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Share Class Suits Raise Questions About Prospectus Accuracy

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Recent lawsuits and news articles have raised questions about the information that funds provide to investors concerning the expenses of different share classes and the way conversion of Class B shares to Class A shares impacts performance.

The debate seems to center on investors with less than $50,000 to invest and whether Class A shares will ever be a better choice for such investors than Class B or C shares. Two lawsuits that name **MFS** and **Lord Abbett**, as well as articles in *The New York Times,* allege that fund prospectuses may be misleading. They claim that disclosures are misleading because they don't provide investors with information about compensatory conflicts brokers face in selling different share classes and don't illustrate in performance charts the impact of the conversion of Class B shares to Class A shares.

In addition, the lawsuits allege that investors may be misled by fund expense examples that show Class A shares as being less expensive over time than B and C shares, when the less expensive share class doesn't necessarily translate into higher account value for investors.

Taken as a whole, the inaccurate or misleading charts and the perhaps difficult-to-locate information about the way brokers are paid for selling different share classes may lead investors or their financial advisors to favor a share class that won't result in more advantageous account value.

Lord Abbett declines to comment on the suit. MFS says the suit is baseless and without merit. Indeed, some industry observers are skeptical about the validity of the allegations. However, the suits highlight an area where fund companies may be susceptible to litigation: prospectus disclosure. As the industry prepares for an onslaught of litigation in the wake of this year's market turmoil and the big losses that have hit funds, much of the litigation will focus on disclosure, experts say.

For boards, the issue is twofold. Directors sign off on disclosure documents, so there is a question of liability for directors if calculations are inaccurate or disclosure appears to be misleading. On the other hand, nobody expects directors to calculate information in fund prospectus fee and expense tables or charts showing historical performance. Plus, releases from the SEC over the years have provided detailed instructions about what the commission expects from fund companies in registration statements and what those presentations and narratives are expected to explain to investors.

Therefore, observers say, boards should oversee controls in place to ensure that investors receive accurate and meaningful disclosure in fund prospectuses. For chief compliance officers, observers suggest that annual compliance reviews include testing of calculations used in prospectuses.

Howard Suskin, a partner with **Jenner Block**, says fund directors can, as a best business practice, confirm that the calculations in fund prospectuses are correct by hiring an independent firm to audit the prospectus.

"Directors are not going to be expected to be responsible for the calculations being performed or that level of detail or minutiae," says Suskin. "Where they're going to be held responsible in their oversight function is to be comfortable that appropriate controls and systems are in place to do the calculations correctly. That's the level at which the directors, if they are going to be held accountable at all, might be held accountable."

One of the first questions directors can ask advisers, says Jeff Keil, a principal with **Keil Fiduciary Strategies**, is what process the adviser applies to come up with figures in the prospectus and how it's checked and validated before the documents are officially filed with the SEC.

"The document obviously needs to be fully accurate," says Keil. "It needs to disclose all the conflicts of interest to ensure investors make a fully informed choice."

Gene Gohlke, an associate director in the SEC's Office of Compliance Inspections and Examinations, notes that the Division of Investment Management reviews fund registration statements. Beyond the division's review, exam staff in their assessment of the funds' compliance reviews look at controls the fund has in place pertaining to preparers of disclosure language and any charts in the prospectus, he says. Examiners also review mechanisms for checking the information presented to investors.

"So, as part of the board's review and approval of the compliance programs of those service providers, it would seem prudent that the boards pay attention to what controls exist regarding preparation of, review and vetting of disclosure materials, including fee tables, performance tables and whatever type of tabular as well as textual presentation are in disclosure documents," says Gohlke.

Stu Speckman, chairman of research and consulting firm **Broker Village**, says some fund companies have hired his firm to audit prospectus and marketing materials for accuracy. Broker Village, which provides algorithms to the Financial Industry Regulatory Authority (Finra) for its mutual fund expense analyzer, is considering approaching fund board members about some of the problematic issues they see in prospectus and marketing materials.

According to Speckman, the math problems with calculations in prospectuses are hard to see. And if the calculations don't account for the impact of fund dividends, the prospectus is likely inaccurate, he says. For example, miscalculations of the contingent deferred sales charge can result. That contributes to overestimations of the cost of B and C shares, says Speckman.

"Most firms continue to verify the same wrong tables, same wrong charts, and same wrong sales limits," writes Speckman in an e-mail. "These issues disenfranchise investors. Investors may buy the wrong share and, thus, account values are unnecessarily low."

The debate over A and B shares flies in the face of conventional wisdom. Around 2002 and 2003, regulators fined a series of brokers for steering investors into B shares because of the commissions the brokers earned, when A shares would have been the better choice because of breakpoint discounts. In addition, brokers were found by regulators to have broken up investment amounts to escape scrutiny.

Indeed, the public scrutiny of B shares seemed to coincide with a significant drop-off in their sale. Advisers also put into place limits on the amount of B shares that could be sold, and some fund companies got rid of B shares altogether.

The difference between Class A, B and C shares has to do with the way brokers are paid for selling the funds. In an A share, investors pay brokers a commission out of their initial investment amount and pay lower expense ratios. In Class B shares, investors pay higher annual expenses and are subject to a charge if they redeem their shares within the first half dozen or more years.

That's because in a Class B share sale, fund companies front the commission to the broker for selling the funds and recoup the commission over time from the fund investor with a higher underlying expense ratio. The higher expense ratio is typically the result of a larger 12b-1 fee. Class B shares also have a declining CDSC that investors would incur if they redeemed their shares.

The B shares eventually convert to A shares, typically after seven, eight or nine years — although every fund company looks at the economic reasons differently. In an A share, the former B-share investors pay a lower expense ratio. Advisers want to ensure they're going to recoup what they fronted to the broker in commission even if fund performance tanks, explains Eric Jacobson, a fixed-income specialist and former senior analyst with **Morningstar**. Advisers take on the risk; therefore they want to ensure they're fully paid back.

Because of the details in disclosures to investors and in marketing materials, fund companies have formalized systems in place for preparing prospectuses. However, the details of different fee structures for various funds can

be painstaking, observers say.

Indeed, David Lui, CCO with **FAF Advisors** and **First American Funds**, has put a process in place so that there is someone within the fund firm that is accountable for factual information. FAF uses sign-off sheets in composing marketing materials, for example, so that employees higher up the chain know specifically who stands behind the information and that there's integrity in the process, he says.

In addition, Lui conducts testing on the sign-offs. Therefore, he can go back to the person that signed off on the information and ask for the calculations on which the information is based. The sign-off sheets also serve to make the source of the information aware that the data or disclosure will be used for public materials, and that the request for information or data can be taken with the requisite amount of seriousness, he says.

For the most part, fund companies aren't wholly consumed by the fee structure in place, says Jacobson. Advisers are simply setting up a system to get asset management services distributed in the marketplace. Whether it's done through a front-end or back-end load isn't much of a concern, he says.

"The money manager back in his office at the Bloomberg is pretty agnostic most of the time, unless it affects way the money comes in," Jacobson says.

Historically, fund companies had Wall Street firms securitize their 12b-1 fees because the only risk to the payment streams is that the market will tank and an annual payment from investors of 75 basis points on an account that has declined significantly in value is a lower dollar amount than what the fund company paid when it fronted the commission to the broker, says Jacobson.

Wall Street firms structured asset-backed securities so that the purchaser of the security would pay for a claim on the 12b-1 payments coming up in the future, he says.

"In other words, the fund firm is selling a security to Wall Street… to pay brokers," says Jacobson. That way it doesn't come out of their pocket, and then as the fees come in over time, the cash flows go to pay off securitization and everybody is protected in the event of early redemption by a deferred sales charge, he says.

This is the first year in quite some time in which this will be an issue for some fund companies, he says. Massive redemptions and declining asset levels have plagued fund advisers across the board.

For its part, the SEC has long been at work on improving disclosure to investors about the different fees and charges in share classes.

In January 2004, the SEC proposed a rule that the agency hoped at the time would vastly improve disclosure to investors at the point of sale. The SEC in its proposing release laid out numerous concerns with disclosure to investors from brokers and its plans for more clarity in sales loads paid in different share classes from brokers and in the fund prospectus.

"More complete disclosure also may help customers understand the costs associated with purchasing fund share classes that carry deferred sales loads, as well as the potential conflicts of interest that broker-dealers and their associated persons have in connection with the sale of those share classes," states the SEC in the proposing release.

At the time, however, the SEC seemed concerned mainly with brokers' failing to disclose to investors that they could have received the benefit of breakpoints if they had invested in A shares rather than B shares. The agency pointed to recent enforcement actions that had heightened the visibility of conflicts of interest in compensation arrangements that might lead broker-dealers to act against the interests of their clients.

The SEC received thousands of comments on the rule proposal and ultimately opened the rule back up to comment in 2005. The agency has not yet adopted a final rule.

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