

Research

Section 28(e) and Client Commission Arrangements

Research

- “Research is the foundation of the money management industry.”

Source: SEC Inspection Report (Sept. 22, 1998) Soft dollars and Other Brokerage Arrangements, pg. 319.

- What is Research?
 - Advice
 - Analyses
 - Reports

Source: SEC Commission Guidance (July 24, 2006) pg. 41979.

Three Types of Research

- Internal Research
- Wall Street Research
- Third-party Research

History of Research

- The Buttonwood Agreement of 1792 was an association of stock-brokers that evolved into the New York Stock Exchange.
- For years, fixed commission rates by NYSE members did not allow broker/dealers to compete on commission rates.
- Therefore, members competed on the **quality of research and brokerage services** provided.

History of Research Cont...

- Historically, the vast majority of research was Wall Street research.
- Investment Managers generally chose the broker/dealer that provided the highest quality and the most pertinent **research**.

May Day & the Securities Act Amendments of 1975

- “The Commission adopted Rule 19b-3 under the Exchange Act, which ended fixed commission rates on national securities exchanges effective May 1, 1975.”
Source: SEC Commission Guidance (July 24, 2006) pg. 41980.
- Congress realized the importance of research and brokerage services provided to the money managers by the broker/dealer community.
- Therefore, Congress passed the Securities Act Amendments of 1975, in June 1975, which included the Safe Harbor codified as Section 28(e).

What is Section 28(e)?

- “The safe harbor provides that a money manager does not breach his fiduciary duties under state or federal law solely on the basis that the money manager has paid brokerage commissions to a B/D for effecting securities transactions in excess of the amount another B/D would have charged, if the money manager determines the amount of commissions paid is reasonable in relation to the value of the brokerage and research services provided by the B/D.”

Source: SEC Commission Guidance (July 24, 2006) pg. 41980.

The Position of Congress on Payment for Research Services

- “Manager relationships have been based on an environment which enables the investment manager to acquire research from the broker/dealer which research is paid **through the portfolio brokerage** and are **not an expense of management.**”

Source: Senate Banking Committee Minutes 1975, [¶ 2061]

Law at ¶ 1222.

The Effect of the Securities Act Amendments of 1975

- Two types of broker/dealers:
 - 1) Discount Broker - Solely Execution
 - 2) Full Service Broker – Execution, Research and Brokerage Services
- Most money managers chose a full service broker/dealer that provides **research**.

Disclosure Requirements

- What are RIA's Required to Disclose when using a Full Service Broker?
 - Current Form ADV Part II, 12 B
 - If the value of products, research and services given to the applicant or a related person is a factor, describe:
 - the products, research and services
 - whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services
 - whether research is used to service all of applicant's accounts or just those accounts paying for it; and
 - any procedures the applicant used during the last fiscal year to direct client transactions to a particular broker in return for product and research services received.

Disclosure Requirements Cont...

- **Proposed Form ADV**
 - **Research and Other Soft Dollar Benefits.** If you receive research or other products or services other than execution from a broker/dealer or a third party in connection with *client* securities transactions (“soft dollar benefits”), disclose your practices and discuss the conflicts of interest they create.
 - **Note:** Your disclosure and discussion must include all soft dollar benefits you receive, including, in the case of research, both proprietary research (created or developed by the broker-dealer) and research created or developed by a third party.
 - Explain that when you use *client* brokerage commissions (**or markups or markdowns**) to obtain research or other products or services, you receive a benefit because you do not have to produce or pay for the research, products or services.

Types of Brokerage Research

- Proprietary Research (owned by the broker/dealer)
Ex. Wall Street Research
- Independent Third-Party Research (provided by the broker/dealer) Ex. Bloomberg

Why is Research Moving Third-Party?

- Global Settlement (April 28, 2003)
- Federal and State authorities fined the 10 largest investment banks \$1.4 Billion for conflicts of interest between research and investment banking.
- “To ensure that stock recommendations are not tainted by efforts to obtain investment banking fees, research analysts will be insulated from investment banking pressure. The firms will be required to sever the links between research and investment banking, including prohibiting analysts from receiving compensation for investment banking activities, and prohibiting analysts’ involvement in investment banking ‘pitches’ and ‘roadshows.’”
Source: Global Settlement, April 28, 2003.

The Effect of the Global Settlement

- Decline in proprietary research and analysts and increase in third-party independent research
- “Since 2000, the number of brokerage, or sell-side, analysts has fallen about **40%** to roughly 9,300, and is projected to drop by at least another third by 2008, according to a report by the TABB Group, a Westborough, Mass., research firm.”

Source: Barron's Rethinking Research, Jan. 22, 2007.

How is Third-Party Research Acquired?

- As stated in the Senate Banking Committee Minutes 1975, research is not an expense of management.
- Research is paid for through client commission arrangements, i.e. commissions and/or markups.
- **On the Equity Side** - 90% of research is paid for through client commission arrangements
- **On the Fixed Income Side** – 21% of research is paid for through client commission arrangements

Who Can Provide Fixed Income CCA's?

- The SEC states that positioning desks are not allowed to characterize a principal trade as an agency trade and charge a commission. Therefore, positioning desk at B/D is disqualified from providing for research under the Safe Harbor and Section 28(e).
- A non-positioning B/D performing “a legitimate *agency* function,” is eligible to provide research under Section 28(e).

Source: SEC No Action Letter written to Hoenig & Co, Soft dollars and Other Brokerage Arrangements, pg. 102-104.

How to Acquire Fixed Income Research

Three Ways to Acquire Fixed Income Research with clients' funds in the form of commissions or markups/downs.

- 1) **New Issues** – Commission is disclosed on the prospectus.
- 2) **Agency Transaction in Fixed Income** – Both sides of transaction are at the same price and a commission is added to pay for research services. The executing desk must be non-positioning acting as an agent seeking best execution in the market place.

Note: Bloomberg recently added a commission field on the fixed income trade tickets.

How to Acquire Fixed Income Research

- 3) **Certain Riskless Principal Transaction in Fixed Income with a non-positioning B/D** (two conditions required)
 - a) Trade Reporting System to verify markups.
 - Munis = MSRB
 - Corporates = TRACE
 - Agencies = TRACE (coming soon)
 - b) Markups/downs have to be reported on the clients confirmations

Legal Consequences of Not Paying-up for Research

- “While some money managers have expressed concern about being sued for paying-up for research, even though protected by section 28(e) of the Exchange Act, it appears that they should be more concerned about acting imprudently if they deliberately cut themselves off from street research or refuse to pay-up for other needed brokerage services to the detriment of the accounts they manage.”

Source: Soft dollars and Other Brokerage Arrangements, pg. 119-120.

Types of Third-Party Research

- Bloomberg
- Reuters North America
- CreditSights
- Gimme Credit
- KDP
- Bank Credit Analysis
- Intex
- Factset
- Derivative Solutions
- CMS BondEdge
- Realpoint
- ABS NET

Is Section 28(e) Still Pertinent?

- Yes, according to the 2004 Mutual Fund Task Force co-chaired by Mary Schapiro.
- “The Task Force unanimously agreed that the safe harbor set forth in Section 28(e) of the Exchange Act should be preserved. The Task Force believes that investors will be best served if research of all types, including both proprietary and third-party research, continues to be widely available to all investment managers.”

Source: Report of the Mutual Fund Task Force (Nov. 11, 2004).

Why/How CCM Provides Best Execution

- “As support of its claim to be acting in a legitimate agency function, a B/D acting as an agent in fixed income securities often has a larger trading desk and more extensive market contacts than many money managers, resulting in better executions.”

Source: Soft dollars and Other Brokerage Arrangements, pg. 104.

SUPPLIERS

ABN AMRO



Barclays

Bank of America



Credit Suisse



Deutsche Bank



Goldman Sachs



Jefferies



Morgan Keegan

Morgan Stanley



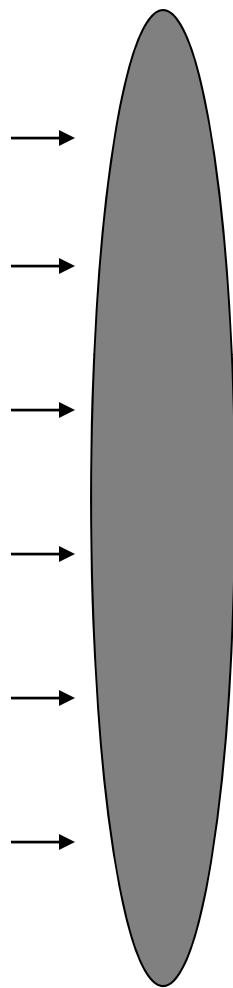
Raymond James



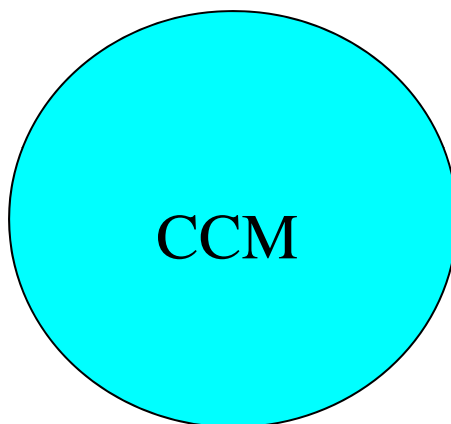
Wells Fargo

Wachovia

Database



DISTRIBUTOR



-CCM acts as a “distributor” for positioning b/d’s (“suppliers”). CCM has an excellent working relationship with all of the positioning fixed income b/d’s on the street.

-CCM helps customers find product in a highly fragmented market.

-CCM has the most cost-effective business model in the secondary fixed income market.

Result: Greater Liquidity.

CUSTOMERS

Money Managers

Hedge Fund

Mutual Fund

Investment Advisors

Trust Departments

Insurance Companies

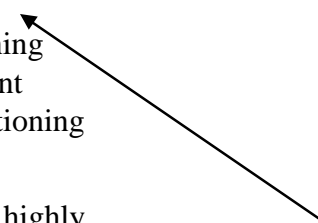
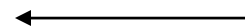
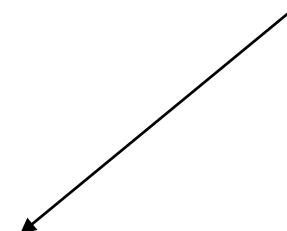
Endowments

Pensions

Bank

Thrift

Inquiry



Over 70 broker/dealers

Lower markup/downs for customers.

Over 1500 Institutional Clients

Sources

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