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How Wall Street 'Sweeps' the Cash

Investors' Idle Money Is a Brokerage-Firm Bonanza

By **RANDALL SMITH**

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The phrase "cash sweep" may sound like a cleaning crew gathering loose change. But on Wall Street, the top brokerage firms are increasingly turning cash sweeps into gold.

The blue-chip securities firms are reaping bigger profits from a few simple changes to how investors' idle cash balances are treated. And most investors either don't notice or don't care that Wall Street's gains are coming at their expense as brokers turn around and reinvest the money for their own benefit at a higher rate.

PROFITABLE CUSTOMERS

• **The Situation:** Wall Street brokers are making more money from the cash sitting in customer accounts. • **The Context:** Most customers barely notice they are receiving a low interest rate while the brokerage is making a profit reinvesting their money. • **Bottom Line:** In the past year the trend has accelerated despite red flags from market regulators.

Merrill Lynch & Co., which pioneered such tactics starting in 2000, is expected to report next week that its profits derived mainly from reinvesting customers' cash will top \$2 billion for 2006, up from \$1.3 billion two years ago.

Last year **Morgan Stanley** ramped up the same strategy of "sweeping" client cash to insured bank deposits, which pay rates as low as 1.25% on the smallest accounts. And the Smith Barney unit of **Citigroup Inc.** in September also began paying rates as low as 1.51% for cash in smaller accounts.

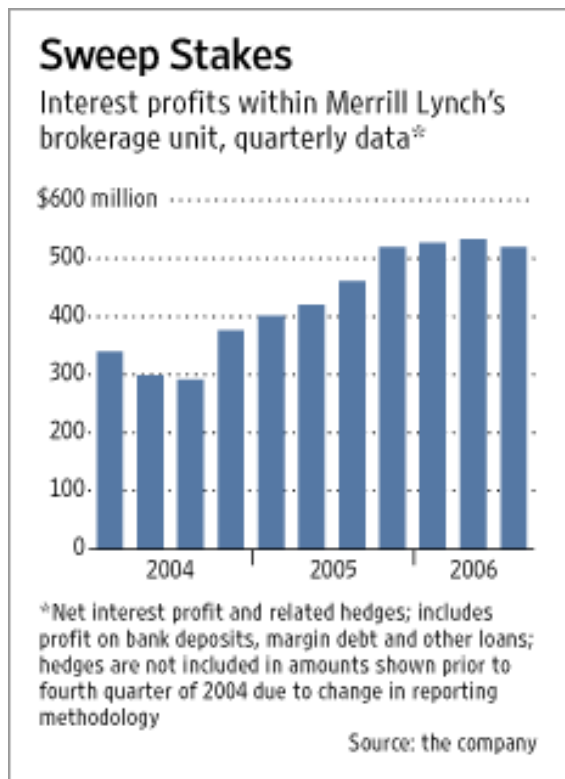
Smith Barney had considered such moves earlier, but hesitated because its former chief executive, Sallie Krawcheck, who led the firm between 2002 and 2004, raised questions about whether such "tiering" tactics could hurt customers, according to people at Citigroup. This year the firm decided it couldn't afford to pass

up the profits and risk being left at a competitive disadvantage, other people said.

In a statement, Smith Barney said it shifted "to a relationship-based offering" that included "clear and abundant client disclosure." The firm said it offers rates "among the most competitive in the industry," and clients have "ample" alternatives.

Regulators at the New York Stock Exchange warned firms and investors in 2005 that such programs risked being instituted "without fully appropriate levels of disclosure or customer consent."

Bank deposits are more profitable for Wall Street because they can be reinvested at profits of roughly three to four times the fees on money funds.



But the bank deposits where the money is swept all pay less than 2% annually for the smallest accounts, far below current money fund rates of 4.72%, where Wall Street firms could put clients' idle cash.

Merrill has about \$78 billion in bank deposits, which pay as little as 1.51% for small brokerage accounts. Last year, Morgan Stanley's total deposits rose to \$13.3 billion from just \$1.7 billion in 2005. James Gorman, who helped establish Merrill's program as a top executive of its brokerage force, took the top brokerage job at Morgan Stanley last March.

Analysts estimate that such bank sweeps can be reinvested at a profit of 2% to 2.5% of balances. By comparison, fees and expenses for taxable money-market funds currently average 0.58% of assets, according to iMoneyNet, a newsletter publisher in Westborough, Mass.

"One of the questions that has come up is why customers would put up with this," says Connie Bugbee, managing editor of iMoneyNet. She believes one answer is the inattention of customers who focus instead on which stocks to buy or sell.

Indeed, brokerage executives say their own soundings confirm investors generally aren't focused or overly concerned about rates they receive on cash balances.

Take **Wachovia** Corp. Its brokerage pays just 1% on bank-sweep cash for accounts with under \$100,000 in assets and 1.3% for accounts under \$250,000, while accounts with over \$1 million get 4%.

Joe Nadreau, director of client strategy, acknowledges the lower rates are "beneficial" to Wachovia, but notes they are just one element of its fees and costs in "the whole competitive fee landscape" in which larger accounts are inherently more profitable.

One person familiar with Merrill's decision to move uninvested funds to bank deposits starting in 2000 said it was inspired partly by a strategy pursued even earlier by discount broker **Charles Schwab** Corp.

Schwab had used its own interest-bearing account, effectively a Schwab IOU, as an alternative to money-market funds for client cash, earning a profit by reinvesting the funds at higher rates. Currently, Schwab and other online brokers earn more in interest income from cash balances and margin loans than from commissions.

Amid the regulatory prodding, some firms send clients brochures about their sweep programs that include some cautions. But readers have to look closely to discern that they may suffer financially.

The Merrill Lynch disclosure, for example, carries the bland headline, "Timely Reminder Concerning Yields on Deposits with the Merrill Lynch Banks and Certain Investment Alternatives." It says rates are "tiered" without saying plainly that small accounts get less. But it says the deposits are "financially beneficial" to Merrill Lynch, and a table indicates that accounts with less than \$250,000 will receive just 1.51% and rates of up to 4.4% are available in money funds if clients speak with their broker.

A Merrill spokesman said the tiers are part of "relationship pricing, which rewards those clients with larger asset bases for consolidating all of their business with the firm. The process is transparent and fully disclosed in writing to clients."

Although the interest profits add up to a big number at Merrill, they are small for most of the firm's millions of brokerage clients, said one person at the firm.

Its brokers are "encouraged" to discuss higher-interest options "to meet specific client needs," a Merrill spokesman said.

A disclosure by Wachovia starts out upbeat, saying its cash sweep "allows you to earn a return on the uninvested cash balances -- for which no interest is otherwise earned or paid." But its fourth paragraph is a little more blunt. Wachovia, it warns, "may seek to pay as low a rate as possible."

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