Memo

To: Nebraska Investment Council
From: Tom Schoenbeck
       Max Kotary, CFA
Date: February 19, 2021
Re: Commission Recapture Review

Summary
The Nebraska Investment Council (the Council) requested Aon Investment Consulting ("Aon") review the Council's current commission recapture program and provide an assessment of the program's efficacy. Historically, State Street Global Markets (SSGM) has served as the commission recapture provider for the Council. Aon stresses the importance of best execution when trading securities and recommends that clients do not allow commission recapture programs to interfere with execution quality.

Based on our review, we recommend that the Council terminate its commission recapture program. We do not believe it is likely to provide much, if any, financial benefit to the Council in the future. Eliminating the program will also reduce the likelihood of any future questions about whether or not the Council is receiving best execution on investment portfolio trades.

Commission Recapture Overview
The practice of commission recapture evolved due to changes in commission rates. As regulations allowed for commission rates to change from fixed to variable, investment managers sought a method to pay for research and other services historically covered through fixed commissions. Not to be confused with soft dollar arrangements, commission recapture programs are intended to directly benefit the client that generates the commission. In a typical soft dollar arrangement, the benefit (e., research or other services) accrues to the investment manager, and only indirectly to the client.

In a commission recapture program, an investor gets back a portion of the commissions that investment managers pay to execute trades on their behalf. The mere presence of a commission recapture program suggests that commission dollars are being used inefficiently, which strengthens the case for differentiating research and execution costs. When these costs are combined, a commission recapture program allows the investor an opportunity to "recapture" some of the inefficiencies. Investors must be careful in setting up such programs, as the recaptured commissions in a poorly structured program can be easily offset by costs related to market impact and poor execution.

The investment manager will pay the commission recapture broker (or a broker in their network) the usual commission rate to execute the trade. Once executed, the commission recapture broker will rebate a portion of that commission back to the client. The rebate rate is typically agreed upon in advance, and usually ranges from 60-90%. The exhibit on the following page depicts how this works.
Developments in the Trading Industry

Over the past two decades, the trading industry has been impacted by many developments, and the practice of commission recapture has been directly affected. When the practice of commission recapture was first introduced, the potential for recapturing meaningful commission credits was high. At the inception of the practice, the level of scrutiny placed on commissions was low, technology was relatively primitive, and commission rates were high. As the trading industry has evolved, the prominence and significance of commission recapture has diminished as costs have come down and transparency has increased.

Two primary factors have driven the decline in commission rates: increased regulatory oversight of the trading industry, and technological developments offering alternative routes to market. Regulators such as the SEC have repeatedly scrutinized the practice of using commissions to pay for “other” services. An entire section of the Securities Exchange Act of 1934 is now dedicated to interpreting what investment managers may pay for utilizing commission dollars. This is illustrative of the increased scrutiny placed on commissions. Concurrently, technological developments within the trading industry have increased efficiency and competitiveness, which have in turn driven down commission rates. Algorithmic trading, whereby a computer program identifies the optimal and most cost-effective trade, is one example of these developments. A “dark pool” is another example of an advancement in the trading industry that has aided in driving down commission rates. Dark pools are liquidity pools that allow investors to cross trades and avoid market impact. As commission rates have become more competitive, the potential for earning substantial commission credits has decreased.

The roll out of MiFID II in January of 2018 has also influenced the way that many global investment managers, and all investment managers operating within the European Union, allocate commissions. One of the high-profile aspects of the MiFID II regulation impacts how investment managers pay for research they use when making investment decisions. Post MiFID II, investment managers operating within the European Union can no longer use trading commissions to pay for third party research. This has further impacted the commission recapture market as investment managers trading at execution-only rates leave little to no commissions to recapture.
While we recognize that developments affecting the trading industry have decreased the effectiveness of commission recapture, we believe that in certain instances commission recapture can still be a worthwhile endeavor. For example, if a commission recapture program does not interfere with best execution, and the credits generated are meaningful, then we believe the practice remains appropriate.

**Nebraska Investment Council Commission Recapture Program Results**

The larger the amount of commissions directed to a client's commission recapture broker, the greater the potential for recaptured commissions. However, a given investment manager will likely have other "preferred" brokers, so it is important for clients to manage expectations appropriately. Ultimately, best execution should not be sacrificed for the benefit of earning commission credits.

The table below shows the amount of commissions directed to SSGM since 2013 and rebated back to the Council.

**Commission Recapture Program Results Since 2013**

<table>
<thead>
<tr>
<th>Year</th>
<th>SSGM Gross Commissions</th>
<th>Recaptured Commissions Rebated back to the Council</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$47,190</td>
<td>$37,752</td>
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<tr>
<td>2014</td>
<td>$3,597</td>
<td>$2,878</td>
</tr>
<tr>
<td>2015</td>
<td>$0</td>
<td>$0</td>
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<tr>
<td>2016</td>
<td>$0</td>
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<td>2017</td>
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<td>2018</td>
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<tr>
<td>2019</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2020</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

As shown above, the Council's commission recapture program has not produced any earnings since 2014.

**Conclusion**

For any service that involves trading, Aon believes that the top priority should be to ensure that best execution is achieved. To the extent that a commission recapture program impedes best execution, we recommend that clients forego such programs. Over the past five-plus years, the Council's commission recapture program has produced no earnings. This lack of recaptured commissions can be attributed to a number of factors including increased trading transparency, SEC disclosure rules, technology developments, MiFID II, and more competitive commission rates. After surveying the investment managers currently utilized by the Council, our expectation is that the commission recapture program will continue to produce no earnings for the foreseeable future due to a lack of manager participation.

Our best thinking would be for the Council to eliminate the commission recapture program at this time.