GREENWICH ASSOCIATES

Frost Consulting

Commission Sharing Arrangements

The Changing Face of Research Procurement

Q4 2012

Asset managers today face a much more dynamic environment whereby they can pay for high quality research for their clients without being obliged to simultaneously combine it with trade execution. This "unbundling" of commissions has been made mandatory in some G20 regulatory regimes while in some places the standards are still loose.

This paper maps out:

- **The extent to which the exercise of separating and redistributing execution and non-execution commission components has grown in various jurisdictions.**
- **How commission sharing arrangements (CSA) growth is driven by both alpha generation and regulatory compliance.**
- **The implications of unbundling on the structure of institutional equity markets.**

Decomposing Commissions

Most equity commissions are divided into two components — the "execution" portion, which pay for the stock transaction itself, and the "non-execution" portion, which compensates the executing broker for non-execution services, primarily research.

In most developed markets there's enough oversight over execution commissions as pension funds and mutual funds — clients of asset management firms — demand best execution. This also builds into third party transaction cost analysis (TCA). By contrast, the much larger non-execution commission market has been historically subject to little scrutiny. But that's now changing.

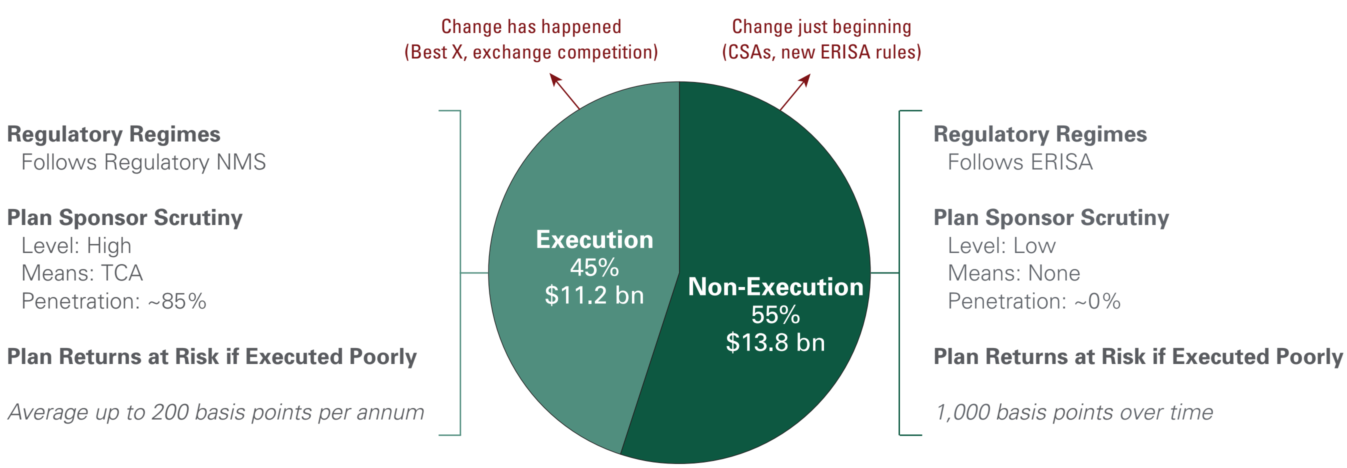
When commissions are bundled the execution and non-execution portions of the commission are inseparable and are captured by the executing broker. When unbundled, the commission not related to trade execution is put in a commission sharing account held by the broker on the asset manager's behalf. The asset manager can retroactively pay a wide variety of third party research providers from this account. An important fallout from this has been the end of the oligopoly of investment banks asset manager research expenditure, estimated by Greenwich Associates to be about $25 billion per annum.

Lessons from the British Model

The origins of the modern commission sharing arrangement concept emerged in the United Kingdom from the government-sponsored Myners Review of Institutional Investment in 2001. Paul Myners, the author and former chairman of U.K. institutional asset manager Gartmore, argued that asset managers should change the way they treat client commissions for the purchase of research and

Institutional Equity Commissions

Global Total 2011e — U.S. $25 Billion*



The regulatory and plan sponsor scrutiny "gap" between the execution and non-execution services commission markets is beginning to close.

Notes: *Estimates — Frost Consulting

Differences Between CSAs and Soft Dollar Arrangements

	Soft Dollar	CSA
Payment Types/Receipts	Specific invoices pre-agreed between broker and asset manager. Typically for market data or non-brokerage research.	Asset manager can pay any research provider or data vendor as per local regulations at any time. Frequently used to pay for brokerage research (rather than via execution with that broker). The CSA execution broker is often paid for the research it produces from this account.
Mechanism	Pre-agreed ratio of additional commission in addition to invoice amount.	Non-execution commission from CSA trades accumulate in CSA account at pre-agreed commission rates. Paid out as per asset manager's instructions.
Agreement	Separate soft dollar contract between the broker and asset manager for each payment recipient. Must be a specific invoiced amount.	Open-ended CSA agreement between the parties to cover all payments. No pre-agreements or invoices required. Asset manager has complete payment flexibility.

execution services. Rather than charge commissions directly back to the client by deducting them from returns, the report suggested including commissions as part of asset management fees.

This proposal, adopted in 2005, had significant implications for the economics of U.K. fund managers given that total annual commission expense could potentially exceed the asset management fee itself, depending upon the portfolio turnover of the fund and the level of annual commission was very difficult to predict in advance.

U.K. asset managers feared clients would not accept this magnitude of price increase. They viewed this proposal as a risk to their operating model and commercial viability.

The compromise solution was that the U.K. asset managers were allowed by the FSA to continue to use commissions to purchase both execution and research services and charge this back to the client, but mandated that research and execution commissions must be split. The execution fee would remain with the executing broker, while the non-execution fee would be placed in a CSA — an account from which the asset manager could pay any type of research producer, not just brokers.

CSAs vs. Soft Dollars

The commission sharing arrangements put in place in the United Kingdom in 2005 differed significantly from the "soft-dollar" arrangement used in the United States at the time. Rather than paying specific pre-agreed bills, the CSA structure allowed the asset manager to retroactively distribute CSA commissions to a wide variety of service providers. Current market practice is that asset managers normally instruct investment banks holding their CSA balances to pay third party research providers from these accounts every quarter.

What can be eligible as CSA services is fairly straightforward. In the United Kingdom, the Financial Services Authority (FSA) says it is any research and sets of raw data that provide analytical value.

The U.S. Model: Client Commission Arrangement

In July 2006 the Securities & Exchange Commission published "Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934." This established the Client Commission Arrangement, (CCA) which is very similar to the CSA as it allows for the creation of commission pools to be retroactively distributed to third party research providers.

What initially hindered the adoption of CCAs in the United States was the refusal by several large banks to accept CCA payments for their research. They argued that in doing so, they would have to register as investment advisors under the Investment Advisor Act of 1940. BNY ConvergEx sought clarification on this issue from the SEC. In September 2010, the SEC issued a "No Action" letter which ruled that banks did not have to register as investment advisors under the 1940 Act if they accepted CCA payments for their research.

This coincided with new reporting requirements for U.S. pension funds regulated by the Department of Labor's Employee Retirement Income Safety Act of 1974 (ERISA). U.S. pension funds were required to name each party to which they had paid $5,000 or more, including any equity brokerage commissions paid on the funds' behalf by their underlying asset managers. If commissions were spent on the purchase of research, the pension fund, with the asset manager's help, would have to provide a valuation framework to show that the price paid for the research was "reasonable."

This called for a close scrutiny of an asset manager's annual equity research spending, which according to a Greenwich Associates study, now stands at $25 billion globally. Although ERISA is a U.S. statute, the effect is global. Regardless of the asset manager's geographic domicile, if the manager has ERISA clients, it will be asked to furnish this information.

CSAs are poised to play a central role in helping asset managers, and by extension their pension fund clients, meet this new ERISA reporting requirement. CSAs should theoretically allow asset managers to make more precise payments for research than bundled execution arrangements.

Global CSA Penetration

There are wide variations in CSA penetration globally among European countries which are all MiFID. Under MiFID (unlike the United Kingdom under the FSA), commission unbundling is not mandatory. Some European jurisdictions have looked to the United Kingdom's FSA principles for guidance. In other markets some regulators and market participants were hesitant to adopt CSAs in the absence of a central CSA clearing mechanism. Most asset manager-broker CSA relationships are managed on a one-to-one basis.

These factors notwithstanding, CSAs are growing everywhere as asset managers, asset owners and regulators increasingly appreciate the resulting efficiency and transparency.

CSA penetration is highest in Europe primarily because the United Kingdom became the first country to mandate the arrangement in 2003. Greenwich Associates research has been measuring CSA penetration in Europe since 2006 — usage has nearly doubled during that period from 21% to 48% of institutions.

While a minority of countries (United Kingdom, France, Sweden, and the United States) have either mandated, endorsed or specifically allowed CSAs, in most cases, national or regional regulators have not offered an opinion. So far large, global asset managers have been driving CSA adoption. These managers tend to have trading desks located in jurisdictions where CSAs are commonplace (United States/United Kingdom). As these global managers compete for institutional and retail business in countries where CSAs are not commonplace, they can use the competitive benefits of using unbundled structures. This in turn puts pressure on the local managers to unbundle.

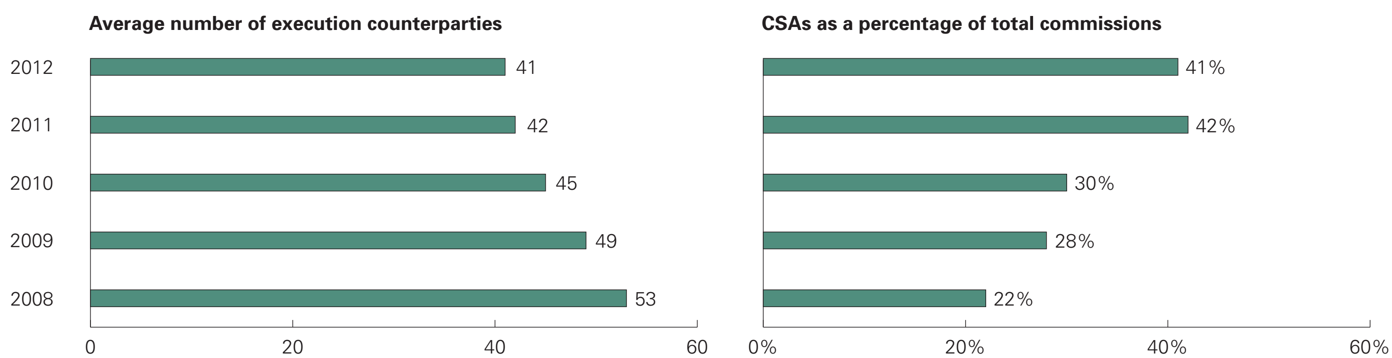
In some jurisdictions, local taxes may unintentionally complicate the CSA process as in Italy and Spain. In these markets local authorities, unlike their counterparts in the United Kingdom and the United States, continue to charge value-added taxes (sales tax) on commissions.

In Asia, the web of national regulation is complex. In Japan, the authorities have taken a cautious approach to CSAs, concerned over the potential impact on smaller brokers. Lack of regulatory guidance is making local asset managers reluctant to unbundle in Korea, Taiwan, Singapore, and India. By contrast, Hong Kong has had a long history with the soft dollar market and hence has the highest CSA penetration rates in Asia.

To be sure, regardless of local regulation, there is nothing to prevent a U.S. or U.K. institution from placing CSA orders in any jurisdiction. The orders can be executed in the local market by global investment banks as per usual — the unbundling affects the distribution of the commission, not the execution of the trade.

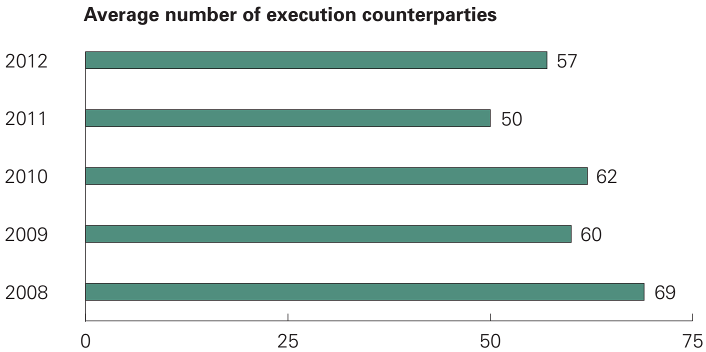
In Europe, by 2012 a little over 40% of total commissions were being allocated to CSAs, according to a Greenwich Associates study.

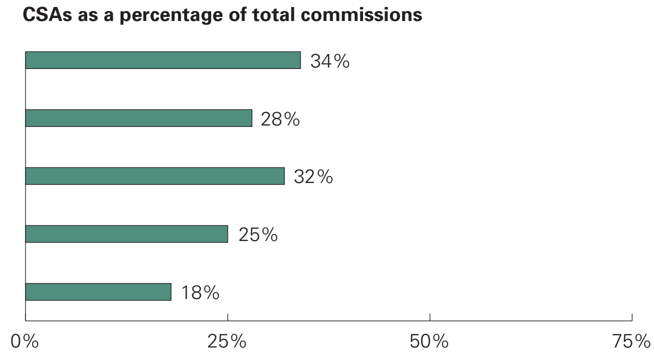
European Commissions



Source: Results based on Frost Consulting analysis of a segment of Greenwich Associates 2012 European Equity Investors Study

United States Commissions





Source: Results based on Frost Consulting analysis of a segment of Greenwich Associates 2012 North American Equity Investors Study

Exchange competition and best execution requirements have spawned an "arms race" for electronic trading tools especially to re-aggregate fragmented execution liquidity. These issues have drawn more attention in the light of the May 2010 "flash crash." The growth of the CSA market has received less attention, but it has grown more quickly than various "low-touch" execution categories in Europe.

Meanwhile, in the United States unbundling is not mandatory. The structure was not sanctioned until 2006 by the SEC and a number of factors described previously slowed its early growth. However, by 2012 more than 82% of the U.S. asset managers surveyed by Greenwich Associates were using CSAs.

The average number of cash execution counterparties has declined by 17% in the last five years. Average execution counterparty per asset manager has remained consistently higher in the United States than in Europe. This may surprise some given the fragmented nature of the various European markets versus those of the United States. A partial reason for this discrepancy is the higher number of quantitative funds in the United States.

Although to a lesser degree than in Europe, CCA growth rates in the United States have exceeded those of electronic execution since 2008.

Implications of Unbundling

- Asset managers can now access top quality research from CSA pool.
- The number of research providers will rise.
- Execution counterparties will continue to shrink staff.

Asset Manager Research Procurement Process

Asset managers purchase a vast majority of their research using commissions because commissions are a plan/fund expense rather than an asset manager expense. The fact that commissions are deducted from client returns has profoundly influenced the structure of the institutional equity market. In the bundled environment, the only way in which asset managers could use client funds to buy research was to buy that research from firms with an equity execution capacity, i.e. brokers. Each research relationship had to be funded by a dedicated bilateral equity execution relationship between the asset manager and the broker producing the research.

The reality is that each trading relationship entails counterparty risk. Asset managers usually placed limits on the number and type of execution parties they were willing to engage with. This was frequently referred to as a broker "approved list." The one-to-one relationship between a research and execution provider meant that counterparty execution risk considerations often placed a limit on the number of research producers an asset manager was willing to pay, regardless of the merits of the research itself.

In an unbundled environment, the "approved list" concept is no longer relevant as the addition of research providers no longer has any bearing on the number of execution relationships.

Because most asset managers bought most of their research from brokers, they would often solicit the views of dozens of analyst and portfolio managers as to which brokers provided most value. This provided a guide to dividing the asset manager's available commissions among the investment banks that provided services.

Since qualified asset managers are "given" research in return for an unspecified amount of equity commission, delivered through the one-to-one execution relationship it has been hard to place a price on brokerage-produced research.

Commission unbundling has been a breakthrough of sorts for asset managers. They can now buy any kind of research from any producer in any quantity or frequency and still use their clients' funds to do it. This ranges from subscribing to various industry journals or data services to hiring specialist consultants to do proprietary work on behalf of the asset manager. But, research producers that are not investment banks have no equity execution capacity. By definition they have a specific price for their research products. One challenge for asset managers is how to adapt their research procurement methodology to accommodate both priced research and unpriced investment banking products — and further, how to equate the two.

Impact on Research and Execution Usage

Based on 2011 Greenwich Associates data, global asset managers used an average of 115 execution counterparties for cash equities and 103 brokerage firms for equity research. (Some firms are used for execution only).

The world's seven largest equity markets (United States, Japan, United Kingdom, Canada, France, Australia and Germany) represent roughly 75% of total global market capitalization. In most of these markets a handful of major brokers control a large portion of the execution market. The top 15 investment banks likely account for more than 70% of global execution volumes in several countries.

Given the high concentration the average of 115 cash equity execution counterparties seems counter-intuitively high. This is likely explained by the historic one-to-one relationship between research and execution. In an unbundled environment it seems likely that the number of research relationships (brokerage combined with non-brokerage) will rise, as research providers can now be added without any obligations to execute trades. Simultaneously, the number of execution counterparties is likely to fall.

Given the rapid growth of the CSA market, it is somewhat surprising that the number of execution counterparties has not fallen further, as it is clear that a growing numbers of brokers are at least partially compensated for their research via CSA payments. This is partly explained by the fact that asset managers may continue to execute some specific trades with brokers even as they switch the bulk of that broker's compensation to CSA payments.

A further challenge for asset managers is to develop a price framework around unpriced research produced by brokers that they are now compensating via CSA payment. This process may gradually create a price framework around all unpriced investment banking research products, irrespective of the mechanism through which they are purchased.

Implications for Sell-Side Cash Equities — Getting Past the Bilateral Spreadsheet Chaos

Research providers range from small private niche providers specializing in equities in certain geographies or sectors to global banks. For the latter group, total equities revenues typically represent between 10% and 30% of total revenue. Cash equities (including research but excluding derivatives and prime brokerage), usually comprise half of what they earn from equities.

As the number of equity execution counterparties used by asset managers decreases, small brokers with narrow geographic execution capability and no specific execution liquidity advantage are at increasing risk of being compensated for their research via CSA payments rather than via execution. This will force them to address their trading/sales capacity as the proportion of revenues via CSAs rises. Furthermore, as CSA payments are frequently at levels below the previous execution-based relationship, firms may need to reconsider their entire cost base against the new revenue environment.

Even the largest firms may be affected. The quicker the investment banking market share of the $25 billion per annum equity research pool decreases, the greater the pressure on capital allocated to the cash equities business segment. Asset managers in turn will look to diversify their sources of research as they face greater scrutiny from pension fund clients over research spending.

A continuing challenge for regulators and all market participants will be to develop a market infrastructure to effectively cope with the CSA segment's rapid growth. In 2012 global CSA commissions are estimated to reach $12 billion. There is no central mechanism for managing or matching these trades which poses fiduciary and regulatory risks for asset managers and asset owners as well as operational nightmares best described as bilateral spreadsheet chaos.

Undoubtedly, commission sharing between brokerages and specialist research providers is going to further evolve over time. Various jurisdictions will eventually agree on principles that would converge and shape into a broader system. Both buyside and sellside constituents will have their work cut out to optimize as much value as they can from this evolution.

This paper was jointly produced by Greenwich Associates and Frost Consulting, a London-based consultancy specializing in research procurement and unbundled commission optimization strategies. For further information, please email Kevin.Kozlowski@greenwich.com (www.greenwich.com) or Neil.Scarth@frostconsulting.co.uk (www.frostconsulting.co.uk).

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