BROKER VILLAGE
A Division of Black Cat Decisions, LLC
1475 Catamount Road, Suite 100, Fairfield, CT 06824
Ph: 203.259.6700 www.brokervillage.com

What's in That Nicely Wrapped Package? Big Fees?

The wildly gyrating markets of the past twelve months have led many mutual fund investors to more actively trade the funds they own. For many investors who chose to invest in wrap-fee programs, this flexibility is a godsend. For other investors, wrap-fee programs may be doing more harm than good.

Amid the tumult, one trend is clear: increasingly, investors are choosing mutual funds through wrap-fee programs. Sales volumes from Cerulli Associates and the broker/dealers themselves bear this out.

Commensurate with this sales growth is the rapid growth in the variety and number of institutional shares offered by fund firms. Many firms offer at least three different shares that can be housed within a wrap account. Each one has different 12b-1 fees and none have front-end or back-end sales charges. I-shares and W-shares often are the names (though they vary by firm), in addition to load-waived A-shares.

But, as more retail investors move away from load fund shares (A-, B-, and C-shares) and into wrap accounts, the issue of suitability remains quite relevant: some investors are ill-suited for wrap accounts. Over time, for some wrap account investors, mounting costs can suppress account value growth. And, reps who move ill-suited investors into wrap fee accounts can face accusations of undisclosed – or poorly disclosed – conflicts of interest. As an unexpected consequence, the slew of new institutional share classes present new compliance and disclosure challenges for fund firms.

Of concern, particularly to FINRA, is the practice known as "double dipping." A double dip happens when an investor owning A-shares moves those shares into a wrap account after having paid a sales charge a few years earlier. Investors may not always understand the true costs of a wrap account. Thus, a fund firm may be at risk if it inadvertently steers investors to institutional shares when the more suitable share is a load share.

Even if a load was waived, or paid many years ago, problems can arise. Wrap fees often exceed the 12b-1 fees that the investor explicitly avoided in the first place. For B- and C-shares, 12b-1s often are 1% per year (of a 1.75% total fee). Wrap fees typically are 25 to 50% higher. If load-waived A's or certain institutional shares are used, total fees approach 2.5% per year, far in excess of typical B- and C-share fees.

For pure institutional shares, prospectus accuracy and suitability still are issues. Consider the expense example. Errors occur when cost figures are transposed, are not based on the associated fee table, or are not derivable from the footnotes. To ensure maximum accuracy and minimum liability, specially tailored analytics are required to "see" the issues. Per suitability, institutional share class prospectuses disclose that investors can pay extra wrap fees. However, they offer little guidance as to the magnitude of those fees. Investors should be informed that, to buy an institutional share, they may have to spend 1.5% per year on a wrap fee.

Plaintiffs' lawyers and regulators could claim that firms have a duty to address these issues more thoroughly. Defending against the claims will cost more than taking the issues off the table now. Fortunately, proactive action can head-off much potential liability.

Douglas J. Weber
March 2009

Mr. Weber is the Director of Research and Client Services for Broker Village. The firm provides analytics and consulting to B/Ds, fund firms, and regulators. Doug is a twenty-year-veteran in advising capital markets firms on their communications and marketing strategies, with a specialty in board and corporate liability issues. He served as Associate Publisher of *Corporate Leader* and *Dealmaker* magazines and the publisher of *Boardroom Liabilities*. Doug has a BA in English from Connecticut College. He and his family live in Westport, CT.