Mutual Fund Share Class Limits and Share Class Suitability

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Executive Summary

Recently, the Securities and Exchange Commission and National Association of Securities Dealers have tackled the topic of *share class suitability* for investors in "load" funds—i.e., funds with embedded sales charges that are sold by financial intermediaries. The two regulatory bodies have shown concern that investors are being overcharged by brokers who have directed clients to B and C share classes rather than realizing breakpoint discounts with A shares. The NASD has conducted numerous "sweeps" of brokerage firms looking for these sales abuses, and has issued more than $50 million in fines and investor restitution since 2003.

As a result of these enforcement actions and concerns about regulatory risk, new "bright line" share class limits have informally emerged such that B and C share classes typically may not be sold to investors who have at least $50,000 or $250,000 respectively to invest.

This study examines the extent to which investors are protected by share class limits, and how financial advisors who seek to fulfill their fiduciary and suitability obligations to their clients can determine which share class is suitable given the client's investment horizon and wealth.

We find that although bright line share class limits are helpful generalizations that protect investors in many situations, there are many exceptions in which share class limits can harm investors. Four specific findings emerge:

- For investors who don't know their time horizon and can achieve a breakpoint, A shares are generally the best choice. However, for small investors with an unknown time horizon who are unlikely to reach a breakpoint, B shares may be a better choice. While B shares don't always come out on top, they are clearly better than A shares in the short term and C shares in the long term, and they rarely underperform the best choice by much.
- For investors who are extremely confident that their time horizon will be three years or less, C shares are almost always the best choice, regardless of the breakpoint available through A shares.
- For investors who believe their time horizon to be between four-to-seven years, the choice of share class is rarely clear-cut and depends upon the breakpoint achievable and the unique structural nuances of the fund being considered.
- For investors who believe their time horizon to be eight or more years, A shares are usually the best choice, although B shares are frequently the best choice for investors with $50,000 or less to invest.

Bright line share class limits are best viewed as the starting point for share class suitability analysis. But advisors should have the freedom to select any share class after carefully considering each investor's unique situation.

Relevant Suitability Factors

Share class suitability refers to the appropriateness of a given mutual fund share class for a given investor. Because different share classes have different mixes of one-time charges vs. fixed charges, the share class that makes the most sense for one investor may not be suitable for the next.

Three factors must be considered when evaluating the appropriate share class for an investor—the specific *share class structure* of the fund under consideration, the investor's *investment amount* and *time horizon*.

Share class structure can be divided into three primary share classes. Each share class generally is structured similarly across fund companies.

- A shares have a front-end sales charge that scales downward as the size of the investment increases and "breakpoints" are achieved. These breakpoint discounts are why investment amount is a critical factor in share class suitability;
- B shares have no front-end sales charge, a higher ongoing fee than the A share, and a contingent deferred sales charge (CDSC) that declines over time. B shares typically have a higher expense ratio than corresponding A shares, which is why time horizon can be a critical factor in share class suitability. Most B shares convert into lower-expense A shares after seven or eight years;
- C shares have no front-end sales charge, a small deferred sales load that typically expires after one year, and the same expense structure as the B share initially. However, because the C share typically doesn't convert to an A share, the higher expense ratio becomes an even greater disadvantage over time than it does with the B share.

If the advisor and investor choice of share class were limited to these three fairly common share class distinctions, the system might lend itself to simple rules. But it isn't that simple. Advisors also must consider annual expenses, load charges, breakpoints, rights of accumulation linkage rules, redemption fees, and conversion features. To complicate matters further, there is little standardization among share classes from fund to fund. For example:

- Many fund companies offer an overwhelming array of less common share classes, such as M class, R class, D class, Investor class, Advisor class, etc.
- Some fund companies offer multiple fee schedules within the same share class depending on the investment style of the fund (e.g., equity and fixed income).

Nuances such as these mean that a B share, for instance, can look and behave quite differently from fund to fund. There are so many exceptions and nuances to share class structure that even diligent, well-intentioned advisors get confused and run the risk of putting investors in share classes that aren't appropriate for their situation. It's no wonder that investors are confused.

There is a good chance that for every situation in which a rogue broker is manipulating share classes to exploit an investor, other situations exist where an investor is being overcharged because the bewildering maze of share class choices confused the broker, or worse, the share class limits designed to protect the investor forced him into higher-cost A shares.

It is unlikely that fund companies have ever competed for client assets on the basis of share classes (e.g., "invest with us, our B share converts a year earlier"). Factors such as risk-adjusted performance and portfolio diversification are much more relevant to the investor. So why doesn't the industry simplify and standardize share classes? The industry should strive for a better balance between simplicity and choice.

Recent Industry Developments

In recent years, the NASD and SEC have paid particular attention to potential cost savings that can be achieved through breakpoints—the dollar amounts that qualify larger investors for lower sales loads when investing in A shares, but not in B or C shares. Periodically, the NASD and SEC have conducted comprehensive "sweeps" of broker-dealers looking for abuses of B and C share class sales that might have led to an investor paying higher fees than he or she would have been charged on A shares. The sweeps revealed certain egregious abuses, such as a broker placing three B share transactions at $49,999 each in order to avoid an A share purchase at the breakpoint of $50,000. Since 2003, brokerage firms have been hit by more than $50 million in fines and investor restitution on such share class suitability issues.

In response to these regulatory enforcement actions, the industry began restricting share classes in three ways:

1. **Establishing bright line share class limits.** Many years ago, a $250,000 limit on the purchase of B shares was fairly standard. But in January 2004 AIM, American Express, and Mainstay lowered their B share limits to $100,000. In April 2004, Fidelity lowered its limit to $50,000 and American Funds followed suit in December 2004.

   For B shares, regulators appeared to anchor on $50,000 as the bright line above which B shares are unsuitable. In March 2005 the NASD, in a $21 million enforcement action against American Express Financial Advisors, Citigroup Global Markets, and Chase Investment Services, stated that the "…firms did not consider that large investments in Class A shares of mutual funds entitle investors to breakpoint discounts, generally beginning at the $50,000 investment level…"

   Most broker-dealers began to implement $50,000 bright line limits shortly thereafter.

2. **Imposing aggregate limits.** To prevent brokers from splitting transactions under a share class limit, some fund companies and broker-dealers in the past year have instituted policies that split share class limits into two parts—a "transaction" limit (typically $50,000 for B shares) and an "aggregate" limit (typically $100,000 for B shares). For example, an advisor would not be allowed to include B shares as a part of an investment plan for a client if the client had more than $100,000 total to invest across multiple funds.

3. **Eliminating B & C shares altogether.** Beginning in 2004 a host of smaller fund families took an additional step. Rather than restrict the amount of money going into B shares, they would eliminate B shares altogether. Franklin Templeton followed suit in January 2005. Since then, several other fund companies have omitted B shares as an option when launching new funds.

These actions had a powerful effect on advisor behavior. According to Financial Research Corporation, during the two-year period from 2004 through 2005, net fund inflows to A shares were $138 billion, while net fund outflows from B shares were $116 billion. The chief compliance officer at one broker-dealer told us "B shares simply aren't sold anymore. Broker-dealers just can't accept the risk of regulatory enforcement."

Regulatory enforcement actions focusing on cost may also be having an unintended consequence for investors. Many advisors feel pressured to consolidate clients' assets within a single fund family to take advantage of breakpoints, despite the fact that diversifying a client's holdings across different fund families can take advantage of each family's comparative advantages in categories such as international equities, bonds, or REITs.

Enforcement Issues

In recent years, the NASD and SEC have consistently focused on cost as a significant determinant in investor suitability, and should be commended for their efforts to protect investors in this regard. Yet both the NASD and SEC have had enforcement actions overturned recently when such efforts focused exclusively on cost and bright line standards.

For example, the NASD Division of Enforcement filed a complaint charging a broker of making "unsuitable recommendations to one customer in violation of NASD Conduct Rules 2110, 2310 and IM-2310-2, by recommending that the customer purchase Class B shares in mutual funds in different fund families, rather than Class A shares in one fund family." In March 2005 an NASD Hearing Officer ruled against the NASD because the broker considered the additional costs of Class B shares, but thought the incremental costs were outweighed by the value of diversifying the client's investment among top-performing funds from several different families. Evidence presented at the hearing showed that the broker's diversified portfolio of B share funds significantly outperformed the single-fund family portfolio of A shares suggested by the NASD, resulting in a hypothetical ending investment value that was more than $12,000 higher, even after accounting for the higher B share fees.

In interpreting the decision, the NASD hearing officer wrote "tailoring recommendations for individual investors requires more than a mechanical comparison of costs; in making a recommendation, a registered representative must take into account a variety of factors that bear upon whether a particular investment is suitable for a specific investor."

In a similar case, the SEC charged the president and chief compliance officer of a broker-dealer with fraud related to the sale of Class B shares to an investor. The SEC argued that Class B shares in amounts of up to $250,000 always underperform Class A shares. An SEC administrative law judge dismissed the SEC's case in February 2005 stating, "an investment of $250,000 in Class A shares will not outperform an investment in Class B shares in all circumstances. Back-of-the-envelope computations of sales charges…applicable to A and B shares that appear to show that A shares always outperform B shares at the $250,000 level do not take account of some significant factors that can affect performance…"

These examples illustrate that cost considerations and bright line share class limits by themselves do not adequately constitute a complete share class suitability policy capable of protecting investors.

Creating the Study

To test the appropriateness of the A, B, and C share classes under different investor scenarios, we created wealth simulations for 115,632 hypothetical mutual fund purchases. The study universe consisted of all 803 mutual fund portfolios that have A, B, and C share class shares, at least $500 million in total portfolio assets, and minimum initial investments of no more than $10,000. For each of the 2,409 share classes, we tested four different initial investment amounts, over 12 time horizons, for a total of 115,632 simulations.

The initial investment amounts within each fund family were $10,000, $50,000, $100,000, and $250,000. The first figure represents the situation of the small investor. The next three amounts are each common breakpoints for the A share class.

We used 12 distinct investor time horizons, from one-to-ten years, plus 15 and 20 years. We assumed all funds earned gross returns of 5% per year, and then subtracted the current annual expense ratio. For A shares, we applied the initial sales load according to the breakpoints established by the fund prospectus. For B shares, we applied the appropriate deferred sales fee assuming that the investor exited the shares at the conclusion of the stated holding period. For B shares that offer an A share conversion feature, we converted the share to the A share expense structure at the appropriate time.

Finally, we ran a sensitivity study to test the robustness of these results to different return assumptions. Rather than assume a consistent gross annual return of 5% per annum, we used the gross returns for the S&P 500 for the period 1986-2005. This provided a return series that was both higher and more volatile than the actual test series that was used. However, the conclusions did not change. The percentages shown on the next several pages reflect the results of the constant 5% gross return series, but the results for the historical series were almost identical.

Results: Certain Time Horizon

As previously discussed, the primary drivers of the share-class suitability decision are investment amount and time horizon. Generally, the initial investment amount to be placed into a fund is fixed. In this section, we assume the investor knows his or her time horizon with certainty. In the next section, the analysis considers the case of uncertain time horizons.

Table 1 illustrates the results for certain time horizons. For a given time horizon and given level of investment, we compared the results for the A, B, and C share classes. If the A share class led to the highest amount, we recorded it as a "victory" for the A share. We applied the same approach to the B and C shares. We then totaled the number of victories for each share class at the given time horizon and level of investment and divided it by the total chances, to arrive at a winning percentage for each share class, as shown in Table 1.

Table 1 – Percentages of Winning Share Classes, Varying by Investment Amount and Holding Period

Investment	Share Class	Holding Period											
		1 Year	2 Years	3 Years	4 Years	5 Years	6 Years	7 Years	8 Years	9 Years	10 Years	15 Years	20 Years
$10,000	A	0%	1%	1%	2%	5%	9%	28%	60%	62%	64%	66%	66%
	B	0%	0%	0%	1%	3%	12%	17%	23%	35%	35%	34%	34%
	C	100%	99%	99%	97%	92%	79%	55%	17%	3%	1%	0%	0%
$50,000	A	0%	1%	1%	2%	7%	29%	74%	85%	85%	86%	86%	86%
	B	0%	0%	0%	1%	3%	9%	8%	8%	14%	14%	14%	14%
	C	100%	99%	99%	97%	90%	62%	18%	7%	1%	0%	0%	0%
$100,000	A	0%	1%	2%	9%	55%	83%	92%	98%	98%	98%	98%	98%
	B	0%	0%	0%	1%	2%	3%	2%	1%	2%	2%	2%	2%
	C	100%	99%	98%	90%	43%	13%	6%	1%	0%	0%	0%	0%
$250,000	A	1%	1%	11%	75%	93%	98%	98%	99%	99%	99%	99%	99%
	B	0%	0%	0%	0%	1%	1%	1%	1%	1%	1%	1%	1%
	C	99%	99%	89%	25%	6%	1%	1%	0%	0%	0%	0%	0%

Three key points emerge from this data:

1. For investors with a **short** time horizon of three years or less, the C share is almost always the best choice, even for buyers with $250,000 to invest. Note that current bright line industry guidelines prohibit the sale of C shares if the investment amount reaches $250,000, which suggests that short-term investors with this much money to invest likely are being harmed by the current C share limits.

2. For investors with an **intermediate** time horizon of between four years and seven years, the best option varies significantly according to the investment amount and the specific economic structure of each fund. In most cases, investors with $10,000 or $50,000 will be best served by C shares, while investors with $100,000 or more will be best served by A shares.

3. For investors with a **long** time horizon of eight years or more, A shares are generally the best choice for all investment amounts. However, B shares are the best long-term choice for one-third of $10,000 cases, and 14% of $50,000 cases.

Table 2 summarizes the consensus optimal decisions that arise from this data. Again, these consensus decisions can be subject to significant exceptions, depending upon the details of the specific share class.

Table 2 – General Share Class Guidelines, Certain Time Horizon

Investment	Intended Time Horizon		
	Short Term (1 – 3 Years)	Intermediate Term (4 – 7 Years)	Long Term (8+ Years)
$10,000	C	C	A/B
$50,000	C	C/A	A
$100,000	C	A/C	A
$250,000	C	A	A

Note that when time horizon is certain, the B share is rarely the optimal solution. However, as the next section shows, the B share shows more favorably when the time horizon is uncertain.

Results: Uncertain Time Horizon

Useful as it might be, the above analysis ignores one critical element of the share-class suitability problem: many investors don't know how long they will own the fund. In general, investors purchase funds with the intention of holding them for extended time periods, but in practice their behavior frequently deviates from their plan. Disappointing fund performances, changing personal circumstances and other factors lead to many unanticipated fund sales.

The logical strategy for many investors, therefore, may be to choose a share class that will show the best aggregate performance across all time horizons. Although a single share class cannot be expected to be optimal for all time horizons, it should at least deliver respectable performance across the board for the uncertain time horizon. Similarly, investors should avoid share classes that have strongly subpar performance for any particular time horizon.

For small investors who are unlikely to achieve a breakpoint, B shares are a reasonable choice because they tend not to underperform the best choice by much, and they are rarely the worst choice. In a short time horizon, A shares suffer due to the large front-end load. In a long time horizon, C shares suffer from a higher expense ratio. In contrast, B shares tend to be competitive across all time horizons. Small investors who buy A shares thinking they will hold for a long time, but then sell quickly would pay significantly more than if they had bought B shares. Conversely, small investors who buy C shares thinking they will get out quickly, but then hold for a long time, would also pay significantly more than if they had bought B shares.

This may be seen in the results shown in Table 3 for the $10,000 investor in Van Kampen Growth & Income, which has a typical structure. The C share is as usual the most attractive of the shares for the shorter-term investor – but when the time horizon extends to 15 years or more, it falls greatly short of the A and B shares (by $935 after 15 years and $1,918 after 20 years). In the first five years, during which time most investors sell, the B share outperforms the A share, but not by a significant amount. But the B share also does not significantly underperform the A share over time horizons as long as 20 years, because of the A share conversion feature. In this case, if the advisor knew with confidence that the investor would hold for at least four years, and potentially much longer, the B share might be the best choice for the investor.

Table 3 – Van Kampen Growth & Income: Ending Value of Investment Relative to Best Share Class

Investment	Share Class	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 15	Year 20
$10,000	A	($521)	($462)	($397)	($327)	($251)	($168)	($78)	Highest	Highest	Highest	Highest	Highest
$10,000	B	($413)	($321)	($277)	($172)	Highest	Highest	Highest	($18)	($19)	($20)	($24)	($30)
$10,000	C	Highest	Highest	Highest	Highest	Highest	Highest	Highest	($18)	($123)	($235)	($935)	($1,918)
$50,000	A	($2,083)	($1,765)	($1,419)	($1,043)	($637)	($197)	Highest	Highest	Highest	Highest	Highest	Highest
$50,000	B	($2,070)	($1,606)	($1,385)	($860)	Highest	Highest	($278)	($790)	($824)	($859)	($1,059)	($1,305)
$50,000	C	Highest	Highest	Highest	Highest	Highest	Highest	($278)	($790)	($1,341)	($1,934)	($5,611)	($10,745)
$100,000	A	($3,123)	($2,442)	($1,704)	($904)	($41)	Highest	Highest	Highest	Highest	Highest	Highest	Highest
$100,000	B	($4,139)	($3,213)	($2,771)	($1,720)	Highest	($892)	($1,896)	($2,978)	($3,105)	($3,237)	($3,990)	($4,919)
$100,000	C	Highest	Highest	Highest	Highest	Highest	($892)	($1,896)	($2,978)	($4,140)	($5,388)	($13,094)	($23,799)
$250,000	A	($521)	($462)	($397)	Highest	Highest	Highest	Highest	Highest	Highest	Highest	Highest	Highest
$250,000	B	($413)	($321)	($277)	($4,995)	($2,980)	($5,442)	($8,091)	($10,937)	($11,404)	($11,892)	($14,658)	($18,067)
$250,000	C	Highest	Highest	Highest	($694)	($2,980)	($5,442)	($8,091)	($10,937)	($13,992)	($17,268)	($37,417)	($65,268)

Table 4 summarizes the consensus optimal decisions that arise from this data.

Table 4 – General Share Class Guidelines, Uncertain Time Horizon

Investment Amount	Share Class
$10,000	B
$50,000	A
$100,000	A
$250,000	A

Variations

The preceding guidelines are just that – guidelines. Mutual funds frequently have dramatically different cost structures across share classes, with unique variables such as expense ratios, front-end loads, breakpoints, rights of accumulation linkage rules, deferred sales charges, different time periods over which deferred sales charges scale downward, and conversion periods for B shares to become A shares. Hence, applying rules of thumb that fail to take each fund's unique economic structure into consideration can result in situations in which the investor is overcharged.

For example, consider an investor who may invest $50,000 into either the Oppenheimer Quest for Value Balanced Fund or Smith Barney Appreciation Fund. Oppenheimer's fund offers a better longer-term deal for the B share, making the B share the optimal for investors from Year 7 onwards. On Year 20, the B share is worth $280 more than the A share, and a whopping $16,980 more than the C share. Table 5 illustrates the relative ending values.

Table 5 – Oppenheimer Quest for Value Fund, Ending Value of Investment Relative to Best Share Class

Investment	Share Class	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 15	Year 20
$50,000	A	($2,154)	($1,894)	($1,590)	($1,237)	($831)	($365)	($116)	($124)	($133)	($142)	($200)	($280)
$50,000	B	($2,155)	($1,758)	($1,902)	($1,422)	($876)	($257)	Highest	Highest	Highest	Highest	Highest	Highest
$50,000	C	Highest	Highest	Highest	Highest	Highest	Highest	($281)	($768)	($1,449)	($2,218)	($7,689)	($16,980)

Conversely, Smith Barney Appreciation Fund offers a substantially better deal for the A shares. Beginning in Year 5, the A shares gain a lead that they never relinquish, finishing the 20 year period $5,406 north of the B shares. Over the entire time period, from 1 to 20 years, the A shares are consistently superior to the B shares for a $50,000 investment. Table 6 illustrates the relative ending values.

Table 6 – Smith Barney Appreciation Fund, Ending Value of Investment Relative to Best Share Class

Investment	Share Class	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 15	Year 20
$50,000	A	($1,582)	($1,239)	($842)	($384)	Highest	Highest	Highest	Highest	Highest	Highest	Highest	Highest
$50,000	B	($2,139)	($1,721)	($1,241)	($692)	($208)	($826)	($1,527)	($2,320)	($2,490)	($2,671)	($3,800)	($5,406)
$50,000	C	Highest	Highest	Highest	Highest	($141)	($739)	($1,419)	($2,189)	($3,058)	($4,037)	($10,985)	($22,790)

Thus, a prospective investor with a given time horizon and investment amount considering either of these two funds would be disserved by an advisor who followed rigid share class limits. Exceptions such as these demonstrate that advisors should take the time to "run the numbers" each time they make a share class recommendation.

Conclusions

- **For Advisors**
  Advisors should regard share class limits as guidelines only and be sure to analyze the specifics of the investor situation, paying particular attention to the investor's intended time horizon and potential investment amount, including possible breakpoint discounts available by applying rights of accumulation and/or letters of intent. Advisors should not determine share class suitability exclusively on the basis of cost, without also considering such factors as investment performance and diversification. Advisors should consider the following best practices:
  - Ask your client what his or her intended time horizon is likely to be for this investment, and how likely he or she might be to sell based on fund performance or life events. Based on the client's answers and past trading behavior (recall that most investors sell their funds within four or five years), determine whether it makes sense to apply the "Certain Time Horizon" or "Uncertain Time Horizon" guidelines as shown in this paper.
  - If using the Certain Time Horizon guidelines, pay particular attention to time horizons between three and eight years, as generalizations of these time horizons can be particularly misleading.
  - For small investors who are not likely to achieve a breakpoint and who don't know their time horizon, consider B shares which tend to be competitive over most time horizons and are rarely the worst choice.
  - If there are any ambiguities about which share class is optimal for the investor, run the numbers and evaluate the relative costs of shares over multiple time horizons. Consider showing illustrations of costs over time to the client for each share class in order to demonstrate the relative economic costs of each choice.

- **For Broker-Dealers and Mutual Fund Companies**
  Consider raising the limit on C shares above $250,000, particularly for funds that support an investor's short- to-intermediate time horizon objectives, such as intermediate bond funds. And encourage advisors to "run the numbers" and illustrate share class costs over multiple time horizons.

  In their current form, share classes complicate the sales process and confuse investors. Consider eliminating or at least standardizing share classes to strike a better balance between simplicity and investor choice.

- **For Regulators**

  Consider whether aggressive enforcement of bright line share class limits is really in the best interests of investors. Factors such as performance and diversification can trump cost savings when determining share class suitability. Because of the numerous factors and nuances involved, suitability is a subtle exercise that doesn't lend itself to gross generalizations and back-of-the-envelope computations. Advisors and brokers are in the best position to make suitability determination for their clients based on all of the factors involved.