THE BRANDES INSTITUTE

Commission Recapture: Considerations and Reflections

In this article, the Brandes Institute seeks to evaluate commission recapture ("CR") programs from various perspectives, clarify and raise awareness of key issues surrounding these programs, and stimulate debate regarding their potential benefits and consequences. It is not our intention to argue a certain position on commission recapture.

Recently, escalating demand for CR has prompted brokers and investmentmanagers to scrutinize more closely the services they provide to various constituents, their corresponding pricing structures, whether these aspects of their businesses are consistent with their best interests and those of their clients, and whether any changes are necessary. We believe any potential changes resulting from the current scrutiny will likely affect plan sponsors, managers, and brokers. Thus, we believe it is in the interests of all parties to have a full and frank exchange of information and views.

Sources at commission recapture-broker Russell, with whom we talked for this article, said that CR exists because the market is inefficient. They attribute this inefficiency to the current "bundling" of commissions that may include not only execution, but research, access to capital, trading information and advice, and other services. In this context, they view CR as an avenue for plan sponsors and their money managers to un-bundle those commissions and pay only for execution on some trades. They add that as long as commissions are bundled, CR provides a viable method to demonstrate that plan sponsors and money managers are actively managing their commission costs.

Our discussions with select institutional clients have revealed that some believe they are getting a "free lunch" with CR. Others believe this lunch is not free; in fact, they believe it can come at a significant cost. Thus, the debate is far broader than arguing that select clients engaging in CR may get a better deal through the rebate of commissions and hence may be "subsidized" by non-CR clients. It is arguable that non-CR clients may get a better deal – even when paying higher commissions.

Thus, central to the debate over CR is the concept of "best execution." First, we explore best execution and its different definitions and perceptions. Later in this piece, we investigate other aspects of CR. To stimulate debate with this piece, we pose a number of questions at the end in a section titled, "Issues for Further Discussion."

BEST EXECUTION

"Best execution" appears to be a simple concept, but may be defined or interpreted differently by regulators, brokers, managers, and clients. All agree that best execution generally implies increasing value when conducting trades. But the diverse components that comprise best execution – and varying degrees of focus on these components – may cause confusion or conflict.

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For example, some plan sponsors, particularly those with strict budget constraints, may focus on the *transaction cost* – the amount of commission paid for trades. They may view rebated commissions that arrive in the form of a check each quarter as a benefit. Brokers and managers, meanwhile, may focus on the *total cost* of a trade – the amount of commission and the price at which the trade was executed. At the same time, regulators, who seek to ensure that actions are within established guidelines, may scrutinize the *relationship* between client, manager, and broker and whether best execution affects the value-added services that the broker provides beyond trade execution and who shares in those benefits – and how.

Regardless of how best execution is defined, we believe that at the core of the debate is the relationship between two critical variables: cost and value. When purchasing or selling stocks, the transaction cost – or the commission paid for execution – is only one component of the trade. (There are other types of costs associated with trade execution that we will explore later in this piece.) Beyond the commission, one of the larger influences on the total cost of the trade is the market price spread. The price at which trades are executed likely has a greater influence on whether the parties involved believe they earned a "good deal," or did in fact achieve best execution.

For example, a buyer of one million shares of a $10.00 stock who pays a 5-cent per share commission actually pays $10.05 per share. In a CR program that charges the same 5-cent per share commission, but rebates 2 cents to the plan sponsor, the net price to the buyer is $10.03. However, if the CR broker's price paid in the market is $10.04, the net paid by the buyer increases to $10.07. Vinnie Palma, Director of Trading at Brandes Investment Partners®, cautions investors about the potential for being penny-wise and pound-foolish when applying CR. He warns, "With certain stocks, you can save money on the execution, but lose money on the trade."

His comments were echoed by Paul F. Roye, former director of the Securities and Exchange Commission's (SEC) division of investment management, who gave a keynote address before the Public Funds Symposium in 2001. His speech, titled, "Risks and Opportunities for Public Pension Plans," included the following warnings regarding CR:

> To reduce transaction costs, more and more pension plans now have commission recapture programs whereby trades are directed to brokers who are willing to rebate commissions to the plans. But you should note that restricting money managers to only a few brokerage firms can potentially result in poor execution, such that the savings achieved through the rebates can be lost through the price at which the trades are effected.[i]

CR brokers claim that trade for trade, they do *not* pay a higher market price. To address the issue described above, they have sought to create a network of brokers with whom investment managers can trade, allowing them the flexibility to maintain best execution practices. In addition, CR brokers can help guide clients on setting trading targets for the managers participating in CR programs on their behalf. For example, the standard benchmark for liquid markets is to recapture 25% of commissions. According to Russell, history suggests that managers can maintain their best execution practices *and* achieve this commission recapture target.

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Some institutional brokers disagree. They claim that over time, taking into account all other factors (discussed elsewhere in this piece), CR brokers *do* pay a higher market price for trades. This debate highlights a key issue surrounding best execution.

The following table breaks down the hypothetical costs associated with the same trade executed through an institutional broker, an institutional broker accommodating CR, and a CR broker. For this example, we make a number of assumptions, including that the commission paid on the trade is the same in each instance, and that the execution-only cost is also the same, regardless of the executing broker. These assumptions may not be totally realistic, but the point is to illustrate how the remaining "non-execution" amounts may be distributed.

Cents per share	Full service trade, institutional broker	CR trade, institutional broker	CR trade, CR broker
Commission	4	4	4
Less cost of "execution only"	(1)	(1)	(1)
Available after execution	3	3	3
Of which:			
CR broker profit	n/a	1.5	1.5
CR rebate to client	n/a	1.5	1.5
Retained by inst. broker for full service**	3	n/a	n/a
Result:			
Net commission paid by client	4	2.5	2.5

** Research, access to capital, access to trade desk information and advice, etc., including broker's profit margin.

In this example, the client's commission is 1.5 cents lower using CR, even though the CR broker also has taken 1.5 cents out of the trade. The key question is whether paying the extra 1.5 cents for the full service trade actually provides better execution (in its broader sense), than the "no frills" low commission trade. Is the client getting value for that extra payment?

Next, we highlight different perceptions of what constitutes best execution and delve into the value associated with execution.

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PERCEPTIONS OF BEST EXECUTION

The desire to define best execution and evaluate trading effectiveness – including the real cost of commission recapture programs – has spawned a variety of perspectives. In an article titled, "Defining Best Execution," Wayne H. Wagner, Chairman of Plexus Group Inc., a firm that analyzes trading costs, wrote: "I define best execution as the process – not the outcome – that is most likely to capture investment decisions and add maximum value to the portfolio."[ii]

Harold S. Bradley, Senior Vice President at American Century Investment Management, quoted a SEC senior staff member who defined best execution as executing a trade ". . . in a way that the trader believes will realize the maximum value of the investment decision."[iii]

Adding its voice to the debate, the CFA Institute (formerly AIMR) published AIMR Trade Management Guidelines (TMG) that define best execution as "the trading process Firms apply that seems to maximize the value of a client's portfolio within the client's stated investment objectives and constraints."[iv]

Wagner contends the AIMR TMG definition recognizes that best execution:

- is intrinsically tied to the portfolio-decision value and cannot be evaluated independently
- cannot be known with certainty ex ante
- has aspects that may be measured and analyzed over time on an ex post basis, even though accurate measurement on a trade-by-trade basis may not be meaningful in isolation
- is interwoven into complicated, repetitive, and continuing practices and relationships (page 46)

Sharing its own definition of best execution, Wagner notes that the SEC describes it as "a duty to seek the most favorable execution terms reasonably available given the specific circumstances of each trade" (45).

Palma added, "It's impossible to predict precisely the course of action that will provide best execution before a specific trade. There are too many variables at play. I have to evaluate the best potential execution before the trade – based upon past experiences and relationships."

Wagner underscores Palma's point when he writes, "Thus, best execution begins before the trade starts" (46). Closing this debate right where it began, Wagner adds that when it comes to best execution, ". . . the process revolves around balancing value and cost" (47).

BEST EXECUTION AND COMMISSION RECAPTURE

What may tangle the issue of achieving best execution within a commission recapture program is that some plan sponsors may assume that receiving the lowest net commission rate on a trade is itself best execution. Their underlying assumption is that regardless of the level of commission paid, the quality and price of the trade execution itself remains unchanged. If this were true, CR would indeed be

a "free lunch." But this assumption may not in fact be correct. Even though plan sponsors may stipulate both CR and best execution in their investment policy statements, this can still leave all parties interpreting best execution in their own way. Many plan sponsors might agree with the Wagner quote below, but managers and brokers may have a different interpretation. Wagner argues that plan sponsors ". . . have been taught that all brokers operate under the umbrella of best execution, so direction from them [the plan sponsors] should not make a difference to the outcome" (19). Wagner admits, "All managers have some trades that could indeed be implemented by any trader." Appropriately, he calls these "easy trades." But, he asks, ". . . what happens when the trade requires a higher level of broker skill to achieve best execution?" (19). In these cases, achieving best execution may be at odds with participating in a CR program.

To better understand how commission recapture can affect trade execution, we look at the dynamics for executing an "easy" and "hard" transaction when the trades are directed, i.e., the plan sponsor requests commission recapture, and non-directed, i.e., the manager has sole trading discretion.

NON-DIRECTED AND DIRECTED TRADES[v]

In an easy trade that is non-directed, Wagner states that "the defining characteristic of this trade is that the broker waits for liquidity" (19). In other words, the trade is put to the floor and executed when the other side arrives. If the other party isn't there, "the broker waits for liquidity, meting out the order to the market at a digestible pace – one that does not upset the balance of supply and demand" (20).

For a hard trade, which Wagner defines as a quantity of shares that exceeds half the average daily trading volume in that company, it cannot be executed the same way. "The broker has to search to find the liquidity." In this case, brokers may have to work to find buyers and sellers. "Some brokers specialize in putting the buyer and seller together so that they are able to execute; others use their own capital to buy at least part of the sell order from the manager" (20).

With respect to easy trades, Wagner writes, " . . . we cannot find meaningful differences between directed and non-directed trades" (20). In essence, ". . . nothing is lost through recapture in the quality of the brokerage as long as the recapture involves the easy trades" (20).

The term "directed trades" also may apply to "directed brokerage" or "DB" accounts. In a DB account (typically established by a brokerage firm for an individual client), trades are directed through the firm that established the account. This may limit trading opportunities and could affect execution. Individual accounts established with a "non-directed" or "trade various" ("TV") mandate create opportunities for trades to be executed through a number of different brokerage firms. This arrangement may broaden trading opportunities and could enhance execution. Of course, the potential benefits of TV must be weighed against the operational simplicity that DB typically affords.

ORDER OF EXECUTION

While commission recapture programs may appear ideal for easy trades, Wagner cautions that, typically, managers execute trades on behalf of far more than just one account. Some clients may have CR programs. Others may not. In these cases, according to Wagner, managers generally separate the trades for these clients and execute trades for the non-CR clients first with the understanding that clients' trades executed *after* the majority of the block has been done will get a poorer price.

This practice highlights the question posed earlier in this piece regarding whether non-CR clients "subsidize" those who participate in CR.

"The law is silent about how to treat potential conflicts among clients," Wagner writes. "In recognition that a difference exists, arguments have been made supporting the idea that managers ought to rotate accounts. But most managers, when pressed, tell clients that trades with constraints on them will be sequenced last" (20). Put simply, CR client trades often get executed *after* non-CR client trades.

Sources at Russell with whom we spoke said commission recapture trades can be executed in blocks with full commission trades and, at the point of allocation *after* execution, the trades can be designated as participating in commission recapture. This approach is designed to ensure that the CR trade receives the same preference as any non-CR trade.

Institutional brokers we asked said that when placing trades, they might price CR and non-CR trades differently. Or the non-CR client trades might get executed ahead of CR client trades. They stated there is no legal issue when mixing "economies of trades," but added that, typically, they know which portion of a block trade is subject to CR. And even if they didn't, they said they could decline to do the trade as a CR trade even after it was executed.

Wagner states that CR trades can be ". . . an impediment to execution because the whole trade cannot be executed as a block trade and then allocated to every client at the same price" (21). But that's not necessarily true. Brokers may use a "step-out trade" and execute CR and non-CR client trades simultaneously.

Getting back to the question of whether non-CR clients subsidize CR clients, Wagner finds no meaningful difference on directed vs. non-directed trades when the trades are easy. Thus, it appears that brokers can accommodate a certain percentage of trades being directed to CR. But to what extent? Investment managers and brokers likely would agree that they can accommodate CR programs for a handful of clients, but escalating participation creates problems. At the Brandes Institute, we believe the industry is reaching a potential inflection point where CR participation is material, but not yet reflective of a majority. Pushing recent trends to an extreme, could all clients participate in CR? Is this feasible? One-hundred percent CR participation among plan sponsors essentially would imply an across-the-board commission cut.

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Here, we present a few alternatives and associated considerations:

1. Managers accommodate limited CR for all clients.
   - Existing CR clients may have to pare back their current level of participation
   - Existing non-CR clients are given the option to establish a CR program
   - Managers run the risk of jeopardizing relationships with existing institutional brokers
   - Managers and clients must agree on a definition of "best execution"
   - The desire to achieve best execution drives trading decisions; CR is secondary.
2. Managers accommodate CR, but limit participation to a certain number of clients.
   - Raises ethical questions regarding who can participate
   - In this scenario, what percentage of trades can be accommodated with CR – 5%, 25%, 50%, or more?
3. Managers do not accommodate any CR for any client.
   - May raise ethical questions if offering CR is perceived to be a fiduciary responsibility
   - On the notion of CR as a fiduciary responsibility, a manager may argue that, if it believes CR to be detrimental to clients, it is protecting client interests by blocking CR participation. To our knowledge, no manager has adopted such a stance.
   - Managers run business risk of losing existing clients or hindering their ability to attract new clients who wish to participate in CR

Wagner asserts that, ". . . managers believe that excessive direction from the plan sponsor throws sand in the gears of the manager-to-trader-to-broker-to-exchange process" (19). He adds that such direction limits choices for execution, but adds, that asserting the limitations is one thing, "proving them is another" (19).

Russell claims it is the "world's leading provider of commission recapture services." The firm argues that it earns quality execution by providing investment managers ". . . access to global brokers with whom they already do considerable business." The firm states that about 400 investment managers direct trades to Russell's network of 29 broker partners in 44 countries.[vi]

Even amid such claims – and assuming directed trades are not conducted using a step-out – Wagner sees potential consequences in the limits CR creates. Namely, a trader ". . . loses the ability to select the broker he thinks most fit to execute the particular trade" (21). Wagner states the "best" broker is one who:

- knows the stock
- knows where the sellers are
- can principal a trade if need be

- views the continuing relationship with the money manager as important
- can be counted on in difficult trading situations to act in the best interests of the manager – and thus the manager's clients.

Wagner characterizes the relationships money managers have with such brokers as more consistent than those they have with CR brokers. He believes the value of the relationship with non-CR brokers prompts these brokers to do a good job. "In contrast, how can a money manager reward – or punish – a recapture broker whose fidelity and allegiance are to the plan sponsor, not to the money manager?" he asks (21).

In closing, Wagner writes, "Plexus has performed several studies on the effect of using directed trades. We have repeated this study three or four times and always come to the same approximate conclusion: Every 1 cent recaptured in a recapture process costs 3-5 cents a share in performance. The place where it primarily leaks out is in delay and missed trades."[vii]

Delays reflect trades that are not executed in a timely manner to capture favorable prices. Missed trades never get executed for a number of reasons, including unrealistic expectations on the part of the investment manager, the inability of the trader to execute quickly, or a shifting market that removes the advantage that prompted the desire to do the trade in the first place.

ADMINISTRATIVE CONSIDERATIONS

As noted earlier in this piece, participation in CR programs demands unique administrative requirements. In some cases, the complexities of oversight and monitoring involved with maintaining a CR program may offset the actual dollars rebated. To comply with Department of Labor ("DOL") regulations regarding exclusive benefit for plan participants, individual trades may have to berecorded and analyzed. These regulations are designed to ensure both best execution and proper receipt and use of associated commission rebates. We believe the emphasis on accurate recordkeeping may increase as the SEC explores the marketplace effectiveness of CR programs.

CONCLUSION

As highlighted here, there are a number of key issues related to commission recapture programs that offer fertile ground for considerable debate, including best execution, participation levels, and administrative demands.

Wagner asserts that trading reflects a vital part of active management and, "Active management means more than managing the assets in the portfolio; active management means managing the process of getting assets in and out of the portfolio. Only then can a manager achieve best execution and the best performance for the portfolio" (22).

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GENERAL QUESTIONS

WHAT IS COMMISSION RECAPTURE?

Commission recapture broker Lynch, Jones & Ryan ("LJR") defines it as a form of "institutional discount brokerage that rebates a portion of trading commissions to the pension plan or investment fund." Russell, a provider of CR services, defines it, in part, as an arrangement in which an investor, typically an institutional plan sponsor, "requests its investment manager(s) to execute a portion of trades through one or more specified brokers."[viii]

CAN A PLAN SPONSOR APPLY CR IN NON-U.S. MARKETS – OR TO FIXED INCOME TRADES?

According to LJR, while CR typically is applied to equity transactions, it may be used in conjunction with fixed income trades, where the rebate is generated via the spread, rather than a commission.

The firm adds that CR may be conducted in non-U.S. markets, too. LJR states that in the United Kingdom, ". . . commission recapture programs are consistent with English law, the rules of the London Stock Exchange, the rules of the Financial Services Authority (FSA) and the rules of the Investment Management Regulatory Organization (IMRO)."[ix]

According to institutional brokers with whom we talked, many non-U.S. markets accommodate CR. Among the countries that do not: Japan, Taiwan, Israel, and Greece.

DO HEDGE FUNDS ACCOMMODATE COMMISSION RECAPTURE?

Generally, hedge funds do not accommodate CR programs. Typically, hedge funds conduct a great deal of trading and, as such, are typically among an institutional broker's better clients. Hedge funds often depend upon the value-added services brokers provide (whether through conventional or soft-dollar arrangements), including research, access to capital and trade desk information and advice. Participation in CR would reduce the level of commissions they provide to institutional brokers and potentially jeopardize these relationships. In addition, most are capacity constrained and can afford to turn away clients who insist upon CR. Also, hedge funds are pooled vehicles with all trades conducted on behalf of all clients. Thus, each hedge fund client would have to participate in CR.

WHAT IS THE HISTORY BEHIND COMMISSION RECAPTURE PROGRAMS?

Please see the "Commission Recapture Timeline" on page 13 of this piece that chronicles the evolution of this practice and highlights key regulatory action.

WHY WOULD PLAN SPONSORS USE CR PROGRAMS?

In short, CR often is touted as a way for plan sponsors to save money. As described in this piece, there is considerable debate over whether money is actually saved or if there are associated costs that offset any rebated commissions.

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According to information available at its website[x], Russell's commission recapture service has "saved" clients nearly $1 billion since the service began in 1969.[xi]

Note that CR does effectively transfer funds from the pension fund's portfolio to its operating account. This does not impact total assets or total return, as both the portfolio and operating account are plan assets. However, it may help the administrative team at the plan succeed in meeting annual spending budgets.

LJR argues that using CR "is consistent with a pension fund's fiduciary obligations." The broker cites the U.S. Department of Labor's Technical Bulletin 86-1, released in 1986, that describes commissions as pension assets and states, ". . . trustees have a fiduciary responsibility to monitor and control them."[xii]

LJR adds that public funds, such as foundations and endowments, need ". . . to meet minimum annual spending targets. Transaction expenses detract from this aim. Commission recapture reduces trading costs and allows funds to retain more capital to meet their primary spending goals."

HOW DOES COMMISSION RECAPTURE WORK?

Generally, a plan sponsor tells its investment manager(s) to execute a portion of the trades made on behalf of the sponsor with a CR broker. The manager pays its usual commission rate (perhaps 4 cents per share) for these trades. But the CR broker charges less for each trade, perhaps about 1 cent per share. After the trade has been executed, the CR broker rebates a portion of its commission, perhaps 1 to 1.5 cents per share, to the plan sponsor.

Note that within this simple example are a number of complex issues that generate considerable debate regarding CR, including:

- determining "best execution"
- whether plan sponsors who do not participate in CR "subsidize" those sponsors who do
- the administrative burden associated with CR

APPENDIX

STEP-OUT TRADES

Wagner describes a step-out trade and its potential consequences as follows:

> Step-outs occur when the block broker says she will accommodate a certain portion of the directed commission business by putting it into the block and then creating an allocation as if it had been executed by a directed commission broker. She will consider it part of the block because you're a big customer. She is happy to accommodate you but wants to make sure she gets paid to accommodate that step-out. In such a situation, the directed commissions get the same price as the block does, so it works. But an equitability concern arises: Broker A does the work, but Broker B gets paid for it. Clearly, there is a limit to that kind of trade at some point, but as far as I know, the limits have not been tested yet. (23)

The institutional brokers we talked with for this article said that in addition to the inequity described above, the added intermediaries associated with executing step-out trades increase the likelihood for information "leaks" which may adversely affect getting the best prices.

SOFT DOLLARS AND DIRECTED BROKERAGE

It may be difficult to discuss trade execution and commission recapture without raising the issue of "soft dollars." Here, we address soft dollars briefly – and note some key differences between this concept, commission recapture, and "directed brokerage."

Under a soft dollar arrangement, an investment manager sends or directs trades through a particular broker in exchange for trade execution and certain services provided by that broker or through a third party. According to Russell, among the products or services managers may purchase with soft dollars:

- computer hardware and software that assist in decision-making, presumably for the benefit of most, if not all, of the managers' clients
- quotation systems such as Bloomberg or Reuters terminals
- research seminars (excluding travel and accommodations)

As reflected in the "Commission Recapture Timeline" in this piece, following the abolishment of fixed-rate commissions on May 1, 1975, the U.S. Congress enacted Section 28(e) as part of the Securities Acts Amendments of 1975 that created a "safe harbor" to managers. This ruling allows investment managers to legally pay commissions that they know are not the lowest available, provided that they determine ". . . in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided."[xiii]

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Russell adds that CR programs fall outside the scope of Section 28(e) (3). The Department of Labor ("DOL"), through its ERISA guidelines, has commented on the appropriate use of CR programs. In its Technical Release No. 86-1, the DOL supports CR arrangements if:

- they comply with the exclusive benefit rule
- they are prudent and in the pension fund's best interest
- the selected broker-dealer is capable of providing the best price and execution for the fund
- the client monitors the broker-dealer's execution

The third bullet point harkens back to our discussion of best execution and raises questions about the mechanics of trading and the quality of execution that different brokerage firms provide. The last point above touches upon the administrative responsibilities associated with CR programs, explored in greater detail earlier in this piece.

Currently, principal trades are forbidden for soft commissions, but allowed for recapture. Some institutional brokers believe this is inconsistent and suggest that the SEC dictate that principal transactions should not be allowed in recapture. They also suggest the SEC mandate specific costs per share.

DIRECTED BROKERAGE

Russell notes that up until last year, the term "directed brokerage" was used broadly as a synonym for directed trading or ". . . to describe brokerage arrangements including commission recapture and soft dollars." The use of this term changed dramatically when the SEC, on August 18, 2004, adopted a rule to ban what it described as directed brokerage. It is important to note that, according to Russell, the SEC defines directed brokerage as the practice of investment companies rewarding brokers with commissions for aggressively selling its mutual fund shares to investors.

Following the SEC's ruling, the phrase "directed brokerage" took on a more negative connotation. Russell stated it has stopped using the term to describe its CR programs (1).

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COMMISSION RECAPTURE TIMELINE

- Prior to May 1, 1975: Commissions for equity trades are fixed by New York Stock Exchange rules.
- May 1, 1975: Fixed commissions repealed.
- 1975: Investment managers question their fiduciary responsibility in seeking "best execution." Does best execution suggest the lowest commission or the best value, given the other services a brokerage firm may provide?
- 1975: Congress amends the Securities Exchange Act of 1934 with Section 28(e), creating a "safe harbor." This gave investment managers discretion to legally pay com missions that they knew were not the lowest available, provided that they ". . . determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided."
- 1976: According to Russell, the debate over what constitutes "brokerage and research services" prompts the SEC to clarify Section 28(e), stating that it does not apply to "products and services which are readily available and offered to the general public on a commercial basis" (3).
- 1986: The SEC decides the 1976 standard is too difficult to apply and issues another release designed to clarify the definition of research. The SEC states it ". . . provides law ful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities" (3).
- 2004: The SEC considers narrowing the definition of research under Section 28(e) and whether "the costs of research and execution should be quantified and . . . made more transparent." In addition, the SEC suggests pursuing ". . . enhanced requirements for maintaining books and records that would facilitate the Commission's ability to police this area."[xv]

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[i] http://www.sec.gov/news/speech/spch507.htm

[ii] Wagner, Wayne H. "Defining Best Execution." AIMR Publications. 2001: pages 13-24.

[iii] Bradley, Harold S. "Views of an 'Informed' Trader." AIMR Publications. 2003: pages 35-44.

[iv] Wagner, Wayne H. "Cost versus Liquidity: The Quest for Best Execution." AIMR Publications. 2003: pages 45-51.

[v] In August 2004, the SEC banned what it described as "directed trades." But note that the SEC's definition of directed trades – the practice of rewarding brokers with commissions for aggressively selling its mutual fund shares – differs substantially from what had been the industry convention. The SEC's definition has generated additional confusion over directed trading, according to Russell. See the Appendix for more information.

[vi] http://www.russell.com/ii/solutions/implementation_services.asp. Additional information for this article was obtained through direct communication with representatives at Russell's Implementation Services division.

[vii] On page 21 of his "Defining Best Execution" article, Wagner notes several types of trading "costs" that can adversely influence execution, including exposing trading intent, market impact (which Wagner defines as "the effect on the price of the market presence of the order"), delays in execution, and missed trades (where the market has moved beyond the point where executing an idea is deemed to be beneficial.)

[viii] Gilbert, Greg and Dave Griswold. "What Are 'Soft Dollars,' 'Commission Recapture,' and 'Directed Brokerage,' and How Do They Differ?" Russell Practice Note. No. 10 Revision 2. August 30, 2004: pages 1-4.

[ix] http://www.ljr.com/comm_recapture/who.shtml

[x] http://www.russell.com/ii/solutions/commission_recapture/commission_recapture.asp

[xi] http://www.russell.com/II/Search/searchResults.asp

[xii] http://www.ljr.com/comm_recapture/who.shtml

[xiii] http://www.sec.gov/news/studies/softdolr.htm#back

[xiv] http://www.sec.gov/rules/interp/34-45194.htm#P32_4481

[xv] This excerpt was taken from comments made by Susan Nash, Director, Division of Investment Management at the U.S. Securities and Exchange Commission on September 28, 2004 at an FSA Conference titled, "Asset Management: Risk, Opportunity and Regulation." For the full text of Ms. Nash's remarks, visit the following website: http://www.sec.gov/news/speech/spch092804sn.htm

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