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**January 31, 2005** **Volume 14, Number 5**

## Following the Money

It is not unknown for one manufacturer to gossip about another; one preneed financier to put down a competitor; or independent funeral directors to complain individually or en masse about the conglomerates. What is unusual is when a volunteer consumer advocate with nothing to gain on a personal or professional level gets a bee in his bonnet over how a particular preneed trust of relatively minor size and scope operates and reports it results.

A few months ago I started getting calls from a retired engineer in Massachusetts; e-mails with attachments and links to state funeral laws and regulations soon followed. To be fair, I was polite but largely uninterested, even when I learned the investments were exclusively in zero coupon bonds. All those eggs in one basket sounded unusual for a preneed investment; but what do I know.

Then, out of the blue, my husband's IRA zeroes matured. His \$7,500 had ballooned to \$58,000 over 20 years, and I decided it was time to more closely examine the folder of letters, documents, sample agreements, statements, reports, and third party opinions I'd acquired about **Cooperative Funeral Fund** in the past couple months.

First up, I noticed CFF's most recent filing with the SEC online was dated May 2002. But there were other issues as well – an admitted lack of audit, no fiduciary responsibility, scant fund activity, under- and over-allocation of interest "to avoid annual distortions," and fees of 1.25 percent plus expenses on what I learned was \$180 million under management. I submitted some questions to CFF president **Mark Mannix** and a week later he returned some answers – with the explanation he was on his way out of town but agreed to touch base for a follow-up next week.

Some of you are going to find the following first round of questions and answers as boring and dry as old Aunt Lena's retelling of her first communion. Others will say yea,

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but what does this have to do with me. Absolutely nothing if you care more about post-funeral potlucks and parking space minimums than how your future is shaped by others and on what basis you make your preneed investment decisions. If ignorance is bliss, the following may be uncomfortable to read. It's not illegal to be unwise, but it's not smart, either.

**Your investment adviser registration (ADV) on the SEC's website is dated May 3, 2002. Is there nothing more recent? Isn't filing with the SEC as an investment adviser an annual requirement? Are you still registered?**

I apologize for the ADV being obsolete. The paper forms we include in our presentation package were updated in 2003 and again in 2004. Our online submission simply did not transmit correctly. This was brought to my attention by the SEC in a letter dated December 14, 2004. The letter indicated that there were a good number of investment advisers in the same situation. We invite you to re-examine the site, as everything is now up to date. [Google "SEC investment adviser registration," click, then search for Cooperative Funeral Fund]

*Editor's note: If it took the SEC a year and a half to figure out CFF's online registration was two and a half years out of*

*date, the CIA isn't the only government agency facing an electronic world of hurt.*

**According to Item 8, C1, you say you have "NO discretionary authority to determine the securities to be bought or sold for a client's account." Yet in Massachusetts at least, I believe you have sole discretionary power in selecting the investment policy of "passive management," in which marketable securities consist solely of US Treasury STRIPS. Isn't that a contradiction?**

We do have discretion over which US Treasury securities are purchased for the fund. Earlier filings indicated a lack of such discretion because of the extremely limited nature of the investments allowed under the Funeral Service Agreement. In other words, CFF's discretion is narrowly limited by its contractual obligations. An SEC auditor in 2003 suggested that the "discretion" answer should be changed to be technically accurate; CFF still recommends which Treasuries should be purchased for the fund. However, I emphasize that all fund assets are US Treasury bonds.

*This is interesting. There was indeed a contradiction between "no discretion" and "sole discretion" until CFF's online SEC registration was updated January 12. I asked the question on January 11. Coincidence, no?*

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FUNERAL MONITOR (ISSN#1089-8212) is published weekly (except for Memorial Day week, Independence Day week, Labor Day week, and Christmas week) by Abbott & Hast Publications, Inc., 761 Lighthouse Avenue, Suite A Monterey, CA 93940. Copyright 2005 by Abbott & Hast Publications, Inc., (831) 657-9403. Single copies \$5 each, when available. Inquire for bulk reprinting rates. Abbott & Hast Publications, Inc. also publishes *Mortuary Management* magazine, monthly for funeral directors and funeral service industry. Visit our company website at [www.funeralmonitor.com](http://www.funeralmonitor.com).

According to the "review" of the Massachusetts FS escrow account by Benedict Schiraldi dated June 2004, the figures are based on information supplied by CFF. It is not an audit and, therefore, does not reflect Schiraldi's opinion. Why no audit for a fund valued at over \$20 million, and what about an audit for the additional \$95 million in other assets from other states? [Actually those are 2003 numbers. The totals today are \$30.5 million in Massachusetts and \$180 million overall.]

For a number of years we did conduct a full audit. However, one of the elements of those audits was a random sampling of clients to confirm balances. Frequently, it would take two or three requests of the sampled funeral home clients to precipitate a response. In fact, on too many occasions funeral directors would call me to ask what numbers should be inserted on the request form! Naturally, I could not give them the answer. I would have to send them a copy of their December statement and hope that they would respond. This made the audit very expensive for the fund. The process we now employ is essentially the same as an audit, but deals only with the confirmations we receive back, rather than the costly pursuit of those who don't respond. Thus, technically we can no longer call it an audit under accounting standards. Most important, however, is the fact that because CFF does not have access to or custody of the assets in the fund, the SEC does not require an audit.

*The dog ate my homework.*

What is meant by Schiraldi's Note 5 regarding net assets: "Fund management has in the past not fully allocated to the funeral accounts all interest earned by the fund to avoid annual distortions." Then for 2003, you show an over allocation of \$12,245. Not allocated,

over allocated; is any of this real money or just computations based on bonds held to maturity? Please explain.

*This question was overlooked and left unanswered by Mannix. But I'll try again in the follow-up because the over-and under-allocations get to the heart of what some people see as "slush fund accounting."*

As of December 2004, you say you had a current interest rate of 5.7 percent. Gross? After fees and expenses, that probably put returns in the 4 to 4.25 range – not very different from anyone else. What distinguishes you from the others?

In December 2004 our interest rate for the Massachusetts fund for the month was 5.7. For all of 2004 the weighted average was 5.925. This represents better than 4.65 percent net return. This return, with the investments in US Treasuries (the financial benchmark for zero risk), is actually quite good. Preneed insurance companies that I am familiar with are, in their best growth product, crediting 3 percent simple earnings growth, with no compounding. CFF's major selling points are our service, commitment, and overall ease of use, as well as security of funds; not our interest rate.

*Fair enough, although I believe there might be some competitors who disagree.*

**Are crediting rates a discretionary choice for funeral trusts – as they are for insurance companies – based on market forces and competition?**

Our interest rate is determined entirely by what the US Treasuries in the fund earn. It is not discretionary.

*No discretion outside of under- and over-allocating earnings. Am I the only one who's confused?*

Haven't zeroes done considerably better

than gross yields of 6 to 7 percent in the last six or seven years? Doesn't a past history of "not fully allocating all interest earned" shortchange some funeral contracts at fulfillment to soften the blow for a possible future market downturn? Does trust accounting permit that kind of discretion, and who oversees and regulates you?

No. Zero coupon bonds don't do better or worse than regular Treasury notes at the time of purchase. Interest rates on bonds available for sale over the past 4 or 5 years steadily declined from 6.5 to 3.5 on longer maturity issues until mid-2004, when rates started to inch up. We don't under allocate to save for a rainy day. It is just an accounting snapshot of where we are on December 31. We attempt to distribute any underallocations in the first month of the following year. Consistent with valuing the Treasury bonds on a "held to maturity" basis, it is our objective to provide a more stable interest rate rather than to mirror market fluctuations.

*Good answer but it would be even better if it had even a fleeting relationship to the questions. Time to brush up on my Esperanto.*

**In Massachusetts in particular, what would happen if the bond market goes south? If you're exclusively buying zeroes and are forced to sell before maturity to remain liquid, wouldn't that be a dangerous situation?**

Why "in Massachusetts in particular"? It is the same for all the funds. If interest rates should rise rapidly to 10 percent, funeral homes would have to be satisfied with our 5.7 percent (in Massachusetts) return. As Treasuries matured and were reinvested at the new rate, the fund would again achieve more competitive earnings. If the fund had to liquidate Treasuries it holds in the 10 percent environment, the market conditions would dictate a discount

on the sale price to reflect a 10 percent return to the buyer. Theoretically, this would result in a loss for the fund. Certificates of Deposit pose the same problem. A five-year CD paying 3 percent will be subject to early withdrawal penalties (generally six months of interest) if it were surrendered. That is simply a market reality.

CFF has been managing funds for funeral homes for over 15 years. In the way we have "laddered" the Treasuries the fund holds, the fund will weather any anticipated rise in interest rates.

*Another market reality is when you value a bond portfolio on a "held to maturity" basis but liquidity pressures force you to sell them in their youth, accounting deficiencies can raise their ugly heads. Just ask Indiana.*

**In the event of sales, how would you deal with the capital gains?**

If a bond is sold and it generates a capital gain, the gain would be distributed as earnings.

OK.

**Does Wachovia Bank [the trustee] know the identity of the purchasers? What are its fees?**

At the end of every month we send each funeral home a statement which shows every individual preneed client, their beginning balance, any additional deposits, interest earned, claims or withdrawals, fees, and ending balance. A copy of this statement along with every other funeral home's statement goes to Wachovia Bank, N.A.

*Whew! That's a relief. Now, what about the fees?*

**Who has fiduciary responsibility?**

Here is where the relationship may vary state by state. Since you seem more interest in Massachusetts, I will focus my remarks on that state. Newly enacted state board

regulations in the Commonwealth require a state or federally chartered bank with trust powers or a trust company in the Commonwealth to be the "trustee." The overall fiduciary responsibility rests with that trustee. Wachovia Bank, N.A. serves as trustee in our program.

*Another relief. But Article 1 of CFF's funeral services agreement, which is believed to be current as of August 2004, clearly states that Wachovia Bank is the trustee entitled to "compensation for services rendered" and "reimbursement for all expenses incurred," although it has "no fiduciary responsibility...no liability for any losses relating to any investments...and shall not be responsible for the acts or omissions of the funeral director, the investment adviser, or any purchaser." Hmmm...*

**One and one-quarter percent of your [most recent] \$180 million of assets under management works out to \$2.25 million of income annually for "one to five employees," plus expenses. Lucrative yes, but fairly steep in comparison to other funeral trusts. How do your clients respond?**

I know you understand the difference between gross revenues and net profits! Like every other business, revenues need to support expenses. The reference to "one to five employees" is to investment-related or sales employees – not clerical employees or support staff. CFF has 12 employees and a very significant payroll, with full medical insurance and benefits. We have high equipment costs; and other expenses that go along with the kind of service we provide to our clients. I promise you, it is not cheap to run this business. Nevertheless, we are competitive...not expensive.

You inquired about how CFF's clients respond? In 2004 no clients left the CFF preneed program. (Two clients did transfer some of their client funds to insurance

products – the motivation being commissions.) Seventy-five new clients joined CFF. We view that as a positive response to our system and look forward to continued growth as more and more funeral directors become acquainted with the security, service, and convenience that CFF provides.

*Kumbaiya, my Lord, kumbaiya....*

Zero coupon bonds have been very good to me (notice how I've already co-opted my husband's investment?), and they are possibly very good preneed funding vehicles. Yet it's the lack of audit, detail, and financial accounting standards as well as the over and under allocation of interest that raise questions.

Cooperative Funeral Fund does business with 441 funeral homes in Connecticut, Massachusetts, New York, New Jersey, Pennsylvania, Rhode Island, Tennessee, and Maryland. In a perfect world, those eight state funeral boards would have investigated CFF long ago and discovered its investment platform and bookkeeping practices may be unusual, but up to snuff. It is even possible state FDAs would have liked Mannix's investment philosophies so much, they redirected their own master trusts to mimic it, investing exclusively in zeroes.

On the other hand, at least one state board may have said this looks like a good idea but we need some hard evidence the money is really where you say it is. Right now it appears the expiring contracts might be funded by the new money coming in. We understand there are many costs of doing business; and an audit is just one of them.

But it's not a perfect world. State and federal regulators are more attuned to putting out fires than preventing them, so somebody's got to ask the hard questions for FDs who don't have the time, and the consumers who trust them.

## Trust, but Verify

Funeral home owners make decisions every day; most of the time they're pretty good ones but occasionally and regrettably, some clunkers slip in. A decade ago I heard a story about one fortunate fellow who saved himself in the nick of time from what may have been a slow and painful financial death:

A funeral director in his mid-60s with \$6 million in preneed trusts was flattered when invited to dinner by a couple executives from an insurance company he'd never even heard of. The food was delicious and the night was a success.

On the strength of the hosts' assurances the company was in "good financial shape," the FD made plans to transfer them \$3 million – half of the assets of his preneed accounts – for which he'd receive a windfall commission in return. The FD figured why not? He had enough to do arranging and conducting funerals, managing his staff and facility, and keeping everyone happy. What did he know about investing? Besides, these guys were impressive: expensive suits, great storytellers, and top-shelf tastes.

The FD failed to ask about the company's A.M. Best rating, and his dinner companions neglected to reveal it was withheld from the public at the company's own request.

The funeral director, impressed as all get-out by being so royally treated, mentioned his plans to a colleague the next morning, and encouraged him to make the same switch. Lucky for the FD, his friend was cautious about something that sounded too good to be true, and warned him to ask around about the company before putting his future on the line. A few quick calls to his insurance agent, Best, and the state insurance commissioner's office later, the

FD decided to leave the \$6 million parked where it was.

When it comes to funeral trusts, however, state and federal regulators are mostly asleep at the wheel and third-party rating agencies are nonexistent. There could be danger ahead when trusts advertise themselves as the best thing since sliced bread, and FDs who like what they hear line up with a jar of mayonnaise in one hand and a package of baloney in the other.

While the goals of prepaid preneed are the same for the purchasers regardless of whether the contract is funded by trust or insurance, the regulation and oversight of the two couldn't be more different. Insurance operates in the sunlight of state commissioners with rafts of requirements regarding training and licensing, contract language, and a safety net of required reserves. There are also a number of for-profit companies that track and rate the insurers on the bases of financial strength, investment, history, ownership, organization, and leadership.

Not true for funeral trusts which remain, by comparison, largely ignored: unregulated outside of broad investment guidelines, unaudited according to any standard practices, and (just maybe) free to credit earnings on a discretionary basis.

Several years ago I called every state department of banking, finance, and securities, some secretaries of state, and a few attorneys general to try to find out the value of existing funeral trusts across the nation. Fat chance. One state banking commissioner told me flat out: "Funeral funds are such a tiny part of our total responsibility, we don't pay too much attention to them. Sure, our examiners see them on the books, but we have no idea

what they amount to.”

Even worse was the answer repeated time and time again: “Funeral homes are required

to file an annual report with the state. We put them in boxes in storage. No one looks at them – unless there’s a problem.”

## Federal Judge Admonishes PA Board As “Clumsy and Disingenuous”

There’ve been some dueling lawsuits going on in Pennsylvania between the state board and **FD Ernie Heffner** over the dissemination of GPLs since at least 2001; and they aren’t finished yet. Score one for Heffner in the latest go-round after District Court Judge John Jones 3d ruled on January 13 to deny the board’s contention a summary judgment was in order because the claims against it were moot, and defer Heffner’s own motion for a summary judgment to a later time as the feuding continues.

At issue is whether a non-licensed FH employee or agent may “show, distribute, or summarize price information regarding funeral services or merchandise.” The state board’s been a moving target on this one; opining yes, no, and not really since the late 90s. Confusing the offering and explanation of a GPL with funeral directing, the board passed a resolution in 1999 that stated:

The state Board of Funeral Directors believes that the showing, distribution, or summarization of any price list of a specific funeral home or any explanation of the funeral services or merchandise available from any specific funeral home for any commercial purpose whatsoever, except as may be specifically necessary to comply with Regulations of the Federal Trade Commission, for funeral services needed for a person then living, constitutes the practice of funeral directing by engaging in preneed sales. Section 13(a) of the Funeral Director Law limits this practice to licensed funeral directors. The Board may consider it to be unprofessional conduct for any funeral director to authorize or permit any such activity constituting the practice of funeral directing.

On the strength of the Resolution’s later repeal, the board argued the issue was moot, gone, evaporated; and Heffner’s case against it should be dismissed. Plaintiff Heffner disagreed on two grounds: 1) a threat of prosecution by the Board still exists, and 2) despite the Resolution’s rescission, many Board members believe (and a few even testified in their depositions) that the Resolution remains “an accurate statement of the law.”

“It is clear to us,” ruled Judge Jones, “that there is every reason to believe that the Board, despite having rescinded the Resolution, still considers the Plaintiffs’ conduct in question to be prohibited by the Pennsylvania Funeral Director Law. Unquestionably then, Plaintiffs’ conduct is chilled because Heffner faces a direct threat to his livelihood in the event of Board action.”

And he didn’t stop there. “We would be remiss,” he goes on in his Order, “if we did not admonish Defendants that in our view their post hoc [after the fact] attempt to eliminate Plaintiffs’ claim, by withdrawing the Resolution, gave the appearance of being both clumsy and disingenuous.”

And the beat will, no doubt, go on.