

# Danger of consolidating broker trading relations

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Today's Wall Street firms are facing issues that could reduce the amount of capital committed for executing trades. In light of tumultuous credit headlines — the demise of Bear Stearns Cos. and worries about other major financial services companies provoking potential financial industry reform — now is the perfect time for fund sponsors and investment managers to review their trading partners.

Just as individuals diversify their portfolios, a similar approach should apply to trading partners. Diversification includes having a mix of Wall Street, regional and agency or non-proprietary trading firms. Instead, the market has been moving to consolidation, a worrisome development that increased usage of client commission arrangements (also known as “soft dollars”).

In 2006, the SEC issued an interpretive release, paving the way for increased usage of client commission arrangements. The increasing popularity of CCAs has made it easier for the buy side to consolidate its trading partners, with big Wall Street firms reaping more and more of the execution business.

In some cases, institutional investors are slashing their approved lists to 20 or so brokers from 300. While on the surface this trend has streamlined the trading process for the buy side, it comes with a risk.

With a CCA, money managers execute trades with one broker while setting aside a portion of the commissions from those trades to pay for research (proprietary and third-party) from another firm. Brokers and managers negotiate an execution rate and commissions spent above that rate get placed in a pool to pay for investment research. The buy side has embraced CCAs because they are an efficient way to acquire research with commission dollars. In July, a Greenwich Associates study found that 45% of buy-side firms were using CCAs, up from 25% last year, and another 5% said they plan to establish a CCA over the next 12 months.

But the Bear Stearns situation and other recent Wall Street financial problems should serve as a wake-up call, one that poses the question: Is consolidation of all business to the larger firms in the best interest of your clients?

Top Wall Street firms lost 60% in market value in the 12 months through this past June. Additionally, securities firms have announced more than 20,000 job cuts since last summer. Losses may continue as they use less leverage and instill enhanced risk

management processes, which will inevitably reduce earnings growth and available capital.

While CCAs have provided flexibility in choosing execution brokers and research providers, there are unintended consequences to consolidating to fewer brokers or the same type of brokers, i.e., Wall Street firms. It is akin to putting too many of your eggs in one basket, thereby losing the flexibility of using different brokers who specialize in various trading services. Additionally, as trading partners become concentrated among a handful of the larger Wall Street brokers, and smaller broker-dealers disappear, the buy side may find itself with less power to negotiate the price it pays for research. Instead of hundreds of research providers competing for this business, the buy side may very well find that pricing power has shifted over to the small number of surviving sell-side firms. Diversity in trading and service providers is a wise approach from both a business and risk management perspective. It also helps ensure access to a full range of product offerings.

While bulge-bracket firms offer an array of valuable products and services, regional or agency brokers are wise components to the commission allocation process. Regional firms offer specialized research and trading services that can provide a unique market view. Agency brokers offer unbiased research, conflict-free trading and pride themselves on a customer-service focus. When combined with full-service firms, agency shops offer a complete spectrum of services while satisfying best execution obligations.

In evaluating broker relationships, take a look at their business models as well. Generally speaking, regional and agency firms incorporate strict risk management procedures and do not embrace the type of leverage seen at large Wall Street firms. Agency brokers do not trade for their own account, so there is no trading in speculative vehicles such as junk bonds or oil futures. At an agency shop, there is no conflict with a proprietary trading desk or the possibility of leakage of information from prime brokerage or other business lines within the same firm.

It's a good idea to review broker relationships regularly, not just on the heels of a shaky quarter on Wall Street. Ensuring such diversity among trading partners should help weather whatever storms may be on the horizon.

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