http://www.ignites.com/moneyvoices/20090226/prospectus_errors_tarnish_funds

Money Voices: Prospectus Errors Can Tarnish Funds

Column published on Feb 26, 2009 Discuss this column

Guest Columnist: Stuart Speckman is chairman of Broker Village, a research and consulting firm that provides mathematical algorithms to financial services firms.

The accuracy of mutual fund prospectuses recently has come under scrutiny. A fund firm can face huge liability if problems exist. That's because a suitability determination is premised on prospectuses being accurate and unambiguous. Sadly, many fund boards and chief compliance officers (CCOs) have a false sense of security. Problems are more common than generally believed. Prospectus accuracy was central to a U.S. Court of Appeals decision, *SEC v. Tambone*. In that case, Columbia Funds executives were found liable for damages since they knew, or should have known, that prospectuses were inaccurate.

Accuracy also is central to lawsuits against MFS and Lord Abbett. Damage claims are $400 million plus. The suits allege that, for select funds, loaded A-share trades under $50,000 should be discouraged since B- or C-share values always are higher. On this issue, it is claimed that prospectuses are silent, misleading, or in error.

Our clients, the press and regulators constantly ask for our "take" on the cases. We have no opinion on the legal merits. But after careful analysis of the math issues, we find that problems abound. In fact, they extend beyond what the suits brought to light. Problems are buried deep in the math, are hard to see, and may go undetected for years.

Consider trades below $50,000. For many firms, account values for higher-cost B or C shares always are greater than for lower-cost A shares. That conflicts sharply with conventional wisdom. Odd as it seems, cost is no proxy for account value. Prospectuses often state that share class choice be premised on lowest cost. That's not always good advice. The veracity of that claim varies by fund and firm.

Next, we analyzed prospectuses from 20 firms. We found errors in numeric tables, sales limits and textual rationales. Firms forgot B-to-A flips. They capped B shares at $99,999 when the proper limit was $249,999. Disclosure text was not supported by the actual math. Sales brochures and online tools also had issues.

Happily, everything can be fixed quickly and easily. But the work is beyond the normal purview of lawyers and accountants, who often resist the process and believe it is unnecessary. You need special analytics to evaluate non-standard trade sequences, account types and return scenarios. A "fix" may not just be disclosure. It may be a change in a contingent deferred sales charge (CDSC) schedule, trail timing or reallowance. Profits are affected differently, so great care is required.

As a result, CCOs and boards should ensure that accuracy is verified by independent firms that specialize in this area. In fact, the Securities and Exchange Commission recently stated that such an approach was prudent. A fund firm then may limit liability, protecting its profits and brand.

Do you recommend this column? Your Choice: Yes

84% of readers have recommended this column.