Q&A: Commission Recapture
Helping investors manage total commission expenses

In this Q&A, we discuss how Commission Recapture can provide institutional asset owners (plan sponsors, sovereign wealth funds, managed funds, etc.) with an effective framework for managing total plan commission expenses.

What is Commission Recapture?
In short, Commission Recapture (CR) is a negotiated rebate of commissions paid to brokers, which allows asset owners to earn back a percentage of total commissions.
Although it is a similar structure, this is not to be confused with soft-dollar or commission-sharing arrangements which benefit investment managers directly. Commission Recapture is an actual hard-dollar rebate of the commissions spent directly back to the client's portfolio.

How does Commission Recapture work?
The CR provider or administrator of the program negotiates rebates to be received from a panel of brokers. By leveraging the total assets under management of the aggregate client base, the CR provider is able to achieve significant rebates, ranging from 40-70% of the commission paid, on any given trade.

Why would investors want to consider Commission Recapture?
There are a few good reasons. First, it can help reduce transaction costs by lowering the overall commission expense. Secondly, it increases returns to the extent that the commission savings are reinvested into the client's portfolio. Thirdly, it supplements fiduciary oversight by putting structure in place to monitor commission usage.

How does my commission spend compare to AUM fees?
One perception is the use of commissions is inconsequential relative to AUM fees, but this is not the case. If we assume a 40% turnover, 12 bps average commission rate and 40 bps average AUM fee, commission spend can represent 20%+ of the total value proposition for the manager.

Does the relationship between asset owners and asset managers have any inherent conflicts?
There is a potential conflict between maximizing manager profits and reducing trading costs to benefit the client. When external asset managers are employed, AUM fees are directly negotiated on a client-by-client basis; however, the asset owners are not consulted when asset managers make discretionary decisions regarding turnover, commission rates and broker usage.

While commissions are an asset of the client, external managers have an incentive to use them in ways that reduce their own costs and improve their bottom lines. Research purchased via commissions is effectively manager costs being offset by client assets. This research does indirectly benefit the client by improving the investment deliverable, but it is still essentially a manager's cost paid with client assets.
How can CR help address this conflict of interest?

From a fiduciary perspective, CR is the primary tool that institutional investors can use to manage total commission expense. Having an oversight mechanism in place sends the message to external asset managers that commissions are being measured and reviewed. CR is also effective because it helps to manage and reduce overall commission spend without completely eliminating a manager’s ability to purchase research.

What is the most common objection to CR program participation?

The potential impact to a manager’s best execution process. It is a market fallacy to say that individual executions are driven purely by an observable and measurable expected execution quality, rather than any more subjective factors such as relationships or commission budgets/obligations.

Our strong belief, as both a provider of CR as well as a consumer within our funds, is that managers have the ability to select from a variety of qualified and experienced trading providers or venues while still achieving the same competitive price and market impact. This dynamic provides the scope to participate in CR programs at a reasonable level. We recommend conservative targets, starting at 25% of total commission and adjusting lower as you move down the spectrum of mandate liquidity, demonstrating an effort to help managers meet participation targets without affecting execution quality.

Exhibit 1: Suggested participation rates

<table>
<thead>
<tr>
<th>MANDATE</th>
<th>TARGET (% OF TOTAL COMMISSION)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Equity</td>
<td>10-20%</td>
</tr>
<tr>
<td>Developed Asia</td>
<td>10-15%</td>
</tr>
<tr>
<td>Developed Europe</td>
<td>10-15%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>5-10%</td>
</tr>
<tr>
<td>US Large Cap</td>
<td>25%</td>
</tr>
<tr>
<td>US Mid Cap</td>
<td>20-25%</td>
</tr>
<tr>
<td>US Small Cap</td>
<td>15-20%</td>
</tr>
<tr>
<td>US All Cap</td>
<td>15-25%</td>
</tr>
</tbody>
</table>

Are there other common misconceptions about CR?

Another misconception is that if clients demand improved usage and accountability of their commission dollars, investment performance will be negatively impacted, which is not the case. Since only a portion of the trades are allocated to the CR program, the majority of commission dollars are at the managers’ disposal to be used for vital and core research.

How has the usage of CR evolved in recent years?

Though the asset management and brokerage industries have faced many changes over the last 5-10 years, many institutional investors have managed to achieve increasing levels of participation in their CR programs. Plan sponsors, fund companies and sovereign funds—especially at the top end of the institutional marketplace—continue to implement new programs on a global basis and realize savings on their total commission expenses.

What are some practical considerations for investors implementing a CR program?

We work with each of our clients to identify the potential scope of participation, areas of opportunity and address any asset manager concerns. Some of the key practical considerations for investors to keep in mind include the ideas that:

- **Equity trading is most applicable**, as other asset classes still broadly trade without an explicit commission.
- **Actively managed separate accounts will produce the most benefit** relative to passive mandates. Commingled accounts require CR to be attributed at a total fund level.
- **Savings estimates can be produced for all clients and prospects** based on the equity asset levels, specific managers employed and specific mandates being managed.
- **Manager pushback is something that should be expected** and is best dealt with in coordination with your CR provider on a case-by-case basis.
- **Broker coverage is key** to ensuring managers have access to a broad set of liquidity, allowing them to achieve best execution. Russell Investments actively reviews our existing broker network and takes any manager requests into consideration in order to provide managers with avenues to maximize program participation. Currently, there are over 20 brokers available through our network, many already used by the vast majority of managers.

**EXAMPLE: WHAT COULD SAVINGS LOOK LIKE?**

Sample client with $5 Billion in total assets:

Assumptions

- 50% exposure to active global equities
- 40% average turnover and 12 bps average commission
- $2,400,000 a year in total commissions
- 15% average participation across these areas

Expectations

- $175,000 to $200,000 in potential annual savings
How do I implement and manage a CR program with Russell Investments?

Commission recapture programs are easy for asset owners to implement with an experienced CR provider. Ongoing management should only require one to two hours per quarter to review reports and to have any necessary follow-up conversations with managers. Our dedicated CR client relationship team assists with all implementation and maintenance demands of the program. Some of the common considerations are:

- **Terms of business letters** with Russell Investments are very straightforward and can typically be completed within one day.
- **Manager instruction letters** will be produced by Russell Investments and provided to clients for their review. The clients will then sign and send the letters to their investment managers and Russell Investments will follow up with each manager to ensure the relevant accounts are operationally ready for CR.
- **Reporting and payments** will be provided by Russell Investments on a monthly or quarterly basis, as preferred by the client. Our commission management team reconciles all program data and delivers a transparent reporting package that makes it easy for clients to review the program.

What does the program look like after implementation?

Once a client signs a contract with Russell Investments as CR Program Administrator and sends the respective participation requests to their investment managers, Russell Investments oversees the start-up and on-going processes. We will maintain and update the Broker Network, work with managers on account set-up and on-going reconciliation of the account, collect the rebates from brokers, provide regular reporting to clients and ensure rebates are received and paid to clients.

The entire process of entering into a program, requesting participation and the trading, reconciliation and payment cycle is outlined in the process flow diagram in Exhibit 2.

Why do clients choose to work with Russell Investments?

Russell Investments is unique among CR providers for a variety of reasons, the most prominent being our history in the marketplace and our approach to the business. We have the longest history of providing CR dating back to 1969 and have an “average client” size of more than US$20 billion in assets represented. In addition, our strong background in consulting, research and asset management helps drive client relationships and manager participation. In short, clients choose to work with Russell Investments for a few key reasons:

- **Reputation** is more than just a buzzword for Russell Investments; we have been in the business 45 years, have longstanding client relationships and are an industry leader in CR.
- **Dedicated team** of client support and operational staff whose primary focus is Commission Recapture.
- **Results** are demonstrated with client savings. To date, we have delivered more than US$1.3 billion in commission savings back to our clients.
- **Scale** in the business helps us to understand the different needs of our client base and deliver a comprehensive solution to clients globally, including some of the world’s largest pensions, financial institutions and sovereign wealth funds.
- **Focus** on our client base has driven customer loyalty. As a practice, we work with fewer and larger clients, allowing us to focus on maximizing the client experience and benefit.

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**Exhibit 2: Standard CR process flow**

- **Asset Owner**
  - Requests asset manager participation level based on market/mandate

- **CR Program Administration**
  - Relevant trades and commissions are reconciled, client reports are produced and rebates sent to client

- **Asset Manager**
  - Determines which broker(s) it will use to implement the request within its best execution guidelines

- **Russell Investments Trading**
  - Russell Investments’ trading desk or one of the participating network brokers execute trades
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