Perspectives on Trading Practices

Use of Soft Dollars, Affiliated Broker/Dealers
and Recapture Programs in the Mutual Fund Industry

January, 2008

CEDARWOOD ASSOCIATES
Mutual Fund Consulting Services

For an individual analysis or information on other services,
please contact Kathleen Dennis at 440-423-0671
or kdennis@cedarwood-associates.com

Executive Summary

This study examined data from 169 complexes over two years to determine the level and trends of trading practices relating to soft dollars, use of affiliate brokers and the existence of recapture programs. While all advisors have a responsibility to provide best execution to their clients, the trading process is complex and actions may increase or decrease shareholder costs.

<u>Statistical Findings</u>

- A modest improvement was seen in the number of complexes disclosing their soft dollar commissions. The increase from 67% to 70% of the universe reviewed came mostly from those with assets below $2 billion.
- On average, 38% of commissions were used for research and services in the most recent year, up from 33% in the prior year. The change was driven by complexes with assets above $5 billion with the largest change seen in those between $5 and $50 billion. The increase is believed to be the result of more managers including proprietary research in their reporting, rather than a material change in actual soft dollar practices.
- Fewer complexes permit the use of affiliates for trading (28% vs. 33%) however those continuing the practice show an increase in the percentage of commissions directed to the affiliate.
- A significant increase was seen in fund companies disclosing the existence of a recapture program, though overall usage is still low. The 2006 study indicated that only 4% of the 169 complexes used recapture; this number increased to 10% in 2007.

<u>Disclosure Observations</u>

- Disclosure of actual activities continues to be inconsistent. There has been an increase in the number of fund companies clarifying the nature of their soft dollar transactions. Some disclose only third party research, some disclose both third party and proprietary, and some indicate that soft dollars are proprietary only, In several cases disclosure indicates third party research is now either paid for by the advisor or not used. The majority of complexes indicate that the research purchased is supplemental to their own efforts, and may or may not add value. Only a small number make more of an effort to detail their decision making process or changes in approach from prior years.

Survey Objectives and Methodology

Although trading practices are typically established by the advisor and implemented across all clients, mutual fund directors have the responsibility to oversee those practices and to understand the impact on fund shareholders. Fulfillment of the oversight requirement may be made easier with an understanding of how various practices are used across the industry. This study set out to provide answers and data in response to the following questions:

- What is the typical level of usage of soft dollars by mutual funds?
- Is there significant variance in use between large and small complexes?
- To the extent that differences exist year-over-year, what factors may be causing the differences?
- How broadly are affiliated brokers used, and is their usage a significant relative to total commissions?
- How common are recapture programs and can their impact be evaluated?
- What are the general disclosure practices with respect to trading and commission usage?

Trading is a critical component of the portfolio management process, and advisor practices can impact the cost of trading.

- The acquisition of proprietary or third party research with commissions (soft dollars) may result in higher commissions than might otherwise be paid.
- The use of affiliated brokers for trade execution may present conflicts of interest both with respect to commission level and the ultimate impact on best execution.
- Recapture programs provide an opportunity to return dollars to funds or to cover payment of some expenses.

Data was gathered from 169 complexes over a two year period, representing approximately 29% of the industry. Representative samples were obtained from complexes of all sizes, from a low of $10 million in assets to about $1 trillion.
All data was evaluated in five size-related "peer groups" as well as in total. <u>It should be noted that 4 of the 169 complexes were acquired or merged during 2007, thus reducing the total data points in the second year to 165.</u>

The primary source of data was the Statements of Additional Information, reviewed either on the EDGAR database or the funds' websites. Some information was also obtained from Morningstar and fund prospectuses or annual reports.

The Universe

Asset Size	Number of Complexes Reviewed	Number of Complexes In Industry*
$5 million - $2 billion	66	390
$2 billion - $5 billion	36	63
$5 billion - $15 billion	26	49
$15 billion - $50 billion	28	38
More than $50 billion	13	41
Total	**169**	**581**

*Source: Strategic Insights, 10/06

Soft Dollar Usage

Though all complexes include narrative describing the ability to use commissions to pay for soft dollars within the safe harbor guidelines of Sec. 28(e), there is no requirement that actual usage be disclosed. In total approximately 2/3 of the funds surveyed reported the dollar amount of soft dollar expenditures, with the lack of disclosure clearly more evident in smaller complexes.

	Complex Size					
	<$2 B	**$2-$5 B**	**$5-$15 B**	**$15-$50 B**	**>$50 B**	**Total**
# of Funds Surveyed – 2006	66	36	26	28	13	169
# of Funds Surveyed – 2007	66	33	26	27	13	165
# Disclosing Soft Dollars 2006* % of Universe	38 58%	22 61%	18 69%	24 86%	11 85%	113 67%
# Disclosing Soft Dollars 2007* % of Universe	41 62%	23 70%	17 65%	23 85%	12 92%	116 70%

* Includes those complexes that specifically disclose "0" soft dollars.

The modest increase seen from 2006 to 2007 was due in large part to more detailed disclosure by the smaller complexes.

Though 30% of our universe did NOT disclose actual soft dollar usage, it is reasonable to presume that the bulk of these complexes did, in fact, have commissions directed for research and services. Continued expansion of disclosure in this area is likely to be a slow process without SEC guidance or requirements.

The study compared soft dollar commissions to total commissions in order to evaluate the level and trend of usage. The data shows a fairly significant increase in the level of usage from 2006 to 2007; the change is almost entirely attributable to complexes over $5 billion.

	Complex Size					
Soft Dollars % of Total Commissions	**<$2 B**	**$2-$5 B**	**$5-$15 B**	**$15-$50 B**	**>$50 B**	**Total**
2006	38%	29%	38%	28%	30%	33%
2007	39%	22%	50%	42%	37%	38%

In order to more fully evaluate the above increase, we examined the dispersion of results. The data below shows the <u>number</u> of complexes whose ratio of soft dollars to total commissions is in the following ranges.

	2006							2007					
# Reporting	**<$2b**	**$2-5b**	**$5-15b**	**$15-50b**	**>$50b**	**Total***		**<$2b**	**$2-5b**	**$5-15b**	**$15-50b**	**>$50b**	**Total***
0 Soft $	7	3	0	2	1	**13**		6	2	0	2	0	**10**
1-25%	10	11	9	15	5	**50**		13	14	7	5	5	**44**
26-50%	9	3	4	2	2	**20**		9	1	2	3	3	**18**
51-75%	4	3	1	1	2	**11**		3	3	2	2	1	**11**
76-100%	8	2	4	4	1	**19**		10	3	6	11	3	**33**

*In 2006, 113 complexes reported soft dollars; in 2007 the number increased to 116 complexes.

The data shows that in 2006, 63 complexes or 56% of the total reported soft dollars/total commissions at 25% or less. In 2007 the number declined to 54 (46%). At the same time the number reporting soft dollar/total commissions at 76% or greater rose from 19 (17%) to 33 (28%). **What brought about this change?**

We believe that the answer is not attributable to a change in behavior, but rather can be explained by a change in disclosure. In the past, both advisors and the SEC focused primarily on third party research and services when reviewing industry practices. In fact, in 1998 the SEC published data from a series of examinations which indicated commissions used for third party research averaged only 12% of total commissions. In the same report there was no discussion on use of proprietary research.

When the SEC guidance on soft dollars was released in mid-2006, it specifically indicated that the release applies to both proprietary and third party research and services. Within the 2007 data reviewed for this study, there are a number of observations leading to conclusion that more complexes are now including proprietary research as soft dollar expenditure.

In 2007, 25% of our universe specified that soft dollars were either 3rd party, proprietary only, or both. In the prior year this detail was essentially non-existent.

A total of 15 complexes disclosed only third party research. Within this group, soft dollar commissions averaged only 18% of total commissions. (Somewhat higher than the SEC's 1998 data). 14 complexes reported soft dollars as attributable to proprietary only or both proprietary and third party. This group's soft dollar commissions averaged 74% of total commissions.

Eleven complexes showed very large increases in the level of commissions attributable to soft dollars. Nine of the 11 were in the 1-25% range in 2006, and in 2007 fall in the 76-100% range. Not all of these complexes disclosed what they were measuring, but the new levels are consistent with those reporting both proprietary and third party.

One other clear conclusion is seen in the data. A large number of complexes continue to direct the majority of their trades to full service firms, receiving research and services in return. Only a few firms discuss an effort to reduce commission costs through use of ECNs or discount brokers, and commission unbundling is seen only in a few of the largest complexes.

Disclosure Highlights

Much of the disclosure relating to broker selection and use of commissions for research is quite standardized. The inconsistencies and gaps arise in the description of what the managers are actually doing and how it impacts their process. We have already discussed above the multiple ways in which soft dollars are measured and reported. The following observations were also quite interesting.

- Only one fund complex actually discussed the conflicts that may arise in spending client dollars for research.
- At least six reported that soft dollar activities <u>may reduce</u> the expenses of the advisor.
- Many reported that soft dollar activities <u>do not reduce</u> the advisor expenses.
- A significant number stated that it is difficult or impossible to assign a value to the research obtained.
- A few reported that the research has some value to the advisor.
- One small complex actually reported a dollar value of the research received.
- One reported that the research acquired may <u>not</u> be useful and may not add any value.
- One complex discussed the fact that it has negotiated some arrangements to unbundle research and trading.
- Two complexes disclosed that they pay directly for all third party research.
- Only 3 complexes reported actions to reduce their commission levels.

Sec. 28(e) allows a range of uses for commission dollars, and the SEC's 2006 guidance put further clarification to permissible activities. It is presumed that advisors will continue to actively use soft dollars within the defined parameters. Yet the disclosures and the data above lead to <u>a feeling</u> that advisors may be continuing to use full service brokers, and receive the research without active evaluation of whether a less costly alternative exists for shareholders.

Trading Through Affiliated Brokers

The ability to use affiliates for trading is seen in just over 1/3 of the complexes surveyed. The number disclosing the practice declined modestly from 63 (37% of the universe) to 58 or 35% over the two year period. Disclosure of commissions paid to the affiliates is required, and data reported shows that though fewer complexes are actually using affiliates, the commissions paid have increased relative to total commissions.

It is interesting to note that the smaller complexes using an affiliate do so at a much higher rate than larger complexes. Part of the reason appears to be that smaller complexes make more use of sub-advisors, with those managers trading through their affiliates. There is not sufficient data or information for further evaluation. The increase in the 2007 level of usage does raise questions for boards relative to potential conflicts of interest.

	Complex Size						
	<$2 B	**$2-$5 B**	**$5-$15 B**	**$15-$50 B**	**>$50 B**	**Total**	**% of Universe**
# Reporting Affiliated Trades							
2006	17	7	5	12	6	**47**	**28%**
2007	16	5	8	9	4	**42**	**25%**
Average % of Total Commissions							
2006	26%	9%	3%	9%	2%	**13%**	
2007	33%	26%	6%	14%	3%	**20%**	

Commission Recapture and Expense Reduction Programs

Commission recapture has been broadly used in the pension management area, but has been much less prevalent in the mutual fund industry. Benefits of recapture have been reduced generally due to downward pressure on commissions, but programs continue to be offered by a number of providers.

Though still not broadly used, the number of complexes reporting recapture programs more than doubled from 2006 to 2007.

Disclosure is very inconsistent, particularly with respect to the financial impact. Some report no financial data, but only the existence of the program. Others report the total commissions that resulted in recapture. Finally some report the actual dollars that were returned to the fund. Overall 6 of the 15 complexes reported some financial data, though it is not detailed enough to draw conclusions.

It is clear that there are benefits to those complexes which establish a program. As examples, two small complexes, each approximately $1billion in size, reported cash returns to the funds of $267,000 and $650,000. This represented 17% and 12% of total commissions respectively, which is a significant reduction in their trading costs.

Commission Recapture	<$2B	$2-$5B	$5-$15B	$15-$50B	>$50B	**Total**	**% of Universe**
# Using Recapture							
2006	2	0	2	2	1	**7**	**4%**
2007	7	0	3	5	2	**17**	**10%**

Conclusion

The data and information provided in fund registration statements provides some ability to evaluate advisor trading practices. It is, however, only part of the basis for a full evaluation of best execution. The nature of the complex, overall trading volume and other factors can all help put the numbers in context and provide additional support to the oversight process.

Though there were expectations that the SEC's final guidance on Sec. 28(e) would bring about some decline in the use of soft dollars, this does not seem to be the case. It is reasonable to presume that the guidance, combined with the focus on compliance programs, will lead to fewer abuses in the soft dollar area.

We believe that use of affiliated brokers will continue to be limited. The conflicts that arise make tracking and justification a necessary but difficult process for the advisor. In the smaller complexes, where the practice is more prevalent, we would hope that a good system of checks and balances exists.

Finally, we would expect to see continued interest in recapture programs, as boards focus more on the trading function and trading costs.