All that's hot in the mutual fund industry

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Study: Directed Brokerage Ban Improves Performance

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The SEC ban on directed brokerage was effective in removing an incentive for mutual funds to overtrade to generate commissions for top producers. But fund performance, although improved, still suffers due to broker bias.

That's according to a new study issued by George Serafeim, a Harvard Graduate School of Business doctoral candidate. The study argues that the Securities and Exchange Commission rule prohibiting directed brokerage arrangements, which took effect in 2004, successfully targeted excessive trading commissions and "reduced the amount of trading due to mutual fund overtrading in order to compensate brokers for their efforts."

The study further claims that a review of funds from 2000 to 2006 shows that revenue-sharing agreements have served to undermine the ban on directed brokerage.

"What I find after the regulation is an abnormal increase in the management fee, which is consistent with revenue sharing," Serafeim says. "And I find that this abnormal component is related to fund flows, so the more you increase your management fee the more inflow you have."

Serafeim's findings are likely to draw criticism and scrutiny from the fund industry, which is no stranger to academic studies seeking to shed light on its practices. In fact, Ellot Spitzer used a study that examined market timing in mutual funds to help launch his far-reaching investigation into the fund industry. That study was published in 2002 by Stanford business professor Eric Zitzewitz.

Serafeim's study, titled, "Directed Brokerage No More: The Effects of New Regulation in the Mutual Fund Industry," sets out to answer four points, including:

- if turnover decreased after the rule as a result of brokers' presumed lower bargaining power
- if brokers found another way to substitute for lost commissions (by demanding higher sales loads or a share of management fees)
- if mutual fund returns improved after the rule
- if the rule weakened brokers' bias in favor of funds directing brokerage

In attempting to answer those questions, Serafeim evaluated two different groups of funds: those with "marketing and distribution costs" and those without. Fund groups that did not charge marketing and distribution costs were used as a benchmark to measure performance against funds that did.

The study found that after the ban took effect, abnormal returns for funds that charged marketing costs increased approximately 1.2% to 1.5% compared to funds with no marketing costs. The study attributes the improved performance to "better stock picking and a shift to a longer term investment approach."

Serafeim further claims that after the rule took effect, portfolio turnover diminished by between 8% and 15% for affected funds relative to the benchmark, supporting evidence that brokers wielded lower bargaining power. He adds that brokers sought to compensate for this loss with revenue-sharing agreements, which has resulted in higher fund management fees.

"Although affected funds have lower inflows after the regulation, suggesting that brokers' bias is partly eliminated, revenue sharing agreements appear to be the new means of increasing fund inflows," Serafeim writes.

Serafeim's findings were met with skepticism. Jay Baris, partner at **Kramer Levin Naftalis & Frankel**, says that revenue-sharing payments come from advisors' own resources, as opposed to directed brokerage fees that come from the fund itself.

"The difference is that when advisors pay revenue sharing it comes out of their profits as opposed to having funds pay for it through higher brokerage commissions," Baris says. "In theory, it should have less direct effect on shareholders."

Baris acknowledges that conflicts still exist with revenue sharing, "but brokers should disclose that conflict to their customers, and mutual fund registration statements generally disclose information about revenue-sharing payments to fund shareholders."

Baris says that a fund can direct commissions to brokers who sell its shares, "but the sale of the shares cannot be a factor, meaning a fund has to obtain best execution."

Further, management fees in the fund industry have, if anything, gone down since the ban on directed brokerage took effect. An Investment Company Institute study that looked at fund fees and expenses dating

back to 1980 found that fees have not been lower than they were last year. A recent Morningstar study had similar results.

Niels Holch, executive director of the **Coalition of Mutual Fund Investors**, says the study does demonstrate the effectiveness of the SEC rule. But he says competition is a likely antidote to keep fund fees competitive.

"So while I agree there may be some cost shifting, the competitive forces in the industry will somewhat restrain this activity because there is only so much you can charge for your fees and have a competitive product," Holch says.

Serafeim says the problem with revenue-sharing agreements is that the broker still has the incentive to direct people's money into a specific fund.

"By directing people's money toward fund A, what happens is assets under management for fund A increase and therefore management fees increase and the broker gets a portion of this," he says. "[The rule] is a good step in eliminating incentives in overtrading, but there is still a question about revenue-sharing agreements and whether the brokers' advice is unbiased."

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