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Why Maintenance of Records Required By Law Makes Good Business Sense

RICHARD P. CARNEY

THE INVESTMENT ADVISERS ACT OF 1940 AND state securities laws require investment advisers to maintain specific business records for up to six years. Establishing a system to prepare and retain such records can be a difficult task, but failure to follow SEC and state rules could cause other problems.

Although compliance with laws and rules prescribing records for advisers can become tedious, it is wise for investment management firms to look at the requirements positively and as an opportunity to establish a recordkeeping system that will enhance services to clients and protect the firm in the event of a client civil suit, arbitration or regulatory agency investigation. Thorough records also permit an adviser to document its own claim against a client or third party.

Not preparing required records may lead to a reportable SEC or state disciplinary action, or result in the negative effects of lowering the quality of services to clients and supporting failure to supervise claims by both plaintiffs and governmental agencies.

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President's Letter


Will Hepburn

NAAIM HAS INCREDIBLE power that is just waiting to be tapped. I am just beginning to appreciate that fact.

The light bulbs came on in February when listening to Search Engine Optimization wizard Mark McFall talk at the Marketing Cram Session. Mark commented on how a member's link to the NAAIM web site is a big factor in search engine rankings due to NAAIM's longevity, the traffic on our site, and the fact that we are a dot-org rather than a dot-com.

It occurred to me that the NAAIM franchise carries with it a lot of authority and we have only scratched the surface in exercising it. I intend to mine that resource to increase the visibility and value of our organization within the industry with a series of projects each of which alone has the capability to put NAAIM on the map. Executing them all will move NAAIM from being an undiscovered gem to being one of the most respected and sought after organizations in the industry.

Our first effort in this direction was to publish the NAAIM That Trend Survey of Manager Sentiment this past winter, and have seen a steady pick up in interest in it as awareness increases. On June 10th, Schaeffer's Investment Research posted a nice write-up about the survey on their site. You can see it at http://www.schaeffersresearch.com/commentary/content/a+behind-the-scenes+look+at+the+naaim+that+trend+survey+of+manager+sentiment/observations.aspx?id=85221

We are gearing up to publish a second tool, the NAAIM Index of Actively Managed Funds. NAAIM members who manage an equity fund will be eligible to have their funds included in the Index. My vision is that this new Index will promote both NAAIM and active management at the same time. Ron Rowland is spearheading this effort, so if you are coming out with a new fund, please let Ron know.

Jerry Wagner has proposed holding an annual Academic Symposium where NAAIM will award a significant prize, perhaps $10,000, for the best paper supporting active management. It is possible that our winners each year can be nominated for the Nobel Prize for Economics. If you have a doctorate, we will want you on this committee. Please let Susan know if you have a PhD and would like to help on this exciting project.

Greg Morris has agreed to begin compiling a Library of tools and resources relating to active management on our website. The sales tools will be kept on the private, members

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Taxation of Mutual Funds

MONICA HAVEN, E.A., J.D., L.L.M.

WHILE MUTUAL FUND SHARES MAY BE redeemed at any time, the shareholder—and therefore, his advisor—should consider the tax consequences of his actions.

Upon sale of any asset, a taxpayer must report the difference between his sales proceeds and his original purchase cost, adjusted for various items. In the case of mutual funds, the *cost basis* is increased by the amount of any dividends and capital gains that were reinvested into the fund during the time that the taxpayer owned the investment.

Based on the principle of constructive receipt, all distributions declared by the fund are deemed earned by the taxpayer and must therefore be reported as income. Since the investor has the choice to either cash his distribution-check or return the proceeds to the fund to request the purchase of additional shares, the tax law views this as income earned.

Once earned and then taxed, these distributions are added to the cost basis of the fund shares. Thus, upon sale, the difference between the selling price and the cost is reduced, resulting in a lower taxable profit and avoiding potential double taxation. Cleverly, this tax treatment forces recognition of current income and prevents the taxpayer from enjoying the lower capital gains rate.

For example, let's say 100 shares were originally purchased at $10/share, then in the next year a $5/share dividend was distributed and reinvested, and finally all shares were sold in Year 3 at $20/share. Assuming the taxpayer is in the 28% tax bracket, the tax due under current law would amount $215 ($75 long-term capital gains tax based on the difference between the $2000 sales price and the adjusted cost basis of $1500, taxed at a rate of 15%, **plus** $140 ordinary income tax on the $500 dividend, computed at 28%). If, on the other hand, the taxpayer could simply report the difference between the first and final transactions, he would pay a capital gains tax of $150 (15% of the $1000 profit). Alas, this is not possible.

Therefore, an investor must not only consider the timing of the sale of his shares to gain favorable long-term capital gains tax treatment (as opposed to short-term capital gains which are taxed at ordinary income tax rates), but must also watch for the fund's distribution schedule and time his purchase accordingly.

Required by Subchapter M, mutual funds must distribute the bulk of their income to their shareholders at least once each year. Ideally, a fund's Net Asset Value (NAV) should continuously rise as the portfolio appreciates. But then, the NAV will drop automatically by the amount of each distribution immediately after the shareholders have been paid (*ex-dividend* date). So, although there is no advantage to purchasing shares just prior to the ex-date, there may be a distinct tax advantage to postponing a purchase until after (or accelerating a sale) to avoid the receipt of the fund's distribution. As an added bonus, the taxpayer can enjoy the receipt of one less Form 1099 at year-end!

However, as always, investment decisions should not be based on tax consequences alone. Although important, these consequences are but one of many factors to be evaluated when purchasing or selling shares.

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Opinions and recommendations stated herein are limited to those issues discussed above. This opinion does not consider or provide a conclusion with respect to any additional issues that may exist.

Pursuant to Internal Revenue Service Circular 230, be advised that any federal tax advice in this communication, including attachments and enclosures, was not intended or written to be used—and cannot be used by any taxpayer—for the purposes of avoiding any penalties that may be imposed under the Internal Revenue Code.