitute.org)

Highlights of GIPS Revisions

Fundamentals of Compliance

➤ Firm Definition

Must define the “firm” as an investment firm, subsidiary or division held out to existing to potential clients as a distinct business entity

➤ Policies and Procedures

Must document written policies and procedures to maintain compliance with GIPS

➤ Compliance Statement

“[Firm Name] has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).”

Highlights of GIPS Revisions

Fundamentals of Compliance

➤ **Compliant Presentations**

Must make every reasonable effort to provide a compliant presentation to all prospective clients if not received within previous 12 months

➤ **Interpretations**

Must comply with all interpretations published by the CFA Institute on its website and in the GIPS Handbook

➤ **Composite Definitions**

Must provide full composite definitions upon request

Highlights of GIPS Revisions

Input Data

➤ Valuation Frequency

Disclose whether month-end valuations or valuations on last business day of month are not used prior to 1/1/2010

➤ Beginning & Ending Valuation Dates

For periods beginning 1/1/2006, composites must have consistent beginning and ending valuation dates, which must be at calendar year-end or last business day of year unless composite is reported on a non-calendar fiscal year

Highlights of GIPS Revisions

Calculation Methodology

➤ Calculation

For periods beginning 1/1/2006, must calculate composite returns by asset-weighting individual portfolio returns at least quarterly

➤ Bundled Fees

If actual direct trading expenses cannot be identified & segregated from a bundled fee:

- a) **Gross-of-fee returns:** must reduce returns by entire bundled fee or portion that includes direct trading expenses. No estimated trading expenses.
- b) **Net-of-fee returns:** returns must be reduced by entire bundled fee or portion that includes directing trading expenses and advisory fee. No estimated trading expenses.

Highlights of GIPS Revisions

New Disclosures

- **Minimum Asset Level:** must report changes, if any
- **Bundled fees**
 - percentage of composite assets that are bundled fee portfolios
 - various types of fees included in bundled fee
- **Gross-of-fee returns:** fees deducted in addition to direct trading expenses
- **Net-of-fee returns:** fees deducted in addition to advisory fee and direct trading expenses

Highlights of GIPS Revisions

New Disclosures

- Use of subadviser(s) and periods of use
- Subadviser fees (*recommended*)
- Composite description
- Firm redefinitions: date and reason for change
- Composite redefinitions: date and nature of change

Highlights of GIPS Revisions

New Disclosures

- Disclose if, prior to 1/1/2010, calendar month-end portfolio valuations or valuations on last business day of month are not used
- Dispersion method
- Policies for calculating and reporting returns available upon request
- All significant firm events (e.g., departures, mergers)

Highlights of GIPS Revisions Presentation & Reporting

➤ Portability

Must link performance of prior firm if GIPS portability standards are met

➤ Carve-outs

No longer need to include lists of underlying composites from which carved-out segments are drawn

➤ Firm assets

Must report either % of total firm assets represented by composite *or* amount of total firm assets at end of each annual period

Highlights of GIPS Revisions

Verification

- Firms encouraged to undertake verification process
- Firms encouraged to disclose periods of verification and that verification report is available upon request
- Likely mandatory in the future; IPC will reevaluate mandatory verification by 2010

GIPS Wrap Fee/SMA Provisions and Guidance

- Background and Development of GIPS Wrap Fee/SMA Provisions and Guidance
- Key Provisions – Challenges and Changes for Wrap Fee/SMA Firms
- Remember: GIPS are global standards – U.S. advisors must comply with U.S. Law

*

Practical Guide to Wrap Fee/Separately Managed Account Performance and Presentation for GIPS Standards

**The Money Management Institute ("MMI") is the national organization for the managed account industry, representing portfolio manager firms and sponsors of investment consulting programs. MMI is the leading advocate for the industry on regulatory and legislative issues. Visit www.moneyinstitute.com for more information.*

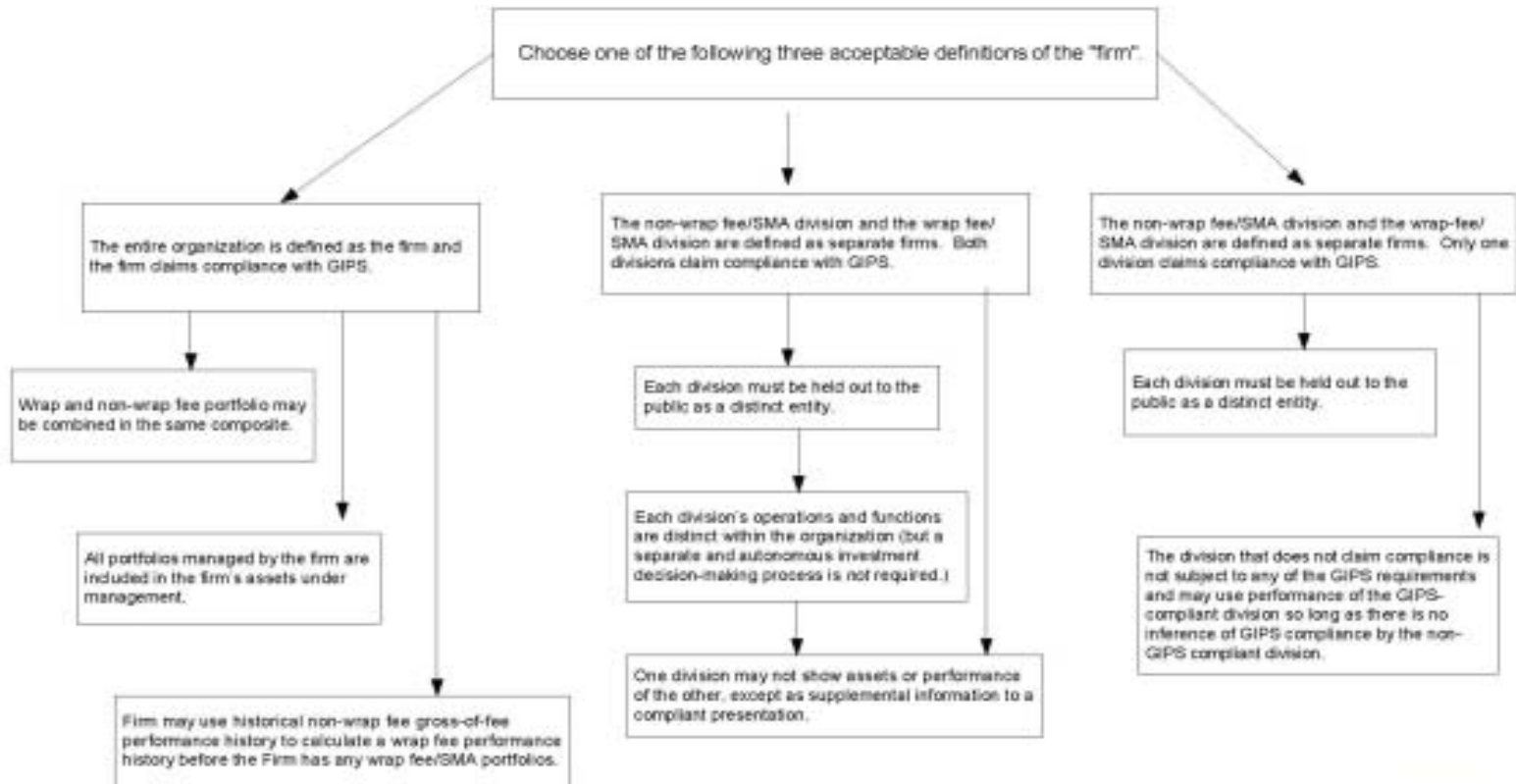
Courtesy of the Money Management Institute

The Money Management Institute*

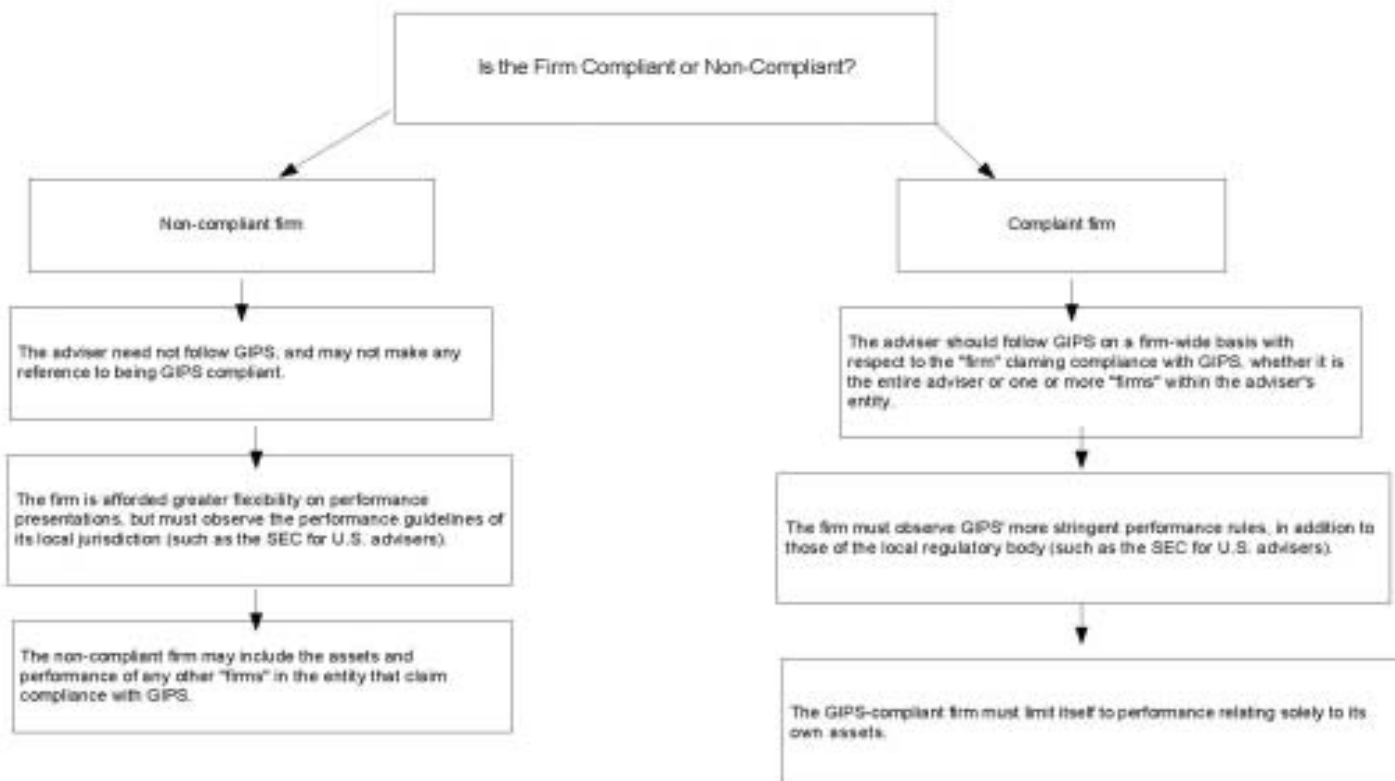
**Practical Guide to Wrap Fee/Separately Managed Account Performance and
Presentation for GIPS Standards**

**The Money Management Institute ("MMI") is the national organization for the managed account industry, representing portfolio manager firms and sponsors of investment consulting programs. MMI is the leading advocate for the industry on regulatory and legislative issues. Visit www.moneyinstitute.com for more information.*

Definition of Firm

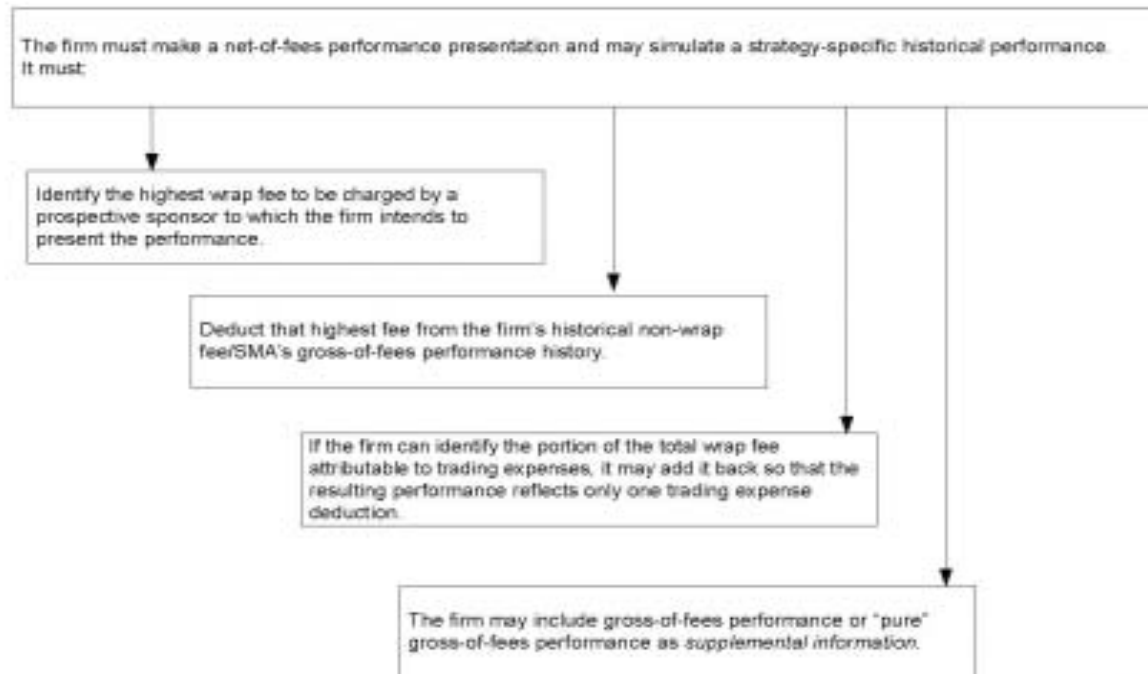


PRESENTATION OPTIONS BASED ON DEFINITION OF "FIRM"



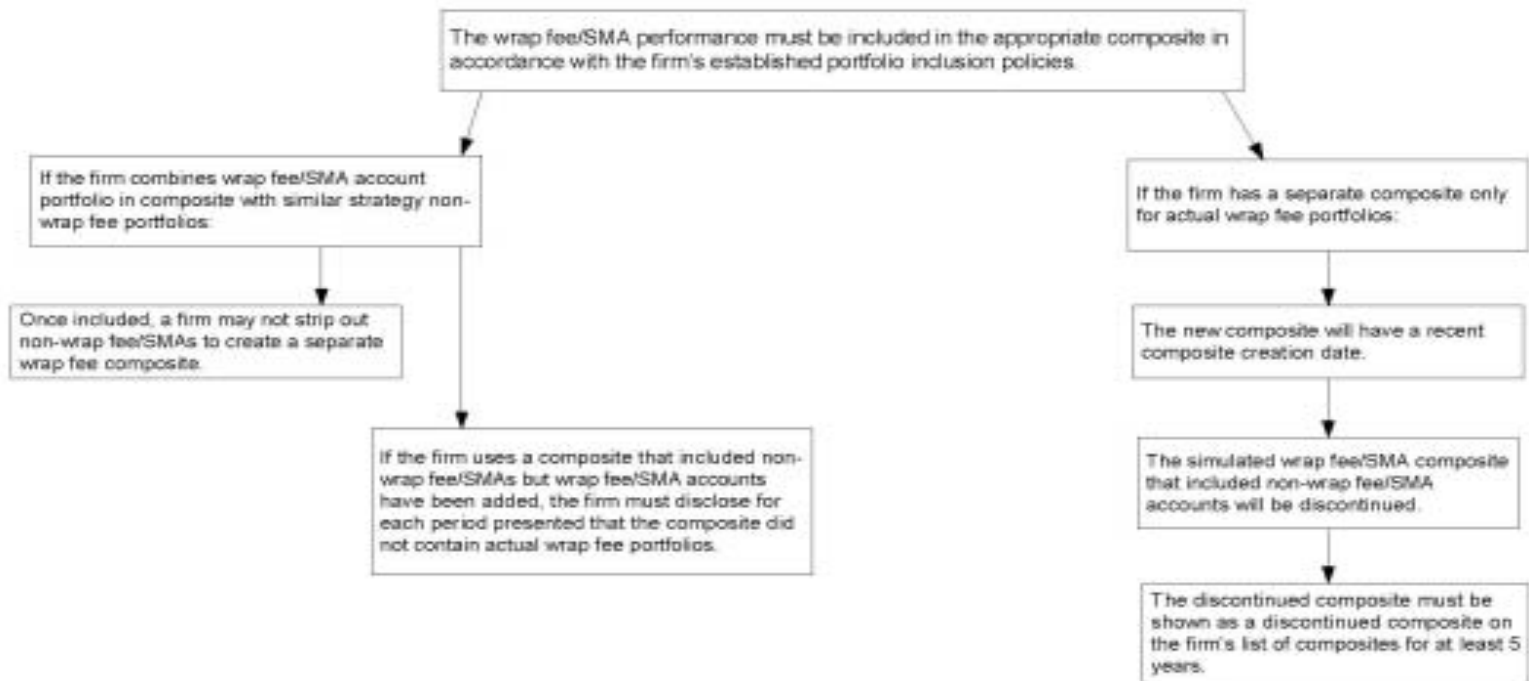
Building A Composite Before Managing Wrap Fee/SMA Portfolios

If the entire organization is defined as the firm, and the firm claims compliance with GIPS, to build a composite for wrap fee/SMA portfolios **BEFORE** a firm begins managing wrap fee/SMA portfolios:



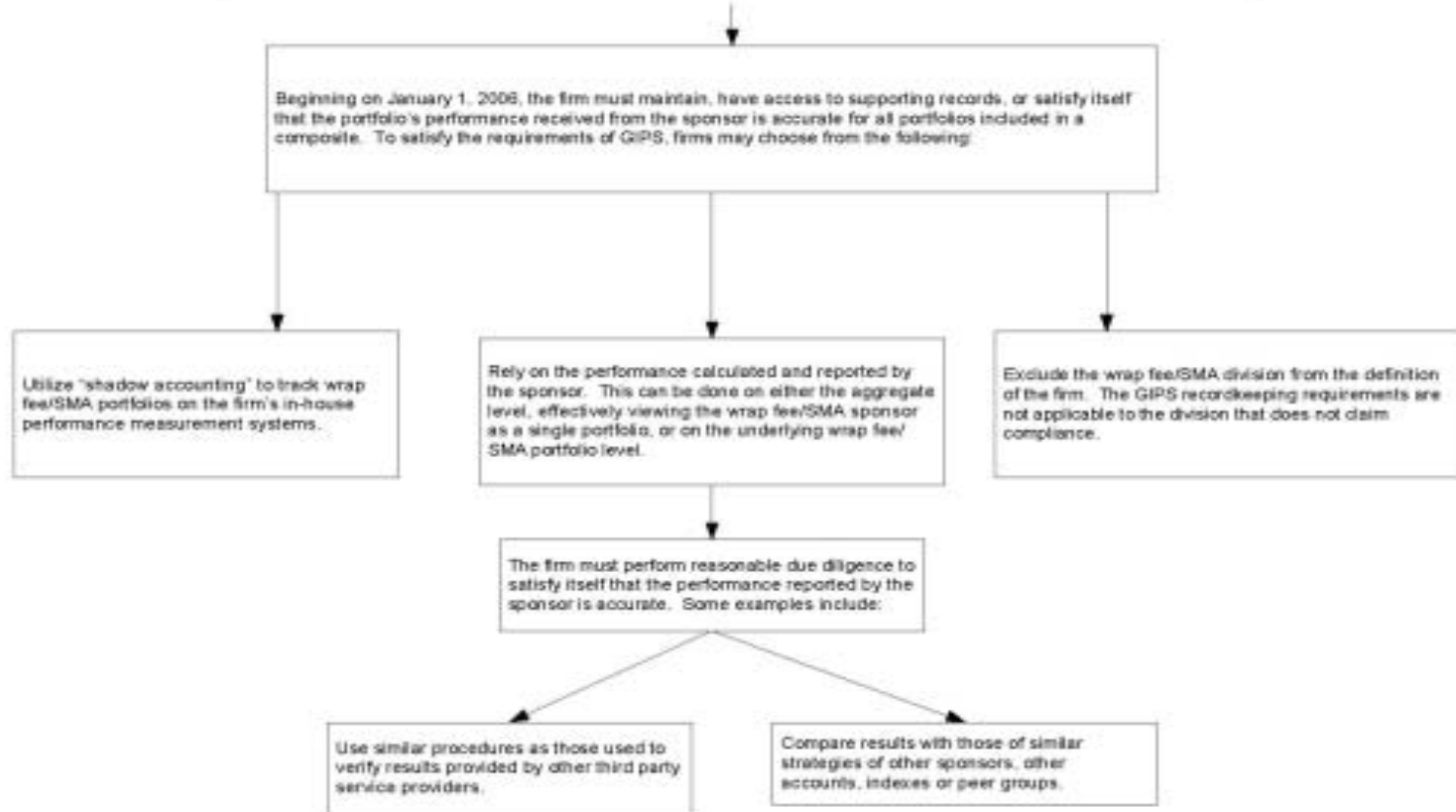
Building A Composite After Managing Wrap Fee/SMA Portfolios

If the entire organization is defined as the firm, and the firm claims compliance with GIPS, to build a composite for wrap fee/SMA accounts **AFTER** a firm begins to manage wrap fee/SMA portfolios:

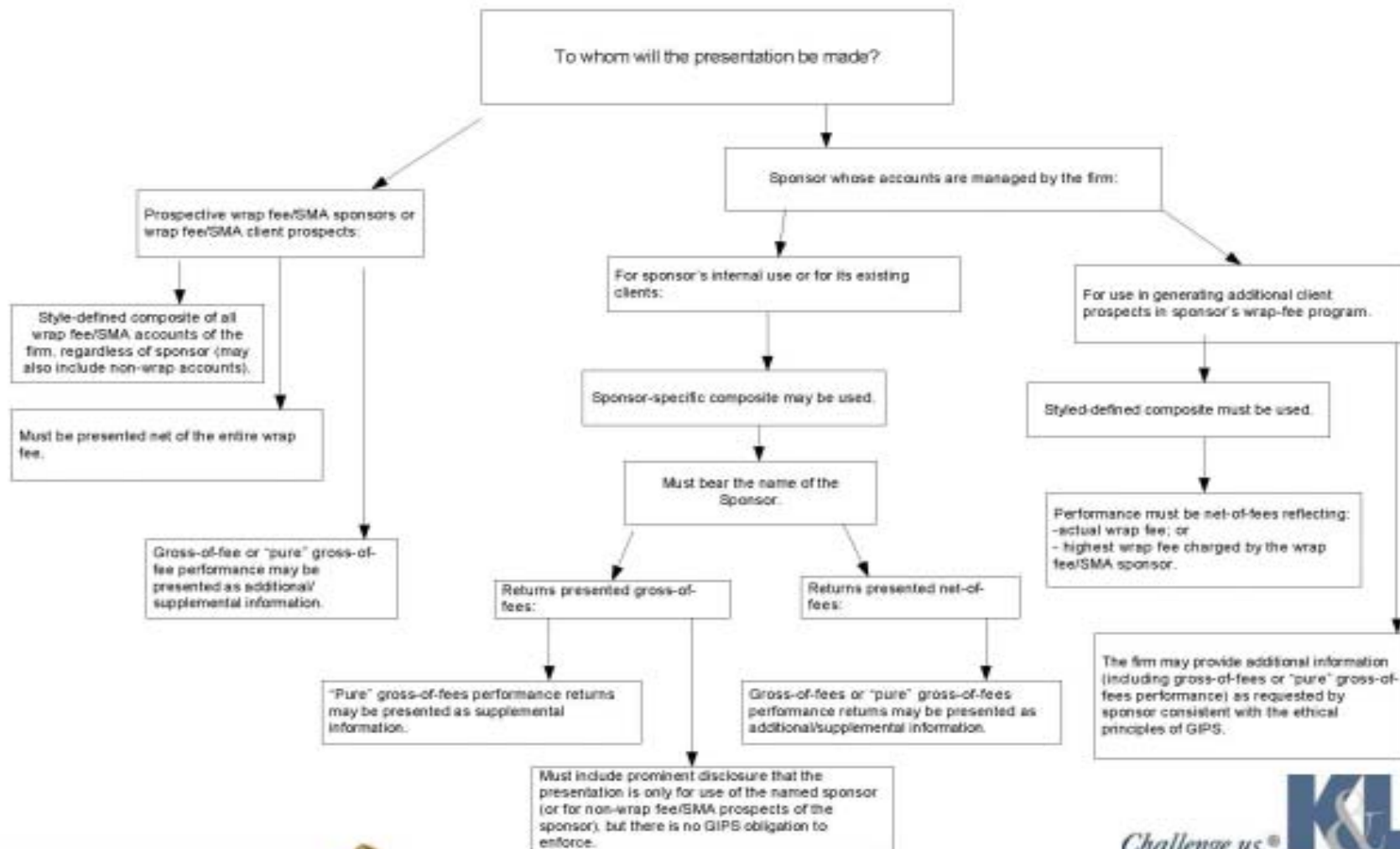


Keeping Underlying Records of Composite Performance

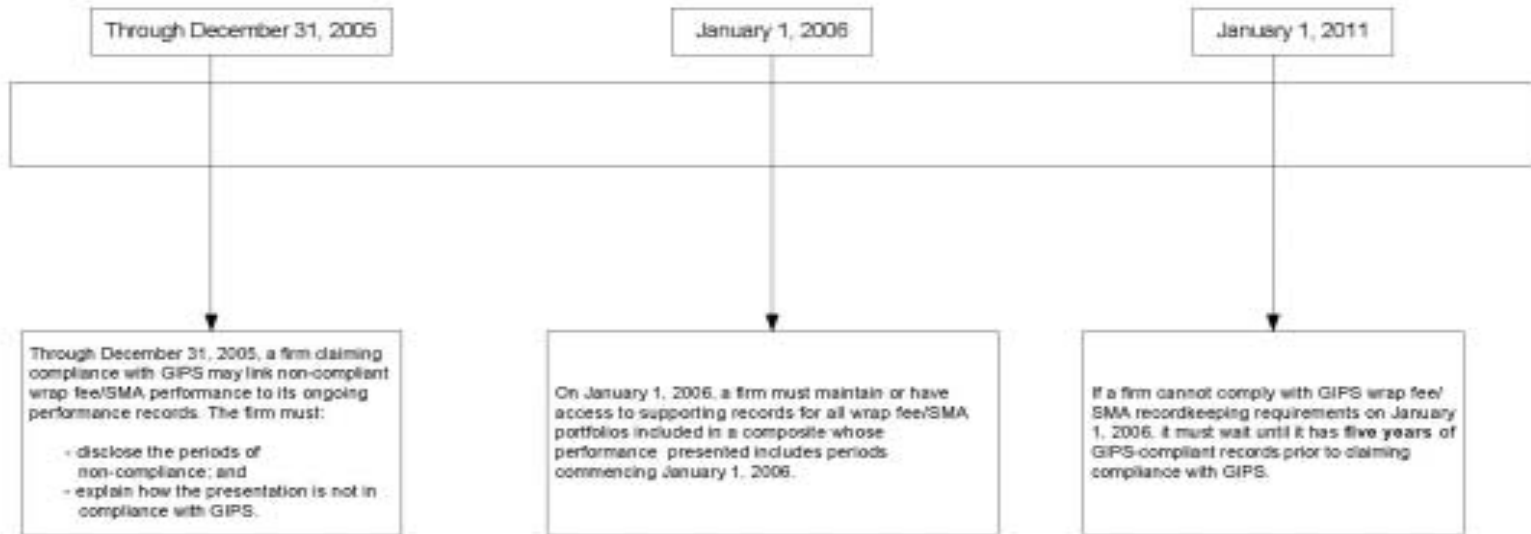
For U.S. advisers, the firm must maintain records in accordance with Rule 204-2 under the Advisers Act. For non-U.S. firms, the firm should consult the recordkeeping requirements of its own jurisdiction. Note: The SEC's recordkeeping requirements apply to the adviser presenting the performance, not the wrap-fee SMA sponsor.



Determining what type of performance may be shown to wrap fee/SMA sponsors and their clients



GIPS WRAP FEE/SMA GUIDANCE TIMELINE



This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

© 2006 THE MONEY MANAGEMENT INSTITUTE, INC. ALL RIGHTS RESERVED.

