



ADVISORY

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Directed Brokerage Programs (1999) (CORBA)

Background. State and local government pension plan investment programs involve millions of security transactions (purchases and sales) which generate millions of dollars of trade commissions. In order to obtain benefits for its participants without raising commission costs, a pension plan may establish a directed brokerage program whereby the broker credits a portion of the commission directly back to the plan. This can be done in the form of commission recapture or "soft dollars."

Commission recapture essentially began when the Department of Labor issued a technical bulletin in May 1986. In this bulletin, the Department of Labor said:

- commissions should be considered an asset of a plan, and as such, sponsors have a fiduciary responsibility to monitor and control these commissions; and
- commission recapture is consistent with a plan sponsor's fiduciary responsibilities if the commissions are used exclusively for the benefit of the participants and beneficiaries of the plan, and the managers continue to attempt to achieve "best execution" for the plan transactions.

While it sounds simple, in reality it is a highly complex process, which encompasses federal disclosure regulations of the Securities and Exchange Commission (SEC) and fiduciary responsibilities under the U.S. Department of Labor. "Hard dollar" commission recapture is a process whereby a pension plan typically receives a cash refund resulting from transactions incurred by the fund's investment managers. This rebate represents a portion of commissions (equity trades) or spreads (fixed income trades) charged on these transactions and subsequently recaptured by the fund, directly reducing transaction costs.

"Soft dollar" programs, on the other hand, are a means by which brokers get paid for providing research and other services to investment managers. Money managers place trades with brokerage firms that offer research services that these managers deem important to the management of those assets. The money managers will then negotiate a level of commission with the broker who the managers feel will justify the cost of both the execution of these trades and the research services provided.

Concerns raised about participation in directed brokerage programs include the following:

- A manager may place directed trades after nondirected trades, causing market impact costs to the plan.
- Certain trades are difficult, because they involve a high percentage of the security's average daily volume, require trading in multiple lots, or commitment of capital by the brokerage firm. Firms specializing in directed brokerage may not be able to provide best execution.
- Soft dollars may give a manager an opportunity to effectively charge expenses to the plan that its own fee income should support, thereby increasing the plan's costs rather than reducing them.
- The off-budget income from directed brokerage may tempt some administrators to misuse the funds generated, or to hide them from appropriate oversight agencies.

Recommendation. The Government Finance Officers Association (GFOA) recommends that public pension funds require comprehensive annual disclosure of all soft-dollar benefits and services received by all vendors, and that all appropriate requests for proposals (RFPs) for services to the plan and its trustees provide a comparison of soft-dollar services against hard-dollar costs if the plan were to instead direct that commissions be recaptured to the fund. Brokerage costs and arrangements should be reviewed formally on a periodic basis to assure that the net costs of transactions and services are as low as feasible. This can be accomplished internally depending upon available resources or by external professionals, as appropriate.

GFOA further urges state and local retirement funds considering directed brokerage programs to carefully review credentials, procedures, and controls of brokerage firms offering commission recapture and/or soft dollar services. Plan officials should carefully evaluate the following:

- Experience in direct brokerage programs
- references
- number of relationships
- number of money managers actively trading
- support staff
- ease of implementation
- acceptance by money managers
- full documentation
- Institutional trading
- product options offered through a Commission Recapture Program (CRP) Broker
- exchange membership(s)
- financial solvency of CRP Broker
- financial commitment to provide essential services
- full disclosure
- all aspects of relationship fully documented
- full SEC compliance is minimum standard
- accurate accounting on a trade date basis
- timely reports (customized to specific needs)
- immediate credit/refund frequency
- Manager reporting
- trade costs per transaction
- broker dealers utilized and why
- soft dollar gains provided at what cost

References

- *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, September 22, 1998.

Approved by the GFOA's Executive Board, 1999.