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B-Share Case Points to Need for Added Disclosure

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A recent case of B-share misconduct by a former broker highlights the potential advantages of a proposed point-of-sale rule, attorneys say.

Indeed, the SEC has previously proposed a rule whereby brokers would be required to provide clients with a standardized document on fund fees and other key factors when pitching funds.

A recent SEC decision to sustain an NASD action over inappropriate sales of B shares has ignited a renewed interest in the rule.

The case involves the SEC's decision to uphold an NASD ruling to disbar broker Raghavan Sathianathan from association with broker-dealers. The broker had previously done stints with **Smith Barney** and **Morgan Stanley**.

The SEC action results from Sathianathan's recommendation that two clients invest large sums of money in B shares, when A shares would have been more suitable. In one case, the broker, who was on probation at Smith Barney, recommended that a client invest $1.75 million in Class B shares. By divvying up the amount among a variety of portfolios from various fund shops, Sathianathan avoided exceeding maximum purchase amounts that fund firms had established for the share class.

Indeed, following a series of high-profile B-share sales enforcement cases brought by the NASD involving broker-dealers, many fund firms over the past three years or so have established limits on the maximum amount brokers can invest on behalf of individual clients in the share class. The idea is that A shares, which offer discounts on up-front sales commissions for larger accounts, are more economical for investors. Indeed, the SEC decision says that expense ratios for A shares can be as much as 75 basis points lower than funds' B-share counterparts.

While the limits on B-share purchases vary from fund shop to fund shop, they can typically be as low as $100,000.

The SEC decision also says that Sathianathan leveraged his clients' portfolios by using brokerage margin and by holding shares of telecommunications company **Jupiter Networks** as collateral.

The clients involved in the matter were also employees of Jupiter and had amassed large positions through employee stock programs. The SEC decision, however, maintains that the stock had previously experienced significant price volatility. When the stock began to decline, Sathianathan's clients were subjected to a margin call, which required that a portion of the mutual fund shares be sold off. That resulted in the broker's clients getting hit with deferred sales charges on the liquidated B shares.

The decision makes no mention of Sathianathan's disclosing to clients the fee structures of different share

picture

classes, points out Todd Cipperman, esquire with law firm **Cipperman & Company**.

"If a point-of-sale disclosure had been provided, this may have been avoided," Cipperman says.

The disclosure is intended to be easier to understand than fund prospectuses, which have become increasingly complex over the years as fund firms use the documents to hedge risk of litigation from shareholders. The goal is to preempt litigation by ensuring that risks associated with a fund as well as fees and other characteristics are properly disclosed in prospectuses. The end result, however, is that the documents have become overly complex.

Cipperman points out that the broker claimed that fund shops encourage the use of A shares because the share class is more profitable. In reality, however, A shares often have lower fees than B shares. A point-of-sale disclosure document could prevent brokers from making such inaccurate claims, he says.

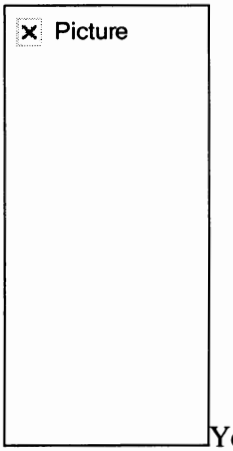
Others agree.

"The point-of-sale rule would help to make the sales process more standardized, and this problem may not have been as severe," says Niels Holch, executive director of the Coalition of Mutual Fund Investors.

Picture

An SEC spokesman says the proposed rule is still pending, but declines to provide additional comment. Some observers add that the SEC is struggling with issues over what type of information should be included in the documents and if fund firms or broker-dealers should foot the cost of providing the materials.

Either way, fund firms are currently doing their part to prevent such abuses by disclosing fees within



prospectuses, says Chip Roame, managing principal with Tiburon Strategic Advisors. Yet, some industry observers say fund firms can do more to stop such abuses.

"Maybe fund firms need to do more than put their funds on distribution platforms," Cipperman says. "Perhaps they need to develop scripts for brokers and provide more training on how to position funds."

Cipperman adds that the broker is ultimately responsible for the problem.