

Soft commissions and bundled brokerage services: post-implementation review

**Report prepared for
Financial Services Authority**

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Executive summary

Introduction and overview

Oxera has been commissioned to conduct supporting research for the Financial Services Authority's (FSA) post-implementation review of the changes in the regime for soft commissions and bundled brokerage arrangements, including both the FSA modification of the regulations and industry-led initiatives. The full changes in the regime came into effect on January 1st 2006.

The FSA wanted to assess the impact of the changes in the regime through a number of performance indicators that could be measured using surveys among representative sample groups of fund managers, brokers and pension funds, with an initial baseline survey undertaken in February/March 2006, and another in 2007/08. The assessment of the impact of the changes in the regime would be based on analysis of the changes in the performance indicators from the results of the two surveys.

Deliverables

Oxera was commissioned, first, to develop a comprehensive range of performance indicators, 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; second, to develop an appropriate and stable methodology that could be replicated for future inter-temporal comparison; third, to undertake the baseline survey to measure these performance indicators and to analyse the data from this survey; and fourth, to review the relationships between market participants both before and in the initial months after the change in the regime for soft commissions and bundled brokerage. The FSA appointed Alan Line, a former UK fund manager, to work with the FSA and Oxera to provide an industry practitioner perspective on these four deliverables.

In agreement with the FSA, Oxera adopted an approach of three workstreams to achieve these deliverables.

1. **Design of performance indicators**—indicators were developed from logical expectations of the changes in both the behaviour of market participants and in market outcomes for all three relationships within the value chain (ie, the relationships between pension funds and fund managers, fund managers and brokers, and fund managers and research providers). These were derived from analysis of the modification of the regulations, market participants' incentives and market conditions.
2. **Design and application of methodology**—the methodology was also designed alongside the performance indicators. An initial survey was undertaken in February/ March 2006 through three questionnaires sent to representative sample groups of pension funds, fund managers and brokers. The size and response rate to the baseline survey are shown in the table below.

Baseline survey: size and response rate

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

Notes and source: see Table 4.1.1 in main report.

Further meetings were arranged with fund managers and brokers, and a supplementary questionnaire sent to managers, to collect data not provided in responses to the original questionnaire.

3. **Analysis of survey results**—the results of the initial survey were analysed to construct the baseline data for the performance indicators, identify any market trends or preliminary findings relating to the impact of the change in the regime, and evaluate the relevance and usefulness of the performance indicators.

The report is divided into four main sections.

- **Performance indicators**—a comprehensive overview of the performance indicators, together with an explanation of how they can be measured, is provided in section 2.
- **Market review**—a high-level assessment of the arrangements put in place by fund managers, brokers and pension funds following the implementation of the new regime is provided in section 3, based on interviews with a small number of market participants conducted in January–March and June–July 2006.
- **Analysis of the baseline survey**—the detailed data used to establish the functional baseline for future comparison is reviewed in section 4 according to the identified performance indicators. From the baseline survey, a number of market trends are identified, together with some preliminary findings on the impact of the change in the regime.
- **Conclusions from the baseline survey**—the quality and usefulness of the performance indicators are assessed in section 5.

Conclusions

The initial workstreams for the post-implementation review of the changes to the regime include the assessment of the approach undertaken. As such, the following conclusions can be drawn from this assessment.

- Considerable judgement was required to ensure that, at this stage in the evolution of the market, the necessary data for the post-implementation review was both suitably collected and available for future comparison. As such, careful application of the methodology and thorough analysis of the baseline survey data were required.
- The quality of data provided in response to the majority of the performance indicators was either good or very good. Given the overlap within the methodology for the measurement of the majority of the performance indicators, any cases where the availability of data was not good do not detract from the overall high quality of the baseline survey results.

- Given the high quality of data provided in the baseline survey, the majority of the performance indicators were, or will be, either useful or very useful for the assessment of the impact of the change in the regime.

Given the careful application of the methodology and thorough analysis of the baseline survey data, a robust approach for carrying out a post-implementation review has therefore been applied. This approach is consistent with the methodology set out in the Oxera report for the FSA on assessing the benefits of financial regulation.¹ Furthermore, given the high quality of data provided and the applicability and usefulness of the identified performance indicators, sufficient data has been gathered to provide a baseline for future inter-temporal comparison.

¹ Oxera (2006), 'A Framework for Assessing the Benefits of Financial Regulation', report prepared for the FSA, June.

Contents

1	Introduction	1
1.1	Objectives and remit	1
1.2	Methodology and approach	2
1.3	Implications for future comparison	4
1.4	Glossary	5
1.5	Structure of the report	6
2	Performance indicators	8
2.1	Reduction in spending on non-permitted goods and services	10
2.2	Reduction in spending on research goods and services	11
2.3	Reduction in spending on execution-related goods and services	12
2.4	Reduction in spending on non-execution goods and services purchased through commissions	12
2.5	Impact on distribution of research costs and market structure	15
3	Arrangements between fund managers and brokers	20
3.1	Commission-sharing arrangements	20
3.2	Types of arrangement	21
3.3	Pension funds	22
3.4	Other observations	22
4	Baseline survey results	23
4.1	Survey sample and representativeness	23
4.2	General description of respondents' data	26
4.3	Reduction in spending on non-permitted goods and services	28
4.4	Reduction in spending on research goods and services	35
4.5	Reduction in spending on execution-related goods and services	44
4.6	Reduction in spending on non-execution goods and services purchased through commissions	48
4.7	Impact on distribution of research costs and market structure	69
4.8	Identified market trends and preliminary findings on the impact of the change in the regime	81
5	Evaluation of the baseline survey	83
	Appendix 1 The compilation of the survey sample	88
A1.1	Pension funds	88
A1.2	Fund managers	88
A1.3	Brokers	89
	Appendix 2 Pension funds questionnaire	90

Appendix 3 Fund managers questionnaire	97
Appendix 4 Brokers questionnaire	107
Appendix 5 Supplementary fund managers questionnaire	114

List of tables

Table 4.1.1	Effective response rate to Oxera questionnaires	24
Table 4.1.2	Response rate to Oxera supplementary questionnaire	25
Table 4.3.1	Weighted average of ratios of non-permitted goods and services purchased to funds under management	29
Table 4.3.2	Weighted average of ratios of non-permitted goods and services to the value of bundled brokerage trades	30
Table 4.3.3	Proportions of change in weighted average of ratios of non-permitted goods and services purchased through commissions to funds under management	32
Table 4.3.4	Effective actual management fees	33
Table 4.3.5	Typical active management fees	34
Table 4.3.6	Typical passive management fees	34
Table 4.3.7	Change in typical active management fees between 2001 and 2005	34
Table 4.3.8	Change in typical passive management fees between 2001 and 2005	35
Table 4.4.1	Use of the IMA Disclosure Code	36
Table 4.4.2	Method for pricing research purchased through bundled brokerage arrangements	38
Table 4.4.3	Number of brokers who had agreed fixed budgets for research	38
Table 4.4.4	Extent of monitoring of quality of research	38
Table 4.4.5	Sharing of results of monitoring brokers with pension fund clients	39
Table 4.4.6	Weighted average of ratios of research to funds under management	41
Table 4.4.7	Weighted average of ratios of research to the value of bundled brokerage trades	42
Table 4.4.8	Proportions of change in weighted average of ratios of research to funds under management	43
Table 4.5.1	Weighted averages of the ratios of execution-related goods and services purchased to funds under management	45
Table 4.5.2	Weighted average of ratios of execution-related goods and services to amount spent on bundled brokerage trades	46
Table 4.5.3	Proportions of change in weighted average of ratios of execution-related goods and services to funds under management	48
Table 4.6.1	Weighted average of ratios of non-execution goods and services to the funds under management	49
Table 4.6.2	Weighted average of ratios of non-execution goods and services to value of bundled brokerage trades	51
Table 4.6.3	Representation of the take-up of commission-sharing agreements	52
Table 4.6.4	Weighted average commission rates for execution-only transactions	54
Table 4.6.5	Weighted average commission rates for bundled transactions	54
Table 4.6.6	Proxy constituents of bundled brokerage commission rates (fund managers)	55
Table 4.6.7	Weighted average commission rates for execution-only transactions	56
Table 4.6.8	Weighted average commission rates for bundled transactions	56
Table 4.6.9	Weighted average commission rate on a menu of brokerage services	57
Table 4.6.10	Proxy constituents of bundled brokerage commission rates (brokers)	57
Table 4.6.11	Estimated constituents of bundled brokerage commission rates (fund managers)	59
Table 4.6.12	Estimated constituents of execution-plus commission rate (brokers)	59
Table 4.6.13	Constituents of bundled brokerage commission rates from aggregated data	61
Table 4.6.14	Turnover ratios	64

Table 4.6.15	Volume of bundled brokerage trades	64
Table 4.6.16	Volume of bundled brokerage trades	65
Table 4.6.17	Substitutability of execution-only and bundled brokerage	65
Table 4.6.18	Proportions of three types of trading	66
Table 4.6.19	Volume of bundled brokerage trades	66
Table 4.6.20	Proportion of trades for a menu of brokerage services (fund managers)	67
Table 4.6.21	Proportion of trades for a menu of brokerage services (brokers)	68
Table 4.7.1	Weighted average commission rates for execution-only transactions	69
Table 4.7.2	Weighted average commission rates for bundled transactions	70
Table 4.7.3	Number of brokers who will set a price for research for brokerage clients in terms of a fixed number of basis points	70
Table 4.7.4	Weighted average management fees for actively managed funds	71
Table 4.7.5	Weighted average management fees for passively managed funds	71
Table 4.7.6	Number of brokers on individual fund managers' approved lists (15 fund managers, 2001–06)	72
Table 4.7.7	Number of brokers on individual fund managers' approved lists (19 fund managers, 2003–06)	73
Table 4.7.8	Weighted average proportions of trades going to brokers (%) (11 fund managers, 2001–05)	73
Table 4.7.9	Weighted average proportions of trades going to brokers (%) (14 fund managers, 2003–06)	74
Table 4.7.10	Extent of monitoring of quality of trade execution and quality of research	76
Table 4.7.11	Offers of independent research from full-service brokers in 2005 (fund managers)	77
Table 4.7.12	Offers of independent research from full-service brokers in 2006 (fund managers)	77
Table 4.7.13	Offers of independent research from full-service brokers in 2006 (brokers)	78
Table 4.7.14	Fund managers' perspectives on market liquidity	79
Table 4.7.15	Fund managers' perspectives on trends in market liquidity	79
Table 4.7.16	Brokers' perspectives on market liquidity	79
Table 4.7.17	Brokers' perspectives on trends in market liquidity	79
Table 5.3.1	Evaluation of performance indicators from sections 2.1 and 4.3	83
Table 5.3.2	Evaluation of performance indicators from sections 2.2 and 4.4	84
Table 5.3.3	Evaluation of performance indicators from sections 2.3 and 4.5	85
Table 5.3.4	Evaluation of performance indicators from sections 2.4 and 4.6	85
Table 5.3.5	Evaluation of performance indicators from sections 2.5 and 4.7	86
Table A5.1.1	Supplementary fund managers questionnaire	114
Table A5.1.2	Supplementary fund managers questionnaire	115

List of figures

Figure 2.1	Potential impacts of the change in the regime throughout the value chain	9
Figure 4.2.1	Proportion of funds managed in the UK for different types of fund	26
Figure 4.2.2	Proportion of funds managed in the UK held in different types of asset	26
Figure 4.2.3	Proportion of trade orders for UK cash equities according to client type	27
Figure 4.2.4	Weighted average proportion of clients according to client type	27
Figure 4.3.1	Weighted average of ratios of non-permitted goods and services purchased to funds under management	29
Figure 4.3.2	Weighted average non-permitted goods and services constituents of bundled brokerage commission rates	31
Figure 4.4.1	Use and implementation of IMA Disclosure Code	36
Figure 4.4.2	Fund managers who received estimates of the cost of non-execution goods and services provided through bundled brokerage arrangements (2005)	37
Figure 4.4.3	Fund managers who received estimates of the cost of non-execution goods and services provided through bundled brokerage arrangements (2006)	37
Figure 4.4.4	Frequency of monitoring quality of research	39

Figure 4.4.5	Weighted average of ratios of research to funds under management	41
Figure 4.4.6	Weighted average research constituents of bundled brokerage commission rates	42
Figure 4.5.1	Weighted average of ratios of execution-related goods and services purchased to funds under management	45
Figure 4.5.2	Weighted average execution-related goods and services constituents of bundled brokerage commission rates	47
Figure 4.6.1	Weighted average of ratios of non-execution goods and services to funds under management	50
Figure 4.6.2	Weighted average non-execution goods and services constituents of bundled brokerage commission rates	51
Figure 4.6.3	Proxy constituents of bundled brokerage commission rates (fund managers)	55
Figure 4.6.4	Proxy constituents of bundled brokerage commission rates (brokers)	58
Figure 4.6.5	Estimated constituents of bundled brokerage commission rates	60
Figure 4.6.6	Execution and non-execution constituents of bundled brokerage commission rates from aggregated data	62
Figure 4.6.7	Two execution and non-execution constituents of bundled brokerage commission rates from aggregated data	62
Figure 4.6.8	Execution and three non-execution constituents of bundled brokerage commission rates from aggregated data	63
Figure 4.6.9	Proportion of trades for a menu of brokerage services (fund managers)	67
Figure 4.6.10	Proportion of trades for a menu of brokerage services (brokers)	68
Figure 4.7.1	Weighted average proportions of trades going to brokers (11 fund managers, 2001–05)	74
Figure 4.7.2	Weighted average proportions of trades going to brokers (14 fund managers, 2003–06)	75
Figure 4.7.3	Frequency of monitoring quality of trade execution	76
Figure 4.7.4	Frequency of monitoring quality of research	77
Figure 4.7.5	Rated importance of factors in brokers competing for business from fund managers	78
Figure 4.7.6	Aggregated fund managers' and brokers' perspective on market liquidity	80
Figure 4.7.7	Fund managers' and brokers' perspective on trends in market liquidity	80

1 Introduction

1.1 Objectives and remit

Oxera was commissioned to conduct supporting research for the Financial Services Authority's (FSA) post-implementation review of the changes in the regime for soft commissions and bundled brokerage arrangements. These changes refer to the FSA modification of the regulations on the usage of trade execution commissions, by fund managers, to purchase research and execution-related goods and services,² and industry-led solutions based around disclosure, such as the IMA Disclosure Code.³

The FSA wanted to assess the impact of the change in the regime through a number of performance indicators that could be measured using surveys among representative sample groups of fund managers, brokers and pension funds.⁴ Oxera therefore conducted a survey, in February/March 2006, to obtain the data to construct the baseline (ie, the situation before the change in the regime in January 2006).⁵ Following the baseline survey, future surveys will be undertaken, initially expected to be in 2007/08.

The comparison of the results from future surveys with the results of the baseline surveys, complemented by an assessment of general market developments, will provide an indication of the impact of the change in the regime for soft commissions and bundled brokerage arrangements. In principle, this type of survey could be undertaken at various points in the future.

Deliverables

Oxera was commissioned in December 2005, first, to develop a comprehensive range of performance indicators, 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; second, to develop an appropriate and stable methodology that could be replicated for future inter-temporal comparison; third, to undertake the baseline survey to measure these performance indicators and to analyse the data from this survey; and fourth, to review the relationships between market participants both before and in the initial months after the change in the regime for soft commissions and bundled brokerage.

In agreement with the FSA, Oxera adopted an approach of three workstreams to achieve these deliverables.

- **Design of performance indicators**—these were developed from logical expectations of the changes in both the behaviour of market participants and in market outcomes for all three relationships within the value chain. These were derived from analysis of the modifications to regulations, market participants' incentives and market conditions.
- **Design and application of methodology**—the methodology was also designed alongside the performance indicators. An initial survey was undertaken in

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, July.

³ IMA (2005), 'Pension Fund Disclosure Code—Second Edition', March.

⁴ Throughout this report, 'pension fund' refers to pension fund trustees, or to the fund itself.

⁵ To improve the quality of data, follow-up surveys were undertaken of a small number of fund managers and brokers.

February/March 2006 through three questionnaires sent to representative sample groups of pension funds, fund managers and brokers. Further meetings with fund managers and brokers were arranged, and a supplementary questionnaire sent to managers, to collect data not provided in responses to the original questionnaire.

- **Analysis of survey results**—the results of the initial survey were analysed to construct the baseline data for the performance indicators, identify any market trends or preliminary findings relating to the impact of the change in the regime, and evaluate the relevance and usefulness of the performance indicators. The results are presented in aggregate form only as the individual responses are confidential.

The FSA appointed Alan Line, formerly a UK fund manager, to work with the FSA and Oxera to inject an industry practitioner viewpoint into the design and development of the set of indicators and the specific aspects of the markets to be addressed. He assisted in designing the questionnaires, assessing recent market developments, liaising with survey respondents and providing high-level analysis of the survey results.

1.2 Methodology and approach

In keeping with the deliverables and workstreams, the impact of the changes in the regime for soft commissions and bundled brokerage arrangements is measured using a number of performance indicators. Alongside these indicators, a methodology was developed for their measurement and applied in the baseline survey. Comparison of the baseline survey results with the results of future surveys, together with analysis of general market developments, will provide an indication of the extent to which the expected changes have materialised.

Design of the performance indicators

As noted above, the performance indicators were developed on the basis of logical expectations of the impact of the change in the regime for soft commissions and bundled brokerage arrangements. These changes in both the behaviour of market participants and market outcomes were derived from the consideration of the three relationships within the value chain—ie, the relationships between pension funds and fund managers, between fund managers and brokers, and between fund managers and research providers.

The development of the performance indicators was initially focused on analysing the change in the regime, market participants' incentives and market conditions. This was supported with the use of existing studies on the regime for soft commissions and bundled brokerage arrangements.⁶ The indicators were also developed through consultation with the FSA, industry trade associations and industry participants.

The performance indicators are either direct or indirect, and hard or soft (see section 2 for full descriptions).

- **Direct performance indicators**—these directly measure the change in the desired outcome of the market. For example, they might measure the change in the amount spent on research through commissions.
- **Indirect performance indicators**—having identified the market detriment which regulation is seeking to address, the next step is to consider the mechanisms or process by which regulation is likely to achieve the desired change in market outcomes. Indirect measurement refers to quantifying 'intermediate' improvements at various points along

⁶ Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', report prepared for the FSA, March. Myners, P. (2001), 'Institutional Investment in the United Kingdom; A Review', March, commissioned by the Chancellor of the Exchequer in the 2000 Budget.

the process. The last step is to validate that the chosen proxies are suitable for drawing inferences about improvements in market outcomes. For example, in addition to assessing directly the change in amount spent on research, it might be possible to assess the way in which fund managers evaluate the quality of research provided by brokers and become more selective about the services they purchase. If fund managers systematically evaluate the quality of research, this is likely to contribute to better research and/or a reduction in the amount spent on research purchased through commissions.

- **Hard performance indicators**—these focus on metrics that can be objectively measured on the basis of data provided by pension funds, brokers and fund 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 fund managers conduct performance reviews of their brokers or the evaluation of the services provided by fund managers to pension funds require subjective responses and are therefore soft indicators.

Design and application of methodology

In parallel with the development of the performance indicators, a methodology for measuring the performance indicators was designed. This ensured that the indicators could realistically be measured, and that the process for gathering data to conduct the baseline was in keeping with the performance indicators that were developed.

The methodology for measuring the impact of the change in the regime for soft commissions and bundled brokerage arrangements incorporated the following stages.

- **In-depth interviews with industry participants and other experts**—these were conducted during the early stages of the study, with the main objective being to obtain insight into the new mechanisms put in place—eg, what type of arrangements brokers and fund managers had entered into, or the type of information disclosed. Oxera conducted interviews with two pension funds, four fund managers, one broker and one pension consultant, and participated in a meeting discussing bundled brokerage services and soft commission arrangements with a number of brokers, organised by LIBA.
- **Survey**—three separate questionnaires, designed to collect data for the construction of the baseline, were sent in February/March 2006 to representative sample groups of pension funds, fund managers and brokers. Appendix 1 describes how these sample groups were selected, and the characteristics of those who responded. Appendices 2 to 4 reproduce the three original questionnaires, referred to in this report as the ‘brokers questionnaire’, ‘original fund managers questionnaire’ and ‘pension funds questionnaire’.
- **Follow-up interviews with respondents**—after analysing the survey results, follow-up interviews were conducted in June and July 2006 with 17 fund managers to obtain more data on the amount spent with soft commissions and on research. A supplementary fund managers questionnaire was used alongside the follow-up interviews to gather data that had not been provided in response to the original fund managers questionnaire. The ‘supplementary fund managers questionnaire’, as it is referred to here, is reproduced in Appendix 5. The meetings with fund managers were attended by both Oxera and Alan Line. Furthermore, for the same purpose, a number of meetings with brokers were arranged by Alan Line in May and June 2006.

Contribution of the baseline survey

The results of the baseline survey, particularly from the pension funds, fund managers and brokers questionnaires, are described in section 4. The baseline survey served two main purposes.

- **To establish the baseline for future comparison:** the baseline refers to the situation before the change in the regime for soft commissions and bundled brokerage arrangements (ie, before January 2006).

Data gathered in the baseline survey was primarily used to provide a functional baseline for future comparison. Section 4 describes the analysis and results of the survey data at a high level of detail, for two reasons.

- First, data was gathered for a wide range of indicators and from many fund managers and brokers over several years. For the purposes of future comparison, it is necessary to document this analysis in detail to ensure like-for-like comparisons with the results of future surveys.
 - Second, although extensive analysis and consultation have identified a range of potential impacts from the change in the regime for soft commission and bundled brokerage arrangements, the actual impacts of the change in the regime are unknown at this time. Therefore, to allow for effective future comparison—ie, to identify the impact of the change in the regime—it is essential that the initial approach is as broad as possible, and that the description of the analysis and survey results is as comprehensive as possible.
- **To assess the usefulness of performance indicators**—the surveys help to ascertain whether the data is available from pension funds, fund managers and brokers, and whether it is of sufficient quality to be relied upon for the impact assessment. This allows an evaluation of the methodology and its applicability in measuring the impact of the change in the regime for soft commissions and bundled brokerage arrangements.

Moreover, to some extent the surveys allow underlying markets trends to be measured, and provide a preliminary assessment of the impact of the change in the regime.

- **Identification of market trends**—through the surveys, underlying market trends within the data can be measured. For example, the impact of a change in the regime must take into account the counterfactual: without the change in the regime, what change would there have been in the brokerage commission rates? This requires the underlying trend changes in brokerage commission rates to be established.
- **Preliminary assessment of the impact of the change in the regime**—as the surveys measure a number of indirect indicators concerning the ways in which market participants interact and how they *intend* to implement the new regime, they can provide some up-front indication of the likely impact of change in the regime for the relationships between brokers and fund managers, and between fund managers and pension funds.

These supplementary outcomes of this study are presented in section 5.

1.3 Implications for future comparison

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. This variation in the time taken for the impacts of the change in the regime to occur arises for two reasons. First, there may be different drivers of different changes—for example, the change in the relationship between pension funds and fund managers may be driven by the disclosure requirements, while the relationship between fund managers and

brokers may alter because of a change in the services allowed to be purchased through commissions. Second, a number of indirect effects may arise from the change in the regime—for example, the impact on the market structure for institutional brokerage will depend on the impact on the relationships between fund managers and brokers, and may therefore take longer to materialise. Thus, the logically expected effects of the change in the regime, and the performance indicators derived from those expected effects, may not be observable immediately.

Furthermore, the change in the performance indicators over time may be driven not only by the change in the regime for soft commissions and bundled brokerage arrangements, but also by a range of other factors, such as general market developments. Also, there may already be certain trends in the market that may be strengthened as a result of the new regime. As such, it is important to make sure that only the *change in the trend* is attributed to the impact of the change in the regime—attributing the whole trend to the change in the regime would mask the actual impact of the change in the regime.

The following methods are available to assist in distinguishing between changes in the indicators as a result of either the new regime for soft commissions and bundled brokerage arrangements or changes in other factors.

- **Indirect and soft indicators**—as explained above, soft indicators are included that would allow changes in the behaviour of brokers, fund managers and pension funds to be identified. These changes are expected to contribute to changes in market outcomes measured by the hard indicators—enabling changes in market outcomes to be related back to the change in the regime for soft commissions and bundled brokerage arrangements.
- **Time series**—by asking for data over a longer period (eg, back to either 2003 or 2001), existing trends in the market may be identified and distinguished from changes resulting from the change in the regime for soft commissions and bundled brokerage arrangements.
- **Other market comparisons** could be used, such as commission rates in other countries (not affected by the change in the regime for soft commissions and bundled brokerage), in order to assess whether a fall in commission rates is due to a general market trend or (partly) caused by the change in the regime for soft commissions and bundled brokerage arrangements. Such benchmarking analysis could be undertaken at the time of future surveys among fund managers, brokers and pension funds.

1.4 Glossary

Types of arrangement

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

- **Soft commission arrangements** are those in which a fund 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 a fund manager, by agreeing to send trades to a broker, receives, in addition to ‘pure’ trade execution, other goods and services from the broker.
- **Commission-sharing arrangements** are those in which a fund manager agrees with brokers that the non-execution constituent of the execution-plus commission rate should be paid into a commission-sharing pool, from which the fund manager can then pay for research from the broker, other brokers or third-party research providers. This may be enacted through an intermediary.

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 prior to the change in the regime for January 1st 2006. It includes payment for execution, bundled non-execution goods and services, and soft commission credits that would have been available as part of full-service brokerage.
- The **execution-plus commission rate** is the commission rate that pays for execution, and other non-execution goods and services that are permitted under the new regime—ie, either research or execution-related goods and services.
- The **execution-only commission rate** is the commission rate for execution-only transactions.

Services

This report distinguishes between the following types of service, as defined by the FSA.⁷

- **Execution** is the service provided by a broker to a fund manager when specific trades are executed for the fund manager.
- **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 do not fall within the modified regulations and the FSA definitions of 'execution' or 'research'. They *are no longer permitted* to be obtained through soft commissions or bundled brokerage arrangements.

1.5 Structure of the report

- Section 2 describes the performance indicators drawn up by Oxera, and how these have been measured in the surveys undertaken for this study.
- Section 3 examines the arrangements put in place between fund managers, brokers and pension funds following the introduction of the new regime.
- Section 4 analyses the results of the survey, evaluating the quality of the data and the usefulness of the performance indicators, identifying market trends, and providing a preliminary assessment of the impact of the change in the regime.
- Section 5 presents the conclusions from the study by providing an evaluation of the methodology undertaken in this study.

⁷ See the modified regulations: FSA Handbook, Conduct of Business Sourcebook 7.18.

- The first appendix outlines how the survey sample groups were compiled, how contacts were sourced and the response rates for the three original questionnaires and the supplementary fund managers questionnaire. The four questionnaires are then reproduced in the subsequent appendices.

2 Performance indicators

This section describes the performance indicators developed by Oxera, in cooperation with the FSA, IMA, LIBA and NAPF, to measure the impact of the new regime over time. The indicators are measured by undertaking surveys among brokers, fund managers, and pension funds.⁸

For the purpose of this impact assessment of the change in the regime for soft commissions and bundled brokerage arrangements, four types of goods and services are considered, as defined in section 1.4.

In agreement with the FSA and the three trade associations, six categories of indicators have been identified, according to the basis of the expected impact.

- 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.

In the description of each performance indicator category, the expected impact is explained. In addition, as part of the first phase of the methodology, appropriate approaches to measuring these indicators are described.

The results and analysis of the baseline survey, including a description of the practical approach for the measurement of the indicators in the baseline survey, are described in section 4, with the results for each of the six categories of performance indicator presented in sections 4.3 to 4.7. An evaluation of the performance indicators, provided in section 5.3, includes suggestions for the improvement of both the selection of participants and the selection and measurement of the performance indicators.

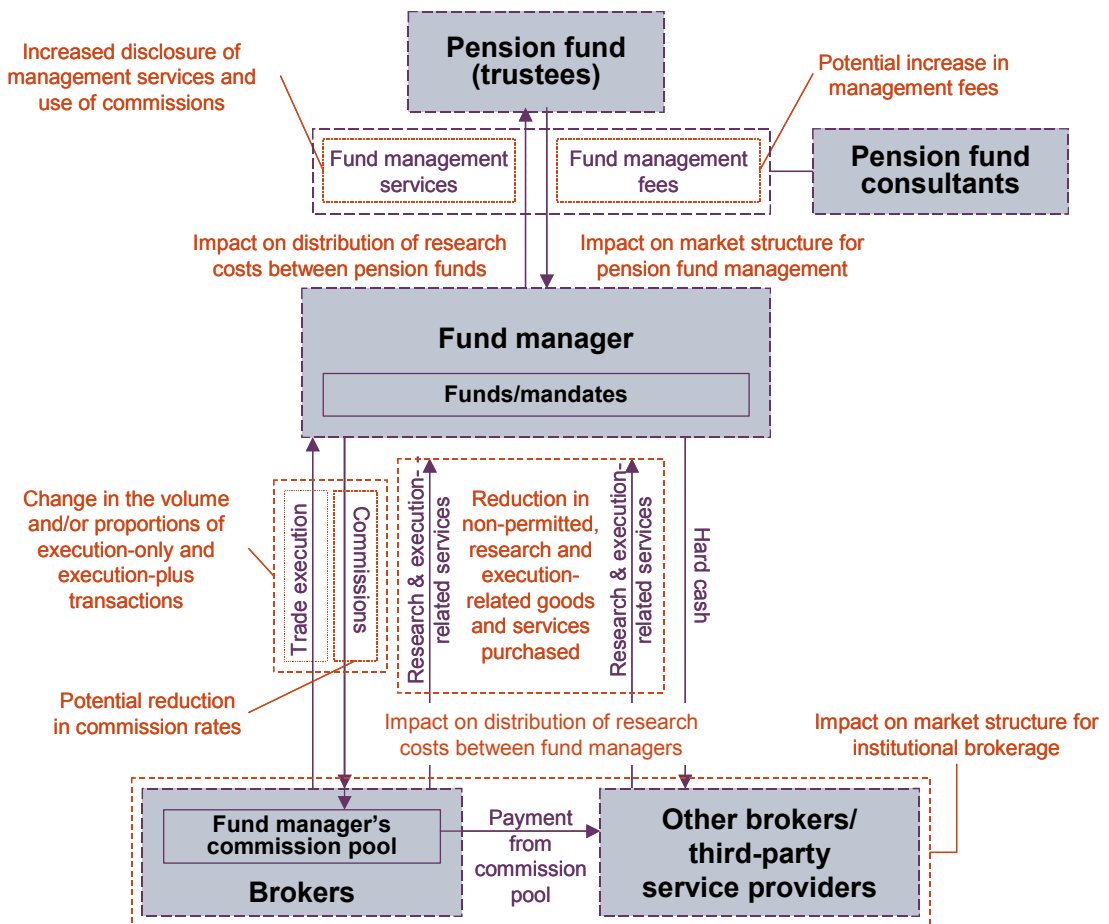
It is also useful to consider where these performance indicators fit within the value chain of the fund management industry. Figure 2.1 portrays the value chain with the possible impacts of the change in the regime for soft commissions and bundled brokerage. This shows the key relationships between pension funds and fund managers, between fund managers and brokers, and between fund managers and research providers.

⁸ Some indicators may be measured in 2007/08 using other data sources such as the FSA database and industry associations.

The relationship between pension funds and fund managers may also include pension fund consultants who advise trustees on their appointment and relationships with fund managers. This relationship is particularly affected by the increased disclosure requirements. However, there may also be potential impacts on the structure of the market for fund management and the management fees charged.

The relationship between fund managers and brokers is twofold: first, fund managers send trade orders to brokers for execution; and, second, the commission rates are paid by the fund or mandate (for execution for that fund or mandate), where the commissioned fees are either used to pay that broker for execution or into a commission pool, from which non-execution goods and services can be purchased. This relationship is affected by a range of factors, including the change in the goods and services purchased, how these are purchased, the potential impacts on the structure of the market for institutional brokerage, and the commission rates charged.

Figure 2.1 Potential impacts of the change in the regime throughout the value chain



Source: Oxera.

2.1 Reduction in spending on non-permitted goods and services

Under the new regime for soft commissions and bundled brokerage arrangements, 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'.⁹

As the four types of goods and services described above suggest, a number of goods and services that were allowed to be obtained under soft commissions or bundled brokerage arrangements are no longer permitted to be purchased through commissions. These non-permitted goods and services provide the first indicator of the impact of the change in the regime: the amount spent on non-permitted goods and services purchased through commissions should fall to zero.

If fund managers are unable to purchase these non-permitted goods and services through commissions, 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. This gives the second indicator: the amount spent on non-permitted goods and services purchased with hard cash.

However, if fund managers are purchasing non-permitted goods and services with hard cash, this must be paid for from fund managers' income (ie, from the management fees charged on the funds under management). As such, the purchase of non-permitted goods and services with hard cash directly affects the profit earned on funds under management. This may lead to fund managers becoming more discerning about the purchase of such non-permitted goods and services, and therefore the fall in non-permitted goods and services purchased through commissions (either soft commissions or bundled brokerage arrangements) may not be fully matched by the increase in non-permitted goods and services purchased with hard cash. This provides the third indicator: the total amount spent on non-permitted goods and services purchased (either through commissions or with hard cash).

Alternatively, the switch from purchasing non-permitted goods and services through commissions to purchasing them with hard cash may lead to higher management fees. Fund 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. Any such effect may be small and it would be difficult to determine that any change in management fees is related to the change in the regime. However, in principle, this provides a potential fourth indicator: the management fees paid by pension funds.

Performance indicators: reduction in spending on non-permitted goods and services

- The amount spent on non-permitted goods and services purchased with soft commissions or through bundled brokerage arrangements—if firms comply with the new regime, this would be expected to be zero from July 2006.
- The amount spent on non-permitted goods and services purchased with hard cash.
- The total amount spent on non-permitted goods and services—ie, purchased either through commissions or with hard cash.
- The management fees paid by pension funds.

These performance indicators were measured by the survey among brokers and fund managers, using quantitative questions. The results of these performance indicators are described in section 4.3.

⁹ These definitions are in the FSA Handbook, Conduct of Business Sourcebook 7.18.

2.2 Reduction in spending on research goods and services

As well as reducing the types of goods and services that can be purchased through commissions, the new regime requires that fund managers make prior and periodic disclosure to their clients, including disclosure of the use of clients' commissions.

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 fund managers about the use of the commissions. If the fund managers come under greater scrutiny from pension funds, they may become more selective about the research goods and services they purchase through commissions. This provides the first performance indicator: the scrutiny, by pension funds, of fund managers' use of clients' commissions.

Following from this, the change in the regime may lead to a reduction in the amount spent on research purchased through commissions. This suggests the second and third performance indicators: the amount spent on research purchased from either brokers or third-party research providers with soft commissions, and the amount spent on research purchased from brokers through bundled brokerage arrangements; or, under the new regime, the amount spent on research purchased through commissions.

However, the change in the regime is not expected to affect the amount spent on research either purchased with hard cash or produced in-house. This suggests the fourth and fifth performance indicators: the amount spent on research purchased with hard cash, and the amount spent on research produced in-house. These provide a check on the trends of spending on research by fund managers.

The intuitive expectation is therefore that the amount spent on research goods and services purchased through commissions may decline, while the amount spent on research goods and services either purchased with hard cash or produced in-house will remain constant. This gives the sixth performance indicator: the total amount spent on research goods and services consumed.

Performance indicators: reduction in spending on research goods and services

- Qualitative and anecdotal evidence on the scrutiny, by pension funds, of fund managers' use of clients' commissions.
- The amount spent on broker/third-party research purchased with soft commissions.
- The amount spent on broker research purchased through bundled brokerage arrangements.
- The amount spent on research purchased with hard cash.
- The amount spent on research produced in-house.
- The total amount spent on research goods and services.

Two difficulties were identified in relation to measuring these performance indicators. First, for the years up to 2006, brokers and fund managers were not expected to know the costs of research provided through bundled brokerage arrangements. Any data before 2006 will therefore be an estimation, while the change in the regime will result in more accurate measures of research costs from 2006. Second, fund managers may be unable to estimate accurately the amount spent on research produced in-house. Any estimates provided should be considered to be indicative only.

These performance indicators were measured by the survey among brokers and fund managers, using several qualitative and quantitative questions. The results of these performance indicators are described in section 4.4.

2.3 Reduction in spending on execution-related goods and services

As described in the previous sub-section, the change in the regime for soft commissions and bundled brokerage arrangements may lead to greater scrutiny of fund managers' use of commissions on trades undertaken for their clients' funds or mandates. If they come under greater scrutiny from pension fund trustees, fund managers may become more selective about the execution-related goods and services that are purchased through commissions. Therefore, the change in the regime may lead to a reduction in the amount spent on execution-related goods and services purchased through commissions. This suggests the first and second performance indicators: the amount spent on execution-related goods and services purchased with soft commissions, and the amount spent on execution-related goods and services purchased through bundled brokerage arrangements; or, under the new regime, the amount spent on execution-related goods and services purchased through commissions.

However, the change in the regime is not expected to affect the amount spent on execution-related goods and services purchased with hard cash. This suggests the third performance indicator: the amount spent on execution-related goods and services purchased with hard cash. This provides a check on the trends of spending on execution-related goods and services by fund managers.

Therefore, the intuitive expectation is that the amount spent on execution-related goods and services purchased through commissions may decline, while the amount spent on execution-related goods and services purchased with hard cash will remain constant. This gives the fourth performance indicator: the total amount spent on execution-related goods and services consumed.

Performance indicators: reduction in spending on execution-related goods and services

- The amount spent on execution-related goods and services purchased with soft commissions.
- The amount spent on execution-related goods and services purchased through bundled brokerage arrangements.
- The amount spent on execution-related goods and services purchased with hard cash.
- The total amount spent on execution-related goods and services.

As identified in the previous section, a difficulty was identified in relation to measuring these performance indicators. For the years up to 2006, brokers and fund managers were not expected to know the full costs of execution-related goods and services provided through bundled brokerage arrangements. Any data before 2006 will therefore be an estimation, while the change in the regime will result in more accurate measures of the amount spent on execution-related goods and services from 2006.

These performance indicators were measured by the survey among brokers and fund managers, using quantitative questions. The results of these performance indicators are described in section 4.5.

2.4 Reduction in spending on non-execution goods and services purchased through commissions

Following from the first three categories of performance indicators, if the amount spent on non-permitted goods and services, research goods and services and execution-related goods and services purchased through commissions all fall, the total spending through commissions on non-execution goods and services will also fall. This provides the first performance indicator: the amount spent on non-execution goods and services purchased through commissions.

Performance indicator: reduction in spending on non-execution goods and services purchased through commissions

- The total amount spent on non-execution goods and services purchased through commissions.

This performance indicator was measured by the survey among fund managers, using quantitative questions. The results of this performance indicator are described in section 4.6.

If the total amount spent on non-execution goods and services purchased through commissions declines, fund managers will require a smaller 'commission pool' from which to purchase goods and services through commissions. In pre-2006 terms, there may not have been explicit 'commission pools'; however, the concept can still be applied to the total amount spent on soft commissions and the total amount spent on non-execution goods and services purchased through bundled brokerage arrangements. The 'commission pool' is generated through the commissions paid to brokers on bundled (pre-2006) or execution-plus (post-2006) commission rates.

A smaller commission pool could be achieved in three ways: first, fund managers could negotiate a reduction in the non-execution constituent of execution-plus commission rates; second, by reducing the volume of execution-plus trading; or third by switching from execution-plus trading to execution-only trading. These form the three sub-categories of performance indicators.

Sub-categories of performance indicators: reduction in spending on non-execution goods and services purchased through commissions

- Reduction in the non-execution constituent of execution-plus commission rates.
- Reduction in the volume of execution-plus trading.
- Changes in the proportions of execution-plus trading and execution-only trading.

Reduction in the non-execution constituent of execution-plus commission rates

As identified above, the commission pool is generated through the commissions paid to brokers on either bundled or execution-plus commission rates. Both of these commission rates can be divided into two constituent parts: the part of the commission rate that pays for the execution of trades on behalf of clients, and the part that pays for non-execution goods and services.

While the former execution constituent of the bundled or execution-plus commission rate pays for the execution of that specific trade, the latter non-execution commission rate generates the commission pool. One means of reducing the commission pool is for the non-execution commission rate to be reduced. This provides the first performance indicator: the non-execution constituent of bundled or execution-plus commission rates.

However, there are difficulties relating to the estimation of the non-execution constituent of bundled brokerage commission rates (ie, the non-execution constituent before the change in the regime). Previously, neither fund managers nor brokers had broken down the bundled brokerage commission rate into execution and non-execution constituents. The soft commission constituent of bundled brokerage can be calculated using actual data for the proportion of trades that were softened, the soft commission multiple, and the amount spent on goods and services purchased with soft commissions. However, most fund managers have not previously calculated the remainder of the non-execution constituent (ie, that which purchased goods and services through bundled brokerage arrangements).

Therefore, proxies for the non-execution constituent of bundled brokerage commission rates must be calculated. There are three ways in which this can be done. First, if it is assumed that the execution constituent of the bundled brokerage commission rates purchases the same service as an execution-only commission rate, the difference between these should provide a proxy for the non-execution constituent of the bundled brokerage commission rate.

This gives the first performance indicator: the difference between the bundled brokerage commission rate and the execution-only commission rate. However, there are reservations about this as a proxy, as confirmed by a number of fund managers. Bundled brokerage may incorporate additional services in relation to the execution of trades above that which is provided for by an execution-only commission rate (eg, actively working on the trade to generate a better trade execution price). However, despite these reservations, this proxy has been retained, as the inaccuracies inherent in the initial assumptions can be tested using the data generated from the 2007/08 questionnaire.

Second, fund managers were asked to provide a backward-looking estimated breakdown of the bundled brokerage commission rate into execution and non-execution constituents. Third, brokers were asked to provide a forward-looking estimation of the expected breakdown of execution-plus commission rates into execution and non-execution constituents. These provide the second and third performance indicators.

Performance indicators: reduction in the non-execution constituent of execution-plus commission rates

- The difference between bundled brokerage commission rates and execution-only commission rates.
- Fund managers' estimates of the non-execution constituent of bundled brokerage commission rates.
- Brokers' estimates of the expected non-execution constituent of execution-plus commission rates.

These performance indicators were measured by the survey among brokers and fund managers, using several quantitative questions. The results of these performance indicators are described in section 4.6.

Reduction in the volume of execution-plus trading

As the commission pool is generated through commissions paid to brokers on either bundled or execution-plus trades, fund managers could make the pool smaller by reducing the volume of execution-plus trading. This provides the second sub-category of performance indicators, and the first performance indicator within that sub-category: the volume of execution-plus trading.

There are two possibilities with regard to the nature of any reduction in the volume of execution-plus commission rates. This could be the result of a switch in trading patterns from using execution-plus to execution-only trades. This would suggest that fund managers are already 'trading optimally', and simply choose to switch from one form of brokerage to another. Alternatively, fund managers may simply reduce the total volume of trading undertaken. This would suggest that, prior to the change in the regime, fund managers were trading above the optimal level in order to generate soft commission credits or to increase the amount spent on goods and services they would receive through bundled brokerage arrangements.

To assess these possibilities, two further performance indicators are required: the volume of execution-only trading and the volume of total commission trading.

Performance indicators: reduction in the volume of execution-plus trading

- The volume of execution-plus trading.
- The volume of execution-only trading (including programme trades).
- The volume of total commission trading.

These performance indicators were measured by the survey among brokers and fund managers, using several quantitative questions. The results of these performance indicators are described in section 4.6.

Changes in the proportions of execution-plus and execution-only trades

Depending on the extent to which each of the three mechanisms through which fund managers generate a smaller commission pool applies—ie, a reduction in the non-execution constituent of execution-only commission rates, a switch from execution-plus brokerage to execution-only brokerage, or a simple decrease in the volume of execution-plus trading—this will lead to changes in the proportions of execution-plus and execution-only brokerage. This gives the third sub-category of performance indicators: the proportions of execution-plus and execution-only trades.

Performance indicator: changes in the proportions of execution-plus and execution-only trades

- The proportions of execution-only and execution-plus transactions by volume of trading.

These performance indicators were measured by the survey among brokers and fund managers, using several quantitative questions. The results of these performance indicators are described in section 4.6.

2.5 Impact on distribution of research costs and market structure

The change in the regime for soft commission and bundled brokerage arrangements may also have a number of impacts on the nature and structure of the fund management industry. These impacts may affect the way in which research costs are distributed among fund managers, or similarly among pension funds; they may alter the structure of the markets for fund management or brokerage; and they may affect the quality of trade execution.¹⁰ These form the five sub-categories of performance indicators.

Sub-categories of performance indicators: impact on distribution of research costs and market structure

- Distribution of research costs among fund managers.
- Distribution of research costs among pension funds.
- Impact on the structure of the market for fund management.
- Impact on the structure of the brokerage market.
- Quality of trade execution.

Distribution of research costs among fund managers

Both before and after the change in the regime, the costs of research and execution-related goods and services provided by brokers to fund managers are paid for through commissions. As such, prior to the change in the regime, given that the volume of trading fluctuated over time, there was little visibility of the actual price paid by any fund manager for the research output they consumed.

Following the change in the regime, when setting execution-plus commission rates between fund 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 fund manager for the research provided by a particular broker more transparent. Large fund managers may now use their relative buyer power to negotiate lower fees than they currently pay for the research provided by brokers. This could be exacerbated by a move towards agreeing a fixed budget for research.

¹⁰ These impacts were discussed in a meeting with the FSA, IMA, LIBA, NAPF and Oxera on January 24th 2006.

Assuming that brokers' costs in providing research do not change, this would result in smaller fund managers bearing a larger share of the costs of research provided by brokers than before the change in regime. This may make smaller fund managers less attractive to funds and could, in principle, contribute to consolidation in the market for fund managers. Whether this will actually happen will depend on the significance of the increase in costs to smaller fund managers. Any consolidation in the market for fund management is likely to be driven by a range of other factors—the new regime for soft commissions and bundled brokerage could be just one of them.

Two means were identified for assessing the impact of the change in the regime for soft commissions and bundled brokerage arrangements on the distribution of research costs among fund managers. First, an increase in the differential between the commission rates paid by large and small fund managers may indicate that the share of the costs of research borne by small fund managers has increased. This provides the first performance indicator: the variation in the commission rates charged to fund managers of different sizes.

The second performance indicator relates to soft questions: qualitative and anecdotal evidence on the way in which brokers charge fund managers for research.

Performance indicators: distribution of research costs among fund managers

- Variation in commission rates charged to fund managers of different sizes.
- Qualitative and anecdotal evidence on the way brokers charge fund managers for research.

These indicators were measured by the survey among brokers and fund managers, using several quantitative and qualitative questions. The results of these performance indicators are described in section 4.7.

Distribution of research costs among pension funds

The change in the regime may also affect the distribution of research costs at the fund level. The costs of research provided by brokers to fund managers are paid for through commissions, and hence are borne by fund managers' clients.

Following the change in the regime, when agreeing execution-plus commission rates between fund 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 commission paid for the research more transparent to the fund managers' clients. Large funds may use their buyer power to negotiate a lower allocation of the costs of research or a lower management fee (to offset part of the costs of research incurred from fund managers).

This would result in either an increase in smaller funds' share in the costs of research relative to their share before the change in regime, or higher management fees for smaller funds than for larger funds. This may make the management of smaller funds more costly than before the change in the regime, while providing an offsetting benefit to large funds.

Three means were identified for assessing the impact of the change in the regime for soft commissions and bundled brokerage arrangements on the distribution of research costs among pension funds.

- An increase in the commission rate paid by smaller funds relative to that paid by larger funds following the change in regime indicates that the share of research borne by small funds has increased. This provides the first performance indicator: the commission rates paid by smaller funds relative to those paid by larger funds, both before and after the change in the regime.

- An increase in the management fees paid by smaller funds relative to those paid by larger funds following the change in the regime indicates that the share of research borne by small funds has increased. This provides the second performance indicator: the management fees paid by smaller funds relative to those paid by larger funds, both before and after the change in the regime.
- The third performance indicator relates to soft questions: qualitative and anecdotal evidence on the way in which pension funds pay for the research provided to fund managers.

Performance indicators: distribution of research costs among pension funds

- The relationship of the commission rates paid by smaller funds relative to those paid by larger funds, both before and after the change in the regime.
- The relationship of the management fees paid by smaller funds relative to those paid by larger funds, both before and after the change in the regime.
- Qualitative and anecdotal evidence.

These indicators were measured by the survey among brokers and fund managers, using several quantitative and qualitative questions. The results of these performance indicators are described in section 4.7.

Impact on the structure of the market for fund management

Given that some costs of managing a fund may be fixed, smaller funds and smaller fund managers may have a cost disadvantage over larger funds and larger fund managers. The mechanisms outlined above would have the effect of exacerbating this cost disadvantage.

This effect may contribute to further consolidation in the market for fund management, resulting in fewer, but larger, fund managers. Funds might also consolidate, where possible, in order to reduce their costs per unit invested. This leads to the first performance indicator: the structure of the market for fund management.

Such consolidation could have positive or negative effects on the net performance of funds. By exploiting economies of scale, the consolidation would lead to a reduction in the total costs of fund management, which would raise the net return on funds. However, if the consolidation of fund managers reduced competitive pressure in the supply of fund management services, the total costs of fund management incurred by funds could rise, reducing the net return.

Performance indicator: impact on the structure of the market for fund management

- The structure of the market for fund management.

The direct measurement of market structure is likely to be best measured from existing data sources such as the FSA or IMA database, which contain market share data for fund management firms. Therefore, it was not necessary to include direct measures in the questionnaires. The changes in market structure can be analysed in the future surveys.

Impact on the structure of the market for brokerage and research services

A different set of mechanisms could affect the market structure of brokers. The change in the regime makes it possible to use commissions paid to one broker to purchase research from another broker (eg, through a commission-sharing agreement).

This leads to the possibility that fund managers could separate their choice of execution venue from their choice of where to purchase research. As a result, fund 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. This provides the first performance indicator: the distribution of trades between brokers, both before and after the change in the

regime. This was supported by the second performance indicator: qualitative and anecdotal evidence.

If this results in fund managers all selecting the same set of brokers for the execution of trades, the concentration of the brokerage market could increase. This leads to the third performance indicator: the structure of the brokerage market.

The impact on fund managers (and funds) of this separation and concentration may again be positive or negative. The separation of brokers into those that specialise in providing execution and those that specialise in providing research may lead 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 lead to the reverse effect—ie, the price of trade execution could increase and its quality decline.

As with concentration in the fund and fund manager markets, data from, for example, the FSA could be used to track overall trends in market concentration of execution. Furthermore, the first step in the process that would link the change in the regime to changes in the concentration of execution—ie, the change in individual fund manager's behaviour with respect to allocation of trading volume to brokers—could be tracked using the survey among brokers and fund managers.

Possible indicators: impact on the structure of the market for brokerage and research services

- The pattern of distribution of trades between brokers, both before and after the change in the regime.
- Qualitative and anecdotal evidence.
- The structure of the brokerage market.

The first two performance indicators were measured by the survey among brokers and fund managers, using several quantitative and qualitative questions. The results of these performance indicators are described in section 4.7.

The direct measurement of market structure is likely to be best measured from existing data sources such as the FSA database, which contains market share data for brokerage firms. Therefore, it was not necessary to include direct measures in the questionnaires. The changes in market structure can be analysed in the future surveys.

Quality of trade execution

There was, therefore, a concern that the change in the regime may affect the quality of trade execution. However, measuring trade execution quality is difficult, particularly on an aggregate basis. Furthermore, due to the range of other factors that may affect the quality of trade execution over time, it is even more difficult to determine the impact of the change in the regime for 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 a reduction in liquidity of the markets. In assessing this impact, it should be taken into account that, in the cost–benefit analysis of the FSA's proposed modifications to the regulations on soft commissions and bundled brokerage arrangements, it was identified that there may be over-trading by some fund managers.¹¹

¹¹ Oxera (2003), 'Cost–Benefit Analysis of the FSA's Policy Propositions on Soft Commissions and Bundling', April.

Measuring the impact on market liquidity is far from straightforward. Even though measures of market liquidity exist, as does 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 number of soft indicators.

The first performance indicator relates to brokers' and fund managers' assessments of liquidity in different segments of the market over time. The second performance indicator relates to fund managers' assessments of the quality of trade execution over time. If there are no significant changes in brokers' and fund managers' assessment of liquidity and the quality of trade execution over time, this would indicate that the change in the regime has not had a significant impact on liquidity and trade execution. If there are significant changes in brokers' and fund managers' assessment, further analysis would be needed to determine the extent to which these changes are caused by the introduction of the new regime. Follow-up interviews with brokers, fund managers and market experts could also be conducted at the time of future surveys. Furthermore, changes in liquidity and execution quality in other countries not affected by the change in the regime might be used to provide additional market comparison.

The quality of trade execution may also be affected by changes in the concentration in the market for brokerage services. This may be assessed by undertaking a statistical analysis of the relationship between concentration and execution quality over time. No survey evidence would be required for such an analysis. Data on concentration in the brokerage sector is available from the FSA, while indications of execution quality could be obtained from professional firms specialising in trade execution analysis.

Performance indicators: quality of trade execution

- Brokers' and fund managers' assessment of liquidity in different segments of the market over time.
- Assessment of changes in the quality of trade execution over time.

These indicators were measured by the survey among brokers and fund managers, using several qualitative questions. The results of these performance indicators are described in section 4.7.

3 Arrangements between fund managers and brokers

An initial indication of the types of arrangement between fund managers, brokers and pension funds put in place following the introduction of the new regime is provided below. The description is based on interviews with pension funds, fund managers and brokers conducted in the first quarter and summer of 2006.

Although only a limited number of interviews were conducted, the types of arrangement identified were confirmed by industry experts and considered to be sufficiently comprehensive. However, the types of arrangement may change over time. The 2006 and 2008 surveys will provide an indication of how many of these arrangements have been put in place and any changes over time.

3.1 Commission-sharing arrangements

Execution-only and execution-plus services

Under the modified regulations, brokers may offer two types of service.

- **A bundle of trade execution and research**—this is referred to as an execution-plus service, for which an execution-plus commission rate is paid.
- **Trade execution only**—this is referred to as an execution-only service, for which an execution-only commission rate is paid.

In agreeing execution-plus commission rates between fund managers and brokers, it must be decided how many basis points are paying for execution and how many paying for research. Some or all of these commissions may be used to pay for research provided by the broker itself, or for research provided by other brokers or third-party research providers.

Commission-sharing arrangements

Using commissions received by one broker to pay for research either from another broker or from a third-party research provider can be made possible by entering into a commission-sharing agreement with the broker. Trades made under a commission-sharing agreement will result in the creation of a sum of money (a commission pool) that can be used by the fund manager to settle invoices for which they are liable, as long as the goods or services to which they relate are permitted services (ie, generally research). The broker typically manages the commission pool on behalf of the fund manager. In other words, fund managers give brokers instructions about how to spend their pool of commissions.

Fund managers explained to Oxera that they typically enter into commission-sharing agreements with a limited number of brokers, often those who together receive a large proportion of the fund manager's trade orders. For brokers with which the fund manager does not enter into a commission-sharing agreement, they agree on an execution-plus commission rate and on an allocation of the commission rate between execution and research—this allocation may be based on the allocation agreed with brokers with whom they have a commission-sharing agreement. However, the non-execution constituent of the commission rate remains with the broker to cover the amount spent on research provided by this broker. In other words, the arrangements with these brokers are similar to the bundled brokerage commission arrangements under the previous regime—the only difference being that the commission rate is explicitly allocated to execution and research.

There are some subtle differences between the way some fund managers and brokers have structured their commission-sharing agreements.

Some fund managers have agreed with their brokers that the whole non-execution constituent of the commission is paid into the commission pool. The fund manager can instruct the broker how to allocate the commission pool—ie, to use it to pay for research from the broker itself, or from other brokers or third-party research providers. The fund manager may agree with the broker in advance on the total amount to be spent on its research in a particular year. If the value of the commission pool exceeds that of the research provided by the broker, the excess can be used to purchase research from other brokers or third-party research providers. Alternatively, the fund manager may decide to change its arrangement with the brokers in order to generate fewer commissions for the pool in the next period, which may serve as a refund to the pension fund clients. If the value of the commission pool is not sufficient to cover the costs of research by the broker, money from commission pools held with other brokers or hard cash may be used to pay for those goods and services.

Commission-sharing arrangement with intermediaries

In addition, a few fund managers instruct an intermediary (clearing agency) to manage their commission pool. The clearing agency receives the non-execution constituent of the commissions from the broker and allocates the commission pool as instructed by the fund manager.

One fund manager explained to Oxera that there were two reasons for using such a model: first, outsourcing the administration of commission-sharing agreements may result in some cost savings; second, by handing over the management of the commission pool from the broker to an intermediary, brokers are prevented from having access to information about the way fund managers allocate their commission pool. Fund managers may consider this information commercially sensitive, and/or, given that the broker administering the commission pool is also in (potential) competition with the other recipients of the pool money, potentially anti-competitive.

The clearing agency charges the fund manager a fee for managing the commission pool and administering the commission-sharing agreements. The fee may be levied as a percentage of the value of the commission pool managed in a year. In practice, this means that fund managers only transfer to the commission pool the non-execution constituent of the commissions that are not allocated to the original broker (to cover the costs of the research provided by that broker). By doing so, they save costs—if they transferred the whole non-execution constituent of the commissions to the clearing agency and then allocated part of that back to the broker for the purchase of research, the fund manager would also pay a fee on the commissions that are used to pay for the research from the original broker.

Execution-only brokers

There are also fund managers who enter into commission-sharing agreements with brokers who offer only trade execution-only services—ie, the broker does not offer research. The fund manager and broker agree on the commission rate for execution-only trade and the fund manager can then ask the broker to add an extra number of basis points to the commission rate. This non-execution constituent will be transferred to the commission pool (or, indeed, an agent) and can be used by the fund manager to purchase research from third-party research providers. In principle, it could also be used to pay for research provided by full-service brokers, although this does not seem to be standard practice at present.

3.2 Types of arrangement

The types of arrangement in place typically vary by fund manager size. Smaller fund managers often follow the LIBA waterfall methodology, which means that the non-execution constituent part of the commission rate remains in principle with the broker. The fund managers decide on a trade-by-trade basis whether a trade falls under the commission-sharing agreement. If it does not, the non-execution constituent of the commission remains with the broker to cover the costs of the research provided by the broker. The execution-only service tends to be used only for programme trades.

Larger fund managers typically transfer the whole non-execution constituent part of the commission rate to the commission pool and subsequently decide on how to use this for the purchase of research from the broker in question, other brokers or third-party research providers.

Large fund managers indicated that they will agree in advance on a quarterly or annual budget for research with their brokers. Thus, any additional commissions generated as a result of extra trading in a particular year will become available for the fund manager rather than for the broker.

3.3 Pension funds

As also indicated by the survey, most fund managers use the IMA Disclosure Code to comply with the FSA disclosure requirements. This means that pension funds receive information about fund managers' spending on trade execution and research. However, the interviews indicate that, in general, pension funds have not started analysing this data to monitor their fund manager's performance. There are also indications that the reports produced by fund managers were hard to read, and, due to differences in periods, difficult to compare across fund managers. This may mean that, at least in the short term, pension funds are unlikely to put much pressure on fund managers regarding their spending on execution and research by directly comparing the performance of fund managers.

3.4 Other observations

A number of fund managers indicated that the (execution-plus) commission they have agreed with their large brokers for 2006 is higher than the bundled brokerage commission rate in 2005. For example, the bundled brokerage commission rate may have been 10bp in 2005, while the execution-plus commission rate in 2006 may be 15bp. This is because brokers' analysis of client profitability indicated that the fund manager had been undercharged—ie, the fund managers had received (most of) the research for free, but will now have to pay for it.

Another effect of the change in the regime is that some fund managers who previously did not have soft commission arrangements may now enter into commission-sharing agreements. While these fund managers used to pay for third-party research and other (execution-related) services by hard cash, under the new regime these services may be paid for using commissions (under a commission-sharing agreement). This means that for some fund managers the total amount spent on goods and services purchased out of commissions may increase.

As explained in section 2, the change in the regime for soft commission and bundled brokerage arrangements makes it easier to use commissions paid to one broker to purchase research from another broker (eg, through a commission-sharing agreement). This raises the possibility that fund managers separate their choices on execution venue from their choices of where to purchase research. As a result, fund managers may choose to use a smaller number of brokers and to select (for execution services) only those that offer the best execution service. Most fund managers interviewed confirmed that the number of brokers on the approved list will fall over time as a result of the change in the regime.

4 Baseline survey results

This section presents the results of the February/March 2006 baseline survey undertaken among fund managers, brokers and pension funds, and the follow-up survey undertaken in June/July 2006 among fund managers and brokers. The principal purpose of the survey was to construct a baseline for future comparison, and this section presents the detailed data that provides this baseline. Supplementary to this objective, initial results are presented below in terms of market trends identified and preliminary findings on the impact of the change in the regime for soft commissions and bundled brokerage arrangements.

The structure of this section is as follows.

- section 4.1 outlines the representativeness of the survey sample;
- section 4.2 presents general market data;
- sections 4.3 to 4.7 provide the baseline data, market trends and preliminary findings of all the 2006 surveys.

4.1 Survey sample and representativeness

Original questionnaires—February/March 2006

Oxera designed three separate questionnaires for pension funds, fund managers and brokers. The objective was to obtain evidence on the usage and effects of soft commissions and bundled brokerage arrangements prior to the change in the regime in January 2006, and evidence on the types of arrangement in place between brokers, fund managers and pension funds in early 2006. This survey enables the construction of the baseline.

In total, the questionnaires were sent to 36 pension funds, 68 fund managers and 54 brokers.¹² The responses, response rates and market coverage are presented in Table 4.1.1. This table shows that the sample groups of fund managers and brokers who 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 fund manager and broker markets.¹³

¹² The initial sample groups of pension funds, fund 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).

¹³ Some fund managers and brokers provided a limited amount of data. More data was later obtained in interviews with fund managers and brokers conducted by Oxera and Alan Line as part of the June/July surveys.

Table 4.1.1 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
Fund managers	68	27	39.7	50
Brokers	54	14	27.5	~60

Note: Responses to the Oxera questionnaires as at the 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 fund 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 (only four pension funds completed the questionnaire) to draw out meaningful quantitative indicators, while also ensuring the confidentiality of the responses. 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. The pension fund questionnaire consisted of two elements: hard data, for example on management fees and commission rates; and soft indicators on the information received from fund managers and how this is used. With regard to hard data, fund management fees and commission rates were also obtained from the fund managers and brokers questionnaires. With regard to qualitative and anecdotal data, information about what type of data pension funds receive from fund managers was also obtained in a small number of interviews with pension funds. These are described in section 4.3, and where relevant, in section 4.4.

Although the response rates for fund 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 fund managers across different questions in the questionnaires. As such, in certain areas the sample for particular questions is smaller than the full sample. The results of these original questionnaires have been used to analyse the performance indicators in sections 4.3 to 4.7. Wherever data is presented, sample sizes are indicated.

Follow-up survey—June/July 2006

In June/July 2006, Oxera undertook follow-up interviews with fund managers and brokers, which served to clarify the data that had been provided. Also, fund managers were asked to complete a supplementary questionnaire, designed to collect the data that had not been provided in the responses to the initial questionnaire. As Table 4.1.2 shows, meetings and conference calls were arranged with 17 fund managers, of which 13 provided further data through the supplementary questionnaire.

Table 4.1.2 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
Fund 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 fund managers provided complete data for the supplementary questionnaire for the years 2003–05, with a further two fund managers providing data for 2005. The aggregated results of the supplementary fund managers questionnaire, shown in section 4.8, have been used to analyse the performance indicators in sections 4.3 to 4.7.

In the meetings/conference calls with fund 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 fund managers' classification of non-execution goods and services.

The FSA has defined 'research' and 'execution-related services', and it is fund managers' responsibility to apply these definitions in practice. When the surveys were undertaken, there was still some uncertainty among fund managers about whether certain services could be considered permitted under the modified regulations and about the difference between research and execution-related goods and services. It is expected that before the end of 2006 fund managers will have a clearer view of how to apply the FSA definitions in practice. This uncertainty about how to apply the FSA definitions will also have affected the way that fund managers classified non-execution goods and services back in time in the survey (for the years 2003–05). In practice, this means that, in particular, the data provided for 'non-permitted goods and services' and the split between 'execution-related goods and services' and 'research' may not be exactly in line with how fund managers will ultimately apply the FSA definitions during the rest of 2006. For example, certain services that may have been classified as permitted in the survey may later be considered not permitted.

At present, no adjustments have been made to the data provided by fund managers in light of these caveats. However, these issues suggest that future questionnaires should also ask for data from 2005 to provide a check on the data provided in response to the 2006 questionnaires.

Appendices

A number of appendices at the end of this report provide further information on the process of these surveys. Appendix 1 describes the characteristics of the fund managers, brokers and pension funds who responded, and how they were selected. Appendices 2, 3 and 4 reproduce the three initial questionnaires to pension funds, fund managers and brokers respectively. In the report, the questionnaires are referred to as the brokers questionnaire, fund managers questionnaire and pension fund questionnaire. Appendix 5 reproduces the supplementary fund managers questionnaire.

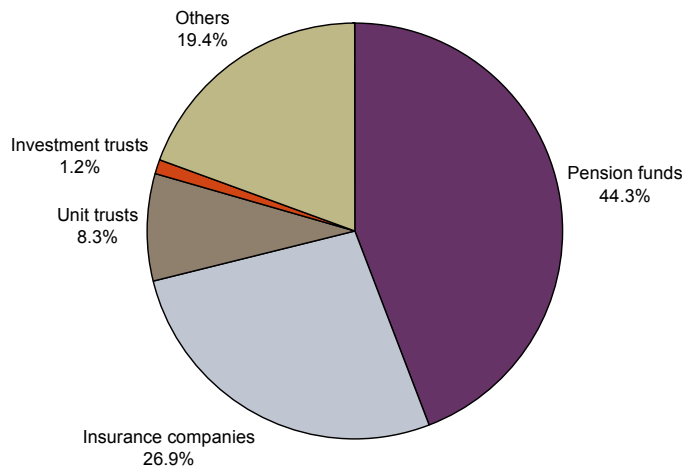
4.2 General description of respondents' data

The market for fund management

As described above, 27 fund managers responded to the original fund managers questionnaire. The 26 fund managers who submitted answers to question 1 represented £1,406.6 billion of funds managed in the UK in 2005. On aggregate, based on 25 responses to question 3, 77.0% of these funds managed in the UK were for UK clients.

The breakdown of the funds managed in the UK into the different types of fund for which those funds are managed is depicted in Figure 4.2.1. This shows that pension funds account for 44.3% of the funds managed in the UK.

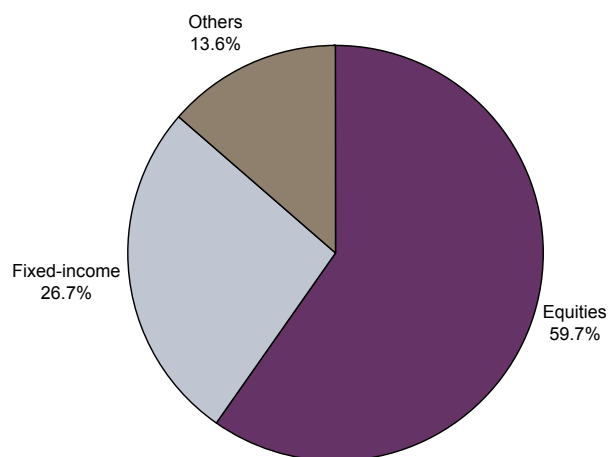
Figure 4.2.1 Proportion of funds managed in the UK for different types of fund



Source: Oxera calculations based on 26 responses to the original fund managers questionnaire (question 4).

Figure 4.2.2 presents the breakdown of funds managed in the UK into the different types of assets in which the funds are held. This shows that 59.7% of the funds managed in the UK are held in equities.

Figure 4.2.2 Proportion of funds managed in the UK held in different types of asset



Source: Oxera calculations based on 26 responses to the original fund managers questionnaire (question 5).

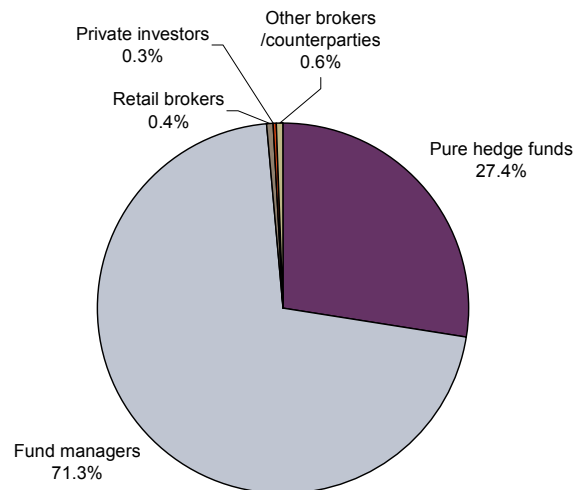
The market for brokerage

In 2005, the 14 brokers who completed the brokers questionnaire had aggregate gross commission revenues of £612.1m in UK cash equity trades for UK-based fund managers.

Only 13 respondents provided data on the aggregate value of trades executed (question 2). These 13 brokers had gross commission revenues of £612.1m on trade orders worth £482.5 billion.

The breakdown of orders for UK cash equity trades according to client type is provided in Figure 4.2.3. This shows that the market is dominated by trade orders from fund managers that are not hedge funds. For this question, 'fund managers' includes long-only fund managers, long-only fund managers with hedge fund divisions, and hybrid funds.

Figure 4.2.3 Proportion of trade orders for UK cash equities according to client type

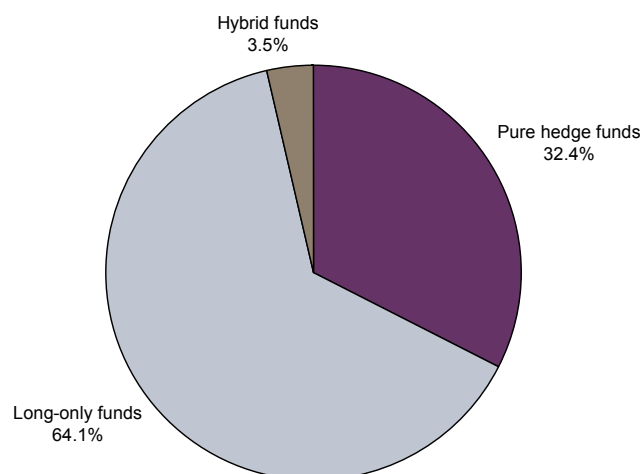


Notes: 'Fund managers' includes long-only fund managers, long-only fund managers with hedge fund divisions and hybrid funds.

Source: Oxera calculations based on 13 responses to the brokers questionnaire (question 3).

The breakdown of UK fund manager clients according to client type is shown in Figure 4.2.4. This is a weighted average of the proportion of each individual broker's clients broken down into three types of fund manager client. These proportions were weighted on the basis of the value of trade orders for UK cash equity trades sent to the broker from UK fund managers.

Figure 4.2.4 Weighted average proportion of clients according to client type



Note: Weights are based on the brokers' volume of trade orders for UK cash equity trades in 2005, as provided in responses to question 2 of the brokers questionnaire.

Source: Oxera calculations based on 12 responses to the brokers questionnaire (question 4).

4.3 Reduction in spending on non-permitted goods and services

As explained in section 2.1, the change in the regime restricted the range of goods and services that can be purchased with soft commissions or through bundled brokerage arrangements. The impact of this was formulated into four performance indicators.

Performance indicators: reduction in spending on non-permitted goods and services

- The amount spent on non-permitted goods and services purchased with soft commissions or through bundled brokerage arrangements—if firms comply with the new regime, this would be expected to be zero from July 2006.
- The amount spent on non-permitted goods and services purchased with hard cash.
- The total amount spent on non-permitted goods and services purchased either through commissions or with hard cash.
- The management fees paid by pension funds.

Amount spent on non-permitted goods and services

Fund managers were asked to provide data on the actual amount spent on non-permitted goods and services purchased with soft commissions and the proportion of the amount spent on non-execution goods and services purchased through bundled brokerage arrangements that were non-permitted goods and services. To account for changes to other factors within the data from the baseline survey and to provide a consistent basis on which to make comparisons with the data from future surveys, the results are presented in two formats:

- ratios of the amount spent on non-permitted goods and services to the funds under management;
- ratios of the amount spent on non-permitted goods and services to the value of bundled brokerage trades.

First, to handle the issue that the funds under management—the management of which may require some of these non-permitted goods—will change over time, it is necessary to compare the change in the amount spent on non-permitted goods and services purchased relative to the funds under management. The most accurate means of generating such a benchmark for future comparison relative to funds under management is to calculate the weighted average of the ratios of the amount spent on non-permitted goods and services to the funds under management calculated for each individual fund manager. This also provides a consistent basis on which to make further comparisons.

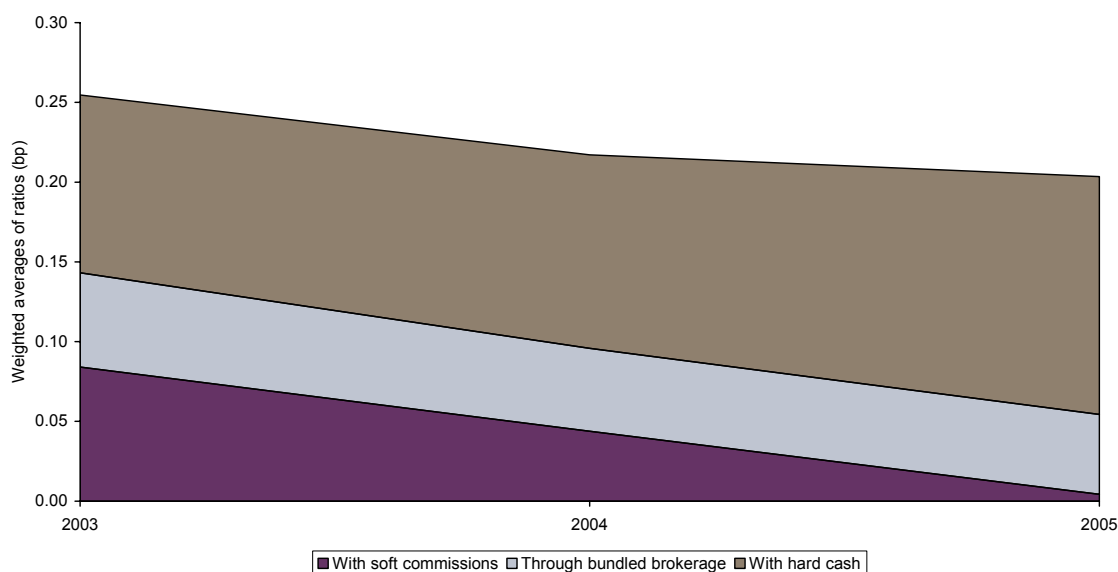
Therefore, the ratios of the amount spent on non-permitted goods and services to the funds under management were calculated for each fund manager, before taking a weighted average of these ratios. This data is shown in Table 4.3.1 and Figure 4.3.1. To allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, the full sample of ten fund managers has been used to provide the most accurate baseline for future comparison.

Table 4.3.1 Weighted average of ratios of non-permitted goods and services purchased to funds under management

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average of ratios of amount spent on non-permitted goods and services purchased. . .				
through commissions to funds under management (bp)	0.143	0.096	0.054	0.047
with soft commissions to funds under management (bp)	0.084	0.044	0.004	0.004
through bundled brokerage to funds under management (bp)	0.059	0.052	0.050	0.043
with hard cash to funds under management (bp)	0.112	0.121	0.149	0.129
to funds under management (bp)	0.255	0.217	0.204	0.175
Number of respondents	8	8	8	10

Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. The data for the consistent sample refers to 8 respondents, of whom 3 used soft commissions and 5 did not.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.3.1 Weighted average of ratios of non-permitted goods and services purchased to funds under management



Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. The data for the consistent sample refers to 8 respondents, of whom 3 used soft commissions and 5 did not.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The data in Table 4.3.1 suggests that, once the change in the funds under management has been taken into account, the amount spent on non-permitted goods and services purchased through commissions declined over the period 2003–05. This change is more clearly expressed in Figure 4.3.1, which shows that, in 2005, the ratio of the amount spent on non-permitted goods and services purchased with soft commissions to funds under management had declined almost to zero, and that the total amount spent on non-permitted goods and services purchased through commissions also declined by almost two-thirds between 2003 and 2005.

This effect may be due to fund managers implementing the new regime for soft commissions and bundled brokerage arrangements in anticipation of the change in the regime in January 2006. From July 2006 onwards, to comply with the modified regulations, the amount spent on non-permitted goods and services purchased either with soft commissions or through bundled brokerage arrangements should be zero.

Second, to handle the issue that the value of bundled brokerage trades—commissions for which paid for the non-permitted goods purchased through commissions—will change over time, it is necessary to compare the change in the amount spent on non-permitted goods and services with the value of bundled brokerage trades. The most accurate means of generating such a benchmark for future comparison relative to the value of bundled brokerage trades is to calculate the weighted average of the ratios of the amount spent on non-permitted goods and services to the value of bundled brokerage trades calculated for each individual fund manager.

Therefore, the ratios of non-permitted goods and services to the fund manager’s value of bundled brokerage trades were calculated for each fund manager, before taking a weighted average of these ratios (see Table 4.3.2). For the non-permitted goods and services purchased through commissions, this serves as a weighted average of the constituents of the bundled brokerage commission rate for non-permitted goods and services, and these constituents are also shown in Figure 4.3.2. Again, to allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, to provide the most accurate baseline for future comparison, the full sample of ten fund managers has been used.

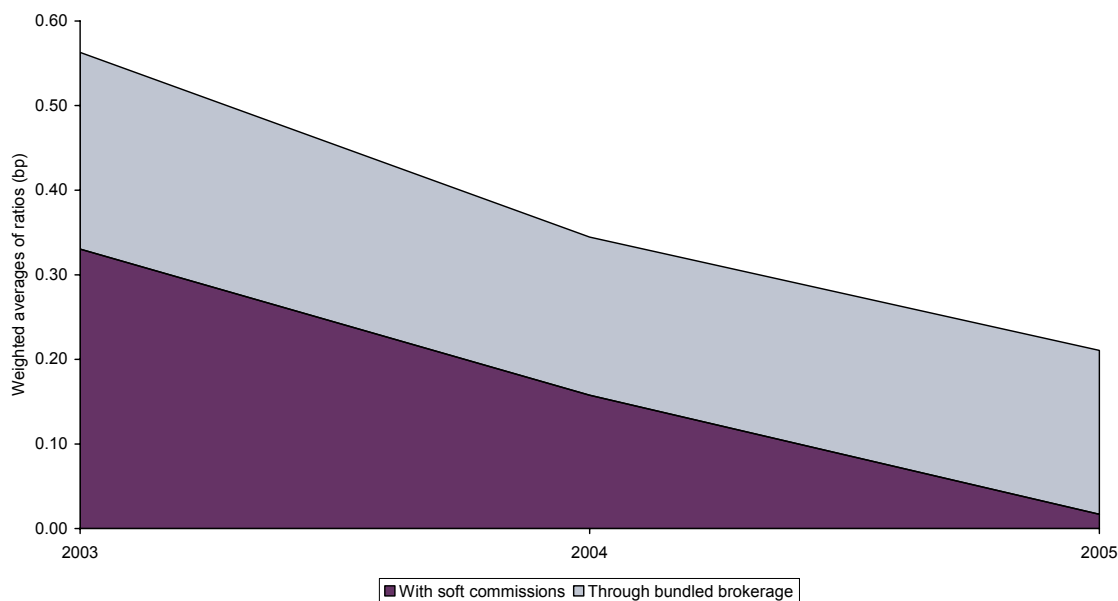
Table 4.3.2 Weighted average of ratios of non-permitted goods and services to the value of bundled brokerage trades

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average of ratios of the amount spent on non-permitted goods and services purchased. . .				
through commissions to the value of bundled brokerage trades (bp)	0.563	0.345	0.210	0.186
with soft commissions to the value of bundled brokerage trades (bp)	0.330	0.158	0.017	0.015
through bundled brokerage to the value of bundled brokerage trades (bp)	0.232	0.187	0.194	0.171
with hard cash to the value of bundled brokerage trades (bp)	0.438	0.436	0.577	0.512
to the value of bundled brokerage trades (bp)	1.001	0.781	0.788	0.699
Number of respondents	8	8	8	10

Note: Weights were based on the fund managers’ reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.3.2 Weighted average non-permitted goods and services constituents of bundled brokerage commission rates



Note: Weights were based on the fund managers' reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The data in Table 4.3.2 and Figure 4.3.2 suggests that, when the increase in the value of bundled brokerage trades has been taken into account, the amount spent on non-permitted goods and services purchased through commissions declined by almost two-thirds between 2003 and 2005. The majority of this reduction was due to the fall to almost zero in the amount spent on non-permitted goods and services purchased with soft commissions in 2005. Furthermore, Figure 4.3.2 indicates that the non-permitted goods and services' constituent of bundled brokerage commission rates also declined. This was as a result of a decline in the non-permitted goods and service constituents of bundled brokerage for both purchases with soft commissions and, to a lesser extent, purchases through bundled brokerage arrangements.

Section 2.1 also raised the question of whether the reduction in the range of goods and services permitted to be purchased through commissions would lead to these goods and services being purchased with hard cash. As such, the data described above can be used to consider whether the change in the amount spent on non-permitted goods and services purchased through commissions led to an increase in the amount spent on non-permitted goods and services purchased with hard cash or to reduction in the total amount spent on non-permitted goods and services.

The initial data presented in Table 4.3.1 and Figure 4.3.1 indicates that a combination of these two effects was occurring—ie, there was both some switching to purchasing non-permitted goods and services with hard cash, and some reduction in the total amount spent on non-permitted goods and services. This is consistent with expectations following the 2002 survey (part of the Oxera study on soft commissions and bundled brokerage undertaken for the FSA in 2002).¹⁴ In response to the 2002 fund managers questionnaire, 31% of fund managers reported that they would purchase fewer goods and services from third parties if

¹⁴ Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', November, p. 75.

they were no longer able to purchase them through soft commission arrangements and had to use hard cash.

To determine which of these effects was the most prevalent, it is possible to calculate the proportion of the change in the weighted average of the ratios of the total amount spent on non-permitted goods and services purchased through commissions to funds under management that was due to either of these effects. Table 4.3.3 shows the change in the weighted average of the ratios of the total amount spent on non-permitted goods and services purchased through commissions to funds under management, and the proportions of this change that were matched by either the switching to purchasing non-permitted goods and services with hard cash, or the reduction in the total amount spent on non-permitted goods and services.

Table 4.3.3 Proportions of change in weighted average of ratios of non-permitted goods and services purchased through commissions to funds under management

	Consistent sample		
	2003–05	2003–04	2004–05
Change in weighted average of ratios of the total amount spent on non-permitted goods and services purchased through commissions to funds under management (bp)	–0.0888	–0.0473	–0.0415
Proportion accounted for by switching to purchasing of non-permitted goods and services with hard cash (%)	42.37%	20.74%	67.05%
Proportion accounted for by reduction in the total amount spent on non-permitted goods and services (%)	57.63%	79.26%	32.95%
Number of respondents	8	8	8

Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

This data suggests that, over the period 2003–05, 42.4% of the reduction in the amount spent on non-permitted goods and services purchased through commissions, after taking into account the increase in funds under management, was replicated through the increase in the amount spent on non-permitted goods and services purchased with hard cash. The other 57.6% of the reduction in the amount spent on non-permitted goods and services purchased through commissions was not switched. Therefore, once the increase in funds under management has been taken into account, the total amount spent on non-permitted goods and service was reduced. This provides a preliminary finding that, prior to the change in the regime, fund managers purchased more non-permitted goods and services than they consider to be optimal since the change in the regime.

However, this does not fully explain the variation in these proportions between 2003 and 2004, and between 2004 and 2005, given that the proportion of the reduction in the amount spent on non-permitted goods and services purchased through commissions, after taking the increase in funds under management into account, rose from 20.74% between 2003 and 2004, to 67.05% between 2004 and 2005. This may suggest some 'levelling-out'—ie, fund managers have already reduced the purchase of unnecessary non-permitted goods and services. However, with data for just two years, it is not possible to establish substantive trends.

Therefore, although there are some uncertainties about the underlying trends in the amount spent on non-permitted goods and services purchased between 2003 and 2005, this data serves as a functional benchmark for future comparison.

The management fees paid by pension funds

It has been seen that there has been some increase in the amount spent on non-permitted goods and services purchased with hard cash, even after the increase in funds under management has been taken into account. This may lead to an increase in the management fee, although, given that the amount spent on total non-permitted goods and services is low, it may be difficult to discern an impact on the management fees. As such, there is limited potential for determining a causal relationship between the change in the regime for soft commissions and bundled brokerage arrangements and any changes in the management fee. However, the management fee is a useful performance indicator as it can be easily measured and analysed, and the data on management fees is robust. This data was gathered from the original and supplementary fund managers questionnaires. Data was also requested in the pension fund questionnaire, but the very limited response to this questionnaire means that the data is of limited usefulness.

To determine the baseline for comparison, effective actual management fees were calculated on the basis of responses to the original fund managers questionnaire.¹⁵ Fund managers were asked to provide data on their gross management fee income (ie, including performance elements), and the funds under management for which those fees applied in question 7 of the original fund managers questionnaire. Subtracting the performance-related elements of gross management fees allowed the net management fees, and thus the weighted average management fee, to be calculated (see Table 4.3.4).

Table 4.3.4 Effective actual management fees

	Full sample, 2005
Performance-related proportion (%)	12.42
Non-performance-related proportion (%)	87.58
Simple average effective actual management fees (bp)	25.39
Weighted average effective actual management fees (bp)	24.34
Range of effective actual management fees (bp)	11.67–41.40
Number of respondents	14

Note: Based on total management fee income for funds managed in the UK in UK equities on behalf of pension fund clients (including both active and passive fund management). Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, as provided in responses to question 7 of the original fund managers questionnaire. These results are primarily for active fund management, but may include some passive mandates.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 7).

The data in Table 4.3.4 provides a baseline for future comparison. However, any assessment of the impact of the change in the regime for management fees also needs to include consideration of the trends in management fees prior to the change in the regime.

To determine these trends, question 9 of the original questionnaire asked fund managers to provide typical management fees for active and passive funds. Weighted averages of this data are presented in Tables 4.3.5 and 4.3.6. Data was requested for the period 2001–05; however, because few of the fund managers provided a dataset for the full period, data is shown for 2003–05 only. To allow comparison over the period 2003–05, consistent sample groups of ten fund managers for active fund management and four fund managers for passive fund management have been used. In addition, to provide the most accurate

¹⁵ The data requested allowed the calculation of the effective management fees (ie, the average management fee charged on aggregate funds under management after performance-related elements have been removed). Since this data was based on the fees charged, this provides an actual management fee indicator.

baseline for future comparison, the full sample groups of 15 fund managers for active fund management and six fund managers for passive fund management have been used.

Table 4.3.5 Typical active management fees

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average typical active management fees (bp)	42.2	40.3	38.4	36.6
Range of typical active management fees (bp)	21–100	25–100	25–100	29–100
Number of respondents	10	10	10	15

Note: Data is for typical management fees for an active £100m UK equity fund. Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, as provided in responses to questions 7 and 17 of the original and supplementary fund managers questionnaires.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 9).

Table 4.3.6 Typical passive management fees

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average typical passive management fees (bp)	5.25	5.20	5.06	6.25
Range of typical passive management fees (bp)	5–6	5–6	5–6	5–12.5
Number of respondents	4	4	4	6

Note: Data is for typical management fees for an active £100m UK equity fund. Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, as provided in responses to questions 7 and 17 of the original and supplementary fund managers questionnaires.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 9).

Further comparison can be made between the data reported in the 2006 original fund managers questionnaire and that in the 2002 fund managers questionnaire.¹⁶ Both questionnaires asked fund managers to provide data on typical management fees charged to pension fund clients for both active and passive mandates of various sizes between £50m and £500m (see Tables 4.3.7 and 4.3.8).

Table 4.3.7 Change in typical active management fees between 2001 and 2005

	£500m	£200–£250m	£100m	£50m
Weighted average of 2005 active fees (bp)	24.68	30.17	36.30	37.61
Weighted average of 2001 active fees (bp)	18.31	27.31	32.32	44.53
Change of weighted averages (bp)	+6.37	+2.86	+3.97	–6.92
Number of respondents	5	5	6	7

Note: Data is for typical management fees for an active UK equity fund. Weights are based on the total value of funds managed in the UK, as provided in question 1 of the 2002 fund managers questionnaire and question 1 of the 2006 original fund managers questionnaire. In 2002 fund managers were asked with respect to a £200m fund, while in 2006 fund managers were asked with respect to a £250m fund.

Source: Oxera calculations based on responses to the 2006 original fund managers questionnaire (question 8) and the 2002 fund managers questionnaire (question 6).

¹⁶ As undertaken for Oxera (2002), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', November.

Table 4.3.8 Change in typical passive management fees between 2001 and 2005

	£500m	£200–£250m	£100m	£50m
Weighted average of 2005 passive fees (bp)	3.9	4.35	5.14	5.73
Weighted average of 2001 passive fees (bp)	4.8	5.25	7.55	10.44
Change of weighted averages (bp)	-0.89	-0.90	-2.41	-4.71
Number of respondents	4	4	4	4

Note: Data is for typical management fees for a passive UK equity fund. Weights are based on the total value of funds managed in the UK, as provided in question 1 of the 2002 fund managers questionnaire and question 1 of the 2006 original fund managers questionnaire. In 2002 fund managers were asked with respect to a £200m fund, while in 2006 fund managers were asked with respect to a £250m fund.

Source: Oxera calculations based on responses to the 2006 original fund managers questionnaire (question 8) and the 2002 fund managers questionnaire (question 6).

With respect to management fees for actively traded funds, the data in Table 4.3.5 suggests that management fees declined over the period 2003–05: the weighted average management fee for an actively managed £100m UK equity fund fell from 42.2bp in 2003 to 38.4 basis points in 2005. However, the data in Table 4.3.7 suggests that management fees rose between 2001 and 2005. Using a smaller sample of respondents to both the 2002 and 2006 questionnaires, the weighted average management fee for a £100m UK equity fund rose from 32.32bp in 2001 to 36.30bp in 2005. This data also suggests that the increase in fund management fees between 2001 and 2005 was focused on larger funds, with the weighted average management fees for a £50m UK equity fund falling by 6.92bp.

With respect to management fees for passively traded funds, the data in Table 4.3.6 suggests that management fees declined slightly over the period 2003–05: the weighted average management fee for a passively managed £100m UK equity fund fell from 5.25bp in 2003 to 5.06bp in 2005. This is supported by the data in Table 4.3.8, which suggests that management fees for smaller passive equity funds fell between 2001 and 2005. Also, this data suggests that the weighted average management fees have declined for all sizes of fund, with smaller funds seeing a larger decline.

Although the data suggests that the underlying trend is for management fees to decline, this trend is not perfectly clear. However, although reservations about the effective impact of the change in the regime remain, sufficient data has been collected to provide a functional benchmark for future comparison.

4.4 Reduction in spending on research goods and services

As explained in section 2.2, the change in the regime for soft commissions and bundled brokerage requires fund managers to disclose the use of clients' commissions. If fund managers come under greater scrutiny from pension funds, they may become more selective about the research they purchase through commissions, which may lead to a reduction in the amount spent on research goods and services purchased through commissions. The measurement of this impact was formulated into six performance indicators.

Performance indicators: reduction in spending on research goods and services

- Qualitative and anecdotal evidence on the scrutiny, by pension funds, of fund managers' use of clients' commissions.
- The amount spent on broker/third-party research purchased with soft commissions.
- The amount spent on research purchased through bundled brokerage.
- The amount spent on research purchased with hard cash.
- The amount spent on research produced in-house.
- The total amount spent on research goods and services.

Pension fund scrutiny of fund managers

There are two aspects to the potential for greater scrutiny, by pension funds, of fund managers' use of clients' commissions: it is necessary to consider, first, the take-up of disclosure mechanisms by fund managers; and, second, how pension funds use such reports. The qualitative and anecdotal evidence in this sub-section is applicable to changes in the amount spent on research (described in this section) and in the amount spent on execution-related goods and services purchased (described in section 4.5).

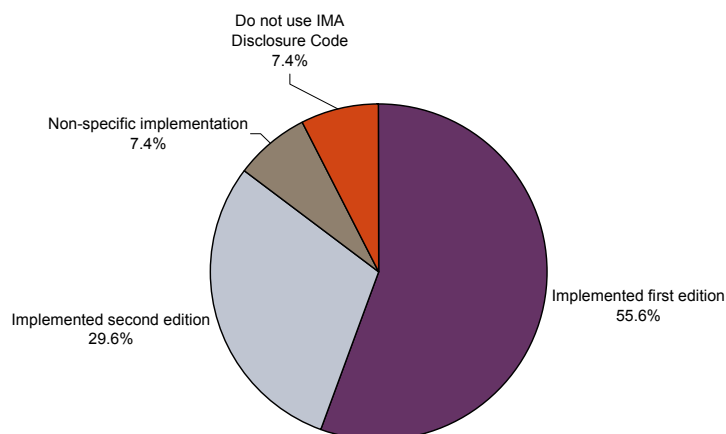
With regard to the disclosure mechanism, it is first possible to consider whether fund managers use the IMA Disclosure Code (see Table 4.4.1). This data shows that of those who replied, most do, with only one using its own means of disclosure, and another not having decided at the time of the original fund managers questionnaire. This data is also presented in Figure 4.4.1, which provides a breakdown of those who use the IMA Disclosure Code into those who started using the first edition and those who started using the second edition.

Table 4.4.1 Use of the IMA Disclosure Code

Use IMA Disclosure Code ¹	Use own means of disclosure	Means of disclosure not yet determined
25 (93%)	1 (3.7%)	1 (3.7%)

Notes: ¹ 15 fund managers indicated that they had used the first edition of the IMA Disclosure Code, 8 fund managers stated that they had started using the second edition, while 2 did not provide this information. Source: Oxera calculations based on responses to the original fund managers questionnaire (question 33).

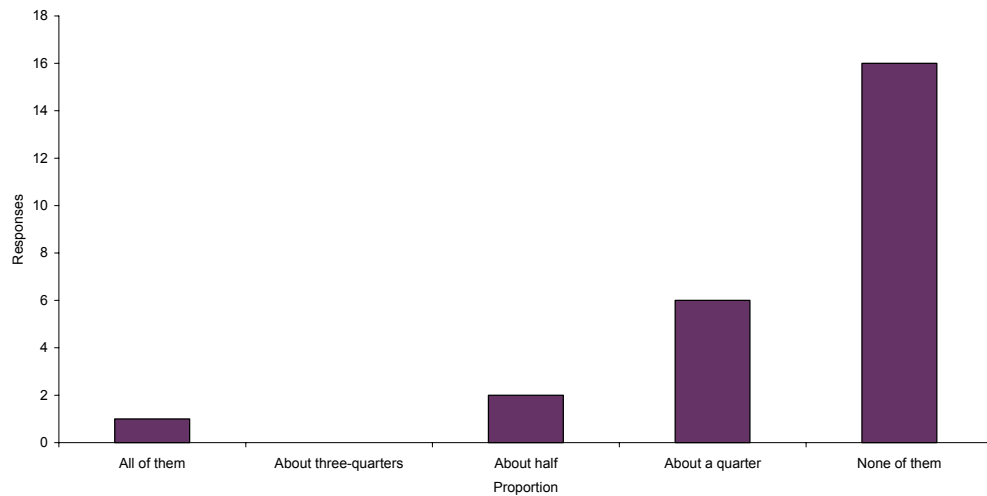
Figure 4.4.1 Use and implementation of IMA Disclosure Code



Source: Oxera calculations based on responses to the original fund managers questionnaire (question 33).

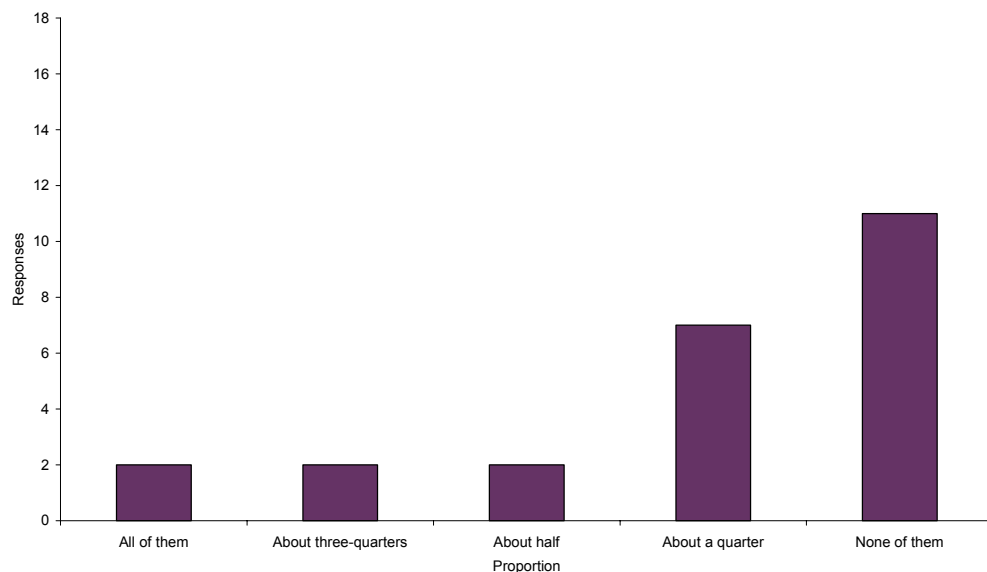
Although a significant number of fund managers appear to use the IMA Disclosure Code, before the change in the regime fund managers were not fully informed of the cost of the research they purchased through commissions. While the amount spent on research from other brokers or third-party research providers purchased with soft commissions would have been known, the data in Figure 4.4.2 indicates that fund managers had not been provided with estimates of the amount spent on research received through bundled brokerage arrangements. This appears to have improved very slightly between 2005 and early 2006, as the data in Figure 4.4.3 indicates.

Figure 4.4.2 Fund managers who received estimates of the cost of non-execution goods and services provided through bundled brokerage arrangements (2005)



Source: Oxera calculations based on responses to the original fund managers questionnaire (question 19).

Figure 4.4.3 Fund managers who received estimates of the cost of non-execution goods and services provided through bundled brokerage arrangements (2006)



Source: Oxera calculations based on responses to the original fund managers questionnaire (question 19).

Another issue, as identified by several fund managers and described in section 3, is that the price paid by fund managers for the research they receive through bundled brokerage arrangements is predominantly related to the volume of trading, rather than to the underlying value of the research, which, in turn, would be related to the quality of the research and the volume of research goods and services received. However, in accordance with the modified regulations, a number of fund managers indicated that they would agree budgets with full-service brokers for the research that they will receive. In the follow-up survey among fund managers, fund managers were asked whether, for 2006, they had agreed the price of research on the basis of turnover (as under the previous regime) or on the basis of a fixed budget for research. The results are shown in Table 4.4.2. Brokers were asked a

corresponding question about how many fund managers they had agreed a fixed budget for research with (see Table 4.4.3).

Table 4.4.2 Method for pricing research purchased through bundled brokerage arrangements

	Responses
How have you priced research in 2006?	
By volume of trading	6
By fixed budget for research	5

Source: Oxera calculations based on 11 responses to the follow-up survey among fund managers.

Table 4.4.3 Number of brokers who had agreed fixed budgets for research

Responses	How many brokers agreed fixed budgets for research with fund managers for 2006?	With how many fund managers were fixed budgets for research agreed?	
Yes	4	Range	1–5
		Range (by proportion of fund manager clients)	0.29–2.27%
No	9		

Source: Oxera calculations based on 13 responses to the brokers questionnaire (question 21).

Given the data from fund managers and brokers on the availability of information on the costs of research provided through bundled brokerage and the uncertainty about how this research will be valued in the future, it is important to consider whether fund managers are monitoring the quality of research provided by brokers.

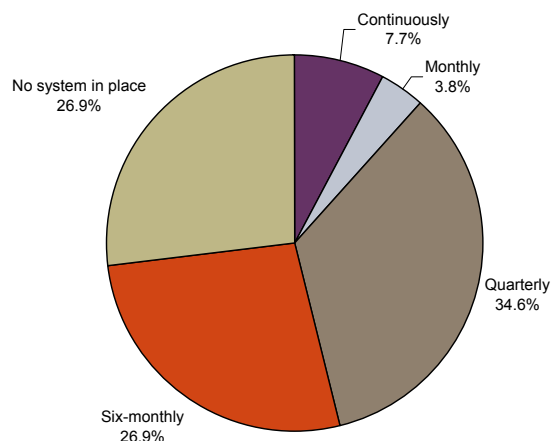
Table 4.4.4 shows that 19 of the 26 respondents indicated that they had systems in place to monitor the quality of research provided by brokers or third-party research providers. The frequency of these reviews ranged from continuous to six-monthly, with nine fund managers indicating that this review took place quarterly, and seven indicating that it took place every six months. The other seven fund managers did not have systems in place. This data is also shown in Figure 4.4.4 below.

Table 4.4.4 Extent of monitoring of quality of research

	Number of fund managers	Total funds under management (billion)
Fund managers		
who have a system in place	19	£1,071.5
Monitoring continuously	2	
Monitoring monthly	1	
Monitoring quarterly	9	
Monitoring every six months	7	
who do not have a system in place	7	£335.0
Total respondents	26	£1,406.6

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 31).

Figure 4.4.4 Frequency of monitoring quality of research



Source: Oxera calculations based on responses to the original fund managers questionnaire (question 31).

This data suggests that almost three-quarters of fund managers have systems in place to monitor the quality of research. However, in order for fund managers to face greater scrutiny from pension funds about their use of clients’ commissions, pension funds would require information on the quality of research provided to fund managers. As such, fund managers were asked whether they shared with their clients the results from their systems to monitor brokers. Table 4.4.5 shows that 13 of the 26 respondents indicated that they did. In relation to research, 11 of the 19 fund managers who had systems in place to review quality of research received from brokers or third parties shared the results of their reviews with their clients. However, how much information on the quality of research received by fund managers is actually shared with pension fund clients is not clear.

Table 4.4.5 Sharing of results of monitoring brokers with pension fund clients

	Results shared	Results not shared
Total number of fund managers who shared results (out of 26)	13	13
Number of fund managers who monitored research who shared results (out of 19)	11	8

Source: Based on 26 responses to the 2006 fund manager questionnaire (question 32).

This data therefore suggests that fund managers are using the IMA Disclosure Code to carry out the requirements for prior and periodic disclosure in the new regime for soft commissions and bundled brokerage. Also, the evidence suggests that fund managers are monitoring the quality of research they are receiving, although it is unclear to what extent the information is shared with pension funds.

As has already been explained, the most significant factor is whether pension funds will put pressure on fund managers with regard to the latter’s use of clients’ commissions. Qualitative questions were therefore asked to establish whether pension funds received disclosure reports, and how these were used. Question 20 asked pension funds whether they had received reports complying with the IMA Disclosure Code, while question 21 asked whether they had hired external consultants to assist in the analysis of the information received, and whether they had found this information useful. Question 19 asked for broader information on the information provided by pension funds.

Furthermore, questions 17 and 18 inquired about the use of information received by pension funds, focusing on pension fund scrutiny both of the commission rate paid for trades (question 17), and of the use of commissions on the pension funds’ trades (question 18). Questions 22 inquired about the extent to which pension funds monitored the research being

purchased by fund managers on their behalf. Question 23 inquired whether the data provided by fund managers to pension funds was being monitored, and, if so, by whom. However, due to the very low response rate to the pension fund questionnaire, and the quality of responses provided, it has not been possible to provide aggregate analysis of the answers to any of these questions.

As explained in section 3, interviews with pension fund trustees suggest that pension funds have not started analysing the data in the reports received from fund managers. Also, the very low response rate from pension funds to the survey for this impact assessment of the change in the regime for soft commissions and bundled brokerage arrangements may suggest that the issue of fund managers' use of clients' commissions is currently not high on the agenda of pension fund managers or trustees.

Also, despite the IMA Disclosure Code, there were some indications from interviews with pension funds that the disclosure reports from fund managers were either difficult to understand or difficult to compare across fund managers. Therefore, at least in the short term, this may suggest that it is unlikely that pension funds will thoroughly scrutinise fund managers or put pressure on them with regard to their use of clients' commissions. These issues of monitoring and disclosure will require reassessment in future surveys.

Amount spent on research goods and services

Fund managers were asked to provide data on the actual amount spent on research purchased with soft commissions and the proportion of the amount spent on non-execution goods and services purchased through bundled brokerage arrangements that was research. As with the data on non-permitted goods and services, to account for changes to other factors within the data from the baseline survey and to provide a consistent basis on which to make comparisons with the data from future surveys, the results are presented in two formats:

- ratios of the amount spent on research to the funds under management;
- ratios of the amount spent on research to the value of bundled brokerage trades.

Fund managers were also asked to provide an estimate for the amount spent on research produced in-house, although a number of fund managers were unwilling to disclose this data for confidentiality reasons. Also, some fund managers were unable to provide this data, as it is not readily available from their accounts. The data that was provided has been excluded due to reservations about its quality. However, the trend for this data was that the costs of in-house research were increasing, although at a slower rate than for funds under management.

First, to handle the issue that the funds under management—the management of which will require this research—will change over time, it is necessary to compare the change in the amount spent on research relative to the funds under management. The most accurate means of generating such a benchmark for future comparison relative to funds under management is to calculate the weighted average of the ratios of the amount spent on research to the funds under management calculated for each individual fund manager. This also provides a consistent basis on which to make further comparisons.

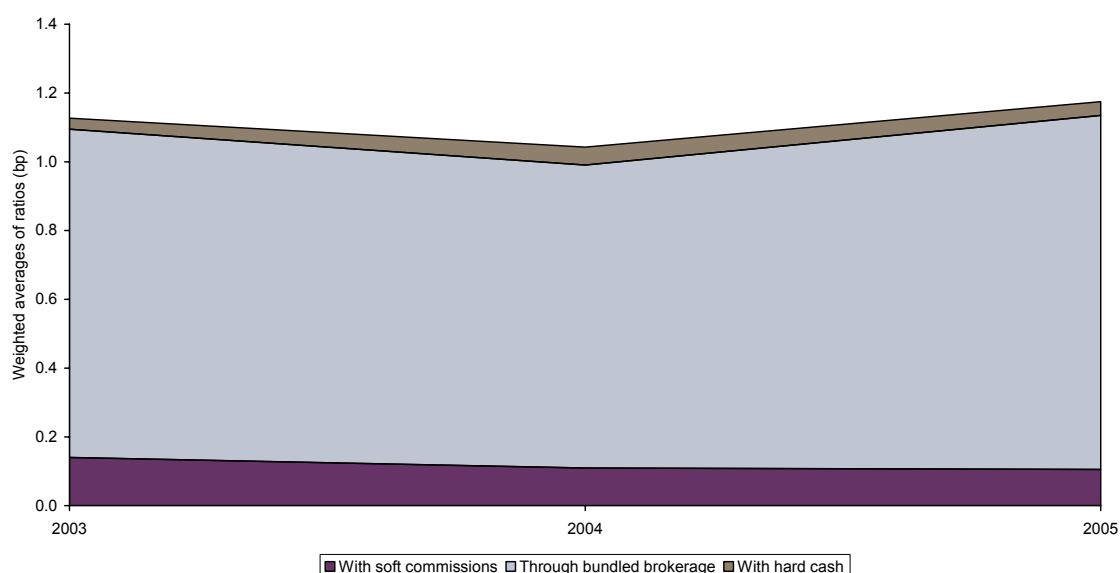
Therefore, the ratios of the amount spent on research to the funds under management were calculated for each fund manager, before taking a weighted average of these ratios (see Table 4.4.6 and Figure 4.4.5). To allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, the full sample of ten fund managers has also been used to provide the most accurate baseline for future comparison.

Table 4.4.6 Weighted average of ratios of research to funds under management

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average of ratios of amount spent on research purchased. . .				
through commissions to funds under management (bp)	1.095	0.990	1.135	1.145
with soft commissions to funds under management (bp)	0.140	0.110	0.106	0.091
through bundled brokerage to funds under management (bp)	0.955	0.881	1.029	1.055
with hard cash to funds under management (bp)	0.032	0.052	0.040	0.182
to funds under management (bp)	1.127	1.042	1.175	1.327
Number of respondents	10	10	10	12

Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.4.5 Weighted average of ratios of research to funds under management



Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The data in Table 4.4.6 suggests that, once the change in the funds under management has been taken into account, the amount spent on research purchased through commissions to the funds under management increased between 2003 and 2005. This change is more clearly expressed in Figure 4.4.5, which shows that, in 2005, although the ratio of the amount spent on research purchased with soft commissions declined, the ratio of the total amount spent on research purchased through commissions increased between 2003 and 2005. This data also suggests a slight increase in the ratio of the amount spent on research purchased with hard cash.

To handle the issue that the amount spent on bundled brokerage trades—commissions for which paid for the research purchased through commissions—will change over time, it is necessary to compare the change in the amount spent on research with the value of bundled brokerage trades. The most accurate means of generating such a benchmark for future comparison relative to the value of bundled brokerage trades is to calculate the weighted

average of the ratios of research to the value of bundled brokerage trades for each individual fund manager.

Therefore, the ratios of the amount spent on research to the fund manager's value of bundled brokerage trades were calculated for each fund manager, before taking a weighted average of these ratios (see Table 4.4.7). For the research purchased through commissions, this serves as a weighted average of the constituents of the bundled brokerage commission rate for research, and these constituents are also shown in Figure 4.4.6. Again, to allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, to provide the most accurate baseline for future comparison, the full sample of ten fund managers has been used.

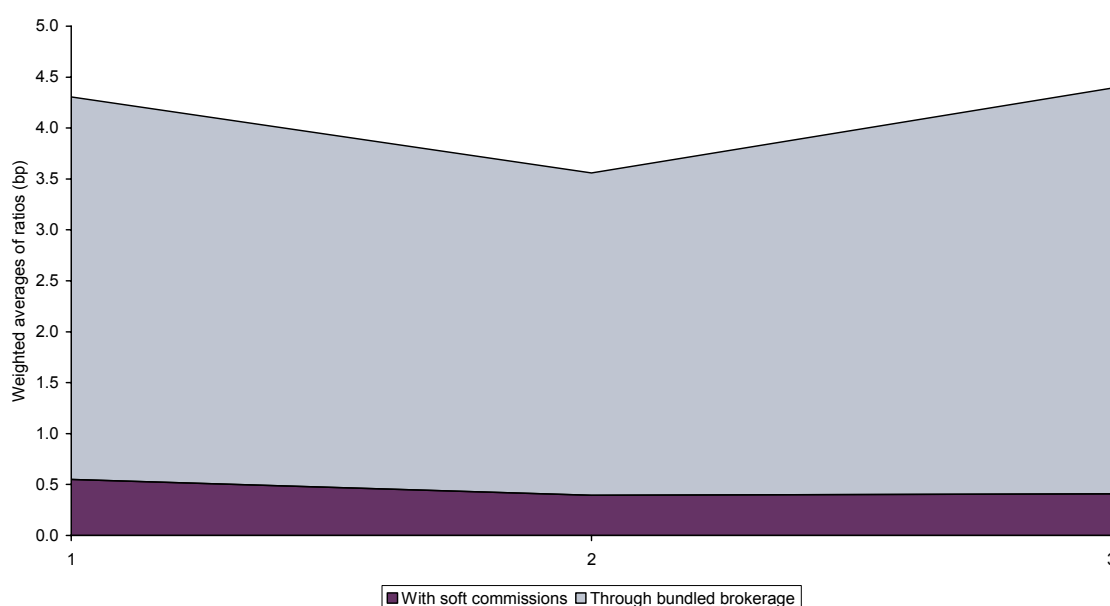
Table 4.4.7 Weighted average of ratios of research to the value of bundled brokerage trades

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average of ratios of amount spent on research purchased . . .				
through commissions to the value of bundled brokerage trades (bp)	4.305	3.559	4.391	4.565
with soft commissions to the value of bundled brokerage trades (bp)	0.550	0.395	0.408	0.361
through bundled brokerage to the value of bundled brokerage trades (bp)	3.755	3.164	3.983	4.204
with hard cash to the value of bundled brokerage trades (bp)	0.100	0.140	0.117	0.540
to the value of bundled brokerage trades (bp)	4.430	3.746	4.546	5.289
Number of respondents	10	10	10	12

Note: Weights were based on the fund managers' reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.4.6 Weighted average research constituents of bundled brokerage commission rates



Note: Weights were based on the fund managers' reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

This data suggests that, when the increase in the value of bundled brokerage trades has been taken into account, the amount spent on research remained roughly constant between 2003 and 2005. Within this result, there is both a decrease in the amount spent on research purchased with soft commissions and an increase in the amount spent on research purchased through bundled brokerage arrangements. As such, Figure 4.4.6 indicates that the overall research constituent of bundled brokerage commission rates has remained roughly constant.

Section 2.2 also raised the question of whether a reduction in the amount spent on research purchased through commissions would lead to a similar reduction in the total amount spent on research. After taking into account the increase in funds under management, the data in Table 4.4.6 and Figure 4.4.5 suggests that there was an increase in the total amount spent on research, which appears to have been predominantly driven by the change in the amount spent on research purchased through bundled brokerage arrangements.

However, for future comparison it will be necessary to determine what impact the change in the amount spent on research purchased through commissions would have on the amount spent on research purchased with hard cash or on the total amount spent on research. The data described above can be used to consider whether the change in the amount spent on research purchased through commissions led to an increase in the amount spent on research purchased with hard cash, or to a reduction in the total amount spent on research. To determine these impacts, it is possible to calculate the proportion of the change in the weighted average ratios of the amount spent on research purchased through commissions to funds under management that led to either of these changes. Table 4.4.8 shows the change in the weighted average of the ratios of the total amount spent on research purchased through commissions to funds under management, and the proportions of this change that were matched by either switching to purchasing research with hard cash or reducing the total amount spent on research.

Table 4.4.8 Proportions of change in weighted average of ratios of research to funds under management

	Consistent sample		
	2003–05	2003–04	2004–05
Change in weighted average of ratios of total amount spent on research purchased through commissions to funds under management (bp)	0.0397	–0.1047	0.1444
Proportion accounted for by change in the amount spent on research purchased with hard cash (%)	–21.08%	19.27%	8.17%
Proportion accounted for by change in the total amount spent on research purchased (%)	121.08%	80.73%	91.83%
Number of respondents	8	8	8

Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The data in Table 4.4.8 suggests that the impact of the increase in the amount spent on research purchased through commissions was primarily that the total amount spent on research, either through commissions or with hard cash, rose. The corresponding change in the amount spent on research purchased with hard cash between 2003 and 2005 was also positive. This suggests that between 2003 and 2005, fund managers increased the amount spent on research purchased both through commissions and with hard cash.

The underlying trend is an increase in the amount spent on research purchased through commissions—and predominantly through bundled brokerage—relative to funds under management or the value of bundled brokerage trades. This data serves as a functional benchmark for future comparison.

4.5 Reduction in spending on execution-related goods and services

As explained in section 2.3, the change in the regime for soft commissions and bundled brokerage arrangements requires fund managers to disclose the use of clients' commissions. If fund managers come under greater scrutiny from pension funds, they may become more selective about the execution-related goods and services they purchase through commissions, which may in turn lead to a reduction in the amount spent on execution-related goods and services purchased through commissions.

As in section 4.4, the expectation that the amount spent on execution-related goods and services purchased through commissions will decline depends on the scrutiny, by pension funds, of the use by fund managers of clients' commissions. Qualitative and anecdotal evidence about such scrutiny was described in the previous section, but also applies to this category of performance indicators. The measurement of this impact was formulated into four performance indicators.

Performance indicators: reduction in spending on execution-related goods and services

- The amount spent on execution-related goods and services purchased with soft commissions.
- The amount spent on execution-related goods and services purchased through bundled brokerage.
- The amount spent on execution-related goods and services purchased with hard cash.
- The total amount spent on execution-related goods and services consumed.

Amount spent on execution-related goods and services

Fund managers were asked to provide data on the actual amount spent on execution-related goods and services purchased with soft commissions and the proportion of the amount spent on non-execution goods and services purchased through bundled brokerage arrangements that were execution-related goods and services. As with the data on non-permitted goods and services and research, in order to account for changes to other factors within the data from the baseline survey and to provide a consistent basis on which to make comparisons with the data from future surveys, the results are presented in two formats:

- ratios of the amount spent on execution-related goods and services to the funds under management;
- ratios of the amount spent on execution-related goods and services to the value of bundled brokerage trades.

First, to handle the issue that the funds under management—the management for which will require these execution-related goods and services—will change over time, it is necessary to compare the change in the amount spent on execution-related goods and services relative to the funds under management. The most accurate means of generating such a benchmark for future comparison relative to funds under management is by calculating the weighted average of the ratios of the amount spent on execution-related goods and services to the funds under management calculated for each individual fund manager. This also provides a consistent basis on which to make further comparisons.

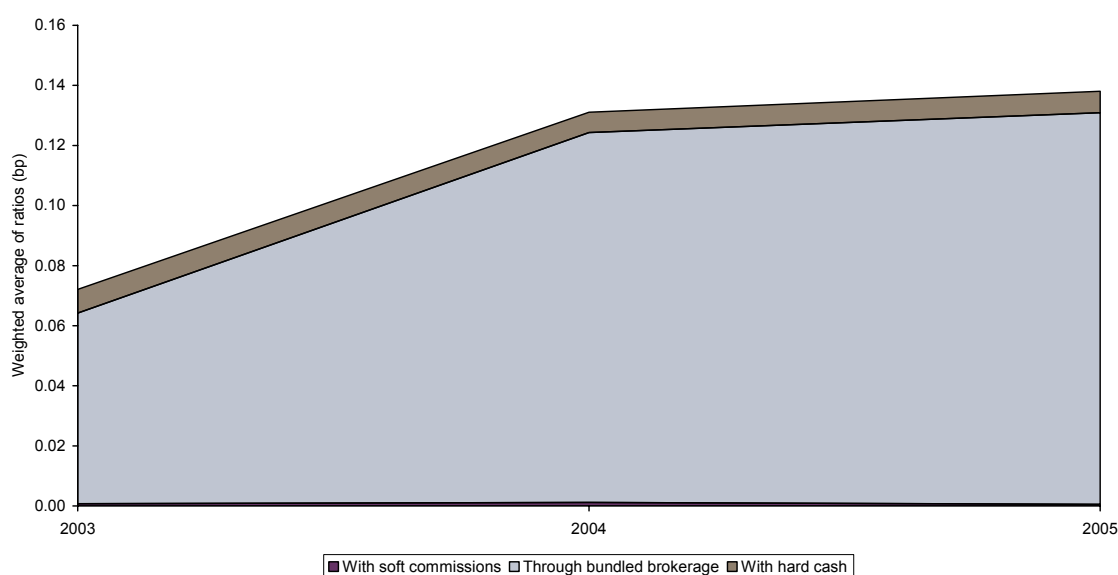
Therefore, the ratios of the amount spent on execution-related goods and services to the funds under management were calculated for each fund manager, before taking a weighted average of these ratios (see Table 4.5.1 and Figure 4.5.1). To allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, the full sample of ten fund managers has been used to provide the most accurate baseline for future comparison.

Table 4.5.1 Weighted averages of the ratios of execution-related goods and services purchased to funds under management

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average of ratios of amount spent on execution-related goods and services purchased. . .				
through commissions to funds under management (bp)	0.064	0.124	0.131	0.112
with soft commissions to funds under management (bp)	0.001	0.001	0.001	0.001
through bundled brokerage to funds under management (bp)	0.063	0.123	0.130	0.112
with hard cash to funds under management (bp)	0.008	0.007	0.007	0.043
to funds under management (bp)	0.072	0.131	0.138	0.155
Number of respondents	8	8	8	10

Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.5.1 Weighted average of ratios of execution-related goods and services purchased to funds under management



Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The data in Table 4.5.1 suggests that, once the change in the funds under management has been taken into account, the amount spent on execution-related goods and services purchased through commissions to the funds under management has increased significantly between 2003 and 2005. This is even more clearly expressed in Figure 4.5.1, which shows the significant increase in the amount spent on execution-related goods and services purchased through bundled brokerage arrangements.

Second, to handle the issue that the value of bundled brokerage trades—commissions for which paid for the execution-related goods and services purchased through commissions—will change over time, it is necessary to compare the change in the amount spent on

execution-related goods and services relative to the value of bundled brokerage trades. The most accurate means of generating such a benchmark for future comparison relative to the value of bundled brokerage trades is by calculating the weighted average of the ratios of execution-related goods and services to the value of bundled brokerage trades calculated for each individual fund manager.

Therefore, the ratios of the amount spent on execution-related goods and services to the fund manager's value of bundled brokerage trades were calculated for each fund manager, before taking a weighted average of these ratios (see Table 4.5.2). For the execution-related goods and services purchased through commissions, this serves as a weighted average of the constituents of the bundled brokerage commission rate for execution-related goods and services, and these constituents are also shown in Figure 4.5.2. Again, to allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, to provide the most accurate baseline for future comparison, the full sample of ten fund managers has been used.

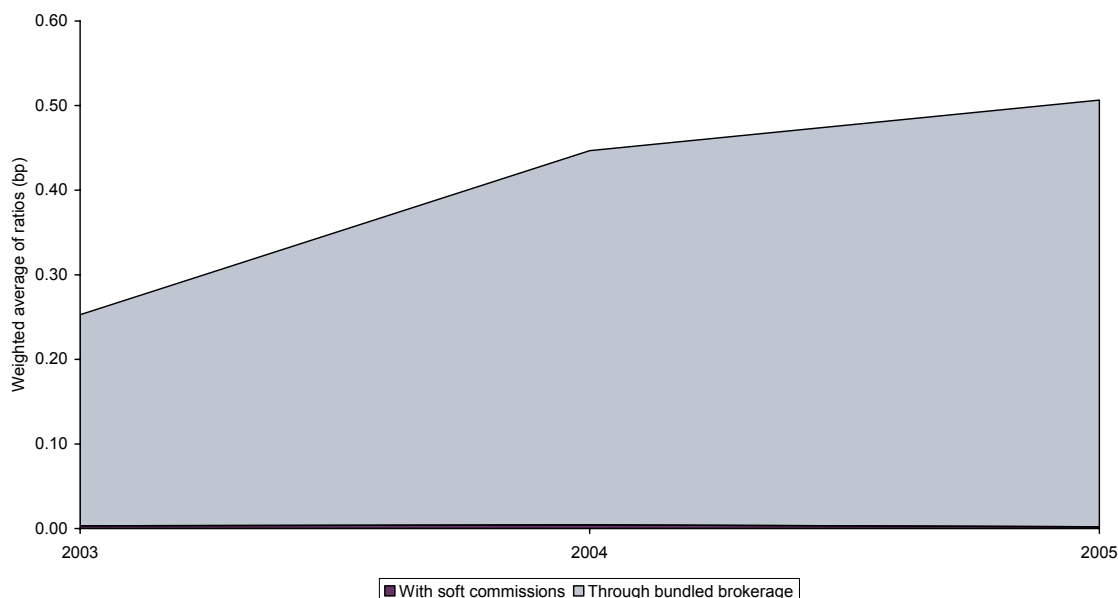
Table 4.5.2 Weighted average of ratios of execution-related goods and services to amount spent on bundled brokerage trades

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average of ratios of amount spent on execution-related goods and services purchased . . .				
through commissions to the value of bundled brokerage trades (bp)	0.253	0.447	0.507	0.448
with soft commissions to the value of bundled brokerage trades (bp)	0.003	0.004	0.002	0.002
through bundled brokerage to the value of bundled brokerage trades (bp)	0.249	0.443	0.504	0.446
with hard cash to the value of bundled brokerage trades (bp)	0.031	0.024	0.028	0.171
to the value of bundled brokerage trades (bp)	0.284	0.471	0.534	0.619
Number of respondents	8	8	8	10

Note: Weights were based on the fund managers' reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.5.2 Weighted average execution-related goods and services constituents of bundled brokerage commission rates



Note: Weights were based on the fund managers' reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data includes three fund managers who reported that they purchased research with hard cash.
 Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

This data suggests that, once the increase in the value of bundled brokerage trades has been taken into account, the amount spent on execution-related goods and services purchased through commissions has increased substantially. This result is driven by the increase in the amount spent on execution-related goods and services purchased through bundled brokerage arrangements, while the amount spent on execution-related goods and services purchased with soft commissions has fallen slightly.

Section 2.3 also raised the question of whether a reduction in the amount spent on execution-related goods and services purchased through commissions would lead to a similar reduction in the total amount spent on execution-related goods and services purchased. After taking into account the increase in funds under management, the data in Table 4.5.1 and Figure 4.5.1 suggests that there was an increase in the total amount spent on execution-related goods and services, which appears to have been predominantly driven by the change in the amount spent on execution-related goods and services purchased through bundled brokerage arrangements.

However, for future comparison it will be necessary to determine what impact the change in the amount spent on execution-related goods and services purchased through commissions would have on the amount spent on execution-related goods and services purchased with hard cash or on the total amount spent on execution-related goods and services. The data described above can be used to consider whether the change in the amount spent on execution-related goods and services purchased through commissions led either to an increase in the amount spent on execution-related goods and services purchased with hard cash or to a reduction in the total amount spent on execution-related goods and services. To determine these impacts, it is possible to calculate the proportion of the change in the weighted average ratios of the amount spent on execution-related goods and services purchased through commissions to funds under management that led to either of these changes. Table 4.5.3 shows the change in the weighted average of the ratios of the total amount spent on execution-related goods and services purchased through commissions to funds under management, and the proportions of this change that were matched by either

the switching to purchasing execution-related goods and services with hard cash, or the reduction in the total amount spent on execution-related goods and services.

Table 4.5.3 Proportions of change in weighted average of ratios of execution-related goods and services to funds under management

	Consistent sample		
	2003–05	2003–04	2004–05
Change in weighted average of ratios of the total amount spent on execution-related goods and services purchased to funds under management (bp)	0.0666	0.0600	0.0066
Proportion accounted for by change in the amount spent on execution goods and services purchased with hard cash	1.15%	1.90%	–5.72%
Proportion accounted for by change in the total amount spent on execution-related goods and services purchased	98.85%	98.10%	105.72%
Number of respondents	8	8	8

Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The data in Table 4.5.3 suggests that the impact of the increase in the total amount spent on execution-related goods and services purchased through commissions was predominantly that the total amount spent on execution-related goods and services rose.

The underlying trend is therefore an increase in the amount spent on execution-related goods and services purchased through commissions—predominantly through bundled brokerage—relative to either the funds under management or the value of bundled brokerage trades. This data serves as a functional benchmark for future comparison.

4.6 Reduction in spending on non-execution goods and services purchased through commissions

As explained in section 2.4, the reduction in the range of goods and services that can be purchased with soft commissions or bundled brokerage, combined with the requirements for increased disclosure of the use of clients' commissions, should lead to a reduction in the total amount spent on non-execution goods and services purchased through commissions. The measurement of this impact was formulated into a single performance indicator.

Performance indicator: reduction in spending on non-execution goods and services purchased through commissions

- The total amount spent on non-execution goods and services purchased through commissions.

Amount spent on non-execution goods and services purchased through commissions

Fund managers were asked to provide data on the actual amount spent on non-execution goods and services purchased with soft commissions, while the amount spent on non-execution goods and services purchased through bundled brokerage was calculated using fund managers' estimates of the proportion of bundled brokerage commissions that purchased non-execution goods and services. To account for changes to other factors within the data from the baseline survey and to provide a consistent basis on which to make comparisons with the data from future surveys, the results are presented in two formats:

- ratios of the amount spent on non-execution goods and services to the funds under management;

- ratios of the amount spent on non-execution goods and services to the value of bundled brokerage trades.

First, to handle the issue that the funds under management—the management of which may require some of these non-execution goods—will change over time, it is necessary to compare the change in the amount spent on non-execution goods and services relative to the funds under management. The most accurate means of generating such a benchmark for future comparison relative to funds under management is by calculating the weighted average of the ratios of the amount spent on non-execution goods and services to the funds under management calculated for each individual fund manager. This also provides a consistent basis on which to make further comparisons.

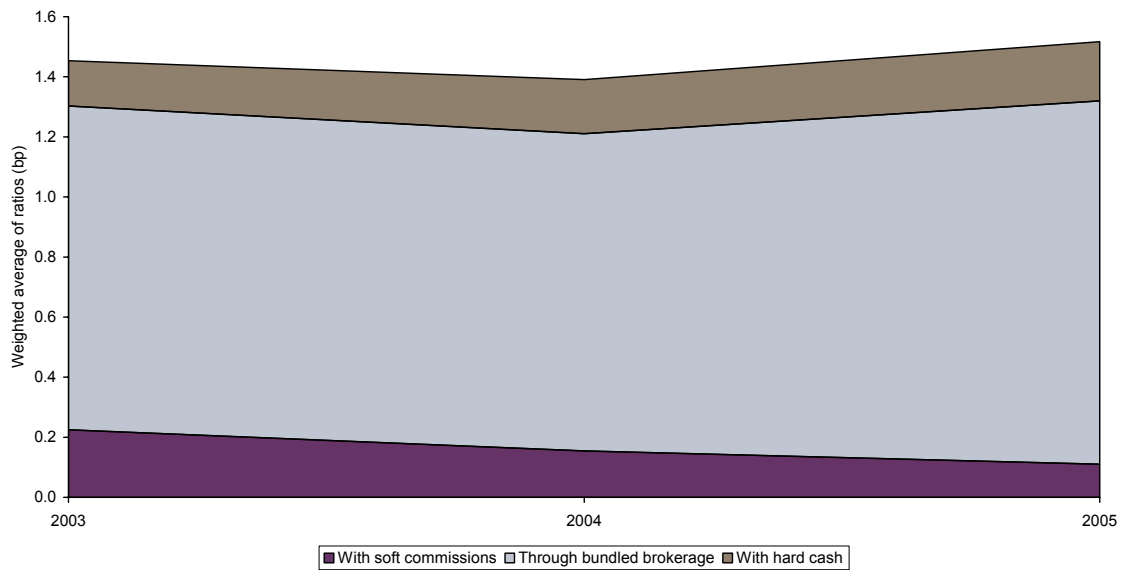
Therefore, the ratios of non-execution goods and services to the funds under management were calculated for each fund manager, before taking a weighted average of these ratios (see Table 4.6.1 and Figure 4.6.1). To allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, the full sample of ten fund managers has been used to provide the most accurate baseline for future comparison.

Table 4.6.1 Weighted average of ratios of non-execution goods and services to the funds under management

	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average of ratios of the amount spent on non-execution goods and services purchased . . .				
through commissions to the value of bundled brokerage trades (bp)	1.302	1.210	1.320	1.304
with soft commissions to the value of bundled brokerage trades (bp)	0.225	0.155	0.110	0.095
through bundled brokerage to the value of bundled brokerage trades (bp)	1.078	1.056	1.210	1.209
with hard cash to the value of bundled brokerage trades (bp)	0.151	0.180	0.196	0.353
to the value of bundled brokerage trades (bp)	1.454	1.391	1.516	1.657
Number of respondents	8	8	8	10

Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.6.1 Weighted average of ratios of non-execution goods and services to funds under management



Note: Weights were based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The data in Table 4.3.1 suggests that, once the change in the funds under management has been taken into account, the amount spent on non-execution goods and services purchased through commissions remained roughly constant between 2003 and 2005. Within this result, there is both a decrease in the amount spent on non-execution goods and services purchased with soft commissions and an increase in the amount spent on non-execution goods and services purchased through bundled brokerage arrangements. This is even more clearly expressed in Figure 4.6.1, which shows both the increase in the ratio of the amount spent on non-execution goods and services purchased through bundled brokerage and the decrease in the ratio of the amount spent on non-execution goods and services purchased with soft commissions. The data in Table 4.6.1 and Figure 4.6.1 also indicates that the ratio of the amount spent on non-execution goods and services purchased with hard cash increased between 2003 and 2005.

Second, to handle the issue that the value of bundled brokerage trades—commissions for which paid for the non-execution goods and services purchased through commissions—will change over time, it is necessary to compare the change in the amount spent on non-execution goods and services purchased relative to the value of bundled brokerage trades. The most accurate means of generating such a benchmark for future comparison relative to the value of bundled brokerage trades is by calculating the weighted average of the ratios of the amount spent on non-execution goods and services to the value of bundled brokerage trades calculated for each individual fund manager.

The ratios of non-execution goods and services to the fund manager's value of bundled brokerage trades were calculated for each fund manager, before taking a weighted average of these ratios (see Table 4.6.2). For the non-execution goods and services purchased through commissions, this serves as a weighted average of the constituents of the bundled brokerage commission rate for non-execution goods and services, and these constituents are also shown in Figure 4.6.2. Again, to allow comparison over the period 2003–05, a consistent sample of eight fund managers has been used. In addition, to provide the most accurate baseline for future comparison, the full sample of ten fund managers has been used.

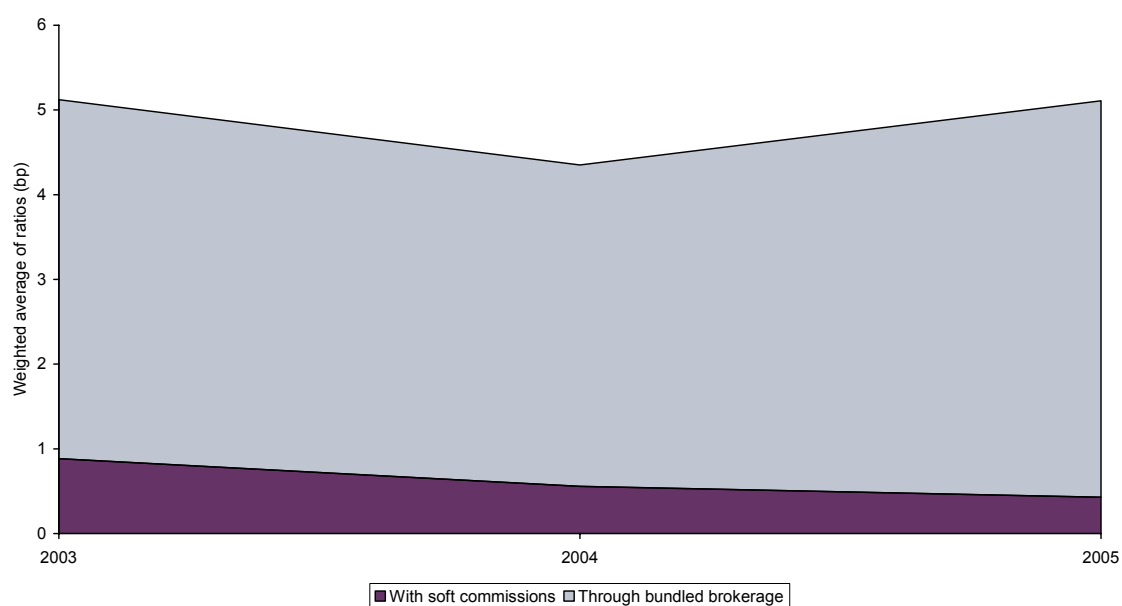
Table 4.6.2 Weighted average of ratios of non-execution goods and services to value of bundled brokerage trades

	Consistent sample			Full sample
	2003	2004	2005	2005
Aggregate funds under management (£ billion)	157.3	188.2	233.6	272.2
Weighted average of ratios of the amount spent on non-execution goods and services purchased				
through commissions to the value of bundled brokerage trades (bp)	5.121	4.350	5.108	5.199
with soft commissions to the value of bundled brokerage trades (bp)	0.884	0.556	0.427	0.378
through bundled brokerage to the value of bundled brokerage trades (bp)	4.237	3.794	4.681	4.822
with hard cash to the value of bundled brokerage trades (bp)	0.594	0.647	0.760	1.407
to the value of bundled brokerage trades (bp)	5.715	4.997	5.868	6.607
Number of respondents	8	8	8	10

Note: Weights were based on the fund managers' reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.6.2 Weighted average non-execution goods and services constituents of bundled brokerage commission rates



Note: Weights were based on the fund managers' reported value of bundled brokerage trades, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

This data suggests that, once the increase in the value of bundled brokerage trades is taken into account, the amount spent on non-execution goods and services purchased through commissions remained roughly constant between 2003 and 2005. Within this result, there is both a decrease in the amount spent on non-execution goods and services purchased with soft commissions and an increase in the amount spent on non-execution goods and services purchased through bundled brokerage arrangements. Figure 4.6.2 indicates that the overall non-execution constituent of bundled brokerage commission rates has remained roughly constant.

Using either the ratios to funds under management or the ratios to the value of bundled brokerage trades, the proportion of non-execution goods and services that were purchased with soft commissions has remained roughly constant. The data on both sets of ratios suggests that there may have been a switch from purchasing non-execution goods and services with soft commissions to purchasing non-execution goods and services through bundled brokerage. This may reflect an expectation of some fund managers, prior to the announcement of the modified regulations on soft commissions and bundled brokerage, that the modified regulations would prohibit the purchasing of non-execution goods and services with soft commissions, but allow the purchasing of non-execution goods and services through bundled brokerage.

However, there are some reservations about the quality of this data, in terms of fund managers' breakdown of execution-related goods and services between those purchased with soft commissions and those purchased through bundled brokerage arrangements. The impact of this on the assessment of the impact of the change in the regime is insignificant, as this assessment considers the total amount spent on execution-related (or other non-execution) goods and services purchased through commissions—ie, those execution-related (or other non-execution) goods and services purchased through commissions from either the trade execution broker, other brokers or third-party providers.

The principal means of purchasing permitted non-execution goods and services since the change in the regime will be through commission-sharing agreements (described in section 3). However, to gather information on the initial changes in the market in response to the change in the regime, both fund managers and brokers were asked for qualitative data on their take-up of commission-sharing agreements. Fund managers (brokers) were asked how many brokers (fund managers) they had set up commission-sharing agreements with in the first quarter of 2006. The responses were categorised into four groups.

- Group 1—fund managers (brokers) who had set up commission-sharing agreements with the majority of their brokers (fund managers).
- Group 2—fund managers (brokers) who had set up commission-sharing agreements with a small number of their brokers (fund managers), but not others.
- Group 3—fund managers (brokers) who had set up commission-sharing agreements with none or very few of their brokers (fund managers).
- Group 4—fund managers (brokers) who primarily conduct execution-only trades.

The results of these questions and categorisations are shown in Table 4.6.3.

Table 4.6.3 Representation of the take-up of commission-sharing agreements

	Group 1	Group 2	Group 3	Group 4	Total
Fund managers	1	11	6	3	21
Brokers	3	3	3	2	11
Total	4	14	9	5	32

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 22) and the brokers questionnaire (question 25).

Following from this, in question 26 of the original fund managers questionnaire, fund managers were asked what proportion of their trades would be put through a commission-sharing agreements in 2006. 19 respondents indicated how much they would put through commission-sharing agreements, from which a weighted average of 48.53% was calculated. Seven fund managers reported that they would not put any of their trades through commission-sharing agreements. The other 12 fund managers suggested a range of

proportions from 5% to 90% of their trades, from which a non-zero weighted average of expected proportions of 58.57% was calculated.

Altogether, this suggests that there have been three approaches to the use of commission-sharing agreements—those who have chosen:

- not to use commission-sharing agreements at all;
- to use commission-sharing agreements in a few circumstances
- to use commission-sharing agreements for the majority of their trading.

However, the follow-up interviews with fund managers suggest that there may be some fund managers who, prior to the change in the regime, had not purchased non-execution goods and services with soft commissions, but who intended to start using commission-sharing agreements to purchase non-execution goods and services.

Section 2.4 also highlighted that a reduction in the total amount spent on non-execution goods and services purchased through commissions would lead to fund managers requiring a smaller 'commission pool'. Furthermore, as explained in section 2.4, this could be achieved in three ways: through a negotiated reduction in the non-execution constituent of execution-plus commission rates; through a reduction in the volume of execution-plus trading; and through a switch from execution-plus to execution-only trading.

Sub-categories of performance indicators: reduction in spending on non-execution goods and services purchased through commissions

- Reduction in the non-execution constituent of execution-plus commission rates.
- Reduction in the volume of execution-plus trading.
- Changes in the proportions of execution-plus trading and execution-only trading.

Reduction in the non-execution constituent of execution-plus commission rates

Data on commission rates was gathered from the original fund managers questionnaire, the brokers questionnaire and the supplementary fund managers questionnaire. As highlighted in section 2.4, there are three methods of calculating a proxy for the non-execution constituent of execution-plus commission rates. The measurement of this mechanism was formulated into the following performance indicators.

Performance indicators: reduction in the non-execution constituent of execution-plus commission rates

- The difference between bundled brokerage commission rates and execution-only commission rates.
- Fund managers' estimates of the non-execution constituent of bundled brokerage commission rates.
- Brokers' estimates of the expected non-execution constituent of execution-plus commission rates.

To determine the first proxy, bundled and execution-only commission rates were asked for in both the fund managers questionnaires and the brokers questionnaire.

Fund managers were asked to provide actual commission rates for both execution-only and bundled brokerage services in question 17 of the original fund managers questionnaire and in the supplementary fund managers questionnaire. Simple and weighted averages for execution-only and bundled commission rates were calculated, as shown in Tables 4.6.4 and 4.6.5. Data in the original questionnaire were requested for the period 2001–05, although few fund managers provided a complete set of data for the five years. As very few of the fund managers were able to provide data for 2001–02, the supplementary questionnaire only requested data for the period 2003–05, as is reported here. Furthermore, the number of fund managers for whom the weighted average commission rates could be calculated varies for each year. To allow comparison over the period 2003–05, consistent sample groups of 13

fund managers for execution-only brokerage and 12 fund managers for bundled brokerage have been used. To provide the most accurate baseline for future comparison, full sample groups of 16 fund managers have been used for both execution-only and bundled brokerage.

Table 4.6.4 Weighted average commission rates for execution-only transactions

	Consistent sample			Full sample
	2003	2004	2005	2005
Simple average execution-only commission rate (bp)	9.25	8.67	7.42	7.47
Weighted average execution-only commission rate (bp)	6.77	7.90	6.92	7.04
Range of execution-only commission rates (bp)	4.57–19	3.84–16	3.38–10	3.38–10
Number of respondents	13	13	13	16

Note: Data is for actual commission rates. Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to question 17 of the original fund managers questionnaire or the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 17) and the supplementary fund managers questionnaire.

Table 4.6.5 Weighted average commission rates for bundled transactions

	Consistent sample			Full sample
	2003	2004	2005	2005
Simple average bundled brokerage commission rate (bp)	16.70	16.49	15.86	15.05
Weighted average bundled brokerage commission rate (bp)	13.44	13.48	13.24	12.89
Range of bundled brokerage commission rates (bp)	10–24.67	9.97–25.17	10–23.67	10–23.67
Number of respondents	12	12	12	16

Note: Data is for actual commission rates. Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to question 17 of the original fund managers questionnaire or the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 17) and the supplementary fund managers questionnaire.

From the data in the tables above, it is possible to use the difference between the bundled commission rates and execution commission rates as a proxy for the non-execution constituent of bundled brokerage. However, due to potential differences in the type and/or quality of execution provided between bundled brokerage and execution-only brokerage, there are reservations about the accuracy of this proxy. Table 4.6.6 presents the weighted averages of the bundled brokerage commission rate, execution-only commission rate and the proxy for the non-execution constituent of the bundled brokerage commission rate. In order to ensure consistency, these weighted averages are calculated for those fund managers who reported both a bundled brokerage commission rate and an execution-only commission rate for the given year. To allow comparison over the period 2003–05, a consistent sample of ten fund managers has been used. To provide the most accurate baseline for future comparison, the full sample of 13 fund managers (ie, those who provided bundled brokerage commission rate and execution-only commission rate data for 2005) has been used.

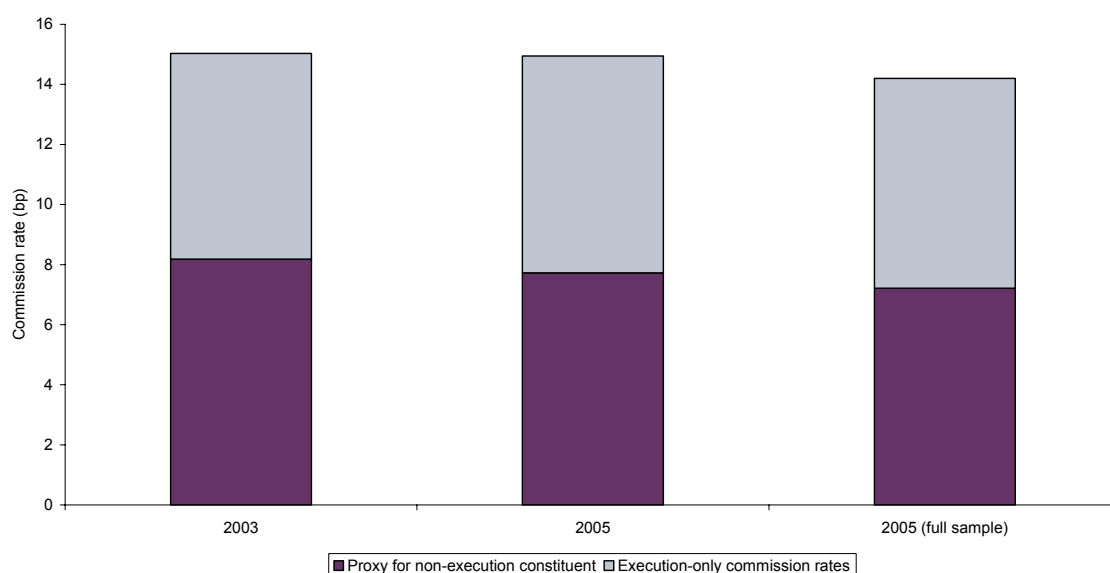
Table 4.6.6 Proxy constituents of bundled brokerage commission rates (fund managers)

	Consistent sample			Full sample
	2003	2004	2005	2005
Bundled brokerage commission rate (bp)	15.03	15.46	14.94	14.20
Execution-only commission rate (bp)	6.84	8.16	7.72	7.22
Proxy for the <i>non-execution</i> constituent of the bundled brokerage commission rate (bp)	8.18	7.30	7.21	6.99
Number of respondents	10	10	10	13

Note: Data is for actual commission rates, based on weighted average commission rates on execution-only and bundled brokerage. Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to question 17 of the original fund managers questionnaire or the supplementary fund managers questionnaire. Data for 2004 was skewed due to the data from two fund managers; therefore, while shown here, for ease of comparison between 2003 and 2005, the 2004 data was removed from Figure 4.6.3.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 17) and the supplementary fund managers questionnaire.

Figure 4.6.3 Proxy constituents of bundled brokerage commission rates (fund managers)



Note: Data is for actual commission rates, based on weighted average commission rates on execution-only and bundled brokerage. Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to question 17 of the original fund managers questionnaire or the supplementary fund managers questionnaire. Data for 2004 was skewed due to the data from two fund managers; therefore, while shown in Table 4.6.7, for ease of comparison between 2003 and 2005, the 2004 data was removed from this figure.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 17) and the supplementary fund managers questionnaire.

Brokers were asked to provide typical commission rates for both execution-only and bundled brokerage services in question 15 and across a menu of brokerage service types in question 18 of the brokers questionnaire. Simple and weighted averages for execution-only and bundled commission rates were calculated, as shown in Tables 4.6.7 and 4.6.8. Data in the questionnaire was requested for the period 2001–05, although few brokers provided a complete set of data for the five years. As very few of the brokers were able to provide data for 2001–02, data is only shown for 2003–05. Furthermore, as with the responses to the fund managers questionnaires, the number of brokers for whom the average commission rates

could be calculated varies for each year. To allow comparison over the period 2003–05, consistent sample groups of five brokers for execution-only brokerage and eight brokers for bundled brokerage have been used. In addition, to provide the most accurate baseline for future comparison, the full sample groups of nine brokers for execution-only brokerage and ten brokers for bundled brokerage have been used.

Table 4.6.7 Weighted average commission rates for execution-only transactions

	Consistent sample			Full sample
	2003	2004	2005	2005
Simple average execution-only commission rate (bp)	10.80	7.00	6.30	6.74
Weighted average execution-only commission rate (bp)	8.17	6.93	6.24	6.34
Range of execution-only commission rates (bp)	4.98–23	5–8	5–8	5–10
Number of respondents	5	5	5	9

Note: Data is for typical commission rates. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.
Source: Oxera calculations based on responses to the brokers questionnaire (questions 15 and 18).

Table 4.6.8 Weighted average commission rates for bundled transactions

	Consistent sample			Full sample
	2003	2004	2005	2005
Simple average bundled brokerage commission rate (bp)	17.68	15.76	15.22	15.28
Weighted average bundled brokerage commission rate (bp)	17.27	14.93	14.03	14.69
Range of bundled brokerage commission rates (bp)	13–20	12.5–20	12–20	12–20
Number of respondents	8	8	8	10

Note: Data is for typical commission rates. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.
Source: Oxera calculations based on responses to the brokers questionnaire (questions 15 and 18).

Brokers were also asked to provide typical commission rates across a menu of brokerage service types in question 18 of the brokers questionnaire. Weighted averages for the commission rates on these brokerage types have been calculated, as shown in Table 4.6.9. As previously noted, the number of responses varies across brokerage type and year. However, due to the small sample and amount of variation, it is not possible to construct a robust consistent sample. Therefore, Table 4.6.9 also includes the number of responses used to construct the weighted average.

Table 4.6.9 Weighted average commission rate on a menu of brokerage services (bp)

	2003	2004	2005
Programme trades	6.49	5.14	4.74
Number of respondents	4	4	5
Execution-only brokerage			
Direct market access	6.56	5.31	4.18
Number of respondents	3	4	7
Algorithmic	n/a	7.18	6.90
Number of respondents	0	2	5
Bundled brokerage	16.83	15.38	14.80
Number of respondents	7	7	9
Buy-side trade managed	14.73	14.37	14.32
Number of respondents	5	5	6
Sell-side trade managed	14.73	14.37	14.32
Number of respondents	5	5	6
Liquidity (capital commitment)	13.65	13.21	12.03
Number of respondents	5	5	7

Note: Data is for typical commission rates. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.
Source: Oxera calculations based on responses to the brokers questionnaire (questions 15).

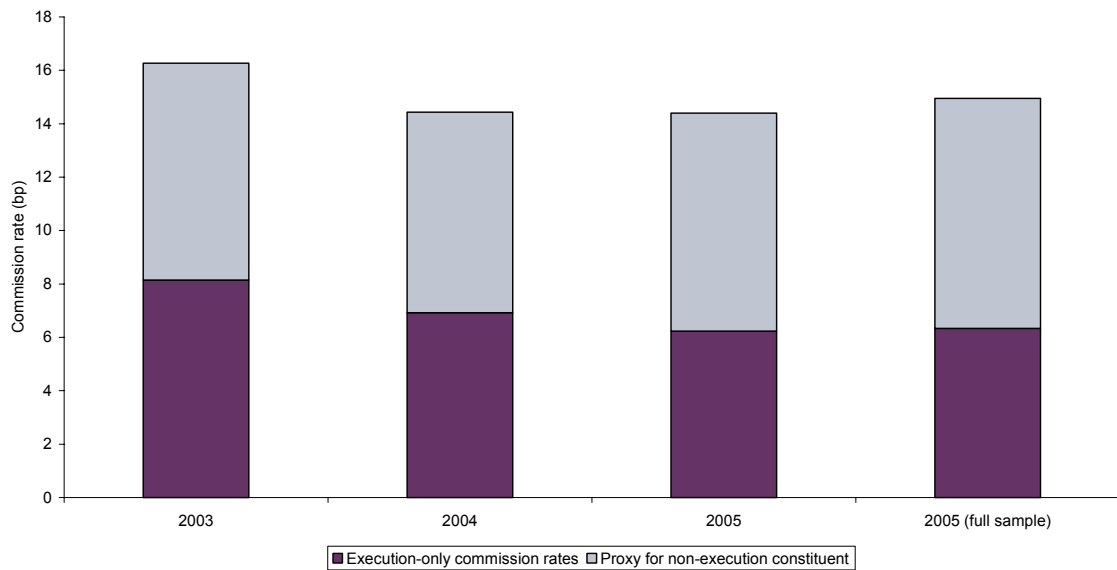
From the data in the tables above, it is possible to use the difference between the bundled commission rates and execution commission rates as a proxy for the non-execution constituent of bundled brokerage. Table 4.6.10 presents the weighted averages of the bundled brokerage commission rate, execution-only commission rate and the proxy for the non-execution constituent of the bundled brokerage commission rate. In order to ensure consistency, these weighted averages are calculated for those fund managers who reported both a bundled brokerage commission rate and an execution-only commission rate for the given year. To allow comparison over the period 2003–05, a consistent sample of four brokers has been used. In addition, to provide the most accurate baseline for future comparison, the full sample of nine brokers (ie, those who provided both bundled brokerage commission rate and execution-only commission rate data for 2005) has been used.

Table 4.6.10 Proxy constituents of bundled brokerage commission rates (brokers)

	Consistent sample			Full sample
	2003	2004	2005	2005
Bundled brokerage commission rate (bp)	16.26	14.43	14.39	14.95
Execution-only commission rate (bp)	8.14	6.93	6.24	6.34
Proxy for the <i>non-execution</i> constituent of the bundled brokerage commission rate (bp)	8.12	7.51	8.15	8.61
Number of respondents	4	4	4	9

Note: Data is for typical commission rates. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.
Source: Oxera calculations based on responses to the brokers questionnaire (questions 15 and 18).

Figure 4.6.4 Proxy constituents of bundled brokerage commission rates (brokers)



Note: Data is for typical commission rates, and is based on weighted average commission rates on execution-only and bundled brokerage. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.

Source: Oxera calculations based on responses to the brokers questionnaire (questions 15 and 18).

This data suggests that the execution constituent of bundled brokerage was already declining between 2003 and 2005, with the non-execution component remaining fairly constant. However, care must be taken in interpreting these proxies for the non-execution constituent of bundled brokerage, as the actual commission rate for worked execution with soft commissions or bundled brokerage may be higher than the execution-only rate given by respondents. Despite this caveat, this data can be compared with the non-execution constituent of execution-plus commission rates in the 2008 survey, and therefore provide a functional baseline for future comparison. Furthermore, data from the 2007/08 questionnaires can be used to test the reasonableness of execution-only commission rates as a proxy for the execution constituent of bundled brokerage commission rates.

The second means of calculating a proxy for the non-execution constituent of bundled brokerage commission rates is from fund managers' estimates of the breakdown of bundled brokerage into execution and non-execution constituents. Fund managers were asked, in the supplementary fund managers questionnaire, to provide these backward-looking estimates, for 2003–05, for the breakdown of bundled brokerage commission rates. The sample was large enough for meaningful analysis, although a number of fund managers emphasised that these breakdowns had not previously been calculated and are rough estimates.

Table 4.6.11 presents the weighted averages of the bundled brokerage commission rate, estimated execution constituent and estimated non-execution constituent. To allow comparison over the period 2003–05, a consistent sample of ten fund managers has been used. In addition, to provide the most accurate baseline for future comparison, the full sample of 11 fund managers (ie, those who provided both bundled brokerage commission rate and execution-only commission rate data for 2005) has been used.

Table 4.6.11 Estimated constituents of bundled brokerage commission rates (fund managers)

	Consistent sample			Full sample
	2003	2004	2005	2005
Bundled brokerage commission rate (bp)	12.16	12.74	12.75	12.79
Estimate for the <i>execution</i> constituent of the bundled brokerage commission rate (bp)	6.41	6.58	6.47	6.40
Estimate for the <i>non-execution</i> constituent of the bundled brokerage commission rate (bp)	5.75	6.16	6.28	6.38
Number of respondents	10	10	10	11

Note: Data is for actual bundled brokerage commission rates, and estimates of the breakdown into execution and non-execution constituents. Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

The third means of calculating a proxy for the non-execution constituent of bundled brokerage commission rates is from brokers' expectations of the breakdown of execution-plus commission rates into execution and non-execution constituents. Brokers were asked to provide these forward-looking estimates for 2006 in question 16 of the original brokers questionnaire. The sample size was small, with only five brokers providing estimates of the breakdown. Given this small sample size, and that this data shows estimated breakdowns on expected execution-plus commission rates, the weighted averages cannot be relied upon to provide a robust breakdown of execution-plus commission rates. However, as forward-looking estimates, they provide an indication of brokers' expectations.

Table 4.6.12 presents the weighted averages of the expected execution-plus commission rate, the estimated execution constituent and the estimated non-execution constituent. Nine brokers provided estimates of the expected execution-plus commission rate, shown under the heading 'Full sample'. Five brokers provided estimates for the execution-plus commission rate with a breakdown into estimates of the execution and non-execution constituents of the execution-plus commission rate, shown under the heading 'Full breakdown'.

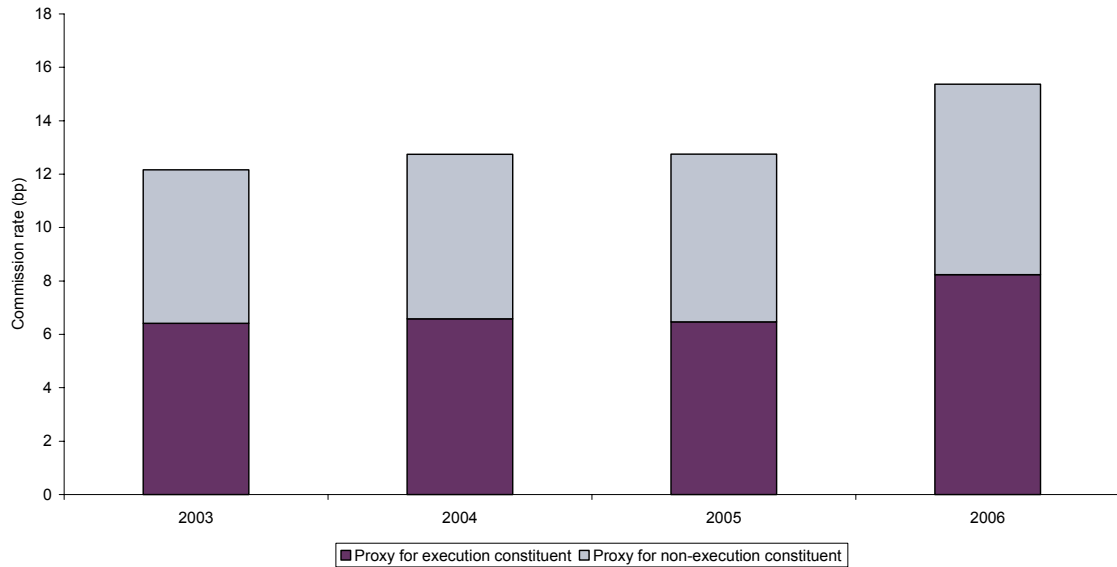
Table 4.6.12 Estimated constituents of execution-plus commission rate (brokers)

	Full sample 2006	Full breakdown 2006
Expected execution-plus commission rate (bp)	15.07	15.37
Estimated <i>execution</i> constituent of the bundled brokerage commission rate (bp)		8.23
Estimated <i>non-execution</i> constituent of the bundled brokerage commission rate (bp)		7.13
Number of respondents	9	5

Note: Data is for estimated execution-plus brokerage commission rates, and estimates of the breakdown into execution and non-execution constituents. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.

Source: Oxera calculations based on responses to the brokers questionnaire (question 16).

Figure 4.6.5 Estimated constituents of bundled brokerage commission rates



Note: Data for 2003–05 is for actual commission rates from fund managers. Weights are based on the fund managers’ reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. Data for 2006 is for typical commission rates from brokers. Weights are based on the brokers’ gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire. Source: Oxera calculations based on responses to the supplementary fund managers questionnaire and the brokers questionnaire (question 16).

This data also suggests that the non-execution constituent of bundled brokerage was already declining between 2003 and 2005. However, care must be taken in interpreting these proxies for the non-execution constituent of bundled brokerage, as they rely upon fund managers’ estimates for breakdowns that have not previously been calculated. Despite this caveat, this data can be compared with the non-execution constituent of execution-plus commission rates in the 2008 survey, and therefore provide a functional baseline for future comparison.

There is a further means of calculating the breakdown of the bundled brokerage commission rate into its constituents for execution and the three non-execution goods and services. In the supplementary fund managers questionnaire, fund managers were asked to provide data on the estimated breakdown of the bundled brokerage commission rate into execution and non-execution constituents. Then, using the execution-only commission rate as a proxy for the price of pure execution brokerage, the execution constituent can be broken down into pure execution and worked execution (ie, additional execution services provided to full-service brokerage clients). Also, fund managers were asked to provide data on the amount spent on goods and services purchased with soft commissions and the proportion of the amount spent on non-execution goods and services purchased through bundled brokerage that were research, execution-related goods and services, or non-permitted goods and services. This data can be aggregated across all the respondents to the supplementary fund managers questionnaire to calculate the aggregate breakdowns of the bundled brokerage commission rate.

These calculations have been done—Table 4.6.13 and Figures 4.6.6, 4.6.7 and 4.6.8 show the breakdowns of the bundled brokerage commission rate from the aggregated data.

Table 4.6.13 Constituents of bundled brokerage commission rates from aggregated data (bp)

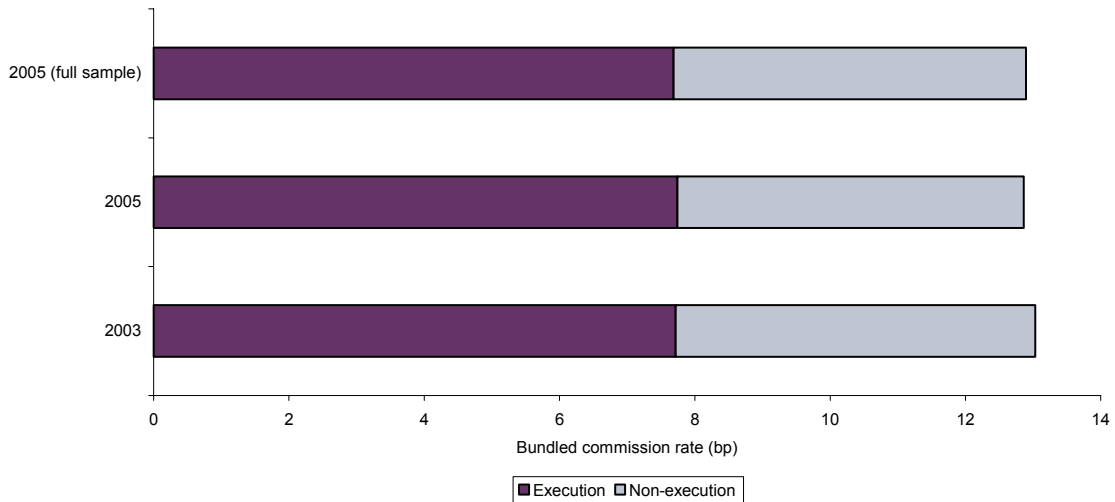
	Consistent sample			Full sample
	2003	2004	2005	2005
Weighted average bundled brokerage commission rate	12.90	12.68	12.85	12.88
Execution constituent	7.45	8.15	7.58	7.54
Pure execution constituent	6.83	9.18	9.35	9.22
Worked execution constituent	0.61	-1.03	-1.76	-1.68
Non-execution constituent	5.46	4.53	5.26	5.34
Non-execution constituent for softed goods and services	4.50	3.94	4.82	4.95
Non-execution constituent for softed research	4.03	3.32	4.13	4.34
Non-execution constituent for softed execution-related goods and services	0.27	0.47	0.53	0.46
Non-execution constituent for softed non-permitted goods and services	0.20	0.16	0.16	0.14
Non-execution constituent for bundled goods and services	0.96	0.59	0.45	0.39
Non-execution constituent for bundled research	0.60	0.42	0.43	0.38
Non-execution constituent for bundled execution-related goods and services	0.00	0.00	0.00	0.00
Non-execution constituent for bundled non-permitted goods and services	0.36	0.17	0.02	0.02
Non-execution constituent for research	4.62	3.73	4.55	4.71
Non-execution constituent for execution-related goods and services	0.27	0.47	0.53	0.47
Non-execution constituent for non-permitted goods and services	0.56	0.32	0.18	0.16
Number of respondents	8	8	8	10

Note: Data for 2004 was skewed due to the data from two fund managers; therefore, for ease of comparison between 2003 and 2005, the 2004 data was removed from this figure.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.6.6 shows the breakdown of the bundled brokerage commission rates into execution and non-execution constituents. This data suggests that the execution constituent remained almost constant between 2003 and 2005, while the non-execution constituent decreased slightly.

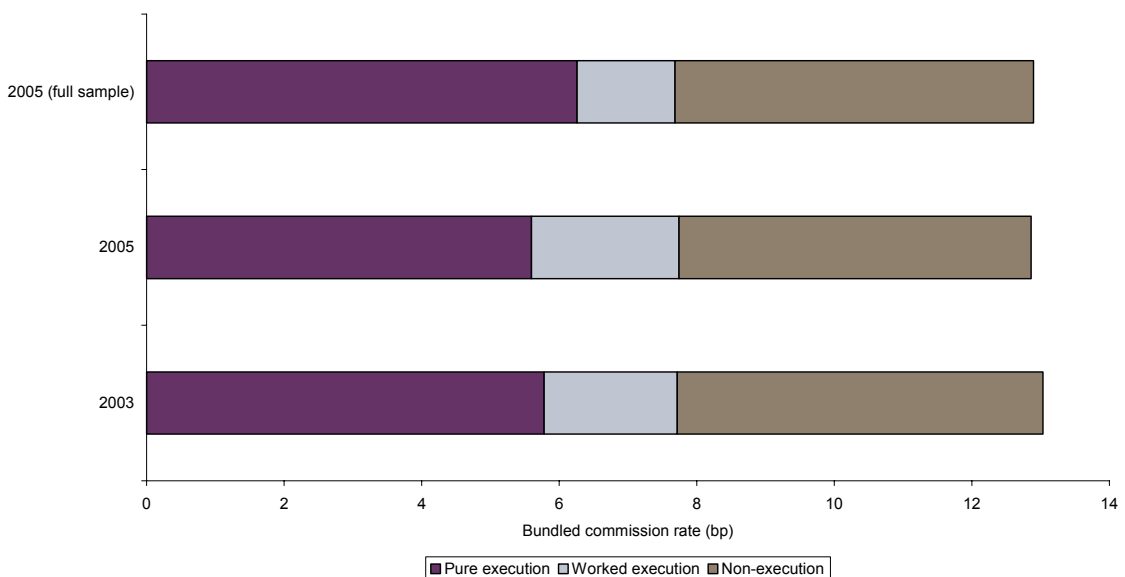
Figure 4.6.6 Execution and non-execution constituents of bundled brokerage commission rates from aggregated data



Note: Data for 2004 was skewed due to the data from two fund managers; therefore, for ease of comparison between 2003 and 2005, the 2004 data was removed from this figure.
 Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.6.7 shows the breakdown of the bundled brokerage commission rates into pure execution, worked execution and non-execution constituents. First, this provides a provisional test of the assumption that the execution-only commission rate is a proxy for the execution constituent of bundled brokerage. This data suggests that the execution-only commission rate does not equal the execution constituent of the bundled brokerage commission rate, and that additional execution services are priced at between 1.5 and 2bp. It is unclear whether this data suggests that the price of pure execution is increasing or decreasing.

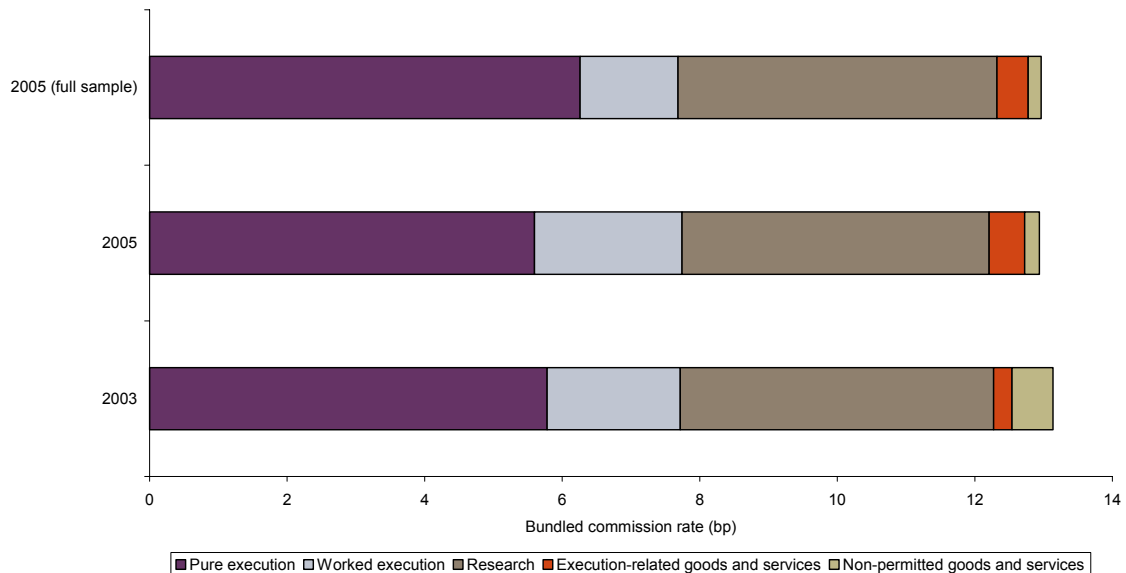
Figure 4.6.7 Two execution and non-execution constituents of bundled brokerage commission rates from aggregated data



Note: Data for 2004 was skewed due to the data from two fund managers; therefore, for ease of comparison between 2003 and 2005, the 2004 data was removed from this figure.
 Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Figure 4.6.8 shows the breakdown of the bundled brokerage commission rates into the pure execution and worked execution constituents and the three non-execution constituents for research, execution-related goods and services, and non-permitted goods and services. This data suggests that the non-execution constituent for research has remained roughly constant, the non-execution constituent for execution-related goods and services has increased, and the non-execution constituent for non-permitted goods and services has declined.

Figure 4.6.8 Execution and three non-execution constituents of bundled brokerage commission rates from aggregated data



Note: Data for 2004 was skewed due to the data from two fund managers; therefore, for ease of comparison between 2003 and 2005, the 2004 data was removed from this figure.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

This data on the constituents of bundled brokerage serves as a functional benchmark for future comparison.

Reduction in the volume of execution-plus trading

This performance indicator measures whether there has been a reduction in the volume of execution-plus trading. Data for this performance indicator was gathered from both the supplementary fund managers questionnaire and the brokers questionnaire.

Fund managers were asked to provide data on the volume of their trading within three types of brokerage: programme trading, execution-only trading and bundled brokerage. However, in order to take into account the context in which any change to the volume of trading for each of the three types of trading occurs, it is necessary to consider both the gross turnover ratio and the net turnover ratio (ie, for commissions trading). Weighted averages for these measures are shown in Table 4.6.14, which includes data for both active and passive fund managers. To allow comparison over the period 2003–05, a consistent sample of nine fund managers has been used. To provide the most accurate baseline for future comparison, the full sample of 11 fund managers has also been used for 2005.

Table 4.6.14 Turnover ratios

	Consistent sample			Full sample
	2003	2004	2005	2005
Turnover ratio for all trades (%)	74.94	84.39	81.85	68.21
‘Net trades’ (%)	10.40	8.22	6.74	3.06
‘Commission trades’ (%)	89.60	91.78	93.26	96.94
Turnover ratio for commissions trades (%)	67.01	77.53	76.69	64.40
Number of respondents	9	9	9	11

Note: Weights were based on the fund managers’ reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire. This data is for both active and passive fund managers.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

This data suggests that the turnover for commission trades remained roughly constant over the period 2003–05. However, there has been a shift away from using ‘net trades’, which has led to a fall in the turnover ratio for all trades. This data provides a framework for further analysis and serves as a functional benchmark for future comparison.

Given this framework, Table 4.6.15 presents the data on the relative volumes of bundled brokerage trading for 2003–05. This table shows the weighted averages for both the turnover ratio for bundled trades (ie, the volume of bundled trades given the funds under management), and the proportion of bundled trades in relation to commission trades. As before, to allow comparison over the period 2003–05, a consistent sample of nine fund managers has been used. To provide the most accurate baseline for future comparison, the full sample of 11 fund managers has also been used for 2005.

Table 4.6.15 Volume of bundled brokerage trades

	Consistent sample			Full sample
	2003	2004	2005	2005
Bundled trades as a proportion of commission trades (%)	81.18	82.02	79.49	70.41
Bundled turnover ratio (%)	54.52	63.82	61.46	49.97
Number of respondents	9	9	9	11

Note: Weights were based on the fund managers’ reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Brokers were asked to provide data on the total volume of trading for UK fund manager clients, and the proportions of this volume within two types of brokerage: execution-only trading and bundled brokerage. Weighted averages for this data are shown in Table 4.6.16. To allow comparison over the period 2003–05, a consistent sample of six brokers has been used. To provide the most accurate baseline for future comparison, the full sample of 11 brokers has also been used for 2005.

Table 4.6.16 Volume of bundled brokerage trades

	Consistent sample			Full sample
	2003	2004	2005	2005
Bundled trades as a proportion of commission trades (%)	81.52	79.08	72.59	79.38
Number of respondents	6	6	6	11

Note: Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.

Source: Oxera calculations based on responses to the brokers questionnaire (question 18).

These indicators provide sufficient data for a functional benchmark for future comparison.

To set this benchmark in context, qualitative data was also gathered in relation to the substitutability of execution-only trading for execution-plus trading. Fund managers were asked whether their full-service brokers had offered them execution-trading services (see Table 4.6.17).

Table 4.6.17 Substitutability of execution-only and bundled brokerage

Responses	Did any of the full-service brokers you use regularly offer an execution-only service as an alternative?	Commission rate difference (as a proportion of bundled brokerage commission rate)	
No	19	n/a	
Yes	6	Simple average	47.1%
		Range	30.0–60.0%

Source: Oxera calculations based on 25 responses to the original fund managers questionnaire (question 20).

This data indicates that fund managers consider execution-only trading to be a substitute for bundled brokerage trading, and that they have been offered access to such trading.

Changes in the proportions of execution-plus and execution-only trades

This performance indicator measures whether there has been a shift from execution-plus to execution-only trading (or programme trades)—ie, whether a reduction in the volume of execution-plus trading has been matched by an increase in the volume of execution-only trading (or programme trades). Data for this performance indicator was gathered from the original fund managers questionnaire, the brokers questionnaire and the supplementary fund managers questionnaire.

As for the previous performance indicator, fund managers were asked to provide data on the volume of their trading within three types of brokerage: programme trading, execution-only trading and bundled brokerage. Weighted averages for both the turnover ratios and proportions of these types of trading are shown in Table 4.6.19. As previously, to allow comparison over the period 2003–05, a consistent sample of nine fund managers has been used. To provide the most accurate baseline for future comparison, the full sample of 11 fund managers has also been used for 2005.

Table 4.6.18 Proportions of three types of trading

	Consistent sample			Full sample
	2003	2004	2005	2005
Programme trades as a proportion of commission trades (%)	11.84	11.78	11.45	12.65
Execution-only trades as a proportion of commission trades (%)	6.98	6.20	9.05	16.95
Bundled trades as a proportion of commission trades (%)	81.18	82.02	79.49	70.41
Number of respondents	9	9	9	11

Note: Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to the supplementary fund managers questionnaire.
Source: Oxera calculations based on responses to the supplementary fund managers questionnaire.

Also, as for the previous performance indicator, brokers were asked to provide data on the total volume of trading for UK fund manager clients, and the proportions of this volume within two types of brokerage: execution-only trading and bundled brokerage. Weighted averages for this data are shown in Table 4.6.19. To allow comparison over the period 2003–05, a consistent sample of six brokers has been used. To provide the most accurate baseline for future comparison, the full sample of 11 brokers has also been used for 2005.

Table 4.6.19 Volume of bundled brokerage trades

	Consistent sample			Full sample
	2003	2004	2005	2005
Execution-only trades as a proportion of commission trades (%)	18.48	20.92	27.41	20.62
Bundled trades as a proportion of commission trades (%)	81.52	79.08	72.59	79.38
Number of respondents	6	6	6	11

Note: Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.
Source: Oxera calculations based on responses to the brokers questionnaire (question 18).

A more complete breakdown of trading volumes into proportions for different types of trade was also undertaken. Both fund managers and brokers were asked to provide data on the proportions of trades within a menu of brokerage services. Table 4.6.20 and Figure 4.6.9 show the breakdown provided by fund managers. For both the comparison over the period 2003–06 and to provide the baseline for future comparison, a consistent sample of 14 fund managers was used.

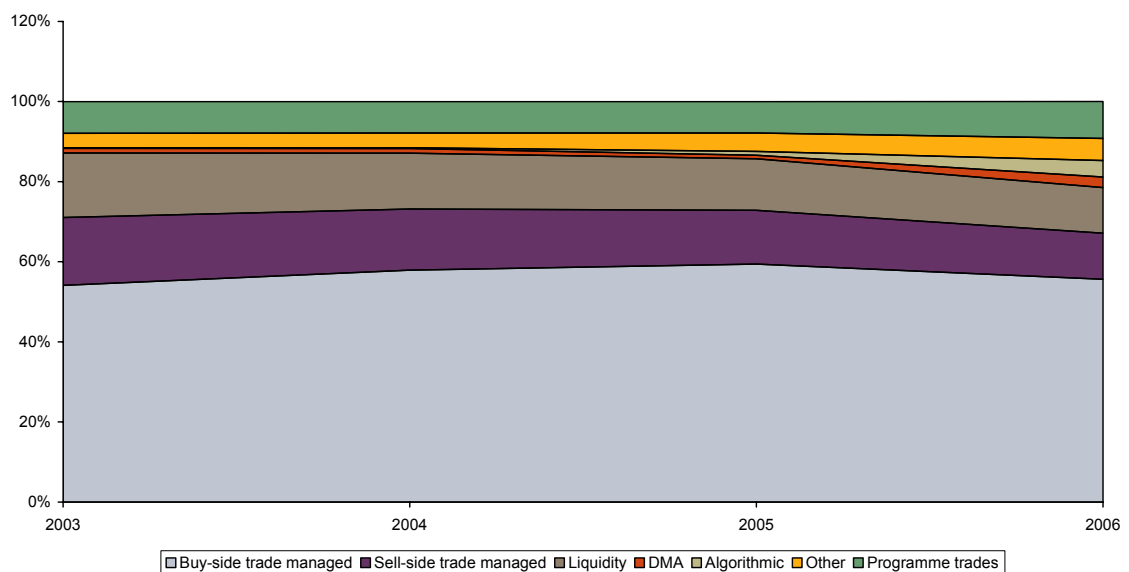
Table 4.6.20 Proportion of trades for a menu of brokerage services (fund managers)

	2003	2004	2005	2006 (estimates)
Programme trades (%)	7.92	7.84	7.85	9.21
Execution-only brokerage (%)	4.94	5.07	6.44	12.29
Direct market access (%) (DMA)	1.20	1.18	0.89	2.65
Algorithmic (%)	0.07	0.18	0.94	4.13
Other (%)	3.68	3.71	4.61	5.51
Bundled brokerage (%)	87.13	87.09	85.71	78.50
Buy-side trade managed (%)	54.11	57.92	59.43	55.63
Sell-side trade managed (%)	16.94	15.26	13.42	11.49
Liquidity (%)	16.08	13.91	12.86	11.39
Total (%)	100.00	100.00	100.00	100.00
Number of respondents	14	14	14	14

Note: Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to question 17 of the original fund managers questionnaire or the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 24).

Figure 4.6.9 Proportion of trades for a menu of brokerage services (fund managers)



Note: Weights are based on the fund managers' reported funds under management for pension fund clients in UK equities, for 2003–05, as provided in responses to question 17 of the original fund managers questionnaire or the supplementary fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 24).

Table 4.6.21 and Figure 4.6.10 show the breakdown provided by brokers. To allow comparison over the period 2004–06, a consistent sample of five brokers has been used. To provide the most accurate baseline for future comparison, the full sample of eight brokers has also been used for 2005 and 2006.

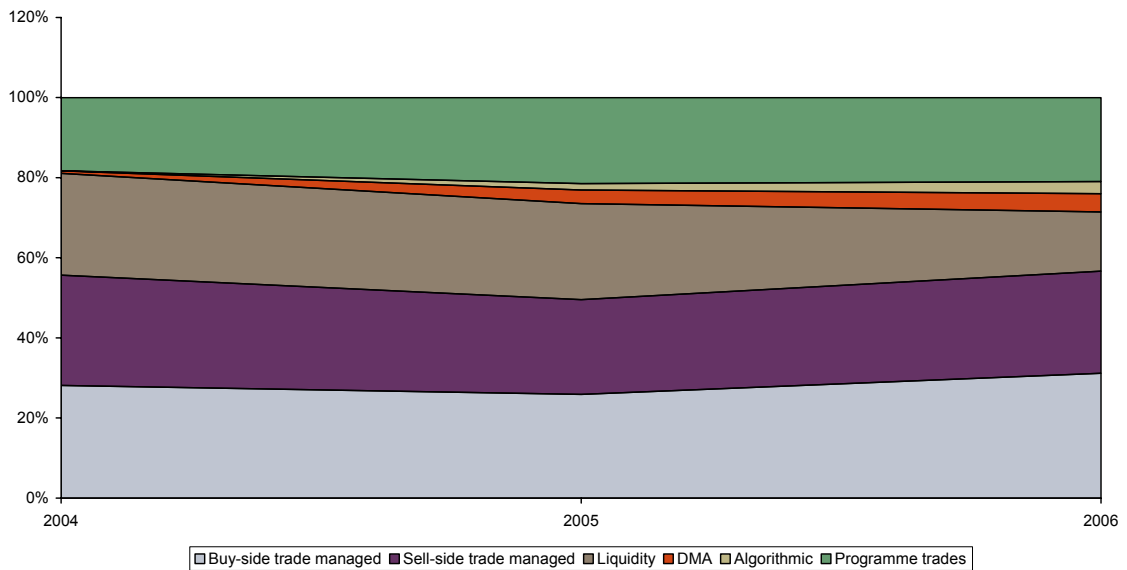
Table 4.6.21 Proportion of trades for a menu of brokerage services (brokers)

	Consistent sample			Full sample	
	2004	2005	2006	2005	2006 (estimates)
Programme trades (%)	18.30	21.49	20.95	15.88	13.56
Execution-only brokerage (%)	0.61	4.98	7.62	4.59	6.14
Direct market access (%)	0.59	3.40	4.55	2.39	2.89
Algorithmic (%)	0.01	1.59	3.07	2.20	3.14
Bundled brokerage (%)	81.10	73.53	71.44	79.53	80.31
Buy-side trade managed (%)	28.11	25.91	31.20	21.43	32.61
Sell-side trade managed (%)	27.57	23.62	25.44	37.56	34.35
Liquidity (%)	25.42	23.99	14.79	20.54	13.35
Total (%)	100.00	100.00	100.00	100.00	100.00
Number of respondents	5	5	5	8	8

Note: Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.

Source: Oxera calculations based on responses to the brokers questionnaire (question 8).

Figure 4.6.10 Proportion of trades for a menu of brokerage services (brokers)



Note: Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.

Source: Oxera calculations based on responses to the brokers questionnaire (question 8).

The data in Tables 4.6.20 and 4.6.21 and Figures 4.6.9 and 4.6.10 suggests some trends in the brokerage market:

- there is a trend of increasing execution-only trades;
- there is a trend of decreasing bundled brokerage;
- within bundled brokerage, there has been a shift away from liquidity trades and supply-side trade managed trades towards buy-side trade managed trades.

These indicators provide sufficient data for a functional benchmark for future comparison.

4.7 Impact on distribution of research costs and market structure

As explained in section 2.5, the change in the regime for soft commission and bundled brokerage arrangements may also have a number of impacts on the nature and structure of the fund management industry. The new regime may affect the way research costs are distributed among fund managers, or similarly among pension funds. Consequently, they may alter the structure of the markets for fund management or brokerage, and may also affect the quality of trade execution.

Sub-categories of performance indicators: impact on distribution of research costs and market structure

- Distribution of research costs among fund managers.
- Distribution of research costs among pension funds.
- Impact on the structure of the market for fund management.
- Impact on the structure of the brokerage market.
- Quality of trade execution.

Distribution of research costs among fund managers

Section 2.5 identified that the change in the regime may lead to smaller fund managers bearing a larger share of the costs of research provided by brokers than before the change in the regime. As such, this sub-category of performance indicators provides benchmarks for assessing the distribution of research costs between different fund managers.

Performance indicators: distribution of research costs among fund managers

- Variation in commission rates charged to fund managers of different sizes.
- Qualitative and anecdotal evidence on the way brokers charge fund managers for research.

Data on the first of these performance indicators was gathered from the brokers questionnaire. In question 17, brokers were asked to provide typical commission rates for both execution-only and bundled brokerage services. Weighted averages for execution-only and bundled commission rates were calculated, as shown in Tables 4.7.1 and 4.7.2. The number of brokers for whom the weighted average commission rates could be calculated varied, although, to ensure consistency of the data, weighted averages were only calculated for brokers who provided data for all three volumes of trading.

Table 4.7.1 Weighted average commission rates for execution-only transactions

	£500m	£250m	£100m
Weighted average execution-only commission rate (bp)	6.31	6.80	6.85
Range of execution-only commission rates (bp)	4.1–8	5–8	5–10
Number of respondents for whom commission rates vary	4	3	
Number of respondents	8	8	8

Note: Data is for typical commission rates. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire. Source: Oxera calculations based on responses to the brokers questionnaire (question 17).

Table 4.7.2 Weighted average commission rates for bundled transactions

	£500m	£250m	£100m
Weighted average bundled brokerage commission rate (bp)	13.33	15.97	18.58
Range of bundled brokerage commission rates (bp)	12–20	13–20	15–20
Number of respondents for whom commission rates vary	5	6	
Number of respondents	9	9	9

Note: Data is for typical commission rates. Weights are based on the brokers' gross commission revenues for UK cash equity trades in 2005, as provided in responses to question 1 of the brokers questionnaire.
Source: Oxera calculations based on responses to the brokers questionnaire (question 17).

As the data in Tables 4.7.1 and 4.7.2 shows, the weighted average commission rates did vary for both execution-only and bundled brokerage across the different volumes of trade orders sent to brokers. However, not all brokers varied their commission rates according to the volume of trades orders. This data provides a benchmark for future comparison.

Further qualitative data was gathered from the brokers questionnaire. Brokers were asked whether they will, in 2006, set a price for research for brokerage clients in terms of a fixed number of basis points, and if so, whether that price would vary according to the volume of trade orders sent to the broker. The results, presented in Table 4.7.3, show that almost half of the survey respondents indicated that they would vary the fees charged for research according to the volume of trade orders. However, the majority of brokers indicated, either in response to question 23 or during interviews, that the price of research would be determined by negotiations between the fund manager and the broker.

Table 4.7.3 Number of brokers who will set a price for research for brokerage clients in terms of a fixed number of basis points

Will the price of research for brokerage clients be in terms of a fixed number of basis points?		Will the level of fees vary according to the volume of trade orders?		How will the price be determined?
Yes	5	Yes	4	In either case, the price of research will primarily be determined by negotiations between the fund manager and the broker
		No	1	
No	8	Yes	2	
		No	6	

Source: Oxera calculations based on 13 responses to the brokers questionnaire (question 23).

Distribution of research costs among pension funds

The change in the regime may also affect the distribution of research costs at the fund level. The costs of research provided by brokers to fund managers are paid for through commissions, and are therefore borne by fund managers' clients. As such, this sub-category of performance indicators provides benchmarks for assessing the distribution of research costs between different funds.

Performance indicators: distribution of research costs among pension funds

- The relationship of the commission rate paid by smaller funds relative to the commission rates paid by larger funds, both before and after the change in the regime.
- The relationship of the management fee paid by smaller funds relative to the management fee paid by larger funds, both before and after the implementation of the new regime.
- Qualitative and anecdotal evidence.

The first performance indicator, relating to the commission rates paid by pension funds, was based on questions in the pension fund questionnaire. As such, given the low response rate

to the survey by pension funds, it is not possible to quantify this performance indicator from the results of the 2006 pension fund questionnaire. However, the performance indicator should remain and may be used in the 2007/08 questionnaire.

The second performance indicator would have been measured using data gathered from both the original fund managers questionnaire and the pension fund questionnaire. As already identified, data from the pension fund questionnaire is insufficient to provide an accurate benchmark for future comparison, and this performance indicator will have to be measured using data gathered from the original fund managers questionnaire.

Fund managers were asked to provide typical management fees for both actively and passively managed funds for four sizes of mandate, in question 8 of the original fund managers questionnaire. Weighted averages of these management fees were calculated (see Tables 4.7.4 and 4.7.5). The number of fund managers for whom the weighted average management fees could be calculated varied. However, to ensure consistency of the data, weighted averages were calculated for fund managers that provided data across all four sizes of fund.

Table 4.7.4 Weighted average management fees for actively managed funds

	£500m	£250m	£100m	£50m
Weighted average management fee (bp)	31.1	35.5	40.7	45.2
Range of management fees (bp)	15–88	20–100	29–100	24–100
Number of respondents who changed management fees	14	13	12	
Number of responses	15	15	15	15

Note: Data is for typical management fees for an active UK equity fund. Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 8).

Table 4.7.5 Weighted average management fees for passively managed funds

	£500m	£250m	£100m	£50m
Weighted average management fee (bp)	4.6	5.0	5.6	6.2
Range of management fees (bp)	1.9–6.1	2.0–6.3	5.0–6.6	5.0–7.2
Number of respondents who changed management fees	4	4	3	
Number of responses	5	5	5	5

Note: Data is for typical management fees for an passive UK equity fund. Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 8).

As the data in Tables 4.7.4 and 4.7.5 shows, the weighted average management fees did vary for both actively and passively traded funds according to the size of the mandate; the majority of fund managers indicated that fees varied in this way. Management fees fall when the size of the fund increases, indicating that fund management may involve some economies of scale. However, the data indicates that management fees for passive funds larger than £500m only decline to a limited extent—they tend towards around 2bp–3bp for funds in excess of £1–£2 billion. Management fees for active funds tend towards around 5bp–10bp for funds in excess of 1–£2 billion.

This data provides a benchmark for future comparison.

Impact on the structure of the market for fund management

Section 2.5 highlighted that the change in the regime for soft commissions and bundled brokerage may lead to consolidation in the market for fund management services.

Performance indicator: impact on the structure of the market for fund management

- The structure of the market for fund management.

This performance indicator can be measured using existing data sources, such as the FSA database, which allows the calculation of market share information for fund management firms, and direct measures were not included in the questionnaires. The changes in market structure will be analysed in 2007/08.

Impact on the structure of the market for brokerage and research services

As described in section 2.5, a different set of mechanisms could affect the market structure of the brokerage industry. The change in the regime makes it possible to use commissions paid to one broker to purchase research from another broker, which may lead to a separation of brokers into those that provide research and those that provide execution. This may in turn lead to consolidation of the market for brokerage services.

Possible indicators: impact on the structure of the market for brokerage and research services

- The pattern of distribution of trades between brokers, both before and after the change in the regime.
- Qualitative and anecdotal evidence.
- The structure of the brokerage market.

Qualitative data on the pattern of distribution of trades between brokers was gathered from the fund managers, who were asked to provide data on the number of brokers that they had on their approved list. Data in the original questionnaire was requested for the period 2001–06, although not all fund managers provided a complete set of data for the six years. Therefore, the data is presented in Tables 4.7.6 for a consistent sample of 15 fund managers for 2001–06, and in Table 4.7.7 for a consistent sample of 19 fund managers for 2003–06.

Table 4.7.6 Number of brokers on individual fund managers' approved lists (15 fund managers, 2001–06)

	2001	2002	2003	2004	2005	2006
Simple average number of brokers on the approved list	60.00	62.38	64.25	65.81	64.56	62.19
Weighted average number of brokers on the approved list	71.86	72.18	72.48	74.83	76.00	71.82
Weighted average of the change in the number of brokers on an individual fund manager's approved list	–	2.66%	3.24%	4.08%	1.97%	–3.05%
Range of change in the number of brokers on an individual fund manager's approved list	–	–17.65% to 84.44%	–13.64% to +46.15%	–16.67% to +20.24%	–43.59% to +18.60%	–23.61% to +8.43%

Note: Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 12).

Table 4.7.7 Number of brokers on individual fund managers' approved lists (19 fund managers, 2003–06)

	2003	2004	2005	2006
Simple average number of brokers on the approved list	61.20	63.10	63.55	63.35
Weighted average number of brokers on the approved list	69.58	71.69	73.35	72.05
Weighted average of the change in the number of brokers on an individual fund manager's approved list	–	3.26%	2.56%	–0.12%
Range of change in the number of brokers on an individual fund manager's approved list	–	–18.97% to +24.00%	–43.59% to +61.29%	–23.61% to +26.73%

Note: Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 12).

The data in Tables 4.7.6 and 4.7.7 shows that the number of brokers on the approved list increased up to 2005, and there are initial signs that the number of brokers on the approved lists of individual fund managers has started decline from 2006. Also, the finding that the weighted averages of the number of brokers on the approved list is higher than the simple averages indicates that larger fund managers tend to have more brokers on their approved lists. This data may not give a clear indication of the concentration of the brokerage market because fund managers suggested in the follow-up interviews that brokers are commonly left on the approved list even if no trades are sent to that broker.

Therefore, fund managers were also asked to provide data on the proportion of trade orders that were sent to the top 5, top 10, top 15 and top 20 brokers. The weighted averages of this data are shown in Table 4.7.8. Data in the original questionnaire was requested for the period 2001–06, although not all fund managers provided a complete set of data for the six years. Therefore, the data presented in Table 4.7.8 is for a consistent sample of 11 fund managers for 2001–05, and the data in Table 4.7.9 is for a consistent sample of 14 fund managers for 2003–06.

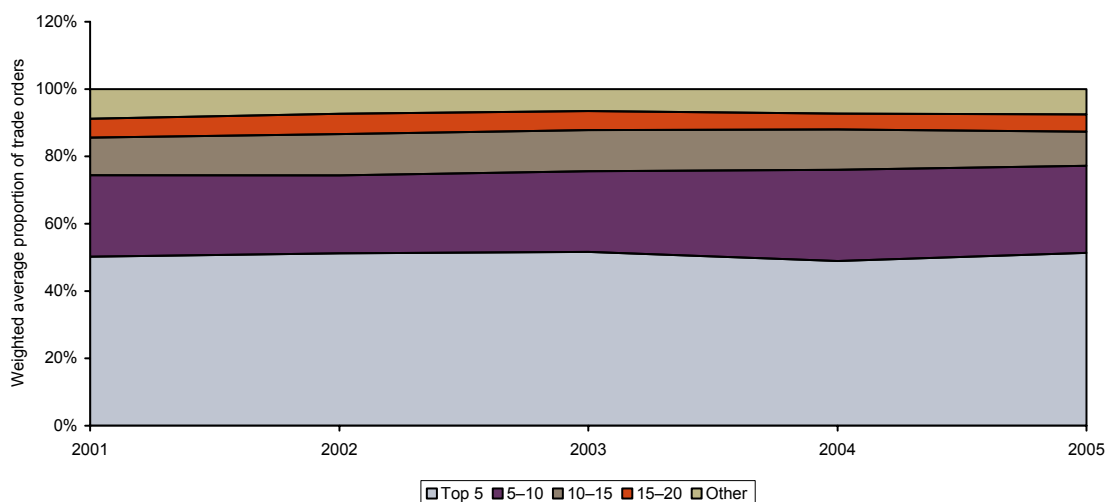
Table 4.7.8 Weighted average proportions of trades going to brokers (%) (11 fund managers, 2001–05)

		2001	2002	2003	2004	2005
Top 5 brokers	Proportion	50.24	51.20	51.63	48.87	51.30
	Cumulative	50.24	51.20	51.63	48.87	51.30
Brokers 6–10	Proportion	24.19	23.10	23.96	27.15	25.89
	Cumulative	74.43	74.31	75.59	76.02	77.19
Brokers 11–15	Proportion	11.15	12.31	12.19	12.00	10.16
	Cumulative	85.57	86.62	87.78	88.02	87.35
Brokers 16–20	Proportion	5.59	6.00	5.68	4.69	5.15
	Cumulative	91.16	92.62	93.45	92.71	92.50
Other brokers	Proportion	8.84	7.38	6.55	7.29	7.50
	Cumulative	100.00	100.00	100.00	100.00	100.00

Note: Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 13).

**Figure 4.7.1 Weighted average proportions of trades going to brokers
(11 fund managers, 2001–05)**



Note: Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 13).

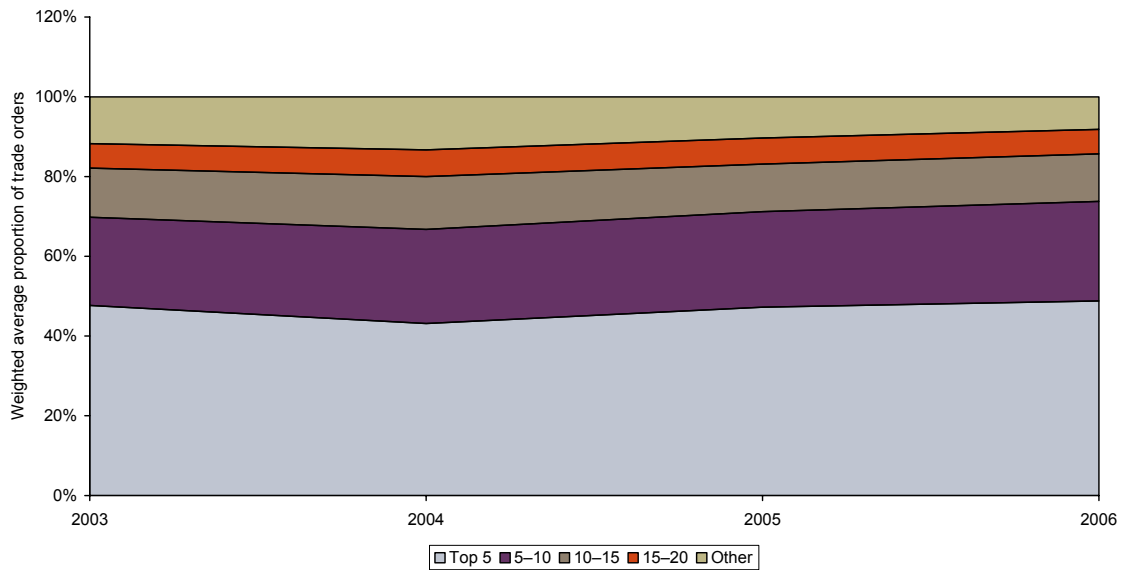
**Table 4.7.9 Weighted average proportions of trades going to brokers (%)
(14 fund managers, 2003–06)**

		2003	2004	2005	2006
Top 5 brokers	Proportion	47.68	43.17	47.24	48.81
	Cumulative	47.68	43.17	47.24	48.81
Brokers 6–10	Proportion	22.11	23.57	23.93	24.97
	Cumulative	69.79	66.74	71.16	73.78
Brokers 11–15	Proportion	12.33	13.25	11.98	11.90
	Cumulative	82.12	79.99	83.14	85.69
Brokers 16–20	Proportion	6.17	6.69	6.51	6.16
	Cumulative	88.29	86.68	89.66	91.85
Other brokers	Proportion	11.71	13.32	10.34	8.15
	Cumulative	100.00	100.00	100.00	100.00

Note: Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 13).

Figure 4.7.2 Weighted average proportions of trades going to brokers (14 fund managers, 2003–06)



Note: Weights are based on the total value of funds managed in the UK, as provided in question 1 of the original fund managers questionnaire.

Source: Oxera calculations based on responses to the original fund managers questionnaire (question 13).

The cumulative data in Table 4.7.9 and Figure 4.7.2 shows that concentration in the use of brokers for execution has been increasing since 2004, and was expected to increase in 2006. This established a useful indication of the trend for concentration in the brokerage market, and this data provides a benchmark for future comparison.

However, a necessary condition for the brokerage industry to segment into those brokers who provide high quality of trade execution and those who provide high-quality research is that fund managers closely monitor the quality of execution and research undertaken by brokers. Therefore, fund managers were asked qualitative questions on whether they had systems in place to monitor the quality of trade execution or research, and, where such systems were in place, how frequently they were reviewed.

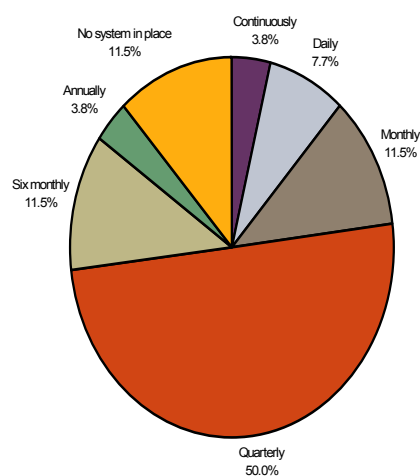
Table 4.7.10 shows that 23 of the 26 respondents indicated that they had systems to monitor the quality of trade execution, while 19 of the 26 respondents indicated that they had systems to monitor the quality of research provided by brokers or third-party research providers. This data is also shown in Figures 4.7.3 and 4.7.4.

Table 4.7.10 Extent of monitoring of quality of trade execution and quality of research

	Monitoring of quality of trade execution		Monitoring of quality of research	
	Number of fund managers	Funds under management	Number of fund managers	Funds under management
Fund managers				
who have a system in place	23	£1,346.7 billion	19	£1,071.5 billion
Monitoring continuously	1		2	
Monitoring daily	2			
Monitoring monthly	3		1	
Monitoring quarterly	13		9	
Monitoring every six months	3		7	
Monitoring annually	1			
who do not have a system in place	3	£59.9 billion	7	£335.0 billion
Total respondents	26	£1,406.6 billion	26	£1,406.6 billion

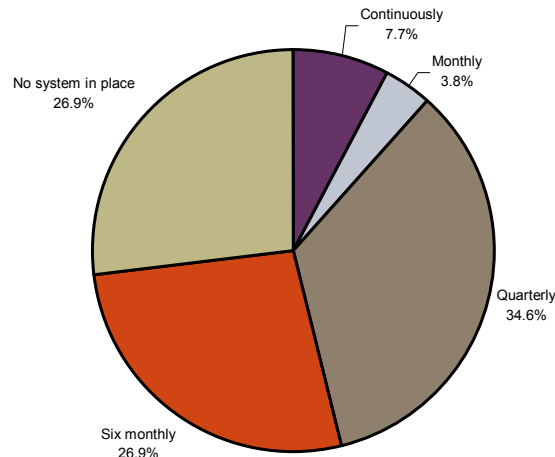
Source: Oxera calculations based on responses to the original fund managers questionnaire (questions 1, 30 and 31).

Figure 4.7.3 Frequency of monitoring quality of trade execution



Source: Oxera calculations based on responses to the original fund managers questionnaire (question 30).

Figure 4.7.4 Frequency of monitoring quality of research



Source: Oxera calculations based on responses to the original fund managers questionnaire (question 31).

As well as recognising that fund managers monitor the quality of trade execution and research, it is useful to consider whether they have been offered access to brokers' research services for a fixed fee—ie, independent from trade execution. In question 22, fund managers were asked whether any full-service brokers had offered such services in 2005, and, if so, how many brokers had offered these services. The results, presented in Table 4.7.11, show that, in 2005, full-service brokers did not offer research independently from trade execution. In question 27, fund managers were asked whether any full-service brokers had offered such services for 2006. The results, presented in Table 4.7.12, show that in early 2006, full-service brokers were still predominantly not offering research independently from trade execution.

Table 4.7.11 Offers of independent research from full-service brokers in 2005 (fund managers)

Responses	Did any full-service brokers offer research for a fixed fee, rather than as part of the full-service brokerage?	How many full-service brokers offered research independently?
Yes	1	n/a
No	25	1

Source: Oxera calculations based on 26 responses to the original fund managers questionnaire (question 22).

Table 4.7.12 Offers of independent research from full-service brokers in 2006 (fund managers)

Responses	Have any full-service brokers offered research on an independent basis?
Yes	2
No	21

Source: Oxera calculations based on 23 responses to the original fund managers questionnaire (question 27).

Brokers were also asked whether they had offered research goods and services independently from trade execution. These results provided a different picture, as shown in Table 4.7.13.

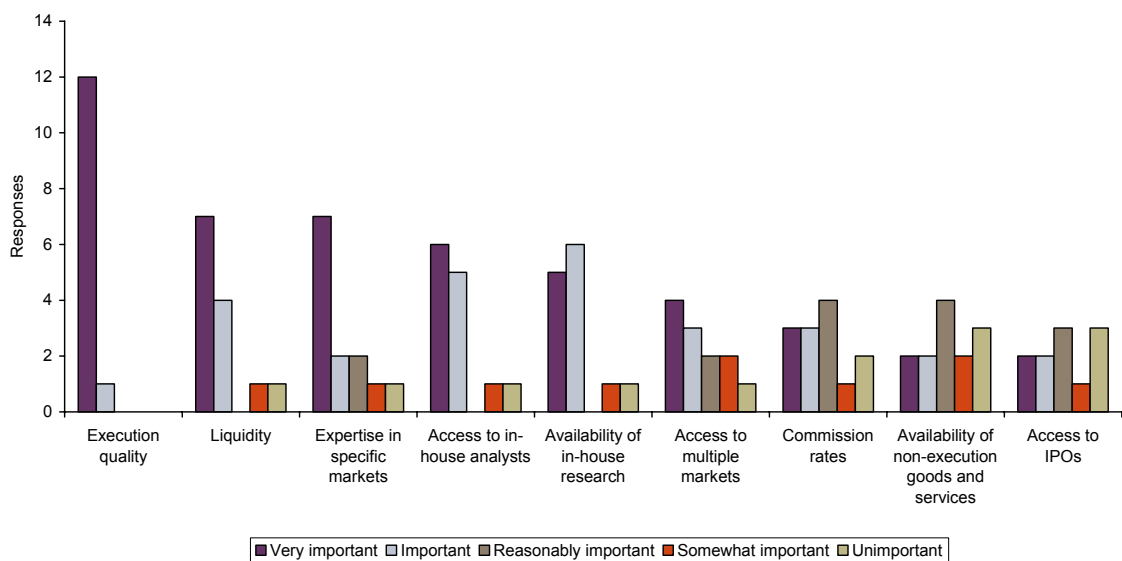
Table 4.7.13 Offers of independent research from full-service brokers in 2006 (brokers)

Responses	Have you offered any fund managers research on an independent basis?	
	2005	2006
Yes	6	7
No	6	5

Source: Oxera calculations based on 12 responses to the brokers questionnaire (questions 19 and 20).

It is also useful to analyse the areas in which brokers compete. Brokers were asked to rate the importance of different means in which they compete for business from fund managers. The results of the responses to this question are shown in Figure 4.7.5.

Figure 4.7.5 Rated importance of factors in brokers competing for business from fund managers



Note: This data is based on the responses of 13 brokers, with the exceptions of 'Access to multiple markets', for which only 12 brokers provided ratings, and 'Access to IPOs' for which only 11 brokers provided ratings. Source: Oxera calculations based on responses to the brokers questionnaire (question 9).

Figure 4.7.5 shows that the most important factor in competing for business from fund managers is the quality of trade execution. Commission rates appear to be the third least important factor.

This provides a useful qualitative benchmark for future comparison, particularly with respect to whether there is a split between brokers who rate the importance of the quality of execution and those who rate the importance of access to in-house research. In comparing the availability of in-house research with the quality of execution, two of the brokers provided significantly different ratings for the importance of quality of execution and the importance of the availability of in-house research. The changes in market structure will be analysed in 2007/08.

Quality of trade execution

As explained in section 2.5, there was also a concern from the trade associations that the change in the regime would affect the quality of trade execution, and in particular liquidity in the different market segments.

Performance indicators: quality of trade execution

- Brokers' and fund managers' assessment of liquidity in different segments of the market over time.
- Fund managers' assessment of quality of trade execution in different segments of the market over time.

Data on brokers' and fund managers' assessments of liquidity of different segments of the market over time was gathered from the brokers questionnaire and the original fund managers questionnaire. Assessments of the quality of market liquidity and underlying trends are presented in Tables 4.7.14 and 4.7.15 (fund managers), and Tables 4.7.16 and 4.7.17 (brokers).

Table 4.7.14 Fund managers' perspectives on market liquidity

	FTSE 100	FTSE 250	FTSE Small Cap
Excellent	12	1	0
Good	13	9	1
Reasonable	2	15	9
Poor	0	2	14
Very poor	0	0	2

Source: Oxera calculations based on 27 responses to the original fund managers questionnaire (question 6).

Table 4.7.15 Fund managers' perspectives on trends in market liquidity

	FTSE 100	FTSE 250	FTSE Small Cap
Better	13	16	9
Same	13	9	12
Worse	0	1	5

Source: Oxera calculations based on 26 responses to the original fund managers questionnaire (question 6).

Table 4.7.16 Brokers' perspectives on market liquidity

	FTSE 100	FTSE 250	FTSE Small Cap
Excellent	7	0	0
Good	6	8	1
Reasonable	0	5	6
Poor	0	0	6
Very poor	0	0	0

Source: Oxera calculations based on 13 responses to the brokers questionnaire (question 14).

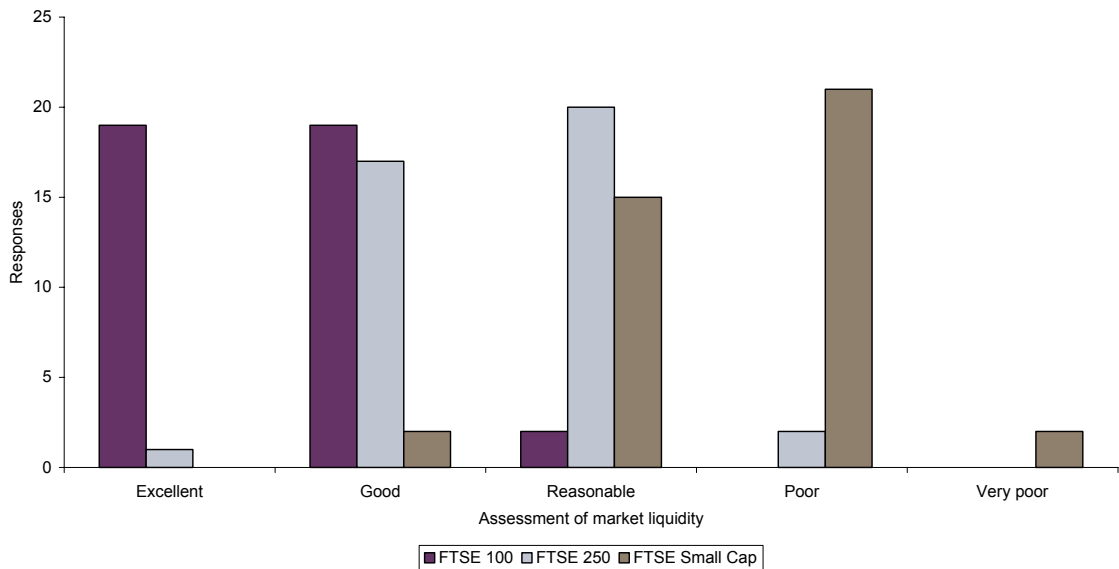
Table 4.7.17 Brokers' perspectives on trends in market liquidity

	FTSE 100	FTSE 250	FTSE Small Cap
Better	8	9	4
Same	5	4	9
Worse	0	0	0

Source: Oxera calculations based on 13 responses to the brokers questionnaire (question 14).

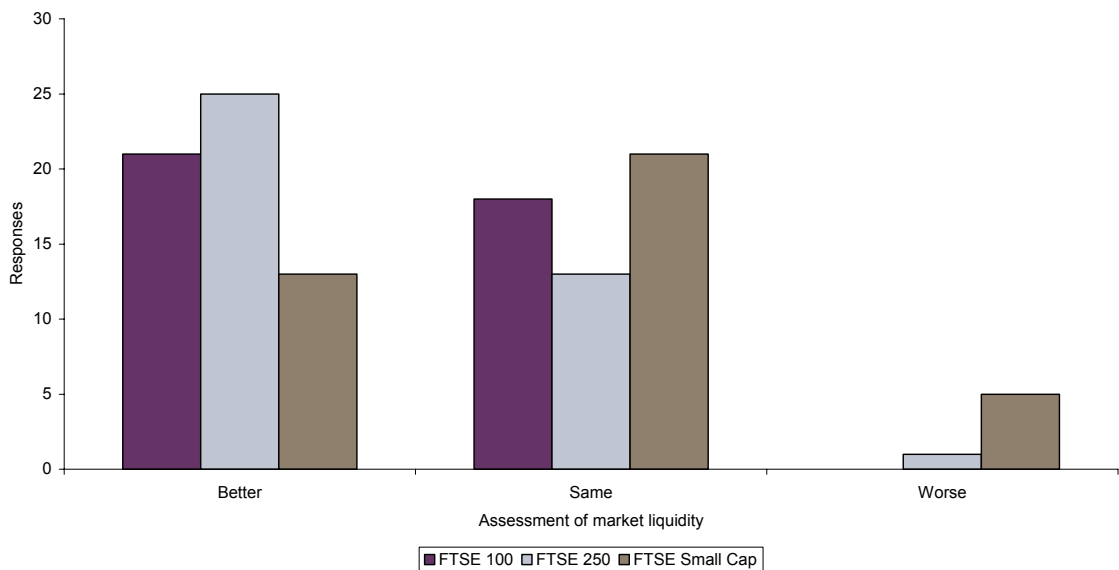
The responses of both fund managers and brokers to these questions have been aggregated, as shown in Figures 4.7.6 and 4.7.7.

Figure 4.7.6 Aggregated fund managers' and brokers' perspective on market liquidity



Source: Oxera calculations based on 40 responses—27 to the fund manager questionnaire and 13 to the brokers questionnaire.

Figure 4.7.7 Fund managers' and brokers' perspective on trends in market liquidity



Source: Oxera calculations based on 39 responses—26 to the fund manager questionnaire and 13 to the brokers questionnaire.

The data in Figure 4.7.7 shows that the vast majority of respondents believe that the underlying trend in the liquidity of these three market segments has been constant or improving. These questions provide a qualitative benchmark for future comparison of the perception of fund managers and brokers of the liquidity of the market segments.

4.8 Identified market trends and preliminary findings on the impact of the change in the regime

Most of the data gathered in the baseline surveys was just to provide a functional baseline for future comparison. The detailed baseline data has been described in sections 4.3 to 4.7. However, the data already allows some results to be identified. This section provides an overview of these preliminary findings from the baseline survey, including:

- market trends identified in the baseline data (section 4.8.1);
- preliminary findings relating to the impact of the change in the regime for soft commissions and bundled brokerage arrangements (section 4.8.2).

Identified market trends

These are the market trends identified in the baseline survey data. Identifying market trends is important for the establishment of the counterfactual for future comparison.

- **Commission rates**—the baseline survey data from both fund managers and brokers shows that commission rates for programme trades, execution-only brokerage and bundled brokerage have been declining. With respect to bundled brokerage, the execution constituent of bundled brokerage commission rates has remained constant, although the ‘pure execution’ constituent of bundled brokerage commission rates has declined. This represents an increase in the price of ‘worked execution’—ie, additional execution services provided to full-service brokerage clients. The baseline survey data also suggests that the decline in bundled brokerage commission rates was due to a decrease in the non-execution constituent of bundled brokerage. The data suggests that this was driven by a reduction in the amount spent on non-permitted goods and services purchased through commissions.
- **Proportions of trading volumes according to types of brokerage**—the baseline survey data from both fund managers and brokers shows that there has been a switch from bundled brokerage trades to execution-only trades. The reduction in the bundled brokerage proportion of trades was primarily driven by a switch away from using liquidity trading. The increase in the execution-only proportion of trades was driven by both the increase in direct market access and algorithmic trading. The baseline survey data from fund managers suggests that the programme trades’ proportion of trades remained broadly constant.
- **Management fees**—the baseline survey data from both fund managers and brokers shows that management fees for both active and passive funds are declining. The decrease in management fees for active funds is more pronounced than that for passive funds.
- **Concentration of the brokerage market**—the baseline survey data shows that fund managers have concentrated their use of brokers for UK cash equity trades on a smaller number of brokers. This trend has been increasing since 2004, with the expectation that this will have continued in 2006.

Preliminary findings on the impact of the change in the regime

These are the market developments identified in the baseline survey data that may be related to the change in the regime.

- **Non-permitted goods and services**¹⁷—the baseline survey data indicates that the total amount spent on non-permitted goods and services purchased through commissions has fallen; primarily driven by the amount spent on non-permitted goods and services purchased with soft commissions, declining to almost zero in 2005. This is likely to be due to fund managers acting on the change in the regime prior to its full effectiveness from January 1st 2006.
- **Research and execution-related goods and services**—the baseline survey data suggests that the total amount spent on research or execution-related goods and services purchased through commissions has, relative to funds under management or bundled brokerage trades, remained broadly constant. Although there appears to have been a switch from purchasing research or execution-related goods and services with soft commissions, to purchasing through bundled brokerage arrangements, there are reservations about this data. This suggests that there may be some confusion among industry participants about the goods and services that are permitted within the FSA definitions of ‘research’ and ‘execution-related’ goods and services.
- **Commission-sharing agreements**—these will allow fund managers to purchase permitted non-execution goods and services from the trade execution broker, other brokers and third parties. The data from the baseline survey suggests that the take-up of commission-sharing agreements in the first quarter of 2006 was mixed. However, a number of fund managers indicated that, while they did not previously use soft commissions, they do intend to use commission-sharing agreements. This could result in an increase in the amount spent on permitted non-execution goods and services purchased through commissions.

¹⁷ 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 do not fall within the new rules and the FSA definitions of ‘execution’ or ‘research’; they *are no longer permitted* to be obtained through soft commissions or bundled brokerage arrangements. These are as defined by the FSA.

5 Evaluation of the baseline survey

This section provides an evaluation of the 2006 survey. This includes an evaluation of both the performance indicators and the 2006 questionnaires, and suggestions for the improvement of both the selection of participants and the selection and measurement of the performance indicators.

In seeking to provide a baseline for the post-implementation assessment of the impact of the change in the regime for soft commissions and bundled brokerage arrangements, performance indicators have been selected, as described in section 2, which will allow the expected impact of the change in the regime for soft commissions and bundled brokerage arrangements to be measured. The measurement of these performance indicators in 2006 has provided the baseline, and is expected to be repeated in 2007/08, to make a comparison against this baseline data.

Therefore, this section provides an evaluation of the performance indicators identified in sections 2.1 to 2.5, based on the data collected in the baseline surveys and described in sections 4.3 to 4.7. The results of this evaluation are shown, for each category of performance indicator, in Tables 5.3.1 to 5.3.5. Each performance indicator identified in section 2 is detailed with its source in the baseline survey, the quality of the data provided (very good, good, mixed, poor, very poor), and the usefulness of the indicator (very useful, useful, mixed, limited, very limited). In the tables, SMFQ refers to the supplementary fund managers questionnaire; OFMQ refers to the original fund managers questionnaire, PFQ refers to the pension funds questionnaire, and BQ refers to the brokers questionnaire.

Table 5.3.1 Evaluation of performance indicators from sections 2.1 and 4.3

Performance indicator	Source	Quality of data received	Usefulness of indicators
Reduction in the spending on non-permitted goods and services			
Amount spent on non-permitted goods and services purchased through research	SFMQ	Good—for those fund managers who supplied data for these indicators, the data appears to be of good quality. Fund managers required clarification of the meaning of 'non-permitted goods and services', although, once understood, data was forthcoming	Very useful—this indicator gives an indication of fund managers' preparation for compliance with the new regime
Amount spent on non-permitted goods and services purchased with hard cash	SFMQ		
Total amount spent on non-permitted goods and services purchased	SFMQ		
Management fees paid by pension funds	OFMQ	Very good—the data provided by fund managers appears robust	Very limited—the management fee will be determined by a range of factors; given this noise, determining the impact of the change in the regime will be difficult
	PFQ	Poor—insufficient data provided	

Source: Oxera analysis.

Table 5.3.2 Evaluation of performance indicators from sections 2.2 and 4.4

Performance indicators	Source	Quality of data received	Usefulness of indicators
Reduction in the spending on research			
Qualitative and anecdotal evidence	FMQ, BQ, interviews	Mixed—data from a range of qualitative questions was mixed. Information on compliance with disclosure requirements appears to be good. Other soft indicators do not appear very robust	Mixed—where data was provided, aspects of the mechanism through which fund managers may come under greater scrutiny from pension funds could be assessed
	PFQ	Poor—insufficient data provided	However, the key element was determining the extent to which pension funds monitor fund managers' use of clients' commissions. Limited information was available on this
Amount spent on research purchased with soft commissions	SFMQ	Good—for those fund managers who supplied data for these indicators, the data appears to be of good quality	Very useful—this indicator provides a functional baseline for future comparison
Amount spent on research purchased through bundled brokerage arrangements	SFMQ		
Amount spent on research purchased with hard cash	SFMQ		
Cost of research produced in-house	SMFQ	Poor—a number of fund managers were unable or unwilling to supply this data; where supplied, there are reservations about how this was calculated	Mixed, due to reservations about the quality of this data
Total amount spent on research consumed	SMFQ	Good—for those fund managers who supplied data for these indicators, the data appears to be of good quality	Very useful—as for constituents

Source: Oxera analysis.

Table 5.3.3 Evaluation of performance indicators from sections 2.3 and 4.5

Performance indicators	Source	Quality of data received	Usefulness of indicators
Reduction in the spending on execution-related goods and services			
Qualitative and anecdotal evidence	OFMQ, BQ, interviews	Mixed—as for similar indicator in Table 4.10.2	Mixed, as for similar indicator in Table 4.10.2
	PFQ	Poor—insufficient data provided	
Amount spent on execution-related goods and services purchased with soft commissions	SFMQ	Good—for those fund managers who supplied data for these indicators, the data appears to be of good quality. There were some reservations about the split between purchasing with soft commissions and purchasing through bundled brokerage. However, due to the nature of the new regime, these will not be split in the 2007/08 questionnaire	Very useful—this indicator provides a functional baseline for future comparison
Amount spent on execution-related goods and services purchased through bundled brokerage arrangements	SFMQ		
Amount spent on execution-related goods and services purchased with hard cash	SFMQ		
Total amount spent on execution-related goods and services consumed	SMFQ		

Source: Oxera analysis.

Table 5.3.4 Evaluation of performance indicators from sections 2.4 and 4.6

Performance indicators	Source	Quality of data received	Usefulness of indicators
Reduction in the spending on non-execution goods and services			
Amount spent on non-execution goods and services purchased through commissions	SFMQ	Good—for those fund managers who supplied data for these indicators, the data appears to be of good quality	Very useful—this indicator provides a functional baseline for future comparison
Reduction in the non-execution constituent of execution-plus commission rates			
Difference between bundled brokerage commission rates and execution-only commission rates	SFMQ, OFMQ, BQ	Very good—the three questionnaires collected extensive data on commission rates. This data appears robust	Limited—this proxy is based on an assumption that the execution-only commission rate is a proxy for the execution-plus constituent of bundled brokerage. However, other data suggests that this assumption does not hold The proxy was nevertheless retained, as the extent to which the assumption does not hold can be tested from the results of the 2007/08 questionnaire
Fund managers' estimates of the non-execution constituent of bundled brokerage commission rates	SFMQ	Good—for those fund managers who supplied data for these indicators, the data appears to be of sufficiently good quality	Very useful—these indicators provide a functional baseline for future comparison with actual data

Performance indicators	Source	Quality of data received	Usefulness of indicators
Reduction in the spending on non-execution goods and services			
Brokers' estimates of the non-execution constituent of execution-plus commission rates	BQ	Mixed—only a very limited number of brokers provided estimates of the non-execution constituents of execution-plus commission rates. This was expected, given initial uncertainties following the change in the regime	Mixed data from the baseline survey was to be expected, given that these were estimates. In the 2007/08 questionnaire, it will be possible to measure the actual non-execution constituent of execution-plus commission rates
Reduction in the volume of execution-plus trading			
Volume of execution-plus trading	SFMQ	Good—for those fund managers who supplied data for these indicators, the data appears to be of good quality	Very useful—this indicator provides a functional baseline for future comparison with actual data
Volume of execution-only trading	SFMQ		
Volume of total commission trading	SMFQ		
Changes in the proportions of execution-plus trading and execution-only trading			
Proportion of execution-only and execution-plus transactions by volume of trading	SFMQ, BQ	Good—for those fund managers and brokers who supplied data for these indicators, the data appears to be of good quality	Very useful—this indicator provides a functional baseline for future comparison with actual data

Source: Oxera analysis.

Table 5.3.5 Evaluation of performance indicators from sections 2.5 and 4.7

Performance indicators	Source	Quality of data received	Usefulness of indicators
Impact on distribution of research costs and market structure			
Distribution of research costs among fund managers			
Variation in commission rates charged to fund managers of different sizes	BQ	Good—sufficient data provided by brokers	Useful—this data gives an indication of the impact of economies of scale in the fund management industry
Qualitative and anecdotal evidence	OFMQ, BQ, interviews	Mixed—data from a range of qualitative questions was mixed	Mixed—where data was provided, it was possible to consider the relationships between the parties in the market
Distribution of research costs among pension funds			
Relationship of the commission rates paid by smaller funds relative to those paid by larger funds	PFQ	Poor—insufficient data provided	Unknown
Relationship of the management fees paid by smaller funds relative to those paid by larger funds	OFMQ	Good—sufficient data provided by fund managers	Useful—this data gives an indication of the impact of economies of scale in the pension fund industry
	PFQ	Poor—insufficient data provided	

Performance indicators	Source	Quality of data received	Usefulness of indicators
Impact on distribution of research costs and market structure			
Qualitative and anecdotal evidence	PFQ, OFMQ, interviews	Mixed—data from a range of qualitative questions was mixed	Mixed—where data was provided, it was possible to consider the relationships between the parties in the market
Impact on the structure of the market for fund management			
Structure of the market for fund management	Other sources	To ensure consistency of data, it was decided that this performance indicator would only be measured in the 2007/08 survey	
Impact on the structure of the market for brokerage services			
Pattern of distribution of trades between brokers	OFMQ	Good—sufficient data provided by fund managers	Useful—this data provides an indication of the potential separation of the brokerage market
Qualitative and anecdotal evidence	OFMQ, BQ, interviews	Mixed—data from a range of qualitative questions was mixed	Mixed—where data was provided, it was possible to consider the relationships between the parties in the market
Structure of the market for brokerage services	Other sources	To ensure consistency of data, it was decided that this performance indicator would only be measured in the 2007/08 survey	
Quality of trade execution			
Brokers' and fund managers' assessments of market liquidity in different segments of the market over time	BQ, OFMQ	Very good—almost all fund managers and brokers responded to these questions	Limited—the data provided gave soft indicators of participants' perspectives
Assessment of changes in the quality of trade execution	Other sources	To ensure consistency of data, it was decided that this performance indicator would only be measured in the 2007/08 survey	

Source: Oxera analysis.

This evaluation suggests that the quality of data provided in relation to most performance indicators was either good or very good. The main problems, in terms of the quality of data provided, relate to the very low response rate to the pension fund questionnaire or to data that fund managers were unable to provide in 2006.

This evaluation also suggests that most performance indicators were either useful or very useful for the assessment of the impact of the change in the regime. The indicators assessed as either not relevant or not useful were predominantly due to two causes: there would be high levels of noise in the data (ie, it would be difficult to establish the impact of the change in the regime), or the data was too qualitative to draw firm conclusions on the impact of the change in the regime.

Therefore, the evaluation suggests that sufficient data has been gathered on suitable performance indicators to provide functional baseline data for future comparison, and therefore these indicators can be used in the 2007/08 survey.

The data collected from a subsequent survey, again made up of questionnaires to pension funds, fund managers and brokers, would allow analysis of the performance indicators—in light of identified market trends—to provide an assessment of the impact of the change in the regime for soft commissions and bundled brokerage.

Appendix 1 The compilation of the survey sample

A1.1 Pension funds

Sample for 2006 questionnaire

Data about UK pension funds was provided by NAPF. The pension funds were screened to ensure that they were segregated or co-mingled and that they employed external fund managers. Having ranked the funds according to their 2005 market value, they were split into three groups according to value. The use of the grouping approach follows from the concentration of a large proportion of pension fund assets among a relatively small number of firms. Splitting the sample into three groups ensured that the questionnaire was sent to several of the relatively large pension funds and to many of the smaller pension funds.

To generate a functional baseline for future assessment of the impact of the new rules on soft commission arrangements and bundled brokerage, a sample of 38 pension funds was suggested. The selection of the three groups of pension funds that was initially proposed is shown in Table A1.1.

Table A1.1 Sample for pension fund questionnaire

	Fund sizes	Number of pension funds to whom questionnaires were sent
Group 1	Up to £200m	7
Group 2	Between £200m and £6.5 billion	24
Group 3	£6.5 billion and above	7
Total		38

A1.2 Fund managers

Sample for original 2006 questionnaire

Data on UK fund managers was provided by the FSA. The fund management companies were ranked by the value of funds under management, and divided into three groups accordingly. This follows from the need to survey a cross-section of all fund managers (when ranked by size), while concentrating on the small group of fund management companies which manage the majority of funds. A sample of 91 fund managers was suggested. The selection of the three groups of fund management companies is shown in Table A1.2.

Table A1.2 Sample for fund manager questionnaire

	Size of funds under management	Number of fund managers to whom questionnaires were sent
Group 1	Less than £1 billion	41
Group 2	Between £1 billion and £20 billion	40
Group 3	£20 billion and above	10
Total		91

For the supplementary fund managers questionnaire, 20 of the respondents to the original fund managers questionnaire were identified by Oxera and Alan Line as those for whom

more complete data could or should be collected. Oxera attempted to set up meetings with these 20 fund managers, of whom 17 agreed to a meeting or conference call with Oxera and Alan Line. All 17 fund managers were asked to complete the supplementary fund managers questionnaire.

A1.3 Brokers

Sample for 2006 questionnaire

Data on brokers in the UK was provided by the FSA. The brokers in the FSA database were ranked according to the level of gross commission revenue and divided into three groups so that both a high percentage of the market could be covered by the questionnaire and brokers of all sizes could be represented. A sample of 76 brokers was suggested. The selection of the two groups of brokers is shown in Table A1.3.

Table A1.3 Sample for brokers questionnaire

	Broker's gross commission revenue	Number of brokers to whom questionnaires were sent
Group 1	Less than £20 billion	30
Group 2	£20 billion and above	46
Total		76

Appendix 2 Pension funds questionnaire

Oxera has been commissioned by the FSA to conduct research for its assessment of the changes introduced in January 2006 with respect to soft commission arrangements and bundled brokerage services. The aim of this survey is to elicit data on soft commission and bundled brokerage arrangements prior to the implementation of the new regime—this will enable the FSA to construct the baseline.

Instructions

Please fill in the questionnaire and send it to one of the addresses provided below. The deadline for completion of the questionnaire is March 10th 2006. When completing the questionnaire, we would appreciate it if you would bear in mind the following.

- Please enter all monetary values in a consistent currency, as selected in Part 1.
- Please enter all data in full and without abbreviations—ie, without abbreviating \$1,000,000 to \$1m.

Base for completion

Unless stated otherwise in the question, the scope of this questionnaire is to relationships between yourself and UK fund managers.

Availability of data

Many of the questions ask for data going back to 2001. Please provide data going back as far as possible given the reliability of data.

Mergers and acquisitions

If your pensions funds or mandates have been affected by mergers or acquisitions since 2001, please give consolidated data for all parties for years prior to the merger or acquisition. Please give details of these mergers or acquisitions in Part 4.

Contact details

Please send the questionnaire to one of the following:

By email: FSA@oxera.com
By fax: +44 (0)1865 204 606
By post: Oxera, Park Central, 40/41 Park End Street, Oxford, OX1 1JD

If you have any questions regarding the survey please contact either:

Reinder van Dijk (Project Manager) **Anthony Maidment (Analyst)**
Tel: +44 (0) 1685 253 000 Tel: +44 (0) 1865 253 000

Additional comments

There is scope to make additional comments on this questionnaire or the implementation of the new rules on soft commission and bundled brokerage arrangements, provided in Part 4. If you would like to make more detailed comments, please contact Reinder van Dijk or outline your comments and leave contact details for how we may contact you.

Thank you for taking part in this survey—your contribution is greatly appreciated.

Confidentiality of information

Individual responses to the questionnaire will be kept by Oxera and only presented to the FSA in an aggregated and non-attributable form. We operate under the requirements of an FSA confidentiality agreement and will treat all information received from firms in the strictest confidence.

Part 1 Background information

- i) Name of firm:
- ii) Your name:
- iii) Your position:
- iv) Your contact details
 Email address:
 Telephone number:
 Address:

A number of questions in this questionnaire ask for information relating to a specific year (eg, 2004). Your answers can refer to either the calendar year or the financial year (eg, April 2004–March 2005). Please indicate below which you will use.

- Calendar year
- Financial year

Please give all financial information required in this questionnaire in pounds sterling.

Part 2 General questions

- 1) Please give the year-end total market value of your fund for the last five years.

Average or year-end total market value of fund (£m)	
2005	
2004	
2003	
2002	
2001	

- 2) a) How many different external fund managers, including non-UK fund managers, did you use in 2005?
- b) How many of these are based in the UK?.....
- 3) How many mandates (funds/portfolios) have you divided your fund/assets between?
- 4) a) How many mandates provide for a performance-related fee of some sort?
- b) What proportion of the total value of your pension fund do these represent?

- 5) Please give the **average** management fee you paid to external fund managers (excluding performance-related fees) for each of the previous five years (either as basis points of the funds under management, or in £).

Average management fee (excluding performance-related fees) (bp/£)	
2005	
2004	
2003	
2002	
2001	

- 6) Please give the **average** performance-related fees actually paid expressed as a percentage of the management fee for each of the previous five years. (We understand that performance-related fees are usually calculated as a percentage of the value of outperformance against a relevant benchmark; however, for the purposes of this questionnaire, please express it as a percentage of the management fee.)

Average performance-related fees (as a percentage of the management fee)	
2005	
2004	
2003	
2002	
2001	

Part 3 Mandate-specific questions

- 7) What are your five largest single UK mandates (funds)? Please give the name of both the mandate (fund) and the fund manager, and the value of the fund at the end of 2005.

	Name of mandate (fund)	Name of fund manager	Value of fund at end of 2005 (£)
1			
2			
3			
4			
5			

Please enter the answers for questions 10–16 in the table below. The columns 1–5 correspond with the five mandates (funds) you listed in Q8.

	1	2	3	4	5
1) Is the fund segregated (S) or co-mingled (C)?					
2) Is the fund actively (A) or passively (P) managed?					
3) In 2005, did you prohibit your fund manager using soft commission arrangements? (Y/N)					
4) What is the management fee rate (excluding performance-related fees)? (basis points)					

	1	2	3	4	5
5) What is the equivalent performance-related fee actually paid, expressed as a percentage of the management fee?(%)					

6) For each mandate, what was the value of the fund for each of the previous five years?

	1	2	3	4	5
2005					
2004					
2003					
2002					
2001					

7) For each mandate, what total value of trades was undertaken in each of the previous five years?

	1	2	3	4	5
2005					
2004					
2003					
2002					
2001					

8) For each mandate, how much was deducted from the fund as broker commission in each of the previous five years?

	1	2	3	4	5
2005					
2004					
2003					
2002					
2001					

9) How much commission was spent to purchase non-execution goods and services using soft commissions for each mandate in each of the previous five years?

	1	2	3	4	5
2005					
2004					
2003					
2002					
2001					

10) a) For each of the previous five years, did you discuss with your fund manager the level of commission payments made?

b) Did you compare the commission payment made on your fund with other similar funds?

Please enter your answers (YES/NO) in the table below.

	1		2		3		4		5	
	a)	b)	a)	b)	a)	b)	a)	b)	a)	b)
2005										
2004										
2003										
2002										
2001										

11) a) For each of the previous five years, did you discuss with your fund manager the level of softed services bought with commission payments?

b) Did you compare the level of softing with other similar funds?

Please enter your answers (YES/NO) in the table below.

	1		2		3		4		5	
	a)	b)	a)	b)	a)	b)	a)	b)	a)	b)
2005										
2004										
2003										
2002										
2001										

12) In 2005, did your fund manager(s) provide you with any of the following information specifically for your fund? Please complete the following table (in absolute numbers) detailing how many fund managers did or did not provide each type of information.

	How many fund managers did provide the information for your fund?	How many fund managers did not provide the information for your fund?
Gross return on investments		
Net return on investments		
Total commission paid by fund		
Total commission payment made to pay for execution		
Total commission payment used to pay for non-execution services (eg, broker research and softing)		
Total commission used to pay for soft services		

13) Have you received disclosure reports meeting the IMA Disclosure Code from your fund managers? YES/NO

14) Did you hire a consultant to assist in analysing the information received? YES/NO

Were these reports useful in monitoring the activities of your fund manager(s)?

Yes—very helpful	
Yes—somewhat helpful	
No—not so useful	
No—not useful at all	

15) Do you monitor research purchased, on your behalf, by your fund manager(s)?

Yes—we monitor this closely	
Yes—we sometimes look at this	
No—we have not looked at this	

16) Do you monitor any of the following data from your UK fund managers? If YES, please indicate whether this monitoring is conducted in-house, by the fund manager itself, or by third parties.

	If YES, who monitors?			
	Monitor? (Y/N)	In-house	Fund manager	Third party
Fund performance (after deduction of commission/trading costs)				
Value of trading annually				
Broker commission rates paid by the fund manager				
Value of trades buying non-execution goods and services				
Value of non-execution goods and services bought by fund managers through commissions relating to trades in your investments				
The trading efficiency of the fund manager's trading desk and brokers				
The quality of research purchased by the fund manager				

Any additional comments

Mergers and acquisitions

17) To ensure consistency of data across time, please provide details of any mergers of pension funds or mandates in which your company has been involved since 2001, including the dates these mergers or acquisitions were completed.

.....

18) Are there any comments that you would like to add, with regard to the information provided in this questionnaire or on the implementation of the new rules?

.....
.....

If you have more detailed comments that you would like to discuss directly, please outline your comments and provide relevant contact details.

.....
.....

Appendix 3 Fund managers questionnaire

Oxera has been commissioned by the Financial Services Authority (FSA) to conduct research for its assessment of the changes introduced in January 2006 with respect to soft commission arrangements and bundled brokerage services. The aim of this survey is to elicit data on soft commission and bundled brokerage arrangements prior to the implementation of the new regime—this will enable the FSA to construct the baseline.

Instructions

Please fill in the questionnaire and send it to one of the addresses provided below. The deadline for completion of the questionnaire is March 10th 2006. When completing the questionnaire, we would appreciate it if you would bear in mind the following.

- Please enter all monetary values in a consistent currency, as selected in Part 1.
- Please enter all data in full and without abbreviations—ie, without abbreviating \$1,000,000 to \$1m.

Base for completion

Unless stated otherwise in the question, the base for answering questions within this questionnaire is all the funds managed in the UK for all pension fund clients (regardless of domicile) that are invested in UK equities (ie, equities that are listed in the UK).

Availability of data

Many of the questions ask for data going back to 2001. Please provide data going back as far as possible, where reliable data is available.

Mergers and acquisitions

If your fund management activities have been affected by mergers or acquisitions since 2001, please give consolidated data for all parties for years prior to the merger or acquisition. Please give details of these mergers or acquisitions in Part 5.

Contact details

Please send the questionnaire to one of the following:

By email: FSA@oxera.com
By fax: +44 (0) 1865 204 606
By post: Oxera, Park Central, 40/41 Park End Street, Oxford, OX1 1JD

If you have any questions regarding the survey please contact either:

Reinder van Dijk (Project Manager) **Anthony Maidment (Analyst)**
Tel: +44 (0) 1685 253 000 Tel: +44 (0) 1865 253 000

Additional comments

There is scope to make additional comments on this questionnaire or the implementation of the new rules on soft commission and bundled brokerage arrangements, provided in Part 5. If you would like to make more detailed comments, please contact Reinder van Dijk or outline your comments and leave contact details for how we may contact you.

Thank you for taking part in this survey—your contribution is greatly appreciated.

Confidentiality of information

Individual responses to the questionnaire will be kept by Oxera and only presented to the FSA in an aggregated and non-attributable form. We operate under the requirements of an FSA confidentiality agreement and will treat all information received from firms in the strictest confidence.

Part 1 Background information

- v) Name of firm:
- vi) Your name:
- vii) Your position:
- viii) Your contact details
Email address:
- Telephone number:
- Address:
-

A number of questions in this questionnaire ask for information relating to a specific year (eg, 2004). While we would prefer your answers to refer to the calendar year, we recognise that this may not be possible. Please indicate below which you will use.

- Calendar year
- Financial year

Please indicate below which currency you will use to report financial information in this questionnaire.

- sterling
- US dollars
- euro

Part 2 General questions

- 1) What is the total value of funds that you manage as a company in the UK?
.....
- 2) How many institutional clients do you serve as a company in the UK?
.....
- 3) What proportion of the total value of the funds you manage in the UK is from clients domiciled in the UK?
.....

- 4) Of the funds managed in the UK at present, please give the proportion (by value) managed on behalf of:

	Proportion
Pension funds	
Insurance companies	
Unit trusts	
Investment trusts	
Others	
Total	100%

- 5) What proportions of assets (which you manage in the UK) are held in the following classes of assets?

Assets	Proportion
Equities	
Fixed-income securities	
Others	
Total	100%

- 6) For each of the following UK markets that trade assets held by the funds you managed in 2005, how would you describe the liquidity of each market?

	Description of market liquidity (poor/somewhat poor/reasonable/ good/excellent)	What do you perceive has been the trend over the last three years? (better/same/worse)
FTSE 100		
FTSE 250		
FTSE 350		
FTSE Small Cap		

Part 3 Relations between fund managers and pension funds

The questions in this section relate to the arrangements in place between yourselves and your **pension fund** clients.

Income sources

- 7) For 2005, what is your total management fee income (flat fees plus performance-related fees actually received), excluding VAT, earned from funds managed in the UK in UK equities on behalf of pension fund clients? Please give this figure as an amount of money, not a percentage rate. £.....

What is the value of the assets held in UK equities that Q7 relates to? £.....

What proportion of the fee in Q7 arises as a result of (successfully) meeting performance-related targets?

- 8) Consider the four 'typical' UK equity mandates of different sizes (expressed in £m) in the table below. What would be the average percentage management fee you would have charged for these mandates in 2005, assuming there is no performance element of the fee (ie, the

management fee is the only income available to you)? Please distinguish between active and passive mandates.

Size of equity mandate (£m)	Active UK equity fund average fee (% per annum)	Passive UK equity fund average fee (% per annum)
500		
200		
100		
50		

- 9) Taking the £100m fund as an example, please indicate in the table below the management fee you would have charged over the last five years, again if the only income available to you was the management fee (ie, no performance element).

	Active UK equity fund (£100m) average fee (% per annum)	Passive UK equity fund (£100m) average fee (% per annum)
2005		
2004		
2003		
2002		
2001		

- 10) In 2005, what proportion (by value) of the pension fund assets you managed in the UK in UK equities provided for a bonus element for fund performance?

.....

- 11) What proportion of your total UK fee income from pension fund clients in 2005 was achieved through bonus payments?

.....

Part 4 Relations between fund managers and brokers

The questions in this section relate to the arrangements in place between yourselves as UK-based fund managers and **brokerage firms**.

Looking back to 2005

- 12) For UK equity trades, how many brokers do you have on your approved list?

2006	
2005	
2004	
2003	
2002	
2001	

Is there a formal process for putting a broker on your approved list? YES/NO

If YES, please describe in general terms.

.....

Is there a maximum trading limit for any individual broker? YES/NO

- 13) What proportion of your total orders (by value) for UK equity trades go to the following brokers for each of the following years (for 2006, please provide an estimate)?

	Your top 5 brokers	Next 5 brokers	Next 5 brokers	Next 5 brokers
2006 (estimate)				
2005				
2004				
2003				
2002				
2001				

- 14) What proportion of all your UK equity trades took place on a commission basis (as opposed to a 'net' basis) for each of the following years?

2005	
2004	
2003	
2002	
2001	

- 15) What proportion of your total UK equity trades are client facilitation trades (ie, those that use your capital)? What proportion of client facilitation trades are conducted on a 'net' or commission basis?

	a) Proportion of your total UK equity trades are facilitation trades?	b) Proportion of facilitation trades are conducted on a 'net' basis?	c) Proportion of facilitation trades are conducted on a commission basis?
2005			
2004			
2003			
2002			
2001			

- 16) In 2005, was the 'loss ratio' taken into account in negotiating over execution commission rates with your brokers? YES/NO

Has the 'loss ratio' formed part of your negotiations over the execution commission rate for 2006? YES/NO

- 17) Thinking of your total UK equity market trading activity for all funds managed in the UK on behalf of pension fund clients over the last five years, please complete the following tables.

	2001	2002	2003	2004	2005
Total funds under management					
Total value of all net trades					
Total value of trades transacted on commission basis					
Total value of broker commission paid					
Total spent on commissions on 'execution-only' transactions					
Average commission rate on 'execution-only' transactions					
Total spent on commissions on bundled brokerage					
Average commission rate on bundled brokerage					
Value of goods and services consumed using soft commission arrangements					
Value of credit (soft dollars) used for third-party research					
Total value of 'permitted services', ie the value of services that could in principle be purchased under soft commission arrangements					
Total value of research within the 'permitted services'					
Cost of research/analysis paid for by hard cash					
Cost of research produced in-house					

18) From how many research providers and brokers did you receive research in 2005?

	Paid for through commissions	Paid for by hard cash
Brokers		
Third-party research providers (who do not conduct brokerage)		

19) In 2005, did any of the full service brokers you used regularly provide you with an estimate of the costs of the non-execution services they provided you with out of the commission? (Please tick)

All	About three-quarters	About half	About a quarter	None of them

20) In 2005, did any of the full service brokers you used regularly offer you an execution-only service as an alternative? YES/NO

If YES, how many?

If YES, what was the average difference between the bundled commission rate and the execution-only commission rate? (in basis points)

21) With respect to 2005, please complete the following table, indicating the bundled service and execution-only commission rates for five brokers who offer both services and to whom you sent the largest orders.

	a) Execution-only commission rate (if applicable)	b) Bundled commission rate
1.		
2.		
3.		
4.		
5.		

22) In 2005, did any full service brokers offer you access to their research services for a fixed fee, rather than as part of the full service brokerage? YES/NO

If YES, how many?

If YES, what were the fees, and how was it expressed? Please fill in the relevant column below, with respect to the five brokers to whom you sent the largest orders.

	Flat fee £....	% of assets under management	Other (please specify)
1.			
2.			
3.			
4.			
5.			

23) a) In 2005, how many brokers did you have soft commission arrangements with?

b) What proportion of trades (by value) were softed?

c) What was the average soft commission multiple?

24) What proportion (by value) of your total business did you transact under the following categories for 2001–05? Please provide an estimate for 2006.

	2001	2002	2003	2004	2005	2006 (estimate)

Programmed trades						
DMA						
Algorithmic						
Buy-side trade managed sales trading service						
Broker discretion sales trading service						
Sell-side trade managed sales trading service						
Liquidity (capital commitment)						
Bundled brokerage (up to 2005)						
Other (eg, crossed internally, other trading platforms)						
Total						

Looking forward to 2006

25) Thinking of your relationships with UK brokers in 2006, please fill in the following table relating to how many brokers you have the following types of relationship with.

	From your top 10 brokers		From your other brokers	
	With a commission-sharing arrangement	Without a commission-sharing arrangement	With a commission-sharing arrangement	Without a commission-sharing arrangement
Both execution-plus and execution-only (both types) transactions				
Execution-plus transactions				
Execution-only transactions				

By definition, a commission-sharing arrangement involves an execution-plus commission rate, because part of the commission rate is for research rather than for execution services.

26) How much (by proportion of turnover) of your trades will be put through a commission-sharing arrangement?

27) Have any full service brokers offered you access to their research services on an independent basis (ie, outside a fee based on commissions paid on trades that you pass to them)?

If YES, please complete the table.

Broker	For a fixed fee (£)	For a fee expressed as a % of assets under management	For a fee calculated in some other way (please describe)

28) Have any full service brokers that you have regularly used provided you with a detailed and objective breakdown of the execution-plus commission rate into execution and research?

All	About three-quarters	About half	About a quarter	None of them

29) With how many brokers have you already agreed on the total amount that you will pay them for their research out of commissions?

.....

Monitoring broker performance

30) a) Do you have a system by which you review of the quality of execution by your trading desk and your broker? YES/NO

b) When was this system introduced?

c) How often does this broker review take place?

31) a) Do you have a system by which fund managers regularly review research from individual brokers and analysts? YES/NO

b) When was this system introduced?

c) How often does this broker review take place?

32) a) For the systems referred to in Q29 and Q30; are audit trails in place?

b) Are your findings from these systems shared with your pension fund clients?

Part 5—Other questions

Questions on disclosure

33) Will you meet the disclosure requirements in COB 7.18 by using the IMA Disclosure Code (2nd Edition)? YES/NO

If YES, when did you first adopt the IMA Disclosure Code (either the 1st or 2nd Edition)?

.....

If NO, how will you meet the disclosure requirements in COB 7.18?

.....

34) How many of your institutional clients have asked for regular feedback on measures of execution quality for the following years?

	In 2004	In 2005	Have already asked for 2006
Less than 25%			
Between 25% and 50%			
Between 50% and 75%			
More than 50%			

Mergers and acquisitions

35) To ensure consistency of data across time, please provide details of any fund management mergers or acquisitions in which your company has been involved since 2001, including the dates these mergers or acquisitions were completed.

.....

Any additional comments

36) Are there any comments that you would like to add, with regard to the information provided in this questionnaire, or on the implementation of the new rules?

.....

If you have more detailed comments that you would like to discuss directly, please outline your comments and provide relevant contact details.

.....

Appendix 4 Brokers questionnaire

Oxera has been commissioned by the Financial Services Authority (FSA) to conduct research for its assessment of the changes introduced in January 2006 with respect to soft commission arrangements and bundled brokerage services. The aim of this survey is to elicit data on soft commission and bundled brokerage arrangements prior to the implementation of the new regime—this will enable the FSA to construct the baseline.

Instructions

Please fill in the questionnaire and send it to one of the addresses provided below. The deadline for completion of the questionnaire is March 10th 2006. When completing the questionnaire, we would appreciate it if you would bear in mind the following.

- Please enter all monetary values in a consistent currency, as selected in Part 1.
- Please enter all data in full and without abbreviations—ie, without abbreviating \$1,000,000 to \$1m.

Base for completion

Unless stated otherwise in the question, the base for answering questions within this questionnaire is all UK equity trades (ie, trades in equities listed in the UK) carried out for UK fund managers—ie, pure hedge funds, long-only funds and combinations of hedge funds and long-funds.

Please complete this questionnaire by providing data on a calendar year basis.

Availability of data

Many of the questions ask for data going back to 2001. Please provide data going back as far as possible, where reliable data is available.

Mergers and acquisitions

If your brokers have been affected by mergers or acquisitions since 2001, please give consolidated data for all parties for years prior to the merger or acquisition. Please give details of these mergers or acquisitions in Part 4.

Contact details

Please send the questionnaire to one of the following:

By email: FSA@oxera.com
By fax: +44 (0) 1865 204 606
By post: Oxera, Park Central, 40/41 Park End Street, Oxford, OX1 1JD

If you have any questions regarding the survey please contact either:

Reinder van Dijk (Project Manager) **Anthony Maidment (Analyst)**
Tel: +44 (0) 1685 253 000 Tel: +44 (0) 1865 253 000

Additional comments

There is scope to make additional comments on this questionnaire or the implementation of the new rules on soft commission and bundled brokerage arrangements, provided in Part 4. If you would like to make more detailed comments, please contact Reinder van Dijk or outline your comments and leave contact details for how we may contact you.

Thank you for taking part in this survey—your contribution is greatly appreciated.

Confidentiality of information

Individual responses to the questionnaire will be kept by Oxera and only presented to the FSA in an aggregated and non-attributable form. We operate under the requirements of an FSA confidentiality agreement and will treat all information received from firms in the strictest confidence.

Part 1 Background information

- ix) Name of firm:
- x) Your name:
- xi) Your position:
- xii) Your contact details
 Email address:
 Telephone number:
 Address:

Please indicate below which currency you will use to report financial information in this questionnaire.

- sterling
- US dollars
- euro

Part 2 General questions

- 1) In 2005, what was the approximate value of the broker commission revenues (excluding stamp duty) from total UK cash equity trades for UK based fund managers from your company's/group's brokerage activities (if your company/group is multinational, please give information on the business executed by your UK-regulated entity only)?

- 2) What was the total value of orders of UK cash equities from UK-based fund managers in 2005?

- 3) In the table below, please give an approximate breakdown of your total UK cash equity trades for UK clients, broken down by type of UK client that sends the trade order directly to you (ie, the immediate order passer).

Proportion (by value) of your total cash equity trade orders sent by:

Pure hedge funds	
Others fund managers	
Retail brokers	
Private investors	
Other brokers/market counterparties	
Total	100%

- 4) How many UK-based fund managers do you have as clients, for each of the following types?

Pure hedge funds	
Long-only funds	
Hybrid funds (ie, combination of pure hedge funds and long-only funds)	

- 5) What proportion (by value) of your cash equity trades for UK-based fund managers is undertaken on a commission basis (as opposed to a 'net' basis) for each of the following years?

2005	
2004	
2003	
2002	
2001	

- 6) Please complete the following table relating to client facilitation trades (ie, those that use your capital) in UK equity trades for UK fund managers over the last five years.

	a) Proportion of total UK equity trades for UK fund managers that are client facilitation trades	b) Proportion of client facilitation trades that are conducted on a 'net' basis	c) Proportion of client facilitation trades that are conducted on a commission basis
2005			
2004			
2003			
2002			
2001			

- 7) In 2005, was the loss ratio taken into account when negotiating the execution commission rate with your fund manager? YES/NO

If YES, for each of the last five years, how much of the execution commission rate was due to the loss ratio, by basis points?

2005	
2004	
2003	
2002	
2001	

Will you take the loss ratio into account when negotiating the execution commission rate with your fund managers in 2006? YES/NO

- 8) What proportion (by value) of your total trading business in UK equities for UK fund managers did you transact under the following categories for 2001–05? Please provide an estimate for 2006.

	2001	2002	2003	2004	2005	2006 (estimate)
Programmed trades						
DMA						
Algorithmic						
Buy-side trade managed sales trading service						
Broker discretion sales trading service						
Sell-side trade managed sales trading service						
Liquidity (capital commitment)						
Bundled brokerage (up to 2005)						
Other (eg, crossed internally, other trading platforms)						
Total						

- 9) Please rate the importance of the following factors in how your company's brokerage arm competes with other brokers for business from fund managers.

**Level of importance:
unimportant/somewhat
unimportant/reasonably important/
important/very important**

Execution quality	
Commission rates	
Liquidity	
Access to multiple markets	
Availability of non-execution goods and services	
Availability of in-house research	
Access to in-house analysts	
Access to IPOs	
Expertise in specific markets or specific types of securities	
Other: please specify	

- 10) In 2005, approximately what proportion of your total staff costs at the global level relate to the creation of, and dissemination to, research (as defined by the FSA in COB Section 7.18) for all fund managers?

.....

What proportion of these costs related to the creation of, and dissemination to, research for UK fund managers?

- 11) In 2005, approximately what proportion of your total staff costs in the UK directly related to the process of trade execution for UK fund managers?
.....
- 12) In 2005, what was the total value of goods and services consumed by your UK fund managers using soft commission arrangements with your brokerage firm?
.....
- 13) Approximately what proportion of these credits was spent on independent third-party research (as defined by the FSA in COB Section 7.18)?
.....
- 14) For each of the following UK markets in which you traded in 2005, how would you describe the liquidity of each market?

	Description of market liquidity: Poor/Somewhat poor/Reasonable/ good/Excellent	What do you perceive has been the trend over the last three years? (Better/Same/Worse)
FTSE 100		
FTSE 250		
FTSE 350		
FTSE Small Cap		

Part 3 Arrangements with fund managers

- 15) Please complete the table below, with respect to commission rates charged to a typical UK fund manager that sent you UK cash equity trades with a gross turnover of £250m a year.

	2001	2002	2003	2004	2005	2006
Programmed trades						
DMA						
Algorithmic						
Buy-side trade managed sales trading service						
Broker discretion sales trading service						
Sell-side trade managed sales trading service						
Liquidity (capital commitment)						
Bundled brokerage (up to 2005)						
Other (eg, crossed internally, other trading platforms)						

- 16) What is a typical 'execution-plus' commission rate charged to a typical UK fund manager that sent you UK cash equity trades with a gross turnover of £250m a year?

How is this derived? Please describe in general terms.

- 17) Please complete the table below, with respect to commission rates charged to a typical UK fund manager in 2005 for UK cash equity trades of the following values.

	a) Average execution-only commission rate	b) Average bundled brokerage commission rate	c) Average commission rate
£500m			
£250m			
£100m			

- 18) Please complete the table below with respect for UK cash equity trades conducted for all UK fund managers

	a) % by value of transactions conducted on an execution-only basis	b) Average execution-only commission rate	c) % by value of transactions conducted on the basis of a bundled commission rate	d) Average bundled brokerage commission rate	e) Total value of UK fund manager transactions
2005					
2004					
2003					
2002					
2001					

- 19) In 2005, how many UK fund managers did you supply with research services, independently from trade execution services?

On what basis did you offer to supply such services?

Please describe in general terms

- 20) Up to February 2006, how many UK fund managers have you supplied with research services, independently from trade execution services?

On what basis have you/will you offer to supply such services?

Please describe in general terms

- 21) With how many fund managers have you already agreed the budget for research provided by your analysts for 2006?

22) Thinking of your relationships with UK fund managers in 2006, please fill in the following table relating to how many fund managers you have agreed the following types of relationship with.

	With your top 10 UK fund managers		With your other UK fund managers	
	With a commission-sharing arrangement	Without a commission-sharing arrangement	With a commission-sharing arrangement	Without a commission-sharing arrangement
Both execution-plus and execution-only (both types) transactions				
Execution-plus transactions				
Execution-only transactions				

By definition, a commission-sharing arrangement involves an execution-plus commission rate, because part of the commission rate is for research rather than for execution services.

23) In 2006 have you/will you set access to your research services for your brokerage clients as a fixed basis points of the brokerage commission? YES/NO

- a) If YES, does the level of the fee vary between fund managers reflecting their use of your execution services? YES/NO
- b) If NO, what is the general basis you use to set the price of your research services? Please describe.

.....

Any additional comments

24) To ensure consistency of data across time, please provide details of any mergers or acquisitions of brokers in which your company has been involved since 2001, including the dates these mergers or acquisitions were completed.

.....

25) Are there any comments that you would like to add; with regard to the information provided in this questionnaire or on the implementation of the new rules?

.....

If you have more detailed comments that you would like to discuss directly, please outline your comments and provide relevant contact details.

.....

Appendix 5 Supplementary fund managers questionnaire

The supplementary fund managers questionnaire was only available in an Excel format, and appeared as shown in Tables A5.1.1 and A5.1.2. The highlighting indicates where fund managers were asked to provide data. The non-highlighted cells contain formulae to calculate values, commission rates or proportions, which were visible in the questionnaire to allow the calculation of these values, commission rates or proportions as fund managers completed the questionnaire.

Table A5.1.1 Supplementary fund managers questionnaire

Supplementary questionnaire on soft commissions and bundled brokerage

The base for this questionnaire is consistent with Q17 from the original questionnaire—ie, the base should be the total UK equity market trading activity for all funds managed in the UK for pension fund clients. Therefore, the funds under management should be funds managed on behalf of pension funds (regardless of domicile) in UK equities (as determined by listing), and the remainder of the supplementary questionnaire is with respect to trading activity for these funds

Company name:	
Please indicate with which currency this questionnaire is filled in:	

Table A5.1.2 Supplementary fund managers questionnaire

		2003	2004	2005
A1	Total funds under management			
A2	Total value of trades transacted			
A3	Gross turnover ratio			
A4	Total value of trades transacted on a net basis			
A5	Total value of trades transacted on a commission basis			
A6	Net turnover ratio (ie, for commission trades)			
A7	Total value of broker commission paid			
A8	Total value of programme trades			
A9	Average commission rate on programme trades			
A10	Total spent on commissions on programme trades			
A11	Total value of execution-only trades			
A12	Average commission rate on execution-only trades			
A13	Total spent on commissions on execution-only trades			
A14	Total value of bundled trades			
A15	Average commission rate on bundled trades			
A16	Total spent on commissions on bundled trades			
A17	Proportion of bundled trades that were softed			
A18	Value of trades that were softed			
A19	Commissions spent on brokerage earning soft commissions			
A20	Soft commission multiple			
A21	Total value of soft commissions spent on goods and services			
A22	Proportion of bundled trades that were not softed			
A23	Value of trades that were bundled			
A24	Commissions spent on brokerage that did not earn soft commissions			
A25	Total spent on goods and services with soft commissions			
A26	Total spent on research goods and services with soft commissions			
A27	Proportion of soft commissions spent on research			
A28	Total spent on execution-related goods and service with soft commissions			
A29	Proportion of soft commissions spent on execution-related goods and services			
A30	Total spent on non-permitted goods and services with soft commissions			
A31	Proportion of soft commissions for non-permitted goods and services			
A32	Average commission rate on bundled brokerage			
A33	Proxy execution constituent of bundled brokerage commission rate			
A34	Proxy non-execution constituent of bundled brokerage commission rate			
A35	Proportion of bundled brokerage commission rate for execution			
A36	Proportion of bundled brokerage commission rate for non-execution			
A37	Total spent on goods and services through bundled brokerage			
A38	Proportion of bundled brokerage for research			
A39	Total spent on research goods and services through bundled brokerage			
A40	Proportion of bundled brokerage for execution-related goods and services			
A41	Total spent on execution-related goods and services through bundled brokerage			
A42	Proportion of bundled brokerage for non-permitted goods and services			
A43	Total spent on non-permitted goods and services through bundled brokerage			
A44	Total spent on research/analysis paid for by hard cash			
A45	Total spent on execution-related goods and services paid for by hard cash			
A46	Total spent on non-permitted goods and services by hard cash			
A47	Cost of research produced in-house			
A48	Total spent on research goods and services			
A49	Total spent on execution-related goods and services			
A50	Total spent on non-permitted goods and services			

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