

OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM
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MEMORANDUM

DATE: July 6, 2005

TO: OPERS Retirement Board Members

FROM: Roger Fox, Investment Manager

RE: **Annual Investment Policy Revision
Soft Dollar and Commission Recapture Policy**

Purpose

This memo highlights changes made to the Soft Dollar and Commission Recapture Policy, which was most recently updated in June of 2003.

Background

OPERS has seventeen policies relating to its investment operations. The Brokerage Policy is classified as an Investment Administration policy and covers the Soft-Dollar and Commission Recapture Programs of externally-managed assets.

During the past several years, the securities trading industry has progressed towards an unbundled approach of paying for trade execution and investment research separately, but has not evolved to a point where all investment research can be practically unbundled from fees paid for trade execution. In this environment, Commission Recapture Programs allow OPERS to receive compensation from brokerage fees that exceed the level of Best Execution.

Changes to the Soft Dollar and Commission Recapture policy reflect changes in the securities industry, standards by the CFA Institute and the Securities Exchange Commission (SEC), and a focus on continuously improving Best Execution.

Issues

This Brokerage Policy generally follows the same ordering of sections as the Plan Policies and Asset Class Policies, but customizes some sections, such as Investment Philosophy and Objectives, to Brokerage Philosophy and Objectives.

I. Scope

This section is new for the Soft Dollar and Commission Recapture Policy and specifies that the policy applies to externally-managed assets. The Brokerage Policy applies to internally-managed assets.

II. Purpose

This section is moved from the Section III. Objectives.

III. Legal Authority

This section has no changes.

IV. Brokerage Philosophy

This section is moved from section I.B. Definition and includes a distinction between, internally-generated and independent externally-generated, research provided by brokerage firm. The SEC now requires brokerage firms to offer independent externally-generated research to clients.

V. Objectives

This section has changes that specify the policy applies to externally-managed assets and that external managers will comply with guidance provided by the CFA Institute Soft Dollar Standards or other appropriate regulatory agencies.

VII. Roles and Responsibilities

This section has changed to include roles and responsibilities for external investment managers.

VIII. Monitoring and Reporting

This section changed to specify reporting additional standards.

Removed VI. Asset Class Guidelines

This section is removed because it duplicates other sections of the policy.

Next Steps

Staff will incorporate feedback and either bring changes to the August Investment Committee meeting for approval, or accept approval of suggested changes and finalize the policy.

MEMORANDUM

To: Investment Committee
Ohio Public Employees Retirement System

From: Brady O'Connell, CFA
Kris Ford, CFA

Date: July 7, 2005

Re: Brokerage and Soft Dollar and Commission Recapture Policies

EnnisKnupp has reviewed the proposed changes to the Brokerage Policy and Soft Dollar and Commission Recapture Policy. We recommend the Investment Committee approve both documents. Staff incorporated our feedback into the proposed changes. We involved research specialists that focus on trading and broker commissions in providing our feedback. Staff is largely responsible for implementation and monitoring of the programs, but will provide summary reports to the Investment Committee upon request. We think the Investment Committee should plan to review these evaluations on a regular basis, perhaps annually.

Brokerage Policy

The use of brokerage commissions related to trading securities has been a hot topic in the investment industry. Institutional investors have grown more and more aware of not only the overall level of the commissions they pay to brokers, but what they receive for these commissions. The proposed policy, which applies to internally-managed assets (as external managers conduct their own trading), is consistent with what we think are best practices. Importantly, the policy defines best execution clearly, and seeks to achieve this when making transactions in the various asset classes that employ internal management.

Soft Dollar and Commission Recapture Policy

This policy applies to externally-managed portfolios with the intention to minimize transaction costs involved with OPERS assets. Because OPERS investment staff is not directing trades to brokers for these portfolios, the Brokerage Policy does not apply. In order to make sure trades are being executed efficiently, the Soft Dollar and Commission Recapture policy was established to clarify how soft dollars will be used and when commissions will be recaptured. *Soft dollars* is the term used for credits or a rebate earned with different brokerage firms which can be used to purchase research-related services. These credits are generally created because the commissions charged by brokers are typically more than is needed to just execute a trade. Because it is unclear

how much of a commission is used for execution of a trade and how much goes to providing research through soft dollars, this practice has been identified as a potentially inefficient way to purchase research.

Commission recapture refers to a program used to get “excess” commissions paid to brokers by investment managers steered back to OPERS. Such programs are in place because commissions charged by brokers (and paid by investment managers) are more than is typically needed for execution of a trade. Recapture programs require brokers to send the excess commission payments back to OPERS. If commissions charged by brokers were for execution only, excess commissions would not exist for recapturing.

We think the approach outlined by staff in this policy is appropriate. We also think the Investment Committee would be well served by having staff report on their activities in both areas at least annually.



Ohio Public Employees Retirement System

Soft Dollar and Commission Recapture Policy

~~June~~ July 20053** |**

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Revision History

Policy Established	Date Approved
Policy Revised	June 17, 2003
	July 20, 2005

I. SCOPE

This policy applies to the trading activities associated with externally-managed public market assets of the Ohio Public Employees Retirement System (“OPERS”) Defined Benefit Fund, Health Care Fund and Defined Contribution Fund.

II. PURPOSE~~GENERAL PROVISION~~

This policy establishes a framework~~The primary objective in establishing policies for the use of commission recapture programs and soft dollar arrangements is to minimize total transaction costs while maximizing the value of services received, and provide for proper monitoring and oversight. [From III. Objectives]~~

A. Purpose

~~This policy applies to both internal and external investment managers. The purpose of the Ohio Public Retirement System’s (“OPERS”) Soft Dollar and Commission Recapture Policy is to:~~

- ~~—Establish policies and procedures governing commission recapture programs and soft dollar payment arrangements.~~
- ~~—Establish key roles and responsibilities.~~
- ~~—Establish guidelines for the publicly traded asset classes.~~

H.III. LEGAL AUTHORITY

In accordance with Ohio Revised Code section 145.11, which establishes the fiduciary responsibilities of the Board, the OPERS’ investment staff will use every effort to obtain the best available price and most favorable execution as defined in the Brokerage Philosophy section below, with respect to all portfolio transactions.

IV. BROKERAGE PHILOSOPHY

Best Execution is defined to mean the execution of particular investment decisions at the price and commission that provide the most favorable total cost or proceeds reasonably obtainable under the circumstances. OPERS encourages its external public market investment managers to use a variety of methods and venues for achieving Best Execution: this could include choosing the best broker for the transaction or bypassing the broker entirely. Best Execution does not necessarily mean paying the lowest possible commission fee. A brokerage commission is the fee paid to an agent (a broker) for services rendered as a sum or percentage of a transaction. The broker facilitates transactions and may help reduce total transactions costs for a fee or a markup in price. A brokerage commission is the explicit portion of the total transaction cost. Brokerage commissions are paid for two primary reasons: to compensate the intermediary for

execution, and to compensate brokerage firms for providing both internally-generated and independent externally-generated investment research services.

III.V. OBJECTIVES

A. Soft Dollar

Soft dollars are a commission rebate where a broker pays an agreed-upon amount of ~~OPERS' the investment manager's~~ research expenses out of commissions ~~OPERS has~~ already paid, ~~or promises to pay,~~ the respective broker. ~~OPERS-The investment manager~~ then receives third-party research-related goods or services from the broker. ~~This same type of arrangement is typically employed by OPERS' external managers.~~

OPERS' approach is to pay the minimum commission necessary to achieve favorable order execution, considering all explicit and implicit trading costs. OPERS believes that soft-dollar payment practices are generally an inefficient means to defray investment expenses, and generally give rise to higher overall program costs. Under typical soft-dollar payment arrangements, commissions tend to be higher than required for favorable execution, since part of the commission payment to the broker is used to pay the investment expenses of the investor.

~~OPERS' internal management will refrain from using soft dollar payment arrangements except for services that have not been traditionally available through "invoiced" hard-dollar payment. Examples of this include access to "Wall Street" research and analysts. In addition,~~ OPERS acknowledges its external managers may have entered into soft dollar arrangements with brokers that may benefit all of their clients as a whole. As a result, OPERS will permit its external managers to utilize soft dollar arrangements as long as each respective manager seeks to obtain ~~the best available price and most favorable~~ execution on its securities transactions and fully complies with guidance provided by the CFA Institute Soft Dollar Standards or other appropriate regulatory agencies.

B. Commission Recapture

Commission recapture or client-directed brokerage arrangements generally refer to an arrangement involving the redistribution of brokerage commissions back to OPERS. OPERS can receive benefits in addition to execution services from such an arrangement. Typically, these benefits result in the receipt of a rebate on a pre-determined percentage of recaptured commissions that increase portfolio market values and enhance total returns.

OPERS requires all of its external public market investment managers, ~~both internal and external,~~ to use best efforts to execute portfolio transactions at prices, and commissions, which provide the most favorable total cost reasonably obtained under the circumstances. However, to the extent OPERS' staff determines through trade execution analysis that commissions generated are greater than execution services

rendered, and commission dollars are available for rebate, OPERS will seek to recapture excess commissions.

IV.VI. ROLES AND RESPONSIBILITIES

The delineation of roles and responsibilities are important for the efficient and effective management of OPERS and the investment assets. The duties and responsibilities of the Board, Investment Committee, and Investment Staff, in relation to soft dollar and commission recapture are as stated below.

A. Board of Trustees

The Board of Trustees has the responsibility for approving the Soft Dollar and Commission Recapture Policy, including the Policy and Guideline statement for the publicly traded asset classes developed by Staff.

The Board, with consultation from the Investment Committee, shall review the Soft Dollar and Commission Recapture Policy, including asset class objectives and guidelines periodically to determine if modifications are necessary.

B. Investment Committee

The Investment Committee shall monitor compliance with the Soft Dollar and Commission Recapture Policy as set forth in this document. It evaluates proposals for modifications as needed and makes recommendations for consideration by the Board. The Investment Committee reviews policies on an annual basis

C. Investment Staff

All commission recapture programs must be approved in writing by the OPERS' Director-Investments. Staff is responsible for establishing appropriate procedural documentation. OPERS' investment staff:

- Abides by approved policies.
- Develops and maintains specific procedures.
- Recommends changes to policy, with supporting justification.
- Provides periodic and special reporting to the Investment Committee.
- Develops and maintains procedures, approved by the Director-Investments, to support the Policy.

D. External Public Market Investment Managers

Investment managers are fiduciaries and should conduct all their trading activity in the best interest of OPERS and its members, abide by all OPERS Policies and Procedures, and fully comply with the CFA Institute Soft Dollar Standards or other appropriate regulatory agencies.

V.VII. MONITORING AND REPORTING

OPERS will only allow its external public market investment managers to utilize Soft Dollar Arrangements and will make the following documentation available to the Investment Committee upon request. ~~As a result,~~ OPERS will require its external managers to provide:

- A copy of its soft dollar monitoring procedures.
- An annual report documenting the nature, benefit and source of its soft dollar services categorized by either “Research” or “Administrative” purpose.
- Where possible, an annual trade evaluation report, provided by a third-party vendor, analyzing the securities transactions with its brokers.
- Disclosure required to claim compliance with the CFA Institute Soft Dollar Standards or other appropriate regulatory agencies.

With respect to Commission Recapture programs, investment staff will monitor the quality of the trade execution results relative to the remuneration received in the form of rebated commissions. An annual evaluation will be performed and a report/recommendation will be presented to the OPERS’ Director-Investments, and the Investment Committee upon request.

VI.ASSET CLASS GUIDELINES

~~These guidelines refer to the publicly-traded asset classes within the OPERS’ Investment Division. They are Domestic Equity, Global Bonds, International Equity and the REIT portfolio in Real Estate.~~

- ~~—No internally-managed portfolio will be authorized to use soft-dollar arrangements.~~
- ~~—Soft-dollar arrangements may be utilized by the OPERS’ external managers, but they must provide the requisite documentation as outlined in section V.~~
- ~~—Commission recapture programs may be utilized by the respective asset classes, only after a trade execution analysis has been performed.~~
- ~~—All commission recapture programs must be authorized by the OPERS’ Director-Investments.~~