An Old Favorite Faces a New Paradigm: Reassessing the Broker Cash Management Model

THE AFTERMATH OF A CRISIS

The credit market crunch that started in August 2007 has had a widespread impact on the treasury community's liquidity management practices. Unlike in any previous market downturns, this credit market crisis started with a popular cash investment vehicle, asset-backed commercial paper, and continued with a system-wide shutdown of another, auction rate securities. Treasury managers are now retooling their cash investment practices to cope with a new back-to-basics paradigm. Such changes have included closer scrutiny of existing investments, re-evaluation of investment policies, increased concentration in money market funds and Treasury securities, and curtailing investments in less liquid securities[1]. During this paradigm shift, there has likely been increased focus on the suitability of the broker cash management model. In efforts to strengthen their fiduciary control over cash investment practices, corporations that outsourced these functions to brokerage outfits may now be reassessing the advantages and potential drawbacks of this decision.

What, then, is the broker model? Has the model served the treasury community well? Did it perform well during the current crisis? If not, can it be repaired? What does the future hold? These are some of the questions that first come to mind. Although the "fee vs. no-fee" debate has been ever-present among outsourced investment options, the credit crisis and the new paradigm shift may help practitioners refocus their attention on the risk control aspect of these relationships. In shedding light on this subject, we hope that treasury executives and audit committees can come to their own conclusions on the validity of the model. Also, in the interest of full disclosure, the author of this article is employed by a registered investment advisor which competes with the brokerage community for cash investment businesses.

THE BROKER MODEL – A CROSSOVER

In a typical treasury organization, there are generally a handful of options for investing excess cash: a) money market funds, b) direct purchases of Treasury bills, commercial paper, or bank certificates of deposit, and c) outsourced solutions. The broker model most often attempts to combine the latter two options.

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In a typical direct purchase relationship, a treasury organization has a dedicated investment staff making purchases from a number of brokerage firms through brokers who facilitate trade execution and make certain trade recommendations. The internal treasury staff monitors liquidity needs, makes investment decisions, initiates trades, and ensures compliance. In an outsourced solution with an advisor, the investor hires one or more outside managers to oversee the cash account on its behalf. With a set of investment guidelines, the advisors make "discretionary" investment decisions without the investor's daily intervention. It is also common for an investor to have both direct purchase and outsourced relationships.

Since the late 1980s, several Wall Street firms have seen the opportunity to use their vast brokerage distribution channels to provide liquidity management services to corporations. Instead of passively taking purchase orders from corporate investors, the firms offered to manage their cash assets and take over the daily investment functions for the treasury staff. For accounts that typically buy cash equivalent securities that are low-risk, short-term, and held-to-maturity, brokers often do not charge account level fees for the service, and instead may earn their fees implicitly through the bid-ask spreads from the firms' own trading books.

For treasury organizations, the broker model means an outsourced investment function without an outsourced fee. It also allows for a reduced treasury staff and less demand on investment expertise, with the broker making the daily investment decisions. In many instances, investors stopped dealing with multiple brokers and instead picked a principal broker to take care of the liquidity function for the organization.

From the brokerage firms' perspective, the low-margin cash management business generally was able to strengthen business relationships with their corporate clients and secure a new funding channel for the firms' investment banking and trading activities. It also transformed a former distribution network primarily made up of equity securities for individual investors to also include bonds and cash instruments more appropriate for corporations. Other Wall Street firms recognized the model's benefits and soon built out their own networks of cash management specialists.

BROKER VS. ADVISOR MODELS

Although a brokerage relationship is externally managed, there are a few key differences in how it functions from that of an advisory relationship.

What's In a Name: The distinction of a "broker" from a "registered investment advisor" is more than mere semantics. According to the Investment Advisors Act of 1940, the title "broker" is "any person engaged in the business of effecting transactions in securities for the account of others[2]." An advisor, however, refers to a person or a firm who has registered with the Securities and Exchange Commission in connection with the management of the investments of others[3]. While the name "registered investment advisor" signifies a specific legal designation, brokers do not have regulatory restrictions on what they must call themselves. For example, contemporary terms for brokers include "financial advisor," "financial consultant," "private wealth manager," and so on.

Buy or Sell Side: In investment parlance, the parties that represent a brokerage firm in selling securities to investors are called the "sell side." The parties that represent the ultimate investors are the "buy side." Brokers, along with Wall Street research, trading, and investment banking personnel are on the sell side; while investment advisors, along with mutual funds, pension funds, and hedge funds are on the buy side.

In a full service financial firm, the distinctions between the buy and sell sides may be blurred as the firm may own both investment banking and asset management divisions. Investor protection laws impose a "Chinese Wall" between the units to safeguard against insider trading. Even so, confusion arises when both the buy and sell sides of the same large firms offer cash management services. As a hypothetical example, a large firm can have XYZ Financial Services offering commission-based brokerage service while XYZ Asset Management (part of the same firm) would offer fee-based advisory services.

Different Regulations: According to the Investment Advisers Act of 1940, an advisor must satisfy an annual registration requirement with the Securities and Exchange Commission and prepare a Form ADV disclosing the scope of its services and potential conflicts of interest. Brokers come under the regulation of the Securities and Exchange Act of 1934, and are supervised by the Financial Industry Regulatory Authority (FINRA), formerly known as NASD. The Advisors Act sets forth the fiduciary standard requiring advisors to keep their

clients' best interests ahead of their own. FINRA regulation requires brokers to find "suitable" investments for their investors[4].

Compensation: A brokerage account is often considered to be a "no-fee" account. For bonds underwritten in-house, brokerage representatives get paid from the firm's investment banking or remarketing desks. For off-market bonds, compensation comes from the firm's sales and trading desks based on the bid-and-ask spreads associated with securities off of its trading books. The specific compensation amount is typically not disclosed to investors or stated on account statements. An advisor, on the other hand, is usually paid on a percentage of assets under management, regardless of trading activities and investment returns. In certain cases, the SEC had allowed brokerage firms to charge fees if the investment advice was "solely incidental" to the brokerage services. This rule, the so-called Merrill Lynch Rule, was adopted by the SEC in April 2005, but was overturned by an U.S. circuit court in March 2007[5].

A POPULAR CHOICE WITH SMALL TREASURY ORGANIZATIONS

Since its genesis, the broker model has enjoyed popularity among companies with a moderate treasury staff and short operating history, such as information technology and life science start-ups. The brokerage model may have attracted these corporations for the following reasons:

Staffing: Whereas a large corporation typically employs a large treasury staff including investment specialists, a smaller company may have fewer employees in treasury functions. It is not uncommon for some smaller firms to go without a full-time CFO, let alone a dedicated treasurer or cash manager.

Cost: For firms with large and relatively stable cash balances, such as Microsoft, Cisco, and Ebay, fee-based advisory relationships may benefit from significant economies of scale and may not greatly increase their treasury operating budget. Smaller firms, however, may consider advisor fees, irrespective of the overall investment returns, to be a luxury item.

Relationship: In many mature organizations, the decision to outsource treasury functions involves a formal process that may include, among other things, rounds of proposals, in-depth needs assessments, and analysis. For a younger company, where executives are sometimes forced to wear many hats, the search for an outside manager can be more informal. The personal experience and

satisfaction of a key executive or board member in an existing investment banking or brokerage relationship may play a role in the decision process as well.

"Cash is Cash": Another popular argument for this model is that since the assets for the liquidity accounts are ultra short-term investment grade paper, they are "cash equivalent" with minimal risk, and therefore do not require the watchful eyes of an active manager. If cash is cash, then a no-fee broker relationship would suffice, or so the thinking goes. This logic may also lead some to skip the step of drafting formal investment policies that spell out detailed eligibility and concentration limits.

A MODEL UNDER THE MICROSCOPE

The broker model has existed for much of the last two decades and survived the 2000 credit downturn, despite occasional and anecdotal allegations of unscrupulous practices. Some would argue that advisors could have made the same errors of incompetence. There have always been advocates among treasury managers on both sides of the broker vs. advisor debate.

The breakdown of the broker-sold auction rate securities (ARS) market in 2008 was a watershed event for many. Critics of the broker model allege that some brokers' self interests drove their clients' entire asset base to the brokerage firms' proprietary investments. Sharp criticism aside, sensible investors should ponder neither the competency or integrity of an individual broker representative, nor the survival instinct of a Wall Street firm, but the root cause that contributed to an illiquid treasury portfolio in the first place.

Some argue that the broker model is fundamentally flawed since treasury managers delegated their fiduciary responsibility of safeguarding their cash assets to outside parties against which they have limited legal recourse. Their low-risk assumption on cash investments may also be a factor. As treasury practitioners and audit committees refocus their attention, some of the deficiencies of the broker model may begin to surface.

Level of Care: Regardless of the knowledge, experience, and professional integrity of an individual broker-manager, brokers are generally held to a "suitability" standard, not to the fiduciary standard required of investment advisors. Some advisors allege that brokerage firms fought hard to avoid having their representatives registered as advisors so that they could avoid the litigation

risk implicit to fiduciaries[6]. In securities law litigation, brokerage firms routinely refer to the "suitability" defense in describing the role of a broker as one who provides information and takes trading orders from an investor, not as one who makes decisions for the investors.

Best Execution: Because of their compensation structure, brokers could be incentivized to fill clients' accounts with bonds from their firms' own trading books. Furthermore, it may not be in the best interests of brokerage firms to buy bonds from competing brokerage desks - a practice that is a requirement for investment advisors. This may also be the reason that auction rate securities were among the more popular investments in brokerage accounts because of the proprietary nature, attractive commission, and the low maintenance characteristics of auction resets. In the end, the best execution principal is more difficult to articulate in transactions that involve just one market maker.

Communication: Another unique feature about the broker model is that the broker-manager is typically part of the firm's wealth management division in a decentralized network of brokers placed throughout the country. This is why corporate investors may sometimes be puzzled by their account designation as "retail," "middle market," or "private wealth management" accounts. This structure means that the investors may be several steps removed from the firm's institutional sales and trading desks. It also may present resource and communication challenges in terms of market color and speed of trade execution. Institutional advisors, on the other hand, are often plugged into the institutional desks of Wall Street firms through direct lines and a dedicated sales force.

CASH MANAGEMENT IN THE NEW PARADIGM

Since the elimination of the fixed commission structure in 1975, the full-service brokerage industry has seen its personal wealth management turf invaded by discount brokers, online trading portals, and financial planners. Liquidity management allowed it to gain a beachhead to the treasury management community. From a treasurer's point of view, however, the passage of the Sarbanes-Oxley Act, a heightened investor scrutiny of corporate board governance, ever more zealous independent auditors and recent credit market developments may have made the broker model more difficult to maintain. For accounts with existing broker relationships, we suggest a redoubled focus in the following areas:

Credit Risk Management: Unlike an advisor that typically has a list of approved names regardless of dealer inventory, a broker may pick among limited choices from the firm's inventory. The establishment of a robust pre-trade compliance process independent of ratings, such as fundamental credit analysis and committee approvals, may reduce the chance of deteriorating credits being purchased into an account in a worsening credit environment.

The Crucial Function: A simple "cash is cash" mentality at some organizations often resulted in cash investment decisions being considered an ancillary function. Given that philosophy, signing on to the broker model could then easily have become a "no-brainer" that was simply an add-on to investment banking relationships. As recent events remind us, some of these so-called "high-quality," "safe" and "liquid" securities may have posed significant enterprise risk to the larger organization. Now is the time for cash management to receive more senior executives' attention.

Securities Custody: A broker account generally has its assets registered in the name of the brokerage firm, and the assets become part of the broker's balance sheet. This is also true with direct purchase programs when an investor keeps its assets with its multiple brokers. For some, the insolvency of a major broker-dealer used to be unthinkable, but the collapse of Bear Stearns highlighted the virtues of having securities held in custody accounts in the investors' own names. Custody assets do not enter into a custodian bank's balance sheet, and are not treated as part of the bank's own property in liquidation proceedings in the case of the bank's failure[7].

In today's paradigm of ultra-conservatism, both in risk controls and investment strategies, more treasury organizations are reconsidering an outsourced solution. Given this impending shift, we believe it is time for treasurers to return to the fundamentals and refocus their attention on finding the best solution for their treasury function.

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[1] Treasury Strategies survey, February 2008.

[2] http://www.sec.gov/rules/extra/ia1940.htm#find

[3] http://en.wikipedia.org/wiki/Registered_Investment_Advisor

[4] The Wall Street Journal, What's in a Name?, July 5, 2006, compiled by Shefali Anand.

[5] http://seclaw.blogspot.com/2007/04/merrill-lynch-rule-stricken.html

[6]http://registeredrep.com/branchofficemanager/End_of_Merrill_Rule_Leaves_BOMs_in_Muddle/
[7] Diana Chan, Florence Fontan, Simonetta Rosati and Daniela Russo, The Securities Custody Industry (Occasional Paper Series, No 68/August 2007), European Central Bank.

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