

# Securities Industry News

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## Agency Brokerage

### The Broadening of Agency Services

Independence gives agencies an inherent advantage, says Capis' Wetherington

Agency brokerages became a market force in the 1990s by focusing on buy-side demands for low-cost execution. Today the business is coming full circle: Institutional investors want low-touch trading and algorithmic strategies as well as cross-border and multi-asset-class services at a time when liquidity is increasingly fragmented among traditional and alternative trading venues.

Agency brokerages, in turn, are responding with services that make them look more like their larger, full-service rivals—pre-trade analysis, portfolio management, risk management and compliance. Agency brokerages are also faced with fee-transparency questions: How much information should investors have about how their commission dollars are divided between trade execution and research? The U.K.'s Financial Services Authority (FSA) has recommended the outright unbundling of the two.

The Securities and Exchange Commission has so far taken a less drastic approach in simply clarifying which services can be defined as research. The U.S. regulator has thus attempted to level the playing field between the proprietary research of a full-service firm and the independent research that comes from an organization with no investment banking and related facilities. However, full-service firms—typically Wall Street wirehouses—continue to benefit from the bulk of commission dollars and a greater level of opaqueness. It remains to be seen whether any policy change is in the works and how agency brokerages will benefit.

Boston-based research firm Aite Group has said that even though the agency brokerage community looks ripe for further consolidation, the popularity of its services could increase along with unbundling over the next few years. Those with a proven technology infrastructure and, perhaps more importantly, industry reputation will be best positioned to succeed.



Kristi Wetherington

Founded in 1977, Capital Institutional Services (Capis) in Dallas has been considered a pioneer of the unbundled research model. Kristi Wetherington, who joined the firm as an electronic trading specialist in 1993, succeeded founder Donald Potts as chief executive officer in 2006. Potts, who is also Wetherington's father, remains chairman.

*Securities Industry News* senior international editor Chris Kentouris spoke with Wetherington on the future of agency brokerages, including her views on commission management issues.

**What will the buy side's greater role in the decisionmaking process mean to sell-side brokers?** Trading knowledge that once was primarily on the sell side is now being passed on to the buy side, creating a relationship that is more consultative and more akin to a trading partnership. As buy-side traders become more involved in decisionmaking, they are demanding enhanced trading tools. Not only can the sell side offer their knowledge on how to use the systems and trading tools; they can also provide insight into market conditions through the traders on the trading desk. While technology helps make trading more efficient, it is the people that make the difference through their knowledge and insight.

**How does the paradigm between the sell side and the buy side differ when it comes to agency versus full-service brokers?** Both agency and full-service brokers are becoming more consultative in their dealings with the buy side and continue to expand their offerings to stay competitive. However, agency brokers work in a conflict-free environment; they do not offer the investment management or investment banking services of a full-service broker. An agent by definition is a representative. ... A consultative role is most effective when it is free of any internal conflicts of interest.

**What role has technology played in leveling the playing field between agency brokers and full-service brokers?** Technology has been the driving force behind improvements in the brokerage

industry over the past decade. Broker-dealers are investing in technology, which allows them to maximize order flow with lower fixed costs. Many of the systems we know today as execution management systems [EMS] were started by small broker-dealers who created sophisticated trading systems for their clients. This gained attention from the full-service brokers who noticed the volume that these brokers were executing. In lieu of building a system, it was more prudent for them to purchase the technology—for example, Bank of New York purchased Sonic; JP Morgan purchased Neovest; Citibank bought Lava Trading; Goldman bought Redi; and Lehman purchased [Townsend Analytics] RealTick. These acquisitions allowed the full-service brokers to step into the agency brokers' space. On the flip side, algorithms were generally a tool for full-service brokers' proprietary trading desks. As these algorithms were made available to institutional clients, agency brokerages began creating their own to better compete in that space. In a similar fashion, the majority of dark pools were primarily used for internalization of orders on full-service desks. With the advent of agency broker dark pools such as Liquidnet, Pipeline, Nyfix Millennium and [Investment Technology Group's] Posit, dark pools have become more effective trading tools, offered by both sides.

A result of increased technology has been a slow commoditization of trading. Sell-side desks—whether agency-only or full-service brokers—are often using similar technology to trade with the same market centers. With the commoditizing of trading tools, the sell-side trader is again becoming the differentiator on the quality of the execution.

### **What services can give agency brokers a leg up on full-service rivals?**

Agency brokers need to continue focusing on what they do best—trading and research services without conflict of other business lines. Agency brokers currently compete very effectively against full-service brokerages. Both offer similar tools such as EMS, algorithms, dark pools and transaction cost analysis. The difference is in their approach to business. As the trading and research industry moves toward disclosure of research and execution costs, full-service firms are struggling with how to price research versus execution. Their

initial reaction was to move toward commission sharing arrangements [CSA] and client commission arrangements [CCA] for third-party research, but their clients are asking them to place all third-party and proprietary research in CSA/CCA programs. The full-service firms are resisting because it would force them to price research and execution. We are also witnessing full-service firms trying to move into the independent research arena by investing in independent research providers. These full-service brokers appear to be investing primarily in research firms that do not conflict with their own research. Is research truly independent if it is partially owned by an investment bank?

**Are you saying that it is full-service brokers that need to get a leg up on agencies?** I believe it will be difficult for full-service brokers to get a leg up in the agency brokers' areas of expertise because of the core business model differences. Because of their non-conflicted business model, agency brokers can focus on providing the best possible trading and research solutions without regard to how they will impact other business lines.

### **Are there differences between the U.S. and European competitive landscape?**

The agency-only model is far less prevalent in Europe, where the majority of brokers are full service—the banks have stronger brands and offer capital commitment, which is important to European money managers. The majority of agency brokers in Europe are U.S.-based and have a global presence. Regulation is another consideration. In 2005, the FSA enacted commission disclosure guidelines, while the U.S. has yet to address increased disclosure and transparency. This has caused something of a disconnect for those of us doing business on both sides of the Atlantic. According to a recent survey by Greenwich Associates and Capis, more than 60 percent of the U.S. investment managers and more than two-thirds of the plan sponsors interviewed said they favored regulatory intervention that would help clarify what needs to be disclosed regarding commissions paid to equity brokers for trade execution and research. Such action would potentially help close the gap between the U.S. and U.K. approaches.

### **Will the Markets in Financial Instruments Directive (MiFID) and**

### **potential unbundling of soft-dollar commissions in Europe change that?**

The implementation of MiFID has created numerous alternative trading systems (ATs) including [Instinet's] Chi-X and Project Turquoise. Typically ATs operate as agency brokers. With these new ATs, competition will certainly increase between agency and full-service brokerage firms in Europe, much like it did in the U.S. when order handling rules went into effect in 1997.

### **How much of a role has transaction cost analysis (TCA) played in raising questions about soft-dollar disclosure?**

TCA tools are used primarily to measure a broker's execution quality. As such, we believe TCA plays a minor role in soft-dollar disclosure. It helps identify one component of the total cost of execution by providing information on the price impact of execution using different trading strategies. Another component of the total cost of execution is the commission. With bundled [proprietary] trades, it's hard to determine the cost of execution versus the price of research. With increased disclosure, those execution costs would be more easily identifiable. ... Because best execution is an agency firm's only agenda, the effect on TCA is minimal and can be calculated easily due to transparency of the commission charged.

### **Can you comment on the historic accuracy of soft-dollar commission estimates?**

Investment managers' use of soft dollars has historically been underestimated. When most people think of soft dollars, they don't think that it includes commissions spent on proprietary, or bundled, research. As clearly stated in the SEC's 2006 guidance on client commission practices under Section 28(e), soft dollars include both third-party and proprietary research. In 2006, the estimated cost of soft-dollar expenditures was \$1.2 billion. This only incorporates third-party research. In reality, when you include proprietary and third-party research, an estimated \$10 billion was spent on soft dollars.

**Could the commission management records maintained by institutional asset managers be used to comply with any future brokerage commission disclosure requirements?** We believe commission management records could be easily adapted to comply with

any future disclosure requirements. Commission management systems are usually provided by third-party vendors, brokers or are developed in-house for proprietary use. Since these systems currently provide information related to commission spending, any programming needed for increased disclosure should be easily implemented. Money managers are increasingly asking for additional tools to track and value the dollars spent on research and the vendors are building. Many systems may already provide the tools needed in an increased-disclosure world.

**Might commission disclosure have a long-term negative impact on total portfolio performance?** We do not believe so. Managers have a fiduciary responsibility under Section 28(e) to ensure the services they receive are reasonable in relation to the cost of the service.

**Might disclosure discourage some uses of client commissions that do not contribute to portfolio performance, and thus have a positive impact on portfolio performance?** Any commission that is used to pay for research is held to the standard that it aids in the investment decisionmaking process. Therefore, all commissions used for research should be contributing to the performance of the portfolio. Where commission disclosure could make a noticeable impact on portfolio performance is in

the pricing of proprietary research. If proprietary research is priced, managers can more accurately determine if what they are paying for the service is reasonable in relation to its value. Increased disclosure will put proprietary and third-party research on an even playing field and will allow money managers to determine where their commissions are best spent.

**Do you believe commission disclosure would have any effect on U.S. markets' global competitiveness?**

Increased transparency leads to better information, which is clearly not harmful to investors. U.S. markets are among the most trusted and highly regulated. The differentiator in the research portion of global competition is commission disclosure. The FSA disclosure standards for U.K. pension funds allow investment managers to use client commissions for execution and research. They require asset managers to disclose to their customers details of how commission payments have been spent and what services have been acquired. The disclosure also secures value for clients and promotes competition between those who produce third-party research and those who produce proprietary research. The U.S. has not yet mandated or defined commission disclosure. For those managers who have global clients, it is difficult to adhere to one set of rules for one country and another set for another country.

**How do you view the Investment Company Institute's (ICI) changed stance calling for a level playing field for all institutional investors when it comes to soft dollars?** We have long been confused as to why the ICI supported such an opaque structure. Perhaps, like many in the securities industry, ICI finally realized that a ban on all soft-dollar commissions would also include a ban on using client commissions to pay for proprietary research. This is not in the best interest of ICI members.

**SEC chairman Christopher Cox has asked Congress to support improved disclosure on soft-dollar commissions. Has he muddied the waters or not?**

We fully support enhanced clarity on commission disclosure practices. However, Cox's call to virtually abolish soft dollars was quite a shock to us and many in the brokerage community, especially since the SEC's 2006 guidance was passed unanimously by the SEC—including the chairman. In a recent letter to him, Sen. Charles Schumer questioned the chairman's intentions in asking for congressional action. In subsequent testimony before the Senate Banking Committee, Cox stated that there was no immediate need for legislation and he was unaware of any specific abuses of 28(e) that would prompt immediate action. We look forward to continuing our dialogue with the SEC on disclosure practices. ■



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