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Why Have an SEC?

The recent scandals involving mutual funds were brought to light by state Attorneys General, not the Securities and Exchange Commission (SEC), which has long favored the interests of the financial industry over investors. The amounts investors have lost to illegal, unethical trading at mutual funds are minuscule compared to the many billions of dollars of expenses and loads charged to investors that are legal because they are "fully disclosed."

Few economists now believe that the 1929 stock market crash was an important factor leading to the Great Depression of the 1930s (especially in comparison to the variety of misguided monetary, fiscal, trade, and regulatory policies of the period). Nevertheless, the crash was commonly blamed for the depression and "Wall Street" became a convenient scapegoat for the politicians.

The Securities and Exchange Commission was created by Congress in 1934 in the hopes of preventing the sort of double-dealing and fraud that was the subject of hearings before the Senate Committee on Banking and Currency conducted by its Chief Counsel, Ferdinand Pecora. This committee issued a report based on the hearings that, among other things, stated that:

> The excessive and unrestrained speculation which dominated the securities markets in recent years has disrupted the flow of credit, dislocated industry and trade, impeded the flow of interstate commerce, and brought in its train social consequences inimical to the public welfare.*

The Pecora hearings were carefully orchestrated. However, they did not determine the *extent* of the malfeasance revealed by the episodes that were described in testimony before the Committee. Such malfeasance may well have been exceptional rather than pervasive. More generally there is every reason to believe that misbehavior on Wall Street (with or without regulation) will be more swiftly punished by the general public than it is in, say, politics. Voters have to wait until the next election to "turn the rascals out," while investors can place sell orders on a moment's notice. It may be argued that the "little guy" does not have immediate access to the information needed to make such decisions, but it is the business of investment professionals to discover important information and it is mainly their

* Quoted in Jim Powell, *FDR's Folly*, Crown Forum, New York, 2003, p. 105.

Insider Trading

"Insider trading" has been a major preoccupation of the authorities for some time. One of their assumptions seems to be that all inside information is accurate, and that it needs to be kept confidential until it can be formally announced.

When previously confidential information is announced it is presumed that the price of a company's stock will suddenly go up or down (depending on whether the news is perceived as favorable or unfavorable for the company's prospects) by an unusually large amount. In such circumstances, the rewards of those who bought prior to favorable news or sold prior to unfavorable news presumably come at the expense of the investors on the opposite side of their trades.

Most of the time insider information develops over a period of time. The prospects for a merger, the richness of a new ore body or oil field, and similar corporate developments tend to evolve. If the insiders, employees, suppliers, consultants, even the printers of documents, were allowed to act on the fragments of information (which may or may not be valid) as they receive them, then the price of the securities would increase or decrease gradually, and there would be no sudden gains or losses. Would that not be a better situation for every one?

In fact, this is what seems to happen to a limited extent. Whenever there is a large move in a stock's price resulting from an announcement, the price prior to the announcement almost invariably will be moving in the direction of the sudden jump, because someone will be acting on the inside information.

Sometimes, however, corporate developments happen quickly. In the most publicized "insider trading" scandal, the head of ImClone, Samuel Waksal, and his friend Martha Stewart sold shares immediately prior to the announcement by the FDA that that approval of the company's new drug had been denied. Few observers seem to have noted that the inside information was created by the government. Some time before the announcement, the FDA called Mr. Waksal (presumably as a courtesy to allow him to prepare himself to face reporters and investors). Of course what he should have done, as should any CEO faced with sudden news affecting his company (such as a fire), was to ask the exchange to halt trading until the FDA's decision was publicly announced. Even so, the unsuspecting purchasers of ImClone stock during that interval paid less than they would have had the insiders held their positions.

Brokerage Commissions

The SEC does not require funds to report the commissions that they pay because there often is "no commission" on large trades conducted on a "net" basis whereby securities dealers make their money on the difference between the prices at which they buy securities for their inventories and the prices at which they sell such securities.

All funds are required to report their portfolio turnover ratio, which is a measure of their trading volume, and therefore their trading costs. Actively managed funds (run by "stock pickers") tend to have much higher turnover, often well over 100 percent, than passively managed funds (such as those based on indexes) on which turnover is often less than 10 percent.

buy and sell orders that set market prices.

In any event, a significant effect of the establishment of the SEC and its regulatory procedures was to make it more difficult to raise capital. This was especially so for smaller companies, which account for most job creation. Small companies do not have the resources to hire lawyers and other specialists to comply with the registration requirements for new issues of stocks and bonds.

The deleterious effects of the added costs of raising capital have long been well understood, even when the Commission was created, but such effects have long been assumed to be more than offset by the benefits of having the SEC around to "protect investors." The presumption seems to be that fraud, which reduces the returns to investors by diverting funds to the perpetrators, was common on new issues prior to the establishment of the SEC, and that the SEC's requirements would end or curtail such abuses.

However, investigators have sought in vain for any evidence that the "full disclosure" required by the SEC for new issues has provided any benefit to investors, *i.e.,* no one has been able to demonstrate that there was any improvement in the rate of return on new issues after the SEC came on the scene.

If a prospectus states that the purpose of a new issue is to finance a new business that has never been tried and that its officers and directors have no experience and for which the eventual capital needs are unknown, the Commission may require that the prospectus state on its cover in all capital letters (the most difficult to read of all type formats) something to the effect that THESE SHARES HAVE A HIGH DEGREE OF RISK, but that is all.

What the SEC does is to provide a cover for the underwriters and issuers of new securities—they cannot be successfully sued for fraud for something that was "disclosed" in advance. The main effect of "full disclosure," is to create an unwarranted sense of confidence on the part of investors who all too often assume that simply because the Commission has allowed a registration statement to become effective, that the securities offered are somehow approved as being fairly priced, sound investments. It is this emphasis on "full disclosure," rather than the costs and risks relative to alternative investments, that led E.C. Harwood to identify the Securities and Exchange Commission as one of the "greatest swindles of all time."

In short, as is so often the situation with regulatory bodies, the SEC has usually served the interests of industry rather than investors. It was 40 years before the Commission decided to do anything about the cartel-like systems of fixed commissions charged by members of the New York Stock Exchange. Even then the impetus to permit lower commissions after "Mayday" (May 1, 1975) came from another part of the industry, institutional investors, rather than an urge to benefit the "little guys."

The recent scandals involving mutual funds were brought to light by state Attorneys General and not the SEC. Mutual funds are vulnerable to a variety of nefarious trading practices by their managers. Some of these include:

Front Running—purchases for the manager's own account in advance of purchases for the fund, which can push up the price of a stock.

Scalping—purchasing a stock for the fund that the manager already owns himself.

Cloning—maintaining a separate (and secret) brokerage account by managers engaged in the foregoing to avoid detection.

Market Timing—in-and-out trading to make fast profits. This hurts the fund's long-term investors, because the profits are earned on all of the fund's assets, even though the in-and-outer's stake is never invested. This is not illegal *per se*, but managers who allow it may receive illegal kickbacks from the market timers.

Late Trading is the same thing, except that the in-and-outer's trades are made after the fund has been priced for the day. Late trading is illegal.

Because the prices of open-ended funds are set only once per day, their prices rapidly become "stale." Late traders and market timers can take advantage of late-breaking news that is likely to influence the following day's prices. This is not a factor in closed-end funds or the newer exchange-traded funds (ETFs), which are priced continuously in trading throughout the day.

However, the losses to investors from these practices are vastly smaller than the billions of dollars that mutual funds generate for their managers, salesmen and brokers. Annual expenses average 1.4 percent of assets at domestic equity funds (somewhat more on international funds and somewhat less on bond funds). Many funds also charge front- or back-end "loads" on purchases and redemptions of their shares. These have extracted billions from investors over the years.

With the exception of brokerage commissions on purchases and sales of securities held by a fund (see box) these vast sums are "fully disclosed." But that does not make them any less harmful to the investor. ❑

HOW TO FIND A FINANCIAL ADVISOR*

One of the most important decisions you may make as an investor is whether to turn to someone else for help in making investment choices and financial plans. If you decide to pay someone for his expertise and experience, you should first find out what kind of services you want, how the advisor is compensated, the criteria for his recommendations, and how well they have performed.

Financially successful individuals often find that earning and accumulating money does not always translate into a desire or ability to invest it. If you are one of them, you may be considering hiring an investment professional to help your nest egg grow.

Anyone scouting out investment professionals needs to know more than just names and professional designations. While there are many worthy professionals out there, investors who decide to seek professional assistance should expect to encounter an industry environment that, while it has generally changed for the bet-

* This article was written by Marla Brill, the author of *Windfall—How To Manage Sudden Money Before It Manages You* and publisher of *Brill's Mutual Funds Interactive* (brill.com).

ter over the last few years, still bears the markings of a professional Wild West.

The fact is anyone can call himself a financial consultant, financial analyst, or wealth manager without registering with securities regulators or meeting any educational and experience requirements. Questionable practices can range from an overzealous enthusiasm for high-commission products, to investment recommendations that simply don't make sense (the two are often connected), to outright fraud.

As with any other profession, competence, honesty, and integrity vary widely among financial planners. Some are excellent, while others are outright crooks. And some have their own self-interest, rather than your financial future, at heart.

Separating the shining stars from the rotten apples might take some legwork, and don't become discouraged if your first few interviews don't click. It may take time to settle on someone with whom you feel comfortable divulging your most intimate financial secrets and entrusting your financial future. What follows are some suggestions to aid your search.

What Do You Want From a Financial Advisor?

Investment professionals offer a wide variety of services and products. To narrow the field, consider first how you wish to work with one, your own investment temperament and confidence in your investment abilities, and the kinds of services you want an advisor to perform.

Some people have no desire to manage their portfolios and are happy to give someone else complete discretionary control over their assets. As long as they find the right people to handle their money, monitor their progress periodically, and feel comfortable with the reasoning behind their decisions, handing the investment reins to someone else makes sense for them.

An investment manager who works with clients on an ongoing basis—perhaps one who is compensated based on a percentage of the value of the assets they manage—can be a logical choice here. If this arrangement seems right for you, discuss whether the advisor would work on a discretionary or non-discretionary basis. With non-discretionary accounts, a financial manager agrees to contact clients before making trades in an account. Under a discretionary arrangement, the advisor need not consult a client before making investment changes.

On the other hand, individuals who generally prefer to handle their own investments may not be very good candidates for ongoing investment management, either on a discretionary or non-discretionary basis. Yet they might still want to hire a financial advisor from time to time to coach them about specific events, such as a lump-sum distribution, or to conduct a "financial checkup" to make sure they haven't overlooked anything important. In those cases, a professional who charges an hourly consultation fee, either on a onetime or periodic basis, may be appropriate. While such an individual might make investment, tax, or planning recommendations, the client will usually be responsible for actually carrying them out. Be aware, though, that while certain professions such as accountants or attorneys routinely work under hourly fee compensation arrangements, the majority of investment and financial planning professionals do not.

As you speak with financial advisors, a few may recommend a low or no-cost written financial plan to get a better view of your financial picture. While some may use the information you provide to craft a carefully-considered written plan and an effective, individualized investment program, others will produce an off-the-shelf computer-generated report that serves as little more than a starting point for a sales pitch.

Compensation Arrangements

Financial advisors today are typically paid in one of two ways. They receive a commission on the investment products they sell you, or they are paid a percentage of the value of the assets they manage for you.

A commissioned advisor is paid by the companies whose products he or she sells. To avoid the negative connotation of the word "commission," most advisors have expunged the term from their business cards. Instead, they may refer to themselves as "fee-based," which means they earn their living through a combination of fees and commissions.

Typically, a fee-based advisor will charge a minimal fee for a written financial plan, then implement that plan with mutual funds and other products carrying a sales charge. Advisors who work under a fee-based arrangement usually earn the lion's share of their living from sales commissions, and use the financial plan to get potential clients to "commit" to the process. Some will waive the fee if you later decide to implement the plan by investing through them. Others try to mask their compensation by selling products with "back-end" sales charges that kick in if you sell before a specified period of time. These products can be the most expensive for investors in the long run, and the broker still gets a commission regardless of whether the sales charge is up-front or deferred.

Alternatively, an advisor's compensation may be based on a percentage of the value of the assets under management. This type of compensation is not contingent on the sale of a particular product, and is therefore considered by many to be a more objective way to provide advice. Depending on the advisor's fee structure and the size of your account, it may be more cost-effective over the long-term than a commission-based arrangement.

You may also come across professionals who work on an hourly basis, although these individuals generally provide periodic advice to point you in the right direction, rather than ongoing investment management. Some advisors work through a salary and bonus paid by the employer. Financial advisors who work for banks, credit unions, or other organizations are usually paid a salary, but you will still pay a fee or commission to the employing institutions. A small but growing group work under a flat fee or retainer-type arrangements in which they agree to manage your money and perhaps provide some other services for a set annual fee.

There is a long-standing debate about which type of compensation arrangement is the most cost-effective and objective. Advisors who work on commission have the most incentive to push high-ticket products because they make higher commissions. The only question is whether or not they do it. While many investment professionals who work on commission are honest individuals who work in their clients' best interests, overzealous commission-hounds are still a very common breed. If you decide to use a commissioned advisor, make sure you understand all the fees you are paying.

What Do Professional Designations Really Mean?

Having an alphabet soup of professional designations after someone's name might look impressive, but it is not necessarily a sign of professional accomplishment or competence. Certain professional designations require years of study, while others involve little more than paying membership dues every year.

Professional designations and credentials can provide valuable insight about an advisor's training. They may also provide some clues on the type of products or solutions someone is likely to recommend. An advisor with one or more professional designations that focus on insurance, for example, may lean toward insurance-based products and solutions.

The web site for the National Association of Securities Dealers (NASD), a professional organization for the brokerage industry, now lists 35 professional designations that their membership uses. Per-

haps the most common of these is CFP (Certified Financial Planner). As a prerequisite to obtaining a CFP designation, candidates must have at least three years of personal financial planning experience and a bachelor's degree, or at least five years of personal financial planning experience. They must pass a final certification exam, and meet continuing education requirement of 30 hours over a two-year period.

Individuals who give investment advice and offer investment products such as mutual funds must submit a form to the Securities and Exchange Commission to use the letters RIA (Registered Investment Advisor) after their names. Contrary to appearances this is a legal requirement rather than a professional designation. For a list of other designations, what they mean, and the organizations that confer them, check the NASD web site at www.nasd.com/investor/resources/designations. You can confirm any advisor's professional designation by contacting the issuing organization, which is listed on the web site.

Judging Performance

One of the first questions many people ask a financial advisor is how well his or her investments have performed. It's also one of the trickiest to answer. Unlike money managers who work for pension funds or other institutional investors, financial advisors for individuals rarely have performance audited by a third party. A common trick is to highlight the performance of their most successful accounts, while keeping the clinkers hidden in a drawer.

There are ways to cut through the clutter. A growing number of investment managers publish client newsletters with track record accounts and their historic performance. Reviewing those newsletters, especially those that go back several years, provides both a performance paper trail as well as valuable insight into how a portfolio responds under various market conditions. Other advisors use software that allows them to present their track records based on the aggregate performance of all accounts they manage.

Ask the investment manager about strategies behind the performance. Did a heavy investment in tech stocks cause the portfolios to skyrocket during the late 1990s, but tank in subsequent years? Or did a balanced approach keep things on a more even keel? Does the advisor have a strategy that emphasizes dividend-paying stocks, or does he prefer growth stocks that pay little or no dividends? If you have a taxable account, find out how the manager plans to minimize taxes.

Question any numbers that seem too good to be true. With the brutal beating the stock market took from early 2000 to the beginning of this year, many advisors consider themselves lucky if their equity portfolios broke even over the period. Those claiming annualized returns of 25 percent during those difficult times are either really skilled at picking stocks, or inflating claims.

Check out backgrounds. With an Internet connection and a little information, you need not hire a private investigator to find out if a financial advisor has a shady past. If you are considering working with a broker you should know about the Central Registration Depository (CRD), a computerized database that contains information about most brokers, their representatives, and the firms they work for. CRD information includes employment experience, educational backgrounds, and whether or not a broker has had any run-ins with regulators or has received serious complaints from investors. The NASD's Public Disclosure Program provides CRD information free of charge. You can obtain disclosure reports through the website, or by calling 1-800-289-9999.

Investment advisors who manage $25 million or more in client assets must register with the SEC, which houses information about them in its Investment Adviser Registration Depository (IARD). To find out about advisors, read their registration forms, called the "Form ADV." Part 1 of the form has information about the advisor's business and any problems with clients or regulators. Part 2 outlines services, fees, and strategies. You can obtain copies of Form ADV from the advisor you are considering, or from the investor information section of the SEC's website (www.sec.gov).

Investment advisors who manage less than $25 million must generally register with the state securities agency in the state where they have their principal place of business. For a list of state securities regulators and contact information, visit the web site for the North American Securities Administrators Association at www.nasaa.org.

Red Flags

As you interview candidates, watch for these red flags that the Securities and Exchange Commission says could indicate trouble ahead:

- Recommendations from a sales representative based on "inside" or "confidential" information, such as an upcoming research report or a prospective merger.
- Representations of a spectacular profit over a short period of time.
- A recommendation that you make a dramatic change in your investment strategy, such as moving from low-risk investments to speculative securities, or concentrating your investments exclusively in a single product.
- Switching your investment in a mutual fund to a different fund with the same or similar objective, which may simply be an attempt to generate additional commissions.
- A recommendation to trade the account in a manner that is inconsistent with your investment goals and the risk you want or can afford to take.

Start Slowly

Unless you already feel very comfortable with an investment manager, there is no reason to sign over your life's savings if you would prefer to work your way into a professional relationship gradually. Start with a smaller stake, perhaps as little as the advisor's required minimum account size. You can always add to the account later as you gain confidence and build trust. Another option might be to begin with a non-discretionary account that requires the advisor to contact you before making a trade. Once you feel comfortable with an advisor's investment moves, you can switch to a discretionary account.

Finally, remember that the mark of a worthy investment manager is a strategy that has withstood the test of time in bull and bear markets, and that, when implemented consistently, can help you reach your goals over the long term. It is not someone who nudges clients into high-cost products they don't understand, promises spectacular short-term returns, or implements cookie-cutter strategies regardless of the client's risk profiles or financial goals. ❑

PRICE OF GOLD

	2001	*2002*	—— *2003* ——	
	Dec. 6	*Dec. 5*	*Nov. 27*	*Dec. 4*
Final fixing in London	$274.55	$322.45	$395.45	$402.25

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