

Managers snub the Street for agency brokers

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Money managers, shocked by the fall of Lehman Brothers Holdings Inc., are turning to client commission arrangements with execution-only agency brokers to get top-notch research while avoiding the risk of another Wall Street debacle.

Many managers are now trading a good chunk of their orders with agency brokers that provide best execution and offer CCA programs.

“The financial services landscape as we’ve known it has been altered. For the first time, asset management firms have a concern about counterparty risk,” said Laurie Berke, analyst at financial services consultant TABB Group Inc., New York, referring to the fall of major institutional brokers Lehman and Bear Stearns Cos. Inc.

In the aftermath of such high-profile failures, money managers must address an unprecedented worry: the exposure of the brokerage firms that handle their trades. Money managers fear they suddenly could find commission dollars they thought were safely kept to buy research have simply evaporated.

“Risk managers now want to see how much CCA cash balances are sitting on brokers' books,” said Ms. Berke.

The concern is well founded. In Europe, commission-sharing money that institutions had with Lehman is now tied up in a U.K. bankruptcy court. In the U.S., the fate of such money from Lehman — a big player in the field — is still uncertain.

Unbundling

For execution-only agency brokers, the credit crisis was a blessing in disguise because it raised unprecedented concern among institutional investors about counterparty risk at top Wall Street firms, thus beefing up their business.

“The seminal event was the Lehman failure. We have seen clients wire money into our accounts (from full-service brokers) because, from a counterparty risk perspective, we are an open book and we have a very transparent balance sheet,” said Robert Gasser, chief executive officer at agency broker Investment Technology Group Inc., New York.

“As a result, there has been an increased demand for our (CCA) program,” added Mr. Gasser, whose firm on Dec. 3 launched a program for the Asia-Pacific region.

The old bundled-service model might be a permanent casualty of the crisis and, while the Wall Street powerhouses might not like the trend, they are starting to live with it, he added.

“I have not heard of an instance where a major firm has refused a hard-dollar check from us,” Mr. Gasser said.

Richard Vigsnes, senior vice president and global head of equity trading at [Northern Trust Global Investments](#), Chicago, concurred that the fall of Lehman led money managers to rethink how they manage their commission credits with brokers. The firm has \$652.4 billion under management.

“Anyone who was not been managing CCA balances efficiently and had a large credit (with Lehman) is a creditor, like everybody else,” Mr. Vigsnes.

“You must be much more hands-on in managing CCAs to make sure you don't have a credit that could go away,” Mr. Vigsnes said. He said he expects the current crisis to have a lasting impact on the relationship between institutional clients and Wall Street. “Agency brokers are pushing the idea that they are a safer repository of CCA credits,” he said.

“Four of five years ago, most bulge bracket firms were counting on the elimination of the midtier agency model. That's clearly not going to be the case anymore.”

At Liquidnet Holdings Inc., New York, Vlad Khandros, a member of the corporate strategy group, agreed “recent events have served as catalysts to the unbundling trends — this means best execution and best research are being separated out.”

Mr. Khandros said Liquidnet is used to paying many research providers and “those do include some of the largest brokers and banks on Wall Street.”

“The proof is in the pudding: We now have over 100 buy-side members signed up to Liquidnet Select,” the CCA program which the firm started just two years ago.

A thorny issue

Bulge-bracket firms and agency brokers have opposite stakes in the issue: The large firms would like to protect their trading turf; the execution-only intermediaries want to give their clients access to valuable research they do not offer.

Some big firms tell potential clients they cannot accept client commission dollars to provide research in exchange because this would turn them into investment advisers. Agency brokers have countered that this is a self-serving interpretation of the Investment Advisers Act of 1940 — a gray legal area that needs clarification by the Securities and Exchange Commission.

“This notion that the larger brokers are not playing ball with the agency brokers is misguided,” said Thomas Conigliaro, managing director at Goldman Sachs Group Inc., New York. “Frankly, we have had very few, if any, requests from clients asking us to accept cash payments for research from other brokers. Goldman Sachs does not accept hard dollars for research from our clients or any other clients, because we believe doing so has regulatory implications.”

Mr. Conigliaro said Goldman would be precluded from trading on a principal basis with any client that directed a cash payment to the bulge-bracket firm for research.

“I'm an advocate of transparency about this issue. It would be best if there was some guidance from the SEC. It's a situation that needs to be addressed,” he said.

A legal source close to the SEC said the agency's staff is currently dealing with so many issues related to the credit crisis that the CCA question is on the back burner. Both Wall Street firms and agency brokers asked the SEC for clarification on the matter two years ago, after guidance was issued on soft-dollar policies, the source said.

“We hope to soon have some additional clarification from the SEC on this issue. Our buy-side clients have expressed an interest in being able to pay for research from some of the bigger bulge-bracket brokers through BrokerShare and we'd love to have them as participants,” said Maureen Shankar, head of commission management services at Instinet LLC, New York. BrokerShare is a program that allows Instinet clients to send commissions to broker-dealers for the services they need.

Ms. Shankar said CCA programs give asset managers the ability to choose their trading broker solely based on best-execution considerations. “Given the importance of execution quality in a market like this, (CCA) programs have become even more attractive to many clients,” she said.

Jim Morrow, chief operating officer at Capital Institutional Services Inc., said his firm has seen a 40% jump in CCA business over the past three months, half from new clients. The Dallas-based firm provides execution, independent research and commission management services to plan sponsors and managers.

“One of the biggest complaints is that there are about 10 firms that will not accept payments from CAPIs,” Mr. Morrow said. He added that hard-dollar payments raise a difficult question because they de facto put a price tag on research — a complicated issue due to the complex nature of the research process, and one that, he agrees, requires SEC guidance.

Signal of move

In a sign that managers are steadily moving part of their business toward agency brokers, Mr. Morrow said “one-third of our clients have negative (CCA) balances,” meaning they ask CAPIs to procure services that will be paid with future commissions.

But commission sharing isn't an issue for all money managers.

“Our execution is very concentrated, the majority of which, about 85%, goes to the top 20 brokers. In general, we generate enough U.S. commissions with the bulge-bracket firms that this (use of agency CCA dollars) has not been an issue,” said Jeff Rosen, managing director and chief administrative officer of global equity at [Morgan Stanley Investment Management](#), New York, with \$570 billion in assets under management.

“We also pay about 140 other broker and independent research with CCAs,” Mr. Rosen said. “Paying bulge-bracket brokers with a CCA is a gray area where I absolutely think the SEC should give guidance.”

As an answer to the Lehman debacle, money managers now are more likely to spread their commission dollars among several brokers.

“Lehman was a watershed event. People were very receptive to broker-sponsored aggregation,” said Robin Hodgkins, president of Cogent Consulting LLC. “But when Lehman failed, people realized the danger. Their money was lost forever or tied up in court for six months and they decided they don't want to have that concentration of money in anyone place.” Cogent, Summit, N.J., provides systems that allow money managers and brokers to manage the unbundling of trading and research commissions.

“Definitely, institutional investors are using more brokers with (CCA) programs and they are encouraging a greater number of brokerage firms to offer these programs to their clients,” Mr. Hodgkins added.