

## ***“Pay to Play is Alive and Well”***

*By John A. Straus*

In case anyone thought the proposed Department of Labor fiduciary rule would begin the process of eliminating or reducing conflicts of interest on Wall Street, do not be fooled. The Street is expert at coming up with new ways to pad its own pocket at the expense of clients, and all the while positioning it as being in the client's best interest.

Bloomberg reported recently that as of January 1<sup>st</sup> Morgan Stanley began imposing a “data” fee on ETF providers available on its platform<sup>1</sup>. In its conflict disclosure Morgan Stanley is quick to point out that notwithstanding this new “pay to play” scheme, they have substantially mitigated the conflict of interest with their clients by limiting any additional compensation to their brokers for selling ETFs.

We have a different view. While the advisor may not directly benefit from extra compensation, Morgan Stanley certainly does! In fact, by keeping 100% of the fee they have simultaneously exacerbated the conflict at the firm level, increased non-compensable revenue (which they love), alienated financial advisers, limited client choice and helped pave the road to increasing overall costs to clients for investments that have historically been low cost options.

Unfortunately, ETF providers that do not pay Morgan Stanley will likely see their sales drop because they are no longer

being promoted on Morgan Stanley's distribution platform. Money managers that do not need the incremental distribution that firms like Morgan Stanley provide are unlikely to choose to pay extra to be on the wirehouse's platform. Additionally, there are many smaller and emerging ETF players that may not be able to pay for shelf space and which will no longer be available as investment options for Morgan Stanley's clients, despite potentially lower fees and improved performance.

While this appears to be an obvious conflict, where clients may not see ETFs that do not pay for shelf space, firms continue to line their own pockets at the expense of their clients. While the disclosures they provide regarding their conflicts of interest may meet with current legal obligations in the narrowest sense, it is obvious that actually reducing their conflicts is not on the agenda. As distressing as this sounds, it is not new. The wirehouses have been doing this for years, disadvantaging the client and burying the details in the fine print.

I have often asked wirehouse advisors if they are conflicted. Frequently, the response is “No, because I operate in an open architecture environment.” However, most advisors are not aware of all the fees frequently paid by money management firms to the wirehouses just to be on the firm’s distribution platform. What many advisors are further not aware of is that the universe of investment options available to their clients may be limited as the money managers which do not pay to play may not appear on their firm’s platform. The environment they operate in is not as “open” as they think it is.

This conflicted practice disadvantages the client and is NOT in the client’s best interest. The clients may not be aware of or have access to money managers which may better meet their needs because the money manager chooses not to pay to play. Alternatively, they may be paying more for a product that is available elsewhere where pay to play is not practiced.

The application of pay to play for ETFs is just the newest example of opaque revenue-sharing fees. For instance, Morgan Stanley’s mutual fund conflict of interest disclosure clearly illustrates how mutual funds get on the wirehouse platforms – they pay! The fee is disclosed as research, sales data analytics, and training and sales meeting expenses. These access fees are standard for many wirehouses. In practice, they are rarely tied directly to expenses borne by the

wirehouses. They are just other forms of revenue. Furthermore, these increased access fees for the money managers increase their costs and may cause the money manager to increase the management fee of the funds. Now the client is paying!

Morgan Stanley is not alone in this practice. A Merrill Lynch disclosure document, when referring to some of the revenues they receive from mutual fund managers, states “[t]his compensation is often but not always disclosed in detail in a fund’s prospectus, summary prospectus, statement of additional information or website.” This same document further states “Merrill Lynch makes available to its clients shares of those mutual funds whose affiliates have entered into contractual arrangements with Merrill Lynch that generally include the payment of one or more of the fees described . . . Funds that do not enter into these arrangements with Merrill Lynch are general not offered to clients.”<sup>3</sup>

UBS’s revenue sharing disclosure states “[r]evenue-sharing payments may present a conflict between our interests and those of our customers because the payments give us a financial incentive to recommend that our customers buy and hold shares of those funds that we maintain on our distribution platform and for which we receive revenue-sharing payments.” At least this disclosure is forthright. Too bad is it is buried within other extensive disclosure and you have to be a detective to find it.<sup>4</sup>

While the examples above are focused on pay to play conflicts for ETFs and mutual funds, there are many more examples of conflicts that are not as obvious but equally harmful to clients. It is as much about which managers clients see as it is about which managers clients do not see. No one is begrudging these firms for making money for their services, but we believe firms can remain very profitable without creating additional conflicts of interests with their clients. If conflicts exist, these firms should be more

transparent about how they come about offering only certain products and the recommendations they make - why they include some managers and why they exclude other managers - and how they benefit from doing so.

Two guiding principles at FallLine Securities are: “Just because you can does not mean you should,” and “doing what is best for the client is best for the firm.”

*FallLine Securities, an industry innovator, launched the first wealth management platform designed exclusively for elite Private Wealth Advisors and their ultra-high net worth clients. FallLine is the only UHNW-focused firm that combines a broker-dealer, a turnkey technology/services platform, comprehensive transition services and a network made up exclusively of other successful Private Wealth Advisors. FallLine provides entrepreneurial Private Wealth Advisors with the only clear, unified path to their own hybrid RIA and significant wealth creation opportunities. For more information regarding our market views and services, please contact us or visit us at [www.fallinsec.com](http://www.fallinsec.com).*

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