



Frost
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Introduction to Global Commission Unbundling

Market Structure Change: Upending the Status Quo
Risks and Rewards

July 2012

How do the economics of the institutional equity market work?

Equity Commissions

The "Currency" of the Institutional Equity Business

Equity commissions are attached to every trade to pay for services.

Equity Trade

Asset Manager #1



Equity Order:
BUY 1 Million IBM

Broker



Exchange



IBM

IBM

Shares Purchased



Cash for Equity Trade

Asset Manager #1



Broker



Asset Manager #2



(Seller of Shares)



Equity Commissions

Broker



How big is this market?

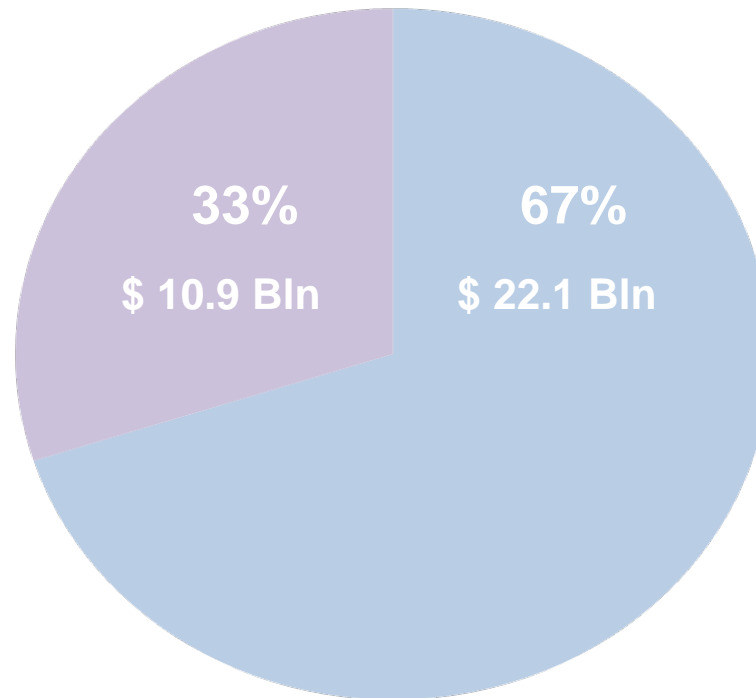
Institutional Secondary Equity Commissions

2011e: \$33 Billion

Most equity commissions are split into 2 components:

Execution

Pays for the physical cost of trading and clearing the transaction.



Non-Execution

Pays for all non-execution services including:
Investment Research

Key Point: Commissions belong to the asset manager's client – *not the asset manager*.
But, the *asset manager decides* where and how to spend them.

Key Points:

- Asset managers use commissions to buy goods and services, *because it's not their money*. It belongs to their asset owner clients. (Pension Funds/Mutual Funds)
- Consequently, the majority of research purchased by asset managers (~\$20 billion per annum) is bought via commissions.
- *In the bundled commission environment, the 2 commission components (execution and non-execution) are inseparable and are captured by the broker executing the equity trade.*
- *Therefore, the only way for asset managers to buy research (and related services) using their client's money, was to buy them from companies with an equity execution capability (investment banks/brokers).*
- *It was the act of equity execution which generated the commissions which could be used to buy goods and services.*
- This meant that investment banks/brokers had a very high market share of asset manager research spending.
- For the last 30 years most asset managers have bought research from fewer than 100 investment banks. Even though thousands of other types of research producers generate information that could aid asset manager investment decisions, these could only be purchased with the asset manager's own funds, rather than with their clients' money.

Regulatory Evolution



- 2003 – FSA (CP-176) Commission Unbundling
(Unbundling mandatory for UK asset managers)



- 2006 – SEC creates similar CCA structure.



- 2007 – MiFID indirectly supports CSAs via Best X Requirements



- 2010 – ERISA : Research Spending Reporting Requirement
(Dept. of Labor requires US pension funds and their underlying asset managers to justify research spending - CSAs will be central to this process.)

Commission Unbundling: Significant Implications for All Market Participants

- Regulatory changes (Commission Sharing Agreements: CSAs) now allow asset managers to unbundle or split their brokerage commissions between the execution and the non-execution components. The execution portion goes to the broker executing the trade. The non-execution portion goes into a separate account.
- The accumulated funds in the separate account can be used to buy research from any type of research producer (not just brokers), just like a regular bank checking/current account.
- The de-regulation of commissions means that the asset managers' content universe is now virtually limitless because they can use commissions to buy new sources of research without having to pay for it via an additional equity execution relationship. As a result, forward-looking asset managers are rapidly adding research sources and reducing the number of equity execution relationships.
- This ends the 35 year-old oligopoly of investment banks over asset manager research spending.
- Asset owners, asset managers and investment banks will have to adjust their strategies to maximize returns in this new regulatory environment.

CSAs: Asset Manager View

Exploding the Asset Manager Content Universe

Asset Manager



Typical Trade

Research Commission – 8 Bps

Execution Commission – 4 Bps

\$22 Billion Globally

\$11 Billion Globally

Client CSA Account
(Held by CSA Broker)

\$22 Billion Globally

CSA Execution Broker

\$11 Billion Globally

Historic Inputs

New Inputs

Inv. Banks/
Brokers

Management
Consultants

Sustainability
SRI/Research

Quants/
Databases

Industry
Publications

Independent
Research

Channel
Checkers

Scientific
Journals

Expert
Networks

Primary
Research

Academic
Journals

Implications

Historic ~100% market share going in one direction – down. This will prompt investment banks to cut research budgets further.

Rewards/Risks for Asset Managers:

- Opportunity to generate more alpha from widened content universe.
- Many will have to revamp research procurement process to take advantage.
- Asset managers that do not unbundle and widen research universe will be at a competitive disadvantage in an increasingly global marketplace.

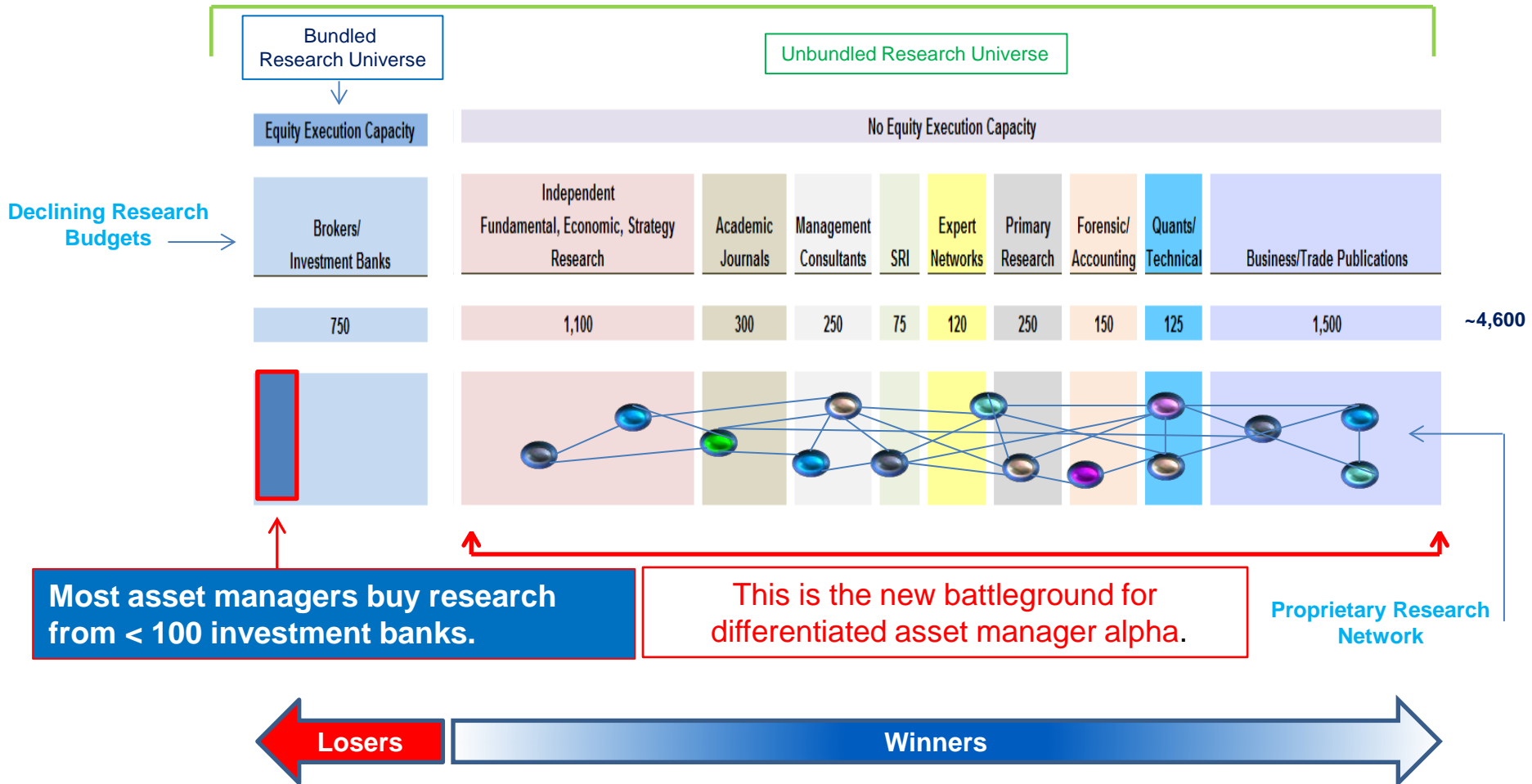
Plan Sponsors:

- Must develop new ways to measure the risk/reward of their managers research procurement processes.

Content Producers:

- Large opportunity to access \$20 billion in annual asset manager research spend.
- Challenge to circumvent asset manager content firewalls.

Asset Owner Challenge: Are Asset Managers Leveraging Market Structure Change?



Question for Pension Funds: Where are your asset managers on this spectrum?

Asset Management Overview

- 8,000 Institutional Equity managers.
- \$30 trillion in assets under management.
- \$200 billion in asset management fees per annum.
- >\$20 billion spent on the purchase of equity research per annum.

Investment Banking Research

- ~750 conventional equity brokerage firms.
- ~\$5 billion in “sell-side” research budgets per annum.
- 3,000 “publishing” analysts producing ~300,000 documents per annum.

Non Investment Banking Research

- Economic, industry, strategy consultants, expert networks, academics, industry journals.
- ~30,000 producers (English Language) producing ~2 million documents per annum.



Global CSAs:

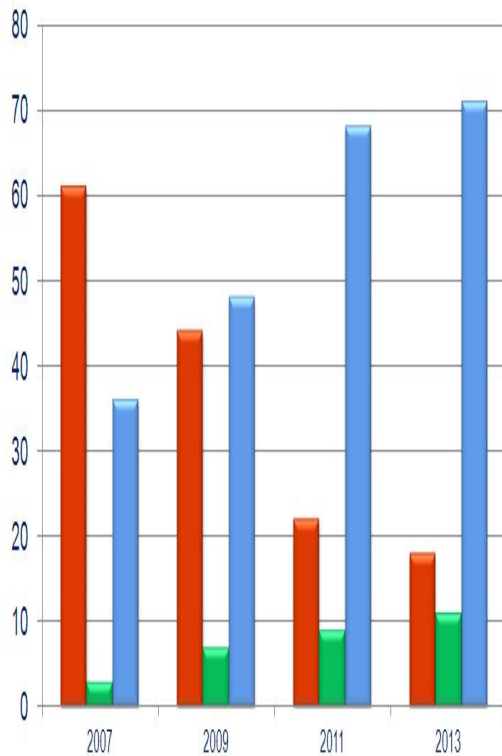
Penetration Rates
Operational Challenges
Increasing Regulatory Scrutiny

Unbundled Commissions: Regional Penetration

Percentage of Total Volume Traded

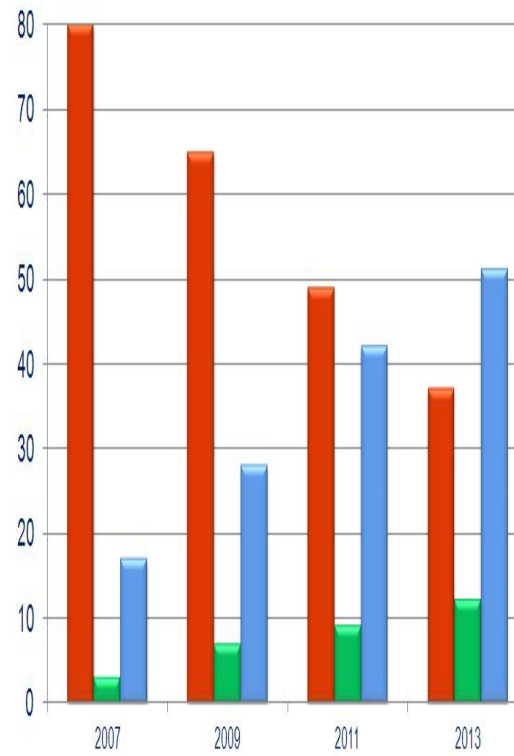
- High Touch
- Electronic
- CSA

UK



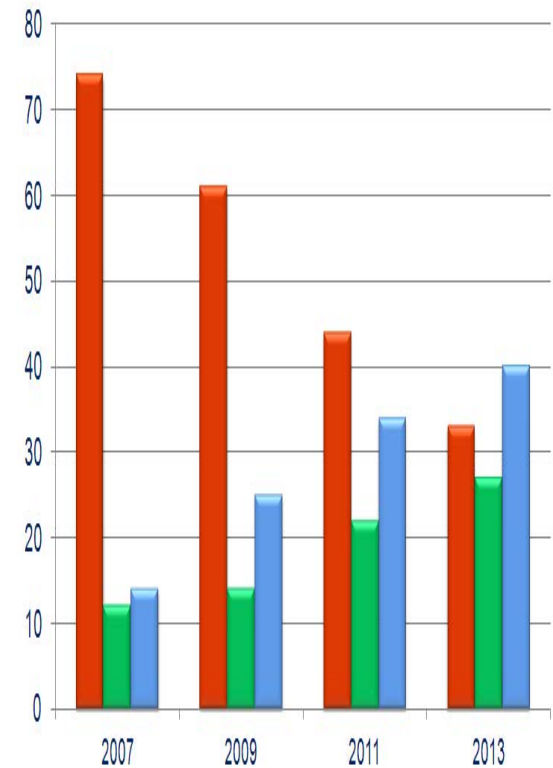
70%

Europe (Ex-UK)



50%

US



40%

CSAs are growing rapidly as asset owners, asset managers and regulators recognize their benefits.

ERISA – New Reporting Regulations

- From July 2010 all ERISA funds will have to report annually to the Department of Labor
 - A) All counter-parties paid more than \$5,000. This includes brokerage commissions paid by their underlying asset managers for research.
 - B) The fund, via the asset manager, will have to value the research purchased to ensure that the cost was “reasonable”.
- *This is a material change in the level of regulatory scrutiny applied to non-execution commissions. “**Failure to Monitor Plan Expenses**” is a frequent complaint in ERISA class-action lawsuits. Brokerage commissions are Plan Expenses.*

Most asset managers’ investment processes are not designed to deal with this new regulatory regime.

Ongoing ERISA Class Action Investigations (62)

Including:

Company	Number of Investigations
State Street	4
Merck	4
Citigroup	3
Merrill Lynch	2
ING	2
Wal-Mart	2
Bear Stearns	2
Northern Trust	1
Lehman Brothers	1
UBS	1
J.P. Morgan	1
MetLife	1
Fidelity	1

Source: Class Advocate

Enforcement

The most effective agent of compliance is *not* the Department of Labor. Class action lawyers get a portion of the ERISA class action settlement fee and are therefore far more motivated than regulators to pursue cases in which there is insufficient transparency in the institutional research commission allocation process. (\$20 billion per annum).

Commission unbundling offers both opportunity and risk to most market participants.

- **Plan Sponsors** – face performance risk/opportunity depending upon the effectiveness with which underlying asset managers address market structure change for research procurement.
 - face regulatory risks relating to ERISA reporting requirements.
- **Asset Managers** – face performance (and commercial viability) risks depending upon the effectiveness with which they address market structure change for research procurement.
 - face client and regulatory risks relating to the more complex CSA payment environment.
- **Investment Banks** – face challenges adjusting their cost bases to a reduced revenue streams as they lose market share in asset manager research spending.
 - risk being disintermediated (paid via CSA from other banks rather than via execution). If they fail to offer competitive CSA execution products they risk irrelevance in the execution market.

Additional information/analysis at:

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