Exclusive: Fund payments to brokerages draw SEC scrutiny

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By Jed Horowitz

NEW YORK (Reuters) - The tens of millions of dollars in annual fees that mutual fund companies pay to brokerages and their financial advisers to encourage sale of certain funds to retail investors are growing in size and variety, but the phenomenon is largely invisible to investors.

The U.S. Securities and Exchange Commission, which 18 months ago began a review of fees paid among mutual fund advisers, fund companies and the brokerage firms that sell the funds, has uncovered a complex geometry of payments that may lead to sales of certain funds at the expense of others and is not clearly disclosed under regulators' current requirements, according to a person familiar with the review.

A final analysis of the fee infrastructure and disclosure holes is expected to be completed by year-end, and could lead to an overhaul of how the industry pays for sales and how the brokerage industry discloses the bounty it collects. Past attempts by the SEC and the Financial Industry Regulatory Authority to improve disclosure and end certain incentive payments have faltered.

The failure of regulators to set broad sales practice rules has led to a "very blatant 'pay to play' business model at brokerage firms" and a wide diversity in how much brokers and funds disclose about the payments, said Niels Holch, executive director of the Coalition of Mutual Fund Investors in Washington.

Gaining a clear understanding of the incentives brokers get for selling certain funds is central to the review, the person familiar with it said, adding that an understanding of how to "follow the money" is beyond the abilities of even a sophisticated investor who reads all disclosures from funds and brokers. Firms vary greatly in what they disclose and how they describe payments from fund companies, according to a Reuters review of disclosures from large and small brokerage firms.

There is no certainty that regulators can follow the money, either, because the web of payments within the fund and brokerage industries is so complex and embedded. In 2006, the SEC prohibited fund managers from sending commission-generating trades through particular brokers as rewards for their sales efforts. But proposals from the regulator as recently as 2010 to end the billions of dollars of 12b-1 fees that are paid to brokers out of fund assets over the lifetime of an investor’s holdings went nowhere.

As a result, there are no clear standards on what information brokerage firms, financial advisers and mutual funds need to tell investors about fees, leading to a great disparity in what they disclose in regulatory filings and on trade confirmations.

If SEC commissioners should act on the pending analysis, however, it could lead to an overhaul of how the fund industry pays for sales and how the brokerage industry discloses the money it collects, fund industry officials said. Most of the officials, who declined to be identified for this story, insist that what they pay for fund sales is perfectly clear.

They also say that brokerages are demanding more sales support and payments than ever before from their fund partners. Large and small broker-dealers have long asked fund companies to devote salespeople, known as wholesalers, to help brokers understand and market funds, make presentations to clients and even offer practice management tools and advice. In recent years the requests have hardened into monetary demands.

"Now they are saying, 'I would like you to provide wholesalers and I am going to charge you for it,'" said a former fund official who asked for anonymity because he now works closely with brokers and funds. "That's where the excess lies."

Brokers also are leaning on fund companies to pay them for more record-keeping services that were traditionally provided by third-party firms at lower costs. In return, the brokerages give the funds detailed data on the brokers and clients who are purchasing specific funds, a tool that helps companies sharpen their marketing strategies.

Fund companies also acquiesce to higher fees to appear on brokerage firms' recommended lists because brokers traditionally sell actively managed mutual funds that generate much higher fees than passively-managed funds. While index and exchange-traded funds are growing in popularity, actively-managed funds have been around much longer and dominate the portfolios of brokerage customers. Assets in actively-managed funds stood at $9.7 trillion as of the end of July 2014 versus total assets of $3.9 trillion in passive funds, according to Morningstar.

Brokerage firms say investors have little reason for concern because financial advisers' pay is not tied to sales of specific funds. They also say they employ analysts who pick their inventory of funds based on quantitative and qualitative criteria.

Still, some of these firms acknowledge that personal relations between advisers and fund company representatives could create conflicts.

"The marketing and educational activities paid for with revenue sharing...could lead our advisors to focus more on those funds that make revenue sharing payments," Commonwealth Financial Network, which offers brokerage services to about 1,500 independent brokers, says in its investment adviser disclosure document.

PATCHWORK DISCLOSURE

There are no industry-wide data on how much money changes hands every year between mutual fund companies and U.S. brokerage firms, but a review of individual disclosures show they can add up.

Morgan Stanley, which has one of the most detailed disclosures in the industry, last year received $25.3 million from 39 companies to be "Fund Family Partners." The designation allows fund companies to "receive supplemental sales information and additional opportunities to sponsor firm events and promote their funds to our financial advisors and clients," Morgan Stanley says in its revenue-sharing disclosure.

Morgan Stanley also received at least another $250,000 each in "shelf space" fees from 104 fund families to be on the list of funds available through its brokerage sales force, the world's biggest by number of financial advisers.

A Morgan Stanley spokeswoman declined to discuss the fees or whether they have risen or fallen in recent years.

Ameriprise Financial Services said it received more than $210 million from 29 fund companies for shelf space and conference support last year. It did not disclose how much it got from about 270 other fund firms whose products can also be bought via its sales force. An Ameriprise spokesman did not respond to requests for comment.

The Reuters review found that fund companies are also getting more creative in winning influence with the brokerage firms that distribute their products.

For example, six asset managers, including American Funds, Deutsche Asset Management and John Hancock Funds, subsidized software that LPL Financial brokers use to make customized investment presentations to clients, according to the brokerage website.

Natixis Global Asset Management, meanwhile, has a resident nutritionist on call for selected brokers, according to a fund industry consultant.

Natixis has several programs to enhance the "strategies, tools and techniques" that advisers use [to strengthen client relations], including "thought leader presentations that include … health and wellness concepts," said spokeswoman Andrea Capodilupo.

(Reporting By Jed Horowitz, editing by Paritosh Bansal and John Pickering)