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November 2, 2007

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-22-07, "Interpretive Rule Under the Advisers Act Affecting Broker-Dealers"

Dear Ms. Morris:

I wish to thank the Commission for the opportunity to submit comments regarding this Proposed Rule.[1] I serve as Chief Compliance Officer and Director of Research for a fee-only registered investment advisory firm. In connection with the proposed rule, "Interpretative Rule Under the Advisers Act Affecting Broker-Dealers" (hereafter "Proposed Rule"), I offer these comments in opposition to several of its provisions. Specifically, it appears that the provisions of the Proposed Rule will:

- incorrectly permit dual registrants to avoid the important protections afforded to consumers by the Investment Advisers Act of 1940 ("Advisers Act");

- be detrimental to the interests of consumers of investment advice and financial planning services; and

- be detrimental to the profession of investment advisory services and the emerging profession of financial planning.

I further provide evidence rebutting some of the presumptions underlying the Proposed Rule or which have been advanced by its proponents. I also note that significant adverse economic impacts will flow should the Proposed Rule be adopted, which have not been adequately considered. Hence, I urge the Commission to withdraw the Proposed Rule, and/or delay its further consideration until a full review can be undertaken by the Commission of all of the inter-related issues involving the standards of conduct which should apply to the delivery of investment advice and financial planning services.

[1] The comments set forth in this letter are those of the author alone, and do not necessarily represent the views of any firm, organization, committee or task force to which the author may belong.

1. **<u>The "Special Rule" – Impermissible Dual Hats?</u>** IA-2652 proposes the following rule:

> §275.202(a)(11)-1(c): Special rule. A broker or dealer registered with the Commission under Section 15 of the Exchange Act is an investment adviser solely with respect to those ***accounts*** for which it provides services or receives compensation that subject the broker-dealer to the Advisers Act. [***Emphasis added.***]

The "Dual Hats" Issue. The language of this Proposed Rule would appear to permit a dual registrant to serve the same client as both an investment adviser (subject to the Advisers Act's broad fiduciary duty to act in the best interests of the client) and as a registered representative (not subject to such broad fiduciary duty, but rather instead only required to adhere to the much lesser standard of "suitability"). Since, as indicated herein, fiduciary status attaches to *persons* and *relationships*, under both the language of the Advisers Act and under time-honored principles of fiduciary law, enabling such conduct to occur would be contrary to law and contrary to the interests of consumers.

The "Removal of the Fiduciary Hat" Issue. The language of this Proposed Rule would appear to permit a dual registrant and/or his or her firm to provide a comprehensive financial and/or investment plan (which should be prepared in the dual registrant's capacity as a fiduciary and subject to the disclosure and other requirements imposed by the Advisers Act), but then implement that plan through the sale of expensive products which are not in the best interests of the client. This could easily lead to "bait-and-switch" scenarios in which consumers are attracted to dual registrants who represent that they develop investment and/or financial plans while acting in the best interests of the consumer, but then switch to non-fiduciary status in order to be freed of the important protections afforded to consumers by fiduciary states.

The "Switching Hats" Issues. Moreover, since modern financial planning and investment advisory services are seldom discrete in nature, but rather occur with a continuum of advice and with an ongoing relationship with a client, the language of this Proposed Rule appears to impermissibly permit a dual registrant to switch back and forth between fiduciary status and non-fiduciary status.

Following is a summary of certain legal and/or public policy arguments as to why the Proposed Rule errs in permitting such inappropriate conduct by dual registrants to occur.

a. The Proposed Rule Creates An Unauthorized Additional Exemption From the Application of the Advisers Act. The express language of the "special rule" contained in the Proposed Rule sets forth a different exemption from the definition of "investment adviser" than the limited and very precise exemption provided by the express terms of the Advisers Act. The National Association of Personal Financial Advisors (NAPFA) has filed a separate comment letter in connection with this Proposed Rule which explores the plain meaning of the definition of "investment adviser" and its intended broad construction, the statutory language granting the very limited broker-dealer exemption, Congressional intent, and other reasons why this Proposed Rule is contrary to the Advisers Act and state common law principles applying fiduciary duties, and I incorporate its comment letter herein by reference.

   It is worthwhile to emphasize, as the *Financial Planning Association vs. SEC* decision makes very clear, that the Commission lacks authority to provide a different exemption for broker-dealers from the application of the Advisers Act beyond the precise exemption provided by the terms of the Advisers Act itself.

   There is no language in the Advisers Act, nor any indication of Congressional intent, that "accounts" of a broker-dealer become exempt. The only existing exemption flows to the broker-dealer (and its registered representatives), under very precise and limited circumstances. The attempt to sever the "account" from the "broker-dealer" (or dual registrant) – in order to avoid the plain language and Congressional intent which supports the very narrow interpretation of the broker-dealer exemption – would, in essence, seek to create an entirely new and impermissible exemption under the Advisers Act.

b. Consumer Confusion Would Be Exacerbated. Many studies have been undertaken as to the current state of understanding of consumers with respect to the roles of investment advisers and registered representatives. Substantial confusion by consumers is clearly manifested by these studies. This Proposed Rule would exacerbate this consumer confusion, since customers of dual registrants would be unable to discern when the dual registrant is acting in a "fiduciary mode" (in which the customer's interests are paramount) and/or acting in a "non-fiduciary mode" (in which there is no legal requirement that the customers' best interests are first and foremost).

c. Section 215(a) Would Be Violated. The fiduciary duties of the Advisers Act are not able to be made inapplicable by any contract between the parties. In other words, under Section 215(a) of the Advisers Act, no investment adviser may seek to have his or her client waive the protections of the Advisers Act (including but not limited to the substantial protections provided by the imposition of broad fiduciary duties upon investment advisers under Section 206). The Commission has no authority under the Advisers Act to negate the application of Section 215(a) of the Advisers Act, by seeking to permit dual registrants to approach their investment advisory clients and propose a switch to an account which would not be regulated under the protections of the Advisers Act. In other words, by rule the Commission cannot authorize dual registrants to seek to have clients waive the application of the Advisers Act, an action by the dual registrant which is prohibited if the dual registrant attempted to seek such waiver by force of contract alone. Any Commission rule attempting to authorize such a waiver of the fiduciary protections of the Advisers Act would be contrary to the express language and plain meaning of Section 215(a). While the anti-waiver provision of Section 215(a) is strong, it was designed by Congress to be very forceful given the very substantial public interest which is addressed by the Advisers Act. Only Congress can modify Section 215(a) – it cannot be modified by Commission rulemaking.

d. Generally, Fiduciary Duties Apply to Relationships, Not Accounts. The concept that fiduciary duties may only apply to an "account" and not to the entirety of a relationship between a trusted advisor and his or client is completely alien to fiduciary principles. Neither the Advisers Act nor common law relating to fiduciary principles supports the Commission's application of fiduciary duties to one *account* for a client while not applying fiduciary duties to another *account* for the same client.

e. No Preemption of State Common Law As To Application of Fiduciary Duties to Relationships, and Fiduciary Status Upon the Whole of the Relationship With the Client. Even if the Proposed Rule is enacted, dual registrants will possess fiduciary duties, applied to the entirety of the relationship, which arise from state common law. It should be noted that neither the Investment Advisers Act of 1940, nor other federal securities statutes (including NSMIA), nor SEC rules, preempt state common law under which broad fiduciary duties are imposed upon those acting in relationships based upon trust and confidence, such as those involving financial planning and investment advisory services. "State and common-law duties and requirements do not directly conflict with the scheme implementing the CRD. Thus, this Court finds that although Congress created the SEC, which in turn gave birth to the NASD, which set up the CRD, *states continue to have control over brokers and securities agents. State-law and common-law duties and requirements continue to govern the behavior of brokers and securities agents and their firms*. Therefore, the existence of the CRD does not imply that state law and common law requirements and rights have withered away. *Rather, the CRD represents the minimum duties that the federal government requires — a floor, rather than a ceiling*." *French vs. First Union*, 209 F.Supp.2nd 818, 829 (M.D. Tenn., 2002). [*Emphasis added.*]

f. <u>The "Sticky" Aspect of Fiduciary Duties When Applied To Duties Which Protect Both The Client And the Public Interest.</u> The duties arising from a fiduciary relationship are not easily cast aside. While either party to an investment advisory agreement can terminate the *agreement* governing the provision of investment advisory services, this does not necessarily terminate the fiduciary duties – which can continue to exist. In fact, it is clear that fiduciary duties which are mandatory under the law, and which benefit the public (such as by encouraging participation by individual investors in the capital markets, and by ensuring that consumers receive trusted advice), are not able to be waived and the relationship of the parties changed as a result to a non-fiduciary one. *See* discussion in NAPFA comment letter on this point. Additionally, I would note the following:

(1) As a general rule, under the common law (which applies fiduciary duties to investment advisory relationships outside the ambit of federal or state statutes and SEC rules, as mentioned above), the fiduciary duty does not terminate merely because the contract for advisory services between the party terminates. For example, in the very recent case of *Western Reserve Life Assurance Company of Ohio v. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007), a dual registrant met twice with a customer, discussing the customer's financial goals and the options for investment of a $2.5m portfolio. The dual registrant recommended a variable annuity to the customer, which investment was entered into. The dual registrant also undertook to monitor the investments in the variable annuity, and acted as the customer's financial advisor. The Texas appellate court, noting that courts do not lightly find fiduciary *relationships* to exist, stated: "Obviously, when a person such as Hutton is acting as a financial advisor, that *role* extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to *one* who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor." [*Emphasis added.*] The court further noted that the dual registrant "was much more than a mere order-taker to the Clients—he acted as a financial advisor whom the Clients trusted to monitor the performance of their investments and recommend appropriate financial plans to them. Accordingly, the duty that Hutton owed the Clients went well beyond the 'narrow' duty of executing trade orders." As illustrated by this case, a dual

registrant cannot seek to “switch on and off” a fiduciary hat, claiming that some actions are fiduciary in nature and others are not. Once a fiduciary relationship is established, it extends to all of the advice given and transactions recommended to the client. Trust received cannot be cast off and then easily betrayed.

(2) The fact that fiduciary duties which benefit the public (such as those imposed by the Advisers Act) cannot be waived, and that fiduciary duties of an investment adviser continue even though his or her contract with the client has been terminated, flows from general principles of fiduciary law and from logic. ***These rules are required in order to protect the client, by prohibiting the fiduciary from undertaking a simply expedient action of casting off fiduciary duties just prior to consummating an act which would otherwise be in breach of a fiduciary duty*.**

(3) In a similar fiduciary context, as to the fiduciary duties owed by partners to each other, under the law of most states certain fiduciary duties of partners are not waivable. Moreover, a partner cannot announce his withdrawal from a partnership one day and then commence competing with the partnership the next day. [*See Leff vs. Gunter*, 22 Cal.3d 508 (1983) (“The notion of a continuing fiduciary duty between former partners is not new … in *Donleavey v. Johnston* (1914) 24 Cal.App. 319, 141 P. 229 … [t]he court properly observed: 'The sound rule is, that [a former partner] cannot make any profit to himself from a secret transaction initiated while the relation of trustee and cestui que trust exists, no matter when it springs into actual operation.' … The foregoing principles were echoed in *Fouchek v. Janicek* (1950) 190 Or. 251, 225 P.2d 783, in which the Oregon Supreme Court found a breach of fiduciary duty by one partner who, without using confidential information, preempted a business opportunity after termination of the partnership, having secretly negotiated for the opportunity on his own behalf while the partnership was also engaged in negotiations therefor … [as]the court graphically noted: ‘When a partner wrongfully snatches a seed of opportunity from the granary of his firm, he cannot, thereafter, excuse himself from sharing with his copartners the fruits of its planting, even though the harvest occurs after they have terminated their association ….”)] [*See also Everest Investors 8 v. McNeil Partners* (2003) 114 Cal.App.4th 411, 424 ("The fiduciary obligations of a general partner with respect to matters fundamentally related to the partnership business cannot be waived or contracted away.”)]

g. Conform The Securities Industry To the Law, Not The Other Way Around. I have often heard the complaint of broker-dealer firms that the Advisers Act is not in accord with "current practices." Such practices have only developed because the Commission has not aggressively applied the Advisers Act and its fiduciary protections, as Congress intended. Furthermore, it is not the function of the Commission to conform the law to "industry practices" which may have arisen. Rather, it is one of the functions of the Commission to conform the securities industry to the law. In addition, the interests of consumers of investment advisory services, and in fact all U.S. citizens, should be protected against an erosion of fiduciary principles. Should the Proposed Rule be enacted another "particular exception" will erode fiduciary protections, and this in turn will lead to an erosion of other fiduciary duties in other contexts. Furthermore, the adverse economic effect of this slippery slope are not addressed in the Proposed Rule.

h. Consideration of Other Adverse Economic Impacts Is Lacking. There appears to be no consideration of the economic impact of the Commission's proposed rules during this period as to: (1) the diminishment of the quality of advice provided to consumers when done under a non-fiduciary standard in which the advice provider is not required to act in the best interests of the client; (2) the detrimental effects on consumers of expensive product sales under non-fiduciary standards of conduct; (3) the negative effect on consumer confusion; and (4) the detrimental impacts on the profession of investment advisory services and the emerging profession of financial planning. Portions of these adverse economic impacts are further explored in paragraphs 2 and 3 below.

2. **Adverse Economic Impact of the Proposed Rule Upon Consumers.** Throughout the rulemaking dealing with the "Merrill Lynch Rule" and now this Proposed Rule, I have often heard SIFMA and various persons representing large broker-dealer organizations argue that investment advisory accounts are "more expensive" than fee-based or full service broker-dealer accounts. In actuality, the vast majority of the time the reverse is true, and investors receive a greater proportion of the returns offered by the capital markets under investment advisory accounts, for reasons I will explain in this paragraph.

Attached hereto as Exhibit B is the pamphlet "Common Sense." As noted therein, in addition to the duty of "suitability" imposed upon broker-dealers (and upon investment advisers, as it is commonly believed) fiduciary investment advisers possess two other important duties with respect to the recommendation of investment products:

o The investment adviser must undertake due diligence as to investment products recommended to the client, seeking to select those investments which best meet the client's needs. In this regard, a financial advisor shall reasonably ensure that the total fees and costs borne by the client in connection with the financial advisor's services and investment recommendations are reasonable. See *Lee v. Hasson*, No. 14-05-00004-CV (Tex. App. 1/30/2007) (Tex. App., 2007), wherein the court noted that because a fiduciary relationship was established between a life insurance agent and his customer where many close business transactions were also undertaken, the burden rested on upon the fiduciary to show that the payment of the fee to the fiduciary constituted a fair and reasonable compensation for the services rendered.

> (This does not mean that the least expensive investment product must be chosen; however, fees and costs – both "disclosed" and "hidden" – should be justified through the due diligence process. Consideration of the impact of an investment product's total fees and costs will result in lower average fees for consumers, and greater returns for investors, since the academic evidence is strong that low-total-expense funds tend to outperform high-total-expense funds.)

o Investment advisers serving retail clients must also reasonably consider and recommend to the client such strategies and investment products which may reduce the tax burdens imposed upon the client over time. Given the taxes are one of the most significant costs that investors in pooled investment vehicles bear (as discussed by the Commission in connection with the adoption of rules requiring greater mutual fund disclosure of after-tax returns), it follows that such a significant and material cost must be the subject of proper consideration when financial planning and investment advisory services are provided to a client.

I am a tax and estate planning attorney in addition to being a Certified Financial Planner™. In these capacities, and over a period of two decades, I have reviewed the portfolios of literally thousands of individuals and couples. I have concluded that full service broker-dealer firms and their registered representatives, nearly 99% of the time, do not adequately consider tax planning in connection with the sale of investment products to their clients. In other words, the products which are sold are usually not tax-efficient, nor is much thought given to proper asset placement in accounts with different tax characteristics (such as taxable personal or trust accounts, versus traditional IRA and other tax-deferred accounts, versus Roth IRA accounts). In fact, the vast majority of broker-dealer contracts with their customers disclaim any requirement by the broker-dealer firm or its representatives to provide tax advice of any kind. As a result, most customers of broker-dealer firms lose far too much of the returns of their investments to taxes. Unfortunately the duty of "suitability" has rarely been extended to impose upon registered representatives the duty to ensure that the customer possesses a tax-efficient investment portfolio. (Note that if such a duty to consider taxes were imposed, and enforced, it would be nearly impossible for so many registered representatives to continue to sell nonqualified variable annuities to 95% or more of the persons they are sold to now, given the conversion of qualified dividends and long term capital gains into ordinary income, the lack of stepped up basis, and other tax disadvantages which exist in connection with these products.)

It has also been my experience that most customers of "full-service" broker-dealer firms are sold products which possess incredibly high costs. For example, in addition to the "disclosed" sales loads and annual expense ratio of a mutual fund, many funds have extremely high "hidden costs." These hidden fees and costs, not included in a fund's annual expense ratio, are explored in a white paper attached hereto as Exhibit C. By contrast, since investment advisers, acting as fiduciaries, possess a duty to consider the total fees and costs relating to investments recommended to the client and the delivery of investment advisory services, most independent investment advisers will recommend much lower "total-fees-and-costs" investment products to their client. In fact, it has been the experience in my registered investment adviser firm that most new clients to our firm who previously were with "full service" broker-dealer firms enjoy total fees and costs savings of 30% to 70%, or even greater, compared to what they were paying previously, even taking into account our investment advisory fees (paid for directly by our clients).

In short, most traditional brokerage firms and product manufacturers (who are often affiliated with broker-dealer firms, or provide shelf space payments, soft dollar compensation, or other compensation to broker-dealer firms or their registered representatives) do an excellent job of transferring wealth created by the capital markets into the hands not of the customer, but rather the outstretched hands of the broker dealer firms and the IRS.

Additionally, investment advisers to retail clients possess a duty to ensure integration of the recommendations with all aspects of a client's investment portfolio. This integration involves a close attention to portfolio risks. A major benefit of the services a registered investment adviser offers is a substantial reduction in risks (of which there are many kinds) for many of its clients, while designing the portfolio to seek to possess a long-term expected rate of return in line with the client's needs and desires.

In essence, investment advisers are simply held to a higher standard than registered representatives. They are required to possess a higher degree of knowledge and skill in order to perform their functions. Many, many investment advisers are able to substantially reduce the fees, costs, taxes, and risks which their clients face through the application of their expertise. By contrast, registered representatives do not possess such broad duties – the duty to act with the due care of an investment adviser, the fiduciary duty of loyalty which includes the duty to act at all times in the client's best interests, and the duty of utmost good faith. Instead, the major duty of a registered representative is one of investment product suitability – a far lesser standard, with far less information to consider and to analyze.

Investment advisory relationships are, as a result, far less expensive for most investors, as a result of the close attention that investment advisers must pay to fees, costs, taxes and risks. Instead of acting as "manufacturer's representatives" (as registered representatives and their firms do), investment advisers act as "purchaser's representatives" in a fiduciary role to their client. This facilitates disintermediation and less total fees and costs to the individual investor.

In fact, the only thing more expensive about investment advisory accounts are the expenses (and/or diminished profits) which *broker-dealer firms* will incur in connection with offering fiduciary accounts. Substantial additional training is required of investment adviser representatives in many instances, in order to adhere to fiduciary duties of due care, loyalty, and utmost good faith. The more expensive (and most profitable for broker-dealer firms) products (including proprietary products, or products offering soft dollar compensation, payment for shelf space, or other compensation to the broker-dealer firm or its registered representatives) cannot be justified for use in investment advisory accounts in most instances. Hence, the "expensive" nature of investment advisory accounts – an argument often advanced by firms which oppose the application of the Advisers Act - relates not to the expenses incurred by the client, but rather relates to the diminished profits of the broker-dealer firm.

Accordingly, the Proposed Rule possesses a substantial and adverse economic impact upon consumers. The Proposed Rule fails to consider this adverse economic impact. If this substantial adverse economic impact were to be properly considered, the "special rule" contained in the Proposed Rule could not be justified.

3. **Adverse Economic Impact of the Proposed Rule Upon the Investment Advisory and Financial Planning Professions.** The Proposed Rule would relegate investment advisers who seek to "switch hats" to a non-fiduciary role (which the customer will not often comprehend nor understand) to a lesser status than that of a true professional who acts in the best interests of his or her client, at least in the eyes of the clients whom will be adversely affected by such switching. This will adversely affect the profession of investment advisers.

Fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment advice or financial planning or law, in recognition of the value such services provide to our society. For example, the provision of financial planning services under fiduciary duties of loyalty and due care encourages sound planning decisions to be made by clients, thereby leading to more secure financial futures for (potentially) hundreds of millions of Americans. Hence, in order to promote public policy goals - such as having the children of our clients possess the means to attend higher education, and having our clients live a more secure retirement – as the government would desire, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status the client is thereby afforded various protections. These protections serve to reduce the risks to the client which relate to the service, and encourage the client to utilize the service. Fiduciary status thereby furthers the public interest.

Why would a person take on the role of a fiduciary, and be subject to fiduciary duties? Specifically, why would a person desire to become a registered investment adviser (or representative of such a firm), knowing that his or her conduct will be subject to a high degree of scrutiny? The law imposes on fiduciary duties of loyalty and due care which limit the freedom of the fiduciary and/or require certain additional actions to be undertaken by the fiduciary for the client. However, the benefit of the assumption of fiduciary status is the increased marketability of the fiduciary. By endowing fiduciaries, such as investment advisers and financial planners, with a reputation for honesty backed by strict adherence to fiduciary standards of conduct, the fiduciary is the recipient of a greater ability to promote and market his or her services. However, should the regulatory body, in this instance the Commission, permit these broad fiduciary duties of due care, loyalty and utmost good faith to be eroded, or should the regulatory body permit others to undertake substantially the same services as those provided by the fiduciary without imposition of fiduciary status, or undertake such services in a situation in which the customer would likely be unaware of the changed role of the investment adviser as he or she shifts to a product-selling registered representative, then the increased marketability of the fiduciary is thwarted. This in turn leads to a degenerative cycle in which:

(1) The expert does not desire to enter into the profession of the fiduciary, as the same services can be performed under lesser standards (i.e., with greater freedom of action, and with less risk exposure to the fiduciary) under a functionally similar occupation. There is no clear benefit to the expert in terms of increased marketability of services, which might otherwise arise from the assumption of the fiduciary mantra.

(2) The client, who does not possess the knowledge and skill to discern the functional distinctions between the expert fiduciary and the expert non-fiduciary, and confronted with two persons who appear to functionally provide the same services (i.e., under the Proposed Rule, an investment adviser who at all times maintains a fiduciary role with respect to the client, versus a dual registrant who is permitted to switch hats upon a whim), is unable to distinguish any increased benefit from those who possess fiduciary status at all times. Even written disclosures, however detailed and prominent, cannot overcome the client's lack of knowledge, given the wide gap of knowledge which exists between the experts and the client. The client perceives that the one who is not a fiduciary at all times is supposed to act objectively and in the client's best interest (i.e., under fiduciary standards of loyalty and due care), when in fact this does not occur. Instead, the "part-time fiduciary" shifts roles and possesses conflicts of interest, the nature and effect of which are seldom understood by the client until after harm results.

(3) The foregoing interplay leads to a downward spiral which results in the erosion of the reputation enjoyed by the fiduciary's profession – that of the investment adviser and that of the

financial planner. Functionally similar non-fiduciaries engage in conduct which results in harm, and such conduct is then attributed to the profession by consumers who fail to understand the distinctions between the fiduciary and non-fiduciary (or "part-time fiduciaries permitted to switch to non-fiduciary role") persons performing the same services. Concurrently, clients become less trusting of investment advisers and financial planners alike, and less likely to utilize the services which public policy sought to promote.

Fiduciary status does not result from the negotiations of parties to a proposed contract. While entry into a relationship by the parties is voluntary, the law and public policy play a crucial role in the imposition of fiduciary status upon the parties to the contract and the relationship which follows from it. The law vests power and authority in the fiduciary, but requires the fiduciary to exercise that power and authority under strict standards of conduct for the client's benefit. The fiduciary's desire to assume the burdens of such strict standards of conduct results from the monopoly afforded to the fiduciary profession by the law. The client is encouraged to enter into the advisory relationship under the law's assurance that the fiduciary, who possesses superior knowledge as to the subject matter on which advice will be given, will not exploit the client. The law thereby promotes security for each party to the fiduciary relationship - security to the client in terms of the increased duties and protections afforded, and security to the fiduciary in terms of marketing power.

Accordingly, the Proposed Rule would have substantial adverse economic impacts upon the investment adviser profession, upon the emerging profession of financial planning, and even upon America itself. The Proposed Rule fails to consider these adverse economic impacts.

4. **The Issue of Dual Registrant Services Provided Under Two Different Commission Structures: The Higher Commission Structure Appears To Be "Special Compensation."** When a broker-dealer firm provides brokerage services under a low schedule of commissions, and the same firm provides brokerage services under a higher level of commissions, what does the difference in commissions represent? It could represent a fleecing of certain customers of the firm, unaware of the availability of the firm's lower commission structure. The only other alternative is that the customer of the firm is receiving something in addition to execution services – and this must be investment advisory services. Hence, the difference in commission is "special compensation," as the Commission has long opined. Even the U.S. Court of Appeals, D.C. Circuit, noted this long-standing interpretation of the Advisers Act in its recent *Financial Planning Association vs. SEC* decision (March 30, 2007), wherein it stated:

> Very shortly after enactment of the IAA, the SEC advised that any charges directly related to the giving of investment advice would be special compensation. On October 28, 1940, the SEC General Counsel issued an opinion stating:

> Clause (C) of section 202 (a) (11) amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause (C) which refers to "special compensation" amounts to an equally clear recognition that *a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities*.

11 Fed. Reg. 10,996 (Sept. 27, 1946) (reprinting SEC General Counsel opinion letter of October 28, 1940). Thus, any charges "directly related to the giving of advice" would be special compensation. *Id.* [*Emphasis added.*]

Why does the Commission now, through one aspect of this Proposed Rule, reverse course after six decades of consistent interpretation? Again, no logical reason has been provided by the Commission for refusing to apply the Advisers Act where such special compensation is received for services which are clearly investment advisory in nature.

5. **Discretionary Accounts As Investment Advisory Accounts.** Proposed Rule 202(a)(11)-1 would clarify that (i) a broker-dealer provides investment advice that is not "solely incidental to" the conduct of its business as a broker-dealer if it exercises investment discretion (other than on a temporary or limited basis) with respect to an account. This construction of the Advisers Act is appropriate, and this construction also follows general principles of agency law – i.e., when the scope of the agency is broad, the fiduciary duties attaching to the agency are likewise broad. Hence, I agree with the Commission that this is one of the many types of relationships which the Advisers Act was intended to reach.

   Furthermore, it should be noted that a number of federal courts have held that a stockbroker has an affirmative fiduciary duty where the broker deals in discretionary accounts*. See, for example, J.C. Bradford Futures, Inc. v. Dahlonega Mint, Inc*., 1990 WL 95625, (6th Cir., July 11, 1990).

6. **The Extremely Troubling SEC Definition of "Solely Incidental.".** In SEC Release No. IA-2652, the Commission has stated:

> In the 2005 Proposing Release, we explained our understanding that investment advice is "solely incidental to" the conduct of a broker-dealer's business within the meaning of section 202(a)(11)(C) *when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account*. We further explained that our understanding is consistent with the legislative history of the Advisers Act, which indicates Congress' intent to exclude

> broker-dealers providing advice as part of traditional brokerage services. We also explained that it is consistent with the Commission's contemporaneous construction of the Advisers Act as excepting broker-dealers whose investment advice is given "solely as an incident of their regular business." [*Emphasis added.*]

While the Commission does not, by this Release, expressly adopt a definition of "solely incidental,"[2] it is disturbing that the Commission continues to advance this completely unreasonable and overly broad construction of the language in the Advisers Act.[3] It is important to first turn to the plain meaning of the words contained in the exclusion for broker-dealers, which requires (in addition to the requirement that no special compensation be received) that the broker-dealer's "performance of such services is solely incidental to the conduct of his business as a broker or dealer." The adjective *"incidental"* has definitions which, according to Merriam-Webster's dictionary, include: "1 a: being likely to ensue as a chance or minor consequence; b: minor; 2: occurring merely by chance or without intention or calculation." The word "solely," used as an adverb, has the following definitions according to Merriam-Webster's dictionary: "1: without another, singly; 2 : to the exclusion of all else." Hence, by the plain language of the Rule, the advice which is "solely incidental to" the performance of brokerage services means advice which is of "minor consequence." The term "solely" emphasizes the minor nature of the advice.

I would also note that extensive prior commentary has pointed out the Commission's flaws in this overly broad interpretation of "solely incidental," including but not limited to the outstanding comment letter of Barbara Roper, Director of Investor Protection, Consumer Protection of America, dated February 7, 2005, which provides an extensive discussion of the "solely incidental" issue, which is worthy of re-review in its entirety, and which is incorporated into this comment letter by reference. The text of Ms. Roper's letter is reproduced as Exhibit A hereto, but her extensive footnotes are omitted for purposes of brevity.

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[2] SEC Release No. IA-2652 also states: "The situations addressed by these interpretations are not the only ones in which a broker-dealer provides advice that is not solely incidental to its business as a broker-dealer. Commenters are invited to suggest other situations that should be addressed by the rule." Hence, the Commission apparently seeks to lay the foundation for adopting further rules in reliance upon the Commission's "solely incidental" definition. Hence, my comments will address the lack of justification for the Commission's approach.

[3] The Advisers Act provides the following broad definition of investment adviser and the following limited exclusion for broker-dealers (and their registered representatives): ""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 … 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."

7. **The Commission is Urged to Delay Further Consideration of the Proposed Rule Until the RAND Corporation Study Considered.** The RAND Corporation's study, scheduled to be delivered to the Commission in December 2007, will likely trigger a broad-based review of the way the Advisers Act and the Securities and Exchange Act of 1934 are applied in the delivery of services and products to individual investors. Additionally, important issues relating to the application of the Advisers Act to financial planning activities remain to be considered. The Commission should delay enacting any rules in this area until such time as a comprehensive review of all of the many issues is undertaken, and comments received thereon. In fact, given the potential application of the "special rule" and its affect on financial planning activities, it is curious why the Commission seeks to rush this aspect of the Proposed Rule.

8. **The Commission Is Urged to Delay Further Consideration of the Proposed Rule Until Vacancies On The Commission Are Filled.** With two Commissioners having announced their intent to depart the Commission, I would urge the Commission to defer action on this Proposed Rule, which substantially affects the interests of consumers and professionals, until such vacancies are filled.

9. **The Commission Should Address The Issue of "Special Compensation" Received Through 12b-1 Fees.** In previous comments to the Commission I have posited that 12b-1 fees, when used to finance the provision of investment advisory services (which occurs frequently, as admitted in comments filed by securities industry organizations and many registered representatives), violate the "special compensation" limitation on the broker-dealer exclusion. I would respectfully suggest that the Commission's activities should focus on enforcing the literal terms of the Advisers Act, for the benefit of consumers, rather than continuing to formulate new possible exemptions to its application or failing to enforce its provisions.

In Conclusion: **The Commission's Continuing Federal Assault On The Citadel Of Fiduciary Protection Should Cease.** On October 1, 2007, I presented a paper at the North American Securities Administrators Association Annual Conference entitled "The Federal Assault On The Citadel of Fiduciary Protection: How Will State Securities Administrators Respond?" In the expanded version of that paper, posted online at my firm's web site, I stated:

> *The Authors of the Federal Securities Acts Contemplated Fiduciaries As Advisors.* As stated by Professor Steven L. Schwarcz: "Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors" …

> The SEC in recent years has sought to lessen the application of fiduciary duties, including the ill-fated adoption of the rule permitting fee-based brokerage accounts, the recently adopted temporary rule providing relief to investment advisers with regard to principal trading, and SEC expressions of their views on financial planning activities as not subject to regulation under the IAA as fiduciary activities …
>
> [In contrast,] state regulators have increasing applied their state investment adviser registration acts or otherwise imposed fiduciary status to regulate investment advisory and financial planning activities …
>
> To this observer it must also be asked as to why the SEC moved has moved forward with the adoption of regulations which the states have, through the NASAA, so adamantly opposed? There seems little communication between the SEC and the NASAA in the rule-making processes (at least prior to the announcement of a proposed rule), as one would think would naturally occur given the expressed desire for uniformity in federal/state securities regulation. Furthermore, why does the SEC appear to disregard substantial objections raised by the NASAA to its proposed rules so casually? One must ask whether the desire for uniform federal and state securities regulation is actually a desired goal or merely a façade …
>
> While state securities regulators are faced with outright fraud on a daily basis, there is a subtle but far more damaging occurrence each and every day as billions and billions of dollars are fleeced from unsuspecting investors through sales of high-expense products. It is time for state securities regulators to step up their actions to protect investors. In conjunction with the SEC, if possible. Otherwise, through carefully chosen opportunities to expand the reach of the fiduciary standard of conduct in accordance with state statutory law and state common law.

Individual investors are led to believe that they can trust the "financial consultant" before them, when in reality the vast majority of investors today are not served by fiduciary investment advisers at the retail level and instead are served by those who are not legally bound to put the best interests of the client first. The result is a taking of a substantial portion of the gains the capital markets have to offer. Specific disclosures of the amount of total fees and compensation paid by investors, in dollar or percentage terms, is not required. Product manufacturers and product salespersons have been able to hide such fees through such misunderstood terms as 12b-1 fees, through soft dollar compensation, and other means. Moreover, many aspects of the "hidden costs" of mutual funds and other pooled investment vehicles lack any meaningful disclosure at all (such as transaction costs and opportunity costs within mutual funds, as explained in Exhibit C). As a result, the negative impact of these cumulative high fees and costs on the future financial security of individual investors is hardly noticed.

Americans deserve more. Individual consumers deserve a better deal. They deserve to know who they can trust. They should be able to clearly identify between a product manufacturer's representative and a trusted fiduciary advisor. Given the complexity of the capital markets, and the need for substantial knowledge in order to undertake sound financial and tax planning decisions, individual investors are in need of, and should receive at all times – as a matter of public policy – the benefits of fiduciary advice under a fiduciary standard of conduct which is not diminished over time.

Even the casual observer must wonder - why is the Commission so reluctant to apply fiduciary duties of conduct to investment advisory activities, as the Adviser Acts contemplates?

At every industry meeting which I attend at which Commissioners and/or Commission staff is present, the lobbying undertaken by SIFMA and large broker-dealer firms appears to be intensive. In contrast, the Commission does not appear to either actively seek out, or listen with deference to, the opinions and reasoned insights of state securities regulators, consumer organizations, and the organizations which represent fiduciary advisors. One must also question why the Commission appears to accept broker-dealer firm arguments so quickly, while ignoring the learned counsel of state regulators and consumer advocates, and indeed ignoring the plain meaning of the language of the Advisers Act and its Congressionally-intended broad application.

It would be so easy for the Commission to apply the Advisers Act, using its plain language and Congressional intent, much more broadly than it is applied today. But this is not occurring. Instead, the Commission appears to be a significant force is delaying the transition from a conflict-ridden product sales system to the better and consumer-desired system in which objective advice is provided and the selection of investment products is driven by knowledgeable "purchaser's representatives." Given that the forces of disintermediation would substantially lessen the profits of product manufacturers and their sales forces (registered representatives of broker-dealer firms, and insurance agents, for the most part), it is no wonder why the broker-dealer industry devotes so much money to intensive lobbying efforts to preserve an antiquated system of expensive product sales by manufacturer's representatives.

In my comment letter on the ill-fated Merrill Lynch Rule dated August 30, 2004, I stated:

> *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 …
>
> [I]ndividual 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 ould you choose to work with? From who do you think you would get unbiased, and better, advice? …
>
> 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 nor 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 nor 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. They want, and desire, the confidence in their advisors so they that can possess peace of mind.

According to the Committee Reports surrounding the adoption of the Advisors Act, “[t]he essential purpose of [the Advisers Act] ... [was] to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful.” H.R.Rep. No. 76-2639, at 28 (1940). After 67 years, and faced with the continued non-application of the Advisers Act to investment advisory activities by the Commission, the dual purposes of the Advisers Act have yet to be achieved. The time has come for the Commission to reverse course and seek to protect individual investors through the broad application of the Advisers Act, as Congress intended. The forces which oppose disintermediation, consumer protection, and the application of fiduciary standards of conduct – both within and without the Commission – should be examined, exposed, and then countered with the logic of common sense.

The Proposed Rule should be rescinded.

Respectfully submitted.

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Attachments:

EXHIBIT A: **COMMENT LETTER OF BARBARA ROPER, CONSUMER FEDERATION OF AMERICA, RE: DEFINITION OF "SOLELY INCIDENTAL"**

EXHIBIT B: **Pamphlet, "Common Sense"**

EXHIBIT C: **White Paper, "Estimating the Costs of Stock Mutual Funds"**

EXHIBIT A: COMMENT LETTER OF BARBARA ROPER, DIRECTOR OF INVESTOR PROTECTION, CONSUMER PROTECTION OF AMERICA, DATED FEBRUARY 7, 2005, RELATING TO DEFINITION OF "SOLELY INCIDENTAL"

(Footnotes in the original comment letter have been omitted)

February 7, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File Number S7-25-99
Certain Broker-Dealers Deemed Not To Be Investment Advisers

Dear Secretary Katz:

I am writing on behalf of Consumer Federation of America1 in response to the request for comment on the Commission's reading of the legislative history with regard to the broker-dealer exception from the Investment Advisers Act. CFA has also contributed to a group letter on the broader rule re-proposal and concept release, other aspects of which we support.

However, because we consider the interpretation of the "solely incidental to" standard to be so essential to development of an appropriate policy on regulation of financial professionals, and because we consider the Commission's presentation of the legislative history to be not just misguided but misleading, we felt a separate letter on this issue was needed.

I. Introduction

For years, we and other investor advocates have urged the Commission to define what it means for a broker-dealer to give advice that is more than "solely incidental to" its business as a broker. Only by defining the "solely incidental to" standard of the Investment Advisers Act can the Commission create the meaningful functional distinction between brokers and investment advisers that Congress intended and that the Commission itself professes to prefer. We therefore enthusiastically received the Commission announcement in December that it would be issuing a concept release clarifying this standard.

Unfortunately, rather than clarifying the standard, the Commission has in essence interpreted it out of existence. In its place, it has proposed an "in connection with and reasonably related to" standard that would allow brokers virtually unlimited freedom to offer advisory services outside the protection of the Advisers Act. In proposing this anti-investor standard, the Commission has misrepresented much of the legislative record it cites as supporting its position and ignored the vast majority of the legislative record, which directly contradicts its interpretation.

The following analysis, based on a more complete and honest reading of the legislative record, will show that the only logical conclusion, based on both the statutory language and the legislative history, is that Congress intended to provide only a narrow exception for brokers engaged exclusively in typical brokerage activities, such as recommending to customers that they purchase or sell securities and expressing opinions on the merits of various investments. It will also show that, contrary to the claims of the Commission, Congress did not intend to permit brokers to offer a more extensive array of the advisory services outside the protections of the Advisers Act simply because they were offered as part of a package of brokerage services. Nor did it intend to permit brokers to hold themselves out to the public as advisers.

II. The Reason for the Exception

The Commission declares that Congress's intent in crafting the Advisers Act exception for broker-dealers was "not to except broker-dealers whose advice to customers is minor or insignificant, but rather to avoid additional and duplicative regulation of broker- dealer." The Commission cites only two sources in the legislative record for this interpretation, one of which actually refutes the Commission's interpretation. It ignores a large body of the legislative record that contradicts its position. When read in its entirety, the legislative record clearly shows: that Congress was aware of and concerned about abuses associated with brokers offering investment advice; that its concern about these abuses was one motive behind the legislation; and that Congress consciously rejected the approach of providing brokers with a blanket exception and instead chose to provide only a narrow exception for brokers engaged exclusively in certain typical brokerage activities.

One source cited by the Commission in support of its position is an exchange between Rep. William P. Cole, Jr. of Maryland and an investment counselor testifying before the committee about the reasons behind the bill's exception for lawyem4 In the course of that exchange, Rep. Cole offers an interpretation of the reason behind the "solely incidental to" exception that is similar to the Commission's:

> "Well, in the hearings in the Senate, several of the Senators raised considerable objection to the possibility of the bill reaching law firms, for instance, their own firms, where they resided, and I gather from reading the testimony and discussion on the bill, that the only reason that these law firms are not under the bill is that they are pretty well regulated at home."

By citing just this one source, however, the Commission has created a distorted picture of the discussion regarding this issue. A very different picture emerges when one also considers other related testimony. For example, testimony by the SEC Chief Counsel indicates that the basis for the lawyer's exemption was not just that they were already regulated, but also that they had "a high fiduciary duty to their clients, something that could not be said of broker-dealers.

Additional testimony ignored by the Commission explained the narrow scope of the lawyer's exception.
The other source cited by the Commission is a memorandum prepared by the Illinois Legislative Council and entered into the hearing record on S. 3580. The Illinois memorandum analyzes the pros and cons of various approaches to regulating investment advisers as the basis for possible future legislation in that state. The portion of the document cited by the Commission notes that, among the handful of states that had already adopted laws regulating investment advisers, some had chosen to provide exemptions for certain groups, including brokers. It

goes on to state that one reason appeared to be that "such persons and firms are already subject to governmental regulation of one type or another." Again, this statement is only one part of the discussion.

The Illinois report goes on to state that "the investment advice furnished by these excepted groups would seem to be merely incidental to some other function being performed by them." In other words, the reason behind the exemptions was not simply to avoid duplicative regulation, as the Commission suggests, but also that the individuals and firms excepted were not viewed as being engaged in rendering investment advice on more than an incidental basis.

Furthermore, the memorandum notes, in deciding what approach to take on the issue of exceptions, legislators would need to decide "whether to exempt only those who incidentally and occasionally give advice as to investments or whether to exempt as a general rule all who regularly furnish investment advice if they also belong to one of the groups in relation to which some other form of governmental regulation exists."" While the existing state laws cited in the Illinois report provided a blanket exemption for brokers, Congress opted instead to provide exemptions in the federal law "only to those who incidentally and occasionally give advice as to investments." Thus, taken as a whole, the Illinois report refutes rather than supports the Commission's conclusions about congressional intent to avoid duplicative regulation of brokers.

In reaching its faulty conclusion about the reason for the exception, the Commission has not only misrepresented the Illinois report, it has ignored the fact that the original Senate bill (S. 3580) did not provide any exception for brokers, although it did already include the solely incidental exception for lawyers and other professionals. The Commission even ignores a statement by the Senate bill's chief sponsor, Senate Robert F. Wagner of New York, that a significant reason, in his mind, for insisting on legislation rather than deferring to self-regulation, was the need to regulate the advisory activities of brokers. Responding to a representative of the Investment Counsel Association of America (ICAA), who had been arguing in favor of self-regulation, Sen. Wagner made the following comment:

> "Let me say that if I thought you could get all the brokers in, I – as one member of the committee – would be quite satisfied by your regulation under your own association's rules. However, how are you going to get in the others, who may not want to live up to your high standard^?"

This quote helps to better illustrate just what Congress was trying to achieve by regulating investment advisers. As this and other similar testimony suggests, their concern was not primarily with the legitimate Investment Counsel - who provided continuous, ongoing, and professional advisory services to their clients and viewed themselves as fiduciaries with an obligation to avoid conflicts of interest -although the legislation certainly affected them. Their concern was with other elements who had attached themselves to this profession without meeting appropriate professional standards. James N. White of Scudder, Stevens & Clark summed it up this way: "The discussion yesterday seemed to indicate two classes of undesirables: First, the "fringe" as typified by the tipsters; and second, the firms which fall within any reasonable definition of investment counsel and yet have not high standard."

Brokers were clearly identified in the hearing record as one of the groups that was a subject of concern. ICAA President Dwight Rose noted, for example, that their association's survey of the field had found that: "Some of these organizations using the descriptive title of investment counsel were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commission on transactions executed upon such free advice." It is shortly after this comment that Sen. Wagner made his statement regarding the need to regulate brokers.

The Commission acknowledges that Congress knew of the abuses that might arise when brokerage services are combined with advisory services. It cites, among other things, the above quote from Mr. Rose, as well as a portion of the Illinois memorandum. A later section of the Illinois report is even more explicit in its warnings than the section cited by the Commission:

> "The criticisms of counselors also acting as brokers or dealers are founded upon possible encouragement of practices bordering on fraud. The major danger is that a counselor connected with a brokerage house will unduly urge frequent buying and selling of securities, even when the wisest procedure might be for the client to retain existing investment."

Instead of acknowledging this further evidence of its incorrect interpretation of the legislative history, however, the Commission would have us believe that Congress was aware of problems associated with investment advice provided by brokers, including those who did not charge a separate fee for the advice, but chose to ignore them, and that it instead focused its attention on regulating legitimate Investment Counselors, where there had been no similar suggestions of abuse. In addition to being in direct conflict with the legislative history, including the statement by bill sponsor Sen. Wagner, this simply makes no sense.

Ultimately, we believe there is a grain of truth in the Commission's view that Congress adopted the exception to avoid duplicative regulation. But the duplicative regulation being avoided was not regulation of broker-dealers, as the Commission suggests, but of brokerage activities. In other words, Congress recognized that it is impossible to act as a broker without recommending the purchase or sale of securities and expressing opinions on the merits of various investment opportunities, all of which fit within the Act's definition of investment advice.

Having already adopted a regulatory regime to cover brokers engaged in such activities, Congress saw no need to also regulate these same activities under the Advisers Act. So, to the degree that brokers limited themselves to these sorts of typical brokerage activities -activities that were "solely incidental to" their function as brokers -they were excepted from the Act, if they did not charge "special compensation" for that advice. Brokers who provided investment advice that went beyond those inherent to the sales function would not be excepted, regardless of whether they charged "special compensation."

III. The Scope of the Exception

The Commission, on the other hand, argues that Congress intended to regulate under the Advisers Act only those brokers who provided investment advice through a special advisory department and for which customers contracted separately and paid a fee. In support of this view, the Release cites one reference in the testimony to the bill's coverage of such advisory activities and one early Commission interpretation of the bill, IA Release No. 2, that mentions the existence of such departments. Neither of the sources cited actually supports the Commission position. In fact, IA Release No. 2 indicates that the Commission in 1940 clearly believed it was possible that investment advice offered by a broker outside a separate advisory department might not meet the "solely incidental to" standard.

The hearing record cited by the Commission is an excerpt from Senate testimony on S.3580 by Douglas T. Johnston, vice president of the ICAA. In that testimony, Mr. Johnson states that the bill's definition of investment adviser would include "certain investment banking and brokerage houses which maintain investment advisory departments and make charges for services rendered." However, as the Commission surely realized when it cited that testimony, S. 3580 did not provide any exception for broker-dealers. Absent such an exception, Mr. Johnston's reference to the existence of special investment advisory departments can hardly be taken to indicate that these are the only type of broker-dealer advisory activities the legislation was intended to cover.

When read in its entirety, without the ellipses of the SEC's citation, the quote makes clear the real point Mr. Johnston was trying to make – that the Act's definition of investment adviser covered a wide range of advisory activities, many of which bore little resemblance to the professional services provided by Investment Counsel.

In short, far from supporting the notion that Congress intended to regulate only a very narrow range of advisory conduct under the Act, Mr. Johnston's testimony and other testimony like it elsewhere in the hearing record clearly indicates that Congress knowingly and intentionally adopted an expansive definition of investment adviser that would cover a great many different types of investment advice offered by a great many different types of advisers.

In addition, the Release cites an early Commission interpretation of the statute, IA Release No. 2. In the part cited by the Commission, IA Release No. 2 refers to the "well known" fact that "many brokers and dealers have investment advisory departments which furnish investment advice for compensation in the same manner as does an investment adviser who operates solely in an advisory However, the statement quoted simply supports the document's preceding assertion, that a broker is not "excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities."

Far from offering support for the Commission's position, an earlier statement in IA Release No. 2 actually undercuts that position. In the letter from SEC General Counsel Chester T. Lane that makes up the bulk of the Release, Mr. Lane lays the groundwork for the discussion of compensation issues by first establishing the solely incidental nature of any advice offered in the examples. The letter from the SEC General Counsel states, "I shall assume for the purposes of this letter that, in every situation outlined above, the transaction is 'solely incidental to the conduct of ... business as a broker or dealer." (Emphasis added.) Since none of the examples cited in IA Release No. 2 involve advice offered through a separate advisory department and paid for by a fee, this document actually supports an interpretation directly contradicting that put forward by the Commission in its current Release – that the Commission in 1940 assumed that certain investment advice offered as part of a traditional package of brokerage services might nonetheless fail to satisfy the "solely incidental to" requirement of the Act.

Unfortunately, since it is devoted exclusively to issues related to "special compensation," IA Release No. 2 does not offer any further clarification of what sort of investment advice by a broker-dealer would not be excepted under the "solely incidental to" standard.

IV. The Meaning of Solely Incidental

Based on its wholly unfounded conclusion that Congress intended to provide a broad exception for any investment advice a broker might offer as part of a "package" of brokerage services, the Commission has developed an interpretation of the term "solely incidental to" that ignores the simple meaning of the statutory language and is directly contradicted by the legislative record. Specifically, the Commission states:

> "In general, we understand investment advice to be 'solely incidental to' the conduct of a broker-dealer's business within the meaning of section 202(a)(l l)(C) when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account."

The idea that "solely incidental to" could be construed as meaning "in connection with and reasonably related to" would be laughable, if it didn't result in such atrocious public policy. In backing up its claim, the Commission suggests that the phrase "solely incidental" has been improperly interpreted to mean "minor," "insignificant," and "periodic." Such an interpretation is hardly surprising. When you follow the online dictionary link the Commission provides in footnote 100 of the Release, the first definitions for incidental that come up are:

> occurring or likely to occur as an unpredictable or minor accompaniment;
> of a minor, casual, or subordinate nature; and
> subordinate or secondary in importance or position.

The problem with relying on such definitions, according to the Commission, is that commenters have focused too much on the word "incidental" and not enough on how the word is used in the context of the entire section. The language does not mean that the advice is incidental - i.e., minor - according to the Commission, but rather that it is "incidental to" a broker-dealer's business - i.e., "following as a consequence of' that business."

Even if you accept the Commission's selection of the one definition of "incidental to" that doesn't include any reference to the minor or secondary aspect of the term, it still doesn't support the Commission's definition of "solely incidental to" as "in connection with and reasonably related to." Rather, if you paraphrase the "solely incidental to" requirement using the Commission's definition, it would except broker-dealers from the Advisers Act only insofar as they limit themselves to giving nothing more than (solely) the investment advice that follows as a consequence of (incidental to) their primary business of effecting transactions in securities on behalf of customers.

This rephrasing of the statutory language, and the narrower definition of "solely incidental to" it supports, is consistent with the cogent explanation of "solely incidental to" offered by Professor E. Merrick Dodd, Jr., of Harvard Law School in his Senate testimony. Professor Dodd was commenting on the bill's exception for lawyers, since the bill at that time did not include any similar exception for brokers. However, his analysis is equally appropriate to both circumstances, since the broker-dealer exception later added to the bill also hinged on an interpretation of "solely incidental."

"Moreover, it is not accurate to state, as Mr. Loomis stated, that lawyers are exempt from that provision of the bill. They are only exempt insofar as they give advice about investments incidental to conducting their ordinary professional duties as lawyers. What that means it seems to me is obvious. If I, as a lawyer, have a client who is accustomed to come to me for legal advice, and in that connection I have become thoroughly familiar with the financial affairs of that client, who is very likely to be a woman or other person not perhaps very cognizant of investments, and if he or she asks me a question about whether a certain investment he or she proposes is a good risk the bill allows me to answer the question to the best of my ability, without saying: I cannot give you any advice about that because I am not a registered counsel.

> "But that does not mean that because I am a lawyer I can hold myself out as giving good investment advice to all comers. I am not exempt from the provisions of the bill because I am a lawyer, but only exempt in the narrow field where I can give investment advice as incidental to my ordinary duties to my regular legal clients."

Clearly, Professor Dodd would not have accepted the Commission's current practice of allowing brokers to offer extensive advisory services and to hold themselves out to the public as advisers even as they rely on the "solely incidental to" exception. Perhaps that explains the Commission's decision to ignore the one portion of the legislative record that comments directly on the meaning of the term it is attempting to define.

The other problem with the Commission's interpretation of the "solely incidental to" requirement – aside from the fact that it is contradicted by both the clear meaning of the statutory language and by the legislative record -is that, rather than bringing clarity to this issue, it interprets the standard out of existence. It is difficult to imagine a financial advisory service that could not be offered in connection with a brokerage service and that could not be construed as being reasonably related to that service.

This interpretation is particularly troubling when you realize that at least for some at the Commission, a "traditional package of brokerage services" does not mean the kind of services brokers have always offered, but rather any services they may come to offer. This viewpoint is evident in the language in footnote 1 13 of the Release. Having provided a reasonable explanation for why financial planning should be considered an advisory service, and not anything Congress in 1940 could have conceived as part of a traditional package of brokerage services, the Commission adds the following caveat: "On the other hand, the brokerage business has evolved significantly since 1940, and it may be appropriate to consider financial planning to be part of the traditional package of services broadly understood." Such reasoning this is exactly the sort of reasoning that helped to erase any semblance of a functional distinction between brokers and advisers.

V. Conclusion

Brokers today have become indistinguishable from the financial professionals who are regulated under the Advisers Act. They use the same titles. They claim to offer the same services. And they market their services as if they were primarily advisory in nature. This is the direct result of the Commission's past application of its "in connection with and reasonably related to" standard for the broker-dealer exception. Far from providing the kind of functional distinction Congress sought to create and the Commission professes to favor, this approach determines applicability of the Advisers Act based not on the nature of services offered but on the nature of the firm offering the services. That simply makes no sense. It has also been demonstrably harmful to investors. The mutual fund scandals provide ample evidence of abusive sales practices that pervade the broker-dealer community. Evidence of similar abuses has emerged in the area of 529 plans, variable annuities, and elsewhere. The Commission and the NASD Regulation are to be congratulated for their role in bringing many of these problems to light and for their efforts to crack down on the most egregious practices. Such efforts are inevitably piecemeal, however, and the problem is more fundamental. Investors are being encouraged to rely on their brokers as trusted professional advisers, but the brokers are not consistently acting as trusted advisers in their dealings with customers. We believe our narrower interpretation of the "solely incidental to" requirement would benefit investors by providing clear guidelines for distinguishing between advisers and salespeople, by providing better disclosure of conflicts of interest for all those holding themselves out as advisers, and by providing a mechanism for holding all advisers accountable for acting in the clients' best interests, regardless of the context in which they offer their advice.

Despite its total misreading of the "solely incidental to" requirement, the Commission offers a number of very positive suggestions for addressing these issues in this Release.

Specifically, we support regulating all discretionary accounts as advisory accounts, regardless of the method of compensation. We also agree that financial planning is an advisory service. In both these cases, advice is the primary service being sold. And we strongly urge the Commission to stop allowing brokers who are not advisers to hold themselves out to the public as financial advisers, financial consultants, financial planners, etc. To allow them to do so is not just confusing to the public, it is misleading both about the nature of the services being offered and about the nature of the relationship. No amount of disclosure can counteract this effect. One strength of our alternative interpretation of "solely incidental to" is that -in sharp contrast to the Commission's interpretation – it actually supports the policies the Commission has proposed for consideration in this Release.

Despite its beneficial suggestions, the Commission cautions elsewhere in the Release against this narrower approach to "solely incidental to" out of a concern that "it would eventually result in the extension of the Advisers Act to most brokerage relationships." The Commission implies that Congress in 1940 could have had no such intent. But Congress did not intend in 1940 that fixed commissions would be deregulated. And it did not intend that full-service brokers would come to face competition on two sides -from discount brokers offering cheaper execution and from financial planners offering comprehensive financial advice. Congress did not intend that brokers would respond by adopting a more advice-driven business model. Congress did not intend these things, but it did provide for them -by limiting the broker-dealer exception to brokers engaged exclusively in traditional brokerage activities. It is not the Commission's job to preserve the broker's regulatory status when the broker's business model has changed so dramatically. It is the Commission's job to ensure that investors are adequately protected. By that standard, the Commission's past policy has failed abysmally. It does not provide investors with any ability to distinguish between financial professionals subject to two very different standards of conduct. It does not provide adequate disclosure of conflicts of interest by brokers offering advice. And it does not make clear that every broker offering investment advice should be considered a fiduciary with an obligation to place the customer's interests ahead of the broker's own.

The Commission has an opportunity to rescue that failed policy, and several good suggestions in this Release for doing so. However, it would be a grave error and great disservice to investors to let stand the unfounded, illogical, anti-investor interpretation of "solely incidental to" presented in this Release. Instead, we urge the Commission to adopt an interpretation that supports a meaningful functional distinction between brokers and advisers. We believe the alternative interpretation we have provided in this comment letter meets that criteria. It has the added benefits of being consistent -as the Commission interpretation is not -with the statutory language, with the legislative history, and with simple common sense.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

COMMON SENSE;

ADDRESSED TO

POLICYMAKERS and PARTICIPANTS

OF THE

FINANCIAL ADVISORY COMMUNITY

ON THE FOLLOWING INTERESTING

SUBJECTS.

I. Of the Origins of Fiduciary Duties in General, and when Financial Advisors assume Fiduciary Status.
II. The Specific Fiduciary Duties of Financial Advisors.
III. Thoughts on the Present State of Affairs for American Consumers.
IV. Of the Present Opportunities for Change, with some Miscellaneous Reflections.

In the era that lies ahead, the trusted businessman, the prudent fiduciary, and the honest steward must again be the paradigms of our great American enterprises. It won't be easy, but if we all work long enough and hard enough at the task, we can build ... a fiduciary society in which the citizen-investors of America will at last receive the fair shake they have always deserved from our corporations, our investment system, and our mutual fund industry. – John Bogle

UNITED STATES OF AMERICA;
Printed and Distributed in Florida.

30 July 2007

I N T R O D U C T I O N .

> "PERHAPS the sentiments contained in the following pages, are not yet sufficiently fashionable to procure them general favor; a long habit of not thinking a thing wrong, gives it a superficial appearance of being right, and raises at first a formidable outcry in defence of custom. But the tumult soon subsides. Time makes more converts than reason." - Thomas Paine, 1776

Change is not necessary for individuals to embrace; financial services intermediaries are free to become obsolete and vanish if they so desire. Yet the instinct to survive is strong. It compels individuals to undertake conscious choices.

This pamphlet is an appeal to our better selves. It is a calling to something more than the members of the financial advisory community are today. This vision is not new. It was given birth many decades ago by a few, and it has since been cultivated and expanded upon by many. As a vision it represents intense desires of those clients whom financial advisors endeavor to serve. Too few financial advisors currently act within this vision; too many financial advisors are presently excluded from it.

America faces an uncertain economic future. Many challenges lie ahead for our country and in the financial lives of our fellow citizens. The vision set forth herein is but one part of a greater answer to these economic challenges. Nevertheless, the vision expressed herein conveys a significant path for reform – empowered by common sense. This vision can be transformed into a better reality through the leadership of our legislative, regulatory and industry association policy makers. The achievement of this vision, or some outcome akin to it, will require their courage and fortitude.

Table of Contents

I. Of the Origins of Fiduciary Duties in General, and when Financial Advisors assume Fiduciary Status.

The origins of the fiduciary principle. The fiduciary principle is of great antiquity. It is clearly reflected in the provisions of the code of Hammurabi nearly four millennia ago, which set forth the rules governing the behavior of agents entrusted with property. Ethical norms arising from relationships of trust and confidence existed in Judeo-Christian traditions, in Chinese law, and in the Roman era. Cicero stated, "Anyone who betrays such a trust is undermining the entire basis of our social system." Likewise, one of the three basic questions of self-examination attributed to Confucius is the following: "In acting on behalf of others, have I always been loyal to their interests?"

Fiduciary law has evolved over the centuries to refer to a wide range of situations in which courts have imposed duties on persons acting in particular situations that exceed those required by the common law duties of ordinary care and fair dealing. Today fiduciary status attaches to many different situations, including actors in relationships based upon trust and confidence.

Fiduciary status is determined by law, not the parties' agreement. The law plays a crucial role in the establishment of fiduciary status for a financial advisor. To a substantial extent, the law (whether it be statutory law or common law) rather than the parties (and the terms of their contract) determines entry into fiduciary status for a financial advisor. In other words, once the financial advisor establishes a certain relationship with a client, that relationship's classification as either "arms-length" or "fiduciary" in nature, and its legal consequences, are primarily determined by law rather than by an understanding or written agreement of the parties.

Arms-length vs. fiduciary relationships. Generally, relationships between two parties fall into one of two categories. The first category is that in which arms-length negotiations between the parties take place. Sometimes the consumer is aided by specific laws which impose some additional duties on the other party, such as the requirement that investment products sold to an investor be "suitable," at least as to the risks associated with that investment. By contrast, the fiduciary relationship arises in situations where the law has clearly recognized that fiduciary duties attach, such as principal and agent relationships, or where there exists the actual placing of trust and confidence by one party in another and a great disparity of position and influence between the parties.

Ten paths to fiduciary status. It is curious that so many financial intermediaries today are unaware of their fiduciary status, or those situations in which it might attach. Paths to fiduciary status include:

1. Investment Advisers Act of 1940 ("IAA");
2. Limited duties for non-discretionary brokerage accounts;
3. Discretionary brokerage accounts;
4. "Control" amounting to "discretion" over a brokerage account;
5. Common law fiduciary status arising from a relationship of "trust and confidence" between the financial advisor and client;
6. Maryland and Washington state statutory law (financial planners as IAs);
7. ERISA;
8. Express contractual terms;
9. Service as trustee, custodian; guardian, or conservator; and
10. Acting as attorney-in-fact.

The Investment Advisers Act of 1940 (IAA) may have greater breadth in its application than many realize. The U.S. Court of Appeals decision in *Financial Planning Association vs. SEC,* No. 04-1242 (D.C. Cir., March 30, 2007), possesses potentially far-reaching implications. Three times in that decision the Court emphasized that the term "investment adviser" was "broadly defined" by Congress. Additionally, in discussing the exclusion for brokers (insofar as their advice is solely incidental to brokerage transactions for which they receive no special compensation), the U.S. Court of Appeals stated:

> "The relevant language in the committee reports suggests that Congress deliberately drafted the exemption in subsection (C) to apply as written. Those reports stated that 'investment adviser' is so defined as specifically to exclude ... brokers (insofar as their

> advice is merely incidental to brokerage transactions for which they receive only **brokerage commissions**) ....” [**Emphasis added**.]

As a result of this language, all arrangements in which broker-dealer firms and their registered representatives receive compensation other than commission-based compensation should be reviewed to see if the definition of “investment adviser” found in 15 U.S.C. §80b-2.(a)(11) applies:

> “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 ....

For example, the issue has recently been raised as to whether the receipt of 12b-1 fees by broker-dealer firms and their registered representatives, which by the SEC’s own admission are asset-based fees and relationship compensation, run afoul of the IAA when received by those outside investment advisory relationships with their customers. The written statements of many brokerage industry representatives acknowledge that 12b-1 fees are utilized in large part to compensate registered representatives (RRs) for the fostering of an ongoing relationship between the RR and the investor, including the provision of advice over time with respect to a customer’s personal circumstances, and including financial planning, estate planning, and investment advice (not specific to any transaction). While industry representatives have argued that the 12b-1 fee “compensation” received by the broker-dealer firm is not paid by the customer directly, there is no qualification in the definition of investment adviser which says that compensation must be directly paid by an investor. Moreover, there is a common law principle which attorneys were taught when they were in law school: “You cannot do indirectly what you cannot do directly.” In other words, “if it walks like a duck....” While admittedly Class C shares in particular, and fee-based compensation in general, better align the interests of investors with those of financial intermediaries, such an alignment is not the basis of any exclusion from the application of the IAA. Given the significance of this issue, all ongoing payments to advice-providers deserve close scrutiny.

Finding "discretion" exists over a ("non-discretionary") brokerage account: the application of the law of agency. Are broker-dealer firms and their RRs fiduciaries? Yes, as to the scope of their agency. In this regard the broker-dealer firm accepts responsibility as an "agent" of the customer for the proper execution of the brokerage transaction. In connection with the scope of that agency, the broker-dealer and its RRs owe "limited fiduciary duties" or "quasi-fiduciary duties" to the customer, including those to: (1) recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) carry out the customer's orders promptly in a manner best suited to serve the customer's interests; (3) inform the customer of the risks involved in purchasing or selling a particular security; (4) refrain from self-dealing; (5) disclose any personal interest the broker may have in a particular recommended security; (6) refrain from misrepresenting any fact material to the transaction; and (7) transact business only after receiving prior authorization from the customer. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 461 F.Supp. 951, 952 (E.D.Mich.1978) aff'd, 647 F.2d 165 (6th Cir.1981)); *Patsos v. First Albany Corp., 433 Mass. 323, 741 N.E.2d 841, 848-49* (2001). However, it should be noted that the agency relationship between the broker-dealer (and its RRs) and the customer ceases at the conclusion of each transaction. No broad fiduciary duties to exist with respect to most RRs and their broker-dealer firms, under the law of agency, at least with respect to non-discretionary accounts.

Fiduciary duties expand when the broker-dealer firm (through its RR) assumes discretion over an account. While the SEC has yet to reveal (following the *Financial Planning Association vs. SEC* decision) whether it continues to opine that discretionary brokerage accounts are subject to the IAA and its fiduciary duties, it is clear that *common law* fiduciary duties arise from the principal-agent relationship, and that these duties will be interpreted quite broadly. In essence, since the scope of the agency is expanded to include the exercise of discretionary authority to undertake sales and purchases in the account, the agent (RR) owes a fiduciary duty to the principal (the customer) in the actions undertaken which exercise that discretion. Some state courts go further and apply the very broad triad of fiduciary duties – loyalty, due care, and utmost good faith – when the broker-dealer possesses discretion over a customer's account. *See Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*. 461 F Supp 951, 953 [ED Mich. 1978] ["[u]nlike the broker who handles a non-discretionary account, the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense."]. "When a stock broker or financial advisor is providing financial or investment advice, he or she is required to exercise the utmost good faith, loyalty, and honesty toward the client. The broker or advisor implicitly represents to the client that he or she has an adequate basis for the opinions or advice being provided." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006) citing *Hanly v. S.E.C.*, 415 F.2d 589, 596-97 (2d Cir. 1969); *Univ. Hill Found. v. Goldman*, 422 F. Supp. 879, 893 (S.D.N.Y. 1976).

Even though an account may be "non-discretionary" on paper, some state courts find that the RR may exercise *de facto control* over non-discretionary accounts. In essence, such a finding transforms the scope of the agency from a limited one to a broad one, and fiduciary duties then apply to that broadened scope of the agency. For example, if a broker has provided broad advice relative to investment strategies and decisions, and if the customer has frequently relied on that advice, there is a strong indication that the account is discretionary. There are many factors, however, that apply, and in each instance it is a "facts and circumstances" analysis.

For example, a key factor is the investment sophistication of the customer, since an inexperienced or naive customer is more likely to leave the control of an account in the broker's hands. *Kaufman vs. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F.Supp. 528, 536; *Leib*, 461 F.Supp. at 954; *Hecht v. Harris, Upham & Co.,* 283 F.Supp. 417, 433 (N.D.Cal.1968). Conversely, a customer who has sufficient understanding and intelligence to be able to evaluate a broker's recommendations and exercise independent judgment as to those recommendations can be viewed as controlling the account. *Follansbee v. Davis, Skaggs & Co*., 681 F.2d 673 (9th Cir.1982); *Marshak v. Blyth Eastman Dillon & Co., Inc*., 413 F.Supp. 377 (N.D.Okla.1975). Thus, for example, the court in *Leib* considered the customer's age, education, intelligence, and investment experience as among the relevant considerations in determining that the customer was sufficiently involved in and informed about his account to be deemed in control of the account. 461 F.Supp. at 954. Additionally, the *Lieb* court noted that, if the broker is socially or personally involved with the customer, this suggests relinquishment of control by the customer because of the relationship of trust and confidence.

In *Patsos*, the Massachusetts Supreme Judicial Court recognized that the relationship between a stockbroker and a customer may be either a fiduciary one or an ordinary business one, and the court enumerated a number of factual considerations that can determine whether a fiduciary duty has arisen between a stockbroker and a customer; the Court noted that a "customer's lack of investment acumen may be an important consideration, where other factors are present" especially when "the broker holds himself out as an expert in a field in which the customer is unsophisticated." *Patsos*, 433 Mass. at 334-5, 741 N.E.2d at 850-1.

Common law findings of fiduciary status: relationships built upon trust and confidence. Regardless of how a financial advisor is registered – as an investment adviser (representative), RR of a broker-dealer, dual registrant, or insurance agent – another body of law serves to impose fiduciary status upon the financial advisor – the "common law."

What is the "common law"? The common law forms a major part of the law of those countries of the world with a history as British colonies. In the United States, the common law includes extensive non-statutory law reflecting precedent derived from centuries of court decisions, both in the United States and England. Among other prescriptive aspects, the common law imposes duties upon parties to various contracts and relationships, independent of the existence of any statute or regulation.

Fiduciary status – two main branches. The recognition of the existence of a fiduciary relationship under the common law is said to consist of two main branches.

First branch: generally accepted and prescribed relationships. The first branch of fiduciary status consists of a list of accepted and prescribed relationships — principal and agent, attorney and client, executor or trustee and beneficiary, director or officer in the corporation, partners, joint venturers, guardian and ward, and parent and child. The common law has defined, over the years, these relationships to be fiduciary in nature, and they are generally accepted as such. Some of these relationships were recognized to involve fiduciary status for several centuries or longer (such as trustee relationships), while other relationships were only recently universally recognized as such (director or officers of corporations, for example).

Second branch: relationships deemed fiduciary on basis of specific facts and circumstances. The second branch of fiduciary status arises from those relationships which, on their particular facts, are appropriately categorized as fiduciary in nature. Under this test, a variety of circumstances may indicate that a fiduciary relationship exists, as opposed to an arms-length relationship. Such circumstances, or indicia or evidential factors, include influence, placement of trust, vulnerability or dependency, substantial disparity in knowledge, the ability to exert influence, and placement of confidence. Another factor may lie in the ability of the fiduciary, by virtue of his or her position or authority, to derive profits at the expense of his or her client.

The development of this second branch of fiduciary relationships accelerated during the 20th Century and continues today, in response to the increased complexity of our modern world. Increased amounts of specialization are required in modern society, and this in turn leads to greater reliance on others in order to obtain greater affluence. As stated by Professor Frankel, "Courts, legislatures, and administrative agencies increasingly draw on fiduciary law to answer problems caused by these social changes." Tamar Frankel, *Fiduciary Law,* 71 Calif. L. Rev. 795, 796 (1983). With the passage of time it is probable, and indeed highly likely, that certain types of relationships deemed fiduciary on the basis of specific facts and circumstances (such as those of financial advisors) may arise to the level of generally accepted and prescribed relationships.

No contract is needed which expressly sets forth fiduciary status. Courts have held that a fiduciary relationship need not be created by contract. It may arise out of any relationship where both parties understand that a special trust or confidence has been reposed. "A fiduciary relation does not depend on some technical relation created by or defined in law. It may exist under a variety of circumstances and does exist in cases where there has been a special confidence reposed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one reposing the confidence." *In re Clarkeies Market, L.L.C.*, 322 B.R. 487, 495 (Bankr. N.H., 2005). Stated differently, once a relation between two parties is established, "its classification as fiduciary and its legal consequences are primarily determined by the law rather than the parties. Thus, unlike a party to a contract, a person may find himself in a fiduciary relation without ever having intended to assume fiduciary obligations. The courts will look to whether the arrangement formed by the parties meets the criteria for classification as fiduciary, not whether the parties intended the legal consequences of such a relation." Tamar Frankel, "Fiduciary Law," 71 Calif. L. Rev. 795, 817 (1983).

When is fiduciary status found for financial advisors under the common law? Several recent cases indicate that fiduciary status may be found for financial advisors through the actual provision of advice on asset allocation and investment manager selection, by actually providing financial advisory services, or by committing to or actually monitoring a customer's investment portfolio. Other recent cases find fiduciary status when one "holds out" as a "financial planner" or "financial advisor" or "estate planner" or "investment counselor," or as one possessing experience in the field of investment consulting and management, In addition, a dual registrant who undertook the monitoring of variable annuity sub-accounts and to give financial advice, and who held out as a "financial advisor" was held to be a fiduciary. A summary of several cases follows.

The provision of advice regarding asset allocation, portfolio manager selection, investment objectives, and investment guidelines, and holding out as experienced in the field of investment consulting and management, was held by a New York state court to be sufficient to raise a factual issue regarding the existence of fiduciary relationship based upon trust and confidence. *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 4430 (NY 6/2/2005) (NY, 2005).

When a bank held out as either an "investment planner," "financial planner," or "financial advisor," the Wisconsin Supreme Court held that a fiduciary duty may arise in such circumstances. *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005)

Actually acting as a financial advisor could lead to a finding of fiduciary status. "[A] fiduciary relationship can arise in fact regardless of the relationship in law between the parties. . . . For example, acting as an advisor may contribute to the establishment of a fiduciary relationship." *Hatheway vs. U.S. Trust Company, N.A.* (Ct. of Appeals, Washington State, unpublished decision, case no. 33966-8-II, *citing Micro Enhancement Intern., Inc., v. Coopers & Lybrand,* 110 Wn. App. 412, 433-34, 40 P.3d 1206 (2002), which case in turn cites *Liebergesell v. Evans*, 93 Wn.2d 881, 613 P.2d 1170 (Wash., 1980), stating in pertinent part: "A confidential or fiduciary relationship between two persons may exist either because of the nature of the relationship between the parties historically considered fiduciary in character … or the confidential relationship between persons involved may exist in fact. *McCutcheon v. Brownfield*, 2 Wash.App. 348, 356-57, 467 P.2d 868, 874 (1970). *See also* Restatement Contracts § 472 Comment C ('A fiduciary position . . . includes not only the position of one who is a trustee, executor, administrator, or the like, but that of … trusted business adviser, and indeed any person whose relation with another is such that the latter justifiably expects his welfare to be cared for by the former')." *Liebergesell* at 890-1.

Insurance agents who introduced themselves as "investment counselors or enrollers" and who tailored retirement plans for each person depending on the individual's financial position, and who led the customers to believe that an investment plan was being drafted for each customer according to each customer's needs, was held by a federal court, apply Iowa state common law, to lead to the possible imposition of fiduciary status. *Cunningham vs. PLI Life Insurance Company,* 42 F.Supp.2d 872 (1990).

In another case, a federal court, applying New York state law, found that the customer "relied upon superior knowledge. Asset Alliance allegedly was plaintiff's investment advisor and committed to 'monitor the status and performance of [Beacon Hill and Bristol] at least once a month and [to] promptly inform Sanpaolo if, for any reason, it believes that [Beacon Hill or Bristol] should be de-selected.' These allegations are sufficient to plead a fiduciary relationship." *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 414 (S.D.N.Y., 2005).

In a very recent case, a dual registrant crossed the line in "holding out" as a financial advisor, and in stating that ongoing advice would be provided, and other representations, and in so doing the dual registrant, who sold a variable annuity, was found to have formed a relationship of trust and confidence with the customers and was held to a fiduciary duty. The decision also states in part: "Obviously, when a person such as Hutton is acting as a financial advisor, that role extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor. The relationship goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties." *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007).

No General Preemption of State Common Law by IAA. It is clear that neither the 1934 Act nor the IAA of 1940 Act preempt state common law. In other words, the federal securities acts, such as the IAA of 1940, do not in any way disturb or interfere with the development of fiduciary principles under state law. [Note, however, that SLUSA preempts state common law as to certain class actions, and ERISA preempts certain state law claims based on fiduciary duties.] Often, statutory law follows in the footsteps of the ongoing development of common law, and hence it should not be surprising to see an expansion of the application of fiduciary duties by future federal or state legislation.

Other paths to fiduciary status. Certain paths to fiduciary status are both clear and undisputed. If the financial advisor serves as trustee, or custodian of a UTMA or UGMA account, or as guardian or conservator, then he or she are a fiduciary. If the financial advisor agrees (either in writing or verbally) to act as a fiduciary, then he or she has assumed fiduciary status by contract. If a financial advisor provides advice to plan participants or plan sponsors as to ERISA plans, he or she is a fiduciary.

In addition, a person holding himself or herself out as a “financial planner” or “financial consultant,” or who actually provides financial advice for compensation, and who is subject to the laws of the State of

Maryland of the State of Washington, is an investment adviser and hence is a fiduciary with respect to activities carried on in that state, barring the application of various exclusions provided by law or regulations promulgated thereunder.

In conclusion – fiduciary status for many financial advisors is highly likely to already exist. Common law continues to expand upon the situations in which fiduciary status attaches to those who provide financial advice. Holding out as a financial advisor (or the use of similar terms) manifests an acceptance of trust and confidence. Actually undertaking a financial plan (whether comprehensive or segmented) and providing financial advice, especially on an ongoing basis, also manifests an acceptance of trust and confidence. In either situation – "holding out" as a "financial advisor" or the provision of either comprehensive or focused "financial planning" or "financial advice," a fiduciary relationship is likely to result under the common law. Additionally, as many observers of the law note, where there is a substantial wrong the courts seem to find a way to impose liability. Fiduciary duties may be utilized to fill gaps in the law, especially where the law of contracts is insufficient to protect the interests of an innocent victim.

Financial advisors must always remember what financial advisors are called upon to do – provide their expertise to *other people's money*. It is right and just in such circumstances that broad fiduciary duties be applied to those in whom our fellow citizens place their trust and confidence. Financial advisors should be ready to accept the important stewardship of our client's goals, hopes, and dreams.

II. The Specific Fiduciary Duties of Financial Advisors

I set forth in the previous section the likelihood, under the common law (if not through broader application of the Investment Advisers Act), that many financial advisors are already fiduciaries, even though they do not yet know it. In this section, I seek to foster greater understanding of the major fiduciary duties.

I often reflect upon the resistance by some in the securities industry to the promulgation of more specific fiduciary duties for financial advisors. This is especially so when many financial advisors of today, seeking to adhere to the highest standard under the law, both desire and need additional guidance in understanding fiduciary duties. It is true that fiduciary duties are applied to fill a gap, through our courts of equity, to right wrongs which principles of contract or tort law may fail to adequately address. It is also true that fiduciary duties are – in a sense – elastic, and are molded to fit the profession or environment to which they are applied. Nevertheless, establishing contours for the fiduciary duties of those who provide financial and investment advisory services is both reasonable and proper. Guidance is warranted – otherwise legislation by enforcement, which would result from the absence of more specific standards - would inadvertently occur to the detriment of practioners.

With an aim of furthering understanding of fiduciary duties, following are some of the specific duties which flow from the commonly-referred-to triad of the fiduciary duties of due care, loyalty, and utmost good faith.

The duty of due care.

- *Generally.* A financial advisor shall, in the performance of services for a client, act with the due care expected of prudent financial advisors in like situations, applying the requisite knowledge, experience, and attention to the engagement.
    - The duty of care has been considered to involve both process and substance. Procedural due care is often

met through the application of an appropriate decision-making process, and outcomes are judged under the standard of procedural prudence, not necessarily by the end result. Substantive due care is also required, under which the financial advisor is bound to exercise good judgment, applying his or her education, skills, and expertise to the financial planning issue at hand.

    - The standard of prudence is relational; it follows that the standard of care for a financial advisor is the standard of a prudent financial advisor.

- *Competence.* A financial advisor shall provide services to clients competently.
    - A financial advisor is competent only when he or she has attained and has maintained an adequate level of knowledge, skill, and experience, and is able to apply that knowledge, skill, and experience effectively in providing services to clients.
    - Consultation or referral by the financial advisor with other professionals shall be required when a professional engagement exceeds the personal competence of the financial advisor and the competencies of others who might support the financial advisor from within the financial advisor's firm or otherwise.
    - Due to ever-changing laws, regulations, and the development of new strategies, services, and products, the maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a financial advisor's professional life.

- *Diligence.* Financial advisors shall be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility upon financial advisors to render services reasonably, promptly, and carefully and with a reasonable level of thoroughness.
    - The financial advisor should gather necessary factual information regarding the client as necessary and appropriate to provide the recommendations. In recommending securities or investment products to clients, the financial advisor must determine that the security or investment product is suitable for that customer in light of the customer's financial status and investment objectives.
    - The financial advisor should undertake due diligence as to investment products recommended to the client, seeking to select those investments which best meet the client's needs. In this regard, a financial advisor shall reasonably ensure that the total fees and costs borne by the client in connection with the financial advisor's services and investment recommendations are reasonable.
    - Financial advisors shall also reasonably consider and recommend to the client such strategies and investment products which may reduce the tax burdens imposed upon the client over time.

The duties of loyalty and utmost good faith.

- *Generally.* A financial advisor, who is given the highest degree of trust and confidence by the financial advisor's client, is a fiduciary and possesses the duty of undivided loyalty to the client. A financial advisor shall at all times act in the best interests of his or her clients, in utmost good faith, and honestly.

    - The greater the knowledge, experience, and required degree of expertise of the fiduciary, relative to the knowledge and experience of the client, the more significant the fiduciary association becomes as a protector of the client's interest.
    - Clients in receipt of financial planning services will nearly always start off, in discussions with their financial advisors, from a position of contractual weakness and, as to the complexities of tax law, financial planning issues, estate planning issues, insurance, risk management issues, and investments, from the position of relative ignorance. Fiduciary status is thereby imposed by the law upon the party with the greater knowledge and expertise in recognition by the law that the client is in need of protection and care.
- *Maintaining Objective Judgment.* A financial advisor must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities; accordingly, financial advisors must reasonably act to avoid conflicts of interest.
    - A fiduciary cannot serve two masters. The existence of conflicts of interest, even when they are fully disclosed, can serve to undermine the fiduciary relationship and the relationship of trust and confidence with the client. The existence of substantial or numerous conflicts of interest, which otherwise could have been reasonably avoided by the financial advisor, may lead to not only an erosion of the financial advisor’s relationship with the client, but also an erosion of the reputation of the profession of all financial planners and advisors.
- *Compensation.* Financial advisors must not charge an excessive fee. Financial advisors must not offer, solicit, or

accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise the financial advisor's own or another's independence and objectivity.

- Many types of compensation are permissible for financial advisors, including commission-based, a percentage of assets under management, a flat or retainer fee, hourly fees, or some combination thereof. However, the term "independence" requires that the financial advisor's decision is based on the best interests of the client rather than upon extraneous considerations or influences that would convert an otherwise valid decision into a faithless act.
- To avoid disputes with clients relating to conflicts of interest involving compensation, all compensation should be fully and specifically disclosed, in dollar or percentage amounts, in writing and in advance.
- Conflicts of interest involving commission-based compensation might be best addressed through a "level compensation" or "maximum compensation" agreement entered into with the client prior to any recommendation of an investment product.

- *Disclosures and Management of Conflicts.* Financial advisors shall disclose to clients and properly manage all material conflicts of interest which remain following financial advisors' reasonable efforts undertaken to avoid conflicts of interest.
    - Disclosure of conflicts of interest does not defeat the continuing duty to act in the best interests of the client.
    - Financial advisors shall adopt and adhere to reasonable policies and procedures for the management of remaining conflicts of interest in order that the financial advisor may continue to act in the best

interests of the client. This includes, but is not limited to, the adoption and periodic revision of a code of ethics, appropriate compliance policies and procedures, and sound client engagement practices.

- *Fairness.* Financial advisors shall reasonably seek to not favor the interests of any one client over the interest of another client. Since situations may arise in which the financial advisor's ability to treat all of the financial advisor's clients with equal fairness is compromised, or where it may appear that the interest of one client is favored over that of another client, financial advisors shall inform clients in writing and (where possible) in advance of the limitations which financial advisors possess and how the financial advisors will address the situation.
- *Honesty.* Financial advisors must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities. Financial advisors must not engage in any professional conduct involving dishonesty, fraud, or deceit, or commit any act that reflects adversely on their professional reputation, integrity, or competence.
- *The Duty of Loyalty Extends Throughout The Relationship.* The duty of a financial advisor to act in the best interests of a client cannot be waived by the client; it extends to all aspects of the relationship between the financial advisor and client.
    - Fiduciary duties apply to all of the advice and recommendations provided by the fiduciary to his or her client; fiduciary duties cover the entire *relationship*, not just specific accounts.
    - Fiduciary duties, once established, cannot be terminated except through termination of the whole of the relationship.

    - The term "fiduciary" is utilized to mark certain relationships where a party with superior knowledge and information acts on behalf of one who usually does not possess such knowledge and information. Financial planning and financial advisory services involve such relationships, as learning the personal details of clients' financial affairs, their hopes, dreams, and aspirations cultivates confidential and intimate relationships.

- *Preserve Confidences.* Financial advisors shall keep all information about clients (including prospective clients and former clients) in strict confidence, including the client's identity, the client's financial circumstances, the client's security holdings, and advice furnished to the client by the firm, unless the client consents otherwise or except as required by the provisions of law.

- *No Reckless Behavior.* A financial advisor shall act responsibly at all times.

    - Traditionally, the duty of utmost good faith has been closely related to the concept of loyalty. However, reckless, irresponsible, or irrational conduct – but not necessarily self-dealing conduct – may implicate concepts of good faith.

Why is there resistance to the application of fiduciary duties by so many participants in the securities industry? Perhaps it is fear of liability or an unwillingness to undertake the effort required of a fiduciary. However, once fiduciary status is both embraced and understood by a financial advisor, it becomes surprisingly easy to adhere to fiduciary principles while fostering rewarding, long-lasting relationships with clients.

III. Thoughts on the Present State of Affairs for American Consumers

We have a problem in America.

The world is far more complex for individual investors today than it was just a generation ago. There exist a broader variety of investment products, including many types pooled and/or hybrid products, employing a broad range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true "total" fees, costs, investment characteristics, tax consequences, and risks. Additionally, U.S. tax laws have increasingly become more complex, presenting both opportunities for the wise through proper planning, but also traps for the unwary.

As the sophistication of our capital markets, as well as portfolio construction and management methodologies, have increased, so has the knowledge gap between individual consumers and knowledgeable financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today a financial advisor must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

Proper financial planning is essential to encourage both an increase in household savings and in order to invest those funds more effectively. If people do not make careful, rational decisions about how to provide for their financial security over the course of their lifetimes, then the government will have to step in to save people from the consequences of their poor planning.

In the vast majority of the well-regulated capital markets in the world, it is recognized that the imposition of high standards of conduct upon financial intermediaries is necessary to provide protection to consumers from unfair, improper, and fraudulent practices. Such protection fosters confidence in the capital markets by investors, which in turn promotes increased investor participation in efficient capital markets.

In the United States "financial advisors" might refer to several types of financial services intermediaries – registered representatives of broker-dealer firms, registered investment advisers or their representatives, and insurance agents. The term "financial planner," while descriptive of a planning and advisory relationship, is largely unregulated. Of these four types of actors, only registered investment advisers and their representatives are known to always possess broad fiduciary duties of due care, loyalty, and utmost good faith toward their clients.

Federal securities laws and regulations protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to a financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries. However, disclosure does not address investors' difficulties in dealing with the psychological issues of risk aversion, overconfidence, and cognitive dissonance. Moreover, many investors do not enjoy the intended protections of securities laws because disclosures are either inadequate (as to the quality or quantity of information provided), incomprehensible to the individual consumer (in terms of the language or terminology utilized), or deficient in timing (i.e., coming only after the consumer makes a decision). While efforts have been made to formulate disclosures in "plain English," this may have exacerbated a related problem – one in which individual investors receive a large volume of disclosure documents to the point of being overwhelmed.

Furthermore, to accept the premise that investors are responsible for understanding what they read and acting prudently thereafter, it is necessary to conclude that investors are not only armed with timely and adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them, both intellectually and unhampered by behavioral biases. Consumer ability to understand is not only difficult due to the enormous knowledge base required to undertake decisions in dealing with a highly complex financial world, but also due to bounds upon human behavior that limit the extent to which people actually and effectively pursue utility maximization. Individuals possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. *See* Prentice, "Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future," 51 Duke L. J. 1397 (2002). Moreover, "not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but…. competitive pressures almost guarantee that they will do so." Prentice, "Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis, 2003 U.Ill.L.Rev. 337, 343-4 (2003). As evidence of the foregoing, this author has been trained to establish a relationship with a prospective client based upon trust and confidence, long before any discussion of fees or products; such training is commonplace in the securities industry. Once such a relationship is accomplished, the "sale" is easily accomplished.

The fact is that we should no more expect the vast majority of individual consumers to be able to successfully navigate today's complex financial world than we would expect them to act as their own attorney or physician.

While various studies have been undertaken to discern the total costs of intermediation (i.e., all of the costs surrendered by consumers to financial services intermediaries), the data in such studies is usually incomplete. Nevertheless, it would be reasonable to conclude that 25% to 40% of the total returns offered by the capital markets to individual investors are consumed by financial services intermediaries. No one disputes that financial advisors, possessing great skill, deserve reasonable compensation; however, the fact is that a huge amount of the returns of the capital markets do not reach individual consumers, and they are usually unaware of much of this interception and diversion. The way to cure this problem is not only through better disclosures, but also through embracing the notion of purchaser's representatives (fiduciaries), who possess the duty to keep total fees and costs reasonable for their clients. Financial advisors, armed with knowledge of the many "hidden" costs found in investment products, and bound by a duty to act in the best interests of the client (and not as the representative of the product manufacturer), can and will apply economic pressure on product providers to lower fees and costs.

Powerful economic forces oppose the imposition of fiduciary status upon financial intermediaries. This opposition is fueled by billions of dollars excessively diverted each year from the financial futures of individual Americans. Some of our regulators have, from time to time, inadvertently promulgated policies in opposition to the inevitable march of disintermediation. In the face of enormous influence from securities industry participants, leadership and courage will be required by the makers and enforcers of our public policy. Only common sense can counter the self-serving arguments of many in the securities industry who, armed with billions of profits each year, seek to wield their influence in the halls of Washington, D.C. and beyond.

IV. Of the Present Opportunities for Change, with some Miscellaneous Reflections.

The year 2007 has already seen several major developments which add to the foundation for a fuller transition to fiduciary status for all financial advisors. First, the U.S. Court of Appeals ruled in *Financial Planning Association vs. SEC* that the Investment Advisors Act and its imposition of fiduciary status should be broadly applied. Second, the Certified Financial Planner Board of Standards, Inc. announced that it will apply fiduciary duties to its many certificants engaged in material elements of financial planning, effective July 1, 2008. The U.S. Securities and Exchange Commission and the U.S. Department of Labor (as to ERISA accounts) continue to review issues of concern, including the propriety of 12b-1 fees, point-of-sale disclosures, and the proper standards of conduct which should be applied to the provision of financial advice. And the Financial Planning Association's Fiduciary Task Force, building on the prior work of many others, issued its Final Report, which concluded: "We request that a very important dimension of the lives of our fellow citizens – that which relates to each person's own financial security and planning for the achievement of lifetime financial goals – be empowered by consistent professional conduct through the engagement of financial planners held to the highest standards of conduct." (Final Report, June 1, 2007).

The provision of financial advice should be elevated to that of a profession. A profession is a calling. It requires specialized knowledge and often long and intensive preparation, including instruction in skills and methods as well as in the scientific, historical, or scholarly principles underlying such skills and methods. A profession should maintain high standards of achievement and conduct. A profession should commit its members to continued study and to a kind of work which has for its prime purpose the rendering of public service. A true profession embraces the fiduciary standard, the highest standard of conduct under the law.

It is now possible to envision a future for the regulation of financial advisors containing many diverse elements, including the following:

1. *Functional regulation of financial advisors.* Only financial advisors subject to broad fiduciary duties of due care, loyalty, and utmost good faith should be licensed to provide personal financial advisory services (including any advice relative to the suitability of any investment or insurance product to meet a client's needs).

    a. The world should be clearly divided – arms-length transactions with product providers, and fiduciary relationships in which clients put their trust and confidence in trusted advisers.

    b. Product providers, promoters, and wholesalers, and their representatives, should be clearly identified as such. The use of terms such as "financial," "estate," and "wealth" in combination with "advisor," "planner," or "consultant," or similar terms, should only be permitted by fiduciary advisors in order that consumer confusion is abated.

    c. Discussions of the features and characteristics of a product may occur by product sellers, but any advice relating to that product as to whether or not it is suitable for, or fulfills a need of, a client, or as to asset allocation, or other personal financial advice, should be prohibited unless it occurs under a fiduciary standard of conduct.

2. *Uniform or national standards.* As financial advisors often operate across state lines, efforts should continue to establish for financial advisors uniform or national standards of conduct.

3. *State regulation of individual financial advisors.* Professional financial advisors require peer oversight in order to evaluate the professional advisor's adherence to his or her duty of due care in accordance with professional standards of conduct. For this reason, state regulation of individual personal financial advisors

should exist, and state regulatory authorities should be assisted by boards of review comprised of financial advisors.

4. *Split oversight of financial advisory firms.* The SEC and the various states should retain split, but not preemptive, oversight jurisdiction for all financial advisory firms.

While reform rests in large degree with our federal and state legislators and regulators, it must also come from within. Simply put, many financial advisors need to do a better job in serving their clients. Additional educational requirements should be embraced, both for those entering the profession and also for those already within the profession. The provision of fundamental tax advice should never be subject to disclaimers by financial advisors or their firms, as tax advice is an integral part of the financial planning process. All financial advisors must become experts, and the profession of financial advisors must become perceived as a profession of trusted experts.

Reform efforts must also prohibit the wearing of a multitude of hats. It defies logic that a financial consultant can act as a fiduciary for an investment advisory account but also as a non-fiduciary for a brokerage account for the same client. Fiduciary status attaches to the relationship; it is not a function of the legal description of the account upon which advice is given, nor is it a function of the contract between the parties. Moreover, the switching of hats should be prohibited, for it inevitably leads to "bait and switch" activities and substantial confusion by, and harm to, individual consumers. Additionally, it is a gross fiction that individual consumers, faced with complex financial decisions, and unable to discern between financial advisors who are fiduciaries and those whom are not, and burdened with various behavioral biases, can provide informed consent to a change from fiduciary to non-fiduciary status.

In any efforts dedicated to the process of these reforms, the highest standard under the law – that of the fiduciary – must be preserved. Chief Judge Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928), described a fiduciary's duty of loyalty as follows:

> Many forms of conduct permissible in a workaday world for those acting at arm's-length, are forbidden to those bound by

> fiduciary ties. A trustee 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. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

As reform efforts continue and are increasingly set in motion, there are many unanswered questions along the way which deserve the attention and scrutiny of our leaders. How should fiduciary duties be more specifically set forth? To what extent can the scope of a financial advisory engagement be limited? What are the best practices which can be followed? How can entry into the profession of financial planning be limited to trained financial advisors, such as through better regulatory educational and testing standards? How long a transition should be afforded to those current financial intermediaries to re-train to practice under the higher standards (or to seek employment elsewhere)? Answers to these questions will arise only from a combination of ongoing research, analyses, and discussion among the many interested parties and policy makers who will aid the process of reform.

Progress in the course of human affairs often requires disruption of a kind which poses inconvenience to many. The road ahead may be difficult, and may be long. However, the challenges of the path ahead should not deter a collective march toward a better future for all Americans.

A Necessary Disclaimer. The author, Ron A. Rhoades, JD, CFP®, is solely responsible for the content of this publication. This material is presented with the understanding that the publisher or author and the reader are not, merely by the presentation of this material, engaged in an advisor-client relationship nor an attorney-client relationship. This pamphlet contains neither financial nor legal advice. Prior to the application of any of the concepts set forth herein, financial intermediaries should obtain professional guidance.

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Please submit any comments or suggestions regarding this publication to rrhoades@josephcapital.com. Thank you.

A more detailed treatment of the topics set forth in this pamphlet can be found in "Financial Intermediaries: Opportunities To Enhance Standards of Conduct" (April 2007), available at www.JosephCapital.com under "Resources" and then under "SEC Comments."

Estimating The Total Costs of Stock Mutual Funds

A Working Paper from

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Executive Summary:

The "annual expense ratio" of stock mutual funds does not reflect other major expenses incurred by mutual funds arising from trading of stocks and other securities within the fund. These additional expenses include commissions paid by the fund's investment adviser to broker-dealer firms, bid-ask spreads, market impact costs, opportunity costs relating to delayed and canceled trades, and opportunity costs due to cash holdings.

The average total costs of U.S. stock mutual funds are estimated at 2.5% to 3% annually. U.S. large cap blend funds tend to have lower total annual expenses, while small cap and growth funds tend to possess higher total annual expenses.

While commercial index funds and certain exchange-traded funds usually possess relatively low turnover and low disclosed expenses, their market impact costs are often quite high.

Wealth managers should seek out mutual funds in the desired asset classes which not only possess low "disclosed" costs but which also have adopted trading rules and methodologies designed to substantially reduce transaction and opportunity costs, given the substantial impact of total mutual fund costs upon the returns of the capital markets actually secured by individual investors.

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Estimating The Total Costs of Stock Mutual Funds

Why Is Discerning the Total Costs of Mutual Funds So Important?

Striking. That's the only word which might convey the size and impact of the total costs of the vast majority of mutual funds today. Yet most individual investors we meet, even though many have dealt for years with registered representatives of broker-dealer firms, have no idea of the high costs of the mutual funds in their investment portfolios.

Alternatively, take the "do-it-yourself" investor reviewing the prospectus of a stock mutual fund. The investor reads that the fund's annual "expense ratio" is only 0.70% annually. Knowing that this annual expense ratio is below the average of similar stock mutual funds, the investor believes that this fund may be a good choice. Unknown to the investor, however, the high "hidden costs" of this mutual fund balloon the total annual expenses of this fund to well over 3%. In addition, if the fund were held in a non-qualified account (i.e., "personal" or "joint" or "trust" account, not an IRA or qualified retirement plan) of the investor, the "tax drag" upon the individual investor's investment returns would subtract another 1.5% or more annually from his or her net returns.

This is not to say that all mutual funds are poor choices for investors. Mutual funds offer individual investors and smaller pension fund managers and other fiduciaries the ability to achieve broad diversification among individual securities[1] - an important part of risk reduction in investing. Mutual funds may also offer a liquidity, tax management, and bookkeeping services. Hence, for the vast majority of individual investors, stock mutual funds can and should form an important part of their investment portfolio.

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[1] The costs of purchasing 3,000 individual stocks in selected asset classes (the number of U.S. stocks we believe is sufficient to minimize "specific company" risk while providing exposure to multiple asset classes) are too great for most individual investors. By our estimate only investors with $10 million or more to commit to individual stocks can achieve full diversification benefits while realistically keeping costs related to the deployment of cash into the capital markets and management fees associated with portfolio management low. The benefits of such broad diversification relate not just to standard deviation (a measure of the volatility of an investment portfolio, which is one measure of risk), but also relate to terminal wealth dispersion (TWD). Stated differently, a more broadly diversified basket of securities, consisting of several hundred stocks, has a statistical probability (by a 3-to-1 margin) of outperforming a basket of 15 stocks in the same asset class over any 10-year period of time. Well-diversified stock mutual funds therefore permit the vast majority of individual investors to reduce the risks inherent in the probable underperformance of a concentrated portfolio of individual stocks over long periods of time.

However, of the thousands and thousands of stock mutual funds available today, only a few funds successfully keep their "total costs" to very low levels. Why are total costs so important? The higher the costs of a mutual fund, the lower its likely returns when compared to other similar mutual funds.[2] This is because large portfolio transaction costs in a mutual fund can consume a large portion of the mutual fund's potential gross returns.[3]

In this ***Joseph Wealth Management Working Paper*** we survey and summarize much of the recent academic research which explores mutual fund costs and their impact upon the individual investors. We then set forth a proposed methodology for ascertaining the estimated total costs of stock mutual funds. This methodology is utilized in our firm during our initial screening of stock mutual funds and ETFs. This screening process is in turn part of our due diligence process in evaluating investment alternatives for our clients. In our view, part of an investment adviser's due diligence[4] and ability to add value[5] during the

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[2] Mark Carhart finds that net returns are negatively correlated with expense levels, which are generally much higher for actively managed funds. Worse, Carhart finds that the more actively a mutual fund manager trades, the lower the fund's benchmark-adjusted net return to investors. Carhart, Mark, "On persistence in mutual fund performance," *Journal of Finance* 52, 57–82 (1997). A more recent paper also highlights the important of keeping costs low. "The more rigorous academic studies find that annual expense ratios generally detract from fund performance (see, for example, Elton, Gruber, Das and Hlavka (1993), Gruber (1996), and Carhart (1997)). On average, fund managers are unable to recoup the expenses that funds pay via better performance. Wermers (2000) finds that the underlying equity holdings of equity mutual funds do outperform the market, but that cash drag, annual expenses and transaction costs more than offset this outperformance. These findings suggest that basing fund investment decisions at least partially on fees is wise. Lower cost funds have a smaller drag on performance that active managers must overcome. Taken to their logical conclusion, these results may suggest that index funds, accompanied by the lowest expense ratios in the mutual fund industry, are a more logical long-run investment choice than more expensive actively-managed funds." Karceski, Livingston, and O'Neal, "Portfolio Transaction Costs at U.S. Equity Mutual Funds" (2004), available at http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf.

[3] Professor Ian Domowitz considered the impact of mutual fund transaction costs and provided a hypothetical example of their impact. "Consider, for example, an equally weighted global portfolio of stocks. Over 1996:3 through 1998:3, one-way total trading costs for this portfolio average 71 basis points (bps). If the portfolio turns over twice a year, 285 bps in total costs are incurred. Average annual portfolio return over the period is 1228 bps. On this basis, trading costs alone account for 23 percent of returns." Domowitz, Ian, "Liquidity, Transaction Costs, and Reintermediation in Electronic Markets" (2001), available at http://www.smeal.psu.edu/ebrc/publications/res_papers/2001_04.pdf.

[4] We hope that distribution of this working paper within the investment advisory profession may positively impact upon the due diligence process utilized by other wealth managers to individual clients and assist them in their evaluation of mutual fund and similar products. As noted by Professor Mercer Bullard, President of *Fund Democracy, Inc.* and Barbara Roper, Director of Investor Protection, *Consumer Federation of America*, in a recent letter to SEC Chairman Christopher Cox, "advisers have not consistently been held accountable for considering products' costs when determining whether they are in their clients' best interests. While we certainly do not consider cost to be the only important consideration, it does have a significant long-term impact on investors' returns. For that reason, CFA and Fund Democracy have urged the Commission to make clear that advisers have an explicit fiduciary duty to consider costs when determining what products to recommend." *Letter to Chairman Cox*, September 30, 2005, available at www.funddemocracy.org. Wealth managers, together with other investment fiduciaries such as pension plan trustees and mutual fund directors, should demand more detailed and timely information from mutual fund's investment advisors as to transactions costs. Increased disclosure of transaction costs should lead to lower overall costs relating to investing. Much of the historical success of companies in our capital markets is derived from delivering products at lower costs or providing better quality

investment selection process involves the necessity to ascertain the estimated "total costs" of mutual funds which may be recommended.

Total Costs - "Disclosed Costs," "Hidden Costs," and "Tax Drag." Mutual funds and other collective investment vehicles (such as exchange-traded funds, unit investment trusts, collective funds, and hedge funds) often possess extremely high *total costs*. The "disclosed costs" of mutual funds, which is reflected in the annual expense ratio, is only one part of the total cost of the mutual fund. Other costs - including "hidden costs" and "tax impact" (or "tax drag")[6] can often be much higher than the "disclosed costs" of the mutual fund.

What Are The "Disclosed Costs" of Mutual Funds?

The Annual Expense Ratio. The annual expense ratio of a mutual fund is the total percentage of fund assets used for management and administrative fees as well as distribution fees (12b-1 fees). An annual expense ratio of 1.50% per annum means that each year 1.50% of the fund's total assets will be taken to cover these expenses. The annual expense ratio does not include sales costs or brokerage commissions (such as front-end loads charged for Class A shares, nor deferred contingent sales charges which may be imposed upon Class B shares, as discussed below). Nor does the annual expense ratio reflect the many transaction and opportunity costs a mutual fund incurs, as discussed in this working paper.

Management And Administrative Fees. Management fees are fees that are paid out of fund assets to the fund's investment adviser for investment portfolio management. Administrative fees include custodial expenses, legal expenses, accounting expenses, transfer agent expenses, printing costs and other administrative expenses a mutual fund incurs each year.

A portion of a mutual fund's management fee may be paid to broker-dealers in a practice known as "payment for shelf space." By eating into the fund manager's bottom line, such payments may reduce the likelihood that the management fee will be reduced in response to growth in fund assets.[7] For this and

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products at the same cost. Knowledgeable wealth managers can play an important role in fueling the success of lower-cost mutual fund complexes and, in the process, providing individual investors with a greater share of the returns which the capital markets have to offer.

[5] "A significant portion of the value added by the wealth manager may be attributed to his or her management of ... commissions, bid/ask spreads, market impact ... [and] tax drag." Harold Evensky, CFP®, "Changing Equity Premium Implications for Wealth Management Portfolio Design and Implementation," *Journal of Financial Planning*, June 2002.

[6] We will address the high costs of "tax drag" upon an investment portfolio, and tax-efficient portfolio management, in a later working paper.

[7] Testimony of Travis Plunkett, Legislative Director, Consumer Federation of America, before the Senate Governmental Affairs Subcommittee On Financial Management, the Budget, and International Security, regarding "Mutual

other reasons, revenue sharing arrangements including payment for shelf space have been criticized by consumer protection groups.[8]

12b-1 Fees. Rule 12b-1 was adopted by the SEC in 1980 after a lengthy period in the 1970's in which funds had been losing assets. The rule permitted funds to use shareholder assets, rather than fund company assets, for certain marketing expenses. Under the rule, fees of up to 100 basis points, or one percent, can be charged as part of the fund's annual operating expenses.[9] Class C shares, often referred to as "level load" shares, charge neither a front-end nor a back-end load and instead deduct 12b-1 fees over the life of the investment.

Sales Loads. The traditional load mutual fund (A Shares) sold by stock brokerage firms imposes a commission up front, with the balance invested. The SEC does not limit the size of sales load a fund may charge, but the NASD does not permit mutual fund sales loads to exceed 8.5%. As the dollar amount invested rises to fixed points, called "break points," the applied commission rates may fall.[10] Here is a typical A Share pricing schedule:

Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors." This testimony can be found at http://www.consumerfed.org/pdfs/mf_fee_testimony.pdf.

[8] "[R]evenue sharing payments are often little more than a form of legalized payola ... the price brokers exact from fund companies to ensure access to their customers. Investors receive no benefit. Fund companies that can't or won't make the payments are discriminated against. Only brokers benefit by using their position as gatekeeper to exact additional pay." Comment Letter, dated April 5, 2005, to SEC, from Mercer Bullard, Founder and President, Fund Democracy, Inc.; Barbara Roper, Director of Investor Protection, Consumer Federation of America; Kenneth McEldowney, Executive Director, Consumer Action; and Sally Greenberg, Senior Counsel, Consumers Union, regarding on mutual fund point-of-sale document proposal, available at www.funddemocracy.org.

[9] NASD rules limit the amount of the fee that can be paid to broker-dealers to no more than 0.75 percent of the fund's average net assets for the year. However, an additional 0.25 percent service fee can go to the broker for providing ongoing services to investors or for maintaining their accounts. Hence, it is possible that the entire maximum 1.00 percent 12b-1 fee could be paid to the broker-dealer firm by the mutual fund company.

[10] Some mutual funds that charge front-end sales loads will charge lower sales loads for larger investments. For example, a fund might charge a 5% front-end sales load for investments up to $25,000, but charge a load of 4% for investments between $25,000 and $50,000 and 3% for investments exceeding $50,000. The investment levels required to obtain a reduced sales load are commonly referred to as "breakpoints." In the foregoing example the breakpoints were $25,000 and $50,000. Funds that offer breakpoints can set them at their discretion. The SEC does not require a fund to offer breakpoints in the fund's sales load. If breakpoints exist, however, the fund must disclose them. In addition, a brokerage firm that is a member of the NASD should not sell an individual investor shares of a fund in an amount that is "just below" the fund's sales load breakpoint simply to earn a higher commission. An individual investor may also be entitled to combine previous fund purchase amounts to obtain a breakpoint discount upon a purchase made today, or to obtain a breakpoint discount for an investment today if the investor agrees to make additional purchases in the future. In the latter case the individual investor would sign a "letter of intent" to make additional purchases in the future. Some mutual fund companies also aggregate fund purchases by related family members for purposes of breakpoints.

	Sales Charge as Percentage of:	
Amount of Purchase	Offering Price	Net Amount Invested
Less than $50,000	5.75%	6.10%
$50,000 but less than $100,000	4.75%	4.99
$100,000 but less than $250,000	4.00%	4.17
$250,000 but less than $500,000	2.95%	3.04
$500,000 but less than $1 M	2.20%	2.25
$1,000,000 or more	None	None

Note that fee-only registered investment advisers often get sales loads waived for their clients, regardless of the amount of cash invested into the fund.

Deferred Contingent Sales Charges. Class B shares generally charge a "back-end" load for exiting a fund within 5 to 7 years of purchase. This fee is sometimes referred to as a contingent deferred sales charge (CDSC) or a "surrender charge." The back-end charge typically starts at 5% to 7% of the redeemed assets during the first year of purchase and declines by one percentage point each year until it reaches zero. However, since the broker must be compensated for selling the fund whether or not the investor redeems the mutual fund shares in the first several years, Class B shares often have higher annual expenses, including paying an ongoing 12b-1 fee.[11] After the back-end load expires (5 to 7 years), the 12b-1 fee is no longer deducted from fund assets and the B shares convert to A shares. Brokerage sales practices involving Class B shares received substantial criticism in recent years and were the subject of substantial regulatory fines.[12]

No-Load Funds. Mutual funds that do not charge a sales commission are called "no-load funds." Under NASD rules a mutual fund is permitted to pay its annual operating expenses and still call itself "no-load," unless the combined amount of the fund's 12b-1 fees or separate shareholder service fees exceeds 0.25% of the mutual fund's average annual net assets.

[11] We find that is often in the individual investor's interest to redeem a stock mutual fund which still possesses a contingent deferred sales charge, rather than keeping the fund until surrender charges disappear, for several reasons. First, the ongoing annual costs of the fund may be quite high relative to the costs of surrender and reinvestment in lower-cost securities. Second, the investment in the fund may not have been done tax-efficiently. Third, the fund may invest in securities in an undesirable asset class. Fourth, the fund may be subject to various risks to which the individual investor's portfolio should not be subjected (such as lack of adequate diversification, manager risk, and institutional risk). In essence, an investor should regard the contingent deferred sales charge as already having been paid (which, in most cases, it has - at least as to the brokerage firm which sold the fund), even though such charge is slowly and painfully extracted from the investor in the form of higher fees for the term of the surrender period. Each fund subject to a surrender fee requires an individual analysis, by the fee-only wealth manager, as to the appropriateness and timing of any surrender.

[12] In 2005, the NASD fined six major firms -- Citigroup Global Markets, American Express Financial Advisors (now known as Ameriprise Financial Services), Chase Investment Services, Merrill Lynch, Wells Fargo and Linsco/Private Ledger -- a total of more than $40 million for unsuitable B share and C share sales. NASD ordered the firms to offer customer remediation on more than 400,000 mutual fund transactions made by more than 79,000 households, at a cost potentially greater than the amount of the fines. "NASD: 2005 in Review," PR Newswire, December 27, 2005.

The Two Major Components of the "Hidden Costs" of Mutual Funds: "Transaction Costs" and "Opportunity Costs." We use the term "hidden costs" to refer to all of the costs associated with holding a mutual fund other than sales loads, CDSCs, and the annual expense ratio. We use the description "hidden" given the lack of disclosure of these additional costs in the beginning portion of the vast majority of funds' prospectuses (the part of the prospectus *some* investors might read) and given their complete non-disclosure in mutual fund fact sheets.

The "hidden costs" of mutual funds include several types of costs called "transaction costs," as well as "opportunity costs" an investor may incur due to cash holdings by the mutual fund. Transaction cost management has received increased scrutiny in recent years in connection with a mutual fund investment adviser's duty to achieve best execution. Despite this effort, the "hidden costs" of stock mutual funds can often be quite high.

Portfolio Transaction Costs - "Direct Costs" and "Indirect Costs." Mutual fund portfolio "transaction costs" are the hidden costs which result from trading of securities (stocks, bonds, or futures contracts) by the mutual fund. They include "direct costs" (commissions, commission equivalents, mark-ups and markdowns, and taxes) and "indirect costs" (spreads, market impact costs, and opportunity costs due to delayed or canceled trades). How much trading of securities with stock mutual funds occurs? While some recent estimates place portfolio turnover in domestic stock mutual funds at 100% or greater,[13] a study by the Investment Company Institute (a mutual fund trade organization) reports asset-weighted average annual turnover rate for U.S. stock mutual funds as only 51% in 2004 (which is a decline from a 73% turnover in 2001).[14]

What Are "Direct Costs"? Whenever an individual investor buys or sells stocks, he or she pays a commission to a broker. This is also true for institutional investors, such as mutual funds, as they often have to have a commission too (although it is usually less than what an individual pays). Commissions are fees directly paid by a mutual fund to a broker-dealer for executing a trade, including the processes of accepting and routing the order and clearing the trade. Other direct costs could be indirectly paid for executing a transaction, such as markups, markdowns, commission equivalents or other fees. Markups and markdowns which occur when a broker-dealer sells a stock or other security to a mutual fund out of its inventory, or when a broker-dealer purchases a stock or other security from a mutual fund to add to its

[13] "[B]etween 1950 and 1965, it was a rare year when fund portfolio turnover much exceeded 16%, meaning that the average fund held its average stock for an average of about six years. But turnover then rose steadily and surely and fund managers now turn their portfolios over at an astonishing average annual rate of 110% ...." John Bogle, "The Mutual Fund Industry in 2003: Back to the Future," Remarks by John C. Bogle, Founder and Former Chairman, The Vanguard Group, before the Harvard Club of Boston, January 14, 2003.

[14] Investment Company Institute® *Research Commentary*, "Mutual Funds and Portfolio Turnover," November 17, 2004, available at www.ici.org.

inventory.[15] While commissions and commission equivalents should be discernable by a stock mutual fund and inclusively reported, at times a mutual fund may be unaware of whether a transaction was executed on a principal basis (in which case the cost is disclosed by the broker-dealer to the fund) or a riskless principal basis (in which case the true cost of the trade may not be known to the fund).[16] Nevertheless, the commissions disclosed in the mutual fund's Statement of Additional Information can be utilized as an indication of a mutual fund's commission costs for brokerage services.

The level of commissions paid for the same trades can vary widely from one mutual fund to another. This is because many mutual funds shift certain operational costs from the disclosed management fees to the hidden transaction fees.[17] This occurs under a practice known as "soft dollars," under which a mutual fund permits higher commissions to be paid in return for research services. The use of client commissions to pay for research services presents the mutual fund's manager with a significant conflict of interest, and may give incentives for mutual funds to disregard their best execution obligations when directing orders to different brokers. However, in 1975 the U.S. Congress enacted Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") to provide a safe harbor that protects mutual fund managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive "brokerage and research services" provided by a broker-dealer if the managers determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received. While the SEC recently narrowed the types of services eligible for soft

[15] For some regulatory purposes, such as soft dollar disclosures, the SEC has interpreted the term "commission" to include commission equivalents and other forms of remuneration in certain types of "riskless principal" trades. A "riskless principal" transaction is a "transaction in which a member [broker-dealer], after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell." NASD Rule 4632(d)(3)(B). "Traditional" riskless principal transactions can include an undisclosed fee (reflecting a dealer's profit on the difference in price between the first and second legs of the transaction) and are not subject to the disclosure requirements of NASD Rules 4632, 4642 or 6420. With the decimalization of stock prices, broker-dealers are trading on a riskless principal basis more frequently than when stock prices were fractionalized. As a result, commission equivalents are an increasingly large component of mutual fund transaction costs. *Report of the Mutual Fund Task Force Soft Dollars and Portfolio Transaction Costs*, NASD, November 11, 2004. Although riskless principal trades might appear to be relatively easy to quantify, the true cost of these trades (excluding commissions) reflects the extent to which closing prices might move due to the executing broker's actions. Measuring what might have occurred in the absence of a trade is subject to varying estimates.

[16] *Report of the Mutual Fund Task Force Soft Dollars and Portfolio Transaction Costs*, NASD, November 11, 2004.

[17] A mutual fund company that pays for its own research (either through internal staff or by payments to third party research firms) "must bear the cost from its own capital and charge a management fee that makes the cost explicit to investors. Consequently, a fund has an incentive to outsource services in a manner that keeps the cost unobservable to investors. This is accomplished through the trading process. Institutions can legally fund the most basic aspects of their operations out of client assets by paying higher trading commissions, and receiving non-trade related services from the intermediary as a form of 'rebate.'" Robert A. Schwartz and Benn Steil, "Controlling Institutional Trading Costs," *Journal of Portfolio Management* (Spring 2002).

dollar payments,[18] higher commissions for trades are still paid by many mutual funds. A recent positive development, from the standpoint of mutual fund investors, has been a trend toward the "unbundling" of trade execution and research purchases.[19]

Commission rates also vary by market (i.e., by country). For example, agency commissions on equity trades in the UK and Japan average a relatively modest 13 basis points, but agency costs skyrocket in emerging markets such as Korea (33 basis points) and Poland (50 basis points).[20]

What Are "Indirect Costs"? While total direct costs are relatively easy to quantify, indirect portfolio transaction costs, including bid-ask spreads, market impact costs, and opportunity costs (due to delayed or canceled trades), are far more difficult to measure.[21] In fact, industry participants who are responsible for

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[18] SEC Release No. 34-52635, *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934* (October 18, 2005).

[19] ITG "Investor Overview" presentation, December 2005. Some firms may be foregoing soft dollars in the future. "Fidelity Investments struck a deal with Lehman Brothers recently to pay for Lehman's research with its own hard-earned cash rather than that of its millions of small investors. It is pursuing similar deals with other brokers. As part of its campaign, Fidelity has also publicly egged on its many competitors to do the same and use commissions strictly for executions. Fidelity's move to decouple its payments for research from those for executions was not a complete surprise to those in the trading industry. The buyside gorilla had declared its willingness to unbundle in a letter to the SEC just last year ... 'I think there is a very good chance that the rest of the industry will follow Fidelity's lead,' said Ken Worthington, a securities industry analyst with CIBC World Markets." Gregory Bresiger, "Unbundling Looms," *Traders Magazine* (January 2006).

[20] Proszek, Stan, "Transition Management: Simple - But Not Easy," *Benefits and Pensions Monitor* (October 2002).

[21] "The disclosure [of transaction costs] must not only ... measure the cost of conventional limit and market orders, but also of volume-weighted-average-price (VWAP) orders, market-on-close (MOC) orders, basket trading, stop-loss orders and other modern methods of portfolio management, including orders that are hedged in the options or futures markets and orders that arbitrage between equities and derivatives markets ... For many securities (notably many international equities and both US and foreign debt securities), there simply is no continuous two-sided firm-quote data available about the relevant securities. Most if not all of the proposed methods of quantifying spread costs, market impact costs, and opportunity costs are useless if there is no continuous quotation data (or if the available quote data consists merely of non-firm 'invitations to deal' that are often far from actual transaction prices). For many order types, such as VWAP or market-on-close trades (or stop orders), the concepts of trade decision time and trade execution time at best are difficult to apply. Even in the US equities markets, there is rarely reliable, firm depth-of-book quote data available beyond a thin National Best Bid or Offer (NBBO) which is virtually irrelevant to institutional-sized orders ... In short, there is no 'silver bullet' that will allow an easy quantification of transaction costs in a way that would be comparable among all the different types mutual funds. If the Commission were going to go down that path, it would have to develop and constantly modify specific rules for every possible asset class (Argentine high-yield corporate debt, Slovakian sovereign debt, Turkish equities, Chinese/Hong Kong dual-listed securities, etc.) and, within each market, for each order type. ... Even where the data is most available (for example, the market for US large-cap equities), different experts will assess differently the costs of an order ... In sum, transaction cost measurement is an art, not a science - and pretending that it is a quantifiable science would mislead investors, not enlighten them. A whole industry exists in the US to assist institutional investors in measuring transaction costs, and no two players in this industry come up with the same answers ... Just because transaction costs are difficult to measure does not mean they do not have a real and important impact on investors - they do ...." Comments of W. Hardy Callcott, former Assistant General Counsel for Market Regulation, dated January 30, 2004, to the SEC's "Request for Comments on

analyzing these costs for their firms disagree about which measure is most accurate for the various costs.[22] Spread, impact and opportunity costs, sometimes collectively called "implicit costs," can often greatly exceed the explicit commission costs resulting from trading securities.

Bid-ask spreads. Bid-ask spreads are the difference between the bid and the ask for a security at a given time, where the ask is the highest price anyone wants to pay for the security at a given time, and the bid is the lowest price anyone wants to sell the security for at a given time. The simplest way to convince yourself that this spread is a cost is to consider the following scenario: you buy a stock, then turn around and sell it immediately. Since these transactions are simultaneous, the actual price of the stock is presumed constant, but you still lose the spread on the transaction.

The bid-ask spread is, in theory, designed to cover three types of costs or risks The first is the risk and the cost of holding inventory; the second is the cost of processing orders; and the final cost is the cost of trading with more informed investors. The spread has to be large enough to cover these costs and yield a reasonable profit to the market maker on his or her investment in the profession. Bid-ask spreads are greater for companies with smaller market capitalization than for firms with larger market capitalizations, as demonstrated in this table:

Market Cap Range ($Millions)	Names	Daily Trading Volume		**Bid/Ask Spread**
		Shares (mm)	Value ($mm)	
18,157 - 282,290	100	7.45	277.71	**0.07**
2,826 - 18,157	400	1.88	49.58	**0.08**
1,118 - 2,826	500	0.63	11.79	**0.15**
353 - 1,118	1,000	0.30	3.59	**0.28**
138 - 353	1,000	0.08	0.69	**0.56**
0 - 138	2,387	0.04	0.12	**3.24**

Measures to Improve Disclosure of Mutual Fund Transaction Costs," available at http://www.sec.gov/rules/concept/s72903/whcallcott013004.htm.

[22] "[T]here is no generally agreed-upon method to calculate securities transaction costs." SEC Rel. No. IC-26313 (Dec. 18, 2003), 68 Fed. Reg. 74819 (Dec. 24, 2003). Moreover, mutual fund transaction costs vary from one mutual fund company to another. The Plexus Group reports many of the best mutual fund companies have pursued trade cost-reduction programs to the benefit of the investors, often reducing total transaction costs by up to 40% over a two-year period. Testimony of Wayne H. Wagner, Chairman, Plexus Group, before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (March 12, 2003), available at http://financialservices.house.gov/media/pdf/031203ww.pdf.

Source: www.ifa.com, quoting Dimensional Funds Advisors presentation,
utilizing data from Bridge Trading Systems, April 16, 2003.

Bid-ask spreads for mutual funds and other institutional investors appear to have declined since the adoption of decimalization and 1-cent ticks. The General Accounting Office found that total trading costs declined by about 53 percent for NYSE stocks, falling from about 33 cents per share in early 2001 to about 15.5 cents in 2004. For NASDAQ stocks, the decline was about 44 percent, from about 25.7 cents to about 14.4 cents.[23] However, other factors may have contributed to the decline in bid-ask spreads, such as increased attention to transaction costs by mutual funds and the reduction of momentum trading in stocks following the bursting of the tech stock market bubble in 2000-2002. Also, there is some evidence that while bid-ask spreads have declined other implicit costs for mutual fund investors have increased.[24]

Market Impact. Market impact costs result from the effect of a large trade triggering a move in the price of the stock to the moment of trading from the price that would have prevailed had the trade not occurred. When a mutual fund buys a large quantity of shares, the mutual fund has to pay a price higher than the market price at the time of the purchase. Thus, the mutual fund is said to "move the market," as its trade has an impact on the market prices. Obviously "large" is a relative term. For a stock on the Nasdaq exchange that does not trade very often, an order to buy a few thousand shares is "large," while for a stock like General Electric an order to buy a million shares is “large.” Due to the adverse effect of market impact, institutional investors tend to spread their orders over a few days or even weeks, breaking their trades up into smaller packets. Nevertheless, market impact costs still result.[25]

[23] GAO Report #05-535, “Securities Markets: Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment” (July 1, 2005). The GAO report stated that 15 of 23 institutional investors interviewed reported lower trading costs, while 5 reported that they stayed about the same. However, the report also noted that after decimal pricing and the 1-cent tick were implemented in 2001, the volume of shares shown as available for sale—or displayed depth—on U.S. stock markets declined significantly. “[T]he reduction in tick size reduced incentives to large-order investors to display their trading interest. Since the implementation of penny ticks, market participants said that displaying large orders is less advantageous than before because other traders could now submit orders priced one penny better and execute these orders ahead of the larger orders. This trading strategy, called ‘penny jumping’ or ‘stepping ahead,’ harms institutional investors that display large orders and can increase their trading costs.” GAO Report at pp. 34-35.

[24] “We find that trading costs of index funds were unchanged following the two reductions in tick size. In contrast, we find that trading costs of actively managed funds increased both times. Over the five months following the switch to sixteenths, actively managed funds experienced an increase in trading costs equal to 0.157 percent of fund assets. Over the five months following the switch to decimals, the increase was 0.502 percent. Rather than help the small individual investor, as decimalization’s proponents envisioned, decimalization appears to have levied an indirect but important cost in the form of lower mutual fund returns.” Bollen, Buse, *Tick Size, Trading Costs, and Mutual Fund Performance*, p. 6 (2004).

[25] “Large institutional orders are sensitive to market depth for at least two reasons. First, filling a large order may take several days and multiple transactions; hence a large order likely suffers price concessions as market depth is consumed. Second, information leakage may move prices adversely as the institutional investor attempts to fill the order.” Bollen, Busse, *Tick Size, Trading Costs, and Mutual Fund Performance*, fn. 8 (2004).

Why is there "market" or "price" impact? As stated by Professor Aswath Damodaran:

> "There are two reasons for the price impact, when investors trade. The first is that markets are not completely liquid. A large trade can create an imbalance between buy and sell orders, and the only way in which this imbalance can be resolved is with a price change. This price change that arises from lack of liquidity, will generally be temporary and will be reversed as liquidity returns to the market. The second reason for the price impact is informational. A large trade attracts the attention of other investors in that market because if might be motivated by new information that the trader possesses. Notwithstanding claims to the contrary, investors usually assume, with good reason, that an investor buying a large block is buying in advance of good news and that an investor selling a large block has come into possession of some bad news about the company. This price effect will generally not be temporary, especially when we look at a large number of stocks where such large trades are made." [26]

Costs of Delayed or Canceled Trades. Opportunity costs due to delayed or canceled trades refers to the effect of "not owning what you want to own." In trading terms, this type of opportunity cost is the net result (positive or negative) of price movements that occur when execution is delayed. The longer a portfolio transition (i.e., the sale of one security, and the purchase of another) takes, the higher the cost. As time passes, at some point the rising opportunity cost more than offsets the benefits from reduced market impact.

Taxes and Exchange Costs. Taxes and exchange fees can mean extra non-negotiable costs, depending on the market. For example, stamp duties add another 50 basis points to United Kingdom share purchases. We do not address these costs in this working paper, as we concentrate on U.S. stock mutual funds.

Opportunity Costs Due to Cash Holdings. Equity mutual funds hold cash for several purposes. First, funds hold cash to meet shareholders' redemption needs. One of the defining features of open-ended mutual funds is that they are required by law to redeem shares on a daily basis. If investors redeem their fund shares in droves, funds without enough cash on hand have to sell stocks (or borrow cash) to meet these redemptions. Therefore, the primary benefit of holding cash in a mutual fund is to reduce trading costs.

Cash may also be accumulated to pay management fees and other expenses and to make dividend and capital gain distributions. In addition, cash may be accumulated as a result of market timing activities (i.e., an expected drop in prices) or due to fund management delay in identifying appropriate opportunities for investment. Unit investment trusts are not permitted to reinvest stock dividends received during a quarter, as unit trusts accrue cash dividends for the stocks in the trust and pay dividends (less trust

[26] Aswath Damodaran, *Investment Philosophies* (Chapter 5, p. 10) (2002).

expenses) on a calendar quarter basis; this can lead to another means of cash accumulation in certain types of stock mutual funds and certain forms of exchange-traded funds.

In addition, cash holdings to an investor result from dividend and capital gain distributions. Mutual funds go "x-dividend" on a certain date, but the cash is not actually paid to the investor until a later time - days or weeks later. The extend time for payment of dividend and capital gain distributions can even cross calendar years, as occurred during 2005-6 with Vanguard's VIPERS, Barclay's iShares and other exchange-traded funds.

The primary cost of either a mutual fund holding cash (or a dividend or capital gain distribution being undertaken but not yet available for reinvestment) is the opportunity cost inherent in not being invested in stocks or bonds, as the mutual fund's strategy dictates. Wermers (2000) estimated that cash and bond holdings lower the performance of an average equity fund by 70 basis points per year over the period from 1975 to 1994.

How Can Mutual Funds Reduce Transaction Costs? Mutual funds can reduce transaction costs in a variety of ways.

Extremely Low Turnover. Mutual funds which adopt a portfolio design and trading rules permitting extremely low trading within the fund can most effectively reduce transaction costs. It is self-evident that the lowest cost of trading results from "no trade" occurring at all.

Minimizing Fund Inflows and Outflows. Fund policies which discourage cash inflows and outflows can minimize the need to either acquire additional securities or dispose of existing securities, other than needs driven by portfolio management decision-making. Some mutual funds impose redemption fees for a period of time, such as for several months or a year, to discourage short-term investors from entering and leaving the fund. Other mutual funds permit access to their funds only for institutions or through wealth managers who have been granted access[27] and who have tacitly agreed to forego portfolio management strategies such as market timing (including but not limited to certain tactical asset allocation strategies) in order to minimize mutual fund cash inflows and outflows.

Crossing Opportunities. Mutual funds can also seek to lessen trading costs by taking advantage of crossing opportunities, which arise when two different mutual funds desire to purchase or sale the same

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[27] For example, Dimensional Funds Advisors' mutual funds are available to retail investors in two ways - through fee-only investment advisers (www.dfaus.com/find_advisor) or through several major 401(k) plans. Paul Herbert of Morningstar stated that such limited access "is an advantage for fund shareholders because DFA does not 'have to deal with finicky flows' into and out of its funds, which can hurt liquidity and returns." Isentein, Howard, "Reading the Index To Beat the Index," The New York Times (Jan. 11, 2004).

security, either within the same mutual fund complex or externally (using crossing networks[28]). In particular, transferring securities "in-kind"from one fund to another within the same complex can save a mutual fund both commissions (plus any taxes or stamp duties, in some markets) and bid-ask spreads on both sales and repurchases.

Trading Desk Expertise. Investments in technology and the utilization of consulting services can secure for many mutual funds an improvement in trading costs. In addition, trading desk managers or broker-dealer firms may be provided incentives to execute orders within the bid or ask prices.

Patient Trading. Market impact costs decline rapidly from their maximum level as a trade is worked over longer periods of time. Hence, for many mutual funds it is often advantageous to be patient when working a large trade. In most instances agency trading (as opposed to principal trades) is preferable, taking advantage

of natural liquidity in the market. Furthermore, extending the trading horizon by parceling trades into smaller orders can significantly reduce the adverse price effects of market impact.[29] However, as the time to completion of an order increases the transaction costs associated with delayed trades can increase. In some instances hedging, if permitted by a mutual fund's prospectus, can afford a degree of protection to the portfolio against risks in price fluctuations while a position is being unwound or accumulated.

Use of Futures Contracts. Futures and currency forwards may be used to convert cash balances into more continuous equity exposure in a given asset class, in order to provide for a reduction in the opportunity costs due to cash holdings.

Block Discount Purchases. Some mutual funds may seek to undertake block purchases of needed securities at a discount to the exchange's market price of the security.[30] This can lead to negative

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[28] For example, ITG's POSIT crossing systems give buyers and sellers opportunities to match equity orders with confidentiality, access to diverse liquidity pools, zero market impact, and the cost savings of midpoint pricing. Instinet, Liquidnet, Harborside, POSIT, and Jefferies are among many extensively used crossing systems. The use of these systems, which provide anonymity as to the number of shares desired to be sold or purchased, can reduce market impact costs.

[29] This is especially true after the adoption of decimilization and penny ticks in the exchanges. "One of the ways that institutional investors have adapted their trading strategies to continue trading large orders is to break up these orders into a number of smaller lots. These smaller orders can more easily be executed against the smaller number of shares displayed at the best prices. In addition, not displaying their larger orders all at once prevents other traders from stepping ahead." GAO Report #05-535, "Securities Markets: Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment" (July 1, 2005), at p. 37.

[30] Such trades often occur in the "third market" or, more recently, also in the "fourth market." The "third market" in securities refers to OTC transactions in a security that is also traded on an organized exchange. Institutional investors often trade large blocks of stock in this market. Negotiated fees are typical in this market. The "fourth market" in securities refers to transactions that occur directly between a buyer and a seller of a large block of securities. In the fourth

transaction costs for some purchases, which in turn can substantially reduce the trading costs of a mutual fund (even to the point of contributing to the fund's performance).[31]

Once mutual funds have been screened by wealth managers to narrow down the potential funds for utilization in clients' portfolios, the wealth manager should question each mutual fund's investment adviser as to the methods employed by the fund to minimize trading costs. Additionally, the investment adviser should ascertain whether assessments of transaction costs have been undertaken by the fund's investment adviser or its Board of Directors.[32]

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market, brokers and dealers are eliminated. A wire network provides current information subscribers are willing to buy or sell at specified prices.

[31] Block purchasing at discounted prices works most effectively in markets in which liquidity is not present relative to the size of the desired trades, such as that existing for U.S. micro cap stocks. Professor Donald Keim described Dimensional Funds Adviser's ability to garner negative trading costs as follows in a 1998 paper: "The trading strategy is best described as a patient one and is well suited to the illiquid small-cap market. Trade programs are worked patiently by brokers, and are often broken up over several days with instructions to trade inside the spread, buying close to the bid price or selling close to the ask. DFA also participates in the upstairs market for large-bloc trades, effectively playing the role of market maker by standing ready to take the opposite side of seller-initiated blocks that are on DFA's buy list. Thus, DFA is effectively operating as a supplier of liquidity and, as such, should enjoy reduced trading costs. The evidence confirms this: trading contributes 5 basis points per month, gross of fees, to the performance differential [of the DFA9-10 Fund, now called the DFA U.S. Micro Cap Portfolio] during the 1982-95 period. This positive contribution is attributable to the latter portion of the Fund's history: After 1986, a period when at least half of the trading volume in each year was completed using lower-cost block trades, the trading contribution was a significant 17 basis points per month (T - 2.30). Seventeen basis points per month is economically large; it is remarkable when compared to the average *reduction* in value of 1.92% associated with the one-way trade costs of comparable NYSE and AMEX small-stock trades for a sample of institutional money managers in Keim and Madhavan (1997)." Keim, Donald B., "An Analysis of Mutual Fund Design: The Case of Investing in Small-Cap Stocks" (Feb. 1998), available at http://knowledge.wharton.upenn.edu/PDFs/136.pdf.

[32] Funds can seek to measure the amount of transaction costs, either internally or through the use of consultants. Of the many yardsticks to measure trading efficacy at the security-level, VWAP (volume-weighted average price) is the most widely accepted. Grounded in basic statistics, VWAP has the merit of simplicity. Add up the dollars traded for each transaction (price times shares traded) and then divide by the total shares traded for the day. Generally, a purchase below VWAP is 'good,' whereas one above VWAP may not be. Other common transaction benchmarks include previous-day-close and averages of high-low or open-close prices. Historically, transaction cost analysis (TCA) was the providence of specialist firms such as Abel Noser, Elkins McSherry (now State Street), the Plexus Group (acquired from JP Morgan Chase by ITG), the Quantitative Services Group and GSCS Information Services. Today, many brokers and their (algorithmic) trading strategies typically incorporate their own TCA services, and many fund managers have been utilizing these systems or developing their own TCA systems. A 2004 survey conducted by The Tabb Group, a financial markets' consulting firm, of more than 50 head and senior traders at institutional investor firms reported that over 60 percent of these firms were using algorithmic trading vehicles. The Tabb Group, "Institutional Equity Trading in America: A Buy-Side Perspective" (Westborough, Mass.: April 2004), 32. Additional information on algorithmic trading strategies appears in Madhavan A., "The Trading Revolution: navigating the brave new world of algorithmic execution," *Barclays Global Investors Investment Insights* (July 2005).

The Market Impact Costs of Commercial Index Funds. Index funds and exchange-traded funds (ETFs) are attractive at first blush to investors given their relatively low disclosed costs (in most instances) and their consistent long-term average performance advantage over the average performance of actively managed stock funds.[33]

The S&P 500 Index provides the basis for the largest class of mutual funds. With over $100 billion invested in S&P 500 Index funds, many institutions' and individuals' portfolios are grounded and diversified by these funds. Index fund managers' stated goals are to replicate the S&P 500 (minimizing tracking error), limit expenses and alleviate tax responsibilities. However, high costs from bid-ask spreads and market impact can result during the "reconstitution" of the underlying S&P 500 index. For other funds tracking different commercial indices, reconstitution can force even higher costs.

Index reconstitution, which occurs periodically (sometimes once a year, sometimes more often) on pre-announced dates, is necessary because underlying stocks cease to meet the index's criteria for inclusion, or because of major corporate events such as mergers, liquidations, bankruptcy, or delistings from an exchange.

As a result of index reconstitution, a "forced turnover" of stocks within the fund occurs. This is reflected in index fund average turnover rates, estimated as follows for the period of 1998-2003:

S&P 500 index	4.6%
S&P 500 / Barra Value:	26.1%
Russell 2000:	47.6%
Russell 2000 Value:	41.7%

The consequences of multiple mutual funds tracking the same index and being forced to buy and sell certain publicly identified stocks, all within a short period of time, can be quite dramatic. This is because of the vast amounts of monies now tied to specific indices. It was estimated in 2002 that more than 10% of the market cap of the S&P 500 companies was held by S&P 500 index funds, while 6% of the market cap of the companies in the Russell 2000 index was held by funds tied to that index.

[33] "SPIVA shows that longer-term results are consistent with past results. Over the past three years, the S&P 500 has outperformed 61.9% of large-cap funds, the S&P MidCap 400 has outperformed 70.4% of mid-cap funds, and the S&P SmallCap 600 has outperformed 71.4% of small-cap funds. Similarly, over the past five years, the same indices have outperformed 65.4% of large-cap funds, 81.3% of mid-cap funds and 72.4% of small-cap funds … Srikant Dash, Index Strategist at Standard & Poor's [recently stated] … "[T]here is consistency in the longer time horizons, with indices persistently outperforming a majority of active funds over horizons such as three or five years." Press Release, "S&P Releases Year End Index Versus Active Fund Scorecard," January 2006. While there is substantial debate regarding active versus passive management strategies, and substantial academic evidence supporting the average outperformance of passive funds over actively managed funds, a review of the literature on this subject is beyond the scope of this working paper.

Not all indexes are the same, however, in how they are constructed and reconstituted. In contrast to the closed door approach adopted by S&P in adding companies to an index, the Russell indexes are passively formulated. The Russell web site states that "we don't pick the stocks in the Russell indexes — the market does." Such an approach arguably leads to greater arbitrage opportunities as the date for reconstitution approaches. Various indices are reconstituted at different times (such as monthly, quarterly, semi-annually, or annually). Additionally some indices are not currently tracked by a large number of mutual funds and ETFs (one of the reasons behind the switch of many of Vanguard's stock index funds to the MSCI index, as a means of reducing transaction costs during reconstitution).

Various academic studies have estimated the adverse impact to investors from reconstitution of indexes for funds tied to the S&P 500 index (an index of U.S. large company stocks) and for funds tied to the Russell 2000 index (an index of U.S. small company stocks), as seen in the following table:

Study	**Annual Loss to Investors from Index Reconstitution**	
	S&P 500 Index	Russell 2000 Index
Chen, Noranhu, and Singal, "Index Changes and Unexpected Losses to Investors in S&P 500 and Russell 2000 Index Funds" (2004, 2005)	0.03% to 0.12%	1.30% to 1.84%
Gastineau, "Equity Index Funds Have Lost Their Way," *The Journal of Portfolio Management*, Winter 2002, p. 59 [34]	0.50% to 1.00%	2.00% to 3.00%

Various measures have been undertaken to attempt to minimize these costs of reconstitution. Some index funds now employ a multi-day trading strategy and avoid trading on the rebalance day.[35] As noted by Gary L. Gastineau, "The evidence is strong that trading at most times other than the official moment of index adjustment should improve investors' results with most popular indexes. Many ETF managers are

[34] "In the case of the benchmarks, the 50 to 100 basis point estimate for the S&P 500 and the 200 to 300 basis point estimate for the Russell 2000 are rough estimates for recent annual transition/transaction costs for funds based on these indexes. Trading costs to modify and rebalance S&P 500 portfolios probably exceeded 100 basis points in 1999 and ran closer to or even below a 50 basis point annual rate for the first nine months of 2001. The actual transaction costs may average higher than the estimates if index managers underestimate the importance of market impact on both sides of an index fund internal reconstitution transaction." Gastineau, "Equity Index Funds Have Lost Their Way," *The Journal of Portfolio Management*, Winter 2002, p. 59, available at www.etfconsultants.com.

[35] The adoption of such a trading strategy partially explains the performance of the DFA U.S. Large Company Portfolio during 2005. For the year the fund returned 4.85% to investors, just 0.06% less than the 4.91% performance of the S&P 500 Index during the same period. This is despite the fact that the fund has a 0.15% annual expense ratio. Similarly, since 1998 Vanguard appears to have been willing to accept tracking error in order to enhance returns of its 500 Index Fund. *See* Blume, Edelen, "On Replicating the S&P 500 Index" (2002). The Vanguard 500 Index Fund (Investor Shares), with an annual expense ratio of 0.18%, had a 5-year return of 2.24% for the period ending 2/28/06, versus the S&P 500 Index return of 2.36%.

simply reluctant to depart from slavish replication of index changes."[36] For index fund and ETF managers willing to seek reduction in expenses relating to reconstitution, there are several consultants in the field now known as "transition management," such as "Mellon Transition Management Services."

ETFs As A Slight Improvement Over Index Funds. Note that ETFs may improve on the index fund concept, but only slightly. One advantage that ETFs possess over open-ended stock mutual funds relates to cash holdings. Almost all index funds have cash holdings, although they are generally small - less than 1% of the value of the portfolio's assets. By contrast, ETFs normally hold almost no cash since they aren't faced with redemption calls by investors. Cash earns a money market return, which is less than the expected return on the benchmark. When the actual return on the benchmark exceeds (or falls short of) the money market return, the replicating portfolio will earn less (or more) than the benchmark – and there will be tracking error. Another advantage of ETFs (which relates somewhat to the issue of low cash holdings) arises from the manner in which ETFs are created and redeemed. In essence, a conventional mutual fund must accommodate entering and departing shareholders (which can lead to additional transaction costs), while ETFs do not. Additionally, ETFs should be more tax-efficient that open-ended stock mutual funds, as the unrealized gains (or losses) on assets exchanged for redeemed ETF shares disappear's from the fund's tax accounting. Nevertheless, ETFs still suffer from transaction costs incurred during index reconstitution.

Consider A Broad Market Index Fund. A broad market index fund, such as a fund that tracks the Wilshire 5000 Index or Russell 3000 Index, should possess less trading due to reconstitution and hence less transaction costs. In essence, the fund would not need to undertake changes in the underlying stock portfolio due to changes in either the stock's market capitalization or the stock's value/growth characteristics. However, portfolio managers seeking exposure to select asset classes will need to venture into other funds, as U.S. market-wide index funds closely track the U.S. large company blend asset class.

A Solution - Funds Which Track "Silent Indices." Most indices were designed to serve as benchmarks against which active managers' performance could be judged, not serve as investment vehicles. Future years may see the development of mutual funds and ETFs which track "silent indices."[37] While

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[36] Gastineau, "The Benchmark Index ETF Performance Problem," *The Journal of Portfolio Management*, Winter 2004, p. 101, , available at www.etfconsultants.com. The reluctance of index fund managers to trade at other dates relates to their desire to minimize tracking error. "[T]he alternative of trading at the open following the announcement of a change, rather than when the change occurs, results in 25.9 basis points more return per year with virtually no incremental variance. If investment principals knew in advance of these additional returns, they may nonetheless have rationally chosen to forgo such added returns to better monitor their agents. The early-trading strategy has much higher tracking errors than the 2.7 basis-point average of the largest indexer." Blume, Edelen, "On Replicating the S&P 500 Index" (2002).

[37] "The greatest weakness of the current generation of index funds is that the benchmark indexes they use as templates are created and published for other purposes. Consequently, anyone can buy stocks added to the index or sell stocks removed from the index in competition with the index fund. No active fund manager would accept an investment process that would tell the world what trades her fund would make and approximately when it would make them. With

development of such "silent index funds" may be thwarted by SEC policies which promote separation of ETF providers and the index manager,[38] already some no-load, no 12b-1 fee passively managed funds exist in many of the stock asset classes which may be desirable for use in clients' investment portfolios. These low-cost mutual funds utilize, in essence, their own "private index" and are designed and engineered to minimize portfolio turnover and hence, transaction costs.[39]

An Even Better Solution? - "Personal Index Funds." Wealth managers can avoid the need to construct portfolios with funds from distinct asset classes, while still gaining exposure to the Fama-French "small cap" and "value" factors,[40] by seeking out funds which are constructed to provide a relatively consistent degree of exposure to such styles. Since the funds would be broad-based (but tilted in their holdings toward small-cap and value stocks), trading should be minimized within the fund.[41]

Why Are Transaction Costs Not Included In A Mutual Fund's Expense Ratio? Transaction costs are not included in a fund's expense ratio because accounting principles dictate that they are either included as part of the cost basis of securities purchased or subtracted from the net proceeds of securities sold. Despite

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Silent Indexes, index funds can achieve the same kind of trading confidentiality that actively-managed funds enjoy … The Silent Index fund is superior to an index fund based on a benchmark index because benchmark index funds incur unnecessary transaction costs. The multiple licensees of benchmark indexes, together with speculators and other investors who acquire knowledge of benchmark index changes, impose a transaction cost penalty on funds using benchmark indexes. These funds are forced to make portfolio changes amid a flurry of market activity caused by the announcement of changes to an index – and are often forced to buy high and sell low during the blizzard of rebalancing and related speculation. Transaction costs associated with index changes are increasingly embedded in the benchmark index's performance." Gastineau, "Silence is Golden: The Importance of Stealth in Pursuit of the Perfect Fund Index," *Journal of Indexes* (2002).

[38] Lazarra, Craig, "Index Construction Issues for Exchange-Traded Funds," presentation at Hofstra University, May 5, 2003.

[39] Dimensional Funds Advisors (DFA), highly regarded in polls of independent investment advisers for its close attention to minimizing transaction costs and other attributes, is an example of a fund company which runs its own "private indices." An indication of their trading strategies can be discerned from this statement, taken from the public portion of their web site (www.dfaus.com): "Dimensional uses its capacity, reputation, and trading expertise to take advantage of the lower liquidity of the small company marketplace. Whenever possible, we provide a fair price to sellers who are willing to accept a discount for faster execution on large blocks of stocks. Historically, our average block purchase price is 3% below the next day's closing price, which directly results in higher investment returns for clients. For large companies, we also exercise patience. Because Dimensional does not index, we can pick the best trading opportunities. Our hold range further reduces portfolio turnover and trade costs for all strategies."

[40] The utilization of the Fama-French factors in portfolio construction is beyond the scope of this article. The reader is directed to Professor Jim Davis' paper, "Explaining Stock Returns: A Literature Survey" (2000), as a starting point. The paper is available at http://library.dfaus.com/articles/explaining_stock_returns/.

[41] DFA's relatively new "Core Equity" and "Vector Equity" strategies are designed to further reduce trading costs, as the "Fact Sheet" for one such fund notes: "Owning a core portfolio reduces reliance upon asset class strategies and provides targeted factor exposure that can result in lower overall operating expenses and rebalancing costs. A smoother and broader exposure also reduces trading costs and capital gains caused by style drift or the reconstitution of indexes."

calls by various industry and consumer groups, the SEC does not currently require adequate disclosure of mutual fund transaction costs.[42] In our view consumers are misled about mutual fund costs currently; even an admittedly imperfect estimate of total mutual fund costs is better than non-disclosure of same. In the interim, the wealth manager possesses the opportunity, through due diligence, to add value through careful analysis of mutual funds and their disclosed and hidden costs.

What Are the Average Total Costs of U.S. Stock Mutual Funds? Combining data from various sources, we provide the following table of the estimated average total costs of U.S. stock mutual funds, categorized by style category. As expected the total annual expense ratios for small-cap funds are generally higher than those of mid-cap funds, which are in turn substantially higher than large-cap funds. The following estimates of total mutual fund costs compare favorably to other industry estimates. For example, John Bogle stated that "it's fair to estimate that the all-in annual costs of mutual fund ownership now runs in the range of 2½% to 3% of assets."[43] The Plexus Group estimates average trading costs for U.S. stocks as follows: commissions - (17 bp; market impact costs - 34 bp; delays in trading - 77 bp, and missed trades - 29 bp, for total transaction costs of 157 bp, or 1.57%. Such a level of transaction costs, when added to our estimate of average expense ratios for mutual funds of 0.77% to 1.38% (depending upon style), would also yield approximate mutual fund total annual costs of 2.5% to 3%.[44]

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[42] The NASD's Mutual Fund Task Force reported its concern "that many investors may not appreciate the impact of portfolio transaction costs on fund performance. In many cases, this impact may be significant." *Report of the Mutual Fund Task Force Soft Dollars and Portfolio Transaction Costs*, NASD, November 11, 2004. In late 2003 the SEC issued a Concept Release entitled "Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs," Release Nos. 33-8349, 34-48952, and IC-26313. However, the SEC has yet to incorporate additional disclosure of transaction costs into its Proposed or Final Rules.

[43] Statement of John C. Bogle, Founder and Former Chief Executive of the Vanguard Group and President of the Bogle Financial Markets Research Center, Before the United States Senate Committee on Banking, Housing, and Urban Affairs, February 26, 2004, available at http://banking.senate.gov/_files/bogle.pdf.

[44] The Plexus Group reported a substantial drop in overall transaction costs for U.S. large cap stocks between 2001 and 2004, noting the following costs for the "large cap" U.S. stock category in 2004: commissions: 0.14%; market impact: 0.17%; delayed and canceled trades: 0.30%; canceled or missed trades: 0.14%. This 2004 revised total transaction cost amount of 0.77% compares favorably to the total transaction costs shown in the table above for LCG (1.05%), LCB (0.61%), and LCV (0.64%). "Trading Costs-International," a presentation by Wayne H. Wagner, Chairman, Plexus Group, Inc., a business division of JPMorganChase, at the BankReFlow Symposium, Squaw Valley, February 6-8, 2005.

ESTIMATED AVERAGE TOTAL COSTS OF MUTUAL FUND BY STYLE CATEGORY								
Morningstar Style Category	Annual Expense Ratio, Mean Weighted by Net Assets [1]	Brokerage Comm-issions, Mean Weighted by Net Assets [1]	Bid-Ask Spreads, Mean Weighted by Net Assets [1]	Market Impact Costs [2]	Costs of Delayed and Canceled Trades [3]	Oppor-tunity Costs Due to Cash Holdings[4]	Total Estimated Costs	Estimated Mean Portfolio Turn-over[5]
U.S. Large Cap Growth	1.17%	0.24%	0.24%	0.16%	0.41%	0.40%	2.62%	101.3%
U.S. Large Cap Blend	0.77%	0.10%	0.10%	0.11%	0.30%	0.45%	1.83%	72.3%
U.S. Large Cap Value	0.87%	0.13%	0.11%	0.11%	0.29%	0.44%	1.95%	69.6%
U.S. Mid Cap Growth	1.38%	0.40%	0.67%	0.27%	0.68%	0.40%	3.80%	136.4%
U.S. Mid Cap Blend	1.14%	0.22%	0.31%	0.18%	0.45%	0.48%	2.78%	90.9%
U.S. Mid Cap Value	1.12%	0.23%	0.28%	0.17%	0.44%	0.45%	2.69%	87.7%
U.S. Small Cap Growth	1.28%	0.37%	1.13%	0.29%	1.09%	0.12%	4.28%	120.4%
U.S. Small Cap Blend	1.00%	0.20%	0.67%	0.21%	0.80%	0.55%	3.43%	88.2%
U.S. Small Cap Value	1.17%	0.23%	0.51%	0.16%	0.61%	0.64%	3.32%	67.5%

[1] Data on annual expense ratios, brokerage commissions, and bid-ask spreads is derived from Karceski, Livingston, and O'Neal, "Portfolio Transaction Costs at U.S. Equity Mutual Funds" (2004), in a study sponsored by the Zero Alpha Group, and is generally based upon an analysis of over 4,000 U.S. equity funds and 2002 data. Bid-ask spreads are "conservatively" estimated by multiplying bid-ask spreads for each market cap category (25 basis points for large cap stock funds, 65 basis points for mid-cap stock funds, and 132 basis points for small cap stock funds) by the turnover ratio in the style category. Note that the Plexus Group does not report any significant increase or decrease in commissions between the 1st Quarter of 2002 and the 1st Quarter of 2005, as reported by *Segal Advisory* (Nov. 2005). The data presented is very close to the average commission rate of 0.272% found in another 2004 study commissioned by the Zero Alpha Group, Karceski, Livingston, and O'Neal, "Mutual Fund Brokerage Commissions" (2004) (available at http://www.zeroalphagroup.com/news/ZAG_mutual_fund_true_cost_study.pdf).

[2] Market impact costs are estimated based upon Plexus Group 1st Quarter 2005 estimates of 0.16% costs for U.S. large cap stocks and 0.24% costs for U.S. small cap stocks, per trade, as reported in *Segal Advisory* (Nov. 2005). Similar costs for mid-cap stocks are estimated by us at 0.20% per trade. Cost per category is then derived by applying the portfolio turnover rate for the category, determined as set forth below.

[3] Costs of delayed and canceled trades are estimated based upon Plexus Group 1st Quarter 2005 estimates of 0.41% costs for U.S. large cap stocks and 0.91% costs for U.S. small cap stocks, per trade, as reported in *Segal Advisory* (Nov. 2005). Similar costs for mid-cap stocks are conservatively estimated by us at 0.50% per trade. Cost per category is then derived by applying the portfolio turnover rate for the category, determined as set forth below.

[4] Mean cash holdings for all style classes are estimated at 5%. This is below the averages commonly reported by Morningstar, but consistent with academic literature. *See* Yan, "The Determinants and Implications of Mutual Fund Cash Holdings: Theory and Evidence" (Sept. 2005), available at http://www.fma.org/Chicago/Papers/Yan_FundCash.pdf. We then estimate opportunity costs as the mean cash holding multiplied by the annualized historical returns of asset classes from 1/1986 to 11/2005 (based upon Fama-French Big Low, Big Medium, Big High, Small Low, Small Medium, and Small

High indices and the Russell Mid-Cap indices) less our estimate of the average long-term rate of return for cash (4%). Annualized historical rates of returns are, based upon the foregoing, as follows: LCG: 12.0; LCB: 13.1; LCV: 12.8; MCG: 12.0; MCB: 13.6; MCV: 14.0; SCG: 6.4; SCB: 15.0; SCV: 16.8.

[5] Estimates of the annual portfolio turnover are derived from Morningstar data, reflecting average turnover from 1997-2003, as reported by Keith C. Brown and W. V. Harlow in "Staying the Course: Performance Persistence and the Role of Investment Style Consistency in Professional Asset Management" (Nov. 13, 2005 draft), available at http://www.mccombs.utexas.edu/faculty/keith.brown/Research/styleconsistent-wp.pdf

How Can Transaction Costs Be Ascertained By Investors Or Their Advisers? Today the only data mandated for prospectus disclosure that can be used by investors to evaluate the trading activity of a mutual fund, and thereby shed light on the fund's portfolio trading costs, is the requirement that the prospectus disclose the portfolio turnover rate in its financial highlights table. The financial highlights table typically contains additional financial information and is presented toward the back section of the prospectus.

Some information on portfolio transaction costs must be disclosed in the "Statement of Additional Information" (SAI), a document not typically used by individual investors. The mutual fund must disclose the aggregate dollar amount of commissions paid during each of its three most recent fiscal years. In addition, the mutual fund must generally disclosure the manner in which portfolio transactions are effected, including a general statement about commissions and markups/markdowns on principal trades. We utilize as an example the well-known American Funds (Name of Fund Withheld) Class A Shares ((SYMBOL WITHHELD)).[45] This fund discloses the following in its Statement of Additional Information dated November 1, 2005:

> Brokerage commissions paid on portfolio transactions, including investment dealer concessions on underwritings, if applicable, for the fiscal years ended August 31, 2005, 2004 and 2003 amounted to $52,587,000, $54,400,000 and $46,216,000, respectively. With respect to fixed income securities, brokerage commissions include explicit investment dealer concessions and may exclude other transaction costs which may be reflected in the spread between the bid and asked price.

As a percentage of the average fund assets (discerned as set forth below), 2005 commission expense for (SYMBOL WITHHELD) was a relatively low 0.054%. {$52,587,000 / [($114,655,201,000 + $79,198,872,000)/2]}. Additional information on the fund's brokerage policy is discerned from the (SYMBOL WITHHELD) prospectus:

> The investment adviser places orders with broker-dealers for the fund's portfolio transactions. The investment adviser strives to obtain best execution on the fund's portfolio transactions, taking into

[45] We do not recommend this fund to our clients, although the fund has a generally good performance history and the fund company has an excellent reputation among financial consultants. We merely utilize this stock mutual fund, which is one of the largest actively managed stock mutual funds in the U.S. (in terms of the dollar value of the fund's assets) as an example for purposes of illustrating our methodology for estimating true total fund costs.

> account a variety of factors to produce the most favorable total price reasonably attainable under the circumstances. These factors include the size and type of transaction, the cost and quality of executions, and the broker-dealer's ability to offer liquidity and anonymity. For example, with respect to equity transactions, the fund does not consider the investment adviser as having an obligation to obtain the lowest available commission rate to the exclusion of price, service and qualitative considerations. Subject to the considerations outlined above, the investment adviser may place orders for the fund's portfolio transactions with broker-dealers who have sold shares of funds managed by the investment adviser, or who have provided investment research, statistical or other related services to the investment adviser. In placing orders for the fund's portfolio transactions, the investment adviser does not commit to any specific amount of business with any particular broker-dealer. Subject to best execution, the investment adviser may consider investment research, statistical or other related services provided to the adviser in placing orders for the fund's portfolio transactions. However, when the investment adviser places orders for the fund's portfolio transactions, it does not give any consideration to whether a broker-dealer has sold shares of the funds managed by the investment adviser.

Portfolio turnover disclosure requirements, as currently reported in the fund's prospectus (and repeated by data services such as Morningstar) are not particularly useful to investors. This is because "turnover rates" are defined currently as the *minimum* of either purchases or sales for the given period.[46] Such a simplistic measure of turnover, which often ignores the substantial effects of fund inflows or outflows, is inadequate for measuring the true effects of transaction costs. We suggest the following truer method for estimating of portfolio turnover.

To illustrate our method, we utilize the large and well-known (Name of Fund Company Withheld) (Name of Fund Withheld) Class A Shares ((SYMBOL WITHHELD)) as an example. In the fund's SAI is found the statement: "The fund made purchases and sales of investment securities, excluding short-term securities, of $32,791,075,000 and $17,763,268,000, respectively, during the year ended August 31, 2005." Also found in the SAI is the fund's net assets as of August 31, 2005 ($114,655,201,000), an increase from the prior year ($79,198,872,000). We utilize the following formula to ascertain a "true turnover ratio" for the fund:

> [(Purchases of securities + sales of securities) / (beginning of fiscal year net assets + end of fiscal year net assets)] = [($32,791,075,000 + $17,763,268,000) / ($79,198,872,000 + $114,655,201,000)] = 26.07%.

For purposes of comparison, the annual turnover rate reported by the fund in its prospectus is 20% for the same period, and this is the same figure reported by Morningstar on its web site (as of 1/26/2005). We believe our method of computation results in a truer annual turnover rate for purposes of estimating transaction costs.

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[46] The theory underlying the historical measure of trading costs as the lesser of purchases or sales is that transaction levels caused by inflows and outflows should not be attributed to the manager. Fund shareholders, however, share the cost of trading to accommodate new entrants and departing shareholders. Hence, any true measure of transaction costs should consider both purchases and sales.

Cash holdings are reported by Morningstar are 10.4% of the (Name of Fund Withheld)'s assets. Morningstar classifies the fund as a "U.S. Large Cap Growth" fund. The annual expense ratio for this fund's share class, as reported by Morningstar, is 0.50% (which includes 12b-1 fees of 0.25%). The maximum front-end sales charge for the fund is 5.75%. Utilizing this information, we apply the following computations (as set forth in the chart below, in which computations are undertaken based upon style category):

Table for Computation of Estimated Total U.S. Stock Mutual Fund Costs

Morningstar Style Category	Annual Expense Ratio, Mean Weighted by Net Assets	Front-end loads (sales charges) / assumed average holding period of 7 years	Broker-age Comm-issions	Bid-Ask Spreads (using computed turnover rate)	Market Impact Costs (using computed turnover rate)	Costs of Delayed and Canceled Trades (using computed turnover rate)	Oppor-tunity Costs Due to Cash Holdings	Total Estimated Costs
U.S. Large Cap Growth	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 0.25% x 2	Turnover Rate x 0.16%	Turnover Rate x 0.40%	Actual cash holdings x 8.0	
U.S. Large Cap Blend	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 0.25% x 2	Turnover Rate x 0.16%	Turnover Rate x 0.40%	Actual cash holdings x 9.1	
U.S. Large Cap Value	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 0.25% x 2	Turnover Rate x 0.16%	Turnover Rate x 0.40%	Actual cash holdings x 8.8	
U.S. Mid Cap Growth	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 0.65% x 2	Turnover Rate x 0.20%	Turnover Rate x 0.50%	Actual cash holdings x 8.0	
U.S. Mid Cap Blend	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 0.65% x 2	Turnover Rate x 0.20%	Turnover Rate x 0.50%	Actual cash holdings x 9.6	
U.S. Mid Cap Value	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 0.65% x 2	Turnover Rate x 0.20%	Turnover Rate x 0.50%	Actual cash holdings x 10.0	
U.S. Small Cap Growth	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 1.32% x 2	Turnover Rate x 0.24%	Turnover Rate x 0.91%	Actual cash holdings x 2.4	
U.S. Small Cap Blend	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 1.32% x 2	Turnover Rate x 0.24%	Turnover Rate x 0.91%	Actual cash holdings x 11.0	
U.S. Small Cap Value	Per Morning-star	Front-end sales charges / 7	Per fund's SAI	Turnover Rate x 1.32% x 2	Turnover Rate x 0.24%	Turnover Rate x 0.91%	Actual cash holdings x 12.8	

In summary, for (Name of Fund Company Withheld)' (Name of Fund Withheld), we discern the following estimates:

Annual Expense Ratio:	0.50%
Pro rated maximum front end sales charges:	0.82%
Commissions paid:	0.05%
Bid-ask spreads:	0.13%
Market impact costs:	0.04%
Canceled and delayed trades:	0.10%
Opportunity costs due to cash holdings:	0.83%
Total estimated annual fund fees and costs:	2.47%[47]

In undertaking this calculation we do not mean to cast any poor light on either (Name of Fund Company Withheld) or its (Name of Fund Withheld), for both the fund company and the mutual fund itself enjoy an excellent reputation. Furthermore, we acknowledge that our estimates of stock mutual fund costs, including that set forth above, may be either higher or lower than actual total costs. In addition to our errors in estimation, actual transaction costs of a stock mutual fund could be reduced by a wide variety of techniques employed by the fund's management, including those previously discussed.

For purposes of initial screening of stock mutual funds during the due diligence process we believe the methodology set forth above has value to wealth managers and their clients. Initial screening can narrow down mutual fund choices to a reasonable number. This reduced number of funds can then be subjected to further due diligence analyses by the investment adviser to an individual investor. We would suggest that additional steps in the due diligence process would include, at a minimum: (1) a review of the fund's prospectus, SAI, and annual and semi-annual reports; (2) a search for fines or other regulatory actions affecting the fund's management or investment adviser; and (3) research as to trading strategies utilized by the fund which are employed (or not employed) in an effort to reduce trading costs.

[47] For comparison purposes the Zero Alpha Group's commissioned study of mutual fund costs found that the American Funds' (Name of Fund Withheld) (using 2001 data) had annual total costs of 0.953%. The costs included an annual expense ratio of 0.71% (which included 12b-1 fees of 0.25%), brokerage commissions of 0.1134% annually, and implicit trading costs (due to spreads) of 0.1296%. The study did not include pro-rated maximum front end sales charges, market impact costs, and opportunity costs, which in our analysis totaled 1.69%. If such costs were included in the study (using our data for such costs) the total costs of the fund would have risen to 2.64%, which is higher than our estimate of 2.47%. The difference is explained by a lower annual expense ratio for the fund currently. The ZAG-commissioned study: Karceski, Livingston and O'Neal, "Mutual Fund Brokerage Commissions" (2004), which is available at http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf.

Summary and Conclusion. The "annual expense ratio" of stock mutual funds does not reflect other major expenses incurred by mutual funds during their stock trading. These additional expenses include commissions paid by the fund's investment adviser to broker-dealer firms, bid-ask spreads, market impact costs, opportunity costs relating to delayed and canceled trades, and opportunity costs due to cash holdings. The average total costs of U.S. stock mutual funds are estimated at 2.5% to 3% annually. U.S. large cap blend funds tend to have lower total annual expenses, while small cap and growth funds tend to high higher total annual expenses.

While commercial index funds generally have lower turnover and lower expenses, their market impact costs are often quite high. These same high market impact costs can negate the perceived cost advantages of stock index funds and exchange-traded funds which possess no sales charges or 12b-1 fees and which possess relatively low annual expense ratios.

Wealth managers should seek out mutual funds in the desired asset classes which not only possess low "disclosed" costs but which also have adopted trading rules and methodologies designed to substantially reduce trading costs. A screen can be utilized to narrow fund choices as part of the initial due diligence process. Seeking out passive funds which track "private indices" or "personal indices" may lead to reduced transaction costs and taxable capital gain distributions. After the initial screening is undertaken, further inquiry into a fund's history and management policies can then take place through more intense scrutiny of the fund's compliance record, prospectus, SAI, annual and other periodic reports, public statements by fund portfolio managers, and inquiries made directly to fund managers.

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