JOSEPH CAPITAL MANAGEMENT, LLC

A FEE ONLY INVESTMENT ADVISORY FIRM

S7-25-99

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January 24, 2005

The Honorable Richard C. Shelby, Chairman
The Honorable Paul S. Sarbanes, Ranking Member
U.S. Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Michael G. Oxley, Chairman
The Honorable Barney Frank, Ranking Member
U.S. House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Richard H. Baker, Chairman
The Honorable Paul E. Kanjorski, Ranking Member
Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee
U.S. House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Copy to:
Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: **Failure of the Securities and Exchange Commission To Protect The Interests of Individual Investors: A Renewed Imperative for Congressional Oversight In Light of Proposed Social Security Reforms**

Re: **Proposed Rule, Certain Broker-Dealers Deemed Not To Be Investment Advisers [Release Nos. 34-50980; IA-2340; File No. S7-25-99]**

Joseph Financial Group • 2450 N. Citrus Hills Blvd •.Hernando, FL 34442-5348

Phone: (Citrus County) 352.746.4460 • Toll-Free: 1.866.746.4460

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OFFICE OF THE SECRETARY

Dear Sirs:

I am writing to inform you of a **monumental failure** by the U.S. Securities and Exchange Commission to protect the interests of individual investors. Through a perhaps initially well-intentioned but nevertheless poorly designed Proposed Rule, the SEC has proposed to ignore clear statutory language contained in the Investment Advisers Act of 1940, thereby thwarting the intent of the U.S. Congress. Giving the impending debate over Social Security reform, including the potential privatization of some portion of a wage earner's social security contributions, this failure by the SEC increases the threat to the financial security of millions of Americans. I urge the Senate and House Committees and Subcommittees to exercise their Congressional oversight powers to correct the course the SEC has apparently chosen - a course and a direction which will harm millions of individual investors.

A. Background. Individual investors in the United States receive investment advice from three differently regulated professions today:

- Broker-dealer firms and their registered representatives, primarily regulated by the U.S. Security and Exchange Act of 1934, who possess limited duties to their customers, who are subject to a limited "suitability" obligation relative to transactions which are recommended, and who do not, in most circumstances under federal law, possess a fiduciary duty to act in the best interests of their customers. Moreover, while disclosures have been enhanced, there is no requirement to fully and completely disclose to customers, in advance, any and all material conflicts of interest which the registered representative may possess. Also, there is also no requirement to fully and completely disclose all material compensation which might be received by the broker-dealer firm or its registered representative relating to the products sold or a fee-based brokerage account.

- Registered investment adviser firms and their representatives, primarily regulated by the U.S. Investment Advisers Act of 1940 ("Advisers Act"), which imposes upon them a broad fiduciary duty to act in the best interests of their clients and to fully disclose any and all material conflicts of interest and compensation received.

- Insurance agents engaging in life insurance product sales (including sales of annuity products), whom are primarily regulated by various state laws.

The Advisers Act governs all those who provide "investment advice." However, through a limited and narrowly defined exception, it is not applicable to broker-dealer firms and their registered representatives whose advice is:

- *solely incidental to*
- the *conduct of business as a broker or dealer*
- for which *no special compensation* is received.

On November 4, 1999, the SEC issued a Proposed Rule under the Advisers Act in response to the introduction of a new type of brokerage program offered by full-service broker-dealers, called a "fee-based brokerage program." The Proposed Rule addressed whether, as a result of introducing these programs, broker-dealers would be unable to rely on the broker-dealer exception of the Advisers Act. The Proposed Rule took the position that the Advisers Act would not apply to fee-based brokerage accounts. After republishing the rule in 2004 for additional comments, and after receiving over 1,700 comment letters, the SEC re-proposed the rule on January 7, 2005.

Despite monumental opposition from consumer groups, including the AARP and the Consumer Federation of America, the SEC persisted in its January 7, 2005 release to exempt fee-based brokerage accounts from the application of the Advisers Act.

From the standpoint of competition, and as an investment adviser representative, I am personally pleased with the re-issuance of the Proposed Rule. It permits me to hold myself out as a fiduciary, when most broker-dealer firms and their registered representatives will not accept such fiduciary responsibility. It makes marketing my professional services much easier, and it is likely to secure for me many more clients over the years. *However, I cannot sit by and permit my own pecuniary interests to prevail, knowing that the Proposed Rule will (as will be shown in this correspondence) lead to substantial harm to millions of individual investors and, in the long term, the demise of the integrity of the investment advisory profession through differing standards of conduct applied to the same functional acts.*

B. The SEC's Failure to Apply The Advisers Act To All Those Who Functionally Provide Investment Advisory Services Amounts To A Monumental Failure In Its Mission. The SEC's republication of the Proposed Rule, instead of its repeal, indicates the following:

1) The SEC Seeks To Permit The Continued Perpetuation of A Monumental Fraud Upon Individual Investors. The SEC continues to permit deception to be effected upon the individual investor by broker-dealer firms. As indicated in many comments to the Proposed Rule, including many by those who worked as registered representatives of broker-dealer firms, many broker-dealer firms and their

registered representatives hold themselves out as providing "objective advice" and "expert financial advice" to their customers, when in most instances this is simply not the case.

2) The SEC Seeks To Lower, Not Raise, Standards of Conduct. The SEC continues down a path which lowers the standards of conduct that individual investors should expect from those who provide them ongoing and/or comprehensive investment advisory and/or financial planning services, to the great harm of individual investors.

3) SEC's Abandonment of Its Fundamental Mission - To Protect Individual Investors. The SEC has, as a result of its actions, abandoned part of its fundamental mission - the protection of individual investors.

4) SEC - A Rulemaking Process Which Appears To Be Improperly Influenced by Special Interests. It can only be concluded from the SEC's actions and the clear flaws in its interpretation of the exception to the Advisers Act that, at a minimum, a strong bias exists within the SEC in favoring the interests of broker-dealer firms.

5) The SEC Will Become Moot As A Protector Of Individual Investors. Only through U.S. Congressional oversight or the prodding of state regulators will the SEC likely change its course and act in the best interests of individual investors. Otherwise, the SEC will become an ineffective protector of individual investors.

6) The Failure To Protect The Investment Advisory Profession. The Proposed Rule is another step in the continued denigration of the investment advisory profession. By permitting others to hold themselves out as providing "investment advice," without being subject to the fiduciary duties imposed by the Advisers Act to act in the best interests of the client, the SEC will continue to fail to promote and protect the investment advisory profession, thereby undermining the original intent of the Advisers Act. As stated in testimony received by the U.S. Congress at hearings in connection with the establishment of the Advisers Act:

> [T]he whole genesis of investment counseling is a personal professional relationship ... It primarily has to do with the solution of an individual's problems by a person whose advice he could trust ... Now, when you are dealing with investment counsel, you are dealing with reputation. Men who depend for their livelihood upon the opinion of others as to their integrity and their capabilities, are really dependent upon a thing of utmost fragility.

A fee-based brokerage account is fundamentally different that a commission-based brokerage account. Under the concepts of suitability, a customer paying commissions for brokerage transactions is receiving advice which is, by its nature, intermittent and non-continuous. A fee-based brokerage account may, by contrast, involve no trading whatsoever, and the advice given is both continuous and the primary driver of the relationship. By permitting investment advice to be delivered as a primary function of a broker-dealer firm in a fee-based brokerage account, the SEC has again permitted the integrity of the investment advisory profession to be put into jeopardy.

7) The SEC Even Fails To Note The Important Distinctions Between Broker-Dealer Firm Standards of Conduct and Registered Investment Adviser Standards of Conduct In Its Own Literature. Individual investors who seek guidance from the SEC on the differences in the professions, or on proper questions to ask when interviewing those who seek to provide financial planning and/or investment advice to them, need not look at the publications on the SEC's web site. As I have noted in my August 30, 2004 comments to the SEC, the SEC's own literature adds to the confusion of individual investors, and does not lessen it.

8) This Issue Is Important. It Will Define What Constitutes "Investment Advice" and, Perhaps, "Financial Planning," and the Standards of Conduct To Be Observed That Provide Such Professional Services, For Years To Come. Despite a proposed budget of $893 million for FY 2005, and a host of other rulemaking initiatives, this single act by the SEC (in undertaking the Proposed Rule) will set the stage, for years and potentially decades to come, for a continuation of the Wall Street scandals of the past and the fleecing of individual investors by brokerage firms who possess multiple and often-undisclosed conflicts of interest.

Through its actions in recent years the SEC has placed its fingers in the many leaks springing from the dam - the dam which protects individual investors from the floodwaters of greed. However, by this Proposed Rule the SEC has torn down a major section of the dam, and individual investors - not knowing of the perils posed by the water bursting from the dam above them - will be the ones who suffer.

C. Why The SEC's Reasoning Behind The Proposed Rule Is Just Plain Wrong. The Proposed Rule, as re-issued on January 7, 2005, is fundamentally incorrect in its reasoning in so many aspects. Through flawed reasoning and highly selective and incorrect interpretations of statutory language, the SEC has sought to justify a Proposed Rule which is clearly against the will of the U.S. Congress and the plain language of the Advisers Act. At nearly every turn during the process of statutory construction the SEC would have possessed a clear opportunity to choose a different interpretation, and hence would have possessed a much easier justification for the application of the Advisers Act to fee-based brokerage accounts. Instead, the SEC chose the wrong paths - to the detriment of individual investors.

1) The SEC Attempts To Rewrite The Statute By Abandoning The "Special Compensation" Test. Unable to come up with any logical explanation as to what fee-based brokerage accounts don't amount to "special compensation" being received by broker-dealer firms, and even acknowledging that "special compensation" was intended to mean any compensation other than commissions received by broker-dealer firms, the SEC took the illogical step of simply ignoring this statutory language. In essence, *the SEC is attempting by its rule-making efforts to completely re-write legislation enacted by Congress.* The abandonment of the "bright line" "special compensation" test is not an appropriate action by the SEC and clearly exceeds its authority. The SEC's conclusions in its Jan. 7, 2005 Proposed Rule release are unsubstantiated by the language of the Advisers Act, the Committee Reports accompanying the Advisers Act, or by principles of statutory construction. The SEC therefore thwarts the will of the U.S. Congress and blatantly contradicts the clear language and plain meaning of the Advisers Act, without any citation to authority and using language which is merely conclusory. The SEC simply "thinks" that it "knows" that Congress didn't mean "special compensation" to mean "fee based compensation" under brokerage accounts, even in the absence of clear statements in the Committee Reports stating at any compensation other than commissions would be considered "special compensation."

   There is simply no support in the legislative history of the Advisors Act for a construction of "investment adviser" that would exclude broker dealers who receive compensation as a percentage of assets under management from the application of the Advisers Act. As stated in the 1999 Proposed Rule and its footnotes:

   > Fee-based compensation may constitute special compensation under the Act because it involves the receipt by a broker of compensation other than traditional brokerage commissions. [*See* Committee on Banking and Currency, Investment Company Act of 1940 and Investment Advisers Act of 1940, Report No. 1775, 76th Cong., 3d Sess. 22 (June 6, 1940) (section 202(a)(11)(C) applies to broker-dealers "insofar as their advice is merely incidental to brokerage transactions for which they receive brokerage commissions"). *See also* Financial Planners: Report of the Staff of the United States Securities and Exchange Commission to the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance, February 1988 (Appendix B) ("[Special compensation] has been interpreted to exclude ordinary brokerage commissions . . . unless a `clearly definable' part of the commission is for investment advice.")]

The abandonment of the "special compensation" test is an invalid administrative action and would not likely survive judicial review under 5 U.S.C. § 706(2). Additionally, the Proposed Rule is in excess of the Commission's statutory jurisdiction, authority, and right, and a usurpation of the important role of the U.S. Congress.

2) The SEC Complete Ignores The Phrase, "the conduct of business as a broker or dealer." It could easily be argued that the phrase used in the broker-dealer exception to the Advisers Act, "the conduct of business as a broker or dealer," limits the permitted "incidental advice" to that provided when the broker-dealer firm is acting as a "broker" or "dealer" of securities. Instead, the SEC permits the broker-dealer firm to fundamentally change the nature of the services provided under a fee-based brokerage account, permitting the registered representative to provide financial planning and/or investment advisory services, neither of which involves "conduct of business" as a "broker" or "dealer." The SEC fails to even discuss this language, and the limitations it sets forth, in the Proposed Rule.

3) The SEC Fails To Properly Interpret The "Solely Incidental To" Language Applicable To the Broker-Dealer Exception To the Advisers Act. The SEC took great pains to attempt to justify an interpretation of the "solely incidental to" language of the Advisers Act, as it relates to the broker-dealer exception. The SEC even went so far as to pull out various dictionary definitions of "incidental to" language, ignoring other dictionary definitions which indicate the true meaning of "incidental" and also ignoring the adjective "solely" (or, as stated in the Committee Reports accompanying the Advisers Act, the word "merely"). Again, it would have been very easy for the SEC to interpret the "solely incidental to" language correctly (and in favor of protecting individual investors), by using the more common definitions of the word "solely" and the phrase "incidental to":

> "Solely" means "alone" or "exclusively" or "only". As used in the Committee Reports, "merely" means "and nothing more" or "just" or "simply" or "only."
>
> "Incidental" or "incidental to" means "minor or casual or subordinate in significance or nature or occurring as a chance concomitant or consequence."

The SEC instead chose a different, and lesser used, dictionary meaning for "incidental to" and gave no clear effect to the term "solely" (or, as used in the Committee Reports accompanying the Advisers Act, "merely.") It is clear that the SEC has sought to adopt an incorrect construction of the statutory language by a highly selective attempt to grab certain select and subordinate definitions from a dictionary, while ignoring the more common (and clearly applicable) definitions.

The issue of the broker-dealer exception, and its scope, involves issues of statutory construction which are nearly identical to those considered by the U.S. Supreme Court in *Lowe vs. SEC*, 472 U.S. 181 (1985):

> If the [publications] exception is expanded to include more than just publications that are not primarily vehicles for distributing investment advice, it is difficult to imagine any workable definition that does not sweep in all publications that are not personally tailored to individual clients. Indeed, it appears that this is precisely the definition the Court adopts. But such an expansive definition of the exception renders superfluous certain key passages in the primary definition of an "investment adviser": one who engages in the business of rendering investment advice "either directly or through publications or writing" or who "issues or promulgates analyses or reports concerning securities." Had Congress intended the "bona fide publications" exception to encompass all publications, it is difficult to imagine why the primary definition of "investment adviser" should have spoken in the disjunctive of those who rendered advice directly and those who rendered it through publications, analyses, or reports. Nor is it clear why Congress would have chosen the adjective "bona fide" had it not intended that the SEC look beyond the form of a publication in determining whether it fell within the exception. The construction of the Act that would exclude petitioner from the category of investment advisers because he offers his advice through publications thus conflicts with the fundamental axiom of statutory interpretation that a statute is to be construed so as to give effect to all its language.

Similarly to the *Lowe vs. SEC* decision, if the "solely incidental" exemption is expanded to include fee-based brokerage accounts under which continuous fees are paid and continuous investment advice is given, it is "difficult to imagine" how the primary definition of "investment adviser" can be given effect and meaning. In essence, the exception to the rule will swallow the rule, thereby permitting thousands upon thousands of broker-dealer firm's registered representatives to promote and provide (as a primary service) investment advice, a result Congress could not have intended. Had Congress intended the "solely incidental" exception to encompass all brokerage accounts, it is difficult to imagine why the primary definition of "investment adviser" should have been so broad and why the exception provided to brokerage accounts was so narrowly drafted.

4) <u>The SEC Fails To Acknowledge That The Fiduciary Duties Imposed Upon Investment Advisers Amount To A Higher Standard of Conduct Than The Suitability Standards Imposed Upon Broker Dealers.</u>
Perhaps **most troubling** from the January 7, 2005 re-release of the Proposed Rule is the assertion by the

SEC that the broad fiduciary duties of loyalty and due care imposed by the Advisers Act are nearly equivalent to the far lesser regulatory burdens imposed upon broker-dealer firms, such as those which follow from suitability standards. As stated in the January 7, 2005 re-release of the Proposed Rule:

> Some commenters responding to the Proposing Release additionally asserted the proposed exception would impose costs on investors, who would not receive the same treatment afforded a client of an investment adviser under the Advisers Act. While these commenters argued that the fiduciary duties of an adviser outweigh the duties of a broker-dealer, their comments do not fully recognize the extent of broker-dealers' obligations. Just as we do not believe that the congressional exception for certain broker-dealers from the Advisers Act harms investors, so too we do not believe that proposed rule 202(a)(11)-1(a) would result in investor harm.

One can only wonder why the SEC fails to acknowledge the vast differences which exist between the standards of conduct imposed upon broker-dealers and those imposed upon investment advisers, and how they possibly reached this conclusion. *It is not the amount of regulation, nor the number of bodies that provide oversight, that really matters - rather, it is the level of the standard of conduct which is required by the law or regulation.* Nearly every securities litigation attorney will tell you that broker-dealer firms resist the application of fiduciary duty standards at every turn. Nearly every securities litigation attorney will also inform you that the fiduciary duty standards impose by the Advisers Act represent a far greater set of duties, *qualitatively*, upon advisers to individual investors. The standards of conduct imposed upon the representatives of registered investment adviser firms are much higher than the standards of conduct imposed upon registered representatives of broker-dealer firms. Additionally, the entire burden of proof shifts when fiduciary duties exist. Instead of an injured investor having to prove that a transaction was "unsuitable," the investment adviser subject to the fiduciary duty standard must prove that his or her actions were justified and in line with the duties of loyalty and due care. In layman's terms, that means that the plaintiff (i.e., an injured investor) does not have to prove harm, but rather the defendant (investment adviser) must prove innocence.

Chief Judge Cardozo of the Court of Appeals of the State of New York 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. *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928).

The SEC's Proposed Rule, and its assertion that narrow obligations of broker-dealer firms toward their customers somehow equate with the broad and much higher fiduciary standards of conduct imposed upon registered investment advisers, fails to acknowledge the importance of the fiduciary duty concept and raises several important questions:

> Does the SEC fail to understand the laws that it regulates?
>
> Does the SEC understand that a fiduciary possesses much higher standards of conduct than those possessed by a registered representative of a broker-dealer (who is not ordinarily a fiduciary)?
>
> Does the SEC really believe that individual investors will not be harmed when broker-dealer firms, providing ongoing and comprehensive investment advisory services under fee-based brokerage accounts, are relieved of the broad fiduciary duties of loyalty and due care?

5) <u>The SEC Fails To Acknowledge The Harm This Proposed Rule Will Impose Upon Individual Investors.</u> The SEC seeks to substantially lower the bar as to standards of conduct imposed upon those who hold themselves out as providing investment advice and who provide as a key component of their brokerage services such advice. The SEC states, in its Jan. 7, 2005 re-issuance of the Proposed Rule, that it does not believe that the Proposed Rule will harm investors. In enacting the Advisors Act, the U.S. Congress recognized the delicate nature of the investment adviser-client relationship. It sought to formulate a profession in which investment advisers would be prohibited from engaging in practices with respect to their clients which would enable them to gain financial advantages. By its rule-making, the SEC seeks to further undue these important protections, which has and will lead to substantial harm to individual investors.

Seventy years ago Supreme Court Justice Harlan Stone observed:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.' More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it

> recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle ... Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent ... suggest how far we have ignored the necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity are incalculable. [48 Harv. L. Rev. 1, 8 (1934).]

The SEC would be well-served to take into account these words of wisdom. Alas, in the re-issuance of the Proposed Rule, it is readily apparent that the SEC has chosen to seek a construction which is nothing but a "clever legal device" - and a concurrent failure to apply fiduciary principles. As a result, the loss and suffering inflicted upon individual investors will be incalculable.

6) <u>The SEC Seeks To Abandon Functional Regulation Of The Activities Of Those Who Provide Advice To Individual Investors.</u> The Proposed Rule effects an abandonment of *functional regulation* of the securities industry, a result Congress could not have intended. In essence, individuals who provide the same services to the individual investor will be governed by two wholly distinct and different standards of conduct. Moreover, individual investors will seldom know these differences, to their great peril. As pointed out by many commentators, no amount of disclosure will ever suffice to adequately inform and educate the individual investor of these differences. Only one solution is present - the SEC should impose the same standards of conduct upon all those who provide investment advisory services, and these standards of conduct should be high.

<u>D. What Congress Can Do.</u> All of the recent rule-making and enforcement efforts of the SEC, and the actions undertaken by Congress through the enactment of the recent Sarbanes-Oxley legislation, will be rendered substantially moot by the course and path the SEC has chosen through its Proposed Rule. In essence, at the most important point in the provision of access to individual investors to our capital markets - the delivery of advice at the retail level to the individual investor - the SEC's actions undermine the important protections which individual investors both need and want.

I urge the Committees of the U.S. Congress to conduct hearings on the state of the investment advisory profession, and in particular on the hugely detrimental effects of the SEC's Proposed Rule exempting fee-based accounts from the application of the fiduciary duties and high standards of conduct imposed by the Advisers Act. I further urge the Committees of the U.S. Congress to exercise their oversight responsibility to ensure that the important protections provided by the Advisers Act are received by individual investors, and that the exceptions to the Advisers Act's applicability not be interpreted in a fashion as to render the Advisers Act a mere shadow of the important consumer protection legislation which was originally intended. I further urge Congress to make it clear to the SEC that the interests of individual investors should be paramount in the SEC's decision-making processes, and not be suborned to the interests of large Wall Street broker-dealer firms.

__E. Congress Should Also Address Disparate Income Tax Treatment.__ Clients of investment advisers who pay an hourly or flat or fixed fee or a percentage of assets under management are often placed at a substantial disadvantage, from a perspective of federal income tax law, compared to those who compensate their "financial counselor" through commissions, 12b-1 fees, and other arrangements. Investment advisory fees are deductible, but only if the taxpayer elects to itemize deductions, and even then only to the extent that "miscellaneous itemized deductions" are greater than 2% of your adjusted gross income. Additionally, tax laws relating to alternative minimum tax and the phase-out of itemized deductions also can come into play to deny deductibility of investment advisory fees. As a result, many taxpayers, especially retirees, receive no benefit from the possible tax deductibility of investment advisory fees. By contrast, since sales loads, surrender charges and 12b-1 fees are deducted at the investment product level, but often utilized to pay broker-dealer firms and their registered representatives, and these fees offset the level of gross returns of the investment, thereby effectively resulting in a complete income tax deduction. Furthermore, investment advisory fees should be able to be deducted directly from tax-deferred accounts (such as IRAs), without such deduction being treated as a withdrawal by the account holder (and subjected to income taxation to the account holder). In considering tax law changes this year the U.S. Senate and the U.S. House of Representatives should seek to have this disparate treatment corrected.

__F. Observations On The Sad State of The Retail Investment Industry.__ I am an estate planning and tax attorney. In the past 15 years I have observed the activities of stockbrokers with respect to hundreds of my clients. I also serve as Chief Compliance Officer for a registered investment advisory firm, and as such I am familiar with the regulatory structures which govern our securities markets. Over the years I have seen all kinds of improper and scandalous conduct by stockbrokers. Through my extensive contacts with my individual clients I have observed many sales of unsuitable products and churning, and many more sales of products which had such high costs or which were so tax-detrimental to the client that they should have never been considered as appropriate to meet the client's needs.

I have also observed, over the years, the multitude of conflicts of interest which infect the retail delivery of services by broker-dealer firms. Despite billions of dollars of fines assessed by the SEC against the large Wall Street firms over the past few years, I must sadly report that these abuses continue. Wall Street scandals have seemingly become the norm, not the exception. The result is continued erosion of investor confidence in our capital markets system.

Individual investors deserve so much more. They deserve *complete disclosure, in advance and in writing, of all of the fees and costs associated with the investment* products and services which they purchase. For example, there are numerous costs unknown to individual investors in mutual funds and which are not covered by mutual fund expense ratios nor adequately disclosed in the mutual fund prospectus. These costs include commissions paid by the mutual fund with respect to trades within the fund, transaction costs relating to bid-asked spreads and market impact, and opportunity costs arising from cash holdings within the fund.

Individual investors also deserve to know the *total amount of compensation paid* to a broker-dealer firm and its registered representatives, and the source and method of payments of that compensation.

Individual investors should receive a *complete disclosure of any and all material conflicts of interest* which might affect the advice they are receiving. Individual investors should not be misled into believing that they are receiving objective, expert investment advice when the person appearing before them is a product salesperson. Individual investors should instead receive advice from a trusted advisor whose conduct is governed by broad fiduciary principles.

When I inform new clients to my firm of the total fees and costs of the investment products they have purchased, and the fact that their stockbroker did not possess a duty to disclose these costs to them nor to act in their best interests, the reaction is one of shock. This initial reaction is followed by anger at the stockbroker, and then followed by disgust at the failure of our government to mandate full and complete disclosures of fees, costs, and conflicts of interest. Investors simply do not know that the person who sits before them often, more times than not, is a product salesperson and not an objective advisor to them. This vast deception is perpetuated by huge multi-million dollar marketing campaigns by broker dealer firms and, as well, by the SEC's Proposed Rule which would exempt fee-based brokerage accounts from the application of the Advisors Act.

This is the sad state of the retail investment industry today, particularly in the broker-dealer world. It is a land fraught with peril for the individual investor. It is a system which results in many, many instances of deceit, deception, fraud, and scandal. Individual investors are, by and large, not equipped to understand all of these perils, nor fight against them when they are harmed.

Moreover, I have increasingly seen individual investors abandon investing in the capital markets for stocks and bonds, due to disillusionment arising from the many recent Wall Street scandals. The government must act to protect individual investors against the perils posed by the many conflicts of interest which exist, and seek to eliminate such conflicts of interest where possible, and fully and completely disclose them otherwise, as a means of preserving investor confidence in our capital markets system.

While consumer education, such as that provided by a recent AARP Financial Advisor Questionnaire (see Exhibit A, attached), may be helpful, far better would be fundamental shift in the regulatory environment. This fundamental shift should be toward the application of broad fiduciary duties of loyalty and due care upon all those who seek to provide ongoing and/or comprehensive investment advice to individual investors. This fundamental shift should be in favor of the increased protection of all investors, and not, as the SEC would have it by the Proposed Rule, a decline in the standards of conduct which individual investors have a right to expect from those who promote themselves as investment advisers.

G. Conclusion: The Need For Immediate Hearings and Oversight. It is clear to me that the interests of the individual investor have failed to be protected by the SEC. Instead of seeking to apply higher standards of conduct upon those who provide investment and financial advisory services, such as those imposed by the Advisers Act, the SEC has proceeded down a path over the past thirty years which has effectively narrowed the application of the Advisers Act. The Proposed Rule at issue is a final step in rendering the Advisers Act meaningless as an important protection of the interests of individual investors. The Proposed Rule at issue is a final step in thwarting the will and intent of Congress, which was to protect all individual investors who seek out investment advisory services.

The time has come for the Congress to exercise its oversight authority and demand that the SEC apply the Advisers Act to all those who seek to provide investment advisory services. The exceptions provided to the application of the Advisers Act should be narrowed, as a matter of correct statutory interpretation. Public policy considerations compel the need to protect the interests of individual investors. The exceptions to the application of the Advisers Act should not, as the SEC seeks to do, "swallow the rule" and by doing so eviscerate the important protections which the U.S. Congress sought to provide to individual investors.

The proposed privatization of some portion of Social Security retirement funding should not proceed unless and until important protections are actually provided to individual investors. These protections should include, at a minimum, the application of the Advisers Act to all investment advisory activities. All those who hold themselves out as "financial consultants," "wealth counselors," "financial planners," and as providing "investment advice" should be subjected to the all-important and broad fiduciary duties of loyalty to the client and due care with respect to the advice which they provide.

Furthermore, the Congress should seek to impose higher educational standards, both initially and on an ongoing basis, for all investment adviser firm representatives and broker-dealer registered representatives who advise individual investors. The current tests are far too low a barrier for entry into a profession which requires a high degree of skill and care. Instead, passage of the C.F.P.™ exam, or a similar exam, should be required of all those who seek to provide financial planning and/or continuance investment advisory services to clients. I urge the Congress to begin the process of examining the functional delivery of investment advice to individual investors, and ways to improve the quality of the advice being delivered. This is especially necessary in light of the Social Security retirement fund privatization proposals.

The issues involved in the application of the Advisers Act and other relevant securities laws are complicated in some respects, but they are also straightforward as to the absolute need to protect individual investors and the need to restore confidence in our capital markets system. Should you desire I would be more than pleased to provide additional written or oral briefings or testimony on these important issues.

I have previously submitted extensive comments on this issue to the SEC, at five different times, but to no avail. I now believe that only pressure from the U.S. Congress can cause the SEC to come to its senses and abandon this poorly reasoned Proposed Rule. It is apparent, from the language utilized in the Jan. 7, 2005 Proposed Rule and the SEC's ill-advised attempt to avoid the application of fiduciary principles to nearly all who provide investment advice, that only quick Congressional oversight can influence the SEC to provide appropriate protections to the individual investor who seeks out investment advisory services. Congressional oversight and action is necessary in order that the SEC not substantially lessen the protections that Congress so clearly intended to provide to individual investors under the provisions of the Advisers Act.

I urge Congress to take action quickly. Millions of individual investors are in need of your protection.

Respectfully submitted,

Ron A. Rhoades, B.S., J.D.

Attorney & Counselor At Law
Ron A. Rhoades, P.A.

Director of Research and Chief Compliance Officer
Joseph Capital Management, LLC
A Member of the Joseph Financial Group

Exhibit A: AARP Financial Advisor Questionnaire

The U.S. Securities and Exchange Commission says the best advice it can give you about how to invest wisely is: Ask questions. It also encourages investors to thoroughly evaluate the background of any brokerage firm or individual broker or adviser with whom you intend to do business—before you hand over your hard-earned cash. But knowing the right questions to ask to get the right information isn't always easy. Many people feel intimidated when confronting an "expert" and are hesitant to ask questions. For this reason, AARP has developed a questionnaire that ordinary investors can give to brokers, advisers or others in the investment business to help investors evaluate whether they can entrust their money to the person who fills it out.

The 10 questions in the Financial Adviser Questionnaire can give you a lot of good information. You may have other questions, so consider this a first step. Although you can use this questionnaire to guide you during a face-to-face meeting, we suggest that you mail it and get answers in writing. There may be valid reasons why some individuals can't answer all the questions—but make sure they tell you their reasons and be guided accordingly.

While the references in the questionnaire may seem strange to you, investment experts will know what they are about. But before each set of questions is some background on why these questions deserve to be asked.

Background To Questions 1-3. Registered Investment Advisors (investment advisers) and Registered Representatives (also known as brokers, investment representatives, investment specialists, financial advisers, etc.) file disclosure forms with the agencies that regulate them. Reading through the disclosure forms can tell you a lot about their background, how they do business, and whether they've had any regulatory problems. People who call themselves investment advisers must give you at least a part of their disclosure form. Brokers don't have to but there is no law or regulation that forbids them from giving you their U-4 disclosure if you ask for it. Be wary of brokers who resist giving you this form.

1. Are you a Registered Investment Advisor (RIA) under the Investment Advisor's Act of 1940?

2. If you are an RIA, are you registered in the above state or are you registered with the Securities and Exchange Commission (SEC)? Please provide a copy of the most recent and accurate disclosure form.

3. Are you a Registered Representative of a Broker-Dealer?

Background to Questions 4 and 5. It is important to know whether the broker or adviser has been disciplined by either the regulators or one of the professional organizations in his or her field.

4. Have you ever been disciplined by the SEC, a state investment or insurance regulator, or other organization (such as NASD, one of the stock exchanges or the CFP Board)?

5. Have you personally been involved in any arbitration cases?

Background to Question 6. Many investment advisers provide a contract or letter of engagement that clearly specifies what services the client will (and will not) receive, what the role and responsibilities of the adviser are, what compensation the adviser will receive, how the relationship can be terminated and other important disclosures. The fewer surprises, the better.

6. Will you be providing me with an Agreement or Letter of Engagement outlining the services you will be providing and the fees I will be paying? (These agreements are separate from any brokerage agreements I might have to sign.)

Background to Question 7. This question simply asks for a bill for services rendered, just like you might get from a doctor. The bill should be the total dollars the broker or adviser and his or her firm will receive from working with you. Be wary of those who don't want to provide it.

7. Will you provide a written statement of the total dollars in fees and commissions earned by you and your firm and any affiliated broker-dealer, insurance agency or other similar organization because of our relationship? (If the engagement is ongoing, you would be agreeing to provide this information at least quarterly.)

Background to Question 8. "Fiduciary" means that the person working for you owes you the highest possible duty of care and loyalty, so that a relationship of trust and confidence exists between you and the planner. While you may think that this sort of trust and confidence will naturally exist, a fiduciary relationship usually depends on the facts and circumstances of a particular situation. Many brokers will not accept fiduciary responsibility. They may already have a fiduciary relationship with their brokerage firm that can conflict with their duty to you. That usually means you would truly be in a "buyer beware" relationship should you do business with this person, because you are then assumed to be knowledgeable enough to watch out for yourself when it comes to investments. If that's the case, you should know up front. Or, you may wish to work only with professionals who are always fiduciaries to you.

8. Do you accept fiduciary responsibility across all aspects of our relationship?

Background to Question 9. You cannot manage what you cannot measure. Without knowing your portfolio's rate of return and a fair benchmark (for example, the S&P 500 Index), you are left with the broker's assessment of your progress. If, for example, the average index of stocks and bonds similar to yours was up 10 percent last year, wouldn't it be useful to know if your portfolio's return was 15 percent (hooray!) or 5 percent (boo!)? Brokers regularly provide this kind of comparison to their elite clients, so you should get it, too.

9. To the extent that you will be giving me on-going investment advice, will you be providing me with a quarterly written report of my portfolio's rate of return, along with benchmarks very similar to my portfolio, so that I can assess progress?

Background to Question 10. There is lots of useful information an existing customer can provide you. Some examples: Have you had good communication with the broker (especially during down markets)? Has there been any turnover in staff that you've had to adjust to? How has that worked out? Has the growth of your portfolio matched what you were told it would be?

10. Please provide two references from clients who have worked with you over the last five years.

Copies provided to:

Mr. Christopher W. Hansen
Associate Executive Director
AARP
Washington, DC 20049

Ms. Barbara Roper
Director of Investor Protection
Consumer Federation of America
1424 16th Street NW Suite 604
Washington, DC 20036

Mr. Peter M. Kravitz
Director, Congressional & Political Affairs
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Mr. Michael Herndon
Director, Public & Government Affairs
Certified Financial Planner Board of Standards
1235 Jefferson Davis Highway, Suite 602, Arlington, VA 22202

Ellen Turf, CEO
Jamie Milne, Chairman
National Association of Personal Financial Advisors
3250 North Arlington Heights Road, Suite 109
Arlington Heights, IL 60004

Mr. Duane R. Thompson
Group Director, Advocacy
Financial Planning Association
FPA Government Relations Office
1615 L Street, N.W., Suite 650
Washington, D.C. 20036

Mr. Timothy P. Pinnington
Vice Chair & Chief Operating Officer
TD Waterhouse USA
31 West 52nd Street
New York, NY10019-6101

Mr. Charles Fishkin, Dir., Office of Risk Assessment
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington, DC 20549-0609

Paul F. Roye, Esq., Director, Division of Investment Management
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington, DC 20549-0609

Robert L. Tuleya, Esq., Office of Investment Adviser Regulation
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington, DC 20549-0609

Nancy M. Morris, Esq., Office of Investment Adviser Regulation
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington, DC 20549-0609

Katherine Vessenes, Esq.
Vestment Advisors
27125 Marsh Pointe Court
Shorewood, MN 55331

Mr. John Bogle
Bogle Financial Markets Research Center, V22
c/o The Vanguard Group
P.O. Box 2600
Valley Forge, PA 19482-2600