JOSEPH CAPITAL MANAGEMENT, LLC

A FEE ONLY INVESTMENT ADVISORY FIRM

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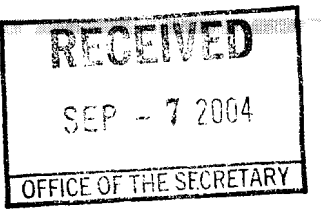

Via Electronic Filing

August 30, 2004

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington, DC 20549-0609

Re: File No. S7-25-99; Comments In Support of Repeal of Proposed Rule:
"Certain Broker-Dealers Deemed Not To Be Investment Advisers"

To the Commissioners:

I appreciate the opportunity to submit additional comments regarding the Commission's proposed rule, "Certain Broker-Dealers Deemed Not To Be Investment Advisers," given the Commission's recent initiative to act upon this 1999 proposed rule by the end of 2004. To encourage a full understanding of the many legal and practical issues raised by the Proposed Rule, my comments are extensive and are attached.

I appreciate the Commission's consideration of these comments on this important Proposed Rule. I trust that the Commissioners or Commission staff will not hesitate to contact me at 352.746.4460 if I may provide any additional information or assistance to the Commission during this process.

Sincerely,

Ron A. Rhoades
Chief Compliance Officer, Director of Research
Joseph Capital Management, LLC

cc: The Honorable William H. Donaldson
The Honorable Harvey J. Goldschmid
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
Charles Fishkin, Dir., Office of Risk Assessment
Paul F. Roye, Esq., Director, Division of Investment Management
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New Imperatives for the SEC - Repeal of Proposed Rule Relating to the Non-Application Of the Investment Advisers Act of 1940 To Fee-Based Accounts of Broker-Dealers: and Proposal for the Complete Application Of the Fiduciary Duties Imposed By the Investment Advisers Act of 1940 To the Activities of All Financial Advisors

Comments submitted by

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August 30, 2004

CONTENTS

-cont. TABLE OF CONTENTS

-cont. TABLE OF CONTENTS

-cont. TABLE OF CONTENTS

New Imperatives for the SEC - Repeal of Proposed Rule Relating to the Non-Application Of the Investment Advisers Act of 1940 To Fee-Based Accounts of Broker-Dealers:

and

Proposal for the Complete Application Of the Fiduciary Duties Imposed By the Investment Advisers Act of 1940 To the Activities of All Financial Advisors[1]

Comments submitted by Ron A. Rhoades, B.S., J.D.[2]

August 30, 2004 [3]

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[1] While it is in the competitive interest of the author's firm that the broker-dealer exception continue [as this would permit our firm to continue to distinguish our independent, objective and fiduciary advisors from registered representatives operating under the fee-based, captive programs of broker-dealer firms (which, under the Proposed Rule, would not be required to register under the Investment Advisers Act and perhaps not be held to its stricter fiduciary duties)], *it is not in the best interests of consumers for the broker-dealer exception to the Investment Advisers Act of 1940 to continue*, as these comments will illustrate. It has been the author's experience that many, if not most, investment adviser firms and their advisors possess a similar consumer-favorable stance toward proposed regulatory changes. Accordingly, these comments are submitted with the best interests of the investing public in mind.

[2] Ron A. Rhoades is Chief Compliance Officer, Director of Research, and Director of Estate and Asset Protection Planning for Joseph Capital Management, LLC, a fee-only investment advisory firm located in Hernando, Florida. He is the primary author of *The Science of Investing: How To Use Academic Research To Increase Returns and Reduce Risks* (Hernando, Florida: Joseph Financial Publications, 2003), and the author of *Estate Planning for the Florida Resident: Questions and Answers* (Hernando, Florida: Tiff-Jen Press, 1995). In 2000 Ron served as consultant to a major financial services firm in the development of a program seeking to provide comprehensive planning activities for retirees and those soon to be retired, to be undertaken by professionals who were not only registered as registered representatives and investment adviser representatives but also were licensed life insurance agents. Ron is a frequent speaker to groups of the general public and to accountants and CPAs on issues involving retirement planning, tax planning, estate planning, Modern Portfolio Theory and asset class investing.

[3] These comments supplement those comments previously submitted by the author on April 5, 2004 and February 17, 2004, with regard to this Proposed Rule.

I. INTRODUCTION: THE LEGAL AND MORAL IMPERATIVE FOR THE COMMISSION TO PROMOTE THE APPLICATION OF THE INVESTMENT ADVISERS ACT OF 1940.

Seventy years ago Supreme Court Justice Harlan Stone observed:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.' More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle ... Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent ... suggest how far we have ignored the necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity are incalculable.[4]

Reflecting on the comments of the late Justice Stone, made in the year (1934) in which the S.E.C. began its operations, one can only wonder if the Proposed Rule is not just another "clever legal device" to avoid application of the all-important fiduciary duty, and how much harm it has already caused and will continue to cause should the Proposed Rule not be repealed.

The Securities and Exchange Commission (Commission), itself 70 years old, is at a crossroads. In one direction is an archaic system of providing intermittent investment advice to clients which has usually failed to serve the best interests of the individual investor.[5] In the other direction is the

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[4] 48 Harv. L. Rev. 1, 8 (1934).

[5] Academic research into Modern Portfolio Theory, and in particular the critical role of strategic asset allocation with regard to determining many aspects of risk and expected returns of investor portfolios, point to the need for continual and comprehensive, and not discrete and incidental, advice for the ordinary investor. As a means of avoiding the "flight or flee" psychological mechanisms and other behavioral responses to market events, the vast majority of investors both need and require the guidance of trusted, objective advisors. The need for continuous, as opposed to intermittent or incidental, advice was aptly demonstrated by DALBAR's 2003 update to the Quantitative Analysis of Investor Behavior (QAIB), which "shows that investors continue to chase investment returns to the detriment of their pocket books. Motivated by fear and greed, investors pour money into equity funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than inflation. The average equity investor earned a paltry 2.57% annually; compared to inflation of 3.14% and the 12.22% the S & P 500 index earned annually for the last 19 years. The average fixed income investor earned 4.24% annually; compared to the long-term government bond index of 11.70%." Press Release, "Market Chasing Mutual Fund Investors Earn

opportunity to apply and promote the fiduciary duties imposed upon those who provide continuous investment advice, which duties arise from the Investment Advisers Act of 1940. This paper summarizes the compelling rational for the repeal of the 1999 Proposed Rule entitled "Certain Broker-Dealers Deemed Not To Be Investment Advisers," a hastily enacted attempt to react to marketplace changes in the manner in which investors sought (and continue to seek) to receive investment and financial advice. Additionally, this paper summarizes the absolute necessity of the Commission to more fully apply the fiduciary duty standards of the Investment Advisers Act of 1940 (Advisers Act) to all "financial advisors" who offer investment advisory services (other than those few who are specifically excepted by the Advisers Act).

The Proposed Rule involves important issues affecting the future of individual investors, and as such it requires thorough, careful and serious deliberation. The heart of the Proposed Rule, in effect, attempts to redefine the distinctions, imposed by Congress over six decades ago, between broker-dealer firms (regulated by the Exchange Act, primarily) and registered investment advisers (regulated by the Advisers Act, primarily).

Through the Advisers Act, the Commission possesses the authority to secure for individual investors a system of financial advisory services which will be both better in terms of quality and in the best interests of the individual investor. Due to recent and ongoing scandals involving multiple conflicts of interest in the securities industry, the Commission possesses the moral imperative to finally exercise such authority, and the stated intent of Congress. Through a proper exercise of its authority under the Advisers Act the Commission can promote of the application of the Advisers Act, not its evisceration. Additionally, the Commission can undertake the necessary steps to more fully apply the fiduciary duties of the Advisers Act for the betterment of individual investors. Such steps are necessary for the preservation and enhanced investor confidence in our securities markets during these troubled times.[6] The Commission should not harm its image of

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Less than Inflation –DALBAR Study Shows," July 15, 2003 (available at www.dalbar.com).

[6] Chairman Donaldson noted the continuing need to enhance investor confidence in a recent statement. "When I became SEC Chairman ... [t]he corporate landscape was littered with high-profile failures, scandals had come to dominate the business news, and equity markets had plunged. Beyond that, there were compelling signs that shortcomings in the performance of corporate leaders were more pervasive - making the numbers, managing earnings in 'good' ways, and other troublesome practices seemed too common and, even worse, there were signs that this sort

protecting the interests of the individual investor by being seen as protecting only the interests of brokerage firms, as would occur should the Proposed Rule be adopted and finalized.

II. THE PROPOSED RULE LACKS LEGAL BASIS

A. Background of the Proposed Rule.

1. The Development of Fee-Based BD Programs. For two decades full service brokerage firms faced growing competition both from traditional investment advisers and from the financial planning industry, whose claim to offer comprehensive, objective financial advice has been an attractive selling point with the public. In response to this new competitive threat, in the late 1990's several full service brokerage firms introduced new types of programs for clients, which gave their customers the option of paying for brokerage services in different ways. In addition to traditional commission-based brokerage, under these new fee-based programs the customers of brokerage firms could also pay for securities transactions, related advice, and other services by paying a fee that is a fixed dollar amount or based on a percentage of assets held on account with the broker-dealer. These programs raise questions as to whether they are receiving "special compensation" and whether the advice remained "merely incidental" to the sale of a security. As a result, the issue arose as to whether broker-dealers and their registered representatives continued to be eligible for the broker-dealer exception to the Advisers Act, at least with respect to those individual fee-based accounts. In essence, these programs raised the question of whether customers participating in these new programs should be treated as advisory clients under the Advisers Act. For convenience in this commentary, I will hereafter refer to these programs as "broker-dealer fee-based programs."

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of unacceptable behavior was on the verge of becoming accepted practice. The cumulative effect of all this produced a crisis of investor confidence, which in turn led to a demand for corrective action ... The past five years or so have had more peaks and valleys, and general tumult, than any other equivalent time period in recent memory. Extraordinary wealth has been created, and destroyed, during this period. Regaining the confidence of all investors will still take time ...." Remarks of SEC Chairman William H. Donaldson, Directors College at Stanford University Law School, June 20, 2004.

2. The Diverse, Large Broker-Dealer Firm Today. Central to the understanding of the issues involved is the fact that many Wall Street broker-dealer firms have become huge, multi-national enterprises with multiple related firms or subsidiaries. Once selling mostly stocks and bonds on a commission basis, they now sell a broad variety of investment products and participate in investment banking activities (i.e., IPOs, etc.). In addition, many large brokerage firms have their own, proprietary mutual funds. Many firms actively participate in hedge fund formation, which they in turn sell to their customers. And many broker-dealer firms strike deals with product providers - arrangements which have been heavily criticized in recent months due to the often-undisclosed conflicts of interest. Illustrations follow:

   a. Payments for Shelf Space To Broker Dealer Firms. To illustrate abuses involving various arrangements, suppose a stockbroker from XYZ Stock Broker Firm sells a mutual fund from ABC Mutual Fund Company. The stock brokerage firm (and its stockbroker) might get paid an up-front commission for its sale (Class A or Class B shares sold), or perhaps get paid over time (Class C shares, or other types of shares). In addition, it was very common for ABC Mutual Fund Company to execute trades of stocks within its mutual funds using XYZ Stock Broker Firm, even though lower-cost trading avenues were available.[7] This resulted in additional profits to XYZ Stock Broker Firm. Also, ABC Mutual Fund Company may have paid XYZ Stock Broker Firm additional "hard dollars" for preferred marketing of its funds.[8] The firm, in turn, often awarded bonuses to its

[7] The failure of mutual funds to achieve best execution and the quid pro quo of directed brokerage in return for increased broker-dealer sales efforts have been widely criticized.

[8] *See* SEC Press Release No. 2004-44 (March 31, 2004), the first enforcement action against a mutual fund manager for its failure to adequately disclose payments for shelf space with fund brokerage commissions. "Based upon negotiated formulas, MFS paid brokerage firms anywhere from 15 to 25 basis points (bps) on mutual fund gross sales and/or 3 to 20 bps on assets held over one year. MFS satisfied the Strategic Alliances in two ways: by paying cash, or "hard dollars," and by directing brokerage commissions. When MFS satisfied the Strategic Alliances with brokerage commissions, it paid 1.5 times (or some other negotiated multiple) the amount it would have paid in hard dollars. MFS did not adequately disclose to the funds' Boards and shareholders the quid pro quo nature of these arrangements and the attendant conflicts of interest they created.

stockbrokers, and rarely were these bonuses disclosed to the brokerage firm customers. Also, ABC Mutual Fund Company may have "sponsored" at times many of the costs associated with trips awarded to stockbrokers, especially those stockbrokers who sold more of its mutual funds. All this has led to multiple conflicts of interest (still existing in many firms). An individual stockbroker may, indeed, have had quite an incentive to continue to sell the products of ABC Mutual Fund Company - due to higher commissions, expectations of greater bonuses, or other perks, even when a lower-cost, better or more suitable mutual fund existed to meet the client's needs.

b. Directed Brokerage and Conflicts of Interest; Class-Action Lawsuits. "The seemingly widespread practice of undisclosed directed-brokerage agreements or other similar undisclosed incentives, such as 'revenue sharing' has received increased scrutiny given the hidden conflicts of interest they create between brokers and their clients."[9] Class-action lawsuits have been filed against brokerage firms relating to these undisclosed conflicts of interest.[10] Directed brokerage by

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'A mutual fund manager's use of fund brokerage commissions to pay for the marketing and distribution of the fund creates a conflict of interest that must be fully and fairly disclosed," said Stephen M. Cutler, Director of the Commission's Division of Enforcement. "The Commission continues to investigate whether the managers of other mutual funds and the brokerage firms that sold those funds have similarly failed to disclose such conflicts.'"

[9] Michael A. Collora, "Mutual Fund Investigations Where Are We? Where Are We Going?," white paper available at Dwyer & Collora web site, www.dwyercollora.com.

[10] For example, a class action lawsuit was filed on February 13, 2004, in the United States District Court for the Southern District of New York, on behalf of a class (the "Class") consisting of all who purchased or otherwise acquired shares or ownership units of Lord Abbett & Co., American Funds, Federated Investors, Inc., Goldman Sachs Group Inc., Hartford Mutual Funds Inc., Putnam Investments Family of Mutual Funds, and Van Kampen Investments Family of Mutual Funds (collectively, the "Mutual Funds") between January 25, 1999 and January 9, 2004, inclusive (the "Class Period"). According to the press release related to the litigation, "The Complaint charges that, throughout the Class Period, defendants Edward D. Jones & Co., L.P. ('Edward Jones'), John W. Bachmann, Douglas E. Hill, Michael R. Holmes, Richie L. Malone, Steven Novik, Darryl L. Pope and Robert Virgil, Jr. violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. More specifically, the complaint alleges that defendants failed to disclose and/or indicate, during the Class Period, that (1) Edward Jones brokers entered into 'revenue sharing' agreements with seven Mutual Fund companies; (2) Edward Jones exclusively trained its brokerage staff to sell the seven Mutual

mutual fund companies to broker-dealer firms was recently proposed to be banned by the Commission.[11]

c. Proprietary Mutual Fund and Hedge Fund Products. The Smith Barney mutual fund family comprises over 60 mutual funds. Other large brokerage firms frequently possess product manufacturing affiliates, which lead to potential

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Funds that entered into 'revenue sharing' agreements with Edward Jones; (3) Edward Jones discouraged its brokers from contacting and selling other mutual funds where no 'revenue sharing' agreement had been made with Edward Jones; and (4) Edward Jones brokers and representatives received extra compensation when they sold any of the seven Mutual Funds to Class Members. The full extent of the scheme was finally revealed on January 9, 2004, when The Wall Street Journal published an article that disclosed Edward Jones' practices. More specifically, the article stated that when training its brokers in fund sales, Edward Jones gave them information almost exclusively about the seven 'preferred' Mutual Funds. Bonuses for brokers depend in part on selling the preferred Mutual Funds, and Edward Jones generally discouraged contact between brokers and sales representatives from rival funds. But while revenue sharing and related incentives were familiar to industry insiders, Edward Jones did not tell customers about any of these arrangements."

[11] Release No. IC-26356; File No. S7-09-04, *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Feb. 24, 2004, stating: "Our staff found that the use of brokerage commissions to facilitate the sale of fund shares is widespread among funds that rely on broker-dealers to sell their shares. Selling brokers appear to have significant leverage over funds because the number of distribution channels is limited, and fund complexes compete to seek a prominent position in them. This leverage permits selling brokers to demand additional payments from fund advisers from their own assets ("revenue sharing") or through the direction of fund brokerage. These payments can purchase prominence (or better "shelf space") in an increasingly crowded fund marketplace ... We are also concerned about the effect of this practice on the relationship between broker-dealers and their customers. Receipt of brokerage commissions by a broker-dealer in exchange for shelf space creates an incentive for the broker to recommend funds that best compensate the broker rather than ones that meet the customer's investment needs. Because of the lack of transparency of brokerage transactions and their value to a broker-dealer, customers may not have appreciated the extent of this conflict. Finally, the direction of valuable fund brokerage to compensate brokers for the sale of fund shares may permit brokers to circumvent the NASD's rules against excessive sales charges ...."

conflicts of interest involving both mutual fund[12] and hedge fund[13] recommendations.

3. What Is An "Investment Adviser"? The Investment Advisers Act of 1940 (Advisers Act) was enacted, at least in part, to strengthen the fiduciary nature of the relationships between advisers and their clients. This begs the question - what is an "investment adviser"?

   a. Statutory Definition. Section 202(11) of the Advisers Act defines an "investment adviser" as including "any person who, for compensation, engages in the business

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[12] "A lawsuit filed against the American Express Company, alleging all kinds of chicanery and fraud at its financial advisory unit ... paints a tearful saga. Supposedly, trusted financial advisors employed by a business unit of American Express, namely American Express Financial Advisors, were not imparting impartial advice to clients planning for their retirement, sending kids to college, or even having a baby. Rather, the American Express Financial Advisors were pitching AMEX's own products, or third party products where AMEX received a cut of the action. Mum to the investor, of course. The language of the complaint is flowery. 'Fund advisors were under 'constant pressure' to steer clients, ***who paid a fee no less***, plus brokerage commissions, into Amex's proprietary funds, or those with which the company had'revenue sharing arrangements. Financial Advisers use the planning process to draw clients in, but depend on product sales for their livelihood, according to current and former American Express financial advisers' states the complaint. 'The financial plan is their claim to fame, but if that is all you did you would starve to death' alleges Judy Reed, an advisor who left American Express after a decade with the company. In some cases, the pressure to sell in-house products is overt. Peggy Bigelow, a financial advisor who left the firm in 2001 after a year, claims that she was repeatedly criticized for recommending that her clients invest in outside mutual funds. Other former advisors say the training they received focused largely on sales techniques and Amex's proprietary insurance products." [***Emphasis added.***] Richard Hendricks, *American Express sued for fraud: "Let's put some lipstick on that pig!"*, SRi Media Corporate Governance News, March 11, 2004.

[13] "Large institutions see a marketing opportunity in the investing public's demand for alternative strategies, and are creating their own funds of funds. Often such ownership compromises the fund of funds' ability to run an objective portfolio. The pressure, explicit or implicit, to accommodate or use the parent firm's hedge-fund products can be irresistible. Investment firms with prime brokerage operations, for example, may be tempted to use — primarily or exclusively — prime brokerage clients. Some firms with fund of funds operations also own hedge funds. A firm that invests with funds it owns may find objective comparisons with competing managers impossible. It may also find firing the captive fund difficult. Some hedge fund of funds operations find, upon their acquisition, that the corporate emphasis shifts from research and management to sales." Brian C. Ziv, "Shopping for Funds of Funds," *Registered Representative*, March 1, 2002.

of advising others ... as to the value of securities or as to the advisability of investing in, purchasing or selling securities ...."[14]

b. "Investment Adviser": Unbiased Guidance From Professionals Who Possess A Broad Fiduciary Duty To Act In The Best Interests Of Their Clients. In *S.E.C. v. Capital Gains Bureau*, 375 U.S. 180 (1963), in its discussion of the formation of the Advisers Act, the U.S. Supreme Court noted this testimony before the Committees of the U.S. Senate by the president of the Investment Counsel Association of America, the leading investment counsel association: "[T]wo fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would limit their efforts and activities to the study of investment problems from the investor's standpoint, not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment

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[14] "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include -

(A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser;

(B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession;

(C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor;

(D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation;

(E) any person whose advice, analyses or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as exempted securities for the purposes of that Act (15 U.S.C. 78a et seq.); or

(F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

judgment; and, second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance."[15] In short, the Advisers Act formed a new profession - one in which the investment adviser had the fiduciary duty to act in the best interests of the investor. An investment adviser was supposed to be just that - a provider of advisory services - not a seller of investment products. Investment advisers are a profession which, as will be detailed in this commentary, owe very high degrees of care and loyalty to their clients.

4. The Commission Has Long Recognized The Distinctions Between Broker-Dealers and Investment Advisers. In a 1978 release, the Commission noted that the protections afforded investors under the Exchange Act "may not be so broad as those afforded under the comparable provisions in Section 206 of the Advisers Act" and that such differences are appropriately related to the obligations of persons required to be registered under the Advisers Act."[16]

5. The 1999 Proposed Rule and Its "No-Action" Pronouncement. On Nov. 4, 1999 the Commission, in IA Release No. 34-42099,[17] the Commission proposed a rule which addressed the new broker-dealer fee-based programs, stating: "Under the proposed rule, a broker-dealer providing investment advice to customers, regardless of the form of its compensation, would be excluded from the definition of investment adviser as long as: (I) the advice is provided on a non-discretionary basis; (ii) the advice is solely incidental to the brokerage services; and (iii) the broker-dealer discloses to its customers that their

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[15] *S.E.C. v. Capital Gains Bureau*, 375 U.S. 180, 190 (1963).

[16] *Final Extension of Temporary Extension from the Investment Advisers Act for Certain Brokers and Dealers*, Investment Advisers Act of 1940 Rel. No. 626; Securities and Exchange of 1934 Rel. No. 14714 (April 27, 1978). The release also notes that "[a]nother reason some broker-dealers have given for desiring an exemption from the Advisers Act is their belief that an investment adviser, as such, may be held to have higher duties to his clients than does a broker or dealer to his customers."

[17] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release No. 34-42099; IA-1845, November 4, 1999 (1999 Release). The Proposed Rule is sometimes referred to as the "Merrill Lynch Rule."

accounts are brokerage accounts."[18] Moreover, the Commission essentially issued a no-action letter to all broker-dealer firms permitting them to rely upon the Proposed Rule, stating: "Until the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the Act."[19] The Commission has taken no formal action on the Proposed Rule since it was enacted.

6. Recent Developments Leading To Reopening Of Comment Period. Despite strong opposition from several major consumer groups,[20] the Proposed Rule has yet to receive final action. Large, multi-million advertising campaigns by broker-dealer firms have sprung up emphasizing advisory services and the merits of asset-based compensation. Recent developments[21] and additional comments received recently received by the Commission in opposition to the Rule, including the filing by the Financial Planning

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[18] 1999 Release, Executive Summary.

[19] 1999 Release, Executive Summary. This "no-action" measure, embodied within the Proposed Rule itself, appears to be unique among numerous Commission proposed rule-makings. *See* Comments submitted by Duane R. Thompson, Group Director, Advocacy, Financial Planning Association, dated June 21, 2004 (page 2).

[20] The following groups have filed comments in opposition to the Proposed Rule: AARP; Certified Financial Planner Board of Standards; Consumer Federation of America; Financial Planning Association; Fund Democracy; Investment Counsel Association of America; and the National Association of Personal Financial Advisors. Despite this strong and early opposition from consumer advocacy groups, the Commission for years resisted any final action on the Proposed Rule. As recently as early April, 2004, the author of this comment was verbally informed by a Commission staff member that final action on the Proposed Rule was "not even on the radar screen," given the many other Commission initiatives underway at the time.

[21] Renewed opposition to the Proposed Rule and concern over the Commission's inattention to the concerns of consumer groups was apparently fueled in part by Arthur Levitt, former Chairman of the Commission, who informed an audience that the Commission "shouldn't grant them [broker-dealer firms] that exception. I think it's wrong." Remarks made at the TD Waterhouse Partnership 2003 conference in Orlando, Florida, following Mr. Levitt's presentation entitled, "The SEC and the Independent Advisor." These remarks were reported in periodicals circulated to investment advisers. In a National Regulatory Conference in early April, 2004, in Naples, Florida, a heated panel discussion regarding the Proposed Rule occurred in response to a question concerning the Proposed Rule's continued viability in light of recent securities industry scandals.

Association (FPA) of a comment letter raising new issues, as well as the FPA's filing of a petition for judicial review of the proposed rule,[22] the Commission reopened the comment period on August 19, 2004 and indicated that action would be taken on the Proposed Rule by December 31, 2004.[23] The extended comment period now expires on September 22, 2004.

B. The Proposed Rule Is Not in Accordance with the Literal Language of the Advisers Act.

1. The Limited Exception Afforded To Broker-Dealers Under the Advisers Act. U.S.C.A. Title 15, Chapter 2D, Subchapter II, Sec. 80b-2(a)(11) provides the definition of "investment adviser" and provides limited exceptions to that definition. The limited exception which specifically relates to broker-dealers specifically states the performance of investment advisory services must be both: (A) "*solely incidental* to the conduct of his business as a broker or dealer"; and (B) "who receives no *special compensation* therefor." [*Emphasis added.*]

2. The Commission Cites No Authority For Its Broad Construction of the Limited Broker-Dealer Exception for "Merely Incidental" Compensation And Its Ignorance of the "Special Compensation" Provision of the Advisers Act. The Proposed Rule *itself* notes that broker-dealer fee-based programs do not fall within the "special compensation" exception provided by the Advisers Act. As stated in the 1999 Release, "[f]ee-based programs offer customers a package of brokerage services -- including execution, investment advice, custodial and recordkeeping services -- for a fixed fee or a fee based

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[22] *Financial Planning Association vs. SEC*, No 04-1242 (D.C. Cir.) (case docketed on July 20, 2004). On July 20, 2004, the Consumer Federation of America, Fund Democracy, Consumer Action, and Consumers Union issued a Press Release which strongly supported the FPA's lawsuit. Barbara Roper, CFA's Director of Investor Protection, was quoted as saying: "The SEC has given brokers a wholesale exemption from the Advisers Act that Congress never intended .. It is long past time for the SEC to withdraw this ill-conceived rule and require brokers to either abide by the standards appropriate to the advisory relationship or stop misrepresenting their services to the public." Sally Greenberg, senior counsel with Consumers Union, was quoted as stating: "The SEC's actions .... represent a retreat from the Commission's mandate to protect the investing public."

[23] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 33-8477, 34-50254, August 19, 2004 (2004 Release).

on the amount of assets on account with the broker-dealer. In some programs, broker-dealers also assess a fixed charge for each transaction ... [This type of program] may result in the loss of the broker-dealer exception to the Advisers Act. Fee-based compensation may constitute special compensation under the Act because it involves the receipt by a broker of compensation other than traditional brokerage commissions."[24] Despite this observation, the Proposed Rule went on to say (without quoting any authority) that the Commission did not believe that the intent of Congress was for the Advisers Act to apply to such programs. The Commission went on to state (again, without quoting any authority) that its was concerned "that, as a result of these new programs, most brokerage arrangements by full service broker-dealers may be subject to regulation under both the Advisers Act and the Exchange Act, a result Congress could not have intended."[25] The Commission appears to rely upon its authority to exclude "such other persons not within the intent of this paragraph, as the Commission may designated by rules and regulations or order."

a. "Solely Incidental." As many other commentators have pointed out, the Commission has not provided any definition of "solely incidental." I believe that the common definition found in dictionaries, "occurring as a minor accompaniment or by chance in connection with something else," is sufficient. The term "solely" reinforces the minor nature which the advice must play in relation to the provision of brokerage services, such as assisting with the purchase or sale of a security. For example, the preparation of a written "financial plan"

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[24] 1999 Release, Section I.

[25] 1999 Release, Section I. The statement that Congress did not, in essence, envision application of both the Exchange Act and the Advisers Act to the activities of broker-dealer firms flies in the face of the literal language of the Advisers Act. For example, Section 206(3) of the Advisers Act provides in part: "It shall be unlawful for any investment adviser .... acting as principal for his own account, knowingly to sell any security to or purchase any security from a client ... without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining consent of the client to such transaction. *The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.*" (Emphasis added.) By clear statutory interpretation, Congress contemplated that broker-dealers could, and would, also act from time to time as investment advisers.

would certainly far exceed the "solely incidental" services permitted by the Advisers Act's exclusion, even if there was no fee (or other "special compensation") separately paid for the preparation of such financial plan.

b. "Special Compensation." By inappropriate administrative rule-making the Commission would attempt to amend the Advisers Act by elimination of the "special compensation" provision.

(1) While some commentators have promoted the idea that "fee-based compensation" is not "special compensation" under the Advisers Act, it is difficult to comprehend any reasonable interpretation of that term which would exclude fee-based compensation, such as a fees based upon a percentage of assets under management or fees based upon a fixed or flat fee. Clearly such fees are far from the commissions, bid-asked spreads, and principal mark-ups and mark-downs traditionally received by broker-dealer firms. It is logical to inquire that if fee-based compensation would not be "special compensation," then what would? As a consumer protection statute, the Advisers Act and its terms should be construed by the Commission broadly and in a manner which benefits the individual investor.

(2) In effect the Proposed Rule would eliminate the receipt of "special compensation" as a bright line test for screening requests for exclusion from the applicability of the Advisers Act, while not providing any real guidance or substantive clarification as to what advice is considered "solely incidental." As a result, adoption of the Proposed Rule would serve to weaken the protections afforded individual investors and so narrow the application of the Advisers Act as to render the important consumer protections for individual investors applicable only to investment advisers. This may encourage new entrants to the securities industry to become registered representatives, as opposed to investment advisers, a result Congress clearly did not intend.

3. The Effect Of the Proposed Rule Is To Have The Exception Swallow The Rule. By implying that these fee-based brokerage accounts would not result in compensation which was other than "merely incidental," the Commission in effect so enlarged this limited exception to the Advisers Act as to make the exception swallow the rule. In creating a "new" class of exempted broker-dealer under the Rule, the Commission has misinterpreted Congressional intent by eliminating the statutory "special compensation" and "other than incidental advice" elements that required broker-dealer registration under the Advisers Act for nearly 60 years.

4. The Effect of the Proposed Rule Is To Eviscerate Important Consumer Protections Put In Place By Congress. By the Proposed Rule the Commission also sought to eviscerate the most powerful authority it possesses to ensure that individual investors are treated fairly in our securities markets when they receive advice relating to financial planning and investments. Although one commentator on the Proposed Rules purports that "clients do not lose any relevant protection when their financial institution is regulated as a brokerage firm rather than as an investment adviser" and further implies that the "suitability duty" of broker-dealers is "very similar" to the fiduciary duty of investment advisers,[26] this is clearly not the case.[27] As will be demonstrated in these comments,

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[26] Comments of W. Hardy Callcott, August 23, 2004, filed with the Commission and available on the Commission's web site.

[27] The comments relative to the Proposed Rule submitted by Harold Evensky, CFP, a well-regarded registered investment adviser and frequent speaker at investment adviser industry events, highlight that there is a large difference in the responsibilities toward investors of broker-dealers vis-a-vis investment advisers. He writes: "Based on my experience as a practicing financial planner for over 25 years, a NASD arbitrator and an occasional expert witness in securities cases, it is inconceivable to me that any rational observer, at least one concerned with the interest of public investors, can support a Broker-Dealer Exemption. The recent fund scandals, closely following the accounting and corporate management scandals, should provide the entire wake up call necessary to justify the elimination of such an insupportable exemption ... ***I can assure you that respondent broker-dealer counsel often make a significant distinction in the responsibilities of BDs vs. RIAs***." [Emphasis added.]

To prove a Rule 10b-5 cause of action for unsuitability, the plaintiff must show (1) that the securities purchased were unsuited to customer's needs; (2) that the broker knew or reasonably believed the securities were unsuited to the customer's needs; (3) that the broker recommended or purchased the unsuitable securities for the customer anyway; (4) that, with scienter, the broker made material misrepresentations (or, owing a duty to the customer, failed to disclose material

investors receive a great deal of additional protection when the advice received is regulated by the Advisers Act, rather than just the Securities and Exchange Act of 1934 (applicable to broker-dealers). While there are several aspects of this protection, the most strident of these protections is the *very broad* (not limited) fiduciary duty to act in the best interests of the client. By contrast, a claim based upon unsuitability could be viewed only as a *limited and specific* form of breach of fiduciary duty.

5. The Commission Exceeded Its Authority In Enlarging The Proposed Exception. The Commission is given the authority to make rules which interpret and apply the Investment Advisers Act of 1940:

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information) relating to the suitability of the securities; and (5) that the customer justifiably relied to its detriment on the broker's fraudulent conduct. *Brown v. E.F. Hutton Group*, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993). By contrast, in a breach of fiduciary duty claim a plaintiff need only show that he or she and the defendant had a fiduciary relationship, that the defendant breached its fiduciary duty to the plaintiff, and that this resulted in an injury to the plaintiff or a benefit to the defendant. The burden of proof for an unsuitability claim is, therefore, much higher than that of a breach of fiduciary duty claim.

A suitability doctrine first introduced by the SEC in the 30's. The idea is that a broker who hangs out a shingle will represent his/her customers fairly and responsibly when making suggestions regarding securities. The New York Stock Exchange requires that brokers know their clients' overall goals, risk preferences and time horizon before they execute an order, whether they recommend the particular transaction or they do not. This is referred to as the "suitability" rule. The NASD also holds brokers firmly to a suitability rule when the seller has recommended the transaction.

NASD Rule 2310, *Recommendations to Customers (Suitability)*, states:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;

(2) the customer's tax status;

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

(c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

[Amended May 2, 1990 eff. for accounts opened and recommendations made after Jan. 1, 1991; amended by SR-NASD-95-39 eff. Aug. 20, 1996.] Selected Notices to Members: 96-60.

> Sec. 80b-11. - Rules, regulations, and orders of Commission; (a) Power of Commission: The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this subchapter.

Moreover, among the listed exceptions to the definition of investment adviser is "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order." *However,* the scope of the broker-dealer exception is very clearly delineated and limited by Congress in the Advisers Act. This compels the conclusion, as a matter of statutory interpretation, that the general grant of authority given to the Commission to grant exceptions to "persons not within the intent of this paragraph" cannot be utilized to expand upon the specifically addressed and limited exception provided by Congress to broker-dealers. It is clear from that Congress intended only a very narrow exclusion for broker-dealers and that Congress viewed the primary business of broker-dealers to be effecting transactions, not offering advice.[28]

6. The Need For Protection of Individual Investors Is Primary. In undertaking rulemaking under the Advisers Act the Commission "is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." Section 80b-2(c) of the 1940 Act. While the Commission can and should promote competition in the marketplace, it should not do so when the protection of investors would be substantially lessened, as this Proposed Rule would effect. Again, the need to foster competition, a secondary consideration, should not overpower the need for investor protection, the primary consideration the Commission should consider when undertaking rule-making under the Advisers Act.

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[28] In providing guidance on Congress's intent, the Senate Committee on Banking and Currency specified that the exclusion was available to brokers only "insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions." *Committee on Banking and Currency, U.S. Senate, Investment Company Act of 1940 and Investment Advisers Act of 1940,* Report No. 1775, 76th Congress, 3rd Session (June 6, 1940), pg. 22.

7. Fee-Based Accounts Are Precisely What The Advisers Act Was Intended To Regulate. Fee-based accounts are, by their very nature, the provision of continuous investment advisory and/or investment management services. Fee-based accounts fit squarely within the scope of the Advisers Act, which defines investment advisers as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." The fact that fee-based accounts of broker-dealer firms may not have existed in 1940 does not provide the Commission with the authority to fundamentally change the regulatory scheme enacted by Congress. The mere fact that large broker-dealer firms now desire to engage in fee-based services, in a nearly identical manner to that undertaken by investment advisers for over 60 years, should not mean that the Commission should relieve broker-dealers of the fiduciary and other duties imposed by the Advisers Act. There is no conflict between the Securities and Exchange Act of 1934 and the Investment Advisers Act of 1940 - both may control the actions of broker-dealers when they desire to provide fee-based services. There is no reason that broker-dealers who desire to provide fee-based services should not adhere to the higher fiduciary standards of the Advisers Act, simply because they are primarily regulated by another body of legislation. The Commission should not usurp the will of Congress nor the intent of Congress - which was, under the Advisers Act, to grant consumers the fiduciary protections they deserve when receiving investment advisory services.

8. The Proposed Release Is Patently Incorrect As To The Premise That Fee-Based Accounts Are Not Substantially Different From Traditional, Commission-Based Brokerage Firm Relationships. The Release appears to set forth an underlying premise by the Commission that:

> We do not believe, however, that Congress intended these programs, which are not substantially different from traditional brokerage arrangements, to be subject to the [Advisers] Act.[29]

[29] 1999 Release.

The Commission should re-examine this premise. A traditional brokerage account arrangement involves episodic transactions in which the broker-dealer firm is paid when there is trading activity. Non-discretionary advice provided to customers of the broker-dealer firm in connection with that transaction and which is solely incidental to the transaction does not alter the transactional nature of the broker-dealer firm's services. The broker-dealer firm is paid upon the entry of a transaction, either by commissions, payments relating to order flow or from bid-asked spreads, principal mark-ups or mark-downs, up front sales loads (such as exist on Class A mutual fund shares), and deferred contingent sales loads (such as exist on Class B mutual fund shares and many variable annuities, which results in payments up front to the registered representative, typically). By contrast, payments of fees based upon a percentage of assets managed, or for a fixed or flat fee each period, involve not discrete transactions but rather accounts in which ongoing advice is given. In fee-based accounts the broker-dealer firm would be paid a fee regardless of whether any transaction takes place. Fee-based accounts therefore, by their very definition and structure, involve the provision of some service which is other than traditional brokerage services. *It is clear that the form of compensation directly bears upon the issue of whether the account should be governed by the Exchange Act, the Advisers Act, or both.* Additionally, while Congress may not have *envisioned* in 1940 the arise of broker-dealer firms fee-based accounts, it is a large, inappropriate and illogical step to take from there to then conclude that Congress did not intend fee-based accounts to trigger regulation under the Advisers Act. Given the literal language of the Advisers Act, Congress recognized that broker-dealer firms could also be regulated under the Advisers Act in certain circumstances. It is clear that Congress did intend that broker-dealers be subject to the increased duties arising from the Advisers Act if they offer investment advice, even though they may be broker-dealer firms.

C. <u>The Proposed Rule Is Fatally Flawed In Both Its Design and Its Intent.</u> The Proposed Rule was hastily conceived in reaction to pressure from broker-dealer firms desiring to enter the field of investment advisory services free from the important consumer protections afforded by the Advisers Act. There is no indication of Congressional intent that the protections afforded to individual investors by the Advisers Act should not be applied to fee-based accounts, whether they are provided through Registered Investment Adviser (IA) firms or

Broker-Dealer (BD) firms. Rather, the reverse is true. The Commission exceeded its authority in undertaking this Proposed Rule. Moreover, the Proposed Rule flies in the face of any rational, logical interpretation of the Advisers Act and its limited exceptions. In conclusion, it is extremely clear, from both a legal perspective and matter of clear statutory interpretation, that the Proposed Rule is substantively flawed and therefore must be repealed. Furthermore, from the perspective of public policy all broker-dealers and their registered representatives who seek to act in an investment advisory role should be subject to the Advisers Act and the fiduciary and other duties the Advisers Act imposes.

D. Merely Because A "No-Action" Position Has Existed For Over 4 Years Does Not Justify the Continued Utilization of a Fundamentally Flawed Proposed Rule.

> "*Just because that's the way it has always been done, doesn't make it right now. Rules can become obsolete for different reasons. Some outlive their original purpose.*" - Commissioner Cynthia A. Glassman.[30]

The Commission's attempted to react to the new marketplace realities with the 1999 Proposed Rule and by its highly unusual no-action position in that pronouncement. However, the lack of efforts by the Commission to revisit and/or finalize or repeal the Proposed Rule over the past few years should not serve as any justification for the continued utilization of the Proposed Rule by broker-dealer firms. Furthermore, the purpose of the Proposed Rule, to encourage the utilization of fee-based accounts by broker-dealer firms, no longer exists, as the marketplace demands are so great as to make fee-based accounts a natural evolution.

[30] Speech before the Practicing Law Institute, "My Top 10 Observations as an SEC Commissioner," March 5, 2004.

The substantial increase in the number of fee-based accounts over the last decade is evidence that individual investors are seeking out fee-based advice, as opposed to commission-based product sales, in great numbers.[31] The repeal of the 1999 Proposed Rule will not substantially affect either this desire by individual investors nor the ability of broker-dealer firms to develop programs which will meet that demand. No further or continued "encouragement" is needed by the Commission to foster fee-based accounts - certainly not by removing from broker-dealer fee-based accounts the important consumer protections of the Advisers Act. The marketplace has substantially evolved over the past decade. Broker-dealer firms will continue to provide fee-based accounts even if the Proposed Rule is repealed. They will do so even if the Advisers Act is applicable and their conduct is held to the higher standards of the Advisers Act - because they must do so in order to compete in today's evolving marketplace. The Commission can easily find that broker-dealer fee-based accounts and certain other "innovative" fee arrangements subject the broker-dealer firm in many instances to regulation under the Advisers Act without tempering either the availability of these accounts to individual investors nor substantially impeding broker-dealer firms. The marketplace will, as it always has, respond to furnish the individual investor with what he or she needs.

[31] Bloomberg, on August 23, 2004, recently reported, "Merrill Lynch & Co., the biggest U.S. securities broker, and UBS AG, the world's largest money manager, are among the Wall Street firms which together are losing some of the wealthiest Americans as clients, a group that pays as much as $28 billion in fees for financial advice each year ... The No. 1 reason for switching advisers was a lack of trust ... Another reason clients left full-service firms was that they wanted an adviser who was not compensated for selling certain products over others ... There's a very strong request for objectivity in people's advice, which is leading to independent firms increasing their market share ...." (The article was authored by Margaret Popper and Adrian Cox.)

III. THE PROPOSED RULE: PUBLIC POLICY IMPLICATIONS - THE NEED TO PROTECT THE INDIVIDUAL INVESTOR FROM CONFLICTS OF INTEREST AND CONFUSION.

A. Fee-Based Programs, To Which The Fiduciary Requirements Of the Advisers Act Apply, Can Be A Positive Development For Consumers. The Commission in its release relating to the proposed rule questions whether fee-based programs by broker-dealer firms are a positive development. The answer is clearly affirmative, *but only if the Advisers Act applies*. Broker-dealer fee-based programs can provide benefits to the broker-dealer's customers by better aligning the interests of the customer with those of their broker-dealers. The broker-dealer fee-based programs are responsive to the best practices suggested in the Report of the Committee on Compensation Practices ("Tully Report").[32] Under these programs, broker-dealers' and their registered representatives' compensation no longer depends on the number of transactions or the size of mark-ups or mark-downs charged, thus reducing incentives for registered representatives to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics.[33] Consumers should welcome the introduction of these fee-based programs, which may reduce substantially conflicts between broker-dealers and their customers. *However*, these broker-dealer fee-based programs also bring with them the potential for:

- consumer confusion as to which type of professional they are dealing with, and the role of that professional relative to the consumer; and

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[32] *See* Report of the Committee on Compensation Practices (April 10, 1995) (available at http://ww.sec.gov/news/studies/bkrcomp.txt).

[33] Former Chairman Arthur Levitt, is his book, *Take On The Street: What Wall Street and Corporate America Don't Want You To Know* (Random House, 2002), writes: "There's a saying that compensation determines behavior ... How serious are the conflicts between broker and investor? Serious enough that a former top official of a major brokerage firm confessed to me privately that he would not send his mother to a full-service broker ... If you have more than $50,000 to invest, you should fire your broker and find an investment adviser. Brokerage firms would like you to think that they perform the same functions as investment advisers. Many brokers call themselves "financial consultants" or "financial advisers." But they're not the same as independent investment advisers ... If you decide to stick with your broker, it's best to find one whose compensation is fee-based. To its credit, the brokerage industry increasingly is replacing commissions with fee-based accounts. But even these pose conflict-of-interest issues that investors must weigh carefully." *Take On The Street*, pp. 20, 28, 31 and 34.

- serious harm to the individual investor if the if the fiduciary standards of the Advisers Act are not imposed upon the broker-dealer.

B. The Stricter Fiduciary Duty Standard Applicable to Investment Advisers, Generally. As a fiduciary, the investment adviser "is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior."[34] The all-important concept of fiduciary duty, and its importance to the individual investor, is explored in a later section of this commentary. Under the Proposed Rule registered representatives offering comprehensive financial planning under fee-based programs would be exempted from this important fiduciary duty. Rather than promoting the interests of individual investors, the Proposed Rule would eviscerate important protections afforded to them under existing law.

The fact that the broker-dealer industry has resisted the application of the Advisers Act to its advisory activities is not a surprise. For example, "to participants who were involved in the original drafting of the duties of a financial planner, brokerage interests strongly objected to [the imposition of a fiduciary duty] requirement. And given the fact that many suitability claims and other litigation are filed against financial planners acting in the capacity of registered representatives or insurance agents, and much of this is arbitrated outside of easily researched court records, the clarity of this duty must remain, for the moment, elusive—except in the minds of those who promote a higher duty."[35]

C. The Average Individual Investor Cannot Distinguish Between Registered Representatives and Investment Advisers. Individual investors already lack needed knowledge of the fundamental regulatory structure affecting brokers, dealers, investment advisers and investment companies. Nearly every new client encountered by our firm has no knowledge of the distinctions between broker-dealer firms (selling products) and registered investment adviser firms (providing advice). Most of our new clients have never even heard of the term

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[34] *Meinhard V. Salmon*, 249 N.Y. 458, Justice Cardozo's opinion.

[35] Duane Thompson, *Tasking the Task Force: When is a CFP® Certificant a Fiduciary?*, Journal of Financial Planning, March 2004.

"registered investment adviser," despite the enactment of this law nearly 64 years ago. The result is increased confusion by investors, precisely at the time when investors need knowledge and clarity in the face of Wall Street's scandals.

Furthermore, the average investor fails to understand that a brokerage account means that the registered representative - unlike a registered investment adviser - has no blanket fiduciary duty to place the client's interests first or an affirmative obligation to disclose all material conflicts of interest. Such conflicts may include special financial awards for selling stocks from inventory (i.e., "principal trades"), sales contests, and bonuses (resulting, in many instances, from hard dollar or soft dollar compensation payments from product manufacturers to broker-dealer firms). Unlike registered representatives, investment advisers also must affirmatively disclose any material disciplinary history, as well as their experience and qualifications.

Given the lack of insight by individual investors into the key distinctions between sellers of products (broker-dealers) and providers of professional advisory services (investment advisers), it is abundantly clear that the investing public does not appreciate the nuances of the Proposed Rule.

D. Consumer Confusion Arising From BD Advertising. One need not look so far back to find examples of how brokers market themselves to the public as if the primary service they had to sell were advice, and not engaging in the sales of products. It is difficult to conclude from these ads that any advice being offered is "merely incidental to brokerage transactions." Even in the 1999 Release concerning the Proposed Rule, the Commission stated: "We have observed that some broker-dealers offering these new accounts have heavily marketed them based on the advisory services rather than the execution services, which raises troubling questions as to whether the advisory services are not (or will be perceived not to be) incidental to the brokerage services."[36]

[36] 1999 Release, Section II.A.1.

E. The Commission's Own Literature Adds to Consumer Confusion. The Commission's own educational materials foster additional confusion for individual investors.

1. One SEC Brochure. For example, in the Commission's online brochure, *Get the Facts: The SEC's Roadmap to Saving and Investing*, under the section titled "How To Pick A Financial Professional," the Commission states:

> *Investment Advisers and Financial Planners.* Some financial planners and investment advisers offer a complete financial plan, assessing every aspect of your financial life and developing a detailed strategy for meeting your financial goals. They may charge you a fee for a plan, a percentage of your assets that they manage, or receive commissions from the companies whose products you buy, or a combination of these. You should know exactly what services you are getting, how much they will cost, and how your investment professional gets paid. Smaller investment advisers are generally regulated by those states with the authority to do so.
>
> *Brokers.* Brokers make recommendations about specific investments like stocks, bonds, or mutual funds. While taking into account your overall financial goals, most brokers will not give you a detailed financial plan. Brokers are generally paid commissions when you buy or sell securities through them.

Interestingly, nowhere in the foregoing document is a discussion of the different duties imposed upon these two distinct professions (i.e., the fiduciary duty of an investment adviser vs. the more limited duties of suitability, etc. of registered representatives). It would seem that the Commission should highlight this important distinction, not minimize it. Moreover, if brokers are to engage in the provision of financial advice without the Advisers Act applying to their activities (as contemplated by the Proposed Rule), then such a critical difference in the role of the broker should be noted.

2. Another SEC Brochure. In a different online brochure, *Invest Wisely: Advice From Your Securities Industry Regulators*, the Commission ignores registered investment advisers completely when it states:

> This document provides basic information to help investors select a brokerage firm and sales representative, make an initial investment decision, monitor an investment and address an investment problem. It is intended to help you identify questions you need to ask and warning signs to look for in order to avoid possible investment problems.
>
> Before making a securities investment, you must decide which brokerage firm – also referred to as a broker/dealer – and sales representative – also referred to as a stockbroker, account executive, or registered representative – to use. Before making these decisions you should ...
>
> Understand how the sales representative is paid; ask for a copy of the firm's commission schedule. Firms generally pay sales staff based on the amount of money invested by a customer and the number of transactions done in a customer's account. More compensation may be paid to a sales representative for selling a firm's own investment products. Ask what "fees" or "charges" you will be required to pay when opening, maintaining, and closing an account.
>
> Determine whether you need the services of a full service or a discount brokerage firm. A full service firm typically provides execution services, recommendations, *investment advice*, and research support. A discount broker generally provides execution services and does not make recommendations regarding which securities you should buy or sell. The charges you pay may differ depending upon what services are provided by the firm. [*Emphasis Added.*]

Again, by failing to clearly set forth the different duties imposed upon registered investment advisers and registered representatives, and by acknowledging that each type of professional can render "investment advice" (without noting that in broker-dealer firms that advice can only be "solely incidental" to the sale of a product), the Commission adds to the confusion of individual investors.

F. The "Prominent Disclosure" Requirement Of The Proposed Rule That An Account is "Brokerage Account" Is Not A Meaningful Protection For Individual Investors. The Proposed Rule requires "prominent disclosure" that the fee-based program is a "brokerage account." I have observed several ads and marketing materials prominently featuring the advice offered in these programs. In nearly all of these ads the brokerage account disclaimer was buried in hard-to-read fine print. The Commission provides no guidance of what is prominent disclosure under the Proposed Rule. Even if prominent disclosure was made, as stated previously the typical individual investor does not understand the difference between investment advisers and registered representatives.[37] Nor would the individual investor understand the important protections he or she would be surrendering as a result of the Advisers Act not being applicable to the broker/advisor-client relationship. Furthermore, as stated in prior comments submitted by the Consumer Federation of America relative to the Proposed Rule:

> If disclosure is to have a hope of being effective, then, it must clearly spell out the fact that any advice being offered is solely incidental to sales transactions and that it is not subject to a requirement that the salesperson place the client's interests ahead of his or her own. Even if the disclosure requirement were strengthened, however, we do not believe that disclosure alone offers adequate protections against misrepresentation and the investor confusion that inevitably results. Such

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[37] Even the Securities Industry Association, in comments submitted on January 13, 2000 to the Commission by Jean Margo Reid, Chair, SIA Investment Adviser Committee, with regard to the Proposed Rule, acknowledges the inadequacy of the suggested "prominent disclosure" of the Proposed Rule, stating: "We agree with the SEC's proposed approach of requiring broker-dealers to clearly disclose the nature of their relationship when entering into a fee-based compensation arrangement that they do not erroneously believe they are receiving investment advisory services or participating in an investment advisory program. However, we do not believe that proposed subsection (a)(3) in its current form will adequately accomplish this, since the disclosure that the accounts are brokerage accounts does not provide sufficient information to customers. Many customers may conclude that it is a brokerage account simply because it is maintained at a broker-dealer, and will not understand that the disclosure is intended to distinguish the account from an investment advisory account. Therefore, we proposed that the language of subsection (a)(3) be expanded to clarify that the account is a brokerage account, rather than an investment advisory account." These comments are especially informative since they come from a trade organization which, at the time, represented more than 740 securities firms, including broker-dealers, investment banks, and mutual fund companies. *See also* Comments of David Riggs, Esq., V.P. and Senior Corporate Counsel, Charles Schwab & Co., Inc., submitted on January 14, 2000 relating to the Proposed Rule, stating: "We recommend that the Commission modify the Rule to require that broker-dealers 'clearly disclose that the accounts are brokerage accounts and not investment advisory accounts."

> a disclosure, no matter how prominent, cannot begin to outweigh the expectations raised by multi-million-dollar ad campaigns ....

Given the lack of understanding by investors of the distinctions between registered representatives (i.e., stockbrokers) and investment advisers, and the additional confusion caused by the permitted (or not prohibited) use of the term "financial consultant" or "financial advisor" over the past several years by broker-dealer firms, meaningful disclosure standards should be applied to all types of advisory contracts, whether they be broker-dealer contracts, sales of life insurance products by life insurance agents, or investment advisers. To be meaningful, such a required disclosure should include, as to broker-dealer accounts (of any type, whether or not fee-based) the following:

> *This account is a brokerage account, not an investment advisory account. (Name of firm) and its registered representatives are subject to suitability standards in providing advice which is incidental to the sale of securities. They do not, however, possess a broad fiduciary duty to act in your best interests, as would be required if this were an investment advisory account subject to the requirements of the Investment Advisers Act of 1940. Consumers should refer to the SEC's web site, www.sec.gov, or call 1-___-_____ for more complete information on the significant consumer protection distinctions between brokerage accounts (which are not also investment advisory accounts) and investment advisory accounts.*

In summary, individual investors, the vast majority of whom are not financially savvy and who do not understand the intricacies securities industry regulation, should receive meaningful disclosure in all circumstances. They should be clearly informed as to whom is sitting across the table from them.[38]

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[38] As one commentator on the Proposed Rule put it: "Those of us who accept fiduciary responsibility and act as agents of our clients ought to be clearly differentiated from salespeople who are beholden to a wirehouse or other financial institution." Charles Simon, MS, President, Taconic Advisors, Inc., Poughkeepsie, New York, comments regarding Proposed Rule submitted on August 26, 2004.

G. The Unfair Advantage Given To Broker-Dealer Firms By the Proposed Rule Over Investment advisers. In essence, the Proposed Rule permits broker-dealer firms and their stockbrokers to misrepresent their fundamental role as one of a financial advisor, not a provider and/or seller of investment products and that of executing trades. This places investment advisers, bound by the Advisers Act, at a competitive disadvantage, as stockbrokers may market financial planning programs under less rigorous regulatory standards (relating, for example, to non-use of client testimonials in advertising and the need to provide each new client with a disclosure brochure). Additionally, broker-dealers are free under such programs, if the Advisers Act is deemed not to apply to them, to not adhere to the full and complete fiduciary standards applicable to investment advisers under the Advisers Act.

If the Proposed Rule is finalized and not repealed, the fact that the same essential services would be performed by investment advisers under the Advisers Act and broker-dealers not regulated by the Advisers Act leads to different standards for conduct for the same functional activity, and substantially different levels of protection for the individual investor. As the Commission has stated in the past, "The Commission believes that the same rules should apply to the same activities in the financial marketplace - particularly when the rules are designed to protect investors."[39]

H. Problems Already Created By The New Rule. The secrecy of arbitration proceedings and private settlements prevents a full assessment by outsiders of the many problems already occasioned by the Proposed Rule. Perhaps only the Commission, NASD, and compliance departments of major brokerage firms are aware of the full extent of the problems created by the Proposed Rule. However, there are a few indications that fee-based accounts of broker-dealer firms are generating problems for investors:

1. Some news reports appear to indicate that broker-dealer firms are utilizing fee-based accounts to sell proprietary mutual funds. (See footnote discussing complaint filed against American Express, at section II.A.2.c. of this memorandum.)

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[39] *See, e.g., Testimony of Arthur Levitt, Former Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization and H.R. 10, the Financial Services Competition Act of 1997*, before the House Committee on Commerce, Subcommittee on Financial and Hazardous Materials (July 17, 1997).

2. One commentator regarding the Proposed Rule notes that registered representatives have "blatantly deceived the public" in the way they explained fee-based brokerage services and that "the proposed rule has confused the public and made false advertising acceptable."[40]

3. Another commentator also notes that many consumers are unable to distinguish the fine line between advisors regulated as salespersons and investment advisers under the Proposed Rule.[41]

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[40] *See* Comments of J. Jeffrey Lambert, submitted August 24, 2004 with regard to the Proposed Rule, where he writes: "When the rule was first proposed, I was working at Merrill Lynch. At that time, it appeared to me that the rule was proposed to accommodate the new fee based brokerage service product that Merrill Lynch had recently begun to offer. It seemed strange to me that the product was unlawful and the SEC was proposing a rule that made it legal. I observed first hand brokers blatantly deceiving the public in the way they explained the service. It continues to this day. Advice being delivered by these programs is not incidental. The services are being sold in ways that claim to offer advice. The public wants advice they can trust. However, they are often contacted by brokers who are not delivering advice but product sales masquerading as advisory services. Firms offering these fee based services continue to position themselves as advice givers, sound like fiduciaries, but are in reality sellers of financial products. Registered Investment Advisor regulations protect the public against self-dealing and product pushing. However, this proposed rule has confused the public and made false advertising acceptable. The rule is harmful to the public."

[41] *See* Comments of Neal J. Solomon, CFP, CLU, ChFC, submitted August 23, 2004 with regard to the Proposed Rule, in which he states: "The financial planning profession has been my calling for more than two decades, and I am also active as an NASD member firm Registered Representative. Based upon this experience I feel qualified to comment on the proposed rule, and more importantly upon its ramifications in the public marketplace. I believe the proposed Rule is detrimental to consumer protection by allowing broker-dealers to avoid the blanket fiduciary protections of the Investment Advisers Act of 1940. By eliminating special compensation as a critical element in the contractual relationship, the Rule permits stockbrokers to misrepresent their fundamental sales role as one of a fiduciary adviser receiving a fee for advice. This in turn places financial planners at a competitive disadvantage by allowing brokers to market programs appearing similar to the offerings of financial planners or investment advisors, under less rigorous regulatory standards for disclosure and advertising. In reality the consumer may receive a totally different set of services and a totally different standard of care. Many consumers are unable to recognize that their advisor is regulated as a salesperson and that buyer beware aptly describes the standard of behavior prevalent at many firms.
One need look no further than the daily advertisements in major publications and broadcast media to conclude that the brokerage firms taking advantage of this proposed rule are not selling transaction capabilities. In fact they are selling advice. Advice is the cornerstone of their advertised and promoted value added proposition. American financial consumers deserve the higher standards mandated by the 1940 Investment Advisers Act

4. At least one news report indicates that the Rule has created problems through a practice called "reverse churning," where the fee-based program is neglected by the registered representative while continuing to accept fees for monitoring account performance (although it is not clear that lesser amount of trading in an account would result in neglect).[42]

5. In November 2003, the NASD published Notice to Members 03-68 reminding brokerage firms that fee-based programs must be appropriate to the customer. The NASD noted that brokers might benefit by simply placing certain customers in "buy-and-hold" fee-based accounts that ultimately may be more costly to the investor than a similar one in which the customer was charged a commission only when placing trades. The news article indicated that the NASD had recently launched an industry-wide probe into abusive practices involving the fee-based brokerage accounts.[43]

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when they place their trust in someone who they view despite the form of registration to be their advisor. Even sophisticated financial consumers should not be expected to understand the nuances incumbent upon differing standards of care due to a firms choice of regulatory filings necessary to conduct business. The typical investor hasn't got a chance at discerning these distinctions. The proposed rule blurs the line to an indiscernible distinction and this must not be deemed to be acceptable."

[42] There has been some commentary that with fee-based compensation that stockbrokers would not trade as often and somehow neglect the client, thereby resulting in "reverse churning." However, the same possibility exists for investment advisers. Moreover, there is compelling academic evidence that the greater amount of trading in an account or fund, the higher the costs (due to transaction costs inherent in trading) and the lower the long-range returns of such accounts relative to accounts or funds that experience far less trading. Hence, assuming the client's advisor adopted a proper asset allocation to begin with, with broad diversification among both asset classes and individual securities, and provided that the client's advisor undertakes adjustments (such as rebalancing) either periodically or upon major movements of asset classes, the lack of trading would not appear to cause much of a concern.

[43] There may be instances where the regular fees of a "fee-based" or "fee-only" account arrangement would be inappropriate. For example, investment advisers and registered representatives must be sensitive to the needs of a fixed income-only investor, where the expected long-term return on the account is much less than equity-only (or mixed equity and fixed income) accounts. In such instances the "value added" of objective advice will still exist, especially in applying a disciplined approach and utilizing the advisor's knowledge to reduce default risk and interest rate risk. However, a reduced fee for such services may, quite often, be appropriate, relative to the fees charged for other accounts which consist of stocks or stock mutual funds. We

6. The investor may be worse off than before the development of broker-dealer fee-based programs, as the investor has been led to believe (through advertising) that fee-based compensation closely aligns his or her interest with that of the registered representative. However, without application of the broad fiduciary duty to act in the best interests of the client, the alignment of interests, while improved, is no where as near as that required by statute under the Advisers Act.

IV. NOW IS THE TIME TO AGGRESSIVELY APPLY THE Advisers Act AND THE FIDUCIARY DUTY IMPOSED UPON THOSE WHO SEEK TO PROVIDE INVESTMENT ADVICE TO INDIVIDUAL INVESTORS

> ***"Investors are entitled to honest and industrious fiduciaries who abide by fair and ethical legal principles."*** - SEC Chairman William H. Donaldson[44]

A. Scandals and The Impact Upon Investor Confidence. As Commissioner Glassman recently stated:

> All of us in the securities industry have faced a barrage of financial scandals that - with the exception of the events leading to the creation of the Commission 70 years ago - are unprecedented ... the financial scandals that unraveled at the dawn of the twenty-first century ... resulted in a tremendous loss of investor confidence.

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do not suggest what an appropriate fee should be, as the level of services of investment advisory firms varies tremendously, with some firms only concentrating on the investment advisory component of the client's needs and referring out other planning needs. By contrast, other firms, such as ours, offer "wealth counsel" and other programs which integrate, in a holistic fashion, financial, tax, estate and asset protection planning with investment advisory services, utilizing a team approach and applying the combined knowledge and expertise of CPAs, attorneys, and a C.F.P.™.

[44] SEC Chairman William H. Donaldson, Remarks Before the Investment Counsel Association of America, April 22, 2004.

> The impact of these scandals cannot be overstated. And, while there are different categories of problems, for example, accounting fraud, analyst conflicts of interest, and market timing of mutual funds, they all share at least six key elements. These elements are: Avarice, Conflicts, Complicity, Opacity, Stupidity, and Temerity. For ease of reference, I like the mnemonic A-C-C-O-S-T, or ACCOST, and believe me, the investing public feels like they have been accosted.[45]

B. Recent Efforts of the Commission Have Helped, But Are They Sufficient? As stated by Commissioner Glassman:

> The Commission's response to the scandals has been a serious ramping up of rulemaking and enforcement action. Last year, much of our time was spent adopting rules to implement the Sarbanes-Oxley Act and bringing a record number of enforcement cases, including the global analyst settlement. More recently, while our enforcement actions continue at a record pace, we have also focused heavily on rules to address a range of mutual fund issues. These rule proposals address late trading, market timing, selective disclosure abuses, mutual fund governance, point-of-sale and confirmation statement disclosures, prohibitions on funds from using brokerage commissions to pay broker-dealers for selling fund shares, requirements that shareholder reports discuss the reasons supporting the board's approval of the fund's advisory contract and fees, and the imposition, in certain circumstances, of a mandatory redemption fee for fund shares. Additionally, and perhaps of particular relevance to this audience, we adopted a rule that requires all funds and advisers to have chief compliance officers and comprehensive compliance policies and procedures, and we have proposed a requirement for registered advisers to adopt a code of ethics. Sometimes I feel like we are the energizer bunny - we just keep on going.[46]

Are all of these reforms, welcomed by this author, sufficient to enhance the protection of the individual investor? Or will the Proposed Rule's creation of different standards of conduct for essentially the same type of services greatly diminish the reforms the Commission has already instituted under Chairman Donaldson's watch?

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[45] Commissioner Cynthia A. Glassman, Remarks at the SIA Compliance & Legal Division's 35th Annual Seminar, March 23, 2004.

[46] Id.

C. How Would an Informed Investor Desire to Receive Investment Advice? If you were an investor today, who would you rather seek investment advice from? A product salesperson, who possessed a limited selection of products from which to offer, and who was often compensated more for selling products which were more costly to you? Or an independent, objective advisor, who received only that compensation paid by you, did not receive any third-party compensation, and who was able to access nearly the entire universe of investment products (by working with whatever broker-dealer firm was chosen)? Therein lies the key problem for the large Wall Street financial services conglomerate today. They possess multiple divisions, ranging from research analysts to investment banking to product manufacturing (proprietary mutual funds, hedge funds, etc.), to ownership of market makers and specialist firms, and their traditional brokerage firm. For an increasing number of investors these large conglomerate attributes are no loner desirable. Rather than be pitched proprietary, often high-priced products, many individual investors desire objective advice complete divorced from the pressure to sell products or engage in higher levels of trading activity.

D. Should Conflicts of Interest Be Avoided, or Merely Disclosed? Investment advisers should seek to avoid, not merely disclose, conflicts of interest, as a means of fulfilling their fiduciary duty. This need to both disclose and minimize the potential conflicts of interest which exist in the investment industry has been acknowledged by many leaders. As stated by Commissioner Glassman: "Conflicts lie at the heart of many of today's scandals ... It is in your interest to minimize conflicts to the greatest extent possible and, for those that can't be eliminated, to manage and disclose them to customers and investors."[47]

Conflicts of interest, other than that relating to compensation for services rendered, are not inherent in the financial services industry. Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities & Exchange Commission, stated:

> Conflicts of interest are inherent in the financial services business. When you are paid to act as an intermediary, like a broker, or as another's fiduciary, like an

[47] Comments before the SIA Compliance & Legal Division's 35th Annual Seminar on March 23, 2004.

> investment adviser, the groundwork for conflict between investment professional and customer is laid. The historical success of the financial services industry has been in properly managing these conflicts, either by eliminating them when possible, or disclosing them. In the long run, treating customers fairly has proven to be good business.[48]

Does acting as a fiduciary to a client create multiple conflicts of interest between an investment professional and a client? No. It is possible to structure a registered investment advisory firm to avoid nearly every conflict of interest. Perhaps the only material conflict of interest which might remain is the need for the (fee-only) investment adviser to receive reasonable compensation. However, every "fiduciary" - whether a trustee, executor of an estate, or otherwise, has a similar "conflict of interest" as to how much they will get paid. This single remaining conflict of interest can be addressed by full and complete disclosure of the complete fees the client may be charged (in order that the client be able to make a fully informed decisions), and by imposition of a standard that any fees charged be reasonable for the services provided.

E. No Large Additional Regulatory Burden Would Be Placed Upon Broker-Dealers To Comply With Advisers Act. So Why The Resistance? Many broker-dealer firms are already dually registered as both broker-dealer firms and as investment advisers. They already receive substantial scrutiny from regulators, including inspections which, in the past, have been more frequent than those given to investment advisers. The frequency of inspections from the Commission or state regulatory authorities would not likely increase due to the application of the Advisers Act to fee-based accounts. Additionally, there is no separate mandatory self-regulatory organization (SRO) for investment advisers. All that is required is that the broker-dealer firm comply with a few additional requirements, such as that of the delivery of a disclosure brochure and compliance with a broad fiduciary duty.

Broker-dealer firms appear to resist the requirement that their conduct in providing advisory services to clients be subject to the fiduciary duty to act in the best interests of their clients. Why? Why don't brokerage firms, which tout so often in recent advertising campaigns the

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[48] *Remarks Before The National Regulatory Services Investment Adviser and Broker-Dealer Compliance/Risk Management Conference*, September 9, 2003.

"objective" nature of their advice, desire their conduct to be scrutinized in such a light? Why would not a business - any business - not desire to put the best interests of its clients or customers first? Isn't putting customers first good for business?[49] There can be only one explanation for this resistance by broker-dealer firms to the application of the Advisers Act to their advisory services - they desire free reign to not act in the best interests of their clients and to continue to make as much money as possible from their clients through the sales of expensive (and often tax-inefficient) products and through high volumes of trading.[50] It is well-known in the fee-only investment adviser community that stockbrokers (i.e., registered representatives of broker-dealer firms) often possess substantial incentives to sell higher-priced, more expensive products to their clients. Broker-dealer firms, traditionally, have represented the "sell" side of the investment purchase transaction, while investment advisers, traditionally, have represented the "buy side." Unfortunately, this significant difference is not known to the vast majority of individual investors.

To all the broker-dealer firms who support this (fundamentally flawed) Proposed Rule - don't fight the changing marketplace and the increasing popularity of investment advisers. Join them! Clients desire, and need, comprehensive advice. Clients desire advice which is objective. Instead of working diligently to avoid the imposition of a broad fiduciary duty to

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[49] *See* Hanna, S., *Profit and the Consumer Interest*, Advancing the Consumer Interest, 1, 12-13 (1989), which reviewed some research that demonstrated that good business behavior should be good for profits.

[50] In our experience in talking with prospective and new clients to our firm, we are constantly amazed that many clients of broker-dealer firms do not know how much their investment products cost. Nor are they aware of the substantial transaction costs associated with frequent trading of securities (to their detriment, but to the benefit of the broker-dealer firm with whom they are with). We frequently calculate that the investment costs of many mutual funds and/or variable annuities sold by brokerage firms run from 2.5% to 5% annually, or even higher, when all of the "disclosed" and "hidden" costs (including transaction costs arising from bid-asked spreads and market impact, and opportunity costs arising from cash holdings within funds) are taken into account. Even more distressing to those we meet is the significant additional tax burden imposed upon many of them by improper positioning of investments between taxable and qualified or other tax-deferred accounts, the improper utilization of variable annuities in taxable accounts, and stock mutual funds placed in taxable accounts which are not tax-efficient. Very few of the individual investors we meet are aware of the significant high costs and taxes associated with many, if not most, of the investment products sold to them by "full-service" brokerage firms. Recent steps the Commission have undertaken to promote full disclosure of transaction costs in mutual funds and to disclose soft dollar compensation are steps in the right direction, but individual investors need even greater protection.

act in the best interests of your customers, accept it, and become a better corporate citizen and better advisor to your customers.

The Commission should not serve as an instrument of the broker-dealer community in resisting this positive and inevitable evolution of the securities industry. The vast majority of investors today both desire and need objective and comprehensive advisory services. The Commission should seek to enable broker-dealer firms to make the transition away from the "used car salesman" mentality of a product seller to the client-centric role of trusted advisor. Broker-dealer firms should move to undertake this change, but not at the expense of investors, and not without imposition upon them of the important investor protections contained in the Advisers Act. Broker-dealer firms should move to embrace the Advisers Act and its protections for their customers, not resist it.

F. The Commission Should Seek To Apply The Consumer Protections of the Advisers Act and To Promote The IA Profession.

1. The continual failure of traditional Wall Street brokerage firms to serve the best interests of individual investors should no longer be tolerated. Wall Street brokerage firms, many of whom are multi-national and include vertical and horizontal integration structures involving various related businesses, such as the manufacture of mutual fund, hedge fund, annuity and insurance products, have rendered themselves unable to provide the objective advice which the investing public desires. The traditional, large Wall Street broker-dealer firm could be viewed as a dinosaur; in the absence of significant change, the next major extinction event is on the horizon.

2. If we were to start over again and ask investors what they desire to receive, they would state:
   a. Knowledgeable about investments;
   b. Knowledgeable about investment theory (including Modern Portfolio Theory, Efficient Markets Hypothesis, Fama-French 3-Factor Model, Behavioral Finance) as it applies to the construction of investment portfolios for the individual investor;
   c. Knowledgeable about taxes - to reduce the tax drag upon investment returns;

d. Knowledgeable about financial planning;

e. Knowledgeable about estate and asset protection planning - to successfully integrate investment advice with such planning;

f. Objective - conflicts of interest kept to minimal levels:

(1) No product sales. Advice on products, but no compensation from product providers, either directly or indirectly, which is material in any way;

(2) If conflicts of interest or third-party compensation exist, fully disclosed and discussed, including its potential impact upon the individual investor and his or her portfolio;

g. Access to broad variety of investment products, and if any limits imposed by their firm as to what investment products can be offered, those limits fully disclosed; and

h. In short - a trusted, knowledgeable, experienced team of advisors providing completely objective advice ... to secure peace of mind for the client.

V. NOW IS THE TIME TO DEFINE THE FIDUCIARY STANDARDS WHICH EXIST UNDER THE ADVISERS ACT

> *Fiduciary relationship - "one founded on trust or confidence reposed by one person in the integrity and fidelity of another."* - Black's Law Dictionary.

A. What Is A Fiduciary? What is a fiduciary? Think in terms of "trustees," the classic form of a fiduciary relationship. A fiduciary has rights and powers which must be exercised for the benefit of another (i.e., a trust beneficiary, or an investment client). A fiduciary has rights and powers which would normally belong to another person. The fiduciary holds those rights which he or she must exercise to the benefit of the beneficiary. A fiduciary must not allow any conflict of interest to infect their duties towards the beneficiary and must exercise a high standard of care in protecting or promoting the interests of the beneficiary. In a position paper prepared by Donald B. Trone of the Foundation for Fiduciary Studies, February 2003, Mr. Trone stated: "At the risk of oversimplifying a complex subject, an investment fiduciary

generally is defined as a person who has the responsibility for managing someone else's assets ... A financial planner may be considered an investment fiduciary when the financial planner provides comprehensive and continuous investment advice."[51]

Another way of thinking about a fiduciary is in contrasting the fiduciary to a salesperson. Katherine Vessenes, author of *Protecting Your Practice*, offers this comparison:

> The distinction between a planner or investment adviser with a fiduciary interest and a salesperson is crucial. The financial planner, under common law and by some statutes, is a fiduciary and not a salesperson, a professional similar to an attorney, trustee or accountant. The planner or investment adviser must always provide services and advice in the best interests of the client. Whereas salespeople may have their own motives and interests at heart and offer goods and services for a price, the fiduciary must serve the client, if necessary at the cost of the fiduciary's own interests. It is generally believed fiduciaries perform their trades for reasons other than money and feel a sense of responsibility that goes beyond simply making a living. To paraphrase Supreme Court Justice Brandeis: "It is an occupation which is pursued largely for others and not merely for oneself. It is an occupation in which the amount of financial return is not the accepted measure of success." On the other hand, the accepted measure of success for the salesperson is usually the amount of financial return.[52]

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[51] *When is a Financial Planner an Investment Fiduciary?* A position paper prepared by: Donald B Trone, Foundation for Fiduciary Studies, February 2003.

[52] Katherine Vessenes, J.D., C.F.P.® *Protecting Your Practice* (Princeton, N.J.: Bloomberg Press, 1997), p. 61.

1. Section 206 Imposes A Fiduciary Duty Upon Investment Advisers. Section 206[53] of the Advisers Act imposes on investment advisers a fiduciary duty to exercise the utmost good faith in dealing with their clients, and to disclose all material facts and conflicts of interest to their clients.[54] The Advisers Act was enacted, at least in part, to strengthen the fiduciary nature of the relationships between advisers and their clients. The Supreme Court has stated that Section 206 of the Advisers Act establishes federal fiduciary standards to govern the conduct of investment advisers. *See Securities and Exchange Commission v. Capital Gains Research Bureau,* 375 U.S. 18 (1963), in which the Court stated that the Investment Advisers Act of 1940 is evidence that Congress recognized the fiduciary nature of the relationship between an investment adviser and its client and intended to "eliminate, or at least expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested."). The fiduciary duty of investment advisers has been reiterated by the Commission in various pronouncements over the years; as described in the following excerpt from an enforcement action:

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[53] Section 206 of the Advisers Act provides: It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly–

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

[54] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 194, 196; *Fundamental Portfolio Advisers, Inc.*, Securities Act Rel. No. 8251 (July 15, 2003), 80 SEC Docket 2234, 2258; *Arleen W. Hughes*, 27 S.E.C. 629, 634-38 (1948), *In the Matter of Clarke T. Blizzard and Rudolph Abel*, IA Rel. No. 2253 (June 23, 2004).

> The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment, an investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice 'in almost every instance.' This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients.[55]

2. Other Specific Duties of Investment Advisers Exist. In addition to the broad fiduciary duty, other specific duties are also imposed upon investment advisers, including the requirement to disclose the investment adviser's (firm and its supervised persons) financial information and disciplinary backgrounds.[56]

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[55] *See, e.g., In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

[56] Rule 206(4)-4 [17 CFR 275.206(4)-4]. There are at least four aspects of the Advisers Act and accompanying laws governing the conduct of investment advisers that are significantly different from those applicable to broker-dealers.

First, as noted above, advisers owe a strict fiduciary duty to each of their clients that goes well beyond any similar legal obligation of broker-dealers.

Second, section 206(3) of the Advisers Act prohibits an investment adviser from selling or purchasing any security to or from a client when acting as a principal for its own account, unless each such transaction is disclosed in writing to the client and the client consents to it. Many broker-dealers have an existing inventory of securities and thus they have a natural incentive to buy and sell such securities to and from clients on a principal basis.

Third, the Advisers Act requires investment advisers to make certain disclosures that differ substantially in timing and content from current disclosures required by broker-dealers. These include requirements to deliver an informational brochure promptly and to make disclosures about an investment adviser's potential conflicts of interests, other business and activities and affiliations, disciplinary history, employees' educational and professional background, and, in some cases, financial condition.

Finally, the Advisers Act flatly prohibits testimonials and past specific recommendations in advertising.

3. No Blanket or Broad Fiduciary Duty Is *Per Se* Imposed Upon Broker-Dealers. There is no imposition of a broad fiduciary duty upon broker-dealer firms in connection with the sale or purchase of securities in situations in which the Advisers Act or some other legislation (such as ERISA) does not apply. Instead, much more limited duties apply to broker-dealers and their registered representatives, such as:
   a. duty of fair dealing (i.e., a broker-dealer represents to its customers that it will deal fairly with them, consistent with the standards of the profession);
   b. duty of best execution;
   c. duty to provide certain information either at or before the completion of a transaction, such as its capacity (agent or principal) and compensation: commission and whether it receives payment for order flow (if it acts as agent) or in some cases mark-up or mark-down (if it acts as principal);
   d. in certain instances, a duty to ensure suitability of the investment for the client.

4. What Comprises The "Fiduciary Duty"? While the fiduciary duty of an investment adviser lacks adopted standards, it is clear that fiduciaries in general owe clients twin duties of loyalty and care. As noted in a Financial Planning Association white paper, the Commission has stated that an investment adviser's fiduciary requirements include

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Brokers frequently employ testimonials in advertising and such use appears to be increasing.

The Commission in its online publication, "General Information on the Regulation of Investment Advisers," summarized the broad range of duties that investment advisers owe to their clients: "Section 206 of the Advisers Act prohibits misstatements or misleading omissions of material facts and other fraudulent acts and practices in connection with the conduct of an investment advisory business. As a fiduciary, an investment adviser owes its clients undivided loyalty, and may not engage in activity that conflicts with a client's interest without the client's consent. In S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), the United States Supreme Court held that, under Section 206, advisers have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients, as well as a duty to avoid misleading them. Section 206 applies to all firms and persons meeting the Advisers Act's definition of investment adviser, whether registered with the Commission, a state securities authority, or not at all. In addition to the general anti-fraud prohibition of Section 206, Rules 206(4)-1, 206(4)-2, 206(4)-3, and 206(4)-4 under the Advisers Act regulate, respectively: investment adviser advertising; custody or possession of client funds or securities; the payment of fees by advisers to third parties for client referrals; and disclosure of investment advisers' financial and disciplinary backgrounds."

a duty to render disinterested investment advice, to make suitable recommendations to clients in light of their needs and financial circumstances, and to exercise a high degree of care in presentations to clients. Further, they must have an adequate basis in fact for their recommendations, representations and projections.[57]

5. Need For Better Standards. The Commission has not acted to substantially clarify the conduct required to meet the fiduciary duty standard. The imposition of the requirement of a Code of Ethics[58] is an important first step, as is the requirement of formal compliance policies and procedures and the designation of a Chief Compliance Officer for investment adviser firms.[59] However, many industry participants may remain uncertain as to what a fiduciary is and what specific standards of conduct are imposed upon fiduciaries. Arising from the recent scandals which have plagued the investment industry, and in a response to corporate abuses of power and conflicts of interest, it is fair to predict that there will be an expansion of state and federal legislation and regulations to codify areas of liability and standards of fiduciary conduct. In fact, this has already occurred to some degree by the Sarbanes-Oxley Act, which

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[57] "Regulation of Financial Planners, A White Paper Prepared for the Financial Planning Association," by Jonathan R. Macey, April 2002, at p. 23.

[58] *Final Rule, Investment Adviser Code of Ethics*, Rel. No. IA-2256 (July 2, 2004). The Rule is intended to reinforce the fiduciary principles that govern the conduct of advisory firms and their personnel. Each code of ethics must define a standard of business conduct that the adviser requires of all its supervised persons. The standard must reflect the fiduciary obligations of the adviser and its supervised persons and must require compliance with federal securities laws. At the SEC open meeting on May 26, 2004, Commissioner Goldschmid noted that there is an overlap between the required provisions of the code of ethics and federal fiduciary standards.

[59] Final Rule, *Compliance Programs of Investment Companies and Investment Advisers*, Rel. No. IA-2204 (Dec. 17, 2003). "Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks." Sect. II.A.1. The Release also requires each investment adviser "to designate a chief compliance officer to administer its compliance policies and procedures. An adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures." Sect. I.C.1.

imposed specific standards of conduct upon officers and directors of publicly held corporations in adherence to their fiduciary duties as such. Nevertheless, the fiduciary duties of investment advisers are only somewhat defined at present. While it is not possible to define every aspect of the fiduciary duty of an investment adviser, for this the broad fiduciary duty should properly be refined and expanded over the course of time as new situations emerge, it is possible to assist investment advisers to define certain standards of conduct in order that they will be more aware of their specific duties. A broad caveat to a listing of specific standards of conduct, such as "other specific duties which are necessary to protect the best interests of the client," would be appropriate if and when a specific set of fiduciary duties is enumerated.

B. Proposal For Defining Standards For The Fiduciary Duty of Care. The fiduciary duty of care requires that decisions on behalf of the client be made only after gathering relevant information, deliberating and acting with "wisdom and caution."[60] As such, the broad fiduciary duty also encompasses the duty to act prudently, or with due care. The duty of care requires the investment adviser to be diligent, utilize common sense, undertake informed judgments, and act reasonably.

The duty of care a fiduciary possesses is higher than that of a salesperson. According to Eli Bernzweig: "The law regards the duty of a fiduciary as a very high one, higher than the negligence standard applicable to most of the planner's other legal obligations."[61]

Specifically, the following standards should exist:

1. The Duty To Obtain Sufficient Information To Form A Rational Basis for the Investment Decision (i.e., the Duty to Determine Investment Objectives, Assess Risk, and to Consider the Purposes, Terms, Distribution Requirements and Other Circumstances of a Portfolio). An adviser possesses a duty to make recommendations

[60] Black's Law Dictionary (7th ed. 1999), at 13.01[A][2].

[61] Eli P. Bernzweig, *The Financial Planner's Legal Guide* (Englewood Cliffs, N.J.: Prentice-Hall, 1986, p. 96.

based on a reasonable inquiry into a client's investment objectives, financial situation and other factors. This is similar to the "suitability" standard imposed upon broker-dealer firms and their registered representatives. This suitability rule recognizes that investment advisers cannot use a cookie cutter approach to investing because their clients have different needs, levels of sophistication, objectives and risk tolerance. An investment plan which may be suitable for an unmarried twenty-something just entering the work force likely is not suitable for a retired 70 year-old with a fixed income. While those are extremes, the point is everyone's circumstances (e.g., financial and tax status, investment objectives and horizon) differ, and investment advisers are charged with inquiring into those circumstances before developing and implementing an investment plan. This duty of suitability also requires updating of information regarding the client's financial situation, investment experience, and investment objectives as necessary, but no less frequently than annually, to allow the adviser to adjust their investment recommendations to reflect changed circumstances.

2. Duty To Be Educated and Informed. Implicit in the suitability standard above is the further duty to be educated enough so as to be able to provide a reasonable basis for investment recommendations. Unfortunately, however, few federal or state regulatory requirements (other than Series 65 testing) address the need for initial and ongoing education of advisers. After taking the Series 65 test, several years ago, my professional colleagues and I were aghast at the very minimal amount of information required to pass the exam. In order to possess the ability to undertake suitable investment recommendations for a client, a broad knowledge of financial planning issues, taxes, investment products, and investment theory should be required. Specifically, in my view investment advisers should possess, at a minimum:

   a. A general knowledge of the securities industry and types of investment products, including the risks associated with such products (including default or specific company risk, and volatility risk), their historical and rates of return, and the fees and costs relating to the investment product [including both disclosed fees and costs as well as transaction costs (bid-asked spreads and market impact costs) and opportunity costs];

b. A general knowledge of Modern Portfolio Theory[62] and its subset, the Efficient Markets Theory, and recent developments in behavioral finance as they affect decision-making by individual investors.

c. Investment advisers who engage in financial planning for individual investors should be required to possess a comprehensive knowledge of a broad range of topics (income tax laws, estate planning, asset protection planning, etc.).

3. The Duty To Diversify Investments (Duty of Caution?). This duty exists under ERISA and under the Prudent Investor Rule applicable to trustees. The applicability of this duty to investment advisers appears dependent upon the circumstances, and in any event would appear to be subject to waiver by an informed individual client. This specific duty could also be a subset of a larger duty - the "duty of caution" - which requires investment decisions to be made with a view to the safety of a portfolio's capital while securing the desired or needed rate of return, a principal tenet of Modern Portfolio Theory.

4. The Duty To Adhere To An Investment Policy. While ERISA imposes a duty to adopt and adhere to an investment policy, this fiduciary duty is not generally imposed upon all investment adviser - client relationships. Development of an investment policy may bring with it such specific duties as the duty to assess risk tolerance, the duty to assess expected returns of either specific investments or asset classes, and the duty to invest in the context of the entire portfolio (i.e., adhering to the precepts of Modern Portfolio Theory).

5. The Duty to Maintain Clear and Accurate Records. Implicit in the duty to provide due care is the duty to maintain clear and accurate records in support of the reasonableness of investment recommendations.

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[62] In 1954, Professor Harry Markowitz published a paper which staked out the basic ideas of what eventually became known as Modern Portfolio Theory. This body of academic work sets forth the central premise that investors must consciously think about risk as well as return. "Fiduciaries that focus on return define investment prudence in terms of portfolio performance not fiduciary conduct," writes W. Scott Simon in his column, *Fiduciary Focus*, available at MorningstarAdvisor.com.

6. The Duty To Act With Care In Delegation of Investment Functions or Authority. If the investment adviser directs a client to another investment adviser, the fiduciary duty of due care would seem to impose a duty to undertake such delegation only following some type of due diligence.

7. Duty To Consider Taxes? The duty of due care imposed by the broad fiduciary duty applicable to investment advisers should, under any reasonable interpretation of the broad duty of due care, extend to a consideration of the tax effects of investment decisions. No longer should brokerage firms providing financial advice, or investment advisers for that matter, be able to state that they do not give tax advice. *Tax advice is integral to investment advice. The suitability of an investment for a customer or client should not be dependent just upon its risk of default or potential volatility (as to value). Rather, suitability properly should also take into consideration the tax consequences of an investment as applied to the particular client's circumstances.*

   a. The Impact of Taxes Upon Individual Investors. The considerable impact of taxes upon individual investors is summarized in this excerpt from the book, *The Science of Investing: How To Use Academic Research to Reduce Risks and Increase Investment Returns*:[63]

> "*[T]he power to tax involves the power to destroy ... the power to destroy may defeat and render useless the power to create ....*" Chief Justice Marshall in MuCulloch vs. Maryland, 17 U.S. 13 (1837).
>
> *Introduction.* It's not what you make, it's what you keep. Most financial advisors pay little attention to taxes, probably due to their limited knowledge of our complicated, interrelated system of federal, state and local income, estate and gift taxes. (A little knowledge can be a dangerous thing, as well.) A handful of wrong moves in realizing capital gains and garnering too much tax-free income from municipal bond income can lead to serious alternative minimum tax consequences. A broad knowledge of the taxation of investment

[63] Joseph Financial Publications, LLC (2003).

returns, tax deductions, and tax credits is altogether necessary to formulate a tax-efficient investment strategy over the long term. What do we mean by "tax efficient investing"? Simply put - it is keeping more of the gross investment returns the capital markets offer - either for you or your heirs, after taxes are paid.

The Importance of Reducing the "Tax Drag." How important is this attentiveness to taxation? According to an Commission study, investors in actively managed mutual funds lose an estimated 2.5% a year in annual returns to taxes. Another study by accounting firm KPMG Peat Marwick for the Congressional Joint Economic Committee found that the annual impact of taxes ranged from zero for the most tax-efficient funds to 5.6 percentage points for the least. Combined with actively managed stock mutual fund costs (both "disclosed" and "hidden") that average 2.8% or more per year, taxes and costs can combine to eliminate 50% or more of an investor's expected annual return. On a compounded basis, that 50% loss can equate to an erosion of the vast majority of the returns the capital markets have to offer to individual investors.

b. The Unsuitability of Variable Annuities Which Invest In Equities, As To Retirees and Many Other Investors. While several alerts have been issued regarding variable annuities by the Commission and/or the NASD,[64] ***I do not believe that these alerts have served to fully advise individual investors regarding all of the negative tax and other consequences of these investment products***. Variable annuities are complicated products which are subject to many sales abuses.[65] The

[64] *See Joint SEC/NASD Report On Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products* (June 2004), in which the Staff of the Commission and the NASD summarized prior alerts issued and urged firms to "consider the sound practices and weak practices summarized in this report and improve their supervisory procedures and compliance systems as appropriate to more effectively reduce potential harm to the investing public." Article VI, Conclusions. This report did not, however, outright ban the weak practices.

[65] *See, e.g.,* Remarks of Commissioner Cynthia A. Glassman before the National Association for Variable Annuities, June 14, 2004, stating: "[C]ompetitive pressures [in the variable annuity industry] can also have at least two potentially unfavorable effects for investors. First, the wide array of products and features may make an already complex product even more difficult for the average investor to understand. Most people can

problems involving the sales of variable annuity products, particularly to retirees, are much greater than the Commission may suspect. In my estimate, the vast majority of registered representatives in Florida promote variable annuities to retirees, even when it is clear that other investment alternatives would be far more suitable from a tax perspective. This is a major problem, and given its significance I therefore attach as Exhibit A to these comments an excerpt from the book, *The Science of Investing: How To Use Academic Research to Reduce Risks and Increase Investment Returns*. This except details the many problems associated with variable annuity products. It is clear to this investment adviser that the fiduciary duty of due care imposed by the Investment Advisers Act of 1940 would prohibit the broad promotion of variable annuities by investment advisers to retirees.[66] ***Additional and urgent action by the Commission is required to address the ongoing problem of unsuitable sales of variable annuity products, especially to retirees.***

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appreciate that when they invest in a mutual fund, their money is pooled and invested according to the objectives set out in the fund prospectus. When you layer on concepts like tax deferral, ordinary versus capital gains treatment, mortality expense, death benefits, guaranteed and non-guaranteed values, surrender periods, early withdrawal penalties and various payout options, the product is (to say the least) not as easily grasped by the average investor. There is, therefore, a greater burden on variable product sponsors to provide investors with clear and understandable information in the prospectus, as well as on broker-dealers and their registered representatives who recommend variable annuities to make sure that they ask for and receive the information necessary in order to make sure their recommendations are suitable to particular individual investors. The second potential problem is that competitive forces may pressure broker-dealers and their representatives to use inappropriate sales tactics or make unsuitable sales or exchanges from one product to another in order to maintain growth rates. Variable products are typically long-term investment vehicles and are generally inappropriate for investors who may need their money in the short term. With respect to product exchanges, it is not clear that investors can adequately evaluate the trade-offs which may be associated with exchanging old variable products for new ones."

[66] The author of this comment, who is an estate planning and tax attorney and an investment adviser, believes that from a tax and cost perspective it would be *extremely rare when a variable annuity would be suitable to meet the investment needs of a retiree*, whether purchased in a qualified account (i.e., IRA) or non-qualified account. This is especially true when the variable annuity is to be invested into stock mutual funds, in whole or in part. To the author's knowledge, neither the SEC nor the NASD has gone so far as to state that variable annuities should normally not be sold to those who are already retired (or approaching retirement), despite the significant tax detriment these products nearly always possess in such circumstances.

8. The Duty to Consider Costs. There may exist a duty to incur only appropriate and reasonable costs. This duty is one which may derive from the dictates of the Prudent Investor Rule, should it be deemed applicable to the formulation of the investment policy at hand. In any instance, a great deal of academic research has shown a direct relationship between higher costs of investment products and lower returns of those products, on average. Similar to the need to minimize the tax drag upon investment returns the investment adviser must also seek to reduce both disclosed costs[67] and hidden costs[68] of investment products on behalf of the individual investor.

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[67] The high management fees of mutual funds and other products have been increasing criticized. As stated by Warren E. Buffet, in Berkshire Hathaway Annual Report, Feb. 21, 2003, "Investment company directors have failed as well in negotiating management fees (just as compensation committees of many American companies have failed to hold the compensation of their CEOs to sensible levels. If you or I were empowered, I can assure you that we could easily negotiate materially lower management fees with the incumbent managers of most mutual funds ... Under the current system, though, reductions meant nothing to 'independent' directors while meaning everything to managers. So guess who wins?" Recent initiatives by the SEC, including the requirement of an independent Chairman for mutual fund boards, and recent settlement in which a mutual fund company agreed to reduce (over time) its management fees, are a step in the right direction. However, given the inevitable conflict of interest boards face when attempting to serve "two masters," perhaps legislation or further rule-making should be considered to specify that the board directors owe their first allegiance to the fund shareholders, and that the interests of shareholders in the mutual fund company are secondary.

[68] The costs of mutual fund and other products are not just those that are "disclosed" - such as management and administrative fees, and mortality and expense charges (for variable annuities). Moreover, investment advisers have an important duty to attempt to ascertain these costs as part of their due diligence prior to recommending an investment product for a client. What are these other "hidden" costs? In Comments filed with regard to Proposed Rule: *Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs* [Release No. 33-8349; 34-48952; IC-26313; File No. S7-29-03], filed by Mercer Bullard, Founder and President, of Fund Democracy, Inc.; Barbara Roper, Director of Investor Protection, of Consumer Federation of America; Sally Greenberg, Senior Counsel, of Consumers Union; Kenneth McEldowney, Executive Director, of Consumer Action , dated March 19, 2004, the commentators noted: "As explained by the Commission, portfolio transaction costs can be divided into four categories: commissions, spread costs, market impact and opportunity costs. The Commission acknowledges that commissions are readily calculable. Indeed, the Commission has already recognized the appropriateness of disclosing the dollar amount of commissions by requiring their disclosure in the Statement of Additional Information ('SAI'). The Commission also recognizes that other components of portfolio transaction costs can be measured, and that, 'to monitor performance and comply with their best execution responsibilities, many fund advisers already gather a substantial amount of data about transaction costs and execution quality.' Many third-party firms provide fund boards with data regarding portfolio transaction costs, and fund directors use it to evaluate the fund manager's performance."

9. The Duty to Exercise a High Degree of Care in Presentations to Clients. Investment advisers must have an adequate basis in fact for their recommendations, representations and projections.

10. The Duty To Vote Proxies In The Best Interest of the Client. Former SEC Chairman Harvey Pitt, on Feb. 12, 2002, wrote in a letter, "We believe, however, than an investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with ... its fiduciary duties under federal and state law to act in the best interests of its clients."[69]

C. Proposal for Defining Standards For The Fiduciary Duty of Loyalty. A duty of loyalty requires fiduciaries to place their clients' interests ahead of their own, and not to favor one client over another. The duty of loyalty is the basic rule designed to insure that fair decisions are made by investment advisers on behalf of their clients. Generally, purpose of the rule is to ensure, for the sake of the client, that the investment adviser's decisions are free from the corrupting influence of a material personal self-interest. In other words, the investment adviser should as a general rule not receive, as a result of the investment decision made, some material personal economic benefit not received by the client. Various specific standards of conduct can be discerned which arise form the fiduciary duty of loyalty, including:

1. The Duty To Avoid Altogether Certain Conflicts of Interest.

a. The Duty to Keep Client Accounts Separate From Those of the Fiduciary.

While mutual funds serve an important purpose in provide diversification for individual investors (thereby providing a minimization of a form of uncompensated risk), the costs to the investor, both in terms of disclosed and hidden costs, must be discerned and then closely monitored by the investment adviser.

[69] *See* William Baue, *SEC Chair Calls Proxy Voting a Fiduciary Duty*, March 29, 2002 article available at www.socialfunds.com. The *Final Rule: Proxy Voting by Investment Advisers*, Rel. No. IA-2106 (March 10, 2003), requires an investment adviser that exercises voting authority over client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of the client.

b. The Duty To Avoid Use of Material Nonpublic Information (Insider Trading). A fiduciary duty which usually flows to all investors in the market, as opposed to the individual client of the investment adviser.

c. The Duty To Avoid Use of Material Nonpublic Information (Avoid Front-Running).

2. The Duty to Minimize Conflicts of Interest. While the duty to minimize conflicts of interest is sometimes referred to in speeches by Commission staff, there do not appear to be any specific regulatory standards which apply. Rather, the duty to minimize conflicts of interest (which are not clearly prohibited) appears to be somewhat aspirational in nature at the present time.

3. The Duty To Disclose Conflicts of Interest Which Are Not Avoided. As to conflicts of interest which are not mandated to be avoided, disclosure is required.

4. The Duty To Disclose All Fees and Compensation. Under the "brochure rule" the investment advisory representative of an investment adviser firm must provide to the client either Form ADV, Part II, or an equivalent brochure, which contains a multitude of disclosures about the RIA firm, its fees, and the investment advisory representatives and their compensation. Additionally, every client of an RIA firm must receive a written fee agreement. These requirements enable the client to ascertain, in advance:
   a. what kinds are services are available;
   b. who is providing those services;
   c. what fees and other expenses will the client be subject to and are they negotiable;
   d. whether the adviser is being compensated from other sources, and if so the nature and amount of such compensation;
   e. whether the adviser is affiliated with another adviser, a broker-dealer or an issuer of securities;
   f. whether, if a financial plan is prepared, the client can implement the financial plan anywhere or whether it can only be implemented through the adviser; and
   g. what other potential conflicts of interest exist that might affect the adviser's recommendations.

Form ADV, Part II is the reference tool with which the client or potential client can compare advisory firms for cost of services and for compatibility with their needs. The duty of disclosure of fees and all other compensation is the means of resolving the only conflict of interest which cannot be eliminated in the adviser-client relationship - that which exists in determining the compensation of the adviser.

5. Duty To Disclose Fee Alternatives. It is required that the ADV disclose if fees are negotiable. Some states appear to require the adviser to disclose whether lower fees for comparable services may be available from other sources.

6. Duty to Act Fairly With Regard To All Clients. The fiduciary duty embodies a duty to treat all clients fairly, which means not favoring one advisory client over another without adequate rationale or justification. *See* Owen T. Wilkinson & Associates, Inc. [1987-1988 Transfer Volume] Fed. Sec. L. Rep. (CCH) P 78,556 (Feb. 3, 1988).

7. Duty to Render Disinterested Advice. It is curious that national investment advisory firms affiliated with product providers are providing comprehensive investment plans to their customers which promote their own proprietary products. In my own investment advisory practice I have had several occasions to review these plans, and have been astounded to see the firm's higher-fee products recommended over the same firm's lower-fee products. This practice begs several questions. First, can a fiduciary serve two masters?[70] Specifically, can a fiduciary investment adviser attempt to serve the best interests of the client while promoting the proprietary products of its

[70] The difficulty in serving two masters is highlighted by the problems confronting most mutual funds. The high management fees of many mutual funds have been heavily criticized. If asset managers at mutual fund providers seek to maximize profits, then they sacrifice the investors' best interests. However, if the mutual fund managers don't seek to maximize profits then the shareholders who have invested in the fund providers would see their best interests' placed secondary. In short, mutual fund asset managers truly possess two masters. Any dollar given to one principal comes directly out of the pocket of the other principal, and vice versa. Only at Vanguard does such dual master problem not arise, as the fund shareholders also are the owners of the mutual fund providers under a "mutual structure." Vanguard has a reputation for low management fees, and it has none of the 12b-1 fees nor soft dollar arrangements with broker-dealer firms which have been recently criticized.

employer? Second, can a fiduciary limit the fiduciary duty by contract to such a degree that the fiduciary duty to render disinterested advice is rendered meaningless? Third, if a contract between the fiduciary and the investor/customer can and does limit the fiduciary duty of the investment adviser, what disclosures should be provided to the investor that the investor will not be receiving impartial, objective advice, and/or that the investor might receive impartial, objective advice from another firm?

D. What Process or Standards of Conduct Might Be Imposed for Minimal Adherence to the Fiduciary Duty? While no uniform standards of conduct have been adopted, the Foundation for Fiduciary Studies has attempted to fill this breach by identifying the practices that define the details of a prudent process for investment fiduciaries. "To date, twenty-seven practices have been identified, each of which is substantiated by legislation, case law, and/or regulatory opinion letters. The practices address the procedures for: (1) analyzing a client's current investment position; (2) diversifying the client's portfolio; (3) preparing an investment policy statement; (4) implementing an investment strategy; and (5) monitoring the investment strategy. The practices are intentionally written to be equally applicable to investment committee members, trustees, and investment advisors."[71] Other organizations, such as the AIMR, FPA, and CFP Board, possess standards or ethical rules which may be construed as standards of conduct for investment adviser fiduciaries.

The question can also be asked as to if and when do the standards of the Uniform Prudent Investor Act (UPIA)[72] apply to the actions of investment advisers. Does the Prudent Investor Rule apply only when the client is a trustee under a private trust, executor under a will, custodian under the Uniform Transfers To Minors Act, court-appointed guardian, and certain

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[71] The practices can be reviewed and critiqued at the Foundation's Website, www.ffstudies.org. The Foundation for Fiduciary Studies and the AICPA have published *Prudent Investment Practices: A Handbook for Investment Fiduciaries*, which identifies 27 practices that detail a prudent investment process from beginning to end.

[72] Also known as the modern version of the Prudent Investor Rule, this Act was introduced in 1994 by the National Conference of Commissioners on Uniform State Laws. In a comment letter dated March 10, 2004, on the SEC Proposed Rule regarding the adoption by Investment Advisers of Code of Ethics (File No. S7-04-04), Knut A. Rostad and Donald M. Rembert suggested that the SEC adopt the tenets of the UPIA as the basis for a Code of Ethics.

other statutorily defined groups (such as state pension fund trustees), or does the UPIA apply more broadly and at all times to the actions of investment advisers who advise individual (non-trustee) investors?

VI. ACTIONS THE COMMISSION SHOULD CONSIDER.

A. The Commission Should Bear In Mind The Interests of Individual Investors. The Commission's role is to protect the investment public, not the profits of broker-dealer firms. As existed in 1940, there is a growing need and demand for unbiased investment information and guidance. I support the comments of the Financial Planning Association president when she recently stated:

> What we fail to understand is why the SEC would propose a rule that allows brokerage firms to misrepresent and actively market themselves to investors as trusted advisers – instead of disclosing their true role as sales agents -- under the B-D rule. The critical problem with the rule proposal is that it allows stockbrokers to call themselves financial planners and financial consultants, and to provide fee-based financial planning services under more lenient broker-dealer sales regulations. The rule permits broker-dealers to avoid the higher standards of a professional adviser, namely those of fiduciary investment advisers registered with the Commission.[73]

B. The Commission Should Act Promptly to Repeal the Proposed Rule. In the context of such repeal, the Commission should specify that all broker-dealer firms should immediately stop marketing fee-based investment advisory programs or taking on new fee-based clients unless full adherence to the Advisers Act is undertaken. As to existing broker-dealer fee-based accounts, the Commission should permit broker-dealer firms a reasonable period of time (not to exceed sixty days, given the importance of this issue to individual investors) in which to convert the brokerage firm fee-based account to one governed by the Advisers Act (and to meet its requirements) or to terminate the fee-based relationship.

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[73] Statement by FPA President Elizabeth Jetton at National Press Club, concerning FPA Legal Challenge to SEC's Broker-Dealer Rule, National Press Building, First Amendment Lounge, July 20, 2004.

C. The Commission Should Promote the Application of the Advisers Act and The Investment Advisory Profession. The Commission should endeavor to promote investment advisers as a separate and distinct profession. It should immediately revise its own literature which adds to the consumer confusion on this issue. It should continue to seek to define the standards of care and loyalty to which investment advisers, as fiduciaries to their clients, should adhere. The Commission should work with Congress to ensure that the investment advisory profession is not put at a disadvantage by tax law, by lack of adequate representation on the Commission, or the lack of a body which seeks to promote the profession. Furthermore, the Commission should preserve the fundamental distinctions between broker-dealer firms (who chose not to abide by the fiduciary duty and other consumer protections afforded by the Advisers Act) and investment advisers.

D. The Commission Should Ensure That The Fiduciary Role Of Investment Advisers Is Not Compromised, and The Commission Should Seek To Provide Education for Investment Advisers As To The Specific Duties Encompassed Within The Broad Fiduciary Duty Owed To Individual Investors. In any action undertaken, the Commission should ensure that the fiduciary role of an investment adviser is not compromised by shared allegiances. In other words, an investment adviser, to be truly objective, cannot serve two masters. Given the very complicated world out there – with a myriad of tax rules, financial planning decisions, the need to integrate investment decisions with asset protection and estate planning, and the myriad of investment products available, investors need truly objective advice. Most investors desire some form of coaching, to make certain they do not make mistakes (such as the common mistake of chasing returns).[74] Investors deserve to receive advice which is truly in their best interests. Conflicts of interest, so prevalent in Wall Street, should be avoided if at all possible. Only when conflicts of interest cannot be avoided should they be permitted, and then only with full disclosure. "The best interests of the client" is not a standard which should be subjected to compromise. The Commission should not act to proceed down a

[74] Investing is a lifelong endeavor, and thinking long-term is not something that comes natural to the vast majority of individual investors, especially in light of increased volatility of security valuations in the capital markets.

"slippery slope," at the bottom of which is a complete erosion of the protections afforded investors who desire and seek objective, unbiased investment advisory services.

In addition, the Commission should seek to assist Investment Advisers by defining for them the many specific duties encompassed within the broad fiduciary duty.[75] Suggestions in this regard could include the issuance of a Commission staff report, a commission of those in the investment advisory profession which would seek to define both the scope of fiduciary duty and "best practices" for investment advisers who advise individual investors,[76] or the use of educational funds (such as those set aside from the research analyst conflicts of interest settlement) to fund projects relating to investment adviser and broker-dealer education as to the nature and extent of fiduciary duties.

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[75] " 'The fact of the matter is, it's one thing to ask people to act and behave like fiduciaries but it's another to give them actual guidance on what that means,' says [Clark M. Blackman, a CPA and investment adviser] ... 'The handbook [Prudent Investment Practices] does something that the DOL and SEC have shirked doing. Up until now, they have purposely avoided putting too hard a definition on fiduciary duty, preferring to leave it to the facts and circumstances of each case. But that makes it very difficult for advisors to know if they're operating within appropriate boundaries.' " As quoted in article by Tracey Longo, *Can Prudent Practices Save Your Business?*, Financial Advisor Magazine, July 2004.

[76] The idea of a commission to be formed to define fiduciary practices is not new. The Foundation for Fiduciary Studies in a March 4, 2002 Press Release stated: "Is it time for an investment industry 'do-over?' - You bet!! So, what needs to be done? First, we need to define the term 'investment advisor.' Where does a brokerage transaction end, and investment advice begin? What is the difference between an investment advisor and a money manager? We propose that an 'investment advisor' be defined as: 'A person who provides comprehensive and continuous investment advice.' This will provide the industry a relatively clean demarcation between brokers and investment advisors, and between investment advisors and money managers. Second, 'investment advisors' should be held to a fiduciary standard of care, with clearly defined practices ... *Third, a committee of investment fiduciary experts should be convened to develop a handbook that defines the details for the above practices. The handbook should carry nearly the same impact as legislation and/or regulations, at much less expense to the taxpayer. And, the handbook (which should be written for the lay-person) should be able to serve as a valuable reference for not only investment advisors, but also for retirement plans, foundations, endowments, private trusts, and individual investors.* Fourth, we should institute minimum education and training requirements. Investment advisors should be required to have a four-year college degree; have completed a comprehensive course on investment fiduciary responsibility and the associated practice standards of care; and, have ongoing continuing education requirements. And lastly, the SEC should create a division for the regulation of investment advisors that is separate and apart from money managers. Furthermore, we should revert back to having all investment advisors regulated by one federal agency." [*Emphasis added.*] This press release is available at www.ffstudies.org.

E. Tax Law and the Deductibility of Investment Advisory Fees Clients of investment advisers who pay an hourly or flat or fixed fee, or a percentage of assets under management, are often placed at a substantial disadvantage, from a perspective of federal income tax law, compared to those who compensate their "financial counselor" through commissions, 12b-1 fees, and other arrangements.

1. Limited deductibility of IA Fees (2% AGI limit, phase-out). Investment advisory fees are deductible, but only if the taxpayer elects to itemize deductions, and even then only to the extent that "miscellaneous itemized deductions" are greater than 2% of your adjusted gross income. Additionally, rules relating to alternative minimum tax and the phase-out of itemized deductions also can come into play. As a result, many taxpayers, especially retirees, receive no benefit from the possible tax deductibility of investment advisory fees. By contrast, since commissions and 12b-1 fees are deducted at the investment product level, but often utilized to pay broker-dealer firms and their registered representatives, and these fees offset the level of gross returns of the investment, thereby effectively resulting in a complete income tax deduction. The Commission should seek to have this disparate treatment addressed by Congress through future tax legislation.

2. Clients with all funds in tax-deferred accounts. An increasingly common occurrence is the client who possesses all of their investment funds in IRA or qualified retirement plan accounts. In order to pay advisory fees funds must be withdrawn from the account, taxed, and the net amount utilized to pay fees. For clients with IRAs who are under age 59½, at times an early distribution [utilizing substantially equal periodic payments under Section 72(t) of the I.R.C.] may be required in order to come up with funds to pay fees to registered investment advisers. Accordingly, fee-based accounts are again put at a significant tax disadvantage relative to commission-based product sales. Again, the Commission should seek to have this inequity addressed by Congress through future tax legislation.

F. Establishment of An SRO for Investment Advisers Who Advise Individual Investors? The Commission should work with Congress to weigh the costs and benefits of establishing a self-regulatory organization (SRO) for investment advisers.[77] The Commission is necessarily involved in all aspects of the securities industry. As such, at times its resources are stretched thin. Broker-dealers have the NASD and the NYSE, but investment advisers have no self-regulatory organization. In order to devote the resources required for the important issues arising from the Advisers Act, an SRO for investment advisers appears to be appropriate. The SRO would generally seek to advance the professionalism of investment advisers, protect the public, and educate the public in the key distinctions between investment advisers and broker-dealers. The specific purposes of an investment adviser SRO could include the following:

1. To promote through cooperative effort the investment advisory business;
2. To standardize the principles and practices of the investment advisory business, including the establishment of minimum standards of conduct in adherence to the strict fiduciary duty imposed upon advisers;

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[77] SROs who are financially and practically independent from the industry they regulate can serve a useful function, but their existence also generates potential resistance by securities industry participants to securities industry reforms and imposes additional costs and burdens upon securities industry participants. Additionally, close supervision of SROs by the Commission is required. As stated by Professor Joel Seligman: "SEC supervision of industry self-regulation is a thread that unites several aspects of the Commission's broad jurisdiction. As articulated during the New Deal chairmanships of Landis, Douglas, and Frank, the necessity for SEC supervision of industry self-regulation stemmed from two quite distinct bases. First, the impracticality of direct SEC regulation of the several thousand broker-dealers and business corporations subject to its jurisdiction. Second, a preference for business, with its greater practical knowledge of its own affairs, to participate in the application of SEC rules and thus reduce the likelihood of unnecessary disruption or inefficiency. Far from being a panacea, SEC supervision of industry self-regulation generally has been effective in its major applications only when the Commission has been willing to threaten or actually use its regulatory authority to create incentives for industrial self-regulation. As a 1973 report of the Senate Subcommittee on Securities aptly stated: 'The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation." Joel Seligman, Remarks at The Duke Global Capital Markets Center Conference on Current Issues In Institutional Equity Trading, December 11-13, 2003, Palm Beach, Florida, titled "Cautious Evolution or Perennial Irresolution: Self-Regulation and Market Structure During the First 70 Years of the Securities and Exchange Commission."

3. To promote aspirational goals for investment advisers which extend beyond minimum standards of conduct;
4. To promote and provide education to the public on the important fiduciary role of the investment adviser and its benefits for consumers;
5. To promote and provide education for advisers in order to enable them to fulfill their duties of due care and loyalty;
6. To encourage investment advisers to fully observe Federal and state securities laws through educational sessions and position papers;
7. To provide a medium through which its membership (all federal investment adviser firms, at a minimum) may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment advisory and securities businesses;
8. To facilitate the resolution of issues facing dual registrants (i.e., firms acting as both broker-dealers and investment advisers);
9. To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices;
10. To promote self-discipline among members; and
11. To investigate and adjust grievances between the public and members and between members.

For example, the SRO could adopt Rules of Conduct, as have been adopted for broker-dealers by the NASD. Of course, the Rules of Conduct for investment advisers would reflect the higher fiduciary standard to which investment advisers are subjected. Additionally, the SRO could work to adopt a higher initial educational requirement for investment advisers,[78] exceeding the often-criticized minimal education needed to pass the Series 65 examination. Uniform continuing education requirements could also be adopted.

[78] The CFP® certification requires a comprehensive educational program covering more than 100 integrated financial planning topics. These topics cover major planning areas such as: (1) General principles of financial planning; (2) Insurance planning; (3) Employee benefits planning; (4) Investment planning; (5) Income tax planning; (6) Retirement planning; and (7) Estate planning. The current Series 65 exam does not address many of these issues. The CFP® certification could serve as a model for a higher test, to be required for investment advisers who advise individual investors in matters involving financial planning.

The SRO should possess a strong leadership which is dedicated to the protection of the public interest and to the advancement of the investment adviser profession. In should be separate and apart from the NASD. In summary, I support the observations contained in the Proposed Rule dated Feb. 5, 2003 ("Compliance Programs of Investment Companies and Investment Advisers") in which the Commission advanced the idea of an SRO of investment advisers.[79] I believe an SRO will serve to educate the public on the benefits of investment advisers, enhance the education and services of investment advisers, and lead to a significant advancement in the role of the investment advisers within the securities industry regulatory scheme.

G. The Commission Should Revise Its Own Literature To Promote Investment Adviser Profession and Eliminate Consumer Confusion. The Commission should have its staff act promptly to revise its own literature which exacerbates consumer confusion by not clearly delineating between broker accounts and investment advisory accounts. The Commission should inform those seeking investment advice that investment advisers are held to a very high fiduciary duty.

H. "Financial Planner," "Financial Consultant," And Similar Terms Should Be Restricted To Use by Investment Advisers. In 1987, the Commission staff opined that "financial planning" activity requires registration as an investment adviser, even if undertaken by a broker-dealer.[80] Moreover, a broker-dealer (or registered representative of the broker-dealer firm)

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[79] In the Final Rule, the Commission stated: "[W]e continue to regard them [SROs and other measures previously proposed] as viable options should the measures we are taking today fail to adequately strengthen the compliance programs of funds and advisers." Final Rule, *Compliance Programs of Investment Companies and Investment Advisers*, Rel. No. IA-2204 (Dec. 17, 2003)

[80] *Applicability of Investment Advisers Act to Financial Planners, Pension Consultants and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, IA Release No. 1092 (Oct. 8, 1992). This release was promulgated in response to multiple request from various segments of the financial services community, and follows the landmark SEC Release IA-770 (1970). Release No. 1092 reaffirmed the three-prong approach that IA-770 had earlier set forth: (1) Does the financial services professional provide advice or analyses about a security; (2) does the financial services professional present himself to the public as being "in the business" of providing advice about securities; and (3) is the financial services professional compensated for such advice (with no distinction being given between fees or commissions). If all three tests are met, the financial services professional is subject to the Investment Advisers

that employs such terms as "financial planner"[81] merely as a device to induce the sale of securities might violate the anti-fraud provisions of the Securities Act of 1933 and the Exchange Act.[82]

As aptly stated by Duane R. Thompson, Group Director, Advocacy, in comments submitted on June 21, 2004 in opposition to the Proposed Rule, "the SEC should prohibit brokers who claim the solely incidental exemption from marketing their services as advisory services by prohibiting use of the terms 'financial,' 'retirement,' 'wealth,' or similar terms in combination with 'advice,' 'consult,' 'counsel,' 'plan,' or any similar combination of words suggesting comprehensive financial planning services; or permitting individuals from using a title similar to 'financial planner.' "

I. Broker-Dealer Firms Must Evolve To Meet The Needs of Their Customers

1. Why Do Broker-Dealer Firms Resist The Application of the Advisers Act? There is a huge resistance by broker-dealer firms to the application of Advisers Act to the advisory activities of their registered representatives. Why? Based upon comments I have heard at conferences and from registered representatives whom have interviewed with our firm, it appears that most traditional "full service" broker-dealer firm are:

Act of 1940.

[81] One commentator to the Proposed Rule illustrates that registered representatives are holding themselves out as financial planners. She writes: "Allowing brokers to infer that they have a fiduciary relationship to a client, when in fact they do not, is the kind of thinking that has caused so many scandals in our profession and undermines public confidence in financial advisors. I witnessed a good example of this at a professional lunch last week. I sat next to a sales representative from a large broker-dealer. When I introduced her to another attendee, the attendee asked, so you are a stockbroker. Her reply, no, I am a financial advisor. If she puts herself out as a financial advisor, she should be subject to the same fiduciary standards as a financial planner not the lesser ones for brokers." Comments of Karen F. Folk, Ph.D., CFP, Certified Financial Planner, Urbana, Illinois, submitted August 26, 2004 relative to the Proposed Rule.

[82] *Cf. In re Haight & Co., Inc.*, Securities Exchange Act Release No. 9082 (Feb. 19, 1971) (Broker-dealer defrauded its customers in the offer and sale of securities by holding itself out as a financial planner that would give comprehensive and expert planning advice and choose the best investments for its clients from all available securities, when in fact it was not an expert in planning and made its decisions based on the receipt of commissions and upon its inventory of securities.)

a. Unwilling to abandon a system which permits the broker-dealer to sell expensive products which are often not suitable, from a tax perspective, to their client's needs. This includes an unwillingness to abandon the sales of proprietary products, or to refuse to accept soft dollar compensation from product providers, practices which would clearly violate a firm's fiduciary duty to its clients. A fiduciary cannot serve two masters, and for that reason investment advisers must seek to avoid, not just disclose, conflicts of interest.

b. Unwillingness to cross the line to give "tax advice," even though an application of tax laws to the needs of individual investors is imperative, given the substantial tax drag which can occur upon investment returns.

c. Unwilling to expend the funds to invest in the training of the registered representatives who act as investment advisers. This training is not that typical to those hired by broker-dealer firms, as to how to "gather assets" (i.e., how to sell a product). Rather, this training must be comprehensive and reflective of the tax, financial planning, estate planning and other knowledge which is wholly necessary in order to provide good and comprehensive investment advice to individual investors.

d. Unwilling to expend the funds to more closely monitor the activities of its registered representatives, as is required when the firm possesses a fiduciary duty to its clients.

e. Unwilling to risk the potential liability which results from the failure to serve the best interests of the client.[83]

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[83] The higher standards imposed upon fiduciaries (as opposed to non-fiduciary salespersons / registered representatives) could lead to a more significant recovery by individual investors against broker-dealer firms during arbitration, and hence the resistance to the application of the Advisers Act to broker-dealer fee-based programs. Andrew Stoltmann, a Chicago securities litigation attorney who represents investors in arbitrations against brokers, was recently quoted as stating: "The fiduciary issue is crucial in arbitrations. Brokerage firms argue at (arbitration) hearings that their broker is nothing more than an order taker. As more investors use a

2. By Contrast, Many Investment Adviser Firms Embrace Their Fiduciary Duty. By contrast, many independent Investment Adviser firms have formed over the past ten years which embrace the fiduciary role and provide high-quality, comprehensive investment advisory services. My firm, combining the knowledge and experience of certified public accountants, estate and tax planning attorneys, and a Certified Financial Planner®, is one formed with the future of the investment advisory profession in mind, not its past. We apply our combined knowledge and experience to comprehensively and holistically meet the planning needs of our clients. We seek to avoid all conflicts of interest, refusing to accept fees or any material compensation from brokerage firms (custodians), mutual funds, or other providers of products or services which we may recommend to our clients. In those rare instances in which we cannot avoid the conflict of interest, we undertake full and complete disclosure of same.

3. Traditional Stock Brokerage Firms May Be "Dinosaurs," and the Next Extinction Event May Well Be Coming. Many millions of years ago a great event happened. The great reptilians, which seemed so strong and so dominant, could not adapt. Much could be said today about traditional Wall Street stockbrokerage firms and insurance companies. In this modern world, with the internet and other communications, each investor has available to us greater information. With greater information should come better choices. Also, disintermediation occurs. This is the process of eliminating, or greatly reducing the role of, middlemen. As a result, the price of goods and services falls. It does not always happen quickly, however.

   a. For example, take the role of 'market makers' on the New York Stock Exchange, which generally control much of the trading in exchange-traded stocks. Some studies show that these middlemen maintain costs for trading which are far higher than some overseas markets which have proceeded to electronically match all buy and sell orders. The days of these 'market makers' are numbered, to be sure. It is

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fee-based broker, it is imperative that the financial adviser be held to the (higher) standard of a fiduciary." *Titles Matter When Financial Adviser Handles Your Nest Egg.* The Detroit News Business, August 5, 2004.

only a question of time before technology supercedes their role, reducing costs for investors.

b. It is the same with the traditional seller of investment products. Disintermediation is occurring, and individual investors want advice, not a product sales pitch. Recent studies have shown that investors, especially those with significant wealth, are turning more and more to objective, independent investment advisers. To illustrate the difference, asked if you could buy a car with the assistance of either a commission-based car salesperson or with the assistance of a consultant who was employed directly by you and had no affiliation with any car dealer, which would you choose to work with? From who do you think you would get unbiased, and better, advice?

c. The old brokerage model is being replaced by fee-only advice. Investors want to seek advice from those who they pay – not from someone who is paid by others. This helps avoid conflicts of interest. Fee-only advice perhaps most closely aligns the interest of the advisor and the client so advisors have no reason not to offer their best advice. As more investors understand that stockbrokers work for their firms, and not directly for the client, more investors will depart from traditional stockbrokers. Instead, they will seek out advisors who are paid only by the investor, who are not restricted as to which investments they can recommend, and who seek to avoid conflicts of interests. In short, investors desire *trusted advisors* who look out for the investor's *best interests*. Investors have been burned

too many times by slick-talking product salesmen.[84] They want, and desire, the confidence in their advisors so they that can possess peace of mind.

d. A investment adviser representative candidate for our firm once worked for a large, national broker-dealer firm. As we discussed the differences between the broker-dealer environment and that of fee-only investment advisory firms, the candidate inquired as to why broker-dealer firms did not adopt the investment adviser business model, and abandon their product-selling ways. I responded that the forward-looking CEO of a major brokerage firm would start down that road; otherwise, over time, the broker-dealer firm would continue to lose business to objective investment advisers. In short, there is no good reason which supports the resistance by broker-dealers to the application of the Advisers Act to their advisory activities. The Commission should encourage broker-dealer firms to evolve, and not keep their heads stuck in the sands of a past, archaic system which no longer responds to the needs of most individual investors. The Commission should seek to foster this evolution of broker-dealer firms away from the "car salesman" mentality of the past and toward that of "trusted advisor" to their

[84] The comments of Mitchell B. Goldberg, Esq., submitted on August 25, 2004 with regard to the Proposed Rule, illustrate the product sales mentality of broker-dealer firms. He writes: "I have heard numerous consumer claims against brokers and their sales representatives alleging improper conduct. Most of the claims involve alleged unsuitable investments. The investment public is being misled by the large brokerage firms when they seek investment advice for the purchase and sales of securities. They are regularly told that their representative is an investment advisor or counselor and they believe that the person is experienced in providing suitable investment advice relative to their entire investment portfolio and other investments relative to their net worth and assets. They are told this at the beginning, then when the purchases of securities go sour because they are in unsuitable investments, the brokers defend against the claims at arbitration stating they are only order takers and not investment advisors. The names of their representatives, however, reveal otherwise names like Investment Advisor or Counselor. These persons and companies should be under the same standards as all other investment advisors and they should be made to prove that they did not take on this role when they solicited the business, and that the customers were fully made aware that they are merely order takers and recommend the purchase or sale of particular securities and they are not offering investment advice relative to the suitability for an entire portfolio. Also, they should not be exempted from conflict of interest disclosure when providing investment advice. I have witnessed too much misconduct among representatives of the large brokerage firms, a lack of training and supervision, and a complete unwillingness to accept responsibility for improper and unsuitable investment advice. This industry needs much more regulation and enforcement of existing laws, and not less in the form of exemptions."

clients. An important first step is for the Commission to not act as a *resistor to change*. The Proposed Rule is just such a resistance effort, and a poor one at that. The Proposed Rule should be repealed and new initiatives adopted by the Commission to promote the important consumer protections afforded by the Advisers Act.

VII. SUMMARY AND CONCLUSIONS

In the absence of complete repeal of the Proposed Rule, the Commission will not adhere to its fundamental mission to protect the interests of the individual investor by enforcing the higher standards of conduct imposed by Congress upon those who seek to provide financial and investment advice.[85] Furthermore, the suggested actions set forth in these comments for the Commission to consider - to establish standards detailing the fiduciary duties and to promote the investment adviser profession - are necessary for the preservation and enhanced consumer confidence in our securities markets, especially in the wake of so many recent scandals affecting the securities industry. Clients seeking and requiring investment advice should expect that their investment adviser adheres to the most exacting standards of professional conduct. The Commission should act promptly to repeal the Proposed Rule and state, unequivocally, that the Advisers Act applies to fee-based accounts.

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[85] An "important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983).

I appreciate your consideration of the comments on this important Proposed Rule. I trust that you will not hesitate to contact me at 352.746.4460 if I may provide any additional information or assistance to you during this process.

Respectfully submitted.

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EXHIBIT A to COMMENT LETTER

Why You Should Avoid Variable Annuities

An Excerpt From

The Science of Investing:

How To Use Academic Research to Increase Returns and Reduce Risks In Your Investment Portfolio

2003-2004 Edition

By The Advisors Of
Joseph Capital Management, LLC
A Fee-Only Investment Advisory Firm
A Member of The Joseph Financial Group

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A special message to the readers of this publication ...

This material is provided as a public service by the directors, investment advisors, certified public accountants, attorneys, and other team members of The Joseph Financial Group.

For years we have been aghast at the continued promotion of variable annuities, especially to retirees. The *tax disadvantages* of variable annuities were magnified by Congress' re-institution of favorable long-term capital gains rates in 1997, followed by a subsequent lowering of capital gains rates by Congress in 2003. In addition, these can be *extremely expensive* products.

Why are these products so heavily sold? We can only come up with two answers:

> The sellers of these products DON'T KNOW. They are unaware of the many tax disadvantages of these products. They simply *lack knowledge.*
>
> The sellers of these products DON'T CARE. They know about the high costs and tax disadvantages of these products, but they don't care. Instead, perhaps are motivated by the higher commissions often associated with the sale of variable annuities. In short, they might be motivated by *greed.*

We think the time has come to put a stop to the rampant sales of these products, especially to retirees. In our analysis, it is clear that ...

> 99% of individuals should avoid purchasing variable annuities!

We hope you find this material informative. *Thank you.*

> - Ron A. Rhoades, B.S., J.D., John J. Ceparano, C.P.A., and Michael J. Tringali, C.P.A., C.F.P.®, the directors of The Joseph Financial Group, and our team of over 30 professionals.

Chapter Thirty-One: Why You Should Avoid Variable Annuities

A Summary of The Key Concepts In This Chapter:

- ✓ Don't succumb to the "sales pitch" for variable annuities. Period. End of Story. No need to read further, unless some salesperson is putting pressure on you.
- ✓ If you already own a variable annuity, read on to more fully understand these products.

Introduction - The Need For Caution. We have cautioned our clients for many years to be extremely cautious prior to purchasing variable annuity products. Variable annuities can be expensive. The provisions in the annuity contracts on fees, guarantees, and annuitization options are often complex and easily misunderstood. In order to promote fully understanding of these products, and to discourage their sale, we provide this special chapter on variable annuities. We conclude in this chapter the following:

- ✓ For retirees, especially those desiring to invest in stock mutual funds, variable annuity products possess very little benefits and can often be detrimental from a tax and investment cost perspective.
- ✓ For those still employed in the job market, variable annuities possess limited benefits. The possible exceptions to this rule are high-risk physicians and other professionals in those states where annuities are protected from potential claims of creditors.

What Others Are Saying About Variable Annuities. We are comforted to know that we are not alone in concerns about the marketing of variable annuities. Here's excerpts from several other writers on the subject of variable annuities from recent years:

- Larry E. Swedroe, in his recent book "Rational Investing In Irrational Times," writes: "Virtually everything (about variable annuities) is not only bad, it is really bad ... Since the only real benefit of this high-cost product is (tax deferral), selling this product to an investor to hold inside an account (such as an IRA) that is already tax-deferred borders on the criminal ... the insurance industry has already been hit with a round of lawsuits on the suitability of annuities and turnover."

- The U.S. Securities and Exchange Commission produced a brochure describing variable annuities and which issued several "cautions" to investors. They warn that: (1) variable annuities may not be appropriate within tax-qualified plans such as individual retirement accounts; (2) no variable annuity benefits are free; (3) tax-free exchanges of annuities under the 1035 section of the tax code may trigger surrender charges; and (4) exchanging one annuity for another can cause the beginning of a new surrender-charge period.

- The National Association of Securities Dealers (NASD), a self-regulatory body for brokerage firms in the United States, issued "Notice To Members 99-35" with these "areas of concern" expressed about variable annuity product sales:

  - Lack of liquidity, which may be caused by surrender charges or penalties for early withdrawal under the Internal Revenue Code, may make a variable annuity an unsuitable investment for customers who have short-term investment objectives. Moreover, although a benefit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds.

  - The member should develop special procedures to screen for any customer whose age may make a long-term investment inappropriate, such as any customer over a

specific age. Based on certain contract features, some customers of advanced age may be unsuitable for a variable annuity investment.

- A member should conduct an especially comprehensive suitability analysis prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account subject to plan minimum distribution requirements.

❑ On May 27, 2003, the NASD issued another "Investor Alert," entitled "Variable Annuities: Beyond the Hard Sell." The NASD stated: "The marketing efforts used by some variable annuity sellers deserve scrutiny - especially when seniors are the targeted investors. Sales pitches for these products might attempt to scare or confuse investors ... as an investor, you should be aware of their restrictive features, understand that substantial taxes and charges may apply if you withdraw your money early, and guard against fear-inducing sales tactics. NASD is issuing this Investor Alert to help seniors and other prospective variable annuity buyers to make informed decisions about how to invest for their retirement ... While earnings in a variable annuity accrue on a tax-deferred basis - typically a big selling point - they do not provide all the tax advantages of 401(k)s and other before-tax retirement plans. 401(k)s and other before-tax retirement plans not only allow you to defer taxes on income and investment gains, but allow your contributions to reduce your current taxable income. That's why most investors should consider annuity products only after they make their maximum contributions to their 401(k)s and other before-tax retirement plans. Once you start withdrawing money from your variable annuity, earnings (but not principal) will be taxed at the ordinary income rate, rather than at the lower capital gains rates applied to investments in stocks, bonds, mutual funds or other non-tax-deferred vehicles in which funds are held for more than one year. Furthermore, proceeds of most variable annuities do not receive a 'step-up' in cost basis when the owner dies. Other types of investments, such as stocks, bonds, and mutual funds, do provide a step up in tax basis upon the owner's death."

❑ Ron A. Rhoades, B.S., J.D., our own Director of Research at Joseph Capital Management, LLC, provided these observations in his 1999 estate planning law firm newsletter to his clients: "Nonqualified annuities designed to purchase and hold stock portfolios should

be purchased by Florida retirees only rarely. I estimate that only 1 in 10 of my clients who possess these products have (or had) circumstances which dictated their purchase. For retirees these tax deferred annuities are actually tax inefficient and often hinder the accomplishment of various estate planning goals."

- SmartMoney Magazine, on its web site (as of 2.3.03): "Variable annuities are sold more aggressively than fake Gucci handbags on the streets of New York City. Thanks in part to commissions around 5%, sales of variable annuities have soared over the past decade. But popularity is no indicator of practicality. The truth is, annuities only make sense for a tiny fraction of the population. The rest of us should be buying plain old mutual funds. Of course, that's not easy to say to your dark-suited cousin who keeps taking you out for steak and Lafitte-Rothschild Bordeaux in hopes that you will sign on the dotted line. But, next time he invites you, you can bring along this article. Just make sure he pays the bill before you give it to him."

- Sue Stevens of Morningstar responds in her "Reader Mailbag" on March 21, 2002 to a reader who writes that her financial planner recommended an equity index annuity for her IRA, but this seems questionable since "why would I want to put my IRA into a tax deferred instrument?" Sue Stevens responds: "You wouldn't. Find another planner. Be sure you know how they are compensated . . . .[T]here are specific situations where annuities may be helpful, but inside a tax deferred plan is never one of those situations." Sue Stevens, CPA, CFP, MBA, and CFA Charterholder, is Director of Financial Planning for Morningstar Associates, LLC.

- In the Wall Street Journal, columnist Jonathan Clements writes about a variable annuity sales tactic in an article titled "Evaluating A Broker, Planner Is A Challenge For Investors," published on Oct. 16, 2001. He observes that one of the top ten lines that, if heard from a broker or financial planner, indicates that "you should probably grab your money and run very fast in the opposite direction," is: "' [t]his variable annuity is perfect for your IRA.' An individual retirement account gives you tax-deferred growth. Why put a tax-deferred annuity inside it? Advisers will talk up the annuity's usually useless insurance feature. The real reason: Annuities generate lucrative commissions for the adviser."

- In a column on TheStreet.com, dated Dec. 4, 2002: "American Express Financial Advisors, the financial planning arm of American Express ... is paying a $350,000 fine to settle allegations that its employees used improper sales practices in peddling variable annuities and life-insurance policies. The NASD ... fined and censured American Express for violations that occurred over a 30-month period ending in 2000. Regulators contend that the firm's employees 'did not adequately explain' to customers the benefits or limitations of a variable annuity and how it differs from an investment in a mutual fund."

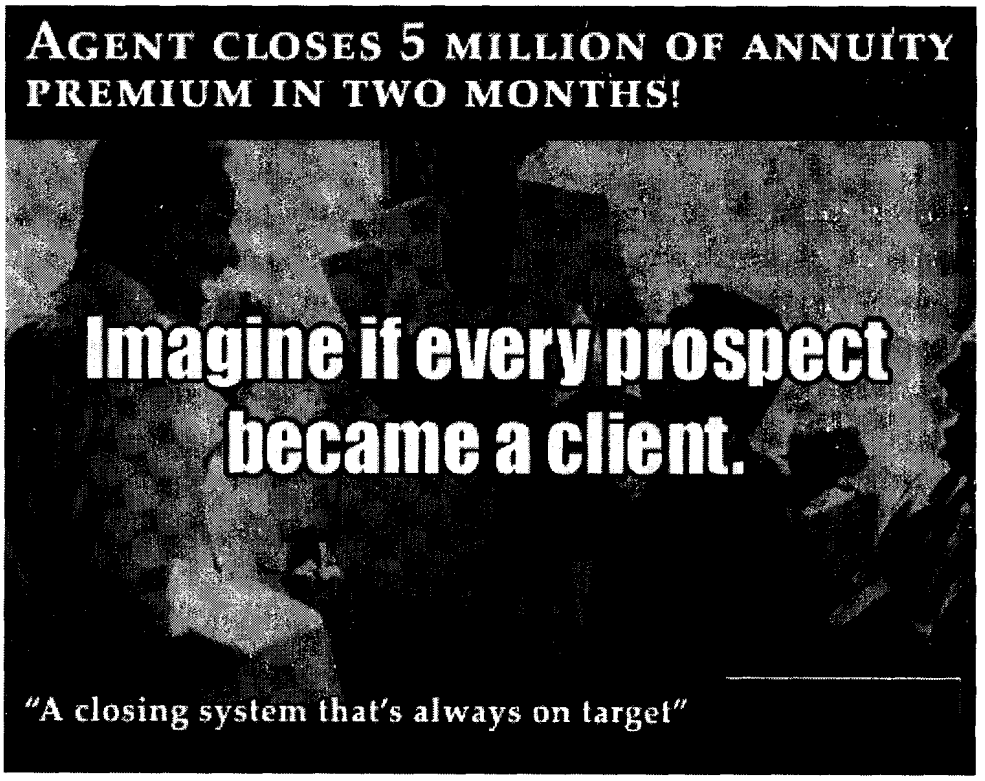
Does Anyone Say Good Things About Variable Annuities? Many articles abound that tout variable annuities, with most of them produced by the manufacturers and sellers of these products. Unfortunately, the variable annuity business is just that - a multi-billion dollar business. This business has a large sales force which is used to making a lot of money. Regardless of whether the variable annuity product withstands intellectual scrutiny by objective advisors and commentators, there will always be a lot of "marketing hype" about these products and their potential uses. As an investor, whenever you see an article about variable annuities, or a sales brochure, ask yourself whether the author has anything to gain from the opinion given.

Since Variable Annuities Are So Bad, Why Do They Continue To Be Sold In Large Numbers? The Tax Reform Act of 1997, which re-instituted lower capital gains rates, and the development shortly thereafter of tax-managed mutual funds, wiped out most (if not all) of the tax-deferral benefits of variable annuity products. Why did variable annuity sales not decline substantially in the late 1990's? The reason is clear - variable annuities often pay substantially higher commissions and fees to the companies, brokers and agents that sell them than other products. Variable annuity tracker VARDS estimates that total variable annuity sales in 2002 were $115 billion, up 2% from the year before. (Source: Investment News, February 3, 2003.)

The 2003 tax legislation reduces long term capital gains tax rates even further (through 2008, from 20% to 15% for those in the 25% or higher marginal income tax brackets, and from 10% to 5% for those in the 10% or 15% marginal income tax brackets). This makes stock mutual funds held in variable annuities even less attractive.

Despite the tax law changes, today we still see variable annuities heavily promoted by securities brokers, insurance agents, and other product salespersons. We hypothesize that many of these

salespersons either don't know about the many disadvantages of variable annuities or they don't care about their clients. We are hopeful that regulatory agencies will continue to put more pressure on insurance companies, traditional brokerage firms and their sales forces to stop the often misleading and unsuitable sales of variable annuity products. However, given the high profitability of these products relative to other investments, we are not surprised that variable annuity sales continue to be pushed by brokers and agents who have little or no concern for their clients' best interests. In short - we hypothesize that there exists two major reasons why variable annuities continue to be sold in such large numbers - ignorance and greed. In short, in our view the majority of the brokers who sell these products either don't know or they don't care.



This advertisement typifies the sales mentality associated with these products.

What Is A Variable Annuity? It's a complicated investment product. From an investment standpoint, a variable annuity consists of either:

> (A) a fixed income component under which a guaranteed interest rate is paid (like a CD, only without the FDIC insurance, and often with certain minimum time periods during which a higher interest is paid, followed by another time period when a lower "guaranteed interest" is paid); and/or
>
> (B) a variable component, under which the investments are placed into stock or bond mutual funds.

Whether mutual funds or a fixed income account, the investments are contained inside an annuity contract. An annuity contract is one form of insurance contract.

A Variable Annuity Possesses A "Guarantee." Think of a variable annuity as an investment product surrounded by a type of insurance policy. The insurance policy provides a form of "guarantee," or life insurance. This insurance may or may not provide an actual benefit, depending upon whether the investments inside the annuity rise or fall in value (relative to the value invested or some other value established from time to time).

> Example: You own a variable annuity that offers a "guarantee," or " death benefit." This "death benefit" states that your heirs will receive, upon your death, an amount equal to the greater of the total amount you have contributed to the annuity contract (less any withdrawals you made during your lifetime). You purchased the annuity in 2000 for $100,000. Because it was invested all in a "growth stock mutual fund," the value of the annuity is now (as of early 2003) only $55,000. You have made no further contributions to the annuity, nor have you withdrawn any funds from the annuity. If you were to pass away, your heirs (i.e., the beneficiary listed by you on the annuity contract) would receive the full amount you initially contributed - $100,000.

While the most common guarantee of a variable annuity contract is that the owner's beneficiary receives at least the original investment, some variable annuities also include (usually for additional

fees) an option for a rising floor - or stepped-up - death benefit. This may guarantee the account value as of a certain date, such as the highest attained value of the variable annuity investments on any annual anniversary date of the policy. Some guarantees offer a death benefit equal to the original investment compounded by some guaranteed interest rate.

What Is "Lifetime Annuitization? Annuity contracts often contain a complicated set of "annuitization" options. These options permit the account owner to elect to receive an income for life, an income for the life of the owner and the owner's spouse, an income for a certain period, and/or some combination of the foregoing. If you are retired and if you barely have enough money to meet your annual expenses or fear that you will outlive your life's savings, then perhaps the purchase of an immediate annuity providing for lifetime income should be considered. However, look at whether the monthly payments you receive will go up each year to offset future inflation. If you live a long time - beyond average life expectancy - this deal may work out for you. However, if you were to die the day following the purchase of the immediate annuity, then the remaining balance of the annuity goes to the insurance company (unless a "minimum term" is also chosen, which effectively lowers the monthly payment offered to you by the insurance company).

> Hint: Rarely should a lifetime annuitization be chosen. In a low interest rate environment, as exists at the time of this writing (August 2003), lifetime annuitization should normally not be considered unless your retirement resources are clearly not sufficient to provide you with a minimal standard of living for the rest of your life. Especially now - why purchase a long-term, locked-in rate of return when interest rates are low?

Despite the decline in interest rates, as variable annuity sales have been tempered by the stock market decline, the insurance companies have responded by training variable and fixed annuity salespersons to sell annuities for their lifetime annuitization features. Yes - there may be instances where such is appropriate - but hardly ever for the higher net worth retiree or those who possess other, adequate pension benefits to meet their anticipated needs. But buyers of annuities rarely fully understand what "annuitization" truly means, and when it may or may not be appropriate. While insurance agents and brokers are trained to sell these products, and seldom are trained about how to give advice on the tax, cost and investment characteristics of these products.

What Are The Annuitization Options For Heirs? In most annuity contracts, upon your death your heirs may receive payments from the annuity in one of several ways:

1. A lump sum payment of the value of the annuity contract (or "death benefit");

2. Distributions made by withdrawals by the beneficiary over a period of five years;

3. A "lifetime stream of payments" paid to the beneficiary for the rest of the beneficiary's lifetime.

4. For qualified annuity contracts (i.e., IRA-type annuities), distributions are also permitted under the required minimum distribution rules promulgated by the IRS, which provide that a beneficiary must take out a certain amount each year (based upon the beneficiary's age).

Most heirs of nonqualified (non-IRA type) variable annuities are better off with a lump sum distribution or a distribution over five years. Insurance companies make a lot of profit when annuities are "annuitized" over someone's life expectancy. Rarely is the rate of return (the "interest" component of the annuitization) offered by the insurance company competitive with the rate of return available in the general marketplace.

What Are The Benefits Of An Annuity To A Purchaser? There are a few benefits of variable annuities. They include:

- *Lifetime Annuity Payments.* First, for those persons who have very modest resources during retirement, and who may "outlive their money" if they live substantially beyond "average" life expectancy, purchasing an immediate annuity (with a single or joint life annuitization) may provide some financial benefit. This is rarely, however, a good option for those with substantial retirement resources.

- *Death Benefits.* Second, the "guaranteed death benefit" of a variable annuity may provide some benefit to the heirs of the owner, especially if investments are made in stock mutual funds and the stock market declines. However, we caution that the cost of this guarantee, in our opinion, is quite expensive, as explained below. We believe that market risk is better handled over the long term through proper strategic asset allocation.

- *Tax Deferral.* Third, variable annuities offer income tax deferral. Tax deferral can sometimes provide a benefit to an investor. Assets can also be reallocated among the subaccounts (mutual funds) inside the annuity without any immediate tax consequence. Please note, however, that there does not exist any tax deferral benefit if the variable annuity is purchased inside a traditional IRA account, as the traditional IRA account already receives tax deferral treatment. Also, distributions from the annuity of accumulated gains are taxed as ordinary income, and do not qualify for capital gain treatment (nor stepped-up basis to eliminate capital gains at time of death).

- *Asset Protection.* Fourth, for residents of a few states variable annuities are protected from the claims of general creditors. This may make the purchase of a variable annuity a beneficial option for someone in a high-risk profession where liability coverage is too expensive to maintain in sufficient amounts, such as a physician. However, there are often better asset protection options, and future law changes may limit or do away with the creditor-exempt status of nonqualified variable annuities. Also, please note that the purchase of a variable annuity does not provide protection against the cost of nursing homes. Instead, a specific form of immediate annuity, purchased immediately prior to the application for Medicaid benefits, is utilized (and only then in certain cases). Do not purchase a variable or immediate annuity for "asset protection purposes" unless you have consulted with an estate planning attorney (as to claims of general creditors) or elder law attorney (as to Medicaid qualification) first and fully explored the suitability and structure of the annuity product as it relates to your specific needs.

How Much Do Variable Annuities Cost? Cost structures vary from product to product, but here's a run-down of the typical costs seen (and not seen) in a brokerage-sold or agent-sold variable annuity product. We utilize a frequently sold annuity product, the Lincoln Life American Legacy III variable annuity contract, as our example. (If you really feel compelled to purchase products

from a full service broker, after all of our warnings about active management, commissions, and high costs, then American Funds' products are better than most other commissioned-based products, in our opinion. Hence, we utilize their product not as an example of one of the worst brokerage-sold products out there, but as an example of one of the "best" products sold by full-service brokerage firms.) Our data regarding the annuity contract, its subaccounts, and costs is derived from Morningstar Principia Pro software, an actual annuity contract for the policy, and the American Legacy III / Funds Prospectus dated May 1, 2003. We break charges down into two areas - those related to the annuity contract itself, and those relating to the mutual funds and other "sub-accounts" within the annuity.

Charges related to the American Legacy III insurance/annuity contract: (1.25% to 1.6%)

Mortality and expense charge:		1.15%
Administrative expense charge:		0.10%
(Optional) Enhanced Guaranteed Minimum Death Benefit (EGMDB) rider		0.15%
		or
(Optional) Estate Enhancement Benefit Rider:		0.35%
Charges related to mutual funds ("sub-accounts") within the annuity, including this following sampling:		0.60% to 1.16%
Growth-Income Fund	0.60%	
Bond Fund	0.70%	
Cash Management Fund	0.71%	
Global Growth Fund	0.96%	
New World Fund	1.16%	

In summary, the *annual cost* of owning this variable annuity (*not including* "hidden" costs of investing - commissions, spreads and other transaction fees, and opportunity costs, within the mutual funds held inside the annuity) ranges from 1.85% to 2.76% a year.

[Note to excerpt readers: the "hidden costs" of mutual funds are explored in other sections of the book, and can range from very low amounts to several percent a year. See also the table on page 16 for an estimate of these hidden costs.]

Is The Basic Guarantee Worthwhile? The basic guarantee can be worthwhile - but only if the value of your investments goes down (and stays down). It seems to us that a 1.25% annual expense ratio for the basic annuity contract results in a lot of additional expenses. If an investor is that concerned about "market risk" - the risk of the stock market investments going down - better diversification (among asset classes) and/or a greater allocation to fixed income investments would be better. Let's use a simple example, by comparing two investment portfolios held inside IRA accounts. Portfolio A is invested in a variable annuity with a 1.25% annual expense charge. Portfolio B is invested directly into mutual funds. We'll assume that the mutual funds in both the variable annuity and held by Portfolio B are the same. We also assume an average annualized rate of return of 9% for stocks over the next 20 years, and 5.5% for a short-term or intermediate term bond fund.

	Portfolio A	Portfolio B
1. Percentage of portfolio allocated to stocks:	80%	45%
2. Expected average annualized rate of return on stock fund holdings over next 20 years:	9%	9%
3. Gross return, subtotal of stock portion:	7.2%	4.05%
4. Percentage of portfolio allocated to bonds.	20%	55%
5. Expected rate of return on bonds, next 20 years:	5.5%	5.5%
6. Gross return, subtotal of bond portion:	1.1%	3.025%
7. Subtotal - combined stock and bond returns:	8.3%	7.075%
8. Less annuity contract annual charges:	(1.25%)	none
9. Total return with annuity contract charge deducted:	7.05%	7.075%

In summary, Portfolio B (without the variable annuity charges) could be allocated much more conservatively - 35% less stocks and 35% more bonds - and still have a net return that is more, under the assumptions set forth above.

A Review of the Optional Riders Of The American Legacy III Policy. Riders often exist that offer "enhanced" death benefits. For the American Legacy III policy, the EGMDB rider is available for an additional 0.15% a year. This rider provides that the "death benefit" provided by the policy could also be the highest of the attained value of the policy on any policy anniversary date (less withdrawals). For example, if you originally invested $100,000, then one year later the annuity investments value was $120,000, and then you died 6 months after that and the annuity investments value was only $90,000, your heirs would receive $120,000. Without this EGMDB rider, the heirs would only receive the original $100,000 invested.

The EEB rider of the American Legacy III policy adds a life insurance feature to the policy. It potentially adds 40% (if the contract owner or joint owner or annuitant is under age 70 at the time the rider is taken out) or 25% (if ages 70-75) to the earnings component of the death benefit amount. In essence, this adds a true "life insurance" element to the policy. The EEB Rider is not available to those age 76 or older when the EEB rider is sought to be added.

In our view, both riders are quite expensive for the benefits they seek to provide. Insurance companies don't offer these riders out of the goodness of their heart - they expect to make additional profits from them, at the investor's expense. There may be a few situations where a rider may make sense - such as a 69-year old person who is in very poor health. But even then, given the tax implications of annuities (discussed below) and the costs of these riders (when added to the basic charges of the annuity contract), the riders still seem awfully expensive for the potential benefits obtained.

Charges Relating to Mutual Funds (Sub-Accounts). The American Legacy III annuity has 13 investment options. The costs of each investment option (mutual fund) are set forth in Columns 2-8 of the table that follows. Column 8 adds the annuity contract charges (discussed on the prior page), and Column 9 provides estimated total expenses.

1. Name of Fund	2. Management Fees	3. 12b-1 Fees	4. Other Disclosed Costs	5. Subtotal - Disclosed	6. Est. Transaction Costs	7. Est. Opportunity Costs	8. Annuity Contract	9. Total Est. Costs
Global Discovery	0.58%	0.25%	0.03%	0.86%	0.10%-1.1%	0%	1.25%	2.2% - 3.2%
Global Growth	0.66%	0.25%	0.04%	0.95%	0.95%-1.95%	0.94%	1.25%	4.1% - 5.1%
Global Small Capitalization	0.80%	0.25%	0.03%	1.08%	1.65%-2.65%	0.87%	1.25%	4.8% - 5.8%
Growth	0.37%	0.25%	0.01%	0.63%	0.40%-1.40%	0.48%	1.25%	2.8% - 3.8%
International	0.55%	0.25%	0.06%	0.86%	1.00%-2.00%	0.45%	1.25%	3.5% - 4.5%
New World	0.85%	0.25%	0.06%	1.16%	0.77%-1.77%	1.07%	1.25%	4.2% - 5.2%
Blue Chip Income and Growth	0.50%	0.25%	0.01%	0.76%	0.16%-1.16%	0%	1.25%	2.1% - 3.1%
Growth-Income	0.33%	0.25%	0.02%	0.60%	0.44%	0.74%	1.25%	3.0% - 4.0%
Asset Allocation	0.43%	0.25%	0.02%	0.70%	0.23%	0.60%	1.25%	2.8% - 3.8%
Bond	0.48%	0.25%	0.01%	0.74%	---	0.22%	1.25%	2.21%
High-Income Bond	0.50%	0.25%	0.01%	0.76%	---	0.07%	1.25%	2.08%
U.S. Govt/AAA-Rated Securities	0.46%	0.25%	0.01%	0.72%	---	0.01%	1.25%	1.98%
Cash Management	0.45%	0.25%	0.01%	0.71%	---	----	1.25%	1.96%

(Transaction costs and opportunity costs are estimated. For estimated transaction costs, we can estimate the costs of trading based upon portfolio turnover. A fund's portfolio turnover rate is 50% if each security in the fund's portfolio was replaced once a year. High portfolio turnover involves correspondingly greater transaction costs in the form of brokerage commissions, dealer mark-ups and "spreads" (which often and usually dwarf commissions). In the table above, we base our estimates of transaction costs on the following formula: [Turnover rate (as revealed by Morningstar, as of 6.30.02), multiplied

by 2 (to reflect that each turnover involves one sale and one purchase), multiplied by 0.65% (for large cap stock funds) or 1.25% (for small cap and international stock funds) (based upon research by The Plexus Group).] Additionally, "market impact" occurs as purchases by a large fund tend to drive prices upward while sales tend to drive prices downward. Based upon research by The Plexus Group, we estimate market impact at 0% to 1% a year for the typical mutual fund. For estimated opportunity costs, we provide estimates as follows. If stocks earn on average 9% a year, and bonds earn on average 5.5% a year, and the average money market fund earns on average 4% a year, for every dollar in a stock mutual fund or bond mutual fund that is held in cash there is an "opportunity cost" over long periods of time. For the chart above we estimate the opportunity costs by multiplying the percentage of cash holdings of the mutual funds in the annuity (based on Morningstar data as of 6.30.02) by either 1.5% for bond mutual funds or 5% for stock mutual funds. As seen, the greater the cash holdings, the greater the opportunity cost.)

Total Annual Estimated Costs of This Variable Annuity. When all of the costs are taken into account, we estimate that the stock mutual funds provided by the American Legacy III variable annuity have annual expenses of 2.1% to 5.8%. These expenses have a severe impact on long-term returns. The cash and bond funds, where we do not estimate the transaction costs such as dealer mark-ups, have expenses of approximately 2% or more.

The foregoing illustrates just one annuity contract. The fees and costs are similar to those of most variable annuities we see sold by full-service brokerage firms. There are higher cost annuity products. There are also no-load and low cost annuity products, sold directly to investors (i.e., Vanguard, Schwab, Fidelity) or available through select fee-only investment advisors (i.e., Aegon/Dimensional).

Brokerage and Agent Commissions. We're surprised at the number of prospective new clients we see who were sold an annuity (or loaded mutual fund) and who still think they've never paid their broker anything in fees. Brokers do get paid - and big money - for annuity sales. In addition to the 0.25% to 1.0% annual 12b-1 fees that a brokerage firm may receive on certain annuity products, the brokerage firm is paid an "up front" commission. For example, on the American Legacy III contract this commission is as much as 6.25% of each purchase payment (per page 23 of the prospectus). The prospectus also notes that from time to time additional sales incentives (up to an annual continuing 0.10% of the contract value) may be provided to some brokers maintaining certain volume levels. Hmm ... the broker might get more money from the annuity company if the broker sells more of the annuity product ... sounds like another conflict of interest (as if commission-based salespersons already didn't possess enough of a conflict of interest).

Surrender Fees. Commissions for the sale of a variable annuity are usually paid to the brokerage firm or agent upon the sale of the annuity contract. Since the investor can usually withdraw funds from the annuity at any time, and since the broker or agent has already been paid his or her commission, if you get out of the annuity too soon the insurance company could lose money. To prevent this the insurance company imposes a surrender fee, also called a "contingent deferred sales charge." You may also hear it referred to as a "back-end load." The American Legacy III contract has surrender fees as follows:

Year surrender occurs, from date of purchase	Surrender charge
1st or 2nd year	6%
3rd year	5%
4th year	4%
5th year	3%
6th year	2%
7th year	1%
8th year and thereafter	0%

We've seen some variable annuity contracts (even those sold by "reputable" full-service Wall Street brokerage firms) with much higher surrender charges which extend for much longer periods of time. But there are also "no-load" annuities that have no surrender fees, and "low-load" annuities that have surrender fees of only 2-4% initially. Most variable annuities permit some withdrawals to occur each year - such as 10% of the account value or 10% of the initial purchase amount. That may be one way to remove assets, over time, out from under the high-cost "umbrella" of an annuity contract without incurring surrender fees. Then again - why buy any investment that has surrender fees? Why be forced to tie up your funds, having complete freedom to invest elsewhere only if you pay a penalty? This imposition of surrender fees, which often effectively limits the liquidity of the investor's funds, may be detrimental to the investor in need of funds for an emergency or simply because a better investment option is then available. If you must purchase an annuity, most full-service brokerage firms and most insurance agents and nearly all fee-only advisors possess access to "no-load" annuities. "No load" may not mean "lower cost," however, as the annual expenses of such annuity contracts must still be scrutinized heavily.

An Abusive Tactic: Brokers Recommending A "Tax-Free Exchange" of Variable Annuity Contracts After The Surrender Fees On An Existing Annuity Contract Disapppear. An all-too-common practice of some brokers and insurance agents is to call their customers as soon as their

annuity no longer has a surrender charge. They attempt to get the customer to "tax-free exchange" the current annuity into a different annuity - one that is characterized as "better" for one reason or the other. This practice has been soundly criticized by regulatory agencies (but it still persists). Why would brokers and agents engage in this practice? One answer is "greed" - to get another big up-front commission. The substantial detriment to the investor, who must endure another surrender period, is too often disregarded.

Summary: The Costs of Variable Annuities. The costs of brokerage-sold, commissioned-based variable annuity products is quite high. While lower-cost, no-load annuities are available, they still possess higher expenses than many similar no-load mutual funds.

The "Fixed Account" Of A "Variable Annuity." Some variable annuity contracts have a "fixed account." In these instances that portion of the variable annuity contract is a "fixed annuity." Under this arrangement, the investor in essence gives the insurance company the invested sum, which is invested by the insurance company as part of the insurance company's overall assets. In return the investor receives an interest payment. In a fixed account, or in a fixed annuity, the investor's money is subject to the general claims of the insurance company's creditors. The financial strength of the issuing company becomes a paramount issue. If the insurance company were to go under then the investor could lose all or a portion of the principal invested. We recommend that investors in fixed annuities stick with companies that are rated in the top third (of the companies rated) by at least two of the four main rating services. (Not all of the rating services rate all insurance companies.) As of August 2, 2002, this would require ratings from the different rating services as follows:

A.M. Best Company	-	A++, A+, or A.
Moody's Investors Services	-	Aaa, Aa1, or Aa3
Standard & Poor's	-	AAA, AA+, AA, AApi, AA-, AA-pi, or A+
Weiss Ratings	-	A+, A, A-, B+, B, or B-.

If you purchase a fixed annuity the ratings of the insurance company should be monitored periodically - preferably at least every six months.

The "Teaser Interest Rate." In recent years we've seen many fixed annuity contracts that offer a "teaser rate" - a higher interest rate for the first few years of the annuity contract. That is followed by a vague promise to pay interest, usually with some "guaranteed minimum." Five years

ago that guaranteed minimum interest rate was often 4%, but in recent years it has dropped to 3% or even lower. As Investment News in its February 3, 2003 issue reporting on 2002 variable annuity sales reported: "With money market yields dropping to 1%, people realized the fixed buckets inside variable annuities would guarantee a 3% return ... so a lot of money started to move to them. Most firms removed the buckets midyear." Some firms, such as Fidelity and TIAA-CREF, stopped selling their fixed accounts altogether in early 2003.

The American Legacy III Fixed Account. To continue our analysis of the American Legacy III annuity contract, this contract is issued by Lincoln National Life Insurance Co. We first confirm what the "fixed account" really means. The annuity contract states: "Purchase payments allocated to the fixed side of the contract become part of Lincoln Life's general account." In other words, the investments in the fixed account are subject to Lincoln Life's general creditors. As of August 2, 2002, the company received financial strength ratings of A+ from A.M. Best, AA3 from Moody's, AA- from Standard and Poor's, and B- from Weiss. As such, the company meets our "financial strength" test. (Lincoln National Life Insurance Co. is the fourth-largest variable annuity company(as ranked by assets), with $34,385,000 of variable annuity assets, as reported by Investment News, Feb. 3, 2003.)

The annuity contract guarantees a minimum interest rate of at least 1.5% (down from 3.0% the prior year). Interest could be higher, as declared by Lincoln Life from time to time. Mortality and expense charges and administrative charges, which amounted to 1.25% or greater on variable account investments, are not imposed on the fixed account. However, like most brokerage-sold fixed annuity contracts, surrender charges still apply. Hence, if interest rates increase and better opportunities for fixed income investing appear, and if Lincoln Life does not substantially raise the interest rate paid to contract holders, the investor in this fixed income account could be at a severe disadvantage. The investor would be faced with incurring a surrender charge (declining over the first seven years of the contract) in order to move to a higher-yielding investment or staying with a (potentially) lower-yielding fixed annuity investment. The investor could remove some of the funds from the annuity contract - 10% per year - under the "free withdrawal" provision of the annuity contract. Under tax rules, however, "deferred income" comes out first, followed only then by "principal," making partial withdrawals from non-qualified annuity contracts tax-troubling.

What Are The Negative Tax Problems Created With Annuities? Variable annuities are often touted for their ability to defer taxable income. Prior to the Tax Reform Act of 1997 and the development of tax-managed mutual stock mutual funds, tax deferral was indeed a benefit for many mutual fund investors. However, with the advent of lower tax rates for realized long-term capital gains and tax-managed stock mutual funds that minimize both realization of capital gains and dividends, the income tax benefit of nonqualified variable annuities has all but disappeared. (Remember - there are no income tax benefits for "qualified" variable annuities - those held in IRA accounts or 403(b) accounts - as these accounts already receive tax deferred treatment.) Let's compare two hypothetical investments, held for about 10 years, and earning an annual rate of return of 7.2%.

	Nonqualified variable annuity	Tax-managed stock mutual fund
Amount invested:	$ 20,000	$ 20,000
Value after 10 years:	$ 40,000	$ 40,000
Increase in value:	$ 20,000	$ 20,000
Tax rate upon withdrawal:	25% (Ordinary income tax rate)	15% (Long term capital gains rate)
Income tax due:	$ 5,000	$ 3,000
Net after withdrawal:	$35,000	$37,000

Of course, several assumptions are made in the simple illustration above. We assume that the investor is in a 25% marginal income tax rate, that the lower 15% long term capital gains rate available under current tax law through 2008 is available, and that the receipt of $20,000 of ordinary income (from the annuity surrender) will not increase the investor's marginal federal income tax rate. We also assume that the tax-managed mutual fund does not distribute any capital gains, dividends or interest during the holding period.

Using this simple illustration we see that the investor with the tax-managed mutual fund receives a net amount of $2,000 more (despite our assumptions which favor the variable annuity). This

translates to an annual average additional after-tax return of 1% over the 10-year period. Of course, the actual difference in returns is much greater - because the annuity investor likely incurred, on an ongoing basis, far greater investment costs due to annuity mortality, expense and administrative charges. These higher costs decrease the net investment returns for the variable annuity investor, thereby further decreasing the attractiveness of the nonqualified variable annuity relative to tax-managed mutual funds.

The Negative Tax Consequences of Leaving Nonqualified Variable Annuities On To Heirs. Think the example above of tax problems for our variable annuity holder during lifetime is bad. It gets worse if the annuity holder dies. Suppose our investor had died the day before the annuity and mutual fund were surrendered. Because a "stepped-up basis" exists for capital gain assets (such as stocks, stock mutual funds), but does not exist for variable annuities, the net to the heirs of the variable annuity (assuming they are in the same tax bracket, and do not possess any state or local income taxes) is still $35,000. The net to the heirs of the mutual fund is $40,000 (as all capital gains are eliminated). (In 2010 a limit is due to be imposed on the stepped-up basis, so that only $1.3 million of capital gain assets would be eligible for stepped-up basis treatment. Unless you have a significant estate, this change in the tax law would not affect our example above.) Another drawback of variable annuity payouts for many retirees and their families is the difference in the relative tax rates among family members. We've seen a lot of lower marginal tax rate retirees in Florida (where there is no state income tax) leave an annuity to children or other heirs who are in higher marginal rates for federal income tax purposes and who also pay state income taxes. In these instances tax deferral results in a deferral of ordinary income so it may be taxed at higher tax rates - and this is hardly ever a good thing.

Estate Planning and Variable Annuities. If you desire to delay distributions to an heir you may desire to leave an annuity to a trust created for that heir. However, an even higher rate of income taxation upon the deferred income can result. The highest federal income tax rate is achieved very early for (irrevocable) trusts - it takes less than $10,000 of income to get to the highest bracket. Although annuities are sometimes sold as probate avoidance devices, other devices work just as well for mutual funds and most other publicly traded investments. These include holding the investment asset or account as "joint tenants with rights of survivorship," "tenancy by the entireties," or in individual or joint names with a "pay-on-death" or "transfer-on-death"

designation (available for nearly all brokerage firm accounts). A revocable living trust could also be considered.

For those with "taxable" estates tax-deferred income (called "income in respect of a decedent") can be subject to both estate taxes and income taxes. As the Tax Relief Act of 2001 calls for a gradual increase in the estate tax exemption through 2010, and since prospects appear (as of this writing) for a "permanent" repeal of estate taxes, a further explanation of this "double taxation" effect does not appear appropriate for most readers of this book at the present time.

How Can I Get Out Of A Variable Annuity? For those who already possess variable annuities the decision to withdraw from them, or surrender them, becomes complicated. The income tax ramifications or a surrender or withdrawal should be examined. Surrender fees (from contingent deferred sales charges) must also be considered. If the value of the variable annuity contract has substantially declined relative to the "death benefit" provided by the annuity contract, then the decision is made more complicated by balancing the likely payment of the death benefit versus the continued high costs of staying inside the annuity contract. Tax-free exchanges to lower-cost (no-load) variable annuity contracts can be considered in some instances, rather than outright surrender, but even then a careful weighing of the overall benefits and costs of such a transaction must be undertaken. Professional guidance from independent, objective advisors is strongly recommended.

Retirees - RUN, DON'T WALK. In conclusion, if you are a retiree, and if your broker, insurance agent, or other advisor suggests a variable annuity to you, a word of advice. "Run, don't walk." Get as far away as possible. There's very little chance that the variable annuity is right for you.

There may be a very few persons out there for whom variable annuities are suitable products. In our view, however, the vast majority of investors should avoid the overblown sales pitches for these often high-cost, tax-adverse products.

[END OF EXHIBIT A.]