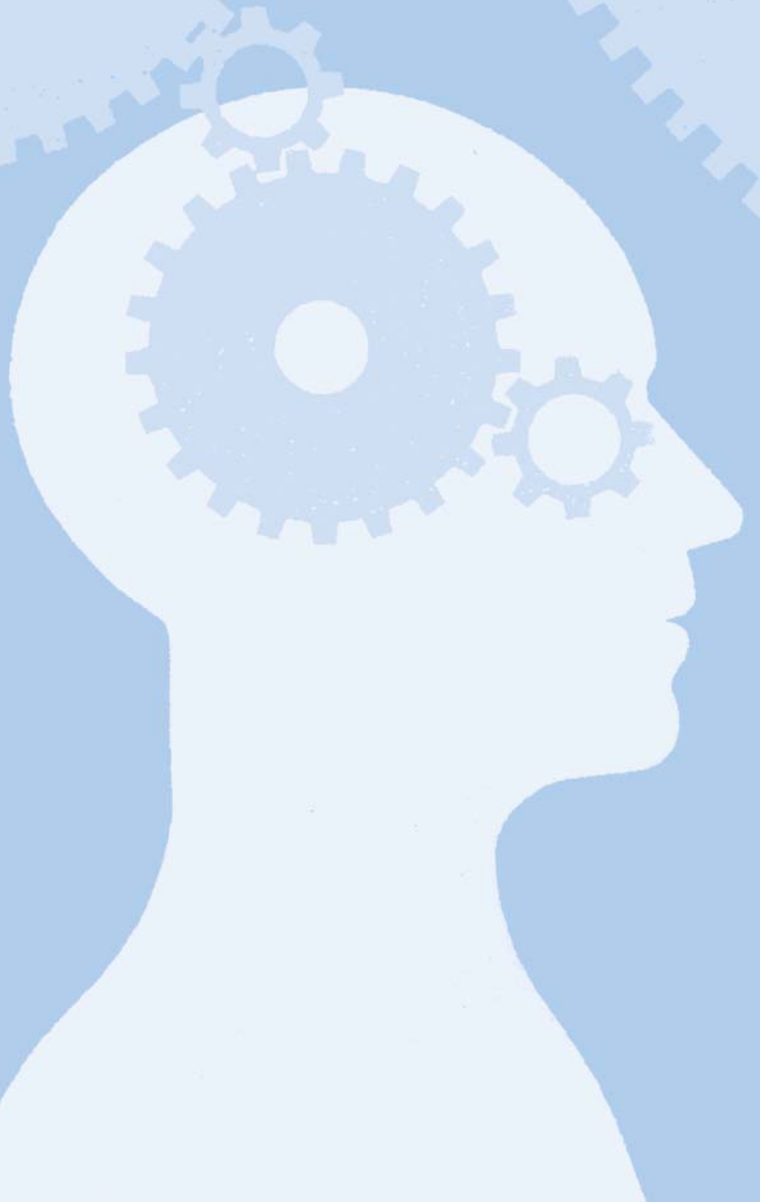
Oxera

The impact of the new regime for use of dealing commission: post-implementation review

Prepared for The Financial Services Authority

April 2009



Executive summary

Background
The Financial Services Authority (FSA) commissioned Oxera to conduct research in support of this post-implementation review. The first part of study, conducted in 2006, established a set of performance measures and measured the baseline. This is the second part of the study.

The changes in the regime for use of dealing commission refer to the rules in COBS 11.6 of the FSA Handbook and the industry codes, and had the following main elements:

– investment managers' use of dealing commission was limited to the purchase of 'execution' and 'research';

– investment managers would give their clients better information about the respective costs of the above, and the overall expenditure on these services;

– investment managers were encouraged to seek, and brokers to provide, clear payment mechanisms that enable individual services to be purchased separately.

To assess the impact of the change in the regime, in a study in 2006 a number of performance indicators were developed that could be measured using surveys among a sample group of investment managers, brokers and pension funds. A second survey in 2008 then evaluated the outcome against the 2006 baseline using these performance indicators.

The report found that the market had responded to the new regime by making more widespread use of Commission Sharing Agreements (CSAs). This put in place a framework that would enable the delivery of the envisaged changes and benefits.

Conclusions
Overall, the performance indicators broadly indicated that the expected changes were occurring, although there were some areas where the findings were ambiguous. Commission rates were expected to fall and the performance indicators suggest that they have fallen. Similarly, as expected, there have been reductions in the expenditure on goods and services purchased with commission, although the outcomes here are more uneven. These and the findings on the other performance indicators are consistent with the theory that the new regime has limited the use of dealing commission and permitted greater separation in the purchase of execution and research, and therefore has delivered benefits.

At the time of implementation, some adverse effects were considered possible. In particular, there was a risk of increased concentration in the brokerage market, which could have negative impacts on smaller brokerage firms. The performance indicators did not provide evidence of significant changes in market structure. There was concern that the new regime may lead to higher trading costs for small trading volumes, but this has not been observed. There was also a risk that the new regime may lead to lower liquidity. While this may have occurred in some areas, it may not be linked to the new regime. In summary, any detrimental effects of the new regime that may have occurred do not appear to have been significant.

With regard to the second part of the new regime—disclosure—the findings were different. While the disclosures have been provided, there is limited evidence that they are being used. It would therefore be hard to attribute the benefits identified above to the disclosure aspect of the new regime. If the use of disclosures were to increase, however, this might deliver further benefits.

On the retail side, the evidence broadly indicated that retail funds were treated in the same way as wholesale funds by investment managers that manage both types of fund. Therefore, the benefits outlined above are potentially also being delivered to retail consumers that use the funds of these types of investment manager.

The key findings are summarised below and in the table at the end of this section.

Use of Commission Sharing Arrangements

Following the introduction of the new regime, it was expected that CSAs would be the principal means through which non-execution goods and services would be purchased. Although the use of CSAs was not an official performance indicator, data on their use provides insight into how the industry has responded to the new regime.

The survey showed an increase in the number of investment managers with CSAs and in the average number of third-party research providers paid by investment managers via CSAs. The proportion of investment managers with CSAs increased to over 70% compared with 50% in 2005. The average number of third-party providers used by an investment manager with a CSA rose from just under 20 in 2005 to over 40 in 2007.

In addition, there were increases in both total CSA expenditure and the proportion going to third-party providers, which grew from 36% to 66% of total CSA expenditure between 2006 and 2007.

Expenditure on non-execution goods and services

The new rules stipulate that only research and execution-related goods and services can now be purchased with commissions. These limitations were expected to lead to a reduction in the total amount spent on non-execution goods and services through commissions.

The survey found that such expenditure out of commissions was now overwhelmingly for research rather than for execution-related services. This may be because research is a broad category and survey respondents found it easier to classify their expenditure in this way now, rather than representing a very significant change in the goods and services actually purchased from commissions.

There is no evidence that the ratio of spending on non-execution goods and services through commissions to funds under management (or to the value of trading) has increased significantly across the whole market. The ratio increased for some investment managers and decreased for others. This means that the outcome for this performance indicator is equivocal.

However, hard cash expenditure on disallowed goods and services increased in the 2008 survey compared with that in 2006. This may be because of greater demand due to regulatory, technological and economic factors, as well as reflecting the displacement of expenditure from commissions to hard cash.

Commission rates and trading patterns

The unbundling of execution and research was also expected to result in greater transparency of research pricing, leading to more competition between brokerage firms and to downward pressure on the element of commission rates used for the purchase of non-execution goods and services.

The survey found that the commission rates charged by brokerage firms have indeed fallen since the new regime was introduced, for both core/bundled brokerage and execution-only trading. However, there has been a longer-term trend towards lower commissions which preceded the introduction of the new rules. In addition, there is evidence that investment managers are directing an increasing proportion of their transactions to transaction methods that incur lower trading commission rates.

Impact on the structure of the market for research services

The new regime enabled investment managers to separate their choice of execution venue from their choice of where to purchase research. One outcome could have been investment managers choosing to use fewer brokerage firms for execution since they had to use those offering the best service. If this resulted in all investment managers selecting the same brokers for the trade execution, the concentration of the brokerage market might have increased. On the other hand, this separation could enable investment managers to purchase execution from the most appropriate source without having to be concerned about the impact on their access to research provided by brokers, thereby potentially reducing broker market concentration.

The survey found that the weighted average of trades going to the top 20 brokers had not changed significantly. Survey participants indicated that changes have arisen in market structure for a variety of reasons not directly linked to the new rules—eg, the introduction of the Markets in Financial Instruments Directive (MiFID).

Notwithstanding the separation of research from execution, the 2008 survey found that there was still, on average, a considerable overlap between investment managers' top 10 suppliers of execution and the top 10 suppliers of research (simple average of 75%), although some investment managers had quite low overlaps (minimum 30%). While there is no direct equivalent of this information for earlier years, the combination in the past of low expenditure on research through hard cash and low proportion of commissions available through soft commission arrangements to pay for (usually non-brokerage) research suggests that the overlap would have been greater than this in the past.

Trends in market liquidity and research quality/coverage

At the time of the introduction of the new rules, there was some concern that the quality of trade execution would be adversely affected, while competition for research would be facilitated.

The 2008 survey found that a significant proportion of respondents indicated that liquidity was unchanged over the period, although some believed it had worsened. The most common explanations given for the worsening of liquidity were the credit crunch and/or increased use of electronic trading/dark pools of liquidity, but there was no evidence that the new regime was a contributory factor. Overall, respondents felt that research quality, coverage and availability were largely unchanged.

Management fees

There was a decline in average fund management fees for actively managed funds between 2006 and 2007, while for passively managed funds there was a slight increase over the same time period. However, the changes were not significant and there is no evidence that this has been related to the introduction of the new regime.

Disclosure and pension funds

Pension funds have been receiving disclosures on spending on trade execution and research from investment managers since the change in the regime in 2006. At the time of the first study, few pension funds had started to analyse this data to monitor fund managers' performance.

The current study found that pension funds generally received the appropriate disclosure from fund managers. However, only one of the six respondents used the information received and none provided feedback on their mandates to investment managers.

The survey found that the most important factors considered by funds when appointing managers were the manager's style, expertise, reputation and past performance. Other factors, such as the level of commission rates, fees and research expenditure, were considered to be less important.

Retail funds

The purpose of the survey of authorised providers of retail funds was to determine the extent to which investment managers were making disclosures, whether they were being made to the appropriate investors' representative, whether the nature of the disclosures corresponded to the requirements of the relevant code, and whether there was evidence of feedback taking place between the representative and the investment manager.

The results showed that few disclosures were made before the middle of 2008, but this was due to participants awaiting industry guidance. Any disclosures made before 2008 tended to be based on the Investment Management Association (IMA)/National Association of Pension Funds (NAPF) code. However, there was evidence that the majority of survey respondents intended to use the new IMA/Depositary and Trustee Association (DATA) code as the basis for their disclosures.

The survey of investment managers indicated that, in general, they treat institutional and retail clients and trades in the same manner. This suggests that, where improvements have materialised for institutional funds, the same benefits are likely to have spilled over into the retail arena.

Impact on the main performance measures

Performance indicator	Expected change	Actual change	Notes	Indicator type
Reduction in the spending on non-permitted goods and services				
Amount spent on non-permitted goods and services purchased through commissions	Reduce to zero	Reduced to zero		Direct hard indicator
Amount spent on non-permitted goods and services purchased with hard cash	Increase (but possibly less than the reduction in non-permitted goods and services purchased with commissions)	Probably increased and probably more than the reduction in non-permitted goods and services purchased with commissions	Insufficient consistent data points to draw a firm conclusion. Discussions with the industry suggest an increase as a result of other changes	Direct hard indicator
Total amount spent on non-permitted goods and services purchased	Stay the same or decrease	Not available	Insufficient consistent data points to draw a firm conclusion	Direct hard indicator
Reduction in the spending on research				
Amount spent on research purchased with soft commissions or CSAs	Increase	Increased	Dominant method of paying for research is now through CSAs	Direct hard indicator
Amount spent on research purchased through bundled brokerage arrangements	Decrease	Decreased		Direct hard indicator
Amount spent on research purchased with hard cash	No impact	Probably increased	A detailed breakdown of hard cash spending was not available	Direct hard indicator

Performance indicator	Expected change	Actual change	Notes	Indicator type
Total amount spent on research through commissions	Decrease	Stable (slight decrease)	Slight decline relative to pension funds under management. Trend less clear relative to value of commission trading	Direct hard indicator
Reduction in the spending on non-execution goods and services				
Commission rates for core/bundled brokerage	Decrease	Decreased	Decreasing trend without change in regime (technological changes)	Direct hard indicator
Commission rates for the non-execution element of core/bundled brokerage	Decrease	Decreased	See above	Direct hard indicator
Changes in the proportion of execution-only trading	Increased	Increased	There has been an increase in the proportion of electronic and programme trading	Direct hard indicator
Impact on the structure of the market for brokerage and research services				
Concentration of investment managers' use of brokerage trade execution services	Increase in concentration	No significant change across the market for execution as a whole	As this change would have been adverse, this is a positive outcome	Indirect hard indicator
Distribution of research costs among investment managers	Relative increase in the commission rates for smaller investment managers	Not observed—in fact, there has been some convergence in commission rates	As above	Direct hard indicator
Concentration of investment managers' use of research (not used as a performance indicator in the previous survey)	Stay the same or decrease	Stayed the same or decreased	Aggregate concentration data is unchanged but evidence at an individual firm level (and from use of CSAs) indicates that it may be decreasing	Indirect hard indicator
Quality of trade execution				
Brokers' and investment managers' assessments of market liquidity in different segments of the market over time	Liquidity might get worse	Liquidity has reduced for a significant proportion of survey participants	The change in liquidity does not appear to be related to the change in the regime The credit crunch was the factor most frequently referred to	Indirect soft indicator

Performance indicator	Expected change	Actual change	Notes	Indicator type
Quality, availability and coverage of research				
Investment managers' assessments of quality and availability of research. Brokerage firms' assessment of their research coverage	Might improve due to greater transparency, but could deteriorate if the market becomes more concentrated	No evidence of significant change from most respondents Some respondents indicated that there had been a deterioration in research coverage of FTSE small stocks		Indirect soft indicator
Disclosure				
From brokerage firms to investment managers	Disclosure of execution/research split	Disclosure		Indirect hard indicator
From investment managers to pension funds	Disclosure of information about commissions	Disclosure	Pension funds appear not to request follow-up information from investment managers	Indirect hard indicator
Reduction in spending on non-permitted goods and services				
Management fees paid by pension funds	Possibly an increase in fee rates (as a result of an increase in spending with hard cash)	Little evidence of significant changes		Indirect hard indicator
Distribution of research costs among pension funds				
Management fees paid by smaller funds relative to those paid by larger funds	Fees paid by smaller pension funds to increase	No consistent evidence of this		Indirect hard indicator

Source: Oxera analysis.

Contents

List of tables

List of figures

1 Introduction

1.1 Objectives and remit

On January 1st 2006, the Financial Services Authority (FSA) introduced rules on the use of dealing commission, replacing the previous rules on soft commission arrangements. These rules were developed in response to market failures identified as part of the review of bundled brokerage and soft commission arrangements in 2003. Following consultation the final rules were implemented in January 2006. At this time the FSA undertook to complete a post-implementation review of the success of this policy.

Oxera was commissioned to conduct research for the FSA in support of this post-implementation review. The first part of study, undertaken in 2006, established a set of performance measures and measured the baseline.[1] This is the second part of the study, and looks at the changes in those indicators, as well as some relevant additional information that is now available.

The changes[2] in the regime refer to the rules in Conduct of Business Sourcebook (COBS) 11.6 of the FSA Handbook and the industry codes[3] and had the following main elements:

– investment managers' use of dealing commission was limited to the purchase of 'execution' and 'research';

– investment managers would give their clients better information about the respective costs of execution and research, and the overall expenditure on these services;

– investment managers were encouraged to seek, and brokers to provide, clear payment mechanisms that enable individual services to be purchased separately.

To assess the impact of the changes in the regime, performance indicators were created that could be measured using surveys among a representative sample group of investment managers, brokers and pension funds.[4]

These were developed during the first study, in cooperation with the FSA and the industry associations (the Investment Management Association (IMA), the London Investment Banking Association (LIBA) and the National Association of Pension Funds (NAPF)), and a number of market participants, to provide an appropriate methodology that could be replicated for future comparison. In addition, a survey was conducted in February/March 2006 to obtain the data to construct the baseline against which subsequent changes in the indicators could be measured (ie, to measure the level of indicators before the change in the regime in January 2006).

This second study, commissioned in 2008, involved a survey among the same type of organisations and to a large extent the same firms, capturing the situation after the change in

[1] Oxera (2006), 'Soft Commissions and Bundled Brokerage Services: Post-implementation Review', report prepared for the FSA, October, available at http://www.oxera.com/main.aspx?id=5403.

[2] The new regime is described in FSA (2005), 'Bundled Brokerage and Soft Commission Arrangements: Feedback on CP05/5 and final rules', Policy Statement PS05/09.

[3] IMA/NAPF, 'Pension Fund Disclosure Code'.

[4] Throughout this report, 'investment manager' refers to a firm managing the funds of other investors, making investment decisions for the funds in accordance with the agreed mandate of the fund, while 'broker' refers to a firm that provides trading services, and 'pension fund' refers to pension fund trustees, or to the fund itself.

the regime (ie, in calendar years 2006 and 2007). The survey was undertaken from mid-August to mid-September 2008.

Comparison of the results from this current survey with those of the baseline survey provides an indication of the impact of the change in the regime for soft commissions and bundled brokerage arrangements.

In addition, and using essentially the same survey, the FSA commissioned Oxera to conduct supporting research for its review of the effect of the new regime from a retail fund perspective. The FSA wanted to know whether equivalent information about the use of commissions is being produced for retail funds as is the case for wholesale funds (ie, pension funds) and whether investment managers' oversight and treatment of dealing commissions for retail funds is comparable to that for wholesale funds. The research conducted for this is presented independently in section 9, as the objectives and remit were somewhat different to those underpinning the main body of the report.

1.2 Deliverables

Oxera broke the research in this study down into three stages.

– **Revision of performance indicators and questionnaires**: first, Oxera assessed whether the performance indicators needed to be changed to take into account any market developments not foreseen when they were developed. Based on interviews with a number of market participants, it was concluded that no additional performance indicators were needed, but that it was useful to add a limited number of questions, particularly in relation to how investment managers operate their Commission Sharing Arrangement (CSA) accounts and in relation to retail funds (see section 9). Furthermore, the questionnaires were revised with the input of market participants; some simplifications were incorporated to ensure that respondents were able to compile the relevant data more easily, and some performance indicators were removed—in particular those considered less useful in the evaluation in the 2006 report. To assist the respondents, the questionnaires were accompanied by a handbook, with a guide to each of the questions, defining the terminology used and supplying answers to frequently asked questions. Interviews were conducted with a number of market participants to further assess whether the questionnaire needed any adjustments and to obtain a better understanding of the developments in relation to the new regime for softing and bundling in the market. Roundtable meetings, organised by LIBA and the IMA, were held with market participants to discuss the questionnaires.

– **The survey**: the survey was then conducted, with the questionnaires and handbooks being made available via the survey website on August 13th 2008. Oxera's team provided further clarification and assisted firms in completing the questionnaires.

– **Data validation and analysis**: the completed questionnaires were validated. This involved contacting respondents with points of clarification or, in some instances, to obtain responses to omitted questions and/or check consistency of the answers. Where necessary, follow-up interviews were conducted with survey participants. Survey results were analysed and compared with the baseline data, and are now presented in this report.

1.3 Methodology

1.3.1 Performance indicators

In the 2006 baseline study Oxera developed performance indicators to measure the impact of the new regime over time on the basis of logical expectations of that impact. Six categories of performance indicators were identified:

1) change in the spending on non-permitted goods and services purchased through commissions;

2) change in the spending on research goods and services purchased through commissions;

3) change in the spending on execution-related goods and services purchased through commissions;

4) change in the spending on non-execution goods and services (ie, execution-related, research or non-permitted goods and services) purchased through commissions;

5) the impact on the distribution of research costs and market structure;

6) other performance indicators measuring other consequences of the change in the regime.

For each performance indicator category, the expected impact of the new regime was investigated using more detailed indicators and a conclusion reached on whether the performance indicator was expected to rise or fall relative to the 2006 baseline if the new regime had the intended effect.

The performance indicator categories (1) – (4) were expected to fall relative to the 2006 baseline (ie, a reduction in spending) and measure a positive market impact, while categories (5) and (6) measure whether a number of other potential consequences of the new regime have occurred. The performance indicators, and the logic behind them, are described in more detail in the separate annex[5] and in the introduction to each of the sections that follow (sections 2–9).

The performance indicators were measured by undertaking surveys of brokers, investment managers, and pension funds, first in 2006 to establish the base line and then in 2008 to measure the changes in the relevant performance indicators.

The performance indicators are either direct or indirect, and hard or soft.

– **Direct performance indicators**—these directly measure the change in the desired outcome of the market. For example, they may measure the change in the amount spent on research through commissions.

– **Indirect performance indicators**—indirect measurement refers to quantifying ‘intermediate’ improvements at various points along the process (for example, the extent to which investment managers disclose information on commissions to their clients and the systems in place to evaluate the quality of research). It provides an indication of the mechanisms or process by which regulation is likely to achieve the desired change in market outcomes (measured, where possible, by the direct performance indicators).

– **Hard performance indicators**—these focus on metrics that can be objectively measured on the basis of data provided by pension funds, brokers and investment managers, such as commission rates, fund management fees, and the amount spent on research purchased through commissions.

– **Soft performance indicators**—these refer to metrics that cannot be measured entirely objectively, as they may require some judgement by respondents. For example, the way in which funds and investment managers conduct performance reviews of their brokers

[5] See Oxera (2009), ‘The impact of the new regime for use of dealing commission: post-implementation review. Annex: Performance indicators and questionnaires’.

or the evaluation of the services provided by fund managers to pension funds require subjective responses and are therefore soft indicators.

The classification of the different indicators is given in the table in the executive summary.

In comparing the results of the baseline and future surveys, it is important to consider that not all effects are visible within the same timeframe. Some effects of the new regime may become visible in the short run, while others are more likely to emerge in the medium or long run.

A number of additional questions were included in the questionnaires for the 2008 survey, for example focusing on how CSAs are managed by investment managers. Although these did not form part of the performance indicators developed in 2006, they can provide useful additional information to understand the impact of the new regime. They are described in the sections 2–9. Some performance indicators which were considered less useful after undertaking the survey in 2006 were removed. For example, the 2006 report concluded that the quality of the data on the cost of research produced in-house was poor and therefore would not be a reliable indicator.

1.3.2 Causality

The aim of the post-implementation review is to assess whether the change in the new rules resulted in the benefits envisaged by the FSA. The performance indicators are intended to measure this in an objective fashion, but correlation does not always imply causation. In some cases, a performance indicator may move in the expected direction, driven by the new regime; in others, however, an indicator may move in the expected direction for reasons entirely unconnected to the implementation of the new regime—for example, because of technological change or economic circumstances.

The performance indicators had been designed to control for this, to the extent that this is possible. For example, use of the appropriate ratios and measuring performance indicators in different ways helps determine whether the change in the regime is the most likely cause of a positive or negative result. Consistency across a number of indicators can also provide positive indications of causality, where alternative explanations for the movement of individual indicators would not result in the same overall pattern. In other cases, judgement needs to be exercised to determine whether changes resulted from the new regime or from other causes. Therefore, survey participants were asked to comment on whether they thought the changes were due to the new regime or to other factors. Where relevant, this is included in the description of the survey results.

Furthermore, by asking for data over a longer period in the 2006 survey (eg, back to either 2003 or 2001), it was possible to identify some existing trends in the market which could then be distinguished from the change in the new regime. Trends in commission rates, proportions of trading volume according to types of brokerage, management fees, and concentration of the brokerage market were identified. These are summarised in the separate Annex.[6]

In summary, the performance indicators provide a framework for measuring whether the new regime generated the benefits envisaged by the FSA. However, each individual performance indicator may not in itself be sufficient to establish causation, and so the results of the performance indicators and the report should be assessed in its totality.

1.3.3 Changes in performance indicators and benefits

Aside from the issue of causation, some of the performance indicators measure expected effects that are correlated with benefits identified by the FSA (eg, a reduction in spending on

[6] See Oxera (2009), 'The impact of the new regime for use of dealing commission: post-implementation review. Annex: Performance indicators and questionnaires'.

non-permitted services), while others are associated with costs (or negative market impacts). For example, there was a perception that liquidity could fall as a result of the rule change and this would represent a cost. This distinction needs to be taken into account when weighing up the importance attached to the changes identified in any performance indicator—the lack of a change in the way expected, where such a change would represent a potential cost, might be considered less important than the absence of change in an indicator associated with a benefit.

1.4 Survey sample

The survey was undertaken among the same types of organisation and to a large extent the same firms as in the 2006 survey. Appendix 2 describes the sample in more detail and indicates that it is sufficiently representative of the market to validate the impact analysis using this methodology, although to a certain extent smaller firms may be under-represented. The survey, together with anecdotal evidence, suggests that, in general, larger firms were quicker than smaller firms in adopting the new regime and entering into CSAs. It is possible that some further changes in the performance indicators could become more apparent in 2009 as a result of some of the smaller firms (fully) adopting the new regime.

The 2008 survey analysis is based on survey responses from 6 pension funds (a 60% response rate, 2% market coverage), 21 investment managers (75% response rate, 28% market coverage), 11 brokerage firms (69% response rate, 57% market coverage), and 8 authorised providers of retail funds (24% response rate, 6% market coverage). However, as not all respondents responded to every question in their questionnaire, the sample sizes for individual questions are sometimes lower. The majority (54%) of investment managers' clients were pension funds, and for brokers the most common clients were long-only funds/fund management firms. Equities were 57% of the total assets managed.[7]

Consistent with how the baseline data was collected, the survey asked for data in relation to trading in UK equities. The impact of the new regime is therefore measured in terms of the changes in commission expenditure in relation to UK equity trading.

1.4.1 Presentation of calculations

Calculations are normally undertaken on both the full sample of responses and a 'consistent' sample. The full sample is based on all responses received, while the consistent sample refers to the group of firms that have consistently responded to a given question across the period of the survey—ie, firms that have not provided information for past periods are excluded. Such firms from the 2006 survey formed the basis of the consistent sample in the 2008 sample. However, not all firms that consistently responded to a question in the 2006 survey did so in the 2008 survey. Therefore, in some cases the consistent sample is smaller in the second sample. To ensure the fullest use of the 2006 data, and consistency with the previous report, results on the consistent sample are presented without removing from the 2006 survey analysis firms that did not report in 2008. Where it was considered that the presence of these firms in the 2006 survey might bias the results, the analysis was also undertaken with these firms removed, although this did not indicate that any different conclusions would have been reached.

The results presented in the tables do not always sum consistently because the figures have been rounded. Discrepancies in some of the underlying data may also lead to this occurring, although this does not significantly affect the findings presented.

1.4.2 Panel analysis

The results are presented in aggregated form across survey participants. In general, averages of the sample responses are calculated using weighted averages; the weights are

[7] Market coverage is determined as a ratio of the assets under management from the survey respondents to the total assets under management for the corresponding category. For further details see Appendix 1.

typically the value of pension funds under management for the investment managers' responses, and the gross commission revenues for brokerage firms' responses. In many cases it is also possible to cross-check the changes measured as a weighted average of the sample with the aggregation of changes experienced by each individual firm, where these firms appear in each sample, as well as the weight average of changes in the consistent sample. These cross-checks are designed to identify aggregate observed changes that are caused by changes in the sample, rather than changes in the market. Where this is identified as a possibility, it is highlighted in the report.

1.5 Glossary

1.5.1 Services

This report distinguishes between the following types of service.

– **Execution** is the service provided by a broker to a fund manager when specific trades are executed for the fund manager.

– **Core brokerage** is a full-service trade execution service in which salespersons and traders typically manage the execution process—ie, it is 'full-touch' trade.

– **Execution-only** refers to transaction methods such as electronic trading and programme trading. Electronic trading includes all light-touch trade execution methods such as Direct Market Access (DMA) and algorithmic trading. Programme trading is the execution of automatically generated transactions for multiple securities bundled into a single trading package.

  Depending on the context, execution-only may also refer to those execution services that are not offered in a bundle with non-execution goods and services. Execution services offered in such a bundle are referred to as bundled brokerage.

– **Execution-related goods and services** are the goods and services used by fund managers in the execution of their trades, but are not directly related to any specific trades that were executed for the fund manager if they can still be obtained through soft commissions or bundled brokerage arrangements.

– **Research goods and services** are the research goods and services used by fund managers to inform their trading decisions, which can still be obtained through soft commissions or bundled brokerage arrangements.

– **Non-permitted goods and services** are the goods and services that *were previously allowed* to be obtained under soft commissions or bundled brokerage arrangements but *are no longer permitted* to be obtained in this way or through CSAs because they do not constitute 'execution' or 'research' (see COBS 11.6.3)

1.5.2 Types of arrangement

This report refers to the following types of arrangement between investment managers and brokers.

– **Soft commission arrangements** were in place before the introduction of the new regime for the use of dealing commission. They refer to arrangements whereby an investment manager, by agreeing to send trades to a broker, receives, in addition to 'pure' trade execution, credits that can then be used to purchase services, such as research and information, from third parties.

– **Bundled brokerage arrangements** are those in which an investment manager, by agreeing to send trades to a broker, receives other goods and services from that broker in addition to 'pure' trade execution.

– **Commission-sharing arrangements** are those in which an investment manager agrees with brokers that the non-execution constituent of the commission should be paid into a commission-sharing pool from which the investment manager can then pay for research from the broker, other brokers or third-party research providers. This may be carried out through an intermediary.

1.5.3 Commission rates

This report distinguishes between the following types of commission rate.

– The **bundled brokerage commission rate** is the commission rate for full-service brokerage, and includes payment for execution and non-execution goods and services.

– The **execution-only commission rate** is the commission rate for execution-only transactions.

1.6 Structure of the report

Section 2 gives a summary of developments in relation to the use of CSAs, which provides useful background to understand the changes in the performance indicators. Sections 3 and 4 then present some of the key performance indicators, focusing on the impact on spending on non-execution goods and services through commissions.

Section 5 focuses on some of the performance indicators that measure potential detrimental effects of the new regime. Section 6 presents some of the remaining performance indicators not covered in the previous sections.

Sections 8 and 9 present the results of the pension funds and retail funds questionnaires respectively.

The executive summary is presented in a separate section at the beginning of this report.

The survey sample and its representativeness are described in Appendix 2; while Appendix 3 provides an analysis of an additional performance indicator referred to in section 3. The methodology and the performance indicators used to assess the impact of the regime are set out in a separate Annex, which also reproduces the four questionnaires, respectively, for pension funds, investment managers, brokerage firms, and authorised providers of retail investment products.

2 Market developments: use of Commission Sharing Arrangements

To separate the market for execution services from the market for research, while still allowing research to be paid for from commission revenues, it is a necessary condition that there are mechanisms in place that allow commission revenues earned with a broker to be spent on research not provided by that broker. The industry responded to the new regime with the introduction of CSAs between investment managers and brokers. CSAs can displace both bundled brokerage and softing arrangements, and it was expected that they would therefore be used extensively under the new regime.

This section reports on relevant changes in market practice that have occurred:

– the use of CSAs has gone up—the proportion of fund managers with CSAs has increased from around 50% to more than 70%;

– more providers are paid from CSAs—from an average of just under 20 to over 40 providers per investment manager with a CSA;

– expenditure through CSAs has increased, as has the proportion of that expenditure going to third parties.

2.1 Introduction

This section describes a number of market and industry developments that occurred in response to the new regime. Following the introduction of the 2006 regime, it was envisaged that CSAs would become the principal means through which non-execution goods and services would be purchased. It was also expected that the value of commission expenditure on non-execution goods and services using CSAs would increase.

In a CSA, investment managers agree, usually with the executing broker, a split in the commission rate for execution and non-execution (primarily research) goods and services. The broker receives the execution component for undertaking the trade and the non-execution portion is then allocated to a CSA commission account. The investment manager can use the resulting non-execution commissions generated to purchase non-execution goods and services from third parties and/or the executing broker. This is distinct from bundled arrangements, where both services are provided by the executing broker as part of an explicit bundle—although, under the 2006 regime, the broker should now quote a split in the rate for execution and research within the bundle. CSAs therefore facilitate investment managers switching their commission expenditure on non-execution goods and services between providers, and are therefore a mechanism by which the transparency of research pricing, and competition, can potentially be enhanced.

The level of CSA adoption and their usage therefore have important implications. The survey therefore contained a number of questions to assess:

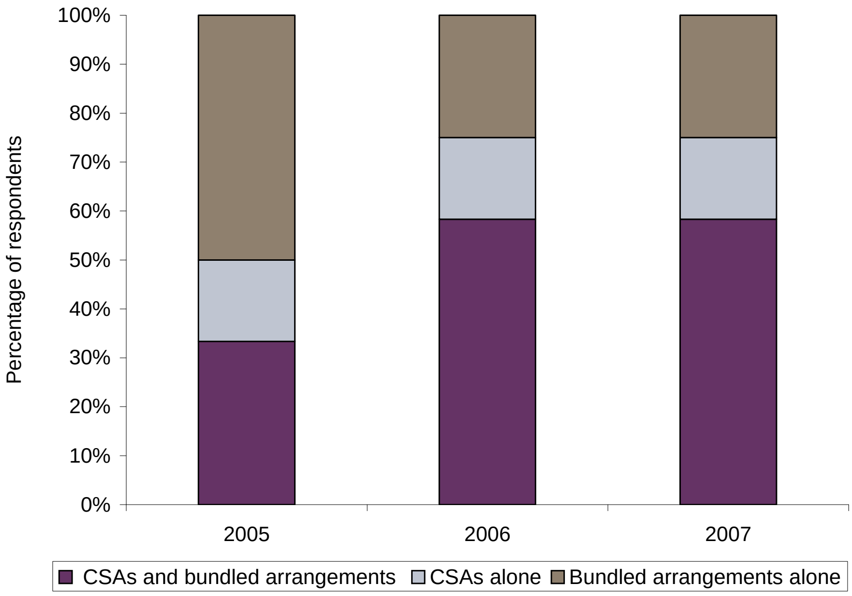
– the proportion of investment managers with CSAs in place;
– the number of providers of non-execution goods and services used by investment managers;
– the value of commission expenditure on non-execution goods and services using CSAs (this is one of the performance indicators);
– the management of CSAs.

The results on this are analysed in this section.

2.2 The proportion of investment managers with CSAs in place

To determine whether the incidence of CSA use has changed, Figure 2.1 shows the proportion of investment managers in the survey that had only CSA or only bundled arrangements, or had both. Survey respondents that provided only partial information on their use of CSAs and bundled arrangements for 2005–07 have not been included, resulting in a consistent sample of 12 respondents.

Figure 2.1 The proportion of respondents using CSAs and/or bundled brokerage



Source: Investment managers questionnaire, Q32, Table 5.13. Based on the same 12 respondents.

The figure shows that the proportion of investment manager respondents with CSAs grew substantially between 2005 and 2006, from around 50% to more than 70%. It then remained at that level in 2007. This increase is due to investment managers with bundled brokerage arrangements also entering into CSAs. There was no change in the number of firms in the sample that used only CSAs. This implies that, in addition to their pre-existing bundled arrangements, investment managers are increasingly entering into CSAs, which will give them greater access to third-party providers of non-execution goods and services. In other words, the arrangements to deliver the benefits of the new regime are being put in place.

2.3 Number of providers of non-execution goods and services used by investment managers

Following the introduction of the 2006 regime, it was envisaged that CSAs would result in more parties being used to provide non-execution goods and services. To determine whether this has been the case, Figure 2.2 below shows the average number of providers from which investment managers purchase non-execution goods and services. It categorises this as follows.

– **Brokerage firms** that are used for trade execution and from which the investment managers purchase non-execution goods and services via:

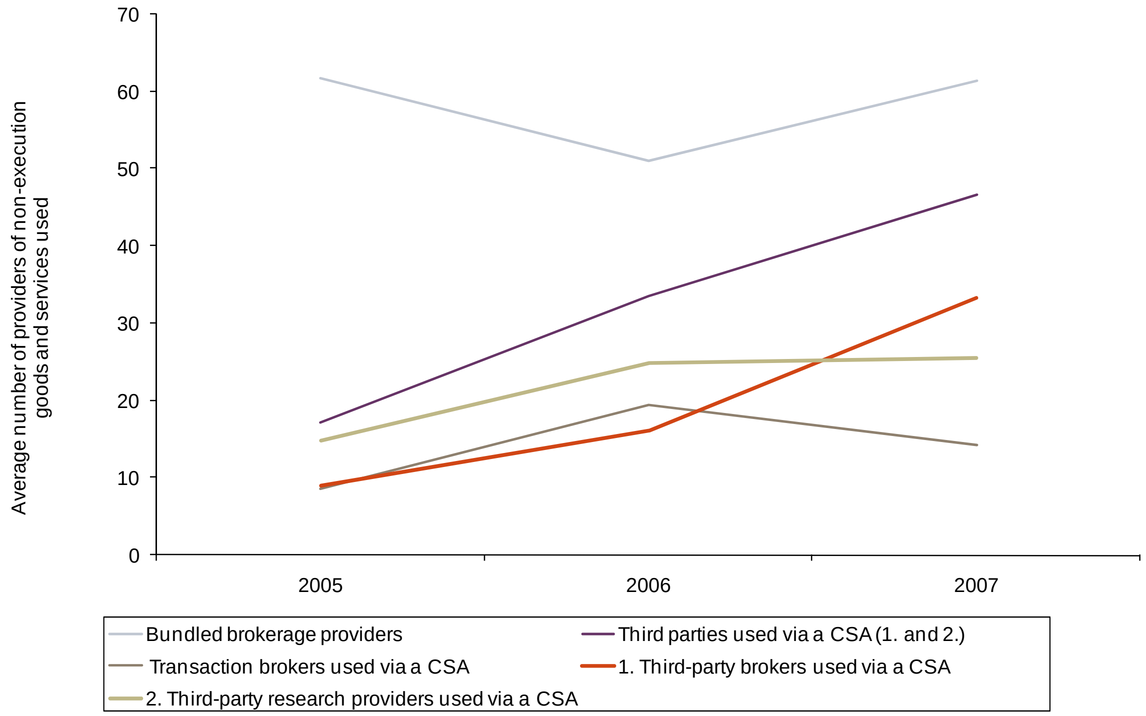
  – bundled brokerage agreements;
  – CSAs.

– **Third parties** from which they purchase non-execution goods and services via a CSA from:

– third-party independent research providers;
– brokers that are used as third-party research providers (but not for trade execution).

The averages are calculated for respondents with these types of arrangements in place ie, the average number of CSA providers is calculated only for firms with CSAs in that year; it is not an average over the entire sample. Thus, the sample size changes over time—eg, the calculation is based on a larger CSA sample in 2006 than in 2005.

Figure 2.2 The average number of non-execution goods and services providers used by investment managers



Note: The numbers presented are simple averages. The number of providers outside a CSA is the number of the executing brokers dealt with which provided non-execution goods and services outside a CSA. For CSAs, the number of parties that provided non-execution goods and services reflects the number of providers that were CSA transaction brokers and/or third parties (either independent research providers and/or brokers that provided research but which were not used for execution). Total CSA providers will not sum to the components because the averages of its components are conditional on the investment manager having dealt with a provider in that category and in some instances because there is missing data.
Source: Investment managers questionnaire, Q32, Table 5.13.

Figure 2.2 indicates the following.

– Investment managers are using their CSAs to contract for non-execution goods and services with an increasing number of third-party providers, in terms of both independent providers and brokers. In discussions at the IMA, it was suggested that the increase in the number of third-party brokers may to some extent be due to brokerage firms that were previously used to provide both research and execution increasingly being used to provide execution-only services.[8]

– There is no clear trend in the average number of execution brokers that are used for either CSAs or bundled brokerage. Their numbers increased and then decreased for CSAs between 2005 and 2007, and vice versa for bundled brokerage. The increase in the number of bundled brokerage providers in 2007 is due to one firm; when this is omitted, there is a very slight fall in the average number of providers between 2006 and

[8] IMA roundtable meeting, December 3rd 2008.

2007. Since there is no reason to consider that the data for this firm is provided on a basis which is inconsistent with the others, Figure 2.2 presents the data for all survey participants.

– The average number of non-execution goods and services providers involved in CSAs (ie, CSA executing brokers + CSA third-party providers) is, by 2007, broadly equal to the average number of providers dealt with through bundled brokerage arrangements, at around 60 providers.

– The number of brokerage firms that are used for execution via a CSA is around 15 providers in 2007. This implies that investment managers currently negotiate CSAs with a relatively small proportion of their brokers. However, these brokers account for a very large proportion of their trade. Anecdotal evidence indicates that these executing CSA brokerage firms are larger firms. Furthermore, section 5 indicates that investment managers send around 80% of their trades to their top 15 brokers. Entering into CSAs results in some costs for investment managers, and having CSAs with all brokers could also further increase the costs of managing them. Investment managers may therefore see no reason to generate commissions for third-party research at smaller brokers.

2.4 Value of commission expenditure on non-execution goods and services using CSAs (performance indicator)

Having assessed the number of CSA and bundled brokerage arrangements in place, the levels of expenditure passing through them are now examined from the perspective of:

– investment managers' purchases of non-execution goods and services;
– the payments received by brokerage firms.

2.4.1 Expenditure on non-execution goods and services by investment managers

Table 2.1 shows the average proportion of investment managers' commission expenditure on non-execution goods and services that was purchased through bundled brokerage and CSAs. The expenditure through the CSAs is broken down into one of the following three categories:

– the same brokerage firm at which the commissions were generated;
– a brokerage firm used for trade execution, but where most of the payment comes from commissions generated at another broker;
– a third party (be it an independent research provider or a non-executing broker).

Table 2.1 Who investment managers buy their research from—spending of dealing commission expenditure on non-execution goods and services (by value) (%)

	2006	2007
Through brokers using bundled brokerage (ie, outside a CSA)	48	36
Through a CSA (total)	52	64
at the brokerage firm at which the CSA commissions were generated	27	24
at brokerage firms used for execution but where trading at a different brokerage generated the commission to pay for these services	7	8
at third parties (which may include other brokers) paid for through CSA commissions	18	31

Note: The numbers presented are simple averages.
Source: Investment managers questionnaire, Q29, Table 5.8.

Table 2.1 indicates that, for those investment managers that responded, on average:

– more than half of the commissions for non-execution goods and services in 2006 and 2007 were spent via CSAs. This proportion increased from 52% to 64% over those years;
– the main recipient of CSA commissions providing non-execution goods and services changed from being the broker where the CSA commissions were generated in 2006 to being third-party providers in 2007;
– commissions generated at one CSA broker being used to pay another CSA executing broker (referred to as 'top-ups') constituted a small proportion of expenditure, at around 7–8%. This may indicate that CSAs lead to investment managers shopping around third parties to provide research services, but not other brokerage firms.

To assess whether the average pattern of expenditure for individual investment managers is also replicated in terms of total spending levels, the aggregate value of non-execution goods and services expenditure flowing through these routes was also assessed (see Table 2.2).

Table 2.2 Proportion of aggregate trades through different trading routes (%)

Proportions of aggregate trades through different trading routes	2006	2007
Brokers using bundled brokerage (ie, outside a CSA)	22	21
Through a CSA (total)	78	79
to the brokerage firm at which the CSA commissions were generated	35	19
to brokerage firms used for execution but where trading at a different brokerage generated the commission to pay for these services	15	8
to third parties (which may include other brokers) paid for through CSA commissions	28	52

Source: Investment managers questionnaire, Q29, Table 5.8.

Table 2.2 shows that, as in firm-level average terms, CSA expenditure is now a significant proportion of total expenditure on non-execution goods and services (more than 75% in 2006 and 2007). Since the average proportion of CSA expenditure across investment managers was lower, this may suggest that investment managers that spend more on non-execution goods and services are also more likely to use CSAs.

There was a decline in the proportion of total expenditure on non-execution goods and services going to brokerage firms where the CSA commissions are generated and a decrease in the use of commissions generated at one brokerage firm being used to pay another executing broker.

2.4.2 Brokers' sources of income for providing non-execution goods and services

Table 2.3 below shows how brokerage firms received income for providing non-execution goods and services. This can be in the form of commission payments (bundled brokerage or CSA) or hard cash. A distinction is drawn between brokers receiving most of their CSA income from commissions generated with them and when they obtain a significant proportion of their CSA income in the form of top-up payments (commissions generated at another brokerage firm or hard cash).

Table 2.3 The sources of dealing commission expenditure (by value) earned by brokers on non-execution goods and services (%)

Provision of non-executive goods and services (value)	2006	2007
Provided to brokerage clients through bundled brokerage (outside of a CSA)	70	63
Provided through a CSA		
to brokerage clients in respect of trades provided by that client (including clients that paid a top-up fee where this represents 50% or less than the total charged for these services)	29	36
to non-brokerage clients (ie, where the respondent was a 'CSA commission recipient') (including brokerage clients, where more than 50% of the total charge comes from top-up-fees)	1	0
Provided for hard cash alone		
to brokerage clients	1	1
to non-brokerage clients	0	0

Note: Simple averages of firm-level data.
Source: Brokerage firms questionnaire, Q13, Table 3.6.

– On average brokerage firms received most of their income for providing non-execution goods and services through bundled brokerage arrangements. This proportion declined from 70% to 63% over the period, with a corresponding increase in the proportion of income accounted for via payments through a CSA.

– Payments were almost exclusively from investment managers that executed with the broker and involved very few top-ups (either in the form of commissions generated at another firm or hard cash). Indeed, hard cash constituted a very small proportion of brokerage firms' revenues for providing non-execution goods and services. Limited income from top-up payments is consistent with the finding that investment managers rarely used commissions generated with a CSA at one broker to pay for non-execution goods and services at another broker used for execution. This implies that investment managers do not directly use CSAs to shop around executing brokers for research, but are more likely to use them to access third-party research providers or to pay for research at the broker with whom they have the CSA.

The finding that brokerage firms received a high proportion of their income from bundled brokerage payments is not necessarily inconsistent with previous tables on investment managers' expenditure, which show that bundled brokerage was a much smaller proportion of investment managers' expenditure. Executing brokers will, because of the services they offer, be much less likely to receive the commission expenditure that goes to third parties. It might therefore be expected that the proportion of their income constituted by bundled brokerage would be higher than the equivalent share of investment managers' expenditure. Furthermore, the higher importance of bundled brokerage expenditure as an income source may be because the brokerage sample was predominantly made up of large brokerage firms that offer a full service, including research.

2.5 Management of CSAs

This section examines the findings on: investment managers' treatment of surplus commissions with CSAs (and bundled brokerage arrangements) and their use of external managers of CSAs.

2.5.1 Management of surplus commissions

An issue with research pricing is that dealing commissions are paid at the time when the trade execution services are used, while non-execution goods and services (particularly research) are generally provided over an extended time period. As a result, investment managers may generate more commissions than they actually need to pay for non-execution goods and services. To assess how investment managers deal with this issue, the survey included questions on the extent of, and response to, commission surpluses in both CSAs and bundled brokerage arrangements. The responses are covered in turn in Tables 2.4 and 2.5.

Table 2.4 What do you do when you are close to generating more CSA commissions for non-execution goods and services than you consider are required?

	No. of responses
The issue has not arisen, and no policy is in place	6
Switch to trading without CSAs	2
Roll positive balance into following year	7
Renegotiate commission rate to reflect a lower proportion of commissions required to purchase research	7
Other	1

Note: Respondents were able to give multiple answers to this question.
Source: Investment managers questionnaire, Q34.

Of the 12 firms that responded on potential surplus CSA commissions, half had no previous experience of this or did not have a policy in place for this eventuality. Those that had experienced it primarily opted to roll positive balances in the commission accounts into the next year, or renegotiated commission rates to reflect a lower proportion of commissions needed to purchase research. Only two firms indicated that they would switch to trading without CSAs (ie, they would use more execution-only trading).

Table 2.5 What do you do when you are close to generating more commissions for non-execution goods and services through bundled brokerage arrangements than you consider are required?

	No. of responses
The issue has not arisen, and no policy is in place	7
Switch to commission rate without a research component	6
Renegotiate commission rate to reflect a lower proportion of research	8
Other	2

Note: Respondents were able to give multiple answers to this question.
Source: Investment managers questionnaire, Q35.

For bundled brokerage arrangements, the issue of surplus commissions had not arisen for around half of the respondents. Where it had, they would generally switch to execution-only trading, or renegotiate commission rates to reflect a lower proportion of research.

2.5.2 External managers of CSA accounts

A practical issue with CSAs is whether an external manager is used to collectively manage an investment manager's CSA commission accounts, or whether the investment manager itself manages each account with the relevant broker. A question was therefore included in the questionnaire to assess the use of external managers (see Table 2.6).

Table 2.6 The use of external managers for CSA commission accounts

	No. of responses
Employ an external manager	4
Manage the commission accounts themselves	11

Source: Investment managers questionnaire, Q36.

Approximately 25% of investment managers with CSAs used an external manager for commission accounts. Among the reasons given for the use of external managers were reductions in the administrative burden and potentially increased speed of payments. Furthermore, using an external manager means that the brokerage firm, where the commissions are generated, should not gain any insight into where the CSA commissions are spent by the investment managers—the brokerage firms and third-party research providers may be in competition, leading to issues around confidentiality of the data on how commissions are spent.

2.6 Application of the softing and bundling regime by investment managers for different types of trade

The investment managers questionnaire contained a question to assess the extent to which the softing and bundling regime was applied to the different types of trade orders listed below.

– Trades sent to brokerage firms domiciled in the UK; Europe (not including UK); Asia and the USA.

– Trades for clients domiciled in the UK; in Europe (not including the UK); outside Europe.

Of the 17 respondents to this question, 15 indicated that they applied the softing and bundling regime to all of the trading types listed above.

2.7 Conclusions

In order for the market for execution services to be separated from the market for research, while allowing commission revenue to be spent on research, arrangements along the lines of CSAs are required. Although not complete, the market has moved significantly in this direction, with most investment managers having an explicit mechanism to enable commission revenue generated with a broker to be spent on research provided by some other party. The volume of revenues going through this type of channel is also increasing, and the spread of recipients of this revenue is also increasing.

The prior conditions necessary for separating the market for execution and research are therefore largely in place and (at least in the areas covered by the survey) no serious operational problems with this emerging structure were evident.

3 Expenditure on non-execution goods and services

This section reports on the performance indicators relating to the spending on non-execution goods and services through commissions and hard cash. It was considered possible that the change in regime for dealing commissions might reduce the commission expenditure on non-execution goods and services. This was due to the increased transparency of research pricing and the restriction that certain goods and services could now only be purchased with hard cash; hard cash expenditure was correspondingly anticipated to increase.

This section concludes that:

– overall expenditure on these items**,** measured relative to the value of assets under management and value of trading**,** has been fairly flat**;**

– there is no evidence of an increase in spending on non-execution goods and services through commissions;

– the spending on this category through hard cash has increased, and may have (slightly) more than offset the reduction in commission spending on these services.

3.1 Introduction

This section assesses the performance indicators related to the spending on non-execution goods and services through commissions and hard cash. The performance indicators are both hard (ie, they concern metrics that can be measured objectively on the basis of data provided by pension funds, brokers and investment managers) and direct (in the sense that they directly measure the change in the desired market outcome).[9]

Under the new regime, the types of goods and services that can be purchased through commissions have been reduced to those that fall under the FSA's definitions of 'execution' and 'research'. The expectation was that spending on non-permitted goods and services would fall to zero. If investment managers are unable to purchase these non-permitted goods and services through commission, they will only be able to purchase them with hard cash. As such, the amount spent on non-permitted goods and services purchased with hard cash may increase. However, since hard cash must be paid for from fund managers' income, the fall in non-permitted goods and services purchased through commissions may not be fully matched by the increase in non-permitted goods and services purchased with hard cash.

As well as reducing the types of goods and services that can be purchased through commissions, the new regime requires that investment managers make prior and periodic disclosure to their clients, including disclosure of the use of clients' commissions. It was considered that this could lead to a reduction in the amount spent on goods and services through commissions.

3.2 Breakdown of spending through commissions (including non-permitted services)

Following the introduction of new regime in 2006, the only categories of non-execution goods and services that could still be purchased with commissions became:

– research;
– execution-related goods and services.

[9] The nature of performance indicators was explained in section 1.3.1.

Table 3.1 below shows the weighted average proportions of investment managers' commission expenditure on the different types of non-execution goods and services, based on the current and the previous survey.

Table 3.1 Breakdown of average commission expenditure on non-execution goods and services (%)

	2003	2004	2005	2006	2007
Non-execution constituent:					
on research (%)	85	83	87	99.8	98.9
on execution-related goods and services (%)	5	10	10	0.2	1.1
on non-permitted goods and services (%)	10	7	3	0	0
Number of respondents	8	8	8	12	12

Note: For pre-2006 data the division is based on the average split in investment managers' commission rates. 2006 and 2007 weights are calculated on the basis of pension fund assets under management in those years. Source: For 2006 and 2007, investment managers questionnaire 2008 Q29, Table 5.9.

The table indicates the following.

– Since the introduction of the new regime, the survey found no evidence that investment managers have made any commission expenditures on non-permitted goods and services. This means that the performance indicator measuring spending on non-permitted goods and services fell to zero, in line with what was expected.

– The majority of commission expenditure on non-execution goods and services is on research. In the previous survey this percentage was never below 80% and in the current survey it is never less than 98%. Indeed, the most common expenditure on execution-related goods and services was zero in the current survey.

Following the prohibition of commission expenditure on certain goods and services, it might have been expected that, all other things being equal, the proportions of commission expenditure on research and execution-related goods and services would increase. However, the proportion spent on execution-related goods and services fell, although it is not clear what is causing this. It should be borne in mind that the proportions in Table 3.1 are rough estimates provided by investment managers, and may therefore not accurately reflect the actual nature of the services purchased. During discussions at the IMA, it was suggested that, following the introduction of the new regime, investment managers had a clearer view about what should be classified as research as opposed to execution-related goods and services, and were consequently more likely to classify expenditure as research.[10]

3.3 Expenditure on non-execution goods and services

In the 2008 survey, investment managers were asked to provide data on the amount spent on non-execution goods and services purchased with commissions inside and outside of a CSA and with hard cash. To control for changes to other factors and to provide a consistent basis on which to make comparisons, the results are presented as a ratio of the amount spent on non-execution goods and services to (pension) funds under management, and as a ratio of the amount spent on non-execution goods and services to the value of trading on a

[10] IMA roundtable meeting, December 3rd 2008.

commission basis. Both measures are equally relevant and the results are similar, hence the latter is presented in Appendix 3.[11]

3.3.1 The ratios of the amount spent on non-execution goods and services to (pension) funds under management

Table 3.2 and Figure 3.1 show the ratio of non-execution goods and services to total pension fund assets under management depending on the different arrangements between the investment managers and brokers. These ratios are presented for both a full sample and a consistent sample of survey participants.

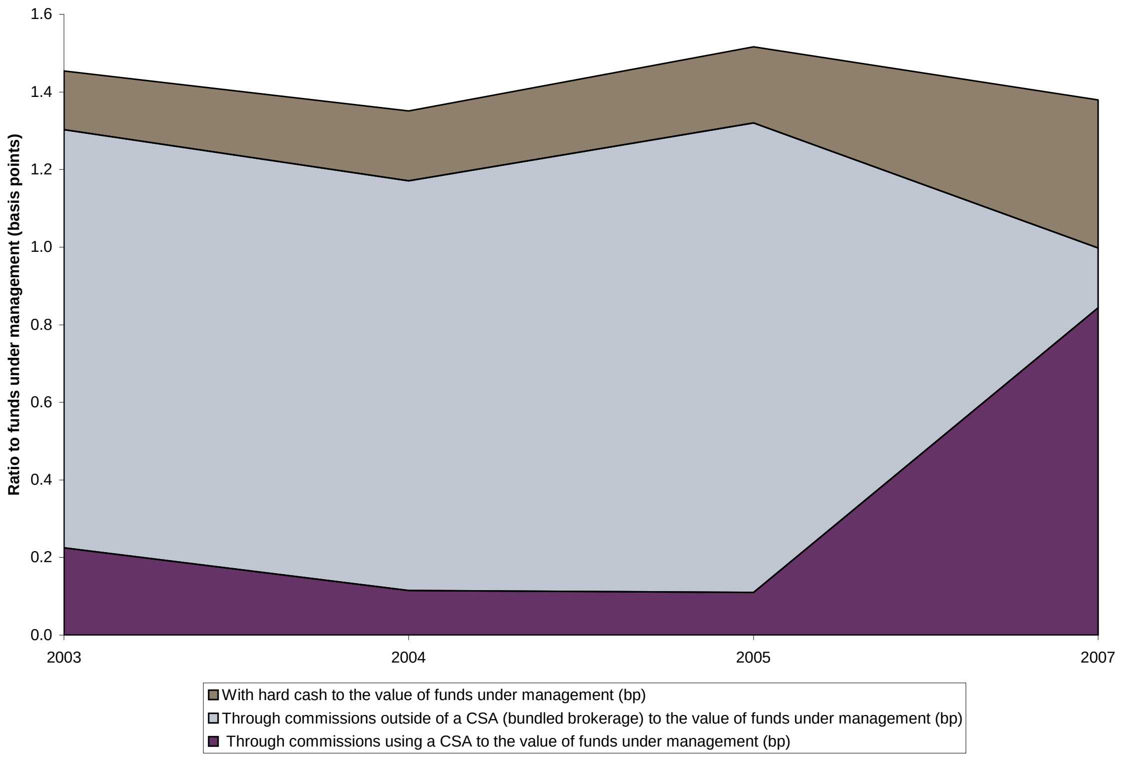
Table 3.2 Weighted average of ratios of non-execution goods and services to the funds under management (basis points, bp)

	Consistent sample				Full sample	
	2003	2004	2005	2007	2005	2007
The total amount spent on non-execution goods and services purchased:						
(1) through commissions to the value of funds under management	1.3	1.2	1.3	1.0	1.3	1.0
(2) through commissions using soft commission arrangements (up to 2005) or a CSA (as from 2006) to the value of funds under management	0.2	0.2	0.1	0.8	0.1	0.7
(3) through commissions outside of a CSA (bundled brokerage) to the value of funds under management	1.1	1.1	1.2	0.2	1.2	0.2
(4) with hard cash to the value of funds under management	0.2	0.2	0.2	0.4	0.4	0.9
(1) + (4) to the value of funds under management	1.5	1.4	1.5	1.4	1.7	1.8
Number of respondents	8	8	8	4	10	12

Note: Owing to insufficient data, observations for 2006 have been excluded from the analysis.
Source: Oxera calculations based on responses to the investment managers questionnaire, Q29.

[11] The analysis in the Appendix 2 shows that there is a small increase in non-execution goods and services expenditure through commissions relative to the value of commission trading on the consistent sample, and a very small decrease in terms of the full sample. This means that there is no evidence of a significant increase.

Figure 3.1 Weighted average of ratios of non-execution goods and services to funds under management (consistent sample)



Note: Owing to insufficient data, observations for 2006 have been excluded from the analysis.
Source: Oxera calculations based on responses to the investment managers questionnaire, Q29.

The data in Table 3.2 suggests that the ratio of non-execution goods and services through commissions to funds under management remained roughly constant between 2003 and 2005. From 2005, the ratio declined slightly for both the consistent and full samples. Underlying this change was an increase in the amount spent on goods and services purchased through CSAs and a decrease in expenditure on goods and services purchased through bundled brokerage. Further examination of the data shows that expenditure on both non-execution goods and services and pension funds under management increased in absolute terms over the period, but the proportionate increase in the funds under management was more significant.

The ratio of total hard cash expenditure to funds under management increased from 2005. The data shows that this hard cash expenditure includes a significant proportion of expenditure on the goods and services that, since 2006, can no longer be purchased with commissions. Although the data on hard cash spending is limited, the increase in such spending on non-permitted goods and services seems to be equivalent to, or larger than, the reduction in commission spending on the disallowed goods and services. Looking at the pattern across individual firms for the 2008 survey, hard cash expenditure on disallowed goods and services has generally increased for firms since the 2006 change in the regime. In discussions at the IMA, it was suggested that some of the increase in hard cash expenditure may be due to increasing technological sophistication and higher data costs following the introduction of MiFID.[12]

3.3.2 Disaggregated analysis

To assess whether the aggregated analysis was hiding any underlying trends among individual investment managers, the data was analysed at the individual firm level. The

[12] IMA roundtable meeting, December 3rd 2008.

number of firms where the ratio of non-execution goods and services to funds under management had increased, stayed the same or decreased was calculated across the different time periods (see Table 3.3).

Table 3.3 Firm-level analysis of trends in the ratio of non-execution goods and services to funds under management

Number of participants for which the ratio of non-execution goods and services to pension fund assets under management:	Increased	Remained constant	Decreased
between 2003 and 2004	5	0	3
between 2004 and 2005	5	0	4
between 2005 and 2007	2	0	3

Source: Oxera calculations based on responses to the investment managers questionnaire, Q29.

Table 3.3 indicates that there was no clear trend; some managers spent more on non-execution goods and services relative to funds under management, while for others this proportion fell. Data is not available for all investment managers between 2003 and 2007, so it is only possible to examine to a limited extent whether a given firm continuously increased (or decreased) its relative expenditure on non-execution goods and services over time. Of the three firms that provided data for all years, none consistently increased (or decreased) its relative expenditure on non-execution goods and services. This, and the absence of a clear pattern of increases or decreases for the time periods in Figure 3.3, indicates that the stability of the aggregate ratio shown in Figure 3.1 is unlikely to hide a significant trend among firms as a whole.

The increase in hard cash spending offsets the reduction in commission spending on non-execution goods and services, which means that the ratio of total spending on non-execution goods and services remained the same.

3.4 Conclusions

The following conclusions can be drawn on the basis of the analysis.

– Since the introduction of the new regime, the survey found no evidence that investment managers have made any commission expenditures on non-permitted goods and services. This means that the performance indicator measuring the spending on non-permitted goods and services fell to zero, in line with what was expected.

– The majority of commission expenditure on non-execution goods and services is for research rather that for execution-related goods and services—in the current survey, most investment managers usually had no commission expenditure on execution-related goods and services. Although this was not a performance indicator, the finding is relevant since it may provide insight into how investment managers are now interpreting the different categories of non-execution goods and services.

– There is no evidence that the ratio of spending on non-execution goods and services through commissions to funds under management (or to the value of trading) has increased across the whole market. If anything, the spending has on average gone down, although the ratio increases for some investment managers and decreases for others. This means that the outcome for the performance indicator is broadly neutral.

– The outcome for the performance indicator measuring the ratio of total spending on non-execution goods and services to the value of funds under management is also broadly neutral, but to the extent that it has changed, it has risen slightly. Hard cash spending has increased since 2005. This offsets the reduction in commission spending on non-execution goods and services, with the result that the ratio of total spending on non-execution goods and services remained the same.

– There was some expectation that the reduction in commission spending on non-permitted services would not be fully offset by an increase in hard cash spending on these services. There does not seem to be any evidence indicating that this expectation has materialised. However, in discussions at the IMA, it was suggested that some of the increase in hard cash expenditure may be caused by a growth in demand for new services, such as new technology and systems, and higher data costs after the introduction of MiFID.

The main performance indicators in this area and their movement are set out in Table 3.4.

Table 3.4 Impact on the main performance measures with respect to spending on non-execution goods and services

Performance indicator	Expected change	Actual change	Notes
Reduction in the spending on non-permitted goods and services			
Amount spent on non-permitted goods and services purchased through commissions	Decrease to zero	Decreased to zero	
Amount spent on non-permitted goods and services purchased with hard cash	Increase	Probably increased	Insufficient consistent data points to draw a firm conclusion. Discussions with the industry suggest an increase as a result of other changes
Total amount spent on non-permitted goods and services purchased	Stay the same or decrease	Not available	Insufficient consistent data points to draw a firm conclusion
Reduction in the spending on research			
Amount spent on research purchased with soft commissions or CSAs	Increase	Increased	Dominant method of paying for research is now through CSAs
Amount spent on research purchased through bundled brokerage arrangements	Decrease	Decreased	
Amount spent on research purchased with hard cash	No impact	Probably increased	A detailed breakdown of hard cash spending was not available
Total amount spent on research through commissions	Decrease	Stable (slight decrease)	Slight decline relative to pension funds under management. Trend less clear relative to value of commission trading

Note: In the 2006 Oxera report, the performance indicators in relation to spending on non-permitted goods and services were summarised in Table 5.3.1 and in relation to spending on research in Table 5.3.2.

4 Commission rates and trading patterns

This section measures the performance indicators relating to the changes in commission rates and trading patterns. It was anticipated that the greater transparency of research pricing brought about by the change in the regime might make investment managers more selective in their research purchasing and strengthen competition among providers, leading to increased use of execution-only trading and downward pressure on the commission rate for non-execution goods and services.

The section concludes that:

– the core/bundled brokerage and execution-only commission rates have generally reduced over time;

– the split in core/bundled brokerage commission rates for execution and non-execution goods and services has been relatively stable over time;

– economies of scale continue to be reflected in commission rates, with higher transaction volumes attracting lower rates, but the differential appears to be narrowing slightly;

– investment managers are increasingly making use of execution-only trading methods such as electronic and programme trading.

The combination of increased use of execution-only methods and the falling basis points for research within core brokerage would indicate that the average cost of execution per unit of transaction is falling.

4.1 Introduction

As explained in section 3, the new regime could lead to a reduction in the amount spent on goods and services through commissions. In such a scenario, investment managers would require a smaller 'commission pool' from which to purchase goods and services through commissions. This could be achieved in three ways: investment managers could negotiate a reduction in the non-execution constituent of commission rates; second by reducing the volume of execution trading through bundled or CSAs; or third by switching to execution-only commission rates (ie, trade execution that does not include any non-execution goods and services).

These ways of reducing the commission pool form additional performance indicators to measure changes in the overall spending through commission and are assessed in the sections below.

The analysis of commission rates is presented first for the responses of the survey of brokerage firms and then the investment managers. The balance between the use of core-brokerage and execution-only trading is then assessed. The performance indicators in this section are hard and direct.

4.2 Findings on commission rates from the brokerage firms questionnaire

This section assesses the commission rates for core brokerage and execution-only, before examining the execution/research split in the core brokerage commission rates and the commission rates by trading type. The individual brokerage firms' commission rates for the 2008 survey are estimated by dividing the brokers' commission revenue for a particular type of trading by the associated value of that trading.

Table 4.1 presents the average commission rates provided by brokerage firms for execution-only transactions. For 2003–05 the execution rate reported in the table corresponds to a specific execution-only commission rate. However, for 2006 and 2007, the commission rate is estimated as a weighted average of estimated commission rates for electronic and programme trading. The weights for electronic and programme trading are calculated in terms of the relative magnitude of commission revenues between the two.

Table 4.1 Average commission rates for execution-only transactions based on the average of electronic and programme trading commission rates (bp)

	Consistent sample					Full sample		
	2003	2004	2005	2006	2007	2005	2006	2007
Simple average execution-only commission rate	10.8	7	6.3	4.2	4	6.7	5.1	4.3
Weighted average execution-only commission rate	8.2	6.9	6.2	4.1	3.5	6.3	5.9	4.6
Range of execution-only commission rates	5–23	5–8	5–8	3–6	2–6	5–10	3–12	1–8
Number of respondents	5	5	5	4	4	9	6	7

Note: Weights prior to 2006 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Weights for 2006 onwards are calculated on an annual basis using the responses to the latest brokerage firms questionnaire, Q6.
Source: Oxera calculations based on responses to the brokerage firms questionnaire (Q15 and Q18).

Table 4.1 indicates that, for the consistent sample, both the simple and weighted average execution-only commission rates charged by brokers declined consistently between 2003 and 2007.

Table 4.2 presents the average commission rates for core brokerage transactions over time. Similar to the figures for execution-only, Table 4.2 indicates that core brokerage commissions have declined from their 2003 levels, but have not fallen substantially in recent years.

For the years prior to 2006, the transactions were defined as bundled brokerage commission rates (which typically consist of core brokerage transactions—ie, 'high-touch' execution services—and in most cases some research). For 2006 onwards they were defined as core brokerage, which may or may not include research.

Table 4.2 Average commission rates for bundled/core brokerage transactions (bp)

	Consistent sample					Full sample		
	2003	2004	2005	2006	2007	2005	2006	2007
Simple average bundled/core brokerage commission rate	17.7	15.8	15.2	13.8	13.3	15.3	15.1	14.8
Weighted average bundled/core brokerage commission rate	17.3	14.9	14	13.7	13.3	14.7	14.5	14.4
Range of bundled/core brokerage commission rates	13–20	13–20	12–20	10–15	7–15	12–20	10–20	7–21
Number of respondents	8	8	8	7	7	10	11	11

Note: Weights prior to 2006 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Weights for 2006 onwards are calculated on an annual basis using the answers to the latest brokerage firms questionnaire, Q6.
Source: Oxera calculations based on responses to the brokerage firms questionnaire (Q15 and Q18).

Table 4.3 shows the trade execution and research constituents of bundled/core brokerage commission rates. For the years 2003 to 2005, the non-execution component of the core brokerage commission rate is proxied by subtracting the execution-only commission rate supplied by the brokerage firms from their bundled brokerage commission rate. However, for the current survey (ie, from 2006), the core brokerage commissions that were used for non-execution goods and services were subtracted from the total core brokerage commission expenditure, and the resulting number divided by the associated value of trading. The execution commission rate calculated on this basis will therefore be for a high-touch execution service. This will tend to result in the figures for the non-execution component of the commission rate for the years before 2006 being overestimated, and reduces the difference between the years before 2006 and 2006 and 2007.

Table 4.3 Constituents of bundled/core brokerage commission rates: brokers

	Consistent sample					Full sample		
	2003	2004	2005	2006	2007	2005	2006	2007
Bundled/core brokerage commission rate (bp)	16.3	14.4	14.4	14.3	14.2	15	14.5	14.4
Trade execution constituent of the bundled or core brokerage commission rate (bp)	8.2	6.9	6.2	7.6	7.6	6.3	7.8	7.5
Non-execution constituent of the bundled or core brokerage commission rate (bp)	8.1	7.5	8.2	6.6	6.6	8.6	6.8	6.9
Proportion for execution (%)	50.1	48.0	43.4	53.4	53.6	42.4	53.4	52.3
Number of respondents	4	4	4	4	4	9	9	9

Note: Weights prior to 2006 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Variation in response rates across the associated value of trades and within questions accounts for the variations in respondent numbers within years, and in some instances will lead to differences across tables and the average components of core brokerage commissions not summing to average core brokerage rates.
Source: Oxera calculations based on responses to Q18 of the brokerage firms questionnaire in 2006, and Q11 of the 2008 brokerage firms questionnaire.

Figure 4.1 The split in brokerage firms' bundled/core brokerage commission rates between execution and research (consistent sample)

Source: Oxera calculations based on responses to Q18 of the brokerage firms questionnaire in 2006, and Q11 of the 2008 brokerage firms questionnaire.

Table 4.3 and Figure 4.1 indicate that the proportional split between execution and research in brokerage firms' commission rates has remained relatively stable over time, at around 45–55%. With the general downward trend in the commission rates for execution-only trading, it might have been expected that the proportion of commissions for non-execution goods and services would have increased over time, but this has not been observed. This may be due to the regime exerting downward pressure on commissions for non-execution goods and services. In addition to results from the actual sales of services to investment managers, brokers were asked to provide typical pricing information for undertaking trades for a typical investment manager. Table 4.4 presents the results for an investment manager sending £250m worth of trades per annum, and indicates the following:

– all the execution-only commission rates—ie, programme trading; algorithmic trading and DMA—show clear downward trends over time;

– consistent with the data presented in Table 4.2, bundled/core brokerage commission rates have declined from their 2003 levels, but have not fallen in recent years.

Table 4.4 Weighted average typical commission rates on a menu of brokerage services (bp)

	2003	2004	2005	2006	2007
Programme trades	6.5	5.1	4.7	4.1	4.1
Number of respondents	4	4	5	7	7
Execution-only brokerage					
Direct market access	6.7	5.3	4.3	4.2	3.7
Number of respondents	3	4	7	6	6
Algorithmic	n/a	7.2	6.9	5.2	5.6
Number of respondents	0	2	5	4	4
Bundled/core brokerage	16.8	15.4	14.8	15.7	16.3
Number of respondents	7	7	9	10	10
Constituent for execution only	n/a	n/a	n/a	7.7	7.2
Constituent for research	n/a	n/a	n/a	8	9
Number of respondents	5	5	7	10/9	10/9

Note: Data is for typical commission rates for an investment manager trading £250m per annum. Weights prior to 2006 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Weights for 2006 onwards are calculated on an annual basis using the answers to the 2008 brokerage firms questionnaire, Q6.
Source: Oxera calculations based on responses to Q15 of the brokerage firms questionnaire in 2006, and Q9 of the 2008 brokerage firms questionnaire.

4.3 Findings on commission rates from the investment managers questionnaire

This section presents the results from the investment managers' survey for the estimated commission rates for execution-only trading, core brokerage and the split in core brokerage between the execution and non-execution components. The commission rates for an individual investment manager were estimated for a given trading type by dividing the investment managers' commission expenditure for that trading type by the associated value of trading.

In accordance with the presentation of the results for the brokerage firms, the execution-only rates estimated for the 2008 survey are based on a weighted average of the commission rates charged for electronic and programme trading. The breakdown of core brokerage commissions is estimated from the proportion of core brokerage commissions indicated by survey respondents (investment managers in this case) that were for execution and non-execution goods and services.

Table 4.5 indicates that, for the consistent sample, both the simple and weighted average declined between 2005 and 2006 (although slightly rose again in 2007). For the full sample, little change in the weighted average was apparent between 2005 and 2006, while in 2007 there was a marked decline.

Table 4.5 Average commission rates for execution-only transactions based on the average of aggregated electronic and programme trading commission rates (bp)

	Consistent sample					Full sample		
	2003	2004	2005	2006	2007	2005	2006	2007
Simple average execution-only commission rate	9.3	8.7	7.4	5.7	6	7.5	7.1	6.1
Weighted average execution-only commission rate	6.8	7.9	6.9	5.5	6	7	7.1	6.1
Range of execution-only commission rates	5–19	4–16	3–10	1–8	1–18	3–10	1–16	1–18
Number of respondents	13	13	13	7	7	16	11	11

Note: For 2003 to 2005, data is for actual commission rates. For 2005 onwards, commission rates are estimated as the average of electronic and programme trading, based on the data provided in response to Q29 of the investment managers questionnaire. Weights are based on investment managers' reported funds under management for pension fund clients, as provided in response to Q17 in the previous survey and Q6 in the current survey. The reduction in the response rate in the consistent sample between the previous and current surveys is due to response rates having varied across years and the removal of outliers.
Source: Oxera calculations and responses to Q6 and Q29 in the current investment managers questionnaire.

The core brokerage commission rate was estimated for the current survey across the consistent sample as the ratio of the total amount spent on core brokerage commissions to the total value of core brokerage trades. Table 4.6 shows the core/bundled brokerage commission rate across the time period analysed in the current and previous surveys.

Table 4.6 Average commission rates for bundled/core brokerage transactions (bp)

	Consistent sample					Full sample		
	2003	2004	2005	2006	2007	2005	2006	2007
Simple average bundled/core brokerage commission rate	16.7	16.5	15.9	12.8	11.9	15.1	12.8	12
Weighted average bundled/core brokerage commission rate	13.4	13.5	13.2	10.8	11.2	12.9	11.4	11.2
Range of bundled/core brokerage commission rates	10–25	10–25	10–24	4–22	4–25	10–24	4–22	4–25
Number of respondents	12	12	12	7	8	16	12	13

Note: For 2003 to 2005, data is for actual commission rates. For 2005 onwards, bundled brokerage commission rates are estimated as the total commission for bundled brokerage trades divided by the total value of bundled brokerage trades, based on the response to Q29 in the investment managers questionnaire. Weights are based on investment managers' reported funds under management for pension fund clients, as provided in response to Q17 in the previous survey and Q6 in the current survey.
Source: Oxera calculations and responses to questions Q6 and Q29 in the 2008 investment managers questionnaire.

Table 4.6 indicates that for both the consistent and full samples, the core/bundled brokerage commission rates have declined almost continuously since 2003—the decline being most pronounced for the simple average commission rate. Table 4.7 provides the split in the core brokerage commission rates into the execution and non-execution goods and services component. For the 2008 survey (2006 and 2007 data), this is based on subtracting the commissions that the respondents indicated they paid for non-execution goods and services from the total core brokerage commissions, and dividing the resulting number by the associated value of trading. Prior to 2008 the execution-only component is proxied by the commission rate charged for execution-only services (which, as for the brokers, may underestimate this component because these services are generally 'low touch'). The figures are not presented for the full sample since consistency issues with the commission components reduced the sample size to a level where it was not substantially different from the consistent sample.

Table 4.7 Proxy for the non-execution commission rates

	Consistent sample				
	2003	2004	2005	2006	2007
Bundled/core brokerage commission rate (bp)	15	15.5	14.9	11.8	9.3
Execution-only commission rate (bp)	6.8	8.2	7.7	6.0	5.5
Proxy for the *non-execution* constituent of the bundled/core brokerage commission rate (bp)	8.2	7.3	7.2	5.9	4.4
Proportion for execution (%)	45.5	52.8	51.7	50.3	55.6
Number of respondents	10	10	10	7	7

Note: For 2003 to 2005, data is for actual commission rates. For 2005 onwards, data is estimated based on responses to Q29 of the investment managers questionnaire. The figures for bundled brokerage and execution-only commissions are weighted averages, and the weights are based on reported pension fund assets under management, provided in response to Q6 of the investment managers questionnaire. Commissions for capital commitment were included as counting towards execution commissions.
Source: Oxera calculations and responses to Q6 and Q29 in the current investment managers questionnaire.

Although the precise numbers are different, the pattern that emerges from both the brokers and investment managers questionnaires is that bundled/core commission rates have tended to fall through time, with the split between execution and non-execution largely stable. Given the underlying downward trend in execution-only commission rates, the proportion of core brokerage commissions for non-execution goods and services might have been expected to increase over time, but this has not happened. Indeed, in the surveys of investment managers and brokerage firms, there is evidence of a slight decrease in the proportion of commissions for non-execution goods and services since 2005, which may imply that the regime is exerting a downward pressure on the commission rates for non-execution goods and services.

4.4 How brokerage firms' commission rates vary according to the size of investment managers' trading orders

It had been argued that the 2006 change in regime might increase the research costs for smaller investment managers relative to larger firms. This is because improved transparency for research pricing might allow the larger investment managers to use their greater buyer power to negotiate lower commission rates from brokers, reducing the cross-subsidisation in research pricing.

To assess this, information was requested (in both the current and previous surveys) from brokerage firms on the typical commission rates charged to investment managers placing trading orders of £100m, £250m and £500m per annum. The information on the weighted average commission rates for these is presented in Tables 4.8 and 4.9 for execution-only and bundled/core brokerage rates respectively. Data for the years 2006 and 2007 is based on the 2008 survey responses, while the 2005 figures are derived from the responses to the previous survey.

Table 4.8 Weighted average commission rates for execution-only transactions (bp)

	£500m			£250m			£100m		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Weighted average execution-only commission rate. Core brokerage execution component used from 2006	6.3	7.7	7.1	6.8	7.7	7.2	6.9	7.9	7.4
Weighted average electronic commission rate		5.5	5.2	n/a	5.8	5.3	n/a	5.8	5.7
Weighted average programme trading commission rate		4.2	3.7	n/a	4.1	4.1	n/a	5.0	5.1
Number of respondents	8	9,4,7	9,4,7	8	9,5,6	9,5,6	8	9,4,6	9,5,6

Note: Data is for typical commission rates. Weights for 2005 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Weights for 2006 onwards are calculated on an annual basis using the responses to Q6 in the latest brokerage firms questionnaire. For 2006 and 2007 some respondents did not provide information on all commission rates; hence the variation in response numbers for these years. Reading from left to right, the number of respondents corresponds to the response rate to the different types of trading reading down the table.
Source: Oxera calculations based on responses to the current brokerage firms questionnaire (Q9) and the previous survey (Q15).

– **Execution component of core brokerage**—the average execution component of core brokerage commission rates appears to be fairly similar across the three sizes of trading order.

– **Electronic trading**—the typical commission rate charged by brokers for electronic trading is generally higher for those investment managers that are sending smaller volumes of transactions to the broker.

– **Programme trading**—the programme trading commission rate charged by brokers is higher for investment managers sending smaller values (£100m) of transactions to the brokerage firm. The differential between the commission rates for investment managers sending £100m worth of trades and those sending larger orders increased slightly between 2006 and 2007 due to a fall in the commission rate for annual trade orders of £500m.

Table 4.9 Weighted average commission rates for core/bundled brokerage transactions (bp)

	£500m			£250m			£100m		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Weighted average core/bundled brokerage commission rate	13.3	14.4	14.4	16.0	15.8	16.3	18.6	16.5	16.2
Range of core/bundled brokerage commission rates	12–20	10–16	10–17	13–20	11–18	11–22	15–20	15–20	12–20
Number of respondents	9	10	10	9	10	10	9	11	11

Note: Data is for typical commission rates. Weights for 2005 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Weights for 2006 onwards are calculated on an annual basis using the responses to Q6 in the latest brokerage firms questionnaire.
Source: Oxera calculations based on responses to the current brokerage firms questionnaire (Q9) and the previous survey (Q17).

Table 4.9 indicates that the typical commission rates charged by brokerage firms are generally lower for the larger trades than for smaller ones. The effect is more pronounced than for execution-only commission rates. However, there seems to have been some convergence in the core brokerage commission rates across the different size categories over the periods. The rates charged to investment managers sending £100m trade orders have decreased year on year, while those for trade orders of £250m and £500m show evidence of increasing in recent years.

One of the potential (unintended) consequences of the new regime that had been identified was an increase in the relative buyer power of large investment manager firms over small ones. If this impact occurred, price dispersion (in terms of a widening gap between typical commission rates) would be expected to increase with the volume of transactions sent to brokers by individual investment managers. The information on what brokers would charge investment managers sending different levels of transactions suggests that this has not happened and, if anything, the differential has narrowed.

4.5 Changes in the use of different types of transaction method

This section assesses the extent to which trading patterns have changed. Table 4.10 shows a breakdown of the distribution of trading activity provided by investment managers. This is for the full sample of investment manager respondents between 2003 and 2007. In the 2006 survey, estimates of the balance of trading in 2006 were provided and these have been included in the table.

Table 4.10 Proportion of trades for a menu of brokerage services: investment managers (%)

	2003	2004	2005	2006	2007
Programme trades	8	8	8	23	22
Electronic brokerage	5	5	6	15	19
DMA	1	1	1	2	1
algorithmic	0.1	0.2	1	8	12
other	4	4	5	n/a	n/a
Bundled/core brokerage	87	87	86	61	58
Total	**100**	**100**	**100**	**100**	**100**
Number of respondents	14	14	14	13	15

Note: Weights are based on the investment managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to Q17 of the original investment managers questionnaire or the supplementary investment managers questionnaire, and the equivalent information from Q6 of the 2008 investment managers questionnaire.
Source: Oxera calculations based on responses to the original investment managers questionnaire (Q24) and the 2008 investment managers questionnaire.

Table 4.10 indicates that investment managers' trading volumes have switched away from core (bundled in the last survey) brokerage and that there have been significant increases in the proportion of trades undertaken through programme and electronic trading. There were higher volumes of programme trading than electronic trading over the whole period.

Oxera calculations, based on the annual survey of UK asset management that is undertaken by the IMA (the IMA 'Asset Management Survey'), indicate that around 40% of investment managers' trading in 2007 was execution only. This is consistent with the finding in Table 4.10 that electronic and programme trading were, collectively, 40%.[13] For previous years the IMA survey indicates a higher proportion of execution-only trading than is found in Table 4.1.

[13] Oxera calculations based on IMA (2007), 'Asset Management Survey', p. 88, Table 12. Weighted average of table categories' midpoints, where the weights are derived from the assets under management.

This may be because the figures in the table relate to UK equities, whereas trading in overseas equities is more likely to involve execution-only trading methods.

Brokerage firms were also asked to provide information on their trading patterns. The responses indicated that among some of the firms there was increased usage of electronic trading in recent years, although others seemed to use a fairly stable level of bundled brokerage over time. This is consistent with the information from brokers. Owing to concerns about data consistency, this information is not considered sufficiently robust to present in table form.

4.6 Conclusions

A number of impacts were expected in relation to commission rates and the pattern of trading. The evidence suggests that the positive impacts have largely been fulfilled, while the possible negative impact of widening the commission differential along the dimension of value of transactions has not taken place. In particular:

– the commission rates charged by brokerage firms have generally fallen over the period for both core/bundled brokerage and execution-only trading. However, the split in core brokerage commission rates for execution and non-execution goods and services has been relatively stable over time;

– there is a generally recognised downward trend in execution-only commission rates owing to technological improvements. It is hard to disentangle the impact of the regime from this, but the evidence of falling core brokerage commission rates and the relative stability of the commission split for execution (and non-execution) goods and services over time are consistent with the regime exerting a downward pressure on the commissions for non-execution goods and services by splitting the market for research from that of execution, and making more explicit the price of research obtained through commissions. Indeed, there is some evidence that the proportion of commissions for non-execution goods and services has fallen since 2005;

– within the general decrease in rates, the differential between typical commission rates for different volumes of transactions remains, but has not increased—if anything it appears to have decreased slightly;

– investment managers are increasingly making use of execution-only trading methods such as electronic and programme trading. The combination of increased use of these methods, and the falling basis points for research within core brokerage, would indicate that the average cost of execution per unit of transaction is falling.

The main performance indicators in this area and their movement are set out in Table 4.11. below.

Table 4.11 Impact on the main performance measures with respect to commission rates

Performance indicator	Expected change	Actual change	Notes
Reduction in the spending on non-execution goods and services			
Commission rates for core/bundled brokerage	Decrease	Decreased	Declining trend without change in the regime (technological changes)
Commission rates for the non-execution element of core/bundled brokerage	Decrease	Decreased	See above
Changes in the proportion of execution-only trading	Increased	Increased	There has been an increase in the proportion of electronic and programme trading

Note: In the 2006 Oxera report, the performance indicators in relation to spending on non-execution goods and services were summarised in Table 5.3.4.

5 Impact on distribution of research and market structure

It was considered possible that the changes brought about by the regime might lead to increased specialisation and concentration in the market for execution, with potential effects on competition. The market for research was expected to become less concentrated, with investment managers gaining easier access to a wider range of research providers through CSAs.

Increased transparency of research pricing might allow larger investment managers to use their relative buyer power to negotiate lower fees than they currently pay for the research provided by brokers leading to greater differentiation in the commission rates obtained by different sizes of investment manager.

This section examines whether these potential negative effects of the new regime have materialised. It measures performance indicators in relation to the structure of the market for brokerage and research services, and the distribution of research costs among investment managers. It concludes that there is:

– little evidence that the total market for brokerage services for UK equity trading has become significantly more concentrated as a result of the change in the regime. This means that this potential negative effect has not materialised;

– there is no evidence of smaller trading volumes becoming significantly more expensive than larger trading volumes and no evidence that this is, in particular, the case for bundled or core brokerage commission rates (which may include research). This suggests that the potential effect of smaller investment managers bearing a larger part of research costs (compared with before the change in regime) has not materialised.

5.1 Introduction

This section examines whether a number of potential negative effects of the new regime have materialised. It measures (direct and indirect hard) performance indicators in relation to the structure of the market for brokerage and research services, and the distribution of research costs among investment managers.

Structure of the market for brokerage and research services—the change in the regime and adoption of CSAs make it possible for investment managers to use commissions paid to one broker to purchase research from another. This leads to the possibility that investment managers may separate their choice of execution venue from their choice of where to purchase research. As a result, investment managers may choose to use a smaller number of brokers, and to select (for the execution of trades) only those brokers that offer the best execution service. If this results in investment managers all selecting the same set of brokers for the execution of trades, the concentration of the brokerage market could increase.

The impact on investment manager (and funds) of this separation and concentration may be positive or negative. The separation of brokers into those that specialise in providing execution and those that specialise in providing research has led to the execution specialists competing on the basis of the price and quality of execution. This would be expected to lead to a reduction in the price of trade execution and an increase in its quality. However, if the market for execution becomes too concentrated, this may have the reverse effect—the price of trade execution could increase and its quality decline.

Distribution of research costs among investment managers—both before and after the change in the regime, the costs of research and execution-related goods and services provided by brokers and investment managers are paid for through commissions. As such, before the change in the regime, there was little visibility of the actual price paid by any investment manager for the research output they consumed.

Following the change in the regime, when setting bundled brokerage commission rates between investment managers and brokers, it must be agreed how many basis points are being paid for execution and how many for research and execution-related goods and services. This means that the new regime makes the total amount of commission paid by a particular investment manager for the research provided by a particular broker more transparent. Large investment managers may now use their relative buyer power to negotiate lower fees than they currently pay for the research provided by brokers; this could also be exacerbated by a move towards agreeing a fixed budget for research. These effects are measured by assessing the variation in commission rates charged to investment managers of different sizes.

5.2 Market structure for brokerage and research services

To assess whether the new regime has affected the distribution of trades between brokerage firms and investment managers, investment managers were asked to provide the proportion of their trades that went to their top 5, top 10, top 15, top 20 and other brokerage firms. The results are presented Table 5.1 and Figure 5.1.

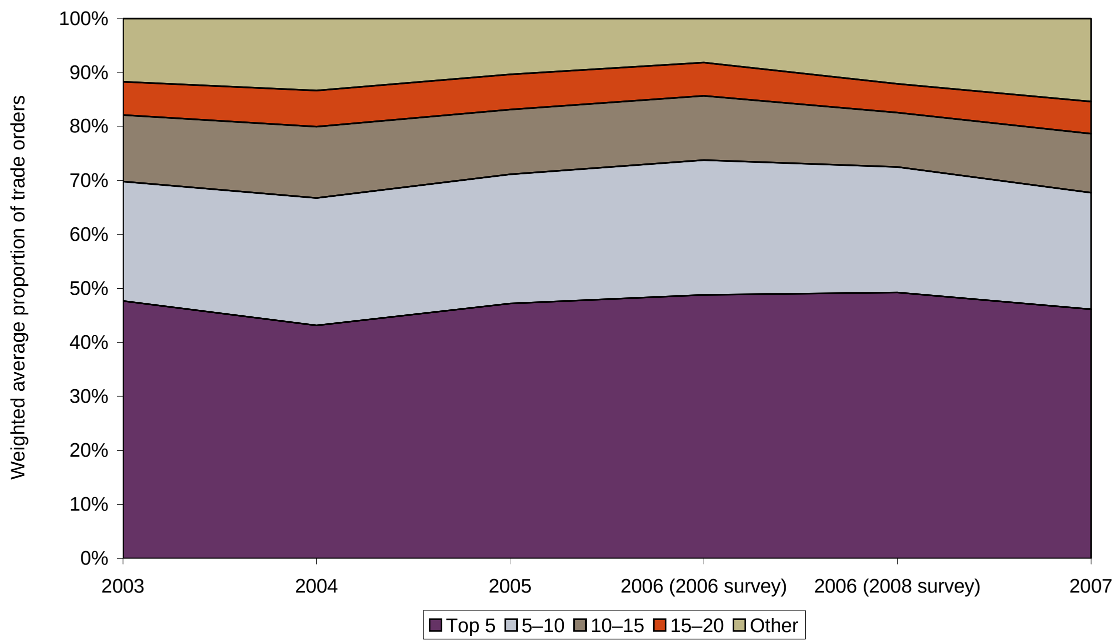
The original sample of investment managers in the first study was 14 firms between 2003 and 2006. There are 11 useable responses from the present survey, which have been used to calculate the weighted average results for 2006 and 2007. Investment managers also provided 2006 estimates in the previous survey, based on the year to March 2006, which have been included for completeness.

Table 5.1 Weighted average proportions of trades going to brokers (%) (14 investment managers, 2003–06, and a sub-set of 11 investment managers, 2006–07)

		2003	2004	2005	2006 (previous survey)	2006	2007
Top 5 brokers	Proportion	48	43	47	49	49	46
	Cumulative	48	43	47	49	49	46
Brokers 6–10	Proportion	22	24	24	25	23	22
	Cumulative	70	67	71	74	73	68
Brokers 11–15	Proportion	12	13	12	12	10	11
	Cumulative	82	80	83	86	83	79
Brokers 16–20	Proportion	6	7	7	6	5	6
	Cumulative	88	87	90	92	88	85
Other brokers	Proportion	12	13	10	8	12	15
	Cumulative	100	100	100	100	100	100

Note: Weights for the current survey are based on total assets under management for 2006 and 2007. Weights for the previous survey are based on the total value of funds managed in the UK, as provided in Q1 of the original investment managers questionnaire.
Source: Oxera calculations based on responses to the original investment managers questionnaire (Q13), and Q19, Table 5.2 of the current investment managers questionnaire.

Figure 5.1 Weighted average proportions of trades going to brokers



Note: Weights are based on the total value of funds managed in the UK.
Source: Oxera calculations based on responses to the original investment managers questionnaire (Q13) and Q19, Table 5.2 of the current investment managers questionnaire.

As can be seen from Figure 5.1 and Table 5.1, there is no clear evidence that the brokerage market is becoming significantly more concentrated in terms of the volume of trade orders. The only significant increase between 2006 and 2007 has been in the 'Other brokers' category. It may be that, as a result of the new regime, investment managers use more smaller brokers because sending trades to them does not affect their ability to obtain research from other brokers—in other words, investment managers separate the choice of execution venue from their choice of where to purchase research.

The fact that most of the proportions have remained stable does not mean that the same brokers are being used. Although the survey data does not provide any further information, it is likely that the actual firms that constitute the top 5, top 5–10 etc, have changed between the years.

When investment managers were asked to examine the concentration by research expenditure of their top 5, top 10, top 15, top 20 and other research providers, the distribution was similar. The values of this for 2006 and 2007 are presented in Table 5.2 below.

Table 5.2 Weighted average proportions of research expenditure by research providers (%)

		2006	2007
Top 5 research providers	Proportion	45	47
	Cumulative	45	47
Next 5 research providers (6–10)	Proportion	22	21
	Cumulative	67	68
Next 5 research providers 11–15	Proportion	11	11
	Cumulative	78	79
Next 5 research providers (15–20)	Proportion	6	7
	Cumulative	84	85
Other research providers	Proportion	16	15
	Cumulative	**100**	**100**

Note: Weights are based on total assets under management.
Source: Oxera calculations based on responses to the investment managers questionnaire, Q21, Table 5.3.

Given the increased use of third-party providers found in section 2, the research purchases might have been expected to have become less concentrated. It should not be assumed that this is necessarily inconsistent with these findings on concentration. The research providers in any given category (eg, top 5, top 10, etc) may not be the same in the years 2006 and 2007—indeed, some changes would be expected. Furthermore, the proportion of expenditure with third-party research providers may have increased, with these companies having displaced some of the brokerage providers in the rankings.

When the change in the concentration ratio is examined at an individual firm level, there is an indication that there is a trend of firms buying a lower proportion of research from their top 5 research providers. Table 5.3 indicates the pattern across firms between 2005 and 2007.

Table 5.3 The number of firms that changed their proportion of research expenditure with their top 5 research providers between 2005 and 2007

Number of respondents for which the proportionate expenditure with their top 5 research providers:	Increased	Remained constant	Decreased
between 2005 and 2007	4	2	8

Source: Oxera calculations based on responses to the investment managers questionnaire, Q21, Table 5.3.

Most firms reduced their expenditure with their top 5 research providers. This does not show up in the weighted average calculations as these are driven by the larger firms. This is generally supportive of a trend for research purchases becoming less concentrated.

Investment managers were also asked what proportion of their top 10 research providers were also their top 10 executing brokers. Although this is not one of the performance indicators, it provides further insight into the extent to which investment managers separate their choice of trade execution venue and research provider.

Table 5.4 The proportion of investment managers' top 10 research providers that were also their top 10 execution brokers (%)

Simple average	75
Mode	70
Range	30–100
Sample size	15

Source: Oxera calculations based on responses to the investment managers questionnaire, Q22.

The mean proportion of investment managers' top 10 research providers that were also their top 10 execution brokers was 75% (the most common expenditure was 70%), although some providers had quite low overlaps (minimum 30%). Given the high proportion of expenditure on research that was through the top 10 research providers (68%), this is consistent with a substantial proportion of expenditure on research currently residing with the large executing brokers. It also explains, in part, why the concentration of execution and research orders is so similar. However, while there is not a direct equivalent of this information for earlier years, the combination in the past of low expenditure on research through hard cash and low proportion of commissions available through soft commission arrangements to pay for (usually non-brokerage) research suggests that the overlap would have been greater than this in the past.

5.2.1 Conclusions on the structure for brokerage and research services

There is little evidence that the total market for brokerage services for UK equity trading has become significantly more concentrated as a result of the change in the regime. There is some evidence of an increase in the level of trading going to the smallest brokers.

Furthermore, at an aggregate level there has been little change in the concentration of the research providers used by investment managers. However, there is evidence from respondents' use of CSAs (see section 2) that investment managers are using a wider range of research providers. Indeed, at an individual firm level, there is evidence that some firms are using an increasing range of third-party research providers, which suggests that the trend may be towards less concentration.

5.3 Distribution of research costs among investment managers

As explained above, improved transparency for research pricing might allow the larger investment managers to use their greater buyer power to negotiate lower commission rates from brokers, reducing the cross-subsidisation in research pricing.

To assess this, information was requested (in both the current and previous surveys) from brokerage firms on the typical commission rates charged to investment managers placing trading orders of £100m, £250m and £500m per annum. The information on the weighted average commission rates for these is presented in Tables 5.5 and 5.6 for execution-only and bundled/core brokerage rates respectively. Data for the years 2006 and 2007 is based on the 2008 survey responses, while the 2005 figures are derived from the responses to the previous survey.

Table 5.5 Weighted average commission rates for execution-only transactions (bp)

	£500m			£250m			£100m		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Weighted average execution-only commission rate. Core brokerage execution component used from 2006	6.3	7.7	7.1	6.8	7.7	7.2	6.9	7.9	7.4
Weighted average electronic trading commission rate		4.6	5.6	n/a	5.0	4.8	n/a	5.6	5.9
Weighted average programme trading commission rate		4.2	3.7	n/a	4.1	4.1	n/a	5.0	5.1
Number of respondents	8	9,5,7	9,5,7	8	9,5,6	9,5,6	8	9,4,6	9,5,6

Note: Data is for typical commission rates. Weights for 2005 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Weights for 2006 onwards are calculated on an annual basis using the answers to the latest brokerage firms questionnaire Q6. For 2006 and 2007 some respondents did not provide information on all commission rates; hence the variation in response numbers for these years. Reading from left to right, the numbers of respondents correspond to the response rate to the different types of trading reading down the table.
Source: Oxera calculations based on responses to the current brokerage firms questionnaire (Q9) and the previous survey (Q15).

– **Execution component of core brokerage**—the average execution component of core brokerage commission rates appears to be fairly similar across the three sizes of trading order.

– **Electronic trading**—the typical commission rate charged by brokers for electronic trading is generally higher for those investment managers that are sending smaller volumes of transactions to the broker. There is some evidence of convergence, with the £500m commission rate increasing between 2006 and 2007, to a level where it is not that much lower than that obtainable by investment managers sending £100m. The rate for £250m of trading fell for the same time period.

– **Programme trading**—the programme trading commission rate charged by brokers is higher for investment managers sending smaller values (£100m) of transactions to the brokerage firm. The differential between the commission rates for investment managers sending £100m worth of trades and those sending larger orders increased slightly between 2006 and 2007 due to a fall in the commission rate for annual trade orders of £500m.

Table 5.6 indicates that the typical commission rates charged by brokerage firms are generally lower for the largest trades than for smaller ones. The effect is more pronounced than for execution-only commission rates. However, there seems to have been some convergence in the core brokerage commission rates across the different size categories over the periods. The rates charged to investment managers sending £100m trade orders have decreased year on year, while those for trade orders of £250m and £500m show evidence of increasing in recent years.

Table 5.6 Weighted average commission rates for core/bundled brokerage transactions (bp)

	£500m			£250m			£100m		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Weighted average core/bundled brokerage commission rate	13.3	14.4	14.4	16.0	15.8	16.3	18.6	16.5	16.2
Range of core/bundled brokerage commission rates	12–20	10–16	10–17	13–20	11–18	11–22	15–20	15–20	12–20
Number of respondents	9	10	10	9	10	10	9	11	11

Note: Data is for typical commission rates. Weights for 2005 are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to Q1 of the brokerage firms questionnaire. Weights for 2006 onwards are calculated on an annual basis using the answers to the latest brokerage firms questionnaire, Q6.
Source: Oxera calculations based on responses to the current brokerage firms questionnaire (Q9) and the previous survey (Q17).

Overall, there is no evidence of smaller trading volumes becoming significantly more expensive than larger trading volumes and no evidence that this is, in particular, the case for bundled or core brokerage commission rates (which may include research). This suggests that the potential effect of smaller investment managers bearing a larger part of research costs (compared with before the regime) has not materialised.

The data in Tables 5.5 and 5.6 is based on typical commission rates rather than the actual rate that is obtained. This means that this measure may only partially pick up the bargaining power of large investment managers, with them in practice being able to negotiate lower commission rates than the rates observed here. However, data from individual investment managers of different sizes was examined and did not provide any indication that smaller investment managers pay now relatively higher commission rates for execution and research than before the regime.

5.4 Conclusions

The following conclusions can be drawn on the basis of the analysis.

– There is little evidence that the total market for brokerage services for UK equity trading has become significantly more concentrated as a result of the change in the regime. There is some evidence of an increase in the level of trading going to the smallest brokers. This means that this potential negative effect has not materialised.

– A number of additional indicators were measured that are not official performance indicators but do provide useful insight into the extent to which investment managers separate their choice trade execution venue and research provider. The aggregate information on the concentration of the market for the provision of research appears to show little change in concentration between 2006 and 2007. Furthermore, the proportion of investment managers' top 10 research providers that were also their top 10 execution brokers is at estimated at 75% on average. Although this may look high, it seems reasonable, on the basis of the previous arrangements for purchasing research, to suppose that this was higher in the past. Indeed, when the survey data is analysed at the individual firm level, there is also evidence that many investment managers are increasingly using a wider range of research providers.

– It was considered possible that the softing and bundling regime might have reduced the core brokerage commissions of the largest investment managers, as they will be the firms best placed to exploit their bargaining power in negotiations on the payment for non-execution goods and services, thereby increasing the difference in the commission rates between firm sizes. However, this effect has not been observed.

The main performance indicators in this area and their movement are set out in Table 5.7 below.

Table 5.7 Impact on the main performance measures with respect to the impact on distribution of research and market structure

Performance indicator	Expected change	Actual change	Notes
Impact on the structure of the market for brokerage and research services			
Concentration of investment managers' use of brokerage trade execution services	Increase in concentration	No significant change across the market for execution as a whole	As this change would have been adverse, this is a positive outcome
Distribution of research costs among investment managers	Relative increase in the commission rates for smaller investment managers	Not observed—in fact there has been some convergence in commission rates	
Concentration of investment managers' purchase of research (not an official performance indicator)	Stay the same or decrease	Stayed the same or decreased	Aggregate concentration data is unchanged, but evidence at an individual firm level (from use of CSAs) indicates that it may be decreasing

Note: In the 2006 Oxera report, the performance indicators in relation to the distribution of research and market structure were summarised in Table 5.3.5.

6 Impact on market liquidity and research quality and coverage

If the change in the regime resulted in increased concentration of the market for execution then it was considered possible that there might be a reduction in the quality of execution (as measured by market liquidity). If there were also significant changes in the market structure of research provision, the availability/coverage and quality of research might also be affected. These were therefore considered as performance indicators.

This section reports on these indicators. It concludes that, although market liquidity has worsened to some extent, there is no evidence that this is due to the new regime, with the credit crunch being identified as the main factor behind any deterioration. Furthermore, most respondents indicated that there had not been substantial changes in the quality, availability and coverage of research. Where respondents indicated deterioration, this was most likely to be in FTSE small cap stocks. Explanations given for any deterioration included larger brokerage firms reducing their coverage in this sector and the current financial environment.

6.1 Introduction

This section measures a number of (indirect hard) performance indicators to assess the potential impact of the new regime on market liquidity and research quality and availability. As discussed in the previous section on market structure, it was considered possible that the new regime might lead to an increased concentration of the brokerage market. There were, as a result, some concerns that the change in the regime for dealing commission might affect the quality of trade execution. The principal means by which the quality of execution might be affected, as identified by LIBA and IMA, is through the liquidity of the market. The trade associations suggested that an impact of the change in the regime would be a reduction in trading, resulting in reduced liquidity.

Measuring the impact on market liquidity is far from straightforward. Even though measures of market liquidity exist, as does the data, any changes in market liquidity may be driven by a range of factors. Therefore, it was agreed to attempt to measure the impact of the change in the regime for the quality of execution by means of a soft performance indicator: investment managers' and brokers' perceptions of liquidity of trade execution in different segments of the market over time.

It was also considered possible that the introduction of the new regime might have an impact on the quality and availability of research. These could potentially improve through increased competition, but might also worsen if industry concentration increased. To assess the extent of any such change, investment managers were therefore asked for their perceptions of research quality and availability, while brokerage firms were asked about their research coverage.

6.2 Assessment of impact on market liquidity

To assess the impact of the new regime on market liquidity, this section analyses investment managers' and brokers' views on market liquidity across the FTSE 100, FTSE 250 and FTSE Small Cap stocks. The survey participants' perceptions of the levels of (and trends in) market liquidity, across the three market segments analysed, are presented below in Tables 6.1 and 6.2 (for investment managers) and Tables 6.3 and 6.4 (for brokers).

Table 6.1 Investment managers' perceptions of market liquidity (% of respondents)

	FTSE 100			FTSE 250			FTSE Small Cap		
	2006 baseline survey	2006 calendar year	2007 calendar year	2006 baseline survey	2006 calendar year	2007 calendar year	2006 baseline survey	2006 calendar year	2007 calendar year
Excellent	44	50	28	4	17	17	0	0	0
Good	48	44	50	33	50	17	4	28	11
Reasonable	7	6	17	56	33	56	35	61	33
Poor	0	0	6	7	0	11	54	11	44
Very poor	0	0	0	0	0	0	8	0	11
Number of respondents	27	18	18	27	18	18	26	18	18

Source: Oxera calculations based on 27 responses to the original investment managers questionnaire for 2006 baseline data. The data for the 2006 and 2007 calendar years is based on 18 responses. For the 2008 survey the categories were slightly different, but were broadly consistent with those identified above.

Table 6.2 Investment managers' perceptions on trends in market liquidity (% of respondents)

	FTSE 100		FTSE 250		FTSE Small Cap	
	2006 baseline survey	2008 survey	2006 baseline survey	2008 survey	2006 baseline survey	2008 survey
Better	50	11	62	17	35	0
Same	50	50	35	39	46	50
Worse	0	39	4	44	19	50
Number of respondents	26	18	26	18	26	18

Source: Oxera calculations based on 26 responses to the original investment managers questionnaire for 2006 baseline data. The data for the 2006 and 2007 calendar years is based on 18 responses. For the 2008 survey the categories were slightly different, but were broadly consistent with those identified above.

Table 6.3 Brokers' perceptions on market liquidity (%)

	FTSE 100			FTSE 250			FTSE Small Cap		
	2006 baseline survey	2006 calendar year	2007 calendar year	2006 baseline survey	2006 calendar year	2007 calendar year	2006 baseline survey	2006 calendar year	2007 calendar year
Excellent	54	70	70	0	0	10	0	9	0
Good	46	20	20	62	20	40	8	9	27
Reasonable	0	10	10	38	80	40	46	36	9
Poor	0	0	0	0	0	10	46	18	45
Very poor	0	0	0	0	0	0	0	27	18
Number of respondents	13	10	10	13	10	10	13	11	11

Source: Oxera calculations based on 13 responses to the brokerage firms questionnaire for 2006 baseline data. The data for the 2006 and 2007 calendar years is based on 10 responses for the FTSE 100 and FTSE 250 stock and 11 responses for the FTSE Small Cap stock. For the 2008 survey, the categories were slightly different, but were broadly consistent with those identified above.

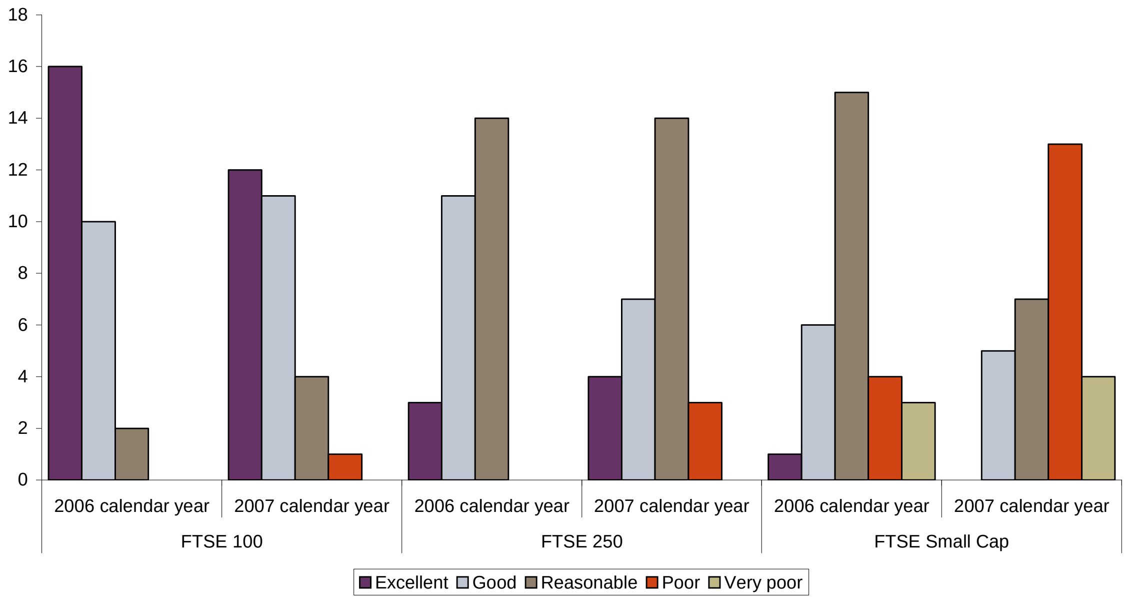
Table 6.4 Brokers' perceptions on trends in market liquidity (% of respondents)

	FTSE 100		FTSE 250		FTSE Small Cap	
	2006 baseline survey	2008 survey	2006 baseline survey	2008 survey	2006 baseline survey	2008 survey
Better	62	30	69	40	31	27
Same	38	60	31	40	69	45
Worse	0	10	0	20	0	27
Number of respondents	13	10	13	10	13	11

Source: Oxera calculations based on 13 responses to the brokerage firms questionnaire for 2006 baseline data. The data for the 2006 and 2007 calendar years is based on 10 responses for the FTSE 100 and 250 stock and 11 responses for the FTSE Small Cap stock.

Figure 6.1 summarises investment managers' and brokers' perception of market liquidity across the three indices for 2006 and 2007. In general, the FTSE 100 was perceived to be the most liquid of the three indices and to have remained broadly constant between 2006 and 2007, or deteriorated somewhat, whereas the liquidity of the FTSE 250 index decreased. The liquidity of FTSE Small Cap stocks decreased 'markedly' between 2006 and 2007, more than the decrease witnessed in the other market segments. This was driven primarily by a change in respondents' perception of liquidity from 'reasonable' to 'poor'.

Figure 6.1 Aggregated investment managers' and brokers' perceptions on market liquidity for 2006 and 2007 (calendar years) (number of respondents)

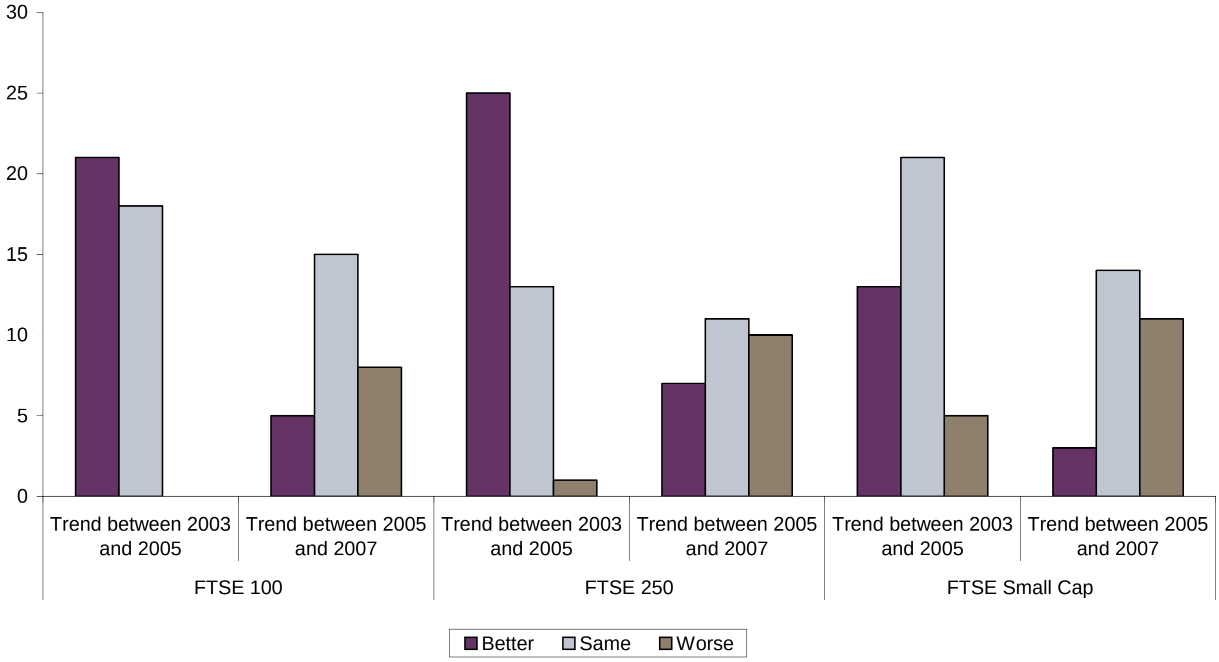


Source: Oxera calculations based on response to investment managers (Q39) and brokerage firms questionnaire (Q19).

Figure 6.2 shows the trend in market liquidity across the three types of indices between 2003 and 2005, and between 2005 and 2007 for both investment managers and brokers. For all the three indices, the perceived underlying trend in market liquidity, where there has been a change, has been predominantly negative.

There appears to be a growing divergence between brokers and investment managers in terms of their perspectives on trends in liquidity. In the 2006 baseline survey, brokers were slightly more optimistic but the difference was not significant. In 2008, only 10% of brokers consider that it is deteriorating for FTSE 100 stocks, while nearly 40% of investment managers consider that it is deteriorating. The divergence is not quite so marked for FTSE 250 and Small Cap stocks, but it is still evident.

Figure 6.2 Investment managers' and brokers' perceptions on trends in market liquidity (number of respondents)



Source: Oxera calculations based on responses to investment managers (Q39) and brokerage firms questionnaires (Q19).

6.3 Trends in research availability and quality

To assess the impact on the quality of research, across the FTSE 100, 250 and Small Cap indices, data on the following was obtained from the questionnaires:

– investment managers' perceptions on research quality and availability;
– brokerage firms' views of their own research coverage.

6.3.1 Investment management firms' perceptions of research quality

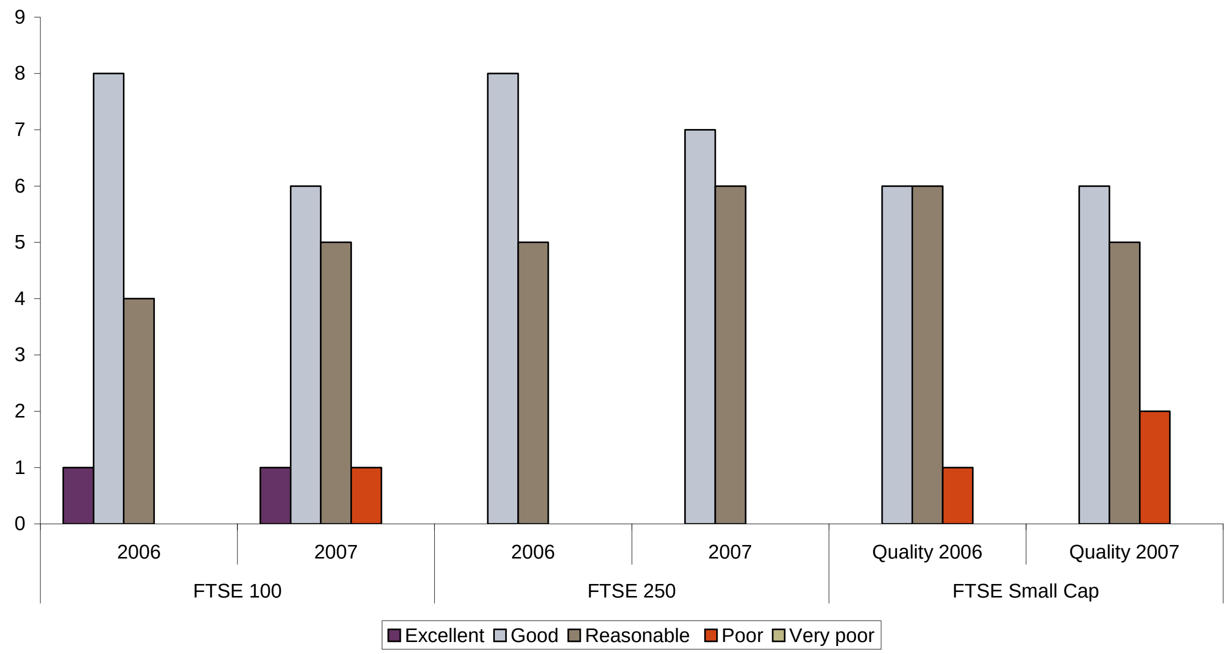
Table 6.5 and Figure 6.3 represent the investment managers' perceptions of the quality of research across the FTSE 100, 250 and Small Cap indices. In general, they considered that the quality of research provided has remained unchanged or deteriorated slightly between 2006 and 2007 for all three FTSE indices.

Table 6.5 Investment managers' perceptions of research quality (% of respondents)

	FTSE 100		FTSE 250		FTSE Small Cap	
	2006	2007	2006	2007	2006	2007
Excellent	8	8	0	0	0	0
Good	62	46	67	54	46	46
Reasonable	31	38	33	46	46	38
Poor	0	8	0	0	8	15
Very poor	0	0	0	0	0	0
Number of respondents	13	13	12	13	13	13

Source: Oxera calculations based on 13 responses to the investment managers questionnaire (Q41).

Figure 6.3 Investment managers' perceptions of research quality (number of respondents)



Source: Oxera calculations based on responses to the investment managers questionnaire (Q41).

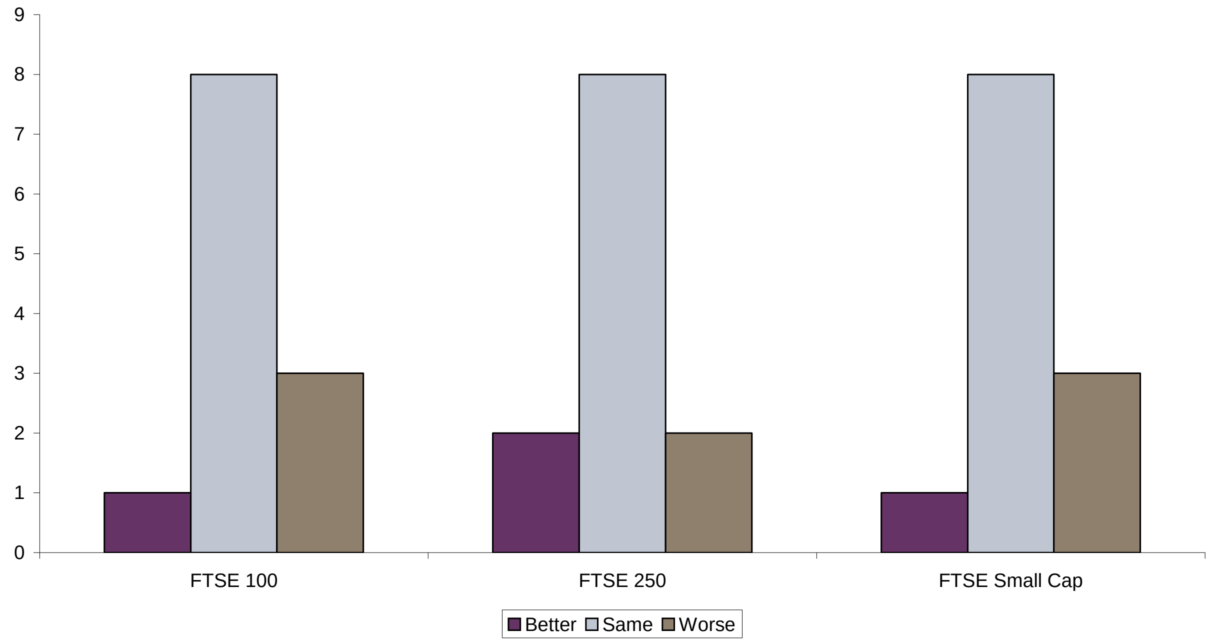
Table 6.6 and Figure 6.4 show the trend in quality of research between 2005 and 2007 for a sample of investment managers. The majority of respondents believed that the quality of research had not changed across the three FTSE indices over the time period analysed, although a small number of firms indicated otherwise.

Table 6.6 Investment managers' perceptions on trends in research quality (% of respondents)

	FTSE 100	FTSE 250	FTSE Small Cap
Better	8	17	8
Same	67	67	67
Worse	25	17	25
Number of respondents	12	12	12

Source: Oxera calculations based on 12 responses to the investment managers questionnaire (Q41).

Figure 6.4 Investment managers' perceptions on trends in research quality (number of respondents)



Source: Oxera calculations based on responses to the investment managers questionnaire (Q41).

6.3.2 Investment managers' assessment of research availability

Investment managers were also asked to assess the availability of research along with any trends in research availability since 2005.

Tables 6.7 and 6.8 present this information over time across the FTSE 100, 250 and Small Cap indices and show that investment managers generally considered the availability of research to have remained largely unchanged.

Table 6.7 Investment managers' perceptions on research availability (% of respondents)

	FTSE 100		FTSE 250		FTSE Small Cap	
	2006	2007	2006	2007	2006	2007
Excellent	38	38	0	0	0	0
Good	62	54	100	85	46	46
Reasonable	0	8	0	8	31	23
Poor	0	0	0	8	23	31
Very poor	0	0	0	0	0	0
Number of respondents	13	13	13	13	13	13

Source: Oxera calculations based on 13 responses to the investment managers questionnaire (Q41).

Table 6.8 Investment managers' perceptions on trends in research availability (% of respondents)

	FTSE 100	FTSE 250	FTSE Small Cap
Better	8	8	8
Same	83	75	75
Worse	8	17	17
Number of respondents	12	12	12

Source: Oxera calculations based on 12 responses to the investment managers questionnaire (Q41).

Some of the participants attributed deteriorating availability and quality of research, primarily in FTSE Small Cap stocks, to the reduced coverage by large brokerage houses. Responses indicating a deterioration were not clearly related to the size or other characteristics of the investment manager. Some also anticipated that new entry into the sector would eventually lead to improvements. The current financial turmoil was cited by some as a driving force behind the declining availability and quality of research, with the decline expected to continue.

As a result of the ongoing financial crisis, some market participants feel that there could be a negative impact on research provision. In addition, some respondents felt that the use of CSAs to pay for independent research has improved access to quality of research, by enhancing competition for research provision.

6.3.3 Brokerage firms' assessment of their own research coverage

Brokerage firms were asked to assess the coverage of their own research between 2006 and 2007. Tables 6.9 and 6.10 show the brokerage firms' perspective on their own research coverage and trends in coverage over time for the FTSE 100, 250 and Small Cap indices. As the tables show, the firms generally considered that their research coverage remained unchanged, although there was evidence that it had got worse for FTSE Small Cap for some participants.

Table 6.9 Brokers' perceptions on research coverage (% of respondents)

	FTSE 100		FTSE 250		FTSE Small Cap	
	2006	2007	2006	2007	2006	2007
Excellent	67	67	33	33	40	40
Good	22	22	11	11	0	0
Reasonable	0	0	44	44	20	10
Somewhat poor	0	0	0	0	10	20
Poor	11	11	11	11	30	30
Number of respondents	9	9	9	9	10	10

Source: Oxera calculations based on 9/10 responses to brokerage firms questionnaire (Q21).

Table 6.10 Brokers' perceptions on trends in research coverage (% of respondents)

	FTSE 100	FTSE 250	FTSE Small Cap
Better	0	33	10
Same	89	67	60
Worse	11	0	30
Number of respondents	9	9	10

Note: The response varies across different market segments.
Source: Oxera calculations based on responses to brokerage firms questionnaire (Q21).

6.4 Conclusions

A significant proportion of investment managers consider that, if market liquidity has changed, it has deteriorated since 2005. This is a less pronounced view among brokerage firms, but there is still evidence that they have become more pessimistic. Liquidity is perceived to have reduced across the different market segments over time, although the effect is most significant for the FTSE 250 and Small Cap indices. The respondents highlighted some key drivers of the deteriorating market liquidity. They referred to an increase in fragmentation of liquidity due to:

– greater use of algorithmic trading and dark pools of liquidity;

– the steep decline in equity markets as a consequence of the credit crunch; and the

– standardisation of the rules on market transparency and conduct of business obligations as a result of MiFID.[14]

However, the new regime was not mentioned by any of the respondents as a cause of this perceived decline in market liquidity. Indeed, as there appears to be little evidence that the brokerage market has become more concentrated, the mechanism through which it was considered that the regime might reduce liquidity has not materialised in any case.

The majority of the respondents indicated that there were no substantial changes in the quality, availability and coverage of research across the FTSE 100, 250 and Small Cap indices. Where a change in the quality or availability in research was found, the most common response was that there had been a deterioration. However, these responses only represent a small number of investment managers, which implies that the effect of the change in the regime on investment managers has, so far, probably been limited. Among the small number of participants that claimed deteriorating quality and availability, varied explanations were given: some claimed that larger brokerage firms were focusing less on the research coverage of small cap stocks, while others indicated that the credit crunch was a factor. Brokerage firms' assessment of their research coverage generally showed little change over time, with the only significant evidence of a deterioration being in FTSE small cap stocks.

The overall conclusion is that, although market liquidity has worsened to some extent, there is no evidence that this is due to the new regime. Furthermore, there are no substantial changes in the quality, availability and coverage of research—only some limited changes in research covering small caps can be observed. The main performance indicators in this area and their movement are set out in Table 6.11.

[14] Some of the participants suggested that the market had become less transparent as a result of the changes in the reporting rules initiated by MIFID.

Table 6.11 Impact on the main performance measures with respect to market liquidity and research quality and coverage

Performance indicator	Expected change	Actual change	Notes
Quality of trade execution			
Brokers' and investment managers' assessments of market liquidity in different segments of the market over time	Liquidity might get worse	Liquidity has reduced for a significant proportion of survey participants. The evidence of this is stronger from investment managers	The change in liquidity does not appear to be related to the change in the regime The factor most cited was the credit crunch
Quality, availability and coverage of research			
Investment managers' assessments of research quality.	Might improve due to greater transparency, but could deteriorate if the market becomes more concentrated	Unchanged for most respondents. For the minority that indicated it had changed, the most common finding was that the quality had declined (FTSE 250 excepted)	Some respondents indicated that the larger brokerage firms may have reduced coverage of small cap stocks. The current financial situation may also be a factor
Investment managers' assessment of research availability	As above	Unchanged for most respondents For the minority that indicated it had changed, the most common finding was that the quality had declined (FTSE 100 excepted)	As above.
Brokerage firms' assessment of their research coverage	As above	Most firms considered that this had not changed. The main evidence of any deterioration was in small cap stocks	

Note: In the 2006 Oxera report, the performance indicators in relation to the quality of trade execution and quality, availability and coverage of research were summarised in Table 5.3.5.

7 Other indicators

This section reports on other performance indicators relating to disclosure and the fees charged to pension funds.

As increased disclosure is a central part of the new regime, the extent to which the different parts of the value chain were complying with the disclosure requirements was examined as a performance indicator.

– Brokerage firms were found to disclose the split in commission rates to investment managers on demand, and there is near-universal compliance with the IMA/NAPF disclosure codes by investment managers in their disclosures to pension funds. However, commission rates are not perceived by brokerage firms as being a central factor when competing for business and pension funds rarely follow up the disclosures with investment managers.

With investment managers able to buy only certain goods and services with hard cash (ie, incurring a direct cost), it was considered possible that they may pass this cost on in the form of higher fees to investment managers. Large funds may use their buyer power to negotiate a lower allocation of the costs of research or a lower fund management fee. These effects were therefore assessed as performance indicators.

– For actively managed funds there has been a decline in the average fund management fee between 2006 and 2007, while for passively managed funds there was a slight increase over the same period. There is little evidence that these changes are related to the introduction of the new regime for softing and bundling.

– In general smaller pension funds are charged higher active and passive management fee. There is no consistent evidence that this has become more pronounced in recent years.

7.1 Introduction

This section analyses the following performance indicators that all relate to fund management firms but measure different types of impact of the new regime.

– Disclosure—as explained in section 1, the new regime requires that investment managers make prior and periodic disclosure to their clients, including disclosure of the use of clients' commission. Pension funds will therefore be more informed about the use of the commissions on trades undertaken for their fund or mandate. This may lead to pension fund trustees scrutinising their investment managers about the use of the commissions. If the investment managers come under greater scrutiny from pension funds, they may become more selective about the research goods and services they purchase from commissions. This section measures the extent to which brokers make disclosures to investment managers and investment managers to pension funds, and the factors that are important for brokerage firms when competing for business from investment managers.

– Changes in fund management fees over time—the switch from purchasing non-permitted goods and services through hard cash (as described in section 3) may lead to higher management fees. Investment managers may regard the increase in purchases of non-permitted goods and services with hard cash as an increase in their direct costs of managing funds; therefore, they may pass these costs on to their clients through higher management fees. In the 2006 report, it was recognised that any such effect could be small and that it would be difficult to determine that any change in management fees is related to the change in the regime, Nevertheless, they are presented in this section.

– Management fees paid by smaller funds relative to those paid by larger funds—following the change in the regime, when agreeing commission rates between investment managers and brokers, it must be decided how many basis points are paying for execution and how many for research or execution-related goods and services. This means that the new regime makes the total amount of commissions paid for the research more transparent to investment managers' clients. Large funds may use their buyer power to negotiate a lower allocation of the costs of research or a lower fund management fee. Section 5 concluded that there is no evidence that indicates that the share of research costs borne by smaller funds has increased. This section assesses whether management fees paid by smaller funds relative to those paid by larger funds following the change in the regime has increased.

7.2 Disclosure along the value chain

An objective of the new regime was to improve the disclosure of pricing information along the value chain. This sub-section assesses the level of compliance with the regime in disclosures from:

– brokerage firms to investment managers;
– investment managers to pension funds.

The extent to which pension funds requested information on the use of dealing commissions is then examined.

7.2.1 Disclosure of the commission rate split from brokers to investment managers

As indicated in Table 7.1 all brokerage firms disclosed the split between the execution and research components of the commission rate where applicable.[15]

Table 7.1 Disclosure of a commission rate split to investment managers

Yes	No	Non-response/not applicable
8	0	3

Source: Brokerage firms questionnaire, Q18. Two responses were 'not applicable' and there was one non-response.

In general, the information was disclosed on request, usually on an annual or biannual basis.

A number of brokerage firms indicated that they did not know how the investment managers used the information provided. One respondent noted that the number of requests for this information had declined as the rate was increasingly available from CSAs.

7.2.2 Use of the IMA disclosure code by investment managers

The investment managers questionnaire included a question to assess the extent to which investment managers used the IMA/NAPF disclosure code in their disclosures to pension funds. Of the 18 investment managers that responded, 17 used the IMA pension fund disclosure code for both 2006 and 2007. The respondent that did not said that their disclosure was virtually identical to the IMA code. All respondents had adopted the code before May 2006.

[15] Some respondents dealt only with internal investment managers.

Table 7.2 Use of the IMA disclosure code

Use IMA/NAPF disclosure code	Use own means of disclosure
17 (94%)	1 (6%)

Source: Investment managers questionnaire 2008, Q8.

Where the investment manager also had retail funds, the form of disclosure used was almost always identical to that for pension funds.

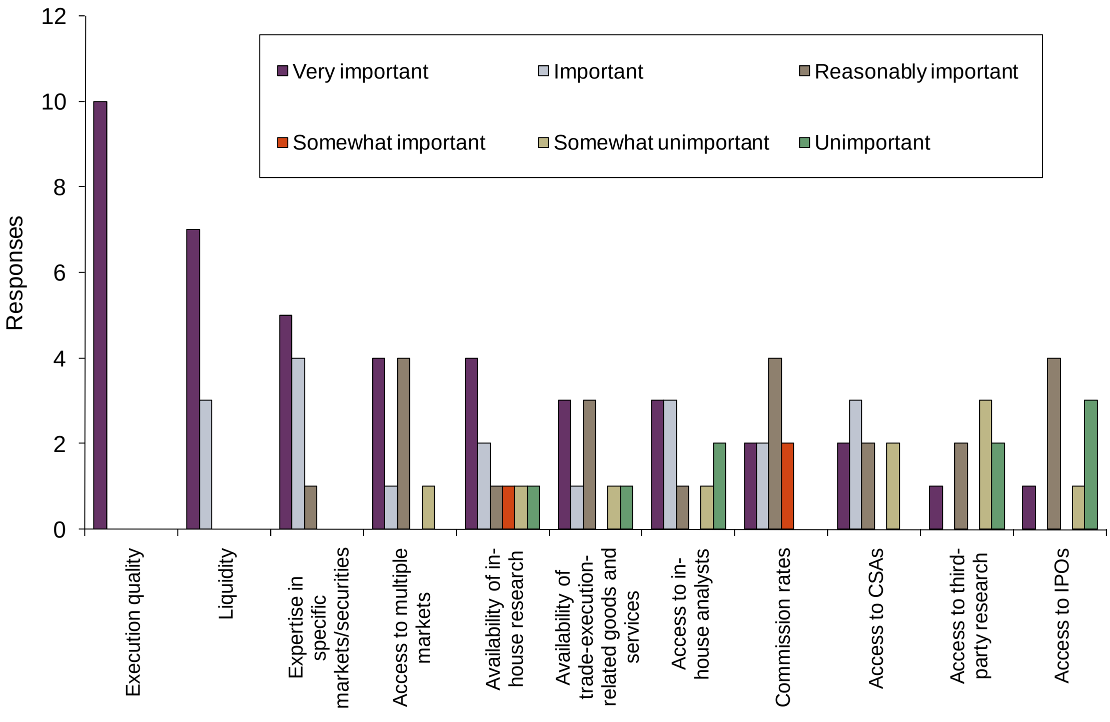
7.2.3 The extent of pension fund requests for information on the use of dealing commissions

Investment managers were asked to indicate from what proportion of their clients they received feedback on the use of dealing commission in relation to execution quality and quality and quantity of research, and execution-related, goods and services. The survey indicates that most managers received no feedback at all and, when they did, this was from less than 5% of their clients.

7.2.4 Factors that are important for brokerage firms when competing for business from investment managers

The surveys asked brokerage firms to indicate how important they considered a range of factors when competing for business. The results from the current survey, presented in Figure 7.1, show that execution quality was regarded by brokerage firms as by far the most important factor in competing for business from investment managers, followed by liquidity and expertise in specific markets. These factors were also those considered most important in the previous survey. Access to third-party research and IPOs were the least important factors, which is also consistent with the previous findings. Commission rates and access to CSAs (which was not listed as a factor last time) were also considered to be less important.

Figure 7.1 Importance of factors in brokerage firms competing for business from investment managers



Source: 2008 brokerage firm questionnaire, Q8, Table 3.2.

7.3 Changes in level of fund management fees paid by pension funds

Investment managers were asked to provide data on their gross management fee income (ie, including performance elements) and the funds under management to which those fees applied. Subtracting the performance-related elements of gross management fees allowed the net management fees (and thus the weighted average management fee) to be calculated for both the current and previous surveys (see Table 7.3).

Table 7.3 Effective annual management fees

	Full sample		
	2005	2006	2007
Performance-related proportion (%)	12	15	16
Non-performance-related proportion (%)	88	86	85
Simple average effective actual management fees (bp)	25	29	35
Weighted average effective actual management fees (bp)	24	16	18
Range of effective actual management fees (bp)	12–41	6–56	4–71
Number of respondents	14	14	15

Note: For 2006 and 2007 onwards, weights are calculated using the total value of pension fund assets under management in the UK 2006 and 2007. Weights prior to 2006 are based on the total value of pension fund assets managed in the UK, as provided in Q1 of the original investment managers questionnaire.
Source: For post-2005 data, the investment managers questionnaire, Q11, Table 3.13. For 2005 data, Q7 of the corresponding previous questionnaire.

Table 7.3 indicates the following.

– Average actual management fees increased on a simple average basis between 2005 and 2006, but on a weighted-average basis they declined. It is therefore difficult to infer a clear trend in actual investment management fees.

– The proportion of the actual fees that are performance-related has increased slightly, but not by a significant amount.

– The range of effective actual management fees is quite wide, in both this survey and the previous one, and appears to be increasing over time. This means that the extent to which there is, in practice, an ‘average’ fee (for active funds) is questionable.

To assess the trends in fees in more detail, the investment managers questionnaire asked for information on typical fees for both active and passive funds, for a range of fund sizes. The previous survey also provided equivalent information over the period 2003–05. In that survey, to allow comparison over the period 2003–05, consistent sample groups of ten investment managers for active funds and four for passive funds were used. Where data from this group of firms is available from the current survey, it has been used to produce a consistent sample to calculate weighted averages. In addition, the weighted average fee information has been calculated based on the full sample of responses for this survey (2006 and 2007) and the past survey (2005). These are calculated using the typical fees, as indicated by the investment managers, that they charge to pension funds of £100m. The results are presented in the tables below.

Table 7.4 presents information on typical management fees that were charged for an active management fund of £100m.

Table 7.4 Typical active management fees (bp)

	Consistent sample					Full sample		
	2003	2004	2005	2006	2007	2005	2006	2007
Weighted average typical active management fees	42.2	40.3	38.4	46.1	42.8	36.6	47.4	44.6
Range of typical active management fees	21–100	25–100	25–100	25–75	25–75	29–100	25–126	25–126
Number of respondents	10	10	10	9	9	15	13	13

Note: Data is for typical management fees for an active £100m UK equity fund. For 2006 and 2007 onwards, weights are calculated using the total value of pension fund assets under management in the UK in 2006 and 2007. Weights prior to 2006 are based on the total value of pension fund assets managed in the UK, as provided in Q1 of the original investment managers questionnaire.
Source: Post-2005 data: the investment managers questionnaire, Q11, Table 3.13. Pre-2006 data: Q8 of the corresponding 2006 survey.

Table 7.4 indicates that the typical fees that an investment manager would charge for an active £100m UK equity fund have increased relative to 2005, which represented a low point in the consistent sample, but not compared with 2003 levels. As noted previously, the range of typical investment manager fees is very wide, which makes it difficult to determine consistent trends over time. This is probably due to the different services that active investment managers offer.

Table 7.5 presents information on typical management fees that were charged for a passive management fund of £100m.

Table 7.5 Typical passive management fees (bp)

	Consistent sample					Full sample		
	2003	2004	2005	2006	2007	2005	2006	2007
Weighted average typical active management fees	5.3	5.2	5.1	5.8	6.0	6.3	5.8	6.0
Range of typical active management fees	5–6	5–6	5–6	5–9	5–9	5–13	5–9	5–9
Number of respondents	4	4	4	3	3	6	3	3

Note: Data is for typical management fees for an active £100m UK equity fund. For 2006 and 2007, weights are calculated using the total value of pension fund assets under management in the UK in 2006 and 2007. Weights prior to 2006 are based on the total value of funds managed in the UK, as provided in Q1 of the original investment managers questionnaire.
Source: Pre-2006 data: investment managers questionnaire, Q11, Table 3.13. Post-2005 data: Q8 of the corresponding 2006 survey.

Table 7.5 indicates that the typical fees charged by an investment manager for a passive £100m UK equity fund have increased slightly since 2003. However, only a limited number of investment managers provided data for this question as the total number of fund managers offering this service is relatively small.

Overall, there is little evidence of significant changes in the level of fund management fees since the change in the regime.

7.4 Distribution of management fees by the size of pension funds

Investment managers were asked to provide their typical management fee rates for a range of pension fund sizes. The results for different sizes of pension fund are presented Tables 7.6 and 7.7.

Table 7.6 Change in typical active management fees between 2001 and 2007 (bp)

	£500m	£200m	£100m	£50m
Weighted average of 2007 active fees	24.1	32.1	44.6	69.5
Weighted average of 2005 active fees	24.7	30.2	36.3	37.6
Weighted average of 2001 active fees	18.3	27.3	32.3	44.5
Change of weighted averages between 2005 and 2007	–0.6	+2	+8.3	+31.9
Change of weighted averages between 2001 and 2005	+6.4	+2.9	+4	–6.9
Number of respondents last survey (2001 and 2005)	15	15	15	15
Number of respondents this survey (2007)	5	5	6	7

Note: For 2006 onwards, weights are calculated using the total value of pension funds under management in the UK in 2006 and 2007. Weights prior to 2006 are based on the total value of pension funds under management in the UK, as provided in Q1 of the original investment managers questionnaire.
Source: For post-2005 data, investment managers questionnaire, Q11, Table 3.13. For pre-2006 data, the source is Q8 of the corresponding 2006 survey.

Table 7.7 Change in typical passive management fees between 2001 and 2007 (bp)

	£500m	£200	£100m	£50m
Weighted average of 2007 passive fees	2.1	3.5	6	10.8
Weighted average of 2005 passive fees	3.9	4.4	5.1	5.7
Weighted average of 2001 passive fees	4.8	5.3	7.6	10.4
Change of weighted averages between 2005 and 2007	–1.8	–0.8	+0.9	+5.1
Change of weighted averages between 2001 and 2005	–0.9	–0.9	–2.4	–4.7
Number of respondents last survey	4	4	4	4
Number of respondents this survey	3	3	3	3

Note: For 2006 onwards, weights are calculated using the total value of pension funds under management in the UK in 2006 and 2007. Weights prior to 2006 are based on the total value of pension funds under management in the UK, as provided in Q1 of the original investment managers questionnaire.
Source: Post-2005 data: investment managers questionnaire, Q11, Table 3.13. Pre-2006 data: Q8 of the corresponding 2006 survey.

Tables 7.6 and 7.7 indicate the following.

– The typical weighted average management fees, for both actively and passively managed funds, are consistently lower for larger pension funds than smaller ones. This may be due in part to economies of scale in fund management.

– There has been a general upward trend of typical active management fees increasing between 2005 and 2007 for the different pension fund sizes, although fees for pension funds of £500m declined. For the £50m and £100m pension funds, the increase is quite substantial, although these findings are based on a significantly smaller sample than that used in the previous survey, and this is not a consistent finding across firms when the same set of firms is analysed across both surveys. The evidence presented in the section on market structure was that there had been convergence in core brokerage commission rates, which implies that this would anyway be unlikely to be a driver of this.

– For typical passive fund fees, there have been increases in the management fee for the £50m and £100m pension funds between 2005 and 2007, following declines across all sizes between 2001 and 2005. There has been a particularly substantial increase in the fees charged for the £50m pension funds, although these figures are based on a very small sample size.

7.5 Conclusions

7.5.1 Disclosure

Brokerage firms now make the split in core/bundled brokerage commission rates for execution and research available to investment managers on request. The IMA pension fund disclosure code is used almost universally by investment managers in their disclosures to pension funds.

However, pension funds appear not to request follow-up information from investment managers, and commission rates do not, in themselves, appear to be particularly important for brokerage firms when competing for business from investment managers.

7.5.2 Changes in level of fund management fees

There is some evidence of a slight upward trend over time in the fund management fees charged to pension funds. However, there is little evidence of significant changes in the level of fund management fees since the change in the regime.

7.5.3 Distribution of management fees by the size of pension funds

Fee rates are generally significantly higher for smaller funds. Fee rates for smaller funds have not consistently increased in recent years relative to larger funds. The evidence on the variation in commission rates for different sizes of trading order was that it had reduced in recent years.

The main performance indicators in this area and their movement are set out in Table 7.8 below.

Table 7.8 Impact on the main performance measures with respect to disclosure and investment managers' fees

Performance indicator	Expected or possible change	Actual change	Notes
Disclosure			
From brokerage firms to investment managers	Disclosure of execution/research split	Disclosure	
From investment managers to pension funds	Disclosure of information about commissions	Disclosure	Pension funds appear not to request follow-up information from investment managers
Reduction in spending on non-permitted goods and services			
Management fees paid by pension funds	Possibly an increase in fee rates (as a result of an increase in spending with hard cash)	Little evidence of significant changes	
Distribution of research costs among pension funds			
Management fees paid by smaller funds relative to those paid by larger funds	Fees paid by smaller pension funds to increase	No consistent evidence of this	The evidence on commission rates was that they had converged according to trade size

Note: In the 2006 Oxera report, the performance indicators in relation to disclosure were summarised in Table 5.3.2, in relation to spending on non-permitted goods and services in Table 5.3.1, and in relation to the distribution of research costs among pension funds in Table 5.3.5.

8 Pension funds

This section measures performance indicators in relation to disclosure to, and scrutiny by, pension funds of commission spending by investment managers. It concludes that pension funds receive the appropriate disclosure from investment managers, but in general do not use it. This may mean that any positive effects of the new regime are not a result of pension fund scrutiny but more related to changes in the internal organisation of investment management firms, which result in greater separation between the choice of trading venues and choice of research provider.

8.1 Introduction

This section measures a number of performance indicators in relation to disclosure to, and scrutiny by, pension funds of commission spending by investment managers. As explained in section 1, the new regime requires that investment managers make prior and periodic disclosure to their clients, including disclosure of the use of clients' commission. Pension funds will therefore be more informed about the use of the commissions on trades undertaken for their fund or mandate. This may lead to pension fund trustees scrutinising their investment managers about the use of the commissions. If the investment managers come under greater scrutiny from pension funds, they may become more selective about the research goods and services they purchase from commissions.

8.2 Pension fund survey results

Ten pension funds were sent questionnaires and six responses were received. The original sample was selected from NAPF members with more than £1 billion of assets under management.

8.2.1 Restrictions on the use of commissions and CSAs by investment managers and awareness of prior disclosure

Only one of the four funds that responded with regard to restrictions on non-execution goods and services imposed restrictions on investment managers using commissions to purchase them. Only one of six respondents prohibited the use of CSAs.

Five out of six respondents indicated that they were not aware of the prior disclosure of use of brokerage commissions made by investment managers before committing their mandates to them. Investment managers' prior disclosure of the use of brokerage commissions did not influence most pension funds' decisions regarding the appointment of investment managers.

8.2.2 Factors determining the appointment of investment managers

Table 8.1 lists the factors determining the appointment of investment managers on a scale of 1 to 5, where 5 is the most important. As there was little variation between the 2006 and 2007 responses, the weighted average importance has been calculated for 2007 only.

Table 8.1 Importance of factors determining the appointment of investment managers

	Weighted average importance, 2007
Use of brokerage commissions for non-execution goods and services	1.7
Proposed fund management fees	2.3
Brokerage commission rates paid by the investment manager	2.3
Past performance of investment managers' funds	4.0
Reputation of investment manager	4.7
Expertise in specific countries/sectors/securities	4.3
Investment managers' style/philosophy	5.0

Source: Pension funds questionnaire. There were two non-responses: one due to no managers being appointed; the other because they had not attended any manager selection meetings.

Factors relating to the use and level of brokerage commissions, and the fees charged by investment managers, were not considered to be particularly important. In contrast, the reputation of the manager, their philosophy and expertise in specific areas were regarded as important.

8.2.3 Monitoring of investment managers

Pension funds were asked what aspects of their investment managers' activities they monitor. The results are as follows.

- All respondents monitored fund performance—most commonly this would be done in-house and by third parties, although investment managers would sometimes be involved.

- Value of trading annually—two respondents indicated that they monitored this.

Most (four of the six) respondents indicated that they did not monitor any of the following:

- broker commission rates paid by the investment manager;
- value of trades buying non-execution services;
- value of non-execution services bought by investment managers through commissions relating to trades in investments;
- the trading efficiency of the investment manager's trading desk and brokers;
- the quality of research purchased by the investment manager.

8.2.4 Disclosure by investment managers

- With one exception, all pension funds indicated that their investment managers complied fully with the IMA NAPF Pension Fund Disclosure Code in 2006 and 2007.

- All respondents that had received a disclosure indicated that the type of information in the disclosure was about right.

- All respondents stated that they made use of pension fund consultants, although none indicated that the consultants assisted in interpreting disclosures on investment managers' use of brokerage commissions.

8.2.5 The extent to which the information provided was used and feedback provided to investment managers

- Five of the six respondents indicated that the information disclosed by investment managers was not used. One respondent indicated that it was used to some extent. No additional feedback was requested by pension fund respondents on the use of brokerage commissions. This is confirmed by the findings of the investment managers' survey that there were few queries from pension funds as a result of these disclosures.

– None of the six pension funds indicated that they provided feedback on their mandates to investment managers in 2006 and 2007 across any of the categories listed below:

  – quality of execution and execution-related services;
  – quality and quantity of research goods and services;
  – comparison to use of commission for research goods and services across all funds managed by the investment manager;
  – commission rates;
  – apparent inconsistencies between level 1 and level 2 information (as required by the IMA/NAPF code) that was received.

8.3 Conclusions

Pension funds are receiving disclosures from investment managers and consider that the type of information disclosed is appropriate. However, the content of the disclosure is not an important input into pension funds' choice of investment managers, and therefore has little impact on their behaviour.

It could be argued that this is consistent with the finding that the level of spending on non-execution goods and services has not changed significantly since the introduction of the new regime (as reported in section 3).

However, as explained in section 2, there are positive effects of the new regime, such as investment managers separating their choice of trading venue from their choice of research provider and an increase in the use of third-party research providers. Investment managers indicated that these are not due to pension fund scrutiny but to changes within the organisation of investment management firms. As a result of the introduction of the new regime, firms clarified the responsibility of the trading desk (which has the duty to choose trading venues that offer best execution) and that of the portfolio managers (which are also responsible for the purchase of research). This means that decisions on trading and research are now taken more independently than before the new regime. This mechanism may have caused the increased use of third-party research providers.

9 Retail funds

The 2006 Oxera report focused on the new regime in the context of pension funds. For this second report, the scope of the research was extended to examine the effect of the new regime from a retail fund perspective. This section concludes that most retail investment managers also run institutional funds and the majority of those surveyed stated that they co-mingle all retail and institutional transactions. This suggests that, where improvements have materialised for institutional funds, the same benefits are likely to have spilled over into the retail arena. Furthermore, there are indications that commission-related disclosures should become more prevalent following the introduction and wider acceptance of the industry code for retail funds. It is still too early to determine whether such disclosures will result in a change of behaviour on the part of fund providers and whether this, in turn, will lead to greater attention being paid to commission rates when selecting and monitoring investment managers.

9.1 Introduction

This section presents the findings of the surveys of the investment managers and authorised providers of retail funds. The purpose of the surveys was to determine the extent to which retail funds were being treated the same as institutional funds; what if any disclosures were being made; to whom they were provided; whether the investor representative model had been adopted and whether it was working.

The rules limiting what can be bundled into, or be paid for with, commissions applies equally to retail and wholesale/institutional investment managers. The main distinction between the two is in the nature of the disclosure and the entity to which the disclosures are made. Industry guidance on the nature of the disclosures necessary and the process for passing them on to entities receiving them was published in June 2008, sometime after the equivalent guidance for pension fund trustees.

Most retail investment managers also run institutional funds and the majority of those surveyed stated that they co-mingle all retail and institutional transactions. This suggests that, where improvements have materialised for institutional funds, the same benefits are likely to have spilled over into the retail arena.

The results showed that although few disclosures were made before the middle of 2008, it is likely that disclosure of commissions will become more widespread. Additionally, it appears that increasing use will be made of the investors' representative model in the future.

9.2 Objectives and remit for the research on retail funds

The FSA sought to review the effect of the regime for softing and bundling from a retail perspective. It asked Oxera to measure performance indicators for retail funds similar to those used for the wholesale/pension fund review. The FSA wanted to know whether:

– equivalent information about softing and bundling is being produced for retail funds as is the case for wholesale funds (ie, pension funds);

– investment managers' oversight and treatment of dealing commissions for retail funds are comparable to those for wholesale funds.

The research involved surveys among investment managers and authorised providers of retail investment products. Examination of the sample of investment managers used for the previous wholesale research and their associated authorised providers indicated that a wide range of different retail funds would be covered. Therefore, it was agreed that the wholesale sample would be extended to cover retail.

In many cases, the investment manager and authorised provider activities are undertaken by the same investment firm or group—ie, often by entities that are legally separate but part of the same organisation.

The current study investigates the nature of the disclosures made and the way in which they have been used. It should be noted that the first relevant industry code (IMA/DATA Code) and guidance on disclosures for authorised investment funds was issued only in June 2008, and therefore that it is still too early to draw any meaningful conclusions as to its effectiveness.

9.3 Background

The FSA's rules and guidance on the treatment of goods and services received by investment managers in connection with dealing commissions were published in July 2005.[16]

The disclosure element of that regime for retail funds was updated in June 2006 in Policy Statement 06/5, in which the FSA recommended independent oversight and scrutiny of disclosure. Previously, disclosures were made to the fund itself or the firm operating it, the 'authorised provider'. The FSA considered disclosure to investors, as is the case for institutional clients, but determined that retail investors would have neither sufficient knowledge or experience to assess effectively the disclosures nor the authority to prompt appropriate responses. Therefore, an alternative approach was proposed which involved the appointment of an unconflicted 'investor representative' who would receive and assess information on behalf of the underlying investors.

The content and analysis of disclosure would be governed by the requirements of industry codes and guidance, discussed further below.

The funds are responsible for nominating the most suitable investor representative but the FSA proposals did make specific suggestions as to the most appropriate type of individual or body for different fund structures. For authorised investment funds it was felt that the depositary would be most appropriate, while independent directors and actuaries would be best suited for investment trusts and managed funds of life insurance funds respectively. [17]

Following the FSA's decision to use this principles-based regime for disclosure to investors' representatives, the IMA began to devise a suitable disclosure code, in consultation with the trade association representing depositaries and trustees (DATA), for use by its members as a framework for their commission disclosures. The Code emerged in June 2008 as a joint initiative between the IMA and the DATA for authorised collective investment schemes. [18]

This Code is closely based on the IMA's Pension Fund Disclosure Code.[19] It sets minimum standards and consequently investment managers can provide additional information if they deem it useful. Its requirements take the form of two distinct levels.

– Level One disclosure covers the policies and procedures that are in place for the management of commissions incurred in the management of the fund.

[16] Financial Services Authority (2005), 'Bundled Brokerage and Soft Commission Arrangements: Feedback on CP05/5 and Final Rules—Policy Statement 05/9', July.

[17] More detail and rationale on these recommendations can be found in CP05-13.

[18] Investment Management Association and Depositary and Trustee Association (2008), 'Collective Investment schemes (CIS) Disclosure Code', June.

[19] IMA/NAPF, 'Pension Fund Disclosure Code'.

– Level Two disclosure refers to the quantitative disclosure of trading volumes, commissions generated and how they are spent for trades undertaken during the reporting period.

The Code requires Level One disclosures to be made on an annual basis unless there is some material change in policy, which must be notified immediately. Level Two disclosures should be made at least every six months.

DATA has also recently issued to its members ‘Operational guidance relating to CIS disclosure issues’. This is intended to support the depositaries in their role as investor representative for authorised investment funds. For example, it outlines the necessity for the depositary to ensure consistency between Level One and Level Two disclosure. It also recommends that trading patterns be assessed at the fund and firm level, together with counterparty concentration, etc.

9.4 Survey among investment managers and authorised providers of retail investment products

As outlined above, it was decided to survey both the managers of retail funds and the authorised providers of these funds.

A section of the investment managers questionnaire was aimed at those managers with responsibility for retail funds, while a separate questionnaire was sent to authorised fund providers. The latter questionnaire was more qualitative in its focus than the surveys sent to other market participants for the non-retail part of the report. The aim was to assess the nature of disclosures for retail funds and, in particular, to identify possible future trends that could be tested through future analysis if necessary.

In addition to the surveys, meetings were conducted with both the IMA and the DATA to ensure that the questions asked accurately reflected the current state of disclosure requirements for retail investment funds. Furthermore, discussions were held with the Association of Investment Companies (AIC), Association of British Insurers (ABI) and a number of investment managers and providers of retail investment funds to provide a qualitative assessment of the impact of the new requirements.

The trade associations emphasised that the disclosure regime for such funds was still at a very early stage of development. It is therefore clear that any apparent trends in disclosure practices and the use of such disclosures by investors’ representatives will only be indicative at this stage, and may not fully reflect potential changes in market participants’ behaviour that may result from the introduction of the new regime.

The evidence gathered was based on the responses to two surveys. The first used the same sample of investment managers as had been used for the wholesale section of this report. A total of 20 responses were received from investment managers that manage retail investment funds. Questionnaires were also sent to a total of 34 authorised providers of retail funds and 12 responses were received. This therefore allows for only an initial assessment of the way the new regime has been implemented. Furthermore, partly due to the way the sample of firms was selected (ie, based on the research on wholesale funds), only two respondents made use of external investment managers, with the remainder undertaking the management of the funds in-house. If further research were undertaken, it would be useful to include a sample of providers that make use of external investment managers. Of the firms that responded, eight were providers of unit trusts, nine had ICVCs, one offered unit-linked funds, one offered with-profits funds, and two offered investment trust savings schemes.

9.5 Survey results

In the case of the 14 investment managers that responded, 12 stated that they co-mingled transactions relating to retail funds with those relating to institutional funds. A further two stated that they co-mingled some transactions while keeping others separate.[20] With regard to their relationships with brokerage firms, 14 respondents made no distinction between transactions for pension funds and those for retail funds, with only one investment manager stating that they did. This implies that the commission arrangements and any CSAs entered into will be applicable to both retail and institutional funds under management for the majority of the respondents.

Over 70% of the investment managers had made disclosures between 2006 and 2008. The IMA/NAPF pension fund disclosure code or a suitable alternative had been used as a basis by all those that had made such disclosures, but all now stated that they would be using the IMA/DATA code for disclosures made after the second half of 2008. The recipients of these disclosures depended on the type of retail fund under management. For collective investment schemes, the recipients were depositaries and trustees, while for other types of fund they were actuaries, the Principles and Practices of Financial Management (PPFM) Committee or directors of funds.

Additional evidence was obtained from the authorised providers of retail products. From the respondents that make use of external investment managers, it is clear that, in both the selection and monitoring of the manager, the most important factors taken into consideration are past performance, management fees and the reputation of the investment manager. The use of brokerage commission rates for non-execution services and brokerage commission rates negotiated by the investment manager were considered among the least important factors for both monitoring and selection of managers. This view had not changed between 2006 and 2007.

A minority of respondents received disclosures between 2006 and the first half of 2008 and, for those that did, disclosures were based on the IMA/NAPF pension fund disclosure code. However, for the second half of 2008, all 12 respondents were expecting to see disclosures being made, with 58% expecting to see disclosures following the IMA/DATA code, while the others were either expecting alternative suitable arrangements to be made or were awaiting confirmation of the nature of disclosure.

The identity of the recipient of the disclosures will be determined by the type of fund for which the disclosure is being made. Nearly 50% of the responses indicated that disclosures would go to depositaries, with a further 30% making use of trustees. There appeared to be some uncertainty among a minority of respondents over the most appropriate representative to use for particular types of funds. Where the funds provided take the form of insurance-based products, such as unit-linked or with-profit funds, disclosures will be made to appointed fund actuaries or the PPFM Committee. All of the respondents indicated that disclosures would be made every six months.

None of the respondents indicated that disclosures would be made to independent directors. This result could be a function of the nature of the sample used. However, the FSA's initial consultation on the proposals in 2005/06 did highlight some market participants' views that independent directors were rarely used by ICVCs. This may also be reflected in the results obtained from the survey. In fact, for ICVCs, the survey revealed that most of the disclosures relating to these funds would be sent to depositaries.

Due to the low incidence of disclosures made prior to the middle of 2008, there was no evidence of feedback from the investors' representative to the investment manager during this period. However, the survey shows that increased use will be made of investors'

[20] The survey results do not indicate why these respondents adopted this strategy.

representatives under the new regime, and, now that established guidelines for the nature and types of disclosures are in place, it may be that representatives will be encouraged to provide feedback on the basis of the evidence they have received. The likelihood of this occurring could be enhanced if it is possible to compare the disclosed information received against some appropriate benchmark.

The use of investors’ representatives was intended to obviate the need to provide commission disclosures to retail investors themselves, which were believed to be less likely to understand and act on the information they were receiving. There was no evidence in the survey that any commission disclosure had been made to retail investors in the past, nor was there any indication that it was felt necessary to pass such information on in the future.

The survey of investment managers asked for information on total retail fund commission expenditure and trading. As explained, most retail investment managers stated that they co-mingle all retail and institutional transactions. Some of the investment managers therefore did not provide any data specifically related to retail funds—any differences in the weighted average commission rate paid, for example, would be due to the profile of trading and transaction methods used rather than to differences in commission rates.

Table 9.1 estimates the commission rates (for UK equity trading) for those investment managers that did provide data. Retail fund commission rates can be estimated from the survey by dividing the level of retail fund commission expenditure for an individual investment manager by the associated value of trading, to obtain the commission rate for retail fund transactions. The results of these calculations are presented in Table 9.1. This is an average commission rate that will include both core brokerage and execution-only (ie, electronic and programme) trades, and therefore does not correspond to a specific table in section 4.

Table 9.1 Commission rates for retail fund transactions (bp)

	Retail funds	
Commission rates	**2006**	**2007**
Weighted average	8.0	7.5
Simple average	13.4	12.2
Range	5–26	2–22
Sample size	6	8

Note: Weights are based on total retail fund assets under management in the UK.
Source: Investment managers questionnaire 2008, Q30.

The significant difference between the weighted and simple average commission rates for the retail funds in Table 9.1 is due to some of the investment managers with substantial retail funds assets also having lower average commission rates, which is likely to be the case because they use a higher proportion of execution-only trading. Where it is possible to compare the commission rates for the same firms’ pension fund transactions, the rates are generally found to be fairly similar, although this was not possible for some of the firms with low commission rates for retail fund transactions.

Table 9.2 shows the average proportion of commissions that are used for non-execution goods and services for investment managers with retail funds. This is lower than the proportion for non-execution goods and services from investment managers’ core brokerage trades. However, where it is possible to compare the proportion of commissions for non-execution goods and services at an individual firm level, these tend to be fairly similar.

Table 9.2 Proportions of commission rates for non-execution goods and services in retail fund transactions

Proportion of commissions for non-execution goods and services	Retail funds 2006	Retail funds 2007
Weighted average	0.37	0.45
Simple average	0.36	0.39
Sample size	5	6

Note: Weights are based on total retail fund assets under management.
Source: Investment managers questionnaire 2008, Q30.

Table 9.3 shows the ratio of commission expenditure on non-execution goods and services to retail funds under management (for UK equity trades). Both expenditure and funds under management have increased over time, although the increases in the former have outweighed the latter, raising the aggregate ratio over time.

The retail funds ratio is higher than that reported in Table 3.2 in section 3 (non-execution goods and services to value of pension assets under management). This is due to differences in the sample of investment managers that provided data on retail funds and those that provided data on pension funds. Where it is possible to compare the equivalent figures for these firms' pension fund transactions directly, in some cases the ratio is quite similar, while in others it is higher for the pension fund transactions or higher for retail fund transactions. There was no consistent pattern.

Table 9.3 Ratio of commission expenditure on non-execution goods and services to retail funds under management (bp)

	Retail funds 2006	Retail funds 2007
Ratio of commission expenditure on non-execution goods and services to retail funds under management	4.1	5.8
Sample size	5	6

Source: Investment managers questionnaire 2008, Q30.

9.6 Conclusions

As mentioned previously, the purpose of the study of retail funds is to provide initial indications of whether progress has been made in achieving the FSA's objectives for softing and bundling. A series of questions may be identified, the answers to which would go some way to determining whether this was the case. The main conclusions can be summarised as follows.

– **To what extent are pension funds and retail funds managed separately?**

  Almost all respondents indicated that their pension and retail funds are managed on a co-mingled basis, and that they do not distinguish between them in their relationship with brokerage firms. This implies that the commission rates faced by pension and retail funds are the same and that any differences in the average commission rates are therefore likely to be due to the use of different trading methods.

– **Have investment managers been making disclosures since the new regime came into force and are they planning to in the future?**

Although there is some evidence that disclosures were being made between the middle of 2006 and the middle of 2008, the overall incidence was not especially marked, as there was no appropriate code in place, and guidelines for the nature of the disclosures had not yet been established at this time. With the emergence of the IMA/DATA code, it is now apparent that there is likely to be far more widespread disclosure of commission arrangements, at least for authorised investment funds.

– **If so, who are the recipients of these disclosures?**

Again, where disclosures have been made in the past, they have tended to be passed from the investment manager directly to the authorised provider. In the future it appears that most disclosures will be made to the most appropriate investor representative. However, there does still appear to be a degree of uncertainty over who constitutes the most appropriate representative in a minority of cases.

– **What form do the disclosures take?**

Where disclosures have been made up to the middle of 2008, they have mostly been based on the IMA/NAPF code. From now on, it seems that most investment managers will be making use of the new IMA/DATA code, although a minority still appear to be planning on using the IMA/NAPF code.

– **Has there been evidence of feedback from the fund provider to the investment manager as a result of the disclosures and, if so, has this been acted upon?**

There was no evidence that analysis of the disclosures that had been made had resulted in feedback being given to investment managers. It is not possible to determine, from the information provided in the survey, whether such analysis and feedback will be undertaken in the future. If feedback is to be given, it does seem that some mechanism will have to be found for investors' representatives to compare the information they receive against an appropriate benchmark.

In conclusion, there are indications that commission-related disclosures should become more prevalent following the introduction and wider acceptance of the code. It is still too early to determine whether such disclosures will result in a change of behaviour on the part of fund providers and whether this, in turn, will lead to greater attention being paid to commission rates when selecting and monitoring investment managers.

A1 Survey sample and representativeness

A1.1 Baseline survey—February/March 2006

To conduct the baseline survey in 2006, Oxera designed three separate questionnaires for pension funds, investment managers and brokers.

In total, the questionnaires were sent to 36 pension funds, 68 investment managers and 54 brokers.[21] The responses, response rates and market coverage, presented in Table A1.1, show that the sample groups of investment managers and brokers that responded cover a large part of the market (in terms of value): 50% and 65% respectively. The high market coverage means that the questionnaire results provide a reasonably reliable picture of the investment manager and broker markets.[22]

Table A1.1 Effective response rate to Oxera questionnaires

	Number of questionnaires sent	Number of questionnaires completed	Response rate (%)	Market coverage of respondents (%)[1]
Pension funds	36	4	11.1	4
Investment managers	68	27	39.7	50
Brokers	54	14	27.5	~60

Note: Responses to the Oxera questionnaires as at close of business on April 24th 2006, the final deadline for submission of responses. [1] Defined as the respondents' share of the total market. For pension funds, this is the sum of the market value of respondents' funds (£20.6 billion in 2005) as a proportion of the total market value of pension funds, which is estimated at £499.2 billion in 2005 (source: NAPF database). For investment managers, this is the sum of the respondents' funds under management (calculated at £1,449.2 billion in 2005) as a proportion of the total value of funds under management in the UK, which is estimated at £2,913 billion (source: Baseline questionnaire and International Financial Services, London, International Financial Markets in the UK). For brokers, the market coverage is an approximation calculated from industry sources.

The response rate to the pension fund questionnaire was too low to draw out meaningful quantitative indicators while also ensuring the confidentiality of the responses(only four pension funds completed the questionnaire). However, this low response rate does not prevent a comprehensive baseline from being obtained for the purpose of future comparison to provide the post-implementation assessment of the change in the regime for soft commissions and bundled brokerage arrangements.

Although the response rates for investment managers and brokers mean that a reasonable sample from the population is represented, the amount and quality of the data provided by respondents varied between investment managers across different questions in the questionnaires.

A1.2 Follow-up survey—June/July 2006

In June/July 2006, Oxera undertook follow-up interviews with investment managers and brokers, which served to clarify the data that had been provided. Also, investment managers were asked to complete a supplementary questionnaire, designed to collect the data that had

[21] The initial sample groups of pension funds, investment managers and brokers were slightly larger. A number of firms withdrew because the survey was not relevant to them (eg, property funds or private client brokers).
[22] Some investment managers and brokers provided a limited amount of data. More data was later obtained in interviews with investment managers and brokers conducted by Oxera and Alan Line as part of the June/July surveys.

not been provided in the response to the initial questionnaire. As Table A1.2 shows, meetings and conference calls were arranged with 17 investment managers, of which 13 provided further data through the supplementary questionnaire.

Table A1.2 Response rate to Oxera supplementary questionnaire

	Number of meetings/ conference calls	Number of supplementary questionnaires completed	Proportion of original sample (%)[1]	Market coverage of supplementary questionnaire respondents (%)[2]
Investment managers	17	13	70.36	35.00

Note: [1] Defined as the supplementary questionnaire respondents' funds under management (calculated at £1,019.6 billion in 2005) as a proportion of the original questionnaire respondents' funds under management (calculated at £1,449.2 billion in 2005). [2] Defined as the respondents' share of the total market. This is the sum of the respondents' funds under management (calculated at £1,019.6 billion in 2005) as a proportion of the total value of funds under management in the UK—estimated at £2,913 billion.
Source: Supplementary questionnaire and International Financial Services, London, International Financial Markets in the UK.

Eight investment managers provided complete data for the supplementary questionnaire for the years 2003–05, with a further two providing data for 2005.

In the meetings/conference calls with investment managers, the supplementary questionnaire was discussed in detail, in particular to ensure understanding of the terminology in the questionnaire. However, given the data provided in response to the supplementary questionnaire, there are reservations about investment managers' classification of non-execution goods and services.

A1.3 Post-implementation review—August/September 2006

The new regime came into effect in mid-2006. In August 2008, Oxera designed four separate questionnaires for pension funds, investment managers, brokerage firms and authorised providers of retail investment products.

In total, the questionnaires were sent to ten pension funds, 28 investment managers, 16 brokerage firms and 34 authorised providers of retail investment products.[23] Table A1.3 shows the responses and response rates. In certain areas the sample for particular questions is smaller than the full sample of responses, mainly driven by lack of, or an inconsistent, response for the relevant question. The results of these questionnaires have been used to analyse the change in performance indicators, across the two surveys.

[23] The initial sample groups of pension funds, investment managers, brokers and authorised providers of retail investment products were slightly larger. A number of firms withdrew because the survey was not relevant to them (eg, property funds or private client brokers).

Table A1.3 Effective response rate to Oxera questionnaires

Type of firm	Number of questionnaires sent	Number of questionnaires completed	Response rate (%)	Market coverage of respondents (%)
Pension funds	10	6	60.0	2
Investment managers	28	21	75.0	28
Brokers	16	11	68.8	57
Authorised providers of retail products	34	8	23.5	6

Note: Responses to the Oxera questionnaires as at the close of business on November 20th 2008. Market coverage of pension fund survey respondents is calculated as the ratio of their assets (£18.2 billion) to the NAPF's estimate from its key funding statistics of £838.5 billion of total UK pension fund assets in March 2007. Market coverage of investment managers is calculated as the ratio of respondents' assets under management (£1.1 trillion) to the IMA's estimate in its 2007 Asset Management Survey of there being £3.8 trillion of assets under management in the UK. For brokers, the market coverage is an approximation calculated from industry sources. Authorised provider coverage is calculated as a ratio of respondents' UK retail assets under management (£49.7 billion) to the value of retail funds under management in the UK, where this is based on the IMA's 2007 figure that 22.8% of all assets managed in the UK are on behalf of retail clients.

To ensure consistency with the previous survey, performance indicators have been analysed for the full as well as the consistent sample. 'Full sample' essentially refers to survey participants that have responded to a question, irrespective of their response rate across different questions and/or the same question in the previous survey. 'Consistent sample' refers to a group of firms that have responded consistently to the questions in the current as well as the previous survey. Given the variation in number and quality of responses across different questions, the full and the consistent sample do not necessarily reflect the same participants over time. As stated above, wherever data is presented, sample sizes are indicated.

A1.4 General description of respondents' data in the 2008 survey[24]

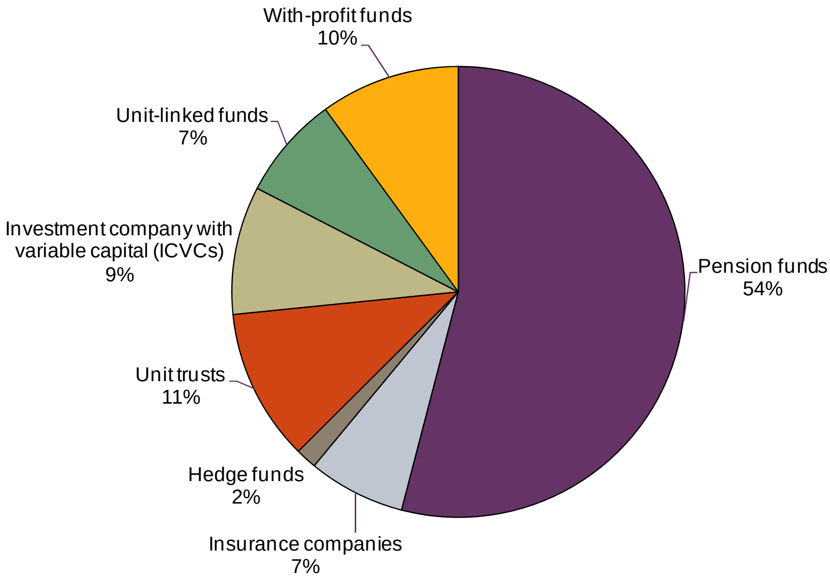
A1.4.1 The market for fund management

As described above, 21 investment managers responded to the 2008 investment managers questionnaire. The 21 investment managers who submitted answers to question five represented £1.1 trillion of funds managed in the UK in 2007.

Figure A1.1 gives the breakdown of the funds managed in the UK into the different types of fund for which those funds are managed. This shows that pension funds account for 59% of the funds managed in the UK.

[24] The corresponding numbers for the 2006 survey may be found in section 4.2 of the previous report—see Oxera (2006), 'Soft commissions and bundled brokerage services: post-implementation review', October.

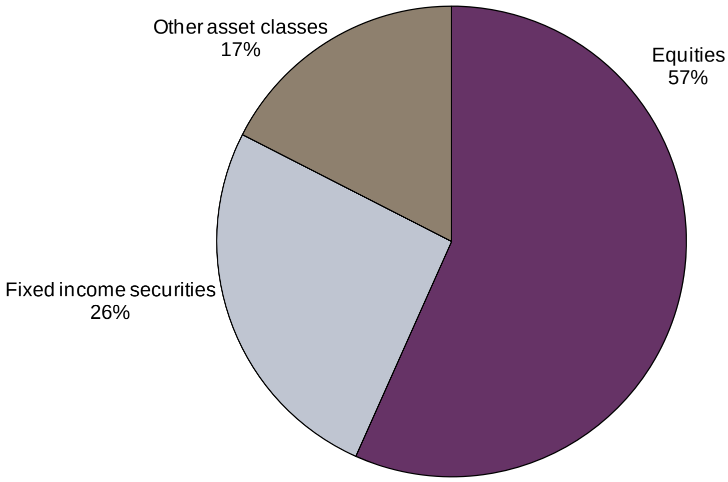
Figure A1.1 Proportion of funds managed in the UK for different types of fund



Source: Oxera calculations based on 20 responses to the 2008 investment managers questionnaire, Q6.

Figure A1.2 presents the breakdown of funds managed in the UK into the different types of assets in which the funds are held. This shows that 57% of the funds managed in the UK are held in equities.

Figure A1.2 Proportion of funds managed in the UK held in different types of asset



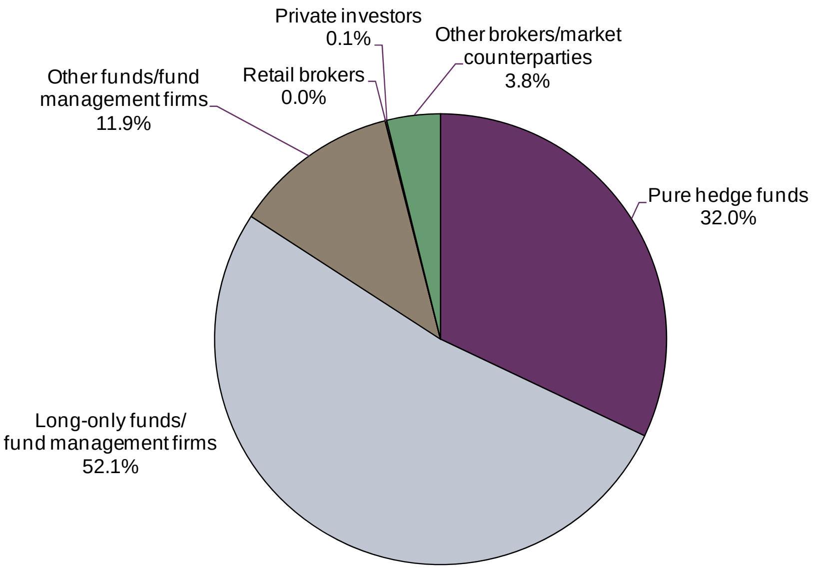
Source: Oxera calculations based on 20 responses to the 2008 investment managers questionnaire, Q5.

A1.4.2 The market for brokerage

In 2007, the 11 brokers who completed the brokerage firms questionnaire had aggregate gross commission revenues of £749.4m on trade orders worth 569.9 billion in UK equity trades for UK-based investment managers.

The breakdown of orders for UK cash equity trades according to client type is provided in Figure A1.3. This shows that the market is dominated by trade orders from investment managers that are not hedge funds. For this question, '*fund managers*' includes long-only investment managers, long-only investment managers with hedge fund divisions, and hybrid funds.

Figure A1.3 Proportion of trade orders for UK cash equities according to client type



Notes: 'Fund managers' includes long-only fund managers, long-only fund managers with hedge fund divisions and hybrid funds.
Source: Oxera calculations based on 11 responses to the brokerage firms questionnaire, Q5.

A2 Additional performance indicator

A2.1 The ratios of the amount spent on non-execution goods and services to the value of commission trading

Table A2.1 contains the supplementary analysis to section 3 of the trend in the ratio of non-execution goods and services expenditure to the value of commission trading.

Table A2.1 Weighted average of ratios of non-execution goods and services to the value of trading (bp)

	Consistent sample				Full sample	
	2003	2004	2005	2007	2005	2007
The total amount spent on non-execution goods and services purchased						
1) Through commissions to the value of trading	3.7	3.3	3.7	4	3.7	3.5
2) Through commissions using soft commission arrangements (up to 2005) or a CSA (as from 2006) to the value of trading	0.6	0.4	0.3	3.4	0.3	2.7
3) Through commissions outside of a CSA (bundled brokerage) to the value of trading	3.1	2.9	3.4	0.6	3.4	0.8
4) With hard cash to the value of trading	0.6	0.6	0.8	1.7	1.4	2.4
1) + 4) to the value of trading	4.3	3.9	4.5	5.8	5.1	5.83
Number of respondents	8	8	8	5	10	13

Note: The distinction in the number of respondents across the two surveys is driven by the response rate for the particular question. Weights were based on investment managers' reported value of trading, as provided in response to the investment managers questionnaires for the previous and the current survey.
Source: Oxera calculations based on responses to the 2008 supplementary fund managers questionnaire, and the 2008 investment managers questionnaire, Q29.

Table A2.1 indicates that, for the consistent sample, the ratio of total non-execution goods and services expenditure to the value of trading transacted on a commission basis remained roughly constant between 2003 and 2005. The ratio of total non-execution goods and services expenditure via commissions was also relatively stable, although within that, total commission expenditure via soft arrangements declined consistently. There was little fluctuation in the ratio of hard cash expenditure to the value of commission trading over the time period.

The survey evidence is that the introduction of the regime in 2006 does not lead to a clear change in the ratio of commission expenditure on non-execution goods and services to value of commission trading. The ratio increases slightly for the consistent sample between 2005 and 2007 and declines slightly for the full sample. Therefore this finding does not clearly support the hypothesis that the change in the regime would result in a reduction in the commission expenditure on non-execution goods and services.

However, there here has been a significant increase in the ratio of hard cash expenditure to the value of commission trading since 2005 (in both the full and consistent sample), which is supportive of the hypothesis that prohibiting the purchase of certain goods and services via commissions would lead to investment managers purchasing them via hard cash. Although, as noted in the main text, issues regarding the comparability of this data mean that it is hard to be certain of the magnitude of this effect.

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