

Commission Recapture - FAQs

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What is the difference between soft dollars and Commission Recapture?

When commission is used by investment managers to buy services consumed by that investment manager, it is described as “soft dollar”. This is a core part of the economic structure of the investment management industry.

When commission is rebated after the trade to the underlying owner of the assets to reduce trading costs, it is described as “Commission Recapture”. This mechanism provides a balance to the soft dollar mechanism, and is designed to protect the interests of the underlying client.

Why do brokers find value in Commission Recapture?

Brokers provide a wide range of services to institutional investors and investment managers to attract their business. Brokers only provide services which they believe will increase their profitable market share. They decide which services to provide based on investment manager demand.

CR is simply one of those services – instead of providing goods and services to the investment manager, the broker provides a post-trade rebate to the underlying client.

Investment managers whose clients have instructed them to participate in CR should make it clear to brokers that the broker’s participation in CR will give that broker the same type of possible incremental business as any other service they might provide the investment manager.

As long as investment managers do that, and do not try to “spend” commission that has already been recaptured on additional broker service, CR is at least as attractive to brokers as the provision of any other service. Done correctly, it should result in lower trade costs for the client and higher profit for the broker.

You suggest managers send just a portion of their trading for our credit, why?

First, not all trading is appropriate for CR. While for most trades there are a wide range of brokers that could provide similar quality execution, there is some proportion of the trades (typically less than 40%) that a manager performs where only one possible broker will provide the optimal execution results for the customer. These trades should not be subject to recapture.

Second, the ability to use soft commission is an important part of the business model of investment managers. The resources available from commission can be as much as half the value of the management fee the investment manager is paid. Changing this basic model would require wholesale reform, which would be difficult and likely to result in unintended consequences.

Why would the Investment Manager participate in Commission Recapture? How does Commission Recapture benefit them?

Investment managers are first and foremost agents of their clients and the expectation should be that investment managers take all reasonable steps to comply with client instructions. Clients that have chosen to participate in CR have, by doing so, made a fiduciary decision about the best use of a portion of the commission generated from their trades. The investment manager should take the same approach to implementing this decision as they do to other decisions of the client. Investment managers do not benefit directly from participating in CR. In fact, because CR participation reduces the amount of soft commission that the manager can spend, managers have an incentive not to participate in CR. Investment managers should not let this affect the way in which they approach client instructions.

My manager states that they have worked hard to reduce commission cost and therefore we don't need Commission Recapture. Is this true?

Generally no.

CR provides a governance mechanism on commissions. Although investment managers negotiate commission rates, they are at the same time negotiating a service bundle from the brokers concerned. This will always result in a conflict of interest. While most managers manage this conflict, CR provides the **owner** of capital with a tool to govern it.

Most practically – if the manager concerned has indeed reduced commissions to such a low level that CR is irrelevant this will become clear from a simple analysis of the services they receive from brokers (which should be at very low levels indeed) and the commission rates paid (which should also be exceedingly low). We are happy to perform such an analysis with data provided by the manager to determine whether such a claim is in fact true.

My managers are saying brokers are no longer doing commission recapture but you are telling me otherwise. What is the real story?

Brokers provide the services demanded by investment managers. Investment managers demand services through regular meetings with brokers, during which they rate the services provided and highlight the services they wish to consume. Unless these broker review meetings contain an explicit demand for CR the broker may be left with the impression that the manager has authority to consume 100% of the commission pool and that CR is not a service they should provide.

In almost every conversation that Russell has with brokers it is very clear that, if managers demanded CR in the same way they demand other services, brokers would provide it in the same way they provide other services.

Investment managers should be able to provide copies of the broker review documents they use to assess broker services, as well as detailed lists of the services received from each broker with which they do business. This would allow these managers to demonstrate that they have indeed followed their clients' instructions, and have demanded CR from their brokers in the same way they demand other services.

My manager says that if they do commission recapture they are compromising Best Execution. Is that true?

No.

Best Execution requires the manager to achieve the best net result for the underlying client or clients when transacting. Commission Recapture reduces the cost incurred by clients (even if not all clients in a block participate in Commission Recapture). As such, consideration of the benefits of CR is part of the Best Execution process, not outside it.

This means that a failure to participate in CR is as much a challenge to Best Execution as potential participation can be. As managers have an economic incentive against participating in CR, claims that Best Execution may be compromised should be backed up with detailed proof before they are accepted by fiduciaries.

My manager says they can't do commission recapture because they trade in blocks. Is this true?

No.

Where the block can be traded with a broker that participates in CR without disadvantaging the non-CR clients in the block, then managers should trade the block with the broker that participates in CR. The question as to whether or not this is possible on an individual trade is a factual one, which should be able to be evidenced by the manager if they make this claim.

In addition, it is important to note that there are many investment managers who are able to participate in CR despite the fact that they trade in blocks (which is, after all, the standard institutional form of trading).

For more information:

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