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FSI On the *issues*

Regulators' Institutional Bias Toward Cost as the Primary Basis for Determining Investment Suitability

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Executive Summary

Independent broker-dealers (IBDs) have become increasingly aware of an important, but subtle, change in the regulators' approach to issues of investment suitability. IBDs perceive that the NASD and SEC now overemphasize the importance of the cost of investments in the decision-making process. In educational materials, enforcement actions, rule proposals, closed-door meetings, and one-on-one conversations, evidence of an institutional bias that places cost in the forefront of suitability determinations is growing. This is perhaps understandable given recent enforcement actions against rogue brokers who have violated just and equitable principles of trade by directing their clients to invest their "nest egg" in the mutual fund share class option generating the highest commission. However, some in the IBD community have argued that members of the NASD and SEC staff may instead be implementing a strategy designed to set limits on the prices of financial services products such as mutual funds, variable annuities, and brokerage account services. There is strong evidence to support this theory, including:

- Educational Materials: The NASD and SEC have assumed the role of educators of the investing public. Having assumed that role, it is fair for investors and IBDs to expect the regulators to perform this function fully and fairly. However, a review of NASD Investor Alerts and SEC educational materials leads to the conclusion that the regulators have elevated the goal of achieving the lowest possible front-end sales load above all other relevant suitability considerations. As a result, the regulators' educational materials overemphasize the importance of cost considerations in mutual fund suitability determinations.
- Enforcement Actions: The SEC and NASD have brought enforcement actions against financial advisors and IBDs for recommendations and sales of mutual fund B shares to their customers, alleging that advisors are not considering or adequately disclosing that an equal investment in Class A shares would generally have been more economically advantageous for their customers by providing a higher overall rate of return. However, the regulators have been unable to prove to the satisfaction of an administrative law judge or NASD Hearing Officer that A share mutual fund portfolios outperform B share portfolios at the $250,000 investment level.

Nevertheless, the regulators continue to ignore other important suitability factors, including diversification, past performance, and service. This enforcement activity provides further evidence of the regulators' blind pursuit of an agenda designed to establish cost as the lynchpin of all mutual fund suitability determinations.

- Point of Sale Disclosure Proposals: The SEC has proposed the adoption of SEC Rules 15c2-2 and 15c2-3 under the Securities Exchange Act of 1934 to require broker-dealers to provide customers with targeted information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that may arise from the distribution of mutual fund shares and other similar products. These proposals are supported by the NASD. Unfortunately, the disclosure documents focus the bulk of their attention on issues of cost while ignoring other important suitability concerns. In addition, the disclosure documents will distract investors' attention from the product prospectus, which contains a more thorough discussion of all relevant suitability issues. These disclosure documents have the potential to harm retail investors who have the greatest need for professional advice to help them achieve their investment goals. However, they do help to further the regulators' apparent goal of establishing cost as the primary determinant of suitability.

IBDs believe that the NASD and SEC actions have created a regulatory environment that devalues service, advice, and the compensation that advisors receive for it through certain fees and commissions. IBDs yearn for a day when the regulators create an environment that recognizes the value of the professional financial advice that encourages Americans to save for retirement and plan for personal and financial goals such as education, retirement, estate planning, and health care needs; an environment in which prices are set by the market and not regulators; an environment in which financial advisors are free to recommend what they truly believe is in their clients' best interest without fear of regulatory entanglement. Only then will the NASD and SEC be serving in their proper role as educator and regulator.

Introduction:

Financial products are complicated—they come in different shapes and sizes and offer unique features and pricing structures designed to meet the needs of the investing public. The plethora of available options is a wonderful byproduct of our free market system, but the choices can be overwhelming. Retail investors need the help and guidance of a trusted advisor to help them make appropriate choices to achieve their financial goals and dreams.

The overwhelming majority of financial advisors realize that their livelihood depends on sustaining their reputations in the community and among their clients. As a result, they educate their clients on the various options available to them. Once the client is familiar with the options available, the financial advisor makes suitable investment recommendations based upon the client's investment objectives, financial and tax status, risk tolerance, and other relevant information. Unfortunately, a small number of financial advisors will take advantage of their clients' ignorance of the vast array of financial products and pricing structures by directing clients to high-priced options intended to line the advisors' pocket without providing benefit to the clients. When an unscrupulous financial advisor abuses an investor's confidence in this fashion, the reputation of all financial advisors is sullied.

Independent broker-dealers understand that the regulatory agencies' enforcement authority is crucial to the public's confidence in the quality of advice offered by financial advisors. As a result, the Financial Services Institute (FSI) supports NASD and SEC enforcement actions brought against individuals who have abused their clients' trust by recommending unnecessarily costly investment options. Nevertheless, IBDs have become increasingly aware of an important, but subtle, change in the regulators' approach. IBDs perceive that the NASD and SEC now overemphasize the importance of the cost of investments in the decision-making process. In educational materials, enforcement actions, rule proposals, closed-door meetings, and one-on-one conversations, evidence of an institutional bias that places cost in the

forefront of suitability determinations is growing. This is perhaps understandable given the regulators' recent focus, for example, on enforcement actions against those who have violated just and equitable principles of trade by directing their clients to invest their "nest egg" in the mutual fund share class option generating the highest commission. In this environment, it is logical and foreseeable that regulators might develop "tunnel vision" on the issue of cost. In addition, cost is a simple, quantifiable, and objective measure. It can easily be compared from fund to fund. This makes cost unique among the various factors relevant to the determination of an investment's suitability for a particular investor. The other suitability factors, including risk, service, and future performance, are subjective in nature. It is, therefore, understandable that inexperienced members of the regulators' staff may be seduced into the mistaken belief that all investment options must first be considered in light of their costs.

Some in the IBD community have argued that members of the NASD's and SEC's staff may instead be implementing a strategy designed to set limits on the prices of financial services products such as mutual funds, variable annuities, and brokerage account services. They argue that this is being accomplished through rulemaking and enforcement activities that seek to establish the cost of products and services as the most important element of investor suitability. The concern expressed by these IBDs is that the regulators' emphasis on cost structure will have the unintended consequence of misleading their clients to believe that suitability can be determined solely on the basis of a product's cost. Since clients are not one-dimensional, these IBDs argue that suitability must continue to be determined on a case-by-case basis in light of the product's overall features and the client's investment objectives, risk-tolerance and personal financial goals.

In an attempt to gain some clarity on this issue, let's review the regulators' approach to cost and suitability in sales of one product type—mutual funds.

NASD Mutual Fund Investor Alerts:

The NASD has published a series of "Investor Alerts" designed to notify investors about the wide variety of mutual fund fee structures that exists. These pieces encourage investors to scrutinize mutual fund share sales charges, fees, and expenses. IBDs support the NASD's efforts to educate investors and believe that well-informed investors make the best clients. However, IBDs are concerned that educational pieces such as these Investor Alerts fail to present a complete picture of the factors to be considered in choosing appropriate mutual fund investments. As a result, the Investor Alerts may do unintended harm by failing to fully educate investors concerning other important factors in the mutual fund investment decision-making process.

One example of such a factor is the concept of diversification. In its common usage, diversification means creating an investment portfolio that contains different types of investments within each of the major asset classes—stocks, bonds, and cash. The concept of diversification is perhaps best summarized in the old cliché "don't put all your eggs in one basket." A groundbreaking 1986 study by Brinson, Hood, and Beebower revealed that asset allocation explains more than 90 percent of portfolio performance.[1] As a result, it is important for investors to diversify their portfolios among various asset classes. True diversification also involves investments in various securities within each asset class. For many retail investors, mutual funds are an appropriate investment vehicle to achieve this goal.

The American Association of Individual Investors[2] Web site includes the following advice for mutual fund investors:

Q: How many different mutual funds should I own?

A: The number of funds suitable for an individual investor will vary depending on individual circumstances—there is no universal number that applies for everyone.

However, as a useful yardstick, consider the range of funds derived from the rationale that diversification should be one of every investor's goals. Simple but broad diversification would imply four funds: a domestic equity fund, a domestic bond fund, an international stock fund, and an international bond fund. Dividing the domestic equity portion into two funds—one specializing in small stocks and the other larger capitalization stocks—brings the count up to five. Splitting the international equity portion into funds specializing in developed economies and funds specializing in developing and emerging economies makes six. If you prefer a separate European fund and Far East fund, the total is up to seven. Building diversity in your domestic bonds by adding a junk bond fund stretches the number of funds to eight. And if we include a money market fund, the number is nine.

The benefits of diversification are difficult to achieve with commitments of less than 10% of your portfolio to any one area, which sets the upper range at not much more than 10 funds. Thus, diversification implies a range of around four to nine funds--all unique in investment objective and security coverage…."[3]

In the world of mutual fund investing, however, diversification means even more than simply choosing four to nine mutual funds. Research shows that it is essential for investors to also diversify their portfolios among a variety of mutual fund product sponsors in order to reduce risk. This concept is explored in a 2004 study conducted by professors from New York University and Emory University. The study is entitled "The Impact of Mutual Fund Family Membership on Investor Risk."[4] The authors of the study examine "whether the propensity of investors to confine their investments to a single fund family influences the risk characteristics of their portfolios."[5] As a result of their research, they state: "Our analysis suggests that investors who limit their investments to one fund family hold riskier portfolios than those who diversify across families."[6]

This increased risk is the result of several factors. The authors describe these factors as follows: "There are several reasons to expect that funds may be more similar inside than outside fund families. Portfolio managers within families are likely to have access to the same research analysis produced either by internal analysts or by a particular set of external research firms. Many families also have a prescribed investment style that influences the types of securities they hold. A common view on individual companies could lead to similar stock holdings across portfolios with even different objectives. In addition, a [fund] family's relationship with an investment brokerage firm could also lead to common holdings of new offerings."[7]

In the end, the study concludes that diversifying mutual fund investments across mutual fund sponsors is essential to reducing a portfolio's risk. "Overall, the results [of the study] suggest that investors would be wise to build portfolios from different fund families…."[8] This research proves what financial advisors have known for years—it is wise to recommend the use of multiple fund families to mutual fund investing clients with significant assets to invest.

A consequence of following this prudent course of action is that clients may not qualify for A share mutual fund breakpoint pricing. They certainly will not achieve the same breakpoint level possible as they would if all of their funds had been invested in A share mutual funds at a single mutual fund product sponsor. Nevertheless, a conscientious financial advisor may very well conclude that the benefits of diversifying a client's assets among various mutual fund families outweigh the additional cost resulting from the missed breakpoints.

Unfortunately, these issues are never addressed by the NASD Investor Alerts related to mutual fund investing. The most relevant of these Alerts is entitled "Mutual Fund Breakpoints: A Break Worth Taking."[9] In it, the NASD describes the purpose of the Alert as follows: "We are issuing this Alert because we are concerned that investors have not received breakpoints [sic] discounts to which they're entitled in many instances and that investors are potentially overpaying front-end

sales loads… This Alert will explain how breakpoints work and what you need to know to make sure you are charged the *lowest possible front-end sales load*."[10] The Alert encourages investors to go to great lengths to avoid missing breakpoints and includes sections entitled "Protecting Yourself," "When You Don't Think You Got a Break You Deserve," and "What Regulators are Doing to Protect You."

While the Alert does a fine job of explaining breakpoints and the steps to be taken by an investor if that person's financial advisor fails to achieve the "lowest possible front end sales load," it misses an opportunity to provide other relevant information. The Alert is incomplete and misleading because it fails to offer investors any basis upon which a financial advisor might rely in making a recommendation that did not maximize the breakpoint received.

This shortcoming is not limited to this single Investor Alert. In fact, the NASD Web site includes a total of eight Investor Alerts dedicated to mutual funds. Of these Alerts, four are specifically focused on mutual fund share class considerations; three of the remaining alerts deal with other cost issues in mutual fund investing. Yet none of these Alerts mentions the need for portfolio diversification to reduce risk or the reasons a financial advisor might recommend a portfolio that does not have achieving the "lowest possible front-end sales load" as its primary goal. Instead, each of the Alerts is focused on cost considerations to the exclusion of all other relevant concerns.

Since the NASD has assumed the role of educator, it is fair for investors and IBDs to expect the NASD to perform this function fully and fairly. However, a review of these Investor Alerts leads to the conclusion that the NASD has overemphasized the importance of pricing considerations in mutual fund suitability determinations. This does a disservice to investors, financial advisors, and IBDs. It is also evidence of an institutional bias establishing cost as the primary basis for determining suitability of investment recommendations.

SEC Educational Efforts:

The SEC also generates educational materials for investors. Many of these educational pieces concern mutual funds and discuss in great detail the cost of these investments. In all fairness, however, the SEC materials do dedicate some portion of their content to other relevant suitability factors. In fact, "The SEC Mutual Fund Cost Calculator: A Tool for Comparing Mutual Funds"[11] includes the following text:

"The Cost Calculator is great for understanding costs, but costs aren't the only thing that should be considered when investing in a mutual fund. Other things to assess include:

- the number of years needed to reach an investment goal,
- the type of stocks, bonds, or other securities that the fund buys,
- the risk of the fund,
- the fit between the fund and the investor's portfolio (diversification),
- the fund company or portfolio manager who runs the fund,
- the fund's track record or performance over time, and
- the types of services offered by the fund company.

You can learn what factors to consider before investing in a mutual fund by reading *Mutual Fund Investing: Look at More Than a Mutual Fund's Past Performance*."[12]

Unfortunately, these 121 words are lost among the voluminous discussions of fees and expenses contained in other investor education pieces posted to the SEC Web site. Lengthy articles entitled "Breakpoints," "Mutual Fund Classes," and "Mutual Fund Fees and Expenses" serve to direct the investor's attention to the cost of the investment options they are considering. These articles could attempt to offer some balance to their discussion by referencing these other suitability

concerns or by providing a hyperlink to an article that explores these issues in depth. However, none of these articles includes such a discussion or a hyperlink to the "Mutual Fund Investing: Look at More Than a Mutual Fund's Past Performance" article despite frequent use of this convention throughout the Web site to draw the reader's attention to detailed information concerning the fees and expenses borne by mutual fund investors.

In addition, the text of these articles tends to exaggerate the importance of cost considerations in the evaluation of investment options. One such example can be found in the article entitled "Mutual Fund Fees and Expenses." In this article, the SEC states, "As you might expect, fees and expenses vary from fund to fund. A fund with high costs must perform better than a low-cost fund to generate the same returns for you. Even small differences in fees can translate into large differences in returns over time. For example, if you invested $10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly $49,725. But if the fund had expenses of only 0.5% you would end up with $60,858—an 18% difference. It takes only minutes to use the *SEC's Mutual Fund Cost Calculator*[13] to compute how the costs of different mutual funds add up over time and eat into your returns."[14] While this is certainly true, it oversimplifies the issues facing mutual fund investors. Investors are rarely presented with investment options that differ only in terms of their cost. Instead, factors such as the mutual fund's investment objectives, historical performance, volatility, tax efficiency, shareholder services, and other concerns determine whether the fund is a suitable investment vehicle for the investor. These factors are not discussed in this article, nor, as was noted above, are readers directed to another resource that provides a detailed discussion of these other issues.

It is also important to note that investors are never privy to the future returns they will experience over the 10-year period following their investment decision. If this information was available, the SEC would be correct in indicating that the process of choosing an appropriate mutual fund involves merely an analysis of its cost relative to other available options. However, in the real world, investors must peer "through a glass, darkly." The process of creating an investment portfolio designed to achieve a client's investment objectives requires careful and thoughtful analysis of their financial and tax status, time horizon, risk tolerance and other factors. The complex nature of this decision leads many investors to rely upon the knowledge and skill of a financial advisor. By reducing the issue of suitability to the mere consideration of the cost of the investment, this article misleads its audience and diminishes the value of the financial advisor's expertise.

Since most of the SEC educational pieces focus on cost considerations to the exclusion of all other relevant concerns, the collective impact is to elevate this concern above all others. The result is that investors are mislead into believing that cost should be the preeminent factor in their investment decision making process. Investors have a right to expect unbiased educational materials from the SEC. However, a review of the materials present on the SEC's web site leads to the conclusion that the SEC has highlighted the importance of pricing considerations in mutual fund suitability determinations at the expense of other equally relevant considerations. The SEC thereby squanders an opportunity to provide investors a full appreciation for the many factors involved in the investment decision making process.

NASD Enforcement Actions:

The NASD has long expressed concern about the sale of inappropriate mutual fund share classes to clients. Specifically, in NtM 95-80 (Sept. 1995), the NASD outlined the following requirements concerning the sale of mutual funds: "Members must ensure:

- complete and balanced disclosure is made to investors regarding the distinctions among classes of a multi-class fund or feeders of a master-feeder fund…
- any recommendation made is suitable and based on the investor's investment objectives…"

Thanks to this NtM, IBDs are well aware of these requirements and have adopted policies and procedures to comply with them. Unfortunately, the NASD has recently used enforcement actions to specify more specific limits on the use of B share mutual fund shares.

Earlier this year, the NASD brought enforcement actions against American Express Financial Advisors[15], Citigroup Global Markets, and Chase Investment Services because "they made recommendations and sales of mutual funds to their customers without considering or adequately disclosing, on a consistent basis, that an equal investment in Class A shares would generally have been more economically advantageous for their customers by providing a higher overall rate of return."[16] In particular, the NASD claimed that the "firms did not consider that large investments in Class A shares of mutual funds entitle investors to breakpoint discounts, generally beginning at the $50,000 investment level, which are not available for investments in other share classes."[17]

These enforcement actions would appear to be an attempt by the NASD to institute an upper limit of $50,000 on B share purchases by clients. The NASD may be pursuing this tack because other attempts to prove that B share purchases at or above this level were per se unsuitable have failed. For example, an NASD Hearing Officer dismissed a case brought by NASD Enforcement against a representative it claimed had violated NASD Conduct Rules for making unsuitable investment recommendations. NASD Enforcement charged, among other things, that the registered representative made unsuitable recommendations to a client that involved the investment of $360,000 in the Class B mutual fund shares of six (6) fund families. Specifically, the NASD Division of Enforcement "filed a Complaint charging that Respondent 1 made unsuitable recommendations to one customer in violation of NASD Conduct Rules 2110, 2310, and IM-2310-2, by recommending that the customer purchase Class B shares in mutual funds in different fund families, rather than Class A shares in one fund family."[18]

The Hearing Officer described the Respondent's defense to NASD Enforcement's claims as follows: "Respondent 1 offered a detailed explanation of the reasoning that led him to conclude that his recommendations were suitable. In particular, he stated that he considered the additional costs of the Class B shares he recommended compared to an investment in Class A shares from a single fund family, but believed those costs were outweighed by the value of diversifying [client's] investment among top performing funds from several different families."[19] In other words, the Respondent considered important suitability factors other than cost and argued that his recommendation to his client was prudent in light of all of the relevant factors.

The Hearing Officer described the NASD's case as follows: "Enforcement's Analysis focused exclusively on the costs savings [the client] would have enjoyed if he had purchased Class A shares in a single-fund family—it did not consider actual or potential performance differences between the funds that Respondent 1 recommended and the Alliance family of funds that Enforcement proposed as a better alternative."[20] The Hearing Officer went on to say that "Enforcement made no effort to challenge the premises underlying Respondent 1's multi factor analysis. Instead Enforcement argued that cost alone is the controlling factor in determining whether Respondent 1 had a reasonable basis for believing his recommendations were suitable for [the client]."[21]

Evidence presented at the hearing indicated that the Respondent's multi-family B share mutual fund portfolio significantly outperformed the NASD proposed single-fund family A share portfolio. The NASD's proposed portfolio was well designed to achieve the "lowest possible front-end sales load." However, because it did not consider other relevant aspects, it failed to provide the kind of return a more thorough analysis of suitability was able to achieve.

In the end, the Hearing Officer decided in favor of the Respondent, concluding that: "Tailoring

recommendations to individual investors requires more than a mechanical comparison of costs; in making a recommendation, a registered representative must take into account a variety of factors that bear upon whether a particular investment is suitable for a specific investor. Ultimately, a recommendation must be based on a careful balancing of the overall potential rewards and risks of a potential investment."[22] Unfortunately for the Respondent, this decision was reached only after many months of agonizing preparation and extensive legal defense costs.

It would appear that the NASD has attempted to use these recent enforcement actions to establish a $50,000 B share purchase limit, a new regulatory requirement that may not benefit investors. This decision and other enforcement actions provide further evidence that the NASD has now adopted a single-minded approach to suitability determinations. Just as their Investor Alerts ignore all other aspects of suitability in their attempt to educate consumers, the NASD Division of Enforcement ignored all such considerations in bringing this action against a registered representative who was attempting to achieve his client's investment objectives through thoughtful application of knowledge and experience. The result is a consistent message to NASD member firms and the investing public—all that matters is the cost of the investment.

SEC Enforcement Actions:

The SEC has also pursued enforcement actions that appear designed to institute an upper limit on B share purchases by clients. An SEC administrative law judge recently dismissed a case brought by the SEC against an IBD firm, the firm's President and Chief Compliance Officer, and two of its independent registered representatives.[23] The SEC charged, among other things, that the firm and registered representatives committed fraud in connection with the sale of Class B mutual fund shares.

After a lengthy trial, the SEC administrative law judge dismissed the SEC's entire case. The judge found, among other things, that the SEC's argument that Class B shares in amounts of up to $250,000 always underperform the same amount of Class A shares was incorrect. The judge stated, "Back-of-the-envelope computations of sales charges, including 12b-1 marketing fees, applicable to A and B shares that appear to show that A shares always outperform B shares at the $250,000 level do not take account of some significant factors that can affect performance, including B share redemptions that are free of CDSC for a variety of reasons. In sum, it is unproven that A shares always outperform B shares at the $250,000 level. Therefore, the registered representatives' failure to inform customers that Class A shares of the mutual funds they were purchasing would have produced materially higher returns than Class B shares of the same mutual funds was not an omission to state a material fact."[24] This conclusion was based on the judge's review of calculations presented by both sides. These calculations indicated that B shares provided superior performance in 25 percent of the hand-picked client accounts that were the basis of the SEC's case.[25]

The judge also determined that the SEC could not prove fraud in this case because, among other things, although the SEC had rule proposals pending, the SEC had no rule at the time the investment transaction took place that would have prohibited the activity it alleged was violative and there was no such court precedent or industry practice. The judge noted that the Commission had considered, but not adopted, rule changes that would mandate transparency in the charges that apply to A and B shares. "In light of the conclusion that A shares do not always outperform B shares at the $250,000 level and in light of the Commission's rulemaking proceedings regarding sales loads and disclosure, it is concluded that none of the registered representatives violated the antifraud provisions in regard to disclosure about the relative performance of A and B shares."[26]

The evidence suggests that the SEC has followed the NASD's lead by also attempting to use enforcement actions to establish an upper limit on B share purchases. It is apparent that the SEC Division of

Enforcement ignored all other relevant considerations in bringing this action against a group of registered representatives who were attempting to achieve their clients' investment objectives through thoughtful application of knowledge and experience. It is disturbing to note that the SEC pursued this course of action without evidence that the new regulatory requirement they sought to implement would benefit investors. Instead, this enforcement action provides further evidence of the regulators' blind pursuit of an agenda designed to establish cost as the lynchpin of all mutual fund suitability determinations.

SEC Proposal on Point of Sale Disclosures:

The SEC has proposed the adoption of SEC Rules 15c2-2 and 15c2-3 under the Securities Exchange Act of 1934 to require broker-dealers to provide customers with targeted information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that may arise from the distribution of mutual fund shares and other similar products.[27] Among other things, the proposal would require broker-dealers to inform customers about the distribution-related costs that the customer would be expected to incur in connection with a mutual fund transaction. This would include separate disclosure (either by reference to the value of the purchase, or, if no amount was specified, by reference to a model investment of, for example, $10,000) about:

1) the amount of sales loads that would be incurred at the time of purchase, and the amount of that load that would be paid to the broker-dealer;
2) estimated asset-based sales charges and asset-based service fees paid out of fund assets in the year following the purchase if net asset value remained unchanged; and
3) the maximum amount of any deferred sales load that would be associated with the purchase if those shares are sold within one year, along with a statement about how many years a deferred sales load may be in effect.

In addition, the rule would require disclosure of whether the broker-dealer receives revenue sharing or portfolio brokerage commissions from the fund complex, as well as whether it pays differential compensation in connection with transactions in the covered security, if the covered security is either a class B share or a proprietary security.

These point of sale documents contain extensive disclosures of mutual fund fees and charges, but fail to provide any other information relevant to the investor's decision to purchase a mutual fund investment. Specifically, the first page of the disclosure discusses fees and charges assessed by the fund and potential conflicts of interest. In other words, the mutual fund's investment objective, past performance, risk, and other relevant details are not discussed at all in the disclosure documents.

IBDs believe that the SEC's emphasis on fees in the model disclosure forms will have the unintended consequence of misleading investors into believing that the primary determinant of product value should be the lowest internal fees. Investors will:

- get the message from the disclosure forms that the lowest cost product is always the best investment
- assume that they no longer need to read the prospectus because the regulators have concluded by virtue of their creation of the model disclosure forms that they need only review the information on the disclosure forms to have a complete understanding of the product
- assume that if other information was important to their investment decision, the SEC would mandate its disclosure on the disclosure forms

Even though the proposed forms will contain a disclaimer that investors should rely upon the prospectus, IBDs believe that this will do nothing to disabuse investors of the belief that the mandated disclosure forms contain all material information about product. In effect, the regulators will be conveying to investors the message that it is appropriate to ignore

the prospectus because it is too complicated to be meaningful and relevant to an investment decision.

While the SEC's proposed point of sale disclosures will certainly raise investor awareness of the cost of their mutual fund investments, it most certainly will also relegate all other concerns to the background. This may advance the regulators' agenda of establishing cost as the issue of paramount importance in determining suitability, but it is also likely to harm investors by encouraging them to ignore other factors relevant to the proper allocation of their investable assets.

NASD Support for SEC Proposals:

The SEC's point of sale disclosure proposals were based in part on recommendations and research performed by the NASD. As a result, it is not surprising that the proposals have been praised by NASD Chairman and CEO Robert R. Glauber: "The SEC proposal is an excellent effort that properly focuses on getting more, better and clearer information to investors at the most important time - prior to purchase. Good point of sale information is crucial for investors…."[28] Unfortunately, as demonstrated above, these proposals continue to overemphasize the importance of price in the consideration of an investment recommendation.

To the NASD's credit, they have offered the Profile Plus as an alternative to the SEC's proposed disclosure documents. While the SEC disclosure document is filled with information about potential conflicts of interest, the costs associated with an investment in the mutual fund and other information relevant to a full understanding of these costs, the NASD's proposed disclosure document does provide other relevant information. Included within the Profile Plus is an extremely brief discussion of investment strategies utilized by the fund manager, risk associated with investing in the fund, and performance figures. However, the Profile Plus still focuses the greatest amount of attention on fees and charges associated with an investment in the fund. In fact, the NASD's Profile Plus dedicates 50% of its content to these cost issues. As a result, the extensive disclosures of mutual fund fees and charges dominate even the point of sale disclosure documents proposed by the NASD.

While the SEC has insisted that it is not its intention to detract investors' attention from the content of the mutual fund prospectus, it appears that the NASD is very much in favor of relegating the prospectus to the ash heap. As NASD President Douglas Shulman recently said at the 2005 NASD Fall Securities Conference, "In this era of instantaneous access to obscure or arcane information, there simply is no reason why an investor should still have to slog through a 30-page prospectus that—let's face it—is often incomprehensible to investors."[29] Clearly, the NASD believes that the detailed disclosures of the prospectus are no longer needed. Instead, they believe the cost-focused disclosures of the Profile Plus provide investors all the information they need to make their investment decisions.

Through its support of the SEC's proposed point of sale disclosures the NASD has continued its efforts to establish price as the preeminent concern in making investment recommendations. By placing so much emphasis on mutual fund internal fees in its own Profile Plus, the NASD diminishes the value of the services provided by the product's investment manager and the advice provided by the investor's financial advisor. This has the potential to harm retail investors who have the greatest need for professional advice to help them achieve their investment goals. However, it does help further the regulators' apparent goal of establishing cost as the primary determinant of suitability.

Conclusion:

IBDs would agree that *if all other factors are equal*, clients should bear the lowest cost possible for an investment product. However, suitability determinations are rarely this clear cut. The process of determining how to achieve a client's investment objectives requires careful and thoughtful analysis of the client's financial

and tax status, time horizon, risk tolerance, and other factors. The plethora of products and pricing options offered by investment companies serves as tools for the conscientious financial advisor to apply to each client's situation. This requires skill and experience, not blind pursuit of the "lowest possible front-end sales load."

Nevertheless, the evidence suggests that the NASD and SEC have identified achieving the lowest cost as the goal of all investment recommendations. Through their educational materials, enforcement actions, and support for rule proposals that overemphasize the importance of cost, the regulators are advancing an agenda that will harm investors by limiting their choices. IBDs believe the persons in the best position to determine the level of class A, B, and C shares that are suitable for any client are the client and their financial advisor. The regulators can then evaluate the transaction and the advisor's recommendation, as they always have, on the basis of all of the facts disclosed by the client to the advisor and the information provided by the advisor to the client at the time of the recommendation. IBDs believe that this process will continue, as it has for many years, to foster client protection and exceptional service by encouraging creative solutions to complex investment needs.

IBDs believe that the actions of the NASD and SEC have created a regulatory environment that devalues service, advice, and the compensation that advisors receive for their efforts through certain fees and commissions. IBDs yearn for a day when the regulators create an environment that recognizes the value of the professional financial advice that encourages Americans to save for retirement and plan for personal and financial goals such as education, retirement, estate planning, and health care needs; an environment in which prices are set by the market and not regulators; an environment in which financial advisors are free to recommend what they truly believe is in their clients' best interest without fear of regulatory entanglement. Only then will the NASD and SEC be serving in their proper role as educator and regulator.

References:

[1] Brinson, Gary, Hood, Beebower, Randolph, and Beebower, Gilbert, "Determinants of Portfolio Performance," Financial Analyst Journal, July/August 1986.

[2] The American Association of Individual Investors (AAII) is a non-profit organization that "arms individual investors with the education and tools they need to build wealth."

[3] AAII, "Mutual Funds Frequently Asked Questions," *available at* http://www.aaii.com/mfunds/faqs/#1.

[4] Fulton, Edwin J., et al., "The Impact of Mutual Fund Family Membership on Investor Risk," May 2004.

[5] *Ibid., page* 1.

[6] *Ibid., page* 2.

[7] *Ibid., page* 1.

[8] *Ibid., page* 19.

[9] NASD, "Mutual Fund Breakpoints: A Break Worth Taking," *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=1248.

[10] *Ibid.* Emphasis added.

[11] SEC, "The SEC Mutual Fund Cost Calculator: A Tool for Comparing Mutual Funds" *available at* http://sec.gov/investor/tools/mfcc/mfcc-int.htm.

[12] *Ibid.*

[13] *Ibid.*

[14] SEC, "Mutual Fund Fees and Expenses," *available at* http://sec.gov/answers/mffees.htm.

[15] Now doing business as Ameriprise Financial, Inc.

[16] NASD, "Improper Sales of Mutual Fund Class B and C Shares," *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013641.

[17] *Ibid.*

[18] OHO Disciplinary Proceeding No. C9B040036, page 2. In accordance with NASD NtM 00-36, all final, litigated decisions issued by the Office of Hearing Officers that do not satisfy specific enumerated criteria are released, but do not identify the parties to the decision.

[19] *Ibid.*, page 15.

[20] *Ibid., page* 12.

[21] *Ibid., page* 18.

[22] *Ibid, page.* 18.

[23] SEC Administrative Proceeding File No. 3-11179. Please note this matter is currently under appeal.

[24] *Ibid.*

[25] *Ibid., page* 41.

[26] *Ibid., page* 26.

[27] SEC Release Nos. 33-8358, 34-49148 and IC-26341.

[28] NASD, "NASD Endorses Concise, Web Based Point of Sale Mutual Fund Disclosure," April 4, 2005, *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013727.

[29] NASD, "Address by NASD President Doug Shulman to the NASD Fall Securities Conference," November 17, 2005, *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015554&ssSourceNodeId=1346.