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ASSESSMENT OF THE ECONOMIC IMPACT OF IMPLEMENTATION OF THE PROPOSALS CONTAINED WITHIN FSA CONSULTATION DOCUMENT CP176 WITH REFERENCE TO INCUMBENT FUND MANAGERS' ABILITY TO COMPETE IN THE UK MARKET

APRIL 2004

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GLOSSARY

The following abbreviations are used in this report:

“BP”	*Basis Point*
“CFD”	*Contract For Difference*
“COBS”	*Conduct of Business Sourcebook*
“EAD”	*Earnings After Depreciation*
“FSA”	*Financial Services Authority*
“FUM”	*Funds Under Management*
“GDP”	*Gross Domestic Product*
“GVA”	*Gross Value Added*
“HMCE”	*HM Customs & Excise*
“IFSL”	*International Financial Services London*
“IMA”	*Investment Managers Association*
“LSE”	*London Stock Exchange*
“MPIS”	*Market Pricing and Information Services*
“ONS”	*Office of National Statistics*
“SEC”	*Securities and Exchange Commission*
“SRO”	*Self Regulatory Organisation*
“TER”	*Total Expense Ratio*

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This report (the “Report”) has been prepared by Deloitte & Touche LLP (“Deloitte”) for the FSA alone in order to inform it of incremental costs that may be incurred by the UK fund management industry as a result of the adoption of proposals contained within FSA Consultation Paper CP176.

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1. Executive Summary

1.1 Introduction

Deloitte has been commissioned by the Financial Services Authority (FSA) to assess the potential impact on the UK fund management industry of the FSA's policy proposals ("the Proposals") concerning soft commission arrangements and bundled brokerage services contained in FSA Consultation Paper CP176. The stated aim of CP176 is to increase transparency and accountability to the customers of fund managers by:

- limiting the goods and services, beyond trade execution, that can be bought using "soft credits"; and
- mandating that the cost of acquiring non-execution services in a package along with trade execution should not be passed through automatically by fund managers to their customers' funds.

The FSA requested that we address two possible impacts of its Proposals:

- incremental costs that may be incurred by the UK-regulated fund management industry as a result of the implementation of one or both proposals contained in CP176; and
- the extent to which incremental costs that are incurred may lead fund managers to exit the UK market, either by relocating operations serving UK customers overseas, selling assets managed in the UK, or closing their UK operations.

We have also undertaken an indicative analysis of the effect that relocation and exit decisions may have on UK GDP.

1.2 Our approach

In order to develop estimates of the source and magnitude of incremental costs that may be incurred by UK fund managers, and their potential strategies in response, we:

- were granted access to a subset of CP176 consultation responses;
- developed hypotheses relating to types of incremental costs that may be incurred by fund managers;
- developed a market segmentation model;
- developed and forwarded questionnaires to fund managers, brokers and industry associations and used these as the basis for interviews with respondents and others; and

¸ obtained industry data from a variety of external sources.

Further detail on our approach can be found at Section 2.4 below. Information sourced in line with this approach consists of data obtained from a number of sources. While we believe this to be reliable, we have in most cases not sought to verify it. Our analysis also depends on opinions expressed to us by fund managers, brokers and others which we have in some cases sought to challenge, validate or supplement using our knowledge of the fund management market.

1.3 Size of the market for softed and bundled services

Using three alternative potential methods, we estimate the size of the market for softed goods and services in 2002/03 to be between £105m and £125m. Within this, we estimate the size of the market for softed Market Pricing and Information Services (MPIS), the focus of Proposal 1 of CP176, to be between £50m and £59m. The size of the market for bundled goods and services is estimated at between £653m and £780m.

Taking into account fund managers' predictions relating to the lower quantity and value of services purchased if the Proposals are implemented, we estimate aggregate cost savings for consumers resulting from altered purchasing patterns following implementation ranging from £61m to £116m.

See Section 3 for further detail on the above estimates.

1.4 Segmentation of the fund management market

To inform our analysis of costs impacting different types of fund management companies, we divided the market into size segments comprising:

1. Large fund managers: over £50bn of Funds Under Management (FUM)

2. Medium-sized fund managers: between £5bn and £50bn of FUM

3. Small fund managers: less than £5bn of FUM

For some analyses, these are further divided into the following sub-segments:

1. Large, UK focused
2. Large, non-UK focused
3. Medium, UK focused
4. Medium, non-UK focused
5. Small, UK focused with above average operating performance*
6. Small, non-UK focused with above average operating performance*
7. Small, UK focused with below average operating performance*
8. Small, non-UK focused with below average operating performance*

* Performance is measured in terms of 2002/03 margins. Derivation of margins data is discussed at Section 6.8.

1. EXECUTIVE SUMMARY

When assessing strategies available to fund managers if the Proposals are implemented, we include hedge funds as an additional sub-segment in recognition that their operating models, level of charges and other factors distinguish them from other small and medium-sized fund managers.

See Section 4 for further detail on this model of segmentation.

1.5 Potential incremental cost impact of the Proposals

Using 2002/03 financial information from an FSA database containing 443 fund management companies, around 73% of the UK fund management market, summary estimates of the margins impact[1] of potential incremental costs incurred by each of the above market segments following implementation of CP176 are shown in the table below. These are based on market analysis, questionnaire returns and interviews with fund managers, brokers and industry associations regarding potential changes to commission levels and patterns of demand for non-execution services, and fund managers' ability to recover incremental costs from customers.

Table 1.1 - Summary of Deloitte analysis of potential margins impact:

Average impact on	Margin 2002/03		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Total market	**13.47%**	**13.85%**	**8.01%**	**10.47%**	**(5.45%)**	**(3.38%)**
Large	**12.30%**	**12.31%**	**6.71%**	**9.47%**	**(5.60%)**	**(2.84%)**
Large UK	5.03%	6.06%	(3.14%)	0.30%	(8.17%)	(5.76%)
Large non-UK	16.67%	17.03%	13.72%	15.18%	(2.95%)	(1.85%)
Medium	**15.17%**	**17.32%**	**11.64%**	**14.46%**	**(3.53%)**	**(2.86%)**
Medium UK	21.17%	22.77%	17.63%	19.97%	(3.54%)	(2.80%)
Medium non-UK	12.60%	15.04%	9.08%	12.16%	(3.52%)	(2.88%)
Small	**10.14%**	**13.90%**	**2.04%**	**9.47%**	**(8.10%)**	**(4.43%)**
Small UK1	43.22%	46.08%	32.93%	40.85%	(10.30%)	(5.22%)
Small UK2	(7.00%)	(6.94%)	(19.45%)	(12.69%)	(12.45%)	(5.75%)
Small non-UK1	42.80%	45.84%	27.04%	40.09%	(15.76%)	(5.75%)
Small non-UK2	(2.14%)	(0.98%)	(7.91%)	(4.29%)	(5.77%)	(3.32%)

Key: Small 1 = Above average margins 2002/03

Small 2 = Below average margins 2002/03

Source: Deloitte analysis

Margins for the industry as a whole are estimated to fall by between 3.4 and 5.2 percentage points. The least impact is anticipated on the medium segment, and the most on the small segment, where the potential impact ranges from 4.8 to 7.5 percentage points.

[1] See Section 6.8 for a detailed description of the derivation of margins data. As an element of depreciation is contained in the cost data, revenues less costs relates to what may be termed Earnings After Depreciation ("EAD") rather than operating profit, and thus margins will understate operating margins. As 2002/03 represented the nadir of the global bear market, margins analyses shown are likely to understate average industry margins over an investment cycle.

We converted the estimates above into an analysis of the number of companies that may have experienced positive and negative margins if CP176 had been implemented in 2002/03. This is shown in the table below.

Table 1.2 - Analysis of positive and negative margins based on Deloitte cost impact assessment

	No. of firms	% of total FUM	Firms with positive margin 02/03	% of segmen t FUM	Firms with negative margin 02/03	% of segment FUM	Firms whose margin may have become negative because of CP176			% of segment FUM			% of firms that may have experienced negative margin following implementation of CP176 (as % of segment FUM)		
							Worst		Best	Worst		Best	Worst		Best
Total	**443**	**100%**	**327**	**79%**	**116**	**21%**	**107**	**-**	**83**	**16%**	**-**	**5%**	**37%**	**-**	**26%**
By segment															
Large	**11**	**46%**	**9**	**79%**	**2**	**21%**	**2**	**-**	**0**	**21%**	**-**	**0%**	**42%**	**-**	**21%**
Large UK	6	29%	4	67%	2	33%	2	-	0	27%	-	0%	60%	-	33%
Large Non-UK	5	17%	5	100%	0	0%	0	-	0	0%	-	0%	0%	-	0%
Medium	**48**	**42%**	**35**	**81%**	**13**	**19%**	**5**	**-**	**3**	**14%**	**-**	**5%**	**33%**	**-**	**24%**
Medium UK	14	13%	12	94%	2	6%	1	-	1	9%	-	9%	15%	-	15%
Medium Non-UK	34	29%	23	76%	11	24%	4	-	2	12%	-	2%	36%	-	27%
Small	**384**	**13%**	**283**	**72%**	**101**	**28%**	**100**	**-**	**80**	**42%**	**-**	**32%**	**70%**	**-**	**60%**
SmallUK1	103	3%	103	100%	0	0%	5	-	3	9%	-	7%	9%	-	7%
SmallUK2	104	3%	62	63%	42	37%	45	-	38	49%	-	39%	85%	-	76%
SmallNon-UK1	66	2%	66	100%	0	0%	11	-	7	23%	-	11%	23%	-	11%
SmallNon-uk2	111	4%	52	44%	59	56%	39	-	32	37%	-	29%	94%	-	86%

Key: Small 1 = Above average margins 2002/03

Small 2 = Below average margins 2002/03

Source: FSA Database / Deloitte analysis

According to this analysis, of the 443 companies included in the FSA's database, a range of 83 to 107 out of 327 companies with a positive margin in 2002/03 may have been vulnerable to reporting a negative margin as a result of implementation of the Proposals at that snapshot in time (equal to 5% - 16% of total FUM), taking the number of firms with a negative margin up to a range of 199 to 223 (equal to 26% - 37% of total FUM).

See Section 6 for further detail on incremental costs that may be incurred by fund managers if the Proposals are implemented.

1.6 Net impact on customers

We examined the potential net impact on funds belonging to customers of fund managers if the Proposals are implemented resulting from the following factors:

- decreases to commission levels;
- changes to the size of the market for softed and bundled services; and

- fund managers' ability to recover incremental costs from customers through increased management fees.

The analysis is indicative of the financial impact on customers that may result from these factors. It is not intended to account for other types of impacts that may affect some but not all customers including:

- potential increased tax liability for some investment vehicles where management fees increase;
- changes to fund managers' trading behaviour or strategy; and
- changes in market structure (e.g. consolidation).

We accepted fund managers' views relating to factors analysed resulting from Implementation of Proposal 1. This resulted in a small aggregate estimated net cost spread across the customers of all UK-regulated fund managers of between £2.0m and £2.4m a year. This arises because fund managers may be able to recover a slightly higher level of costs from customers than the level of counteracting falls in commission obtained from brokers by fund managers on their customers' behalf. However, this trade-off between commissions and cost recovery could easily swing in the opposite direction, and may also be affected by decisions to implement the Proposals simultaneously or individually, as fund managers may be more able to recover the entire value of non-execution services foregone through lower commissions (if both proposals are implemented), than to recover the value of softed services alone (if only Proposal 1 is enacted).

We estimate a net customer impact ranging from a £24.1m net loss to a £290.9m net saving per annum resulting from Implementation of Proposal 2. This is derived from:

- a smaller estimated value of currently bundled non-execution services purchased and passed through to customers following implementation of the Proposals; and
- a higher estimated fall in commissions attributable to bundled services than the anticipated level of cost recovery of these services from customers.

The estimated impact of both proposals taken together ranges from a net cost of £26.1m to a net saving of £288.4m.

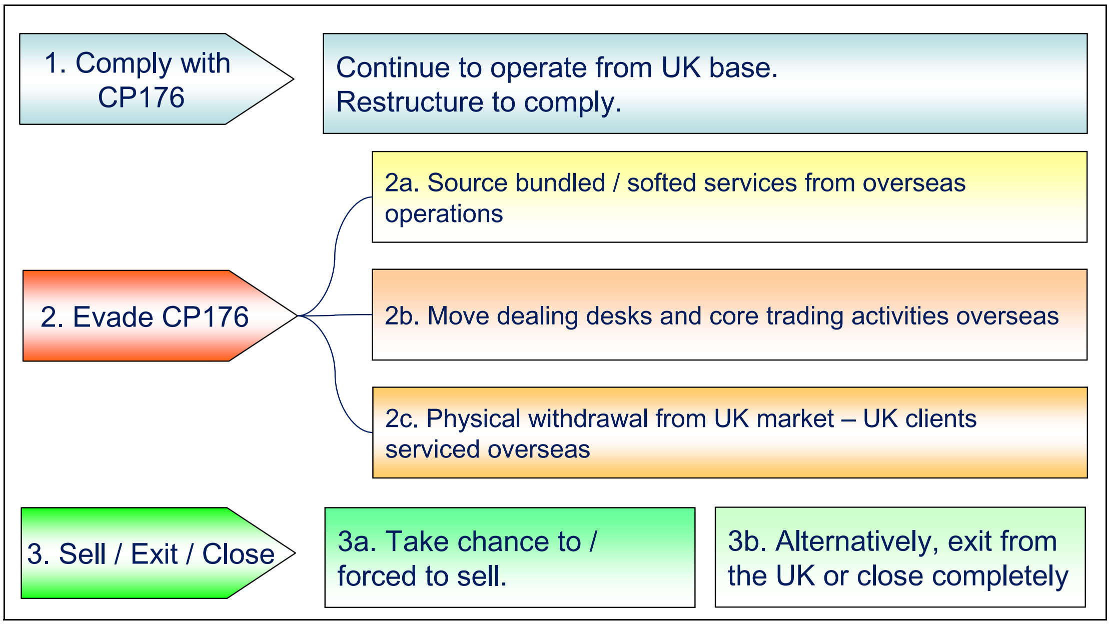
See Section 7 for further detail on the potential customer impact resulting from implementation of the Proposals.

1.7 Post-implementation strategies available to fund managers

The diagram below shows strategies available to fund managers if the Proposals are implemented:

1. Executive Summary

Figure 1.1 - Strategies available to Fund Managers



Strategy 1 above would be followed by fund managers in a position to fully comply with the Proposals, while strategies 2a and 2b imply a level of evasion, but should not result in assets leaving the UK market. However, strategies 2c (relocation), 3a (sale) and 3b (closure / exit) each result in the exit of FUM from the market.

In the table below we have input ranged probabilities of the likelihood of each segment and sub-segment adopting each strategy. These have emerged from discussions with fund managers, brokers and other industry stakeholders, questionnaire responses, market analysis and consultation responses sent by fund managers to the FSA. They are also influenced by the potential cost impact on each segment as detailed in Section 1.5 above.

Table 1.3 - Deloitte assessment of the probability of strategy adoption by segment

Segment /Strategy	1. Comply	2a. Source from overseas	2b. Partially relocate	2c. Relocate	3a. Sell	3b. Exit/Close
Adoption probabilities						
LargeUK	70% - 85%	15% - 25%	0% - 0%	0% - 0%	0% - 0%	0% - 0%
LargeNon-UK	45% - 55%	40% - 50%	0% - 10%	0% - 0%	0% - 0%	0% - 0%
Medium UK	90% - 100%	0% - 5%	0% - 0%	0% - 0%	0% - 5%	0% - 5%
MediumNon-UK	40% - 60%	10% - 30%	0% - 20%	5% - 15%	0% - 0%	0% - 0%
SmallUK1	60% - 80%	0% - 10%	0% - 0%	10% - 15%	0% - 6%	0% - 3%
SmallNon-UK1	40% - 50%	35% - 45%	0% - 0%	10% - 15%	0% - 5%	0% - 5%
SmallUK2	40% - 70%	5% - 10%	0% - 0%	5% - 10%	5% - 20%	5% - 15%
SmallNon-UK2	30% - 40%	15% - 25%	0% - 0%	20% - 30%	5% - 10%	5% - 20%
Hedge funds	65% - 90%	0% - 0%	0% - 0%	5% - 25%	0% - 5%	0% - 5%

Key: ***Small 1 = Above average margins 2002/03***

Small 2 = Below average margins 2002/03

Source: Deloitte analysis

See Section 8 for further detail on the strategies that may be followed by fund managers in response to implementation of the Proposals.

1.8 Potential impact on the UK fund management market

The probabilities shown above of the proportion of each market segment adopting the six possible strategies produce a range of potential FUM exit from £53bn to £142bn (2% to 5.5% of the market, estimated at £2,600bn at the end of 2002[2]). This incorporates a central case estimate of £97bn of funds (3.7%) exiting.

Of this range of estimated exit, £24bn-£80bn is managed by the segment of medium-sized fund managers and £28bn-£62bn by the segment of small fund managers. The highest level of potential exit is among the small non-UK below average performance sub-segment (SmallNon-UK2), in which an estimated range of between 16.5% and 31.4% of FUM may exit.

See Section 9 for further detail on the impact on the UK fund management market resulting from the level of FUM exit estimated above.

1.9 Impact on the UK economy: An indicative assessment

A high-level indicative analysis was carried out of the potential impact on the UK economy resulting from the above estimated range of FUM exiting the UK market following implementation of the Proposals

The level of estimated exit would result in a direct loss of Gross Value Added (GVA) to the economy. An indirect loss also occurs resulting from the knock-on effects on other parts of the supply chain and related industries of a reduced level of employment in the fund management market. Taking each of these effects into account, the total level of GVA loss may be estimated at between £321m and £819m, representing between 0.035% and 0.090% of UK economy GVA (£910bn in 2002/03).

GDP is obtained from GVA by adding taxes paid to and subtracting subsidies received from the Government. As industry-level economic activity is not normally expressed in terms of GDP, the ratio of industry GVA lost to whole-economy GVA is more meaningful than comparing industry GVA with whole-economy GDP. However, for completeness, both ratios are noted in the table below which indicatively shows the impact on the UK economy of the potential level of FUM exit estimated above.

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2 Fund Management, IFSL, 2003.

Table 1.4 – FUM Exit as proportion of 2002/2003 GDP

	Low case (£m)	Central case (£m)	High case (£m)
GVA exiting the economy	321	578	819
2002/03 GVA		909,827	
Exit as proportion of 2002/03 GVA	0.035%	0.064%	0.090
2002/03 GDP		1,054,061	
Exit as proportion of 2002/03 GDP	0.030%	0.055%	0.078%

Source: Deloitte analysis

See Section 10 for further detail on our indicative assessment of the impact on the UK economy resulting from the level of FUM exit estimated above.

2. INTRODUCTION

2.1 Background and scope

Deloitte has been commissioned by the Financial Services Authority (FSA) to assess the potential impact on the UK fund management industry of the FSA's policy proposals concerning soft commission arrangements and bundled brokerage services contained in FSA Consultation Paper CP176. The FSA has specifically requested that we address two possible impacts of its proposals:

- incremental costs that may be incurred by the UK-regulated fund management industry as a result of the implementation of one or both proposals contained in CP176; and
- the extent to which incremental costs that are incurred may lead fund management companies to exit the UK market, either by relocating operations serving UK customers overseas, selling assets managed in the UK, or closing their UK operations.

We have also undertaken an indicative analysis of the effect that relocation and exit decisions may have on UK GDP.

The scope of this report excludes:

- an analysis of costs that may fall on closely related industries (e.g. brokerage);
- the extent to which best execution and the rules governing soft commission are currently dealt with by rules contained within the FSA's Conduct of Business Sourcebook (COBS); and
- consideration of the issue of ease of implementation and enforcement of the proposals contained within CP176.

In carrying out the analysis, and following discussions with the FSA, we have conducted the study on the assumption that, if CP176 is implemented, it will apply to all fund managers regulated in the UK. Thus, the location of customers will not influence the applicability of the regulation to UK fund managers (though the locational mix of clients is likely to influence strategies followed by fund managers following implementation). Under this assumption, re-domiciling funds overseas would not be an effective evasion strategy, and has therefore not been examined in detail in this report.

2. INTRODUCTION

2.2 Proposals contained in CP176

The FSA's stated aim In the above consultation paper is to increase the transparency of transactions carried out on customers' behalf, and the accountability of fund managers to their customers by implementing the following proposals ("the Proposals"):

Proposal 1:

Limit the goods and services, beyond trade execution, that can be bought in the first instance with commission or order flow. The purchase with soft credits of Market Pricing and Information Services (MPIS), such as dealing screens, would be specifically prohibited.

As part of its consultation process, the FSA also sought views on whether the purchase of other services, such as computer hardware and software, other equipment and custody services should be prohibited using soft credits.

Proposal 2:

Mandate that the cost of acquiring non-execution services in a package along with trade execution should not be passed through automatically by fund managers to their customers' funds. This would apply in particular to the use of commission to buy investment research.

The unbundling of execution and non-execution services is not mandated under this proposal though this is one possible outcome. Alternatively, fund managers may continue to buy bundled services, rebate the non-execution portion of these to their customers' funds, and attempt to recover the cost of the purchase through a higher management fee or explicit charges.

2.3 Objectives of the study

Among themes raised by fund managers that contributed to the FSA's consultation process following its publication of CP176, it was claimed that the proposals would result in UK fund managers incurring additional costs such that the industry's international competitiveness would decline. Specifically, it was alleged that the prohibition of automatic cost pass-through to customers for softed and bundled goods and services may have such a large impact on firms' operating costs that it could make UK fund management more expensive, or otherwise less attractive, than that of other jurisdictions, particularly for overseas customers, small companies, and new entrants. As a result fund managers may be incentivised to re-locate to jurisdictions other than the UK.

The purpose of this report is to assess the potential cost impact on UK fund managers of the Proposals and whether this might be significant enough to influence decisions around the location of fund management activities in the UK.

2. INTRODUCTION

2.4 Our approach

In order to develop estimates of the source and magnitude of incremental costs that may be incurred by UK fund managers, and their potential strategies in response, we adopted the following approach:

- we were granted access to around 50 of 150 consultation responses to CP176 that were sent to the FSA by fund managers and brokers. These were chosen by the FSA as being the most relevant and important responses, and as representing a cross-section of opinion forwarded by fund managers, brokers and others;
- in light of views on the source and magnitude of incremental costs put forward in these responses, we developed a number of cost hypotheses, each of which dealt with one or a number of potential incremental costs that might arise from implementation of the FSA's proposals;
- a market segmentation model based on size and geographic focus was developed to assess the differing potential impacts on different segments of the industry, and the strategies open to companies in each segment in response;
- the cost hypotheses were used as the basis for the development of separate questionnaires sent to a cross-section of fund managers to ensure segmental coverage (the "fund managers questionnaire"), and to several brokers and industry associations;
- when questionnaires were complete, each respondent was interviewed to discuss and test the information provided. Interviews were also carried out with companies recommended by the Investment Management Association (IMA) or which had contacted the FSA directly. In total, 24 fund managers were interviewed and 18 questionnaire returns were received, representing around 30% of Funds Under Management (FUM) in the UK fund management industry. Twelve other interviews were also carried out with brokers, industry associations and research companies, and;
- industry data was obtained from a variety of external sources.

In adopting the approach set out above, the information contained in this Report relies on data obtained from a number of sources. While we believe this to be reliable, we have in most cases not sought to verify it. Our analysis also depends on opinions expressed to us by fund managers, brokers and others which we have in some cases sought to challenge, validate or supplement using our knowledge of the fund management market.

2.5 Structure of the report

The remainder of this report is structured as follows:

2. INTRODUCTION

Section 3 contains an indicative estimate of the size of the market for softed and bundled services in the UK.

Section 4 introduces our method of segmenting the UK fund management market in order to assess the ways in which incremental costs may affect each segment, and the strategies available to each segment in response to the Proposals.

Section 5 examines the potential mechanism of implementation of Proposal 2 of CP176, in particular the way that non-execution services may be purchased by fund managers and charged to customers.

Section 6 considers the potential incremental cost impact of the Proposals on each segment of the industry.

Section 7 assesses the potential net impact of the Proposals on customers' funds.

Section 8 examines the post-implementation strategies available to each segment of the industry, and the probability of adoption of each strategy on a segmental basis.

Section 9 assesses the potential impact on the fund management industry in terms of funds exiting the UK from adoption of strategies presented in Section 8.

Section 10 extends the analysis presented in Section 9 to arrive at an indicative estimate of the potential impact on the UK economy.

3. SIZE OF THE MARKET FOR SOFTED AND BUNDLED SERVICES

3.1 Introduction

In this section, we estimate the size of the UK market for MPIS as a subset of softed services, total softed services and bundled services. This analysis has been undertaken for three reasons:

- to inform the FSA as it seeks to fulfil its duty to take account of the principle of proportionality before implementing the Proposals;
- to inform and provide a check on our analysis of the potential cost impact resulting from implementation of the Proposals; and
- to provide a framework to facilitate the updating from 2000 to 2003 of the cost - benefit analysis relating to the Proposals undertaken by OXERA.[3]

The ranged estimate of market sizes given below should be seen as indicative due to a lack of available data that can be used to undertake a full analysis. We have estimated market sizes by using a "top-down" approach which:

- utilises three alternative methods to estimate the level of worldwide commissions paid by UK fund managers to brokers in 2002/03; and
- applies to this estimate the level of MPIS, total softed services and bundled services purchased as a proportion of total commissions.

We were unable to supplement this approach with a "bottom-up" analysis of the market. This might have been achieved by obtaining the value for MPIS provided to fund managers under softing arrangements by the main providers of these services. The total value of softed and bundled services could then be imputed from the value of MPIS by assessing the relative value of these services as a proportion of total commissions. This approach was not taken forward as:

- no definition of MPIS is currently available[4];
- feedback was received from providers of information services that the term MPIS may largely relate to low-value added data feeds previously provided to fund managers, rather than some of the smart research tools now on the market; and

3 "Cost-benefit analysis of the FSA's policy proposals on soft commission and bundling", OXERA (2003).

4 We have not sought to ascribe a definition to MPIS for the purposes of market sizing and assessing cost impacts of the Proposals in this report. We have instead relied on fund managers' perceptions of the value of MPIS that they receive as a proportion of the total value of services provided to them.

- the fragmentation of the market caused by increased provision of data services by investment banks[5] made the estimation of a total market value unrealistic in the time available.

Section 3.2 gives a summary of methods used to estimate total commissions paid by fund managers. Appendix 1 gives further detail on these approaches. Section 3.3 estimates the level of commissions attributable to MPIS, softed and bundled services as a proportion of total commissions. Section 3.4 combines these analyses to arrive at a ranged estimate of market sizes. It also presents an estimate of aggregate cost savings that may accrue from a fall in demand for these services if the Proposals are implemented as drafted.

3.2 Commissions paid by UK fund managers

We have used three methods to arrive at an estimate of worldwide commissions paid by UK fund managers in 2002/03. These are described in summary below and in detail at Appendix 1:

- Method 1: Value of equity trades - the total value of equity trades carried out for UK fund managers was estimated using data on the value of trades in UK equities from the London Stock Exchange (LSE), and data relating to the composition of managed equity funds per world trading region (e.g. Europe / US) from the IMA. This was then multiplied by average UK and overseas commissions data from Elkins McSherry to arrive at an estimate of UK fund managers' total worldwide commission payments.
- Method 2: Stamp duty take - statistics on 2002/03 stamp duty receipts from equity transactions were obtained from the Inland Revenue and used to impute 2003 commissions from UK-traded equities. Commissions relating to overseas equity trades were estimated as in the method above and added to UK commissions to arrive at a worldwide commissions total.
- Method 3: Fund activity analysis - a WM Company survey of the level of trading activity of pension fund equity holdings by world trading region was applied to IFSL and IMA statistics relating to total equity funds under management in the UK to arrive at a total value of worldwide trades placed for UK fund managers. As with the methods above, this was then multiplied by average commission levels to obtain a worldwide commissions total.

5 For example, the acquisition in April 2004 of Barra by Morgan Stanley Capital International Inc.

3.3 Non-execution services as a proportion of commissions

In order to estimate the size of the market for MPIS, softed and bundled services, the proportion of total commissions attributable to these services has been estimated. This allocation has been taken from the fund managers questionnaire which asked fund managers to assess the level of total commissions paid to brokers spent on:

- execution;
- working a trade;
- softed services; and
- bundled services.

Working a trade may be loosely described as the timed placement of different parts of a single order to achieve best execution. As such, it is generally considered to be inseparable from trade execution rather than a service bundled with it. To the extent that some brokers offer commission rates for execution-only services and a separate rate including the active working of trades, working a trade may be considered one of a menu of options offered alongside trade execution and thus on the broadest definition, part of a wider bundle. However, in the remainder of this report we have not included working a trade within our definition of the bundle as this aspect of the trade cannot be provided by a party other than that which executes the trade and so cannot be unbundled in the same way as other (non-execution) services provided by the broker.

Questionnaire respondents' division of commissions paid to brokers into the categories above are shown in Table 3.1. This splits out commission paid to UK and overseas brokers[6], shows an average weighted by the value of commissions paid to each, and compares the results with an earlier analysis undertaken by OXERA.[7]

Table 3.1 Components of commission spend

bps	OXERA	UK brokers	Overseas brokers	Weighted average
Average commission	14.0	14.9	21.2	16.6
Execution only	5-8	7.0	7.7	7.2
Working a trade	2-5	4.7	5.6	4.9
Soft commission	1.0	0.5	1.3	0.7
Bundled services	3.0	2.7	6.6	3.8

Source: Deloitte fund managers questionnaire

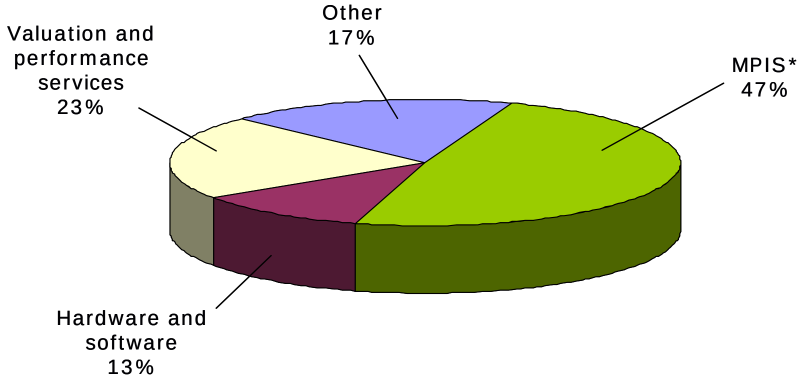
6 Overseas brokers will often be used to execute trades in overseas equities. Fund managers were asked for this split to gain an idea of the extent to which commission levels tended to differ between trades that take place in the UK and those executed overseas. Overseas trades may be executed in less liquid markets than the UK, raising commission levels. However, respondents' estimates indicate that they believe a higher value of bundled services also results from these trades.

7 "An assessment of soft commission arrangements and bundled brokerage services in the UK", OXERA (2003).

3 SIZE OF THE MARKET FOR SOFTED AND BUNDLED SERVICES

The table shows a good deal of similarity between our findings and those of OXERA, with the exception of the higher weighted average commission rate paid. The 0.8bp attributable to soft credits can be further split out between the goods and services below, as extracted from fund managers' responses to the questionnaire.

Figure 3.1 - Softed services received by fund managers, 2002/03

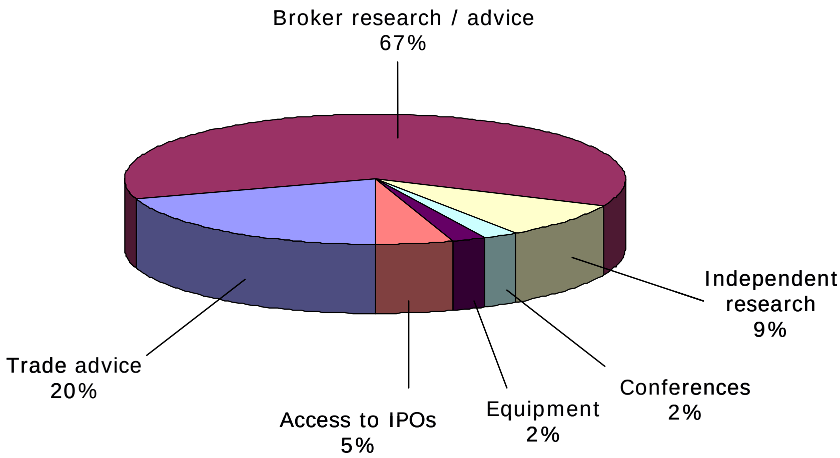


* In 2000 MPIS accounted for about 70% of softing

Source: Deloitte fund managers questionnaire

Respondents also estimated the proportion of bundled services attributable to research and other services.

Figure 3.2 - Bundled services received by fund managers, 2002/03



Source: Deloitte fund managers questionnaire

The above levels of MPIS, softed and bundled services received are summarised as a percentage of total commissions in Table 3.2 below.

Table 3.2 Proportion of commission spend on non-execution services

	Percentage of total
Proportion attributable to:	
MPIS	2%
Other soft commission	2%
Bundled services	23%
Total non-execution	**27%**
Execution/working a trade	**73%**
Total	**100%**

Source: Deloitte fund managers questionnaire

The value of MPIS and softed services can be established from the value of commissions attributable to these services by dividing by an average multiple which reflects the difference between services received and commissions paid. We have applied a multiple of 1.17 to arrive at the value of MPIS and softed services received.[8]

3.4 Estimated market sizes

Table 3.3 below shows estimates of the size of the markets for MPIS, softed and bundled services in 2002/03 by applying the proportion of commissions attributable to these services estimated at Section 3.3 to total worldwide commissions paid by fund managers estimated at Section 3.2.

Table 3.3 Estimated size of the markets for MPIS, total softed and bundled services in 2002/03

		Value £m		
	Total commissions (UK and overseas)	**MPIS**	**Softed services**	**Bundled services**
Proportion of commission attributable to		2%	2%	23%
Softing multiplier		1.17	1.17	
Commissions estimation method:				
1. Value of equity trades	*2,878*	*50*	*105*	*653*
2. Stamp duty take	*3,334*	*58*	*122*	*757*
3. Fund activity analysis	*3,435*	*59*	*125*	*780*

Sources: Fund managers questionnaire/LSE/IMA/IFSL/Inland Revenue/Elkins McSherry/WM Company

The low-case and high-case estimates above can be used to form a range of market sizes of £50m - £59m (MPIS), £105m - £125m (softed services) and £653m - £780m (bundled services). This produces an estimated size of the market for softed and bundled services ranging from £758m to £905m, equivalent to 26.3% of estimated total commissions which range from £2,878m to £3,435m.

8 This is taken from the OXERA report "An assessment of soft commission arrangements and bundled brokerage services in the UK", OXERA, (2003). This multiple applies to 2001. OXERA found the 2000 multiple to be 1.15, implying that it may be relatively stable over time.

3 SIZE OF THE MARKET FOR SOFTED AND BUNDLED SERVICES

The ranges of the size of the markets for MPIS and total softed services are below those estimated by OXERA in its cost-benefit analysis of the Proposals using 2000 commissions data. OXERA estimated a market for softed services of £160m of which £90m was attributable to MPIS. The ranged value of bundled services overlaps OXERA's estimated range of £500m - £720m.

Decreases in the volume and value of trading between 2000 and 2003 are likely to have had a significant downward impact on commissions paid and thus the market sizes for the above services since 2000. Our analysis partly offsets this effect by attempting to take account of trades in overseas equities placed away from the UK, which were not included in OXERA's estimates.

3.4.1 Aggregate cost savings resulting from changes in demand and price

Any fall in demand for non-execution services, and thus the value purchased, if Proposals 1 and 2 were implemented as drafted (e.g. Proposal 1 to incorporate a ban on the softing of MPIS only) results in aggregate cost savings to the purchasers of those services. As the Proposals aim to alter the automatic pass-through of the price of bundled services to consumers, this cost saving should accrue to consumers but will be dependent on the extent to which the value of services purchased can be recovered from them by fund managers. Less then 100% recovery will result in increased costs for fund managers and cost savings for consumers while more than 100% recovery will decrease fund managers' costs and increase consumer costs, offsetting any fall in the value of services purchased.

Questionnaire respondents forecast that, if the Proposals are implemented, an average 4% fall in the quantity of softed services purchased would result[9], while changes in price should not occur as softed services are generally purchased direct from suppliers in the UK, rather than bought in bulk by brokers, as in the United States. This reduction in demand results in an estimated range of cost savings to fund managers of between £2.0m and £2.4m (MPIS), and a range of £4.2m to £5.0m (all softed services).

Respondents were also asked to indicate the anticipated change in price and quantity of bundled services received following implementation of the Proposals.[10] Of those that were willing to estimate both, a 15% drop in the value of services received was reported on average. Of those that indicated changes in price or quantity but gave no answer for the other variable, and if no change is assumed for this variable, a 9% drop in the value of services received results. If these changes in demand and price are used to re-size the market for bundled services, cost savings of between £59m and £114m result. Total cost

9 20% of respondents predicted an average 20% fall in quantity of services purchased. 20% x 20% = 4%.

10 Price and quantity effects could occur in the same direction or different directions. Results are also complicated by 2nd order affects resulting from strategies adopted by fund managers following changed conditions in the research market (e.g. greater use of in-house research to gain a competitive advantage).

savings resulting from falls in demand forecast by fund managers are estimated at between £61m and £116m.

4. MARKET SEGMENTATION

4.1 Introduction

We have separated the UK-regulated fund management market into segments in recognition that it is not homogenous, but it is also not feasible to consider every fund manager in the UK individually. However, by grouping fund managers with similar characteristics into segments and sub-segments, each of these can be analysed separately to judge:

- potential costs arising from the Proposals, which will have a differential impact on different types of company (e.g. those with the smallest cost bases at present may have the greatest difficulties in absorbing extra fixed costs);
- the range of strategies, from compliance to market exit, available to each segment; and
- strategy selection from this range, which will differ by type of company and their position within the market.

4.2 Form of segmentation adopted

We segmented the market by the following characteristics:

- size;
- operational focus; and
- (for the small segment) operating performance.

In addition, hedge funds were analysed separately from other funds to take account of the different model of operations and charges employed by, and different strategies available to, these firms.

Segmentation by type of customer was also considered. For example, retail customers might be expected to respond to the Proposals in a different way to institutional customers; and life company customers may respond differently to pension fund customers. However, this was rejected as:

- around 94% of the customers of UK-regulated fund managers are institutional[11]; and
- a high degree of correlation was found to exist between type of customer and size (e.g. the largest fund managers tend to manage the bulk of the assets of the largest institutional customers).

4 MARKET SEGMENTATION

The definition of the segments was informed by consultation responses to CP176, interviews with fund managers and responses to the fund managers questionnaire. The allocation of individual companies to segments was generated using the FSA database of fund managers ("the FSA database"), and topped up with other publicly available data.[12]

4.3 Segmentation by size

Our primary form of market segmentation is by size and this was the main means of selection of the companies to which the fund managers questionnaire was sent. The other forms of segmentation described in this section are secondary to segmentation by size and thus compose sub-segments of the market.

If the Proposals are implemented, there are a number of reasons to believe that larger fund managers would be affected (and would act) differently to their smaller counterparts:

- it is believed by many that softing and bundling in the UK market results in the subsidisation of smaller fund mangers by their larger peers. Softing and bundling are also said to support the establishment of new fund managers by reducing the costs of start-up, or passing a proportion of these through to customers. Implementation of the Proposals may reduce or end such cross-subsidies, exacerbating any negative cost impact on smaller fund managers and new entrants;
- additional costs to fund managers arising from introduction of the Proposals may be less significant (as a proportion of total costs or FUM) for large fund managers compared to their smaller peers, and could therefore be more easily absorbed and/or represent a smaller proportionate impact on customers' fees;
- the size of a fund manager has some impact on its ability to re-negotiate competitive commissions with brokers and fees with customers; and
- smaller fund managers should be more flexible making it easier for them to quickly put into effect policy decisions which affect the whole business.

For all of these reasons, size may be the most significant factor determining the impact of the Proposals on individual fund management companies. We have allocated fund managers to three segments on the basis of FUM in 2002/03:

- large: greater than £50bn;
- medium: between £5bn and £50bn; and
- small: less than £5bn.

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[11] Fund Management Survey, IMA (2002).

[12] Most notably, Money Management, July 2003

The boundaries for these segmentation criteria were informed by interviews with fund managers and analysis of questionnaire responses.

4.4 Segmentation by operational focus

Relocation of operations to a territory outside the UK may be a feasible potential strategy available to UK-regulated companies if the Proposals are implemented as drafted. The ease with which this can be achieved will depend on a number of criteria, including:

- location of customer base - fund managers with a predominance of overseas customers may find it easier to switch their operations to another territory, and may risk losing some overseas customers if they do not do so. However, a fund manager with mainly UK customers may find it harder to explain to them why it is proposing to move away from the domestic market;
- location of offices - a global player may have offices in several continents and may therefore find it relatively easy to switch operations overseas, or to find other strategies to avoid or reduce the impact of CP176 on their costs and/or operations; and
- location of principal ownership - a fund manager with an overseas-domiciled parent will have access to overseas resources, and its parent may consider the UK a relatively minor part of its wider operations.

We have used the above criteria to inform our judgement of whether companies' operational focus is UK or overseas based. This allocation was informed by publicly available data, discussions with fund managers and our knowledge of the market.

4.5 Segmentation by operating performance

The Proposals may have the greatest impact, in terms of pressure on margins, on smaller fund managers (see Section 6.9.2 below). Whether these firms are able to continue operating in the UK will depend on the extent to which they can both pass on and absorb the cost of non-execution services, the latter of which is in turn dependent on their operating margin. Thus, we have further segmented the small segment according to margin[13]. We defined above average performers as those whose margin was above the FUM-weighted average margin (10%) for small fund managers (i.e. with FUM of less than £5bn) in 2002/03, and below average performers as those with a margin below this.

[13] See Section 6.8 for an explanation of the derivation of 2002/03 margins.

4.6 Hedge Funds

Responses to CP176 and interviews conducted with fund managers both highlighted ways in which customer relationships, level of charges, potential cost impacts, available strategies and their potential adoption differed for hedge funds compared to other fund managers. As little financial information exists for the majority of hedge-only funds, cost impacts have not been explicitly assessed for the segment, but hedge funds have been separately accounted for when assessing the availability and adoption of potential strategies in response to the Proposals.

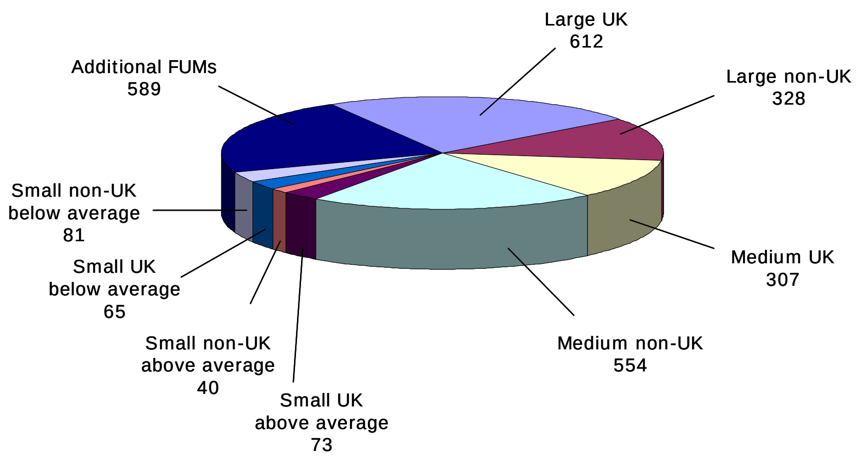
4.7 Summary of our segmentation model

The resulting segmentation model of the fund management market contains three size segments (large, medium and small) and the following nine sub-segments:

1. Large, UK focused
2. Large, non-UK focused
3. Medium, UK focused
4. Medium, non-UK focused
5. Small, UK focused with above average operating performance
6. Small, non-UK focused with above average operating performance
7. Small, UK focused with below average operating performance
8. Small, non-UK focused with below average operating performance
9. Hedge Funds

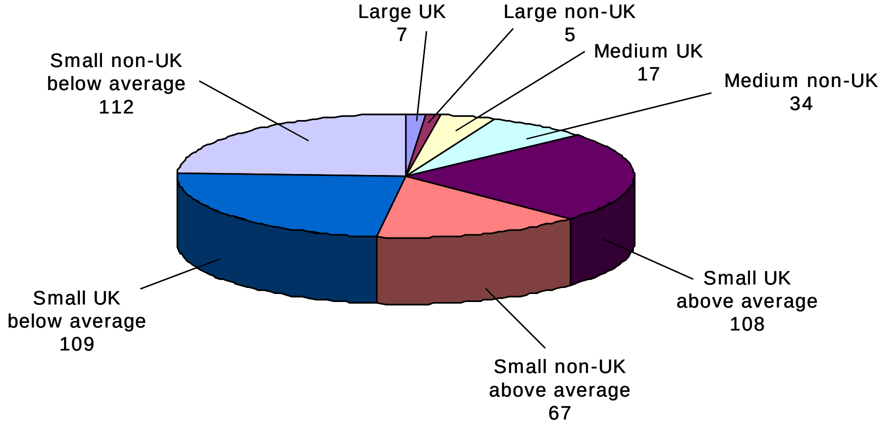
The figures below show composition of the market according to our segmentation model on the bases of FUM and the number of firms in each segment.

Figure 4.1 – Segmental composition of market by Funds under Management (£bn)



Source: Deloitte analysis

Figure 4.2 - – Segmental composition of market by number of firms



Source: Deloitte analysis

5. IMPLEMENTATION OF PROPOSAL II

5.1 Introduction

Proposal 2 of CP176 allows latitude for fund managers to:

- liaise with brokers to decide upon the most suitable method of acquiring non-execution services; and
- decide on the most appropriate way of passing through the cost of these services to customers (i.e. through explicit service charges or an increase in the management fee).

This section summarises the views of fund managers and brokers on market outcomes that might result from these choices.

5.2 Method of acquiring non-execution services

Proposal 2 suggests that fund managers might unbundle the purchase of non-execution from execution services, or alternatively continue to buy bundled services and rebate the non-execution portion of these to their customers' funds.

We asked fund managers and brokers to predict the practices they are most likely to adopt if the proposal was implemented out of the following five options:

A. Bundled execution and non-execution services, with fund managers rebating the non-execution element of these to customers.

B. Separated execution and non-execution services, where non-execution services are purchased for a single bundled price.

C. A menu of separately priced execution and non-execution services (e.g. a tariff pricing model).

D. A mixture of the above depending on broker / customer.

E. Some other arrangement.

5.2.1 Views expressed by fund managers

The table below shows the views expressed by fund managers in total and in each of the size segments introduced in the previous section. Half of the questionnaire respondents were willing to answer this question. Definitions of the large, medium and small segments are given in section 4 above.

Table 5.1 - Predicted method of acquiring execution services if Proposal 2 is implemented

Option	Total	Large	Medium	Small
A	15%	-	28%	-
B	20%	58%	7%	-
C	34%	8%	42%	50%
D	10%	25%	5%	-
E	21%	8%	18%	50%
Total	100%	100%	100%	100%

Source: Deloitte questionnaire

The table shows that a wide variety of views prevailed but, on average, the most popular view was that brokers would implement a tariff pricing system allowing maximum flexibility over the purchase of non-execution services. It should be noted that fund managers choosing this option may have interpreted a tariff pricing model as applying to either cash or commission as a means of paying for these services.

The relative lack of appetite for option A (bundling and rebating) appears to stem primarily from a fear that cost recovery of rebated services will be low. This fear rests on the premise that customers will be less willing, through an increased management fee or explicit charges, to return the purchase price of non-execution services to fund managers once rebated to their funds, than to pay for these services in an unbundled environment.

Among those fund managers that chose option B (the most popular option among the large segment), a model of non-execution purchase arose in which the fund manager is provided with separate bundles of execution and non-execution services, absorbs the cost of the non-execution bundle, and raises management fees to the extent necessary to maintain margins. In this way, the level of services (principally research) consumed is fed into the management fee and customers can choose whether this fee is merited by the performance of the fund manager.

5.2.2 Views expressed by brokers

Brokers were not prescriptive on the method by which fund managers may receive services, indicating that solutions are likely to be fund manager driven and as such a series of options may be available, rather than the imposition of a uniform solution on the market. A general preference was expressed for the provision of sub-bundles paid for through commission rather than services purchased for cash, however cash purchase of services was not dismissed. It was envisaged that a menu of choices, ranging from execution-only to full service brokerage would be available to fund managers, as currently offered by many brokers.

5 IMPLEMENTATION OF PROPOSAL

5.3 Method of charging for non-execution services

5.3.1 Views expressed by fund managers

Fund managers were asked whether they anticipated recapturing the cost of non-execution services through explicit charges for each service or bundle of services, or whether management fees would be raised to cover extra costs. Of those willing to answer the question, 50% said they would seek to raise their management fee, 38% indicated they would need to negotiate with customers to establish whether costs could be passed through and the appropriate method of doing so, while 12% responded that they would not be able to pass costs through as customers would not be willing to bear these charges.

6. POTENTIAL INCREMENTAL COST IMPACT OF CP176

6.1 Introduction

A large number of responses received by the FSA from fund managers in response to CP176 maintained that incremental costs would be incurred as a result of implementation, and that these costs could not be passed through to customers through explicit charges or an increase in the management fee. The three reasons stated most frequently for a rise in costs were:

- though softed and bundled services would no longer be received as part of a commission payment to brokers, commissions would not fall by the full value of services lost. Though this would represent a loss of value to the fund manager's customer, rather than the fund manager, it would lessen the likelihood of fund managers being in a position to recover the costs from customers of direct purchase of these services on their behalf;
- the cost of non-execution services, particularly research, would rise when provided separately from the execution element of the bundle and purchased either as a sub-bundle, or separately for commission or cash; and
- implementation of the Proposals would lead to substantial administration, Information Technology and customer relationship costs on an ongoing basis.

We look at the potential impact on each segment of the industry of these potential sources of incremental costs below, and examine the ability of each segment to pass them through to customers. To do this we look at the views expressed by fund managers from questionnaire responses and interviews. Where appropriate, we also note the opinion of brokers, trade associations and independent research companies.

Taking these views into account, we arrive at ranged conclusions on the potential incremental cost impacts on each market segment.

6.2 Impact of Proposal 1 on commission levels

This section assesses potential changes to commission levels resulting from the partial or total prohibition of softing.

6.2.1 Views expressed by fund managers

Implementation of Proposal 1 as drafted would prevent fund managers sourcing MPIS using soft commission. The proposal also invites views on restrictions on the softing of other services.

Fund managers that receive softed services were either pessimistic about their ability to recapture lost value of soft credits for customers through reduced commissions, or did not think the exercise worth the effort. On average, fund managers anticipated recovering 6% of the value of MPIS lost, and the same proportion of total softed services lost if a full ban was implemented. On a segmental basis, no large fund managers predicted that commissions attributable to MPIS would fall, while small and medium-sized fund managers forecast 7% and 4% decreases respectively. Weighting the analysis such that the opinions of those fund managers receiving the most services carry the most weight reduces the average decrease in commissions to 3% (value of MPIS) and 2% (value of total softed services).

6.2.2 Views expressed by brokers

Some support for fund managers' views that commissions would not fall if softing was partially or fully banned was provided by brokers. This was largely because, even amongst the largest brokers, the quantity of softing has fallen in recent years and so the shrinking or ending of the market for soft credits would not create an effect significant enough to alter overall commission levels.

6.2.3 Our conclusions

We broadly agree with the views expressed by fund managers and brokers that the value of services currently received by fund managers using soft credits will in many cases not be recaptured for customers through lower commissions. The following market dynamics support this view:

- in most cases, fund managers pay the same level of commissions for trades comprising a softed element as for those that do not;
- broker questionnaire responses indicate that the value of soft credits provided to fund managers is around 2.8% of total commissions received, a proportion lower than that indicated by fund managers in Section 3.2 above. A decrease in the value of credits provided from this low base level may not be enough to trigger a re-negotiation of commission levels;
- smaller fund managers, including those utilising prime brokers, disproportionately benefit from softing and, with the exception of hedge funds trading at high volumes, are in a weaker position to negotiate lower commission levels than larger fund managers; and

- many fund managers that currently receive softed services have little incentive to attempt to recover their value through lower commissions. Many larger fund managers have decreased their take-up of such services, possibly in part following the publication of CP176, and the value of services received represents a small part of their cost base. Additionally, some hedge funds trading at high volumes will have sufficient ability to either absorb extra costs incurred through the cash purchase of previously softed services, or greater flexibility over adjustments made to their management fee.

For these reasons, we believe the average commission decrease of between 2% and 6% depending on the basis of estimation used is reasonable, giving many fund managers limited incentive to attempt to recapture this amount from brokers in the absence of Proposal 2, and others limited ability to. However, if both proposals were implemented simultaneously, these levels of recapture may understate the incentive and ability to recapture commissions arising from the lost value of both softed and bundled services.

6.3 Impact of Proposal 2 on commission levels

This section assesses potential changes to commission levels resulting from the unbundling of the non-execution element of commissions. This may result from the adoption of a tariff pricing mechanism through which single services or groups of services are purchased for a cash price, or alternatively through the offer of sub-bundles for less than a full-service bundled commission rate.

For the purposes of this section, and following feedback from fund managers and brokers, non-execution services are defined broadly and may include each of the following services:

- trade advice;
- broker contact;
- proprietary or bespoke research (i.e. sourced from the executing broker or, under commission sharing arrangements, other brokers or independent research companies);
- non-proprietary research (i.e. that produced by brokers and sent to most fund managers – and thought by some to be marketing rather than research);
- conferences / seminars;
- company visits / introductions;
- equipment provided by the broker (e.g. online data feeds and other resources); and
- access to IPOs.

The above list is not exhaustive and covers various media including written material, telephone contact, e-mail, video conferencing and voicemail. As noted at Section 3.2, we have not considered the active working of a trade to be part of the bundle of non-execution services.

6.3.1 Views expressed by fund managers

Fund managers see more chance of proposal 2 resulting in lower commission rates than proposal 1. Large fund managers forecast on average that 38% of the value of bundled non-execution services would be regained through lower commissions. Medium-sized and small fund managers were less optimistic forecasting 15% and 37% recovery respectively, giving an average across all segments of 29% cost recovery. If responses are weighted by those receiving the most bundled services, this reduces to 21%

6.3.2 Views expressed by brokers

The majority of brokers interviewed stated that they already provide sub-bundles and execution-only services in addition to full-service brokerage. They indicated that the number of available sub-bundles or tariff pricing choices where services may be purchased for cash could increase, and as such fund managers would have greater flexibility than that already enjoyed to choose the range of services required for an appropriate commission rate. Therefore, if Proposal 2 was implemented, they predicted that close to 100% of the value of non-execution services previously included in the bundle would be recaptured by fund managers on their customers' behalf through lower commission rates.

6.3.3 Our conclusions

Recent market trends and activities undertaken by a significant proportion of brokers would appear to support their view that if the proposal was implemented, unbundled commission rates offered by traditional full-service brokers would compete with those offered by execution-only specialists, while a number of options would be available to fund managers up to and including a full-service offering. These trends and activities include:

Market trends

- falling commission levels in recent years are empirical evidence that, as an industry, fund managers exercise some market power over brokers (at least during a bear market), and may be in a position to use this to win reasonable service and commission levels if the Proposals are implemented;
- the continued growth of execution-only and programme trading, putting added emphasis on the execution component of commissions; and

- increased awareness of the level of transaction costs among pension fund trustees and other customers following the Myners Report.[14]

Broker activities

- analysis undertaken to identify the cost of elements of a bundle offered to fund managers allowing for the separate pricing of components of the bundle;
- as an extension of this, construction of models to understand the profitability of each fund manager, and thus the break-even commission levels required from a set level of trades; and
- acceptance of and participation in commission sharing arrangements whereby a proportion of commissions are re-directed to other brokers or independent researchers for the provision of non-execution services.

In addition to the above, new Securities and Exchange Commission (SEC) rules[15] in the United States have initiated reforms aimed at ending conflicts of interest which may have arisen partly from cross-subsidies between investment banking and research activities at large brokerage houses. Though the extent to which these have so far impacted the UK market is unclear, they may have given further impetus to the treatment of both sales and research teams as individual profit centres, and thus encouraged an internal requirement for each to be profitable.

In light of the above, it seems likely that, if Proposal 2 is enacted, commission levels would fall in line with the value of services removed from the bundle. However, this benefit may not fully accrue to some small and medium-sized fund managers that are relatively unprofitable for brokers on an individual basis due to a modest volume of trading and / or high uptake of added value services within the bundle currently received. These fund managers may not experience a commensurate fall in commissions for services lost, but as it is likely that bundled services will still be offered by brokers (see Section 5.2.2), they should have the option of continuing to receive these at a comparable commission rate to that currently paid,

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14 "Institutional Investment in the United Kingdom: A Review", Paul Myners, March 2001.

15 Self Regulatory Organization (SRO) Research Analyst Rules announced by SEC Chairman William Donaldson, July 2003. Included:

Separation of Research Analyst Compensation from Investment Banking Influence. Investment banks are required to establish a compensation committee to review and approve the compensation of its research analysts that are primarily responsible for the preparation of the substance of research reports. The committee would report to the Board of Directors and may not have representation from the firm's investment banking department.

Pitch Meetings. Research analysts are insulated from investment banking interests by prohibiting them from participating in "pitches" or other communications for the purpose of soliciting investment banking business.

Prepublication Review of Research Reports. The pre-publication review and approval of research reports by persons not directly responsible for research is restricted. The rules also require that pre-publication communications about a research report between all non-research personnel and the research department be intermediated by legal or compliance staff.

not withstanding any additional costs faced due to a need to rebate the non-execution part of the bundle to customers.

Taking into account the above, we estimate conservatively that the part of commissions previously accounted for by non-execution services will fall on average by a range of 60%-80% if Proposal 2 is implemented. However, for many fund managers this decrease is likely to be 100%. This fall may be additionally supplemented by a continued increase in the take-up of execution-only and other forms of trading that do not require non-execution services, lowering the overall rate of commissions paid.

6.4 Impact of the Proposals on the value of non-execution services purchased

This section examines the possibility of changes in the value of non-execution services purchased if the Proposals are implemented. These may result from changes to either the price, quantity or quality of services received.

Among possible sources of increases in price are loss of economies of scope present in providing bundled services. Such economies primarily relate to the provision of advice on how a trade or series of trades may be undertaken. However, it is possible that economies also exist in the provision of non-trade advice delivered as a consensus view of the research, sales and trading teams familiar with the trading strategy of a fund manager.

Future increases in the price of non-execution services may also result from the following sources unrelated to the Proposals:

- ongoing restructuring of brokerage firms to prevent the cross-subsidisation of research departments from trading commissions (see Footnote 15 above);
- work carried out by brokers to assess the profitability of execution and other services received by individual fund managers; and
- evidence of a slowing down in the rate of decrease of commissions coupled with a partial recovery in stock markets which may in combination result in static or rising commissions in 2004/05.

If some of the above sources of increased price were supplemented by decreases in quantity or quality of research produced, some fund managers may have to spend more to find a suitable quality product in the sectors they wish to cover. However, offsetting the above are possible falls in the value of services received as a result of:

- greater competition for research if independent research companies gain market share in types of research substitutable for outputs produced by brokers due to greater acceptance of cash payment (in an unbundled / tariff pricing environment) or the spread of commission sharing (under a bundling and rebating outcome); and/or

- a fall in the quantity of non-execution services sought as a result of greater choice over those services received and those declined.

We asked fund managers and brokers to predict changes in the price and quality of non-execution services received, and the quantity purchased / produced, following implementation of the Proposals. Generally fund managers were not willing to differentiate effects between services received. The comments below therefore relate to research unless otherwise stated.

6.4.1 Views expressed by fund managers

Softing

The cost of softed services should not rise as in the vast majority of cases these are provided to fund managers directly from service providers, therefore the price negotiation process will not change. This differs from the dominant system in the United States where brokers negotiate a bulk discount with service providers on behalf of fund managers. As noted at Section 3.4.1 above, a 4% decrease in the quantity of services purchased was predicted by fund managers.

Bundling

Half of the questionnaire respondents answered questions on the post-implementation levels of price, quality and quantity of research. Of these, a narrow majority predicted a fall in research prices irrespective of changes in their own demand such that, on average, the cost of research might be expected to fall by 8%. As noted at Section 3.4.1 above, if quantity forecasts are included, the change in the quantity-adjusted value of services purchased was predicted to fall by a range of 9% to 15%.

A narrow majority (56% versus 44%) believed that the quality of research would also deteriorate, as brokers continued to trim research departments and reduce coverage. Set against this, some fund managers thought that less non-proprietary written research would be produced, to which they attach a relatively low value, increasing the average quality of research received. No fund managers envisaged extra costs from undertaking a greater investment in in-house research.

6.4.2 Views expressed by brokers and independent researchers

Brokers

Brokers expressed a consensus view that prices for value-added alpha research services may rise for some or all fund managers for the following reasons:

- research and advice forwarded to fund managers was partly funded by the investment banking activities of large brokers but, in response to SEC actions noted at Section 6.3.3 above, this source of funding has diminished requiring full capture of research costs from fund managers; and
- research provided to a) smaller fund managers with a lower commission spend and b) those with the heaviest demand for broker input to validate the findings of in-house research departments have in the past been subsidised by fund managers with a higher level of trades or less need of broker input to trading decisions. These cross-subsidies would end in an unbundled environment.

Brokers indicated that quantity of maintenance research (i.e. background research arising from company contact) which is useful as a supply of data for fund managers' financial models, may diminish in fringe sectors of the economy, at the extreme resulting in niche and small-cap companies sponsoring publication of research into themselves. A general fall in the quantity of research produced would depend on the success of fund managers' attempts to pass the cost through to customers. If a significant fall in demand is witnessed, a consequent fall in research provided to the UK market may result.

Brokers were sceptical that independent firms could fill any gap in research provision, particularly in the production of maintenance research requiring a high level of contact with companies.

Independent researchers

Independent researchers expressed the view that an unbundled environment would allow them to compete with brokers on a level playing field, providing the opportunity to attract star researchers from larger brokers. They commented that lower overheads currently allow research to be produced more cheaply at independent firms, thus gaining a greater market share as a result of more competitive conditions would decrease the aggregate market price of research.

6.4.3 Our conclusions

It is almost impossible to attempt to predict the future landscape of the research market, as this is affected by the scope of Proposals implemented by the FSA, strategies followed by market participants including fund managers' customers, and external factors including regulatory action in other territories and changes in research provision in line with the investment cycle. Notwithstanding these difficulties, and after challenging some of the opinions expressed above by fund managers and others, we think on a balance of probabilities basis that the following changes to the price, quality and quantity of research services might be expected:

- There is no reason to disbelieve fund managers' aggregate estimate of the price of research falling by 8% and the quantity-adjusted value of services received falling by 9%-15%. Similarly, fund managers' forecast 4% fall in the quantity of softed services purchased may result from a re-assessment of needs if Proposal 1 is implemented.
- However, this reduction in total price may hide increases falling most heavily on those medium and large fund managers that currently make the greatest use of labour-intensive analyst advice from multiple brokers, and small fund managers that have a high reliance on prime brokers for idea generation. Price discovery resulting from the separate charging of research may make the present level of consumption of these services unaffordable to some fund managers.
- Those currently receiving a low level of research within a bundled commission rate may experience an overall drop in the cost of research resulting from the ability to purchase the same amount of research for less commission or cash under or sub-bundle or tariff pricing arrangements. However, this option for some smaller fund managers may be limited by a lack of bargaining power with brokers over commission rates and form of services received (i.e. bundled / unbundled).
- Those making most use of research that is substitutable by the independent sector may experience price falls if this sector flourishes following implementation of the Proposals.
- Those fund managers that successfully circumvent the regulation by sourcing research from abroad (see Section 8.3 below) should escape any price increases in research provided to fully compliant companies. They will also be able to take advantage of price decreases in the UK market where these occur.
- There is no evidence to suggest that an overall fall in quality of research would result from implementing the Proposals.

It is beyond the scope of this report to attempt to judge the optimum level of research provision in the UK investment market, and whether this or another level of consumption may result from implementation of the Proposals.

6.5 Other costs

In this section, we summarise the views of fund managers that responded to our questionnaire on incremental costs that may be incurred following implementation of the Proposals, including:

- the cost of calculating appropriate price structures for presently bundled services;
- incremental costs associated with invoicing;
- costs associated with rebating (for those exercising this option); and
- incremental customer relationship costs.

As no respondents have undertaken a review to quantify the magnitude of these costs, we have not attempted to challenge estimates given in detail. However, the lack of industry consideration of these costs may hide the potential for a large bill for some fund managers.

In addition to the above categories of cost, some fund managers may need to re-negotiate cost structures with customers to avoid incurring a working capital cost resulting from the payment for non-execution services in advance of billing customers for those services. We understand that the majority of management fees are calculated and charged to funds on a daily basis, however for fund managers that levy charges to funds less often, and are unable to re-negotiate this practice, a carrying cost may accrue.

6.5.1 Calculation of unbundled services

This potential cost item is heavily contingent on the necessity for fund managers (as well as brokers) to participate in the process of calculating the payment mechanism for non-execution services, and the extent to which unbundling occurs in the market. The estimates below are therefore contingent on pricing mechanisms adopted in the market and are the high-end of a range that has a low end of zero.

50% of respondents were not in a position to estimate any incremental costs generated by this activity, one of these stating that this would be impossible until the scope of the Proposals was finalised, and another that it would depend on the trading models that brokers imposed on the market. Of the remainder, 22% believed no extra costs would be incurred while 78% thought that they would, however nearly half the respondents did not quantify these costs. Of those that forecast additional costs, these ranged from £5,000 to £300,000, much of which may be temporary. Four of 18 respondents stated that extra staff would need to be recruited, while four said that this would not be necessary.

One respondent stated that incremental resources would be required to scrutinise the quality of the non-execution services it received in order to determine whether they offer value for money. This would result in the recruitment of an extra analyst, at a fully loaded cost of £100,000 per annum. As it may be assumed that this function would only be undertaken if a net gain accrued from it, and that the ability to carry it out may be aided by the Proposals, we do not consider this to be an incremental cost.

6.5.2 Rebating costs

Only four of 18 respondents were willing to predict the likelihood (or not) of incremental costs arising from rebating, reflecting a general unwillingness to engage in this practice. Of these, three forecast that costs would be incurred ranging from £150,000 to £600,000 and comprised largely of one-off rather than ongoing costs. The fourth respondent did not believe costs would be incurred. Anecdotal evidence received suggests that the cost of implementing systems allowing rebating is likely to exceed that of modifying systems facilitating the receipt of unbundled services, however we have been unable to verify this.

6.5.3 Invoicing costs

Implementation of Proposal 2 may result in a change in invoicing systems and/or procedures for fund managers processing broker invoices or issuing invoices to customers. Of the 50% of respondents that were willing to speculate whether incremental invoicing costs would be incurred, 78% forecast incremental costs ranging from £5,000 to £1,000,000 (one-off costs) and £50,000 to £250,000 (ongoing costs), while 22% predicted no extra costs. Eight of 18 respondents forecast the recruitment of extra staff, while three thought recruitment would be unnecessary.

6.5.4 Customer relationship costs

Adoption of the Proposals may require fund managers to invest resources in informing customers about changes to fee and commission structures, and add a degree of complexity to customer relationships (e.g. extra negotiations around the level of non-execution services received). Of the 72% of respondents who expressed an opinion on this issue, 85% envisage incremental costs from increased customer relationship management. Of these, 30% expect a ‘slight increase’, and 55% a ‘significant’ impact, much of this ongoing rather than a one-off cost as arising from increased reporting to customers. However, only two estimates of extra costs were received, one being less than £10,000 and the other being a range of £0.7m - £1.4m.

6.5.5 Our conclusions

Assigning an average cost base impact for the industry or for individual segments arising from the cost categories considered in this Section may be spurious as:

- companies were generally unwilling to speculate on which costs may be incurred and have not carried out work to quantify these;
- the nature and magnitude of each type of cost will not become clear until the market has adjusted to the proposals that are implemented, which in turn depends on their final scope; and
- the cost categories are individual in their nature, and therefore no general impact is readily quantifiable.

In the light of these considerations, we have not included these costs in our conclusions on cost impacts at Section 6.9 below, however a general consideration as to their likely applicability to some companies in the small and medium-sized segments has been taken into account when arriving at assessments of strategies which may be followed by industry participants (see Section 8).

6.6 VAT implications of the Proposals

6.6.1 Introduction

At present commission charged by brokers is wholly exempt from VAT, so the cost for any fund manager receiving brokerage services, regardless of whether they have a taxable or VAT-exempt mandate, is the same. This is in contrast to the situation where non-execution services are provided separately from execution services (e.g. for the cash payment of independent research companies). These transactions are subject to VAT at the standard rate.

The VAT liability of a fund manager's fees depends upon the type of investment vehicle receiving the fund manager's services and in certain circumstances on whether the provider is an insurance company. Thus, a fund manager's fee may be subject to VAT at the standard rate of 17.5% (commonly referred to as taxable services), or exempt from VAT. For the avoidance of doubt any VAT incurred by the fund manager that relates solely to the provision of taxable services may be recovered by the fund manager. Conversely, VAT incurred by a fund manager that relates solely to the provision of VAT-exempt services may not be recovered. Therefore, for fund managers with VAT-exempt mandates, VAT incurred on bought-in services and goods represents an additional cost.

If non-execution services were unbundled and purchased either in cash or commission form, the potential exists for brokerage services to be newly constituted as two supplies, one of taxable research, the other of VAT-exempt brokerage. This would create an additional VAT cost for fund managers which they would need to seek to recover from higher fees or explicit charges.

6.6.2 Precedent

The leading case on the VAT treatment of multiple services from the same supplier is the European Court of Justice decision in Card Protection Plan. This case identified several tests which must be applied when considering whether several services supplied by a single provider should carry the same VAT liability, or be treated separately for VAT purposes. We have paraphrased some of these tests below.

1. All of the circumstances of the case in question must be considered.
2. Every supply of a service must normally be regarded as distinct and independent.
3. Supplies which are a single supply from an economic point of view should not be split.
4. If there is a supply where one element of it comprises the principal service, and the other elements are ancillary, this should be treated as a single supply of services. The VAT liability for the entire supply should follow that of the core supply.
5. A single price for the provision of services is not determinative of the issue.

The fifth test listed above would seem to favour the current treatment applied to brokerage services, as the separate identification of research would under this test simply be an administrative one rather than a change in the nature of services provided. However, the second test would appear to favour the view that there are two separate supplies, of brokerage and research.

There are other cases concerning this issue but none can provide definitive guidance on this matter. As can be implied by the tests given above, the treatment of brokerage services must be determined on a case by case basis. However, HM Customs & Excise (HMCE) may decide that a single policy on the provision of brokerage services should be agreed so that there is no uncertainty for businesses supplying such services.

6.6.3 Conclusion

It is not possible at this stage to determine what HMCE policy would be under such circumstances. The outcome of this may have some bearing on fund managers' attitude to compliance and other strategies as outlined in Section 8.

6.7 The ability of Fund Managers to recover incremental costs from customers

This section assesses the success with which fund managers may be able to recover incremental costs from their customers. These costs may arise from the need to:

- fund the purchase of at least some previously softed and/or bundled services, as detailed in Sections 6.2 and 6.3;
- meet any incremental costs arising from price increases to non-execution services, as described in Section 6.4;
- recover any incremental administration and systems costs, as outlined at Section 6.5; and
- recover any liability for VAT costs, as summarised in Section 6.6.

6.7.1 Views expressed by fund managers

Softed services

Those questionnaire respondents that receive softed services predicted that only 14% of the cost of purchasing these under other arrangements following the implementation of Proposal 1 would be recoverable from customers. When this sample is weighted by those that receive the most services, the recovery rate drops to 7%, implying that some smaller fund managers are confident of a high level of recovery due to close customer relationships or a relatively small value of services received requiring recovery.

Bundled services

Fund managers were asked to project likely cost recovery from:

- non-execution services purchased separately;
- non-execution services purchased in a bundle; and
- administration, systems and VAT costs.

67% of respondents provided answers to one or more of these questions. Whether services are provided in a bundle made little difference to respondents who estimated on average that between 33% and 37% of costs could be recovered under either of these methods. Fewer respondents were willing to estimate cost recovery from administration and other costs, but those that did forecast an average 21% recovery rate. The relatively small size of this category of costs compared to ongoing execution costs also persuaded some respondents not to attempt to recapture the cost, and therefore predict no recapture. The table below summarises fund managers' views on potential cost recapture.

Table 6.1 - Fund managers' average estimated recapture of costs from customers

Cost recovery from customers	Unbundled non-execution services weighted by importance in the bundle	Bundled non-execution services	Incremental administration, systems and VAT costs
Percentage recapture through increased management fee or explicit charges	37%	33%	21%

Source: Deloitte fund managers questionnaire

6.7.2 Our conclusions

Softed services

Fund managers' pessimism around the ability to recover costs related to MPIS, performance and valuation services, equipment and other technical services would appear justified as these are required to run the business in the same way that electricity and heating are necessary, and as a similarly predictable service, should logically be charged for in the same way. That they were previously received under a different method of purchase is unlikely to result in institutional customers agreeing to higher management fees for all but the best performing fund managers with the closest customer relationships.

The ability to recover the cost of softed research should not differ from that of bundled research, since customers' willingness to pay should depend on the service provided rather than the current means of purchase. We estimate below that the potential cost recovery of bundled research ranges from 50%-70%, therefore if research is assumed to constitute approximately 30% of softed services[16], and 50%-70% is on average recoverable, total recovery of softed services may amount to between 15% and 21% of the value lost.

Bundled services

The key to fund managers' ability to recover costs lies in customers' willingness to both understand and accept a different method of charging in the UK compared to other territories. This will be influenced by several factors, including:

16 "An assessment of soft commission arrangements and bundled brokerage services in the UK", OXERA (2003)

- relative size and sophistication of customer, contributing to bargaining power – this can be broadly divided between institutional and retail customers;
- location of customer (e.g. UK customers may be more likely to understand the Proposals);
- relationship between fund manager and customer;
- performance of the fund manager; and
- attitude of investment consultants (primarily those advising UK customers).

Each of the above will influence customers' attitudes towards costs (i.e. is the customer focused on the fund management fee or a more sophisticated expense ratio?) and transparency (retail customers may be less concerned than institutional customers). Those fund managers that have a high proportion of UK institutional customers may have the potential to recapture a greater proportion of costs as:

- these customers will be best positioned to understand the Proposals and have investment consultants who understand (and in many cases) support them; and
- they may treat transparency of costs as more of a priority than other types of customers.

These customers may also be happiest with an increase in the management fee as a predictable cost, rather than bearing fluctuating charges through individual charges for research costs.

The broadly positive stance of investment consultants is also likely to be important in fund managers' attempts to recover costs from UK packaged product retail customers. This class of customer may accept higher charges unless a widespread move to place funds with fund managers seeking to evade the regulation was made by members of their peer group.

Overseas customers may be least willing to accept new methods of charging, particularly if they are obliged to monitor new arrangements such as the rebating of non-execution costs to funds in tandem with the separate charging for these services. Set against this, the UK model may in time appear attractive to overseas institutional investors seeking similar levels of transparency to their UK counterparts if:

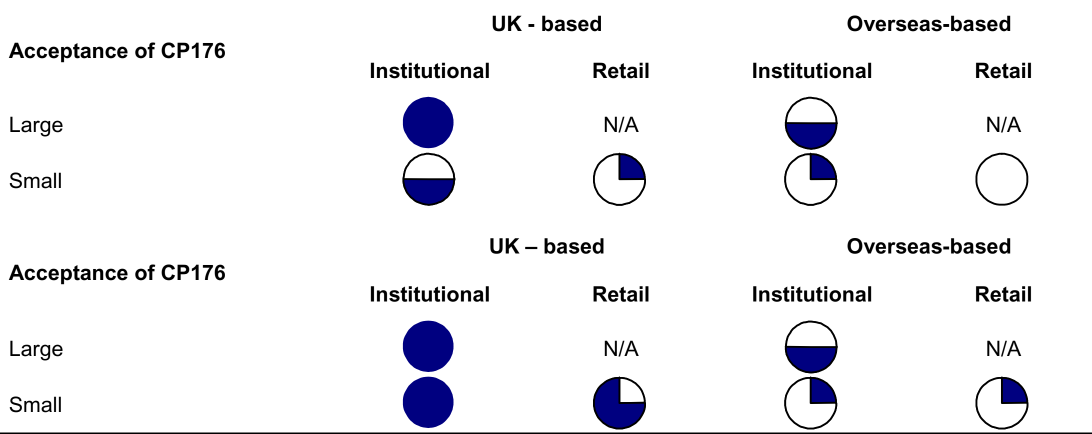
- the Proposals deliver a net saving to clients' funds (see Section 7 below) or, failing this, do not cause the Total Expense Ratio (TER) of UK funds to rise above that of overseas funds;
- post-implementation, UK customers and consultants perceive that they have benefited from greater transparency in the market; and/or

- the proportion of execution-only and programme trades continues to increase, fostering a more global acceptance of the separate payment for additional non-execution services.

On the first of these points, anecdotal evidence suggests that UK TERs are generally lower than those of overseas funds and therefore a small rise in the total expenses of funds would be unlikely to put UK funds at a disadvantage. As we have not been able to validate this assumption, additional analysis may need to be performed to do so.

As noted above, the ability to recapture costs from customers will be heavily influenced by the type of customer (institutional or retail) and their location (UK or overseas). Our assessment of customers' likely initial understanding and acceptance of the Proposals (i.e. before any savings or costs become apparent) is summarised in the diagram below. Full circles denote full understanding / acceptance, empty circles no understanding / acceptance.

Figure 6.1 - Potential understanding and acceptance of the Proposals by customer segment



The diagram shows that fund managers' customer bases will be key to their initial ability to recapture costs. As around 59% of institutional UK FUM is attributable to domestic customers[17], a relatively high level of cost recovery should be possible from these customers. Some level of cost recovery should also be available from overseas customers, particularly for better performing fund managers that are able to maintain competitive TERs. On the basis of this analysis, fund managers' aggregate cost recovery estimates shown in Table 6.1 above may understate potential cost recovery. Though a general cost recovery forecast is not possible with a high degree of certainty, we would advance a range of 50-70% as a reasonable estimate, and we use this in our assessment of the total incremental cost impact on the fund management industry in Section 6.8, and of the potential impact on customers in Section 7.

[17] Fund Management Survey, IMA (2002)

6.8 Potential incremental cost impact on the fund management industry

This section summarises the potential incremental cost impacts discussed above to arrive at a ranged estimated impact for each market segment. As noted at Section 6.5.5 above, we have not included incremental administration and systems costs below, though these contribute to our assessment of strategies available to each segment in Section 8. We have also excluded any VAT impact in our summary calculations as this is contingent on an HMCE assessment that is yet to be made. Data used includes:

- financial information extracted from the FSA database for 443 fund managers representing around 73% of the estimated size of the UK fund management market;
- data on the value of softed and bundled services currently received, and the value that may be purchased if the proposals are implemented, obtained from questionnaire respondents; and
- opinions of respondents on the proportion of the value of services that may be saved for customers through lower commissions[18], and the proportion that may be recovered through increased management fees.

The financial data provided by the FSA has been used to calculate an approximate average margins impact on each segment of the market. As an element of depreciation is contained in the cost data, revenues less costs relates to what may be termed Earnings After Depreciation (EAD) rather than operating profit, and thus margins will understate operating margins.

The tables included in this section summarise the incremental cost impact on the total market and each market segment on four bases:

1. Total impact – impact on margins for the total market / segment when the total value of services lost, and the extent of cost recovery from customers, is applied to total revenues and costs.
2. Average impact - impact on margins for the average company in the market / segment when the average value of services lost and recovered from customers is applied to average revenues and costs.
3. Weighted average impact (financials and cost recovery) – as at 2 above but where:
   - the value of services currently received is used to weight views on the value of services saved through lower commission, and the proportion of costs recovered from higher fees; and

18 Though lower commissions do not directly benefit fund managers' cost bases, they have an indirect impact as savings in commission rates may help to persuade customers that management fees should rise.

- revenues and costs are weighted by funds under management at each company.

4. Weighted average impact (cost recovery only) – as at 2 above but incorporating the weighting of views on commission reductions / cost recovery as in the first sub-point at 3 above.

The purpose of applying these metrics to the views of questionnaire respondents[19] and to our own conclusions[20] resulting from analysis and interviews is to arrive at an incremental cost impact range. The lowest value resulting from comparison of impacts using each metric forms the low-case in the impact ranges shown and the highest value the high-case. Ranged impacts inform the probability of each segment and sub-segment adopting the strategies outlined in Section 8 in response to the Proposals.

It should be noted that financial data included relates to a snapshot of industry performance in 2002/03[21], the nadir of the bear market. Financial performance may be expected to improve as equity markets recover.

We have built into the tables a 4% decrease in the value of softed services received following implementation of the Proposals as forecast by respondents. We have also included a 12% decrease in the quantity-adjusted value of bundled services received. This is the mid-point of the ranged 9% to 15% forecast reduction predicted by respondents. Fund managers' forecasts relating to the post-implementation value of services purchased are discussed at Section 3.4.1 above.

6.8.1 Impact on margins predicted by fund managers: total market

The table below shows the impact on margins resulting from fund managers' predictions relating to changes in commission levels and cost recovery from customers for the total market using the metrics described above.

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19 See Table 6.2, Table 6.4, Table 6.6, Table 6.8, Table 6.10 and Table 6.11 below

20 See Table 6.3, Table 6.5, Table 6.7, Table 6.9, Table 6.12 and Table 6.13 below.

21 Financials relate to 2002 for some fund managers and 2003 for others, depending on year-end.

Table 6.2 - Margins impact forecast by fund managers: Total market

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing	13.47%	13.85%	2.09%	3.57%	6.78%	13.75%	12.57%	13.08%	(0.90%)	(0.77%)
Total ban on softing	13.47%	13.85%	1.95%	3.57%	2.94%	14.25%	10.19%	12.06%	(3.27%)	(1.79%)
Ban on bundling	13.47%	13.85%	16.90%	28.77%	5.32%	34.44%	4.98%	7.96%	(8.48%)	(5.89%)
CP176 as drafted	**13.47%**	**13.85%**					**3.94%**	**7.13%**	**(9.53%)**	**(6.72%)**
Total ban on both softing and bundling	13.47%	13.85%					1.56%	6.17%	(11.90%)	(7.68%)

Source: FSA database / Deloitte fund managers' questionnaire

Fund managers' forecasts would result in a fall in margin from 13%-14% to a range of 4%-7% if the Proposals were implemented as drafted. If softing was banned entirely, margins fall further to a range of 2%-6%.

6.8.2 Deloitte analysis of potential margins impact: Total market

As summarised at Sections 6.2 and 6.3 above, we share fund managers' views regarding their limited ability to secure falls in commission resulting from the loss of softed services, but believe commissions accounted for by bundled services will decrease on average by an estimated range of 60%-80% as a result of the loss of these services.

At section 6.7, we concluded that depending on customer base and performance, fund managers on average may be able to recapture 50%-70% of the cost of bundled services from customers through a higher management fee, and between 15% and 21% of the cost of softed services, but a lower proportion of the cost of MPIS.

Using these assumptions, the Table below summarises our estimate of the impact of increased costs on margins.

Table 6.3 - Deloitte analysis of potential margins impact: Total market

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing	13.47%	13.85%	2.09%	3.57%	6.78%	13.75%	12.57%	13.08%	(0.90%)	(0.77%)
Total ban on softing	13.47%	13.85%	1.95%	3.57%	15.00%	21.00%	10.65%	12.39%	(2.82%)	(1.46%)
Ban on bundling	13.47%	13.85%	60.00%	80.00%	50.00%	70.00%	8.99%	11.24%	(4.48%)	(2.61%)
CP176 as drafted	**13.47%**	**13.85%**					**8.01%**	**10.47%**	**(5.45%)**	**(3.38%)**
Total ban on both softing and bundling	13.47%	13.85%					6.09%	9.78%	(7.37%)	(4.07%)

Source: FSA database / Deloitte analysis

Our analysis shows an estimated fall in margin from 13%-14% to a range of 8%-10% if the Proposals were implemented as drafted. If softing was banned entirely, margins fall to a range of 6%-10%.

6.8.3 Impact on margins predicted by fund managers: Large fund manager segment

The table below shows the impact on margins for the large fund manager market segment as predicted by respondents in this segment.

Table 6.4 - Margins impact forecast by fund managers: Large fund managers

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing	12.30%	12.31%	0.00%	0.00%	0.00%	7.08%	11.68%	11.98%	(0.62%)	(0.33%)
Total ban on softing	12.30%	12.31%	0.00%	0.00%	0.00%	7.01%	10.96%	11.73%	(1.34%)	(0.58%)
Ban on bundling	12.30%	12.31%	33.71%	38.25%	43.41%	60.00%	6.67%	8.82%	(5.63%)	(3.49%)
CP176 as drafted	**12.30%**	**12.31%**					**6.09%**	**8.28%**	**(6.21%)**	**(4.03%)**
Total ban on both softing and bundling	12.30%	12.31%					5.33%	7.55%	(6.97%)	(4.75%)

Source: FSA database / Deloitte fund managers' questionnaire

Fund managers forecasts would result in a fall in margin from 12% to a range of 6%-8% if the Proposals were implemented as drafted. If softing was banned entirely, margins fall to a range of 5%-8%.

6.8.4 Deloitte analysis of potential margins impact: Large fund managers

Using the assumptions detailed at Section 6.8.2 above, the Table below summarises our estimate of the impact of increased costs on margins for large fund managers.

Table 6.5 - Deloitte analysis of potential margins impact: Large fund managers

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing	12.30%	12.31%	0.00%	0.00%	0.00%	7.08%	11.68%	11.98%	(0.62%)	(0.33%)
Total ban on softing	12.30%	12.31%	0.00%	0.00%	15.00%	21.00%	11.07%	11.81%	(1.23%)	(0.49%)
Ban on bundling	12.30%	12.31%	60.00%	80.00%	50.00%	70.00%	7.33%	9.80%	(4.97%)	(2.51%)
CP176 as drafted	**12.30%**	**12.31%**					**6.71%**	**9.47%**	**(5.60%)**	**(2.84%)**
Total ban on both softing and bundling	12.30%	12.31%					6.10%	9.30%	(6.20%)	(3.01%)

Source: FSA database / Deloitte analysis

Our analysis shows an estimated fall in margin from 12% to a range of 7%-9% if the Proposals were implemented as drafted. If softing was banned entirely, margins fall to a range of 6%-9%.

6.8.5 Margins impact forecast by fund managers: Medium-sized fund manager segment

The table below shows the impact on margins for the medium-sized fund manager market segment as predicted by respondents in this segment.

Table 6.6 - Margins impact forecast by fund managers: Medium-sized fund manager

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing	15.17%	17.32%	4.17%	7.44%	2.50%	7.13%	14.10%	16.15%	(1.07%)	(1.17%)
Total ban on softing	15.17%	17.32%	4.17%	6.95%	3.50%	9.24%	13.59%	15.62%	(1.58%)	(1.70%)
Ban on bundling	15.17%	17.32%	14.55%	20.25%	22.50%	25.61%	11.37%	13.14%	(3.80%)	(4.18%)
CP176 as drafted	**15.17%**	**17.32%**					**10.29%**	**11.97%**	**(4.88%)**	**(5.35%)**
Total ban on both softing and bundling	15.17%	17.32%					9.79%	11.44%	(5.38%)	(5.88%)

Source: FSA database / Deloitte fund managers' questionnaire

Fund managers forecasts would result in a fall in margin from 15%-17% to a range of 10%-12% if the Proposals were implemented as drafted. If softing was banned entirely, margins fall to a range of 10%-11%.

6.8.6 Deloitte analysis of potential margins impact: Medium-sized fund managers

The Table below summarises our estimate of the impact of increased costs on margins for medium-sized fund managers.

Table 6.7 - Deloitte analysis of potential margins impact: Medium-sized fund managers

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing	15.17%	17.32%	4.17%	7.44%	2.50%	7.13%	14.10%	16.15%	(1.07%)	(1.17%)
Total ban on softing	15.17%	17.32%	4.17%	6.95%	15.00%	21.00%	13.78%	15.84%	(1.39%)	(1.48%)
Ban on bundling	15.17%	17.32%	60.00%	80.00%	50.000%	70.000%	12.72%	15.63%	(2.45%)	(1.69%)
CP176 as drafted	**15.17%**	**17.32%**					**11.64%**	**14.46%**	**(3.53%)**	**(2.86%)**
Total ban on both softing and bundling	15.17%	17.32%					11.33%	14.15%	(3.85%)	(3.17%)

Source: FSA database / Deloitte analysis

Our analysis shows an estimated fall in margin from 15%-17% to a range of 12%-14% if the Proposals were implemented as drafted. If softing was banned entirely, estimated margins fall to a range of 11%-14%.

6.8.7 Margins impact forecast by fund managers: Small fund managers

The table below shows the impact on margins for the small fund manager market segment as predicted by respondents in this segment.

Table 6.8 - Margins impact forecast by fund managers: Small fund managers

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing	10.14%	13.90%	1.48%	6.94%	6.73%	33.33%	8.19%	13.00%	(1.95%)	(0.90%)
Total ban on softing	10.14%	13.90%	1.38%	6.94%	2.03%	33.33%	3.42%	10.59%	(6.72%)	(3.31%)
Ban on bundling	10.14%	13.90%	16.00%	36.67%	1.69%	33.33%	(1.96%)	5.65%	(12.10%)	(8.25%)
CP176 as drafted	**10.14%**	**13.90%**					**(3.91%)**	**4.25%**	**(14.04%)**	**(9.65%)**
Total ban on both softing and bundling	10.14%	13.90%					(8.68%)	1.05%	(18.82%)	(12.85%)

Source: FSA database / Deloitte fund managers' questionnaire

Fund managers forecasts would result in a fall in margin from 10%-14% to a range of -4% to 4% if the Proposals were implemented as drafted. If softing was banned entirely, estimated margins fall further to -9% to 1%.

6.8.8 Deloitte analysis of potential margins impact: Small fund managers

The table below summarises our estimate of the impact of increased costs on margins for small fund managers.

Table 6.9 - Deloitte analysis of potential margins impact: Small fund managers

Cost impact of:	Margin 2002/03		Proportion of service value recaptured through lower commissions		Proportion of service costs recovered from customers		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Partial ban on softing*	10.14%	13.90%	1.48%	6.94%	6.73%	33.33%	8.19%	13.00%	(1.95%)	(0.90%)
Total ban on softing	10.14%	13.90%	1.38%	6.94%	15.00%	21.00%	4.31%	11.23%	(5.83%)	(2.67%)
Ban on bundling**	10.14%	13.90%	60.00%	80.00%	50.00%	70.00%	3.98%	10.37%	(6.15%)	(3.53%)
CP176 as drafted	**10.14%**	**13.90%**					**2.04%**	**9.47%**	**(8.10%)**	**(4.43%)**
Total ban on both softing and bundling	10.14%	13.90%					(1.85%)	7.70%	(11.98%)	(6.20%)

Source: FSA database / Deloitte analysis

Our analysis shows an estimated fall in margin from 10% - 14% to a range of 2%-9% if the Proposals were implemented as drafted. If softing was banned entirely, estimated margins fall further to -2% to 8%.

6.9 Summary of potential incremental cost impact

In this section we summarise the potential cost impacts highlighted in Section 6.8. This summary relies on the assumption that every company has a static operating model and therefore would not be able to mitigate cost impacts (for example by adopting cost-cutting strategies).

6.9.1 Fund managers' views

Based on the analysis in the previous section, fund managers' conclusions on the potential incremental cost impact for each segment and sub-segment of the market are summarised in the table below.

Table 6.10 - Summary of fund managers' forecasts of potential margins impact

Impact on	Margin 2002/03		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Total market	**13.47%**	**13.85%**	**3.94%**	**7.13%**	**(9.53%)**	**(6.72%)**
Large	**12.30%**	**12.31%**	**6.09%**	**8.28%**	**(6.21%)**	**(4.03%)**
Large UK	5.03%	6.06%	(4.09%)	(1.68%)	(9.12%)	(7.74%)
Large non-UK	16.67%	17.03%	13.40%	14.25%	(3.27%)	(2.79%)
Medium	**15.17%**	**17.32%**	**10.29%**	**11.97%**	**(4.88%)**	**(5.35%)**
Medium UK	21.17%	22.77%	16.27%	17.52%	(4.89%)	(5.25%)
Medium non-UK	12.60%	15.04%	7.73%	9.64%	(4.87%)	(5.40%)
Small	**10.14%**	**13.90%**	**(3.91%)**	**4.25%**	**(14.04%)**	**(9.65%)**
Small UK1	43.22%	46.08%	25.37%	34.82%	(17.85%)	(11.26%)
Small UK2	(7.00%)	(6.94%)	(28.59%)	(19.88%)	(21.59%)	(12.94%)
Small non-UK1	42.80%	45.84%	15.48%	33.44%	(27.32%)	(12.40%)
Small non-UK2	(2.14%)	(0.98%)	(12.15%)	(8.98%)	(10.01%)	(8.00%)

Key: Small 1 = Above average margins 2002/03

Small 2 = Below average margins 2002/03

Source: FSA database / Deloitte fund managers' questionnaire

According to fund managers' forecasts, industry margins could fall by between 7 and 9 percentage points with the small segment suffering the largest potential fall of 10 to 14 percentage points.

Based on these views, we calculated pre- and post-implementation margins for each of the 443 companies contained in the FSA fund managers' database, assuming the Proposals are implemented as drafted (i.e. stopping short of a complete ban on softing). The table below shows the impact on different industry segments in terms of the number of firms moving from a positive to a negative margin post-implementation.

Table 6.11 - Analysis of positive and negative margins as forecast by fund managers

	No. of firms	% of total FUM	Firms with positive margin 02/03	% of segment FUM	Firms with negative margin 02/03	% of segment FUM	Firms whose margin may have become negative because of CP176	% of segment FUM	% of firms that may have experienced negative margin following implementation of CP176 (as % of segment FUM)
Total	**443**	**100%**	**327**	**79%**	**116**	**21%**	**184**	**22%**	**43%**
By segment									
Large	**11**	**46%**	**9**	**79%**	**2**	**21%**	**3**	**30%**	**50%**
Large UK	6	29%	4	67%	2	33%	2	27%	60%
LargeNon-UK	5	17%	5	100%	0	0%	1	18%	18%
Medium	**48**	**42%**	**35**	**81%**	**13**	**19%**	**7**	**16%**	**35%**
Medium UK	14	13%	12	94%	2	6%	1	9%	15%
MediumNon-UK	34	29%	23	76%	11	24%	6	15%	40%
Small	**384**	**13%**	**283**	**72%**	**101**	**28%**	**174**	**64%**	**92%**
SmallUK1	103	3%	103	100%	0	0%	38	37%	37%
SmallUK2	104	3%	62	63%	42	37%	58	57%	94%
SmallNon-UK1	66	2%	66	100%	0	0%	30	53%	53%
SmallNon-UK2	111	4%	52	44%	59	56%	48	43%	99%

Key: Small 1 = Above average margins 2002/03

Small 2 = Below average margins 2002/03

Source: FSA Database / Deloitte fund managers' questionnaire

In 2002/03, 116 firms representing 21% of market FUM had negative margins. Respondents' expectations indicate that, if the Proposals are implemented, a further 184 firms (22% of market FUM) would have experienced negative margins on this basis.

Of small above average performing companies (sub-segments SmallUK1 and SmallNon-UK1), where no firms currently show a negative margin, companies representing 37% and 53% of FUM would have reported negative margins according to fund managers' expectations. Amongst the below average performance sub-segments (SmallUK2 and SmallNon-UK2), 94% and 99% of companies would have experienced negative margins.

6.9.2 Summary of Deloitte analysis

Based on our analysis and views regarding changes to commission levels and recovery of incremental costs from customers, our estimates of the potential incremental cost impact for each market segment are summarised in the table below.

Table 6.12 - Summary of Deloitte analysis of potential margins impact:

Impact on	Margin 2002/03		Adjusted margin 2002/03		Difference (percentage points)	
	LOW	*HIGH*	*LOW*	*HIGH*	*LOW*	*HIGH*
Total market	**13.47%**	**13.85%**	**8.01%**	**10.47%**	**(5.45%)**	**(3.38%)**
Large	**12.30%**	**12.31%**	**6.71%**	**9.47%**	**(5.60%)**	**(2.84%)**
Large UK	5.03%	6.06%	(3.14%)	0.30%	(8.17%)	(5.76%)
Large non-UK	16.67%	17.03%	13.72%	15.18%	(2.95%)	(1.85%)
Medium	**15.17%**	**17.32%**	**11.64%**	**14.46%**	**(3.53%)**	**(2.86%)**
Medium UK	21.17%	22.77%	17.63%	19.97%	(3.54%)	(2.80%)
Medium non-UK	12.60%	15.04%	9.08%	12.16%	(3.52%)	(2.88%)
Small	**10.14%**	**13.90%**	**2.04%**	**9.47%**	**(8.10%)**	**(4.43%)**
Small UK1	43.22%	46.08%	32.93%	40.85%	(10.30%)	(5.22%)
Small UK2	(7.00%)	(6.94%)	(19.45%)	(12.69%)	(12.45%)	(5.75%)
Small non-UK1	42.80%	45.84%	27.04%	40.09%	(15.76%)	(5.75%)
Small non-UK2	(2.14%)	(0.98%)	(7.91%)	(4.29%)	(5.77%)	(3.32%)

Key: Small 1 = Above average margins 2002/03

Small 2 = Below average margins 2002/03

Source: FSA database / Deloitte analysis

Margins for the industry as a whole are estimated to fall by between 3 and 5 percentage points. The least impact is expected on the medium segment, and the most on the small segment, which may see falls in margin of between 5 and 8 percentage points.

This summary of our estimates can also be converted into an analysis of positive and negative margins on the same basis as in Table 6.11, as shown in the table below.

Table 6.13 - Analysis of positive and negative margins based on Deloitte cost impact assessment

	No. of firms	% of total FUM	Firms with positive margin 02/03	% of segment FUM	Firms with negative margin 02/03	% of segment FUM	Firms whose margin may have become negative because of CP176			% of segment FUM			% of firms that may have experienced negative margin following implementation of CP176 (as % of segment FUM)		
							Worst		Best	Worst		Best	Worst		Best
Total	**443**	**100%**	**327**	**79%**	**116**	**21%**	**107**	**-**	**83**	**16%**	**-**	**5%**	**37%**	**-**	**26%**
By segment															
Large	**11**	**46%**	**9**	**79%**	**2**	**21%**	**2**	**-**	**0**	**21%**	**-**	**0%**	**42%**	**-**	**21%**
Large UK	6	29%	4	67%	2	33%	2	-	0	27%	-	0%	60%	-	33%
Large Non-UK	5	17%	5	100%	0	0%	0	-	0	0%	-	0%	0%	-	0%
Medium	**48**	**42%**	**35**	**81%**	**13**	**19%**	**5**	**-**	**3**	**14%**	**-**	**5%**	**33%**	**-**	**24%**
Medium UK	14	13%	12	94%	2	6%	1	-	1	9%	-	9%	15%	-	15%
Medium Non-UK	34	29%	23	76%	11	24%	4	-	2	12%	-	2%	36%	-	27%
Small	**384**	**13%**	**283**	**72%**	**101**	**28%**	**100**	**-**	**80**	**42%**	**-**	**32%**	**70%**	**-**	**60%**
SmallUK1	103	3%	103	100%	0	0%	5	-	3	9%	-	7%	9%	-	7%
SmallUK2	104	3%	62	63%	42	37%	45	-	38	49%	-	39%	85%	-	76%
SmallNon-UK1	66	2%	66	100%	0	0%	11	-	7	23%	-	11%	23%	-	11%
SmallNon-uk2	111	4%	52	44%	59	56%	39	-	32	37%	-	29%	94%	-	86%

Key: Small 1 = Above average margins 2002/03

Small 2 = Below average margins 2002/03

Source: FSA Database / Deloitte analysis

According to this analysis, of the 443 companies included in the FSA's database, a range of 83 to 107 out of 327 companies with a positive margin in 2002/03 may have been vulnerable to reporting a negative margin as a result of implementation of the Proposals at that snapshot in time (equal to 5% - 16% of total FUM), taking the number of firms with a negative margin up to a range of 199 to 223 (equal to 26% - 37% of total FUM).

7. NET IMPACT ON CUSTOMERS

7.1 Introduction

Having examined the potential for incremental costs to be incurred by fund managers in the previous section, we assess below the resulting aggregate impact on customers of UK-regulated fund managers that fully comply with the FSA's Proposals (i.e. before consideration of evasion strategies).

The impact on customers is analysed after accounting for the following three factors:

- decreases to commission levels;
- changes to the size of the market for MPIS and bundled services; and
- fund managers' ability to recover incremental costs from customers through increased management fees.

The analysis is indicative of the financial impact on customers' funds that may result from these factors. It is not intended to account for other types of impacts that may affect some but not all customers including:

- potential increased tax liability for some investment vehicles where management fees increase (see Section 6.6.1 above);
- changes to fund managers' trading behaviour or strategy; and
- changes in market structure (e.g. consolidation).

This section does not therefore provide a complete assessment of the way customers may be impacted if the Proposals are implemented.

In Section 7.2 we assess the potential net customer impact using fund managers' predictions in relation to the three factors listed above. In Section 7.3, we apply our own assessment of the potential impact of changed commission levels, purchasing patterns and cost recovery to arrive at an alternative analysis of potential customer impact.

7.2 Analysis of net customer impact using fund managers' views

The table below uses responses to the fund managers questionnaire to estimate the net impact on customers if the Proposals are implemented. Fund managers' views are shown on a total market basis (e.g. the changed value of services purchased and the extent of cost recovery from customers are applied to total revenues and costs). Best and worst case scenarios are estimated from the point of view of the customer. Thus, a large decrease in commissions paid, large fall in fund managers' demand for non-execution services and low levels of cost recovery are shown as best case scenarios for customers while the reverse would be worst case scenarios.

Table 7.1 - Net customer impact resulting from respondents' views

Decrease in commission levels	**Worst case**	**£m / %**	**Best case**
Total UK and international commissions 2003	2,878	-	3,435
Commission attributable to MPIS	58.2	-	69.5
Estimated decrease in commissions - MPIS		2%	
Commission attributable to bundled services	653.1	-	779.6
Estimated decrease in commissions – bundled services		29%	
Decrease in commissions: MPIS	1.2	-	1.4
Decrease in commissions: bundled services	186.4	-	222.5
Total decrease in commission payments	187.6	-	223.9
Decrease in quantity/price of services purchased	**Worst case**		**Best case**
Value of MPIS purchased	49.7	-	59.4
Fund manager % saving through lower value of MPIS purchased		4%	
Fund manager % saving through lower value of bundled services purchased	9%	-	15%
Fund manager saving on MPIS	2.0	-	2.4
Fund manager saving on bundled services	58.9	-	114.0
Post-implementation market size – MPIS	47.7	-	57.0
Post-implementation market size – bundled services	594.2	-	665.6
Estimated cost recovery from customers	**Worst case**		**Best case**
% cost recovery - MPIS		7%	
% cost recovery - bundled services		32%	
Cost recovery - MPIS	3.2	-	3.9
Cost recovery - bundled services	192.2	-	215.3
Total cost recovery	195.4		219.1
Aggregate customer impact	**Worst case**		**Best case**
Aggregate customer impact: MPIS	2.0	-	2.4
Aggregate customer impact: bundled services	5.8	-	(7.2)
Total customer impact	**7.8**	-	**(4.8)**

Source: FSA database / Deloitte fund managers questionnaire

The table indicates that, if fund managers' views on the variables above came to fruition, funds held by customers managed by UK-regulated fund managers may see an impact ranging from a net saving of £4.8m to a net cost of £7.8m per annum. Whereas fund managers' predictions always result in a net cost resulting from Proposal 1, a saving or cost may result from Proposal 2.

If softing was to be banned altogether, the higher value of services received is offset by slightly different forecasts regarding changes to commission levels and cost recovery. These factors produce a broadly similar customer impact ranging from a £6.3m net loss to a £6.6m net gain.

7.3 Analysis of net customer impact from our assessment of the market

In Section 6, we outlined that fund managers' views appeared reasonable that:

- commissions would not fall significantly to compensate for the lost value of softed services, and that this value was unlikely to be recovered from customers; and

- the value of non-execution services purchased may fall by around 4% (services currently softed) and between 9% and 15% (bundled services).

However, we diverged from the views expressed by respondents on:

- the potential decrease in commissions resulting from Proposal 2, as we share brokers' views that any residual commission charged over and above executing and working trades should be more than 50% lower than commissions previously charged for bundled services. We have estimated a conservative ranged reduction of 60%-80% in this component of commissions (see Section 6.3.3); and
- the potential for recovery of the cost of bundled services and the research element of softed services from customers, which we have estimated to be in the region of 50%-70% (see Section 6.7.2).

If these views are applied to the analysis above (i.e. fund managers' assumptions relating to bundled services are challenged but those relating to softing are accepted), the estimated impact on customers' funds would range from a £26.1m net loss to a £288.4m net gain per annum. This is shown in the Table below.

Table 7.2 - Net customer impact resulting from Deloitte market analysis

		£m / %	
Decrease in commission levels	**Worst case**		**Best case**
Total UK and international commissions 2003	2,878	-	3,435
Commission attributable to MPIS	58.2	-	69.5
Estimated decrease in commissions - MPIS		2%	
Commission attributable to bundled services	653.1	-	779.6
Estimated decrease in commissions – bundled services	60%	-	80%
Decrease in commissions: MPIS	1.2	-	1.4
Decrease in commissions: bundled services	391.9	-	623.7
Total decrease in commission payments	393.1	-	625.1
Decrease in quantity/price of services purchased	**Worst case**		**Best case**
Value of MPIS purchased	49.7	-	59.4
Fund manager % saving through lower value of MPIS purchased		4%	
Fund manager % saving through lower value of bundled services purchased	9%	-	15%
Fund manager saving on MPIS	2.0	-	2.4
Fund manager saving on bundled services	58.9	-	114.0
Post-implementation market size – MPIS	47.7	-	57.0
Post-implementation market size – bundled services	594.2	-	665.6
Estimated cost recovery from customers	**Worst case**		**Best case**
% cost recovery - MPIS		7%	
% cost recovery - bundled services	70%	-	50%
Cost recovery – MPIS	3.2	-	3.9
Cost recovery – bundled services	416.0	-	332.8
Total cost recovery	419.2		336.7
Aggregate customer impact	**Worst case**		**Best case**
Aggregate customer impact: MPIS	2.0	-	2.4
Aggregate customer impact: bundled services	24.1	-	(290.9)
Total customer impact	**26.1**	-	**(288.4)**

Source: FSA database / Deloitte analysis

Our acceptance of fund managers' views on the impact of softing results in the same small negative impact from Proposal 1 as shown in Table 7.1. However, this relies on respondents' predictions that a slightly higher amount of cost recovery may be available from customers than the level of falls in commission available from brokers. This trade-off between commissions and cost recovery could easily swing in the opposite direction, and may also be affected by decisions to implement the Proposals simultaneously or individually, as fund managers may be more able to recover the entire value of non-execution services foregone through lower commissions, than to recover the value of softed services alone.

The indication that Proposal 2 might result in a net saving rather than a net cost to customers results from:

- a smaller value of currently bundled non-execution services to be passed through to customers resulting from decreased demand; and
- the estimated fall in commissions attributable to these services exceeding that of the level of cost recovery from customers. However, even if it was assumed that a 50%-70% fall in commissions occurred, matching the assumed level of cost recovery, the results would still range from a £91m net loss to a £210m net saving per annum.

If the analysis is extended to all softed services, an impact range of a £44.9m net loss to a £273.2m net gain per annum is estimated. This is because a 50%-70% rate of cost recovery from customers is assumed for the research portion of softed services (estimated at 30%) as described at Section 6.7.2 above. This results in a ranged recovery of the cost of softed services of between 17% and 23%, far exceeding the reduction in commission attributable to these services if softing was banned which, in line with fund managers' views, is estimated at 2%.

If net savings did accrue to customers' funds following implementation of the Proposals, fund managers adopting evasion strategies (see Section 8) may suffer some customer loss as the performance of their funds is disadvantaged. A positive customer impact may also encourage overseas customers to transfer assets to UK-regulated fund managers.

8. STRATEGIES AVAILABLE TO FUND MANAGERS

8.1 Introduction

We have sought to identify ways in which different fund managers might respond to the implementation of the Proposals, with particular reference to the costs that they may incur as detailed in Section 6. The strategies outlined below have been derived from interviews with fund managers and brokers, responses to questionnaires and CP176 consultation responses. They are, by definition, hypothetical since no equivalent 'shock' to the market has previously been introduced that might act as a benchmark.[22] Similarly, no other territory has yet introduced the changes proposed by the FSA.

We have tried to analyse below each of the courses of action that fund managers may be incentivised to take. In each case we have explained how we have defined the strategy, assessed the advantages and disadvantages of following it, and as a result, estimated the proportion of each market segment that may do so (see section 4 for the definition of these segments). Our assessment is summarised at Table 8.3. and is based on an assumption that fund managers will act rationally and make decisions based on their economic interest in response to the Proposals.

We have excluded from our analysis those strategies which we think are unlikely to be pursued. These are summarised below:

Re-domiciling funds

Following discussion with the FSA, we have worked on the assumption that if the Proposals are implemented, they would account for all activities of UK authorised fund managers. With the exception of the sourcing of non-execution services from overseas, circumvention would require the relocation of these activities. Therefore, it is assumed that that the movement of funds to new locations (e.g. Dublin or Luxembourg) would not bypass the Proposals.

Net trading

A number of respondents to CP176 remarked upon the potential for equity trading to move to a net basis such that payment for execution and other services takes place through the spread between bid and sell prices, making commissions (and the Proposals in relation to them) redundant. This would bring the method of payment for UK equity trade execution in line with that for fixed income products.

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22 Research was carried out on regulatory changes and cost shocks to the UK (e.g. big bang) and other markets, but we concluded that little similarity with the Proposals was apparent in relation to potential changes to pricing structures and mechanisms.

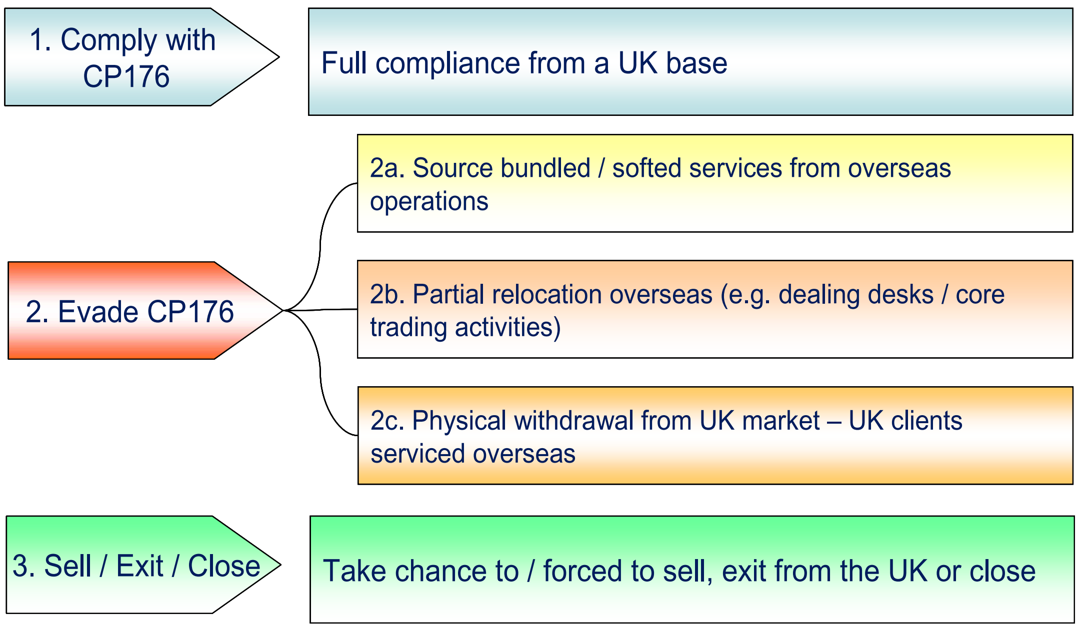
8 STRATEGIES AVAILABLE TO FUND MANAGERS

We concluded that a move to a net market was unlikely to occur as:

- a majority of both fund managers and brokers indicated that, while some brokers may see advantages in selling their services net (as they may be able to maintain market share in the non-execution element of these), fund managers and brokers each had an interest in maintaining the transparency of the market, and fund managers in particular would resist this;
- such a blatant move would be implemented in the face of regulatory concern over trading opacity from both the FSA and the SEC. This could encourage regulatory resistance and further intervention in fixed income markets;

The diagram below identifies strategies that may be adopted by fund managers in response to the Proposals. These are described in Sections 8.2 to 8.7 below.

Figure 8.1 - Strategies available to Fund Managers



8.2 Compliance

The default response to implementation of the Proposals is for companies to comply (some reluctantly) with the new rules. This response assumes that any restructuring or procedures that are necessary to comply with the new guidance are put in place and costs associated with these are either passed onto customers, mitigated (i.e. through cost cutting measures) or absorbed.

8.2.1 Advantages and disadvantages

Advantages of compliance include the following:

- fund managers can highlight transparency gains relating to transaction costs, which may make this the preferred strategy for large UK institutional investors;
- migration of capital, labour and regulatory status is avoided; and
- the strategy is regulator friendly in the UK, and avoids incurring expenses associated with evasion, which carry the risk of regulators in other territories adopting similar proposals.

Disadvantages of compliance may be:

- the loss of automatic pass-through of costs associated with softed and bundled non-execution services to customers, loading costs onto fund managers which may not be fully recovered through increased management fees or explicit charges;
- the potential for the cost of high quality and specialist research to rise if not sourced from overseas; and
- (if management fees rise), the potential for UK fund managers to appear more expensive than overseas rivals on the basis of fees alone, if not on a TER basis.

8.2.2 Probability analysis

Compliance is the most probable course of action for fund managers that:

- have a customer base dominated by medium or large UK-based institutional investors;
- do not have significant fund management operations overseas, increasing the cost of and limiting the practicality of adopting alternative strategies;
- believe that incremental costs can be passed on or absorbed within their cost bases; and/or
- have an operating model that does not rely heavily on softing or large quantities of broker-generated alpha research.

A high degree of compliance is likely from all segments. The greatest proportion of compliance may be amongst medium-sized UK-focused fund managers. This sub-segment may have less opportunity to circumvent the Proposals in ways that may be available to those with overseas operations or the largest UK fund managers. This segment may also be better able to absorb extra costs than smaller fund managers.

Large fund managers are also expected to choose this default option, as they have the highest number of larger UK institutional customers, which are likely to demand compliance with a regulation which, if implemented, may provide them with a net gain (see Section 7). A high rate of compliance should also occur amongst better-performing fund managers in the small segment, and UK-focused managers in all segments.

Hedge funds

The attitudes of the customers of hedge funds may differ from traditional fund managers as their customer base may be considered to be less risk-averse[23], seeking absolute returns (rather than returns relative to a market index), and thus which are more willing to pay higher management and performance fees.

Set against this, as the hedge fund industry is relatively young, many of its members have a greater reliance on (and their entry may have been encouraged by) softed services than more established fund managers. Due to their size and more recent establishment, hedge funds are also relatively mobile and thus able to migrate quickly in search of better returns.

A hedge fund manager's compliance strategy may in turn depend on the core strategy followed by the fund. Some (e.g. many long/short equity funds) rely heavily on real time idea generation and other input from brokers while others (e.g. technical strategies aimed at finding short-term stock undervaluation) have limited need for services in addition to execution.

We think it likely that a relatively high proportion of hedge funds will comply with the Proposals as a result of the ability of most to pass through incremental costs to customers. This view is also partly influenced by the current status of London as the clear European capital for hedge funds, with a 70% market share of FUM[24]. However, to the extent that the location of a cluster in an entrepreneurial market may be volatile, wider ranges have been placed around our judgements concerning hedge funds than most other sub-segments.

8.3 Sourcing of non-execution services from other territories

A number of fund managers highlighted this option in interviews and consultation responses. It may work in one of two ways:

- For larger fund managers, if a broker providing non-execution services is satisfied with the level of business it gains globally or believes more can be won, it may agree to supply services to the UK for free as part of a global commissions agreement. Thus, brokers accept a lower global commission rate, but an element of cross-

23 The customers themselves may be identical to those of non-hedge fund managers, but choose to place a set proportion of their portfolio with a hedge fund manager to seek (more risky) absolute returns.

24 Eurohedge magazine, February 2004.

subsidisation exists from the overseas customers of the fund manager to its UK customers who no longer pay for full-service brokerage.

- For those unable to strike this type of deal, non-execution services could be purchased overseas. An internal recharge mechanism may then be established between the UK and overseas offices of the fund manager. The fund manager would decide whether to raise its management fee for UK-authorised business or attempt to win market share by holding it down and benefiting from any customer migration from other fund managers that do raise fees.

Smaller firms which do not have the global scope to put this strategy into operation themselves could theoretically join forces with overseas fund managers of a similar size to swap resources.

Under each of these methods of implementation, there is no movement of fund management activities or funds away from the UK.

8.3.1 Advantages and disadvantages

The most obvious advantage for fund managers able to adopt this strategy is the ability to continue to receive research and other services using the same mechanism as at present, and to avoid the potential implications of the Proposals in relation to incurring the cost of non-execution services received, negotiating the recovery of costs from customers through higher fees, and incurring any additional administrative, systems, capital or tax costs.

However, this may not represent a complete means of evasion, as some non-execution services will still need to be supplied in the UK (e.g. broker-sponsored introductions to UK companies, trade advice and one-to-one communication of ideas to UK-based staff). As a result, the re-negotiation of services received and commission levels, cost impacts, and the need to alter fees may not be avoided. Fund managers adopting the strategy may also bear the risk of

- strained relations between their UK and overseas offices (depending on form of implementation);
- incremental administrative costs of transfer of services to the UK; and
- customer resistance where benefits from the Proposals are anticipated.

8.3.2 Probability analysis

This option is predominantly available to large fund managers that negotiate receipt of services and commission levels with brokers on a global basis. Smaller companies are less likely to supply the volume of commissions to brokers to persuade them to change the way in which services are delivered, while UK-oriented fund managers may not have the appetite to evade, or (as with hedge fund managers) the overseas resources.

8 STRATEGIES AVAILABLE TO FUND MANAGERS

8.4 Partial relocation

This option involves fund managers moving enough operations overseas in order to evade the regulation. For example, dealing desks to which staff are attached that choose the brokers to place trades with and instruct on how these should be traded may be moved with minimal resource to outwardly manage funds from other territories, while strategic decisions affecting funds' performance may still be carried out in the UK The precise nature of this option, and any requirement to re-novate funds to other territories, would depend upon the final scope of the Proposals.

8.4.1 Advantages and disadvantages

If this strategy can be implemented with minimal interference to ongoing operations, its prime advantage (as with the previous strategy) is the ability to avoid incremental costs that may be incurred as a result of the Proposals and to maintain present trading relationships with brokers on a global basis.

The following may be set against potential advantages of the strategy:

- practicality and cost of implementation, including any affect that the relocation of systems and staff may have on performance;
- customer resistance where benefits from the Proposals are anticipated.
- loss of locational advantages of close working between fund managers and the dealing desk operation (this may particularly affect small companies);
- risk that other regulators may implement similar proposals, negating the strategy's benefits; and
- uncertainty as to whether the strategy will bypass FSA regulations in the long term, and whether it may lead to the adoption of a more complete withdrawal from the UK as described in section 8.5 below.

8.4.2 Probability analysis

It is likely that those fund managers with existing overseas operations (primarily European operations to facilitate the trading of European stocks) will be the main group that consider pursuing this strategy However, as the option is potentially more disruptive than that of sourcing non-execution services from overseas as described in section 8.3 above, and the main adherents of that strategy are also likely to be overseas-focused fund managers, adoption of the strategy may be limited to a small subset of this group that can implement it with the least disruption and cost.

8.5 Full relocation

Companies following this option would relocate all fund management staff from the UK and manage UK customer mandates from overseas.

8.5.1 Advantages and disadvantages

Advantages to this option are as outlined in Sections 8.3.1 and 8.4.1 above,

A key disadvantage is the expense of relocation, and the implications it would have for maintaining a UK customer base. As a result of these, it may be considered a last resort along with the options outlined in sections 8.6 and 8.7. The table below shows cost items a company wishing to relocate may need to consider and a range of illustrative costs for the relocation of 100 staff to new offices. We understand that economies of scale in relocation are of the order of 1%-2% so the costs per staff member shown may be considered to be broadly representative of relocation costs for different numbers of staff.

Table 8.1: Illustrative costs of relocating 100 staff from the UK to an overseas location

Cost of relocating 100 staff	Min	Max
Penalty for terminating lease agreement	£1,000,000	£4,000,000
Cost of preparing a new building	£1,000,000	£3,000,000
Furniture and fittings for the new building	£1,500,000	£3,000,000
Cost of replacing cabling/telecoms	£0	£50,000
Cost of the move itself	£0	£100,000
Cost of paying staff relocation allowance	£300,000	£700,000
Cost of recruiting new staff in new location	£1,000,000	£3,000,000
Cost of redundancy package for staff that do not want to move	£1,000,000	£2,000,000
Total	**£5,800,000**	**£15,850,000**
Total per staff member	**£58,000**	**£158,500**

Source: Deloitte analysis

The costs shown are heavily dependent on the territory relocated to and, for companies that already have an overseas presence, may overstate costs relating to the acquisition of space, fixtures and fittings. In some territories, incentives may also be available to facilitate a move.

A further disadvantage to relocating is the risk of losing UK customer mandates as UK institutional customers in particular may prefer to retain their mandates with a fund manager complying with UK regulations. The loss of current UK customers may also limit future expansion opportunities in the UK market.

As with option 8.4 above, firms incurring the costs of moving operations out of the UK also run the risk that the country they relocate to adopts similar rules to the FSA, thus removing the benefits of the move. There may also be regulatory disadvantages to such a move with cost implications for fund managers and customers and, when moving large numbers of staff to a new location, some leakage of talent may occur.

The benefits of relocation must also be weighed against those of remaining in London. A substantial literature exists on the reasons for London's pre-eminence as a financial services centre in Europe. European Cities Monitor is an annual survey of the views of senior executives from 501 European companies on Europe's leading business cities and the key factors on which to base business location decisions. In the 2003 survey[25] London emerged as the top rated city in several categories seen as important to the maintenance of an international financial services cluster including:

- the availability of qualified staff;
- access to markets and international transport links;
- telecommunications; and
- number of languages spoken.

Relocating from London would forego many of the locational benefits highlighted in the report, but would also risk a loss of reputation through the lack of a presence in the longstanding hub of European financial services. The report developed the following ranking of European cities, and compared this with their position in 2002 and 1990.

Table 8.2: Ranking of European cities 1990, 2002 and 2003

	2003	2002	1990
London	**1**	**1**	**1**
Paris	2	2	2
Frankfurt	3	3	3
Brussels	4	4	4
Amsterdam	5	5	5
Barcelona	6	6	11
Madrid	7	7	17
Berlin	8	9	15
Milan	9	8	9
Munich	10	11	12
Zurich	11	10	7
Dublin	12	12	-
Manchester	13	19	13
Geneva	14	15	8
Lisbon	15	17	16

Source: European Cities Monitor (2003)

8.5.2 Probability analysis

Given the costs and risks associated with this option, it is likely to be followed only by those that have a small UK presence and customer base or those that would otherwise be forced out of business. Given the potentially smaller aggregate impact on their cost base, if large fund managers wish to follow an evasion strategy, they are likely to source services from abroad or pursue partial relocation before fully relocating, which may be particularly expensive for this segment given numbers of staff and complexity of operations.

25 European Cities Monitor, Cushman & Wakefield, Healy & Baker (2003).

Of smaller firms, high-performing companies may have little incentive to relocate, while UK-focused companies may bear a relatively high risk of customer loss and organisational upheaval. Those companies with an overseas parent and main customer base and that have found trading difficult in the UK may consider this the only option, along with those that judge they will not be able to satisfactorily re-negotiate the terms under which the package of non-execution services they currently use are supplied by brokers and third parties, and provided to customers.

8.5.3 Calculation of FUM exit

Relocation is the first strategy which may result in a material level of funds exiting the UK market. In estimating exit, we have taken account of:

- the likelihood that some companies relocating equity funds will move all other fund management from the UK, probably to a single European trading centre; and
- the magnitude of customer migration away from companies deciding to relocate towards fund managers maintaining their UK-regulated status, where benefits are anticipated from the Proposals.

To account for these opposite effects, we have assumed a 70% FUM exit from companies that decide to relocate from the UK. This is composed of the following:

- all equity funds, estimated at 54% of the total[26]; plus
- half of the remaining assets held by relocating companies (i.e. half of 46% = 23%, 54% + 23% = 77%); less
- an assumed 10% of funds that migrate back to UK-regulated companies (10% of 77% = 7%, 77% - 7% = 70%).

8.6 Sale of business

Those fund managers for whom evasion strategies above are not practical options, but may not be able to continue running a profitable business in the UK, are faced with two options: sale or exit.

8.6.1 Advantages and disadvantages

The obvious disadvantage of this strategy is that the fund manager will no longer be able to operate independently. It will therefore only be taken by those that have little other practical option, and are offered an attractive package by a prospective buyer or partner.

[26] Fund Management Survey, IMA (2002).

8.6.2 Probability analysis

Those fund managers that are least able to follow other options discussed above and that incur significant extra costs are expected to be concentrated among the small market segment (by number, and to a lesser extent, by value of FUM). As purchasers of their assets are likely to come from the large or medium segments, this implies some degree of consolidation in the market. In a sector where scale economies may be present, this might imply a net increase in efficiency, offset by reduced choice for consumers.

8.6.3 Calculation of FUM exit

In calculating funds that may exit the UK market, the strategy of the acquirer becomes important. We have assumed that the proportion of companies following the strategies outlined above, encompassing those where no FUM exit is forecast as well as relocation which implies significant levels of exit, is a reasonable proxy for the aggregate level of exit that might occur from the sale decisions of some fund managers. This results in an estimated 1.5% to 3.5% of funds relocating from the UK as a proportion of funds held by companies choosing this strategy.

8.7 Market exit

Under this option, fund managers that are not in a position to implement any of the strategies above exit the UK market and repay remaining assets to customers, who then need to seek other avenues to invest their money

8.7.1 Advantages and disadvantages

This option is imposed on, rather than actively chosen by fund managers. The only advantage is the minimisation of losses incurred.

8.7.2 Probability analysis

Two principle drivers may result in market exit: a lack of long-term commitment to the UK market, and/or the absence of other practical options. Fund managers with little commitment to the UK market are likely to be headquartered away from the UK while those with little option other than exit might be UK-focused but may have failed to find a buyer for their assets. Each category is likely to have found trading conditions difficult during the bear market and registered little improvement subsequently.

8.7.3 Calculation of FUM exit

While it is likely that many customers will re-invest assets with UK-regulated companies, others will choose investments in financial products other than equities, or decide not to re-invest at all. We assume below that 50% of funds returned to customers are re-invested by fund managers operating in the UK and the remaining 50% exit the market.

8.8 Conclusions on the adoption of strategies by market segment

In the table below we have input ranged probabilities of each market segment adopting each strategy. These have emerged from discussions with fund managers, brokers and other industry stakeholders, questionnaire responses and consultation responses sent to the FSA. They are also influenced by the potential cost impact on each segment as detailed in Section 6 above.

Table 8.3 - Deloitte assessment of the probability of strategy adoption by segment

Segment /Strategy	1. Comply	2a. Source from overseas	2b. Partially relocate	2c. Relocate	3a. Sell	3b. Exit/Close
Adoption probabilities						
LargeUK	70% - 85%	15% - 25%	0% - 0%	0% - 0%	0% - 0%	0% - 0%
LargeNon-UK	45% - 55%	40% - 50%	0% - 10%	0% - 0%	0% - 0%	0% - 0%
Medium UK	90% - 100%	0% - 5%	0% - 0%	0% - 0%	0% - 5%	0% - 5%
MediumNon-UK	40% - 60%	10% - 30%	0% - 20%	5% - 15%	0% - 0%	0% - 0%
SmallUK1	60% - 80%	0% - 10%	0% - 0%	10% - 15%	0% - 6%	0% - 3%
SmallNon-UK1	40% - 50%	35% - 45%	0% - 0%	10% - 15%	0% - 5%	0% - 5%
SmallUK2	40% - 70%	5% - 10%	0% - 0%	5% - 10%	5% - 20%	5% - 15%
SmallNon-UK2	30% - 40%	15% - 25%	0% - 0%	20% - 30%	5% - 10%	5% - 20%
Hedge funds	65% - 90%	0% - 0%	0% - 0%	5% - 25%	0% - 5%	0% - 5%

Key: Small 1 = Above average margins 2002/03

Small 2 = Below average margins 2002/03

Source: Deloitte analysis

9. Potential impact on the UK fund management market

9.1 Approach to quantifying impact on the market

In this section, we apply the ranged probabilities of each market segment adopting the available strategies described above to estimate the effect on the UK market. This total market is estimated at £2.600bn[27] of FUM. In doing so, we arrive at a level of FUM that will exit the market either by relocating to serve UK customers from overseas, selling, closing or exiting the UK market completely.

9.2 Summary of impact: Funds Under Management

Table 9.1 below shows the estimated range of potential FUM exit that may occur as a result of the Proposals. In compiling the table and as discussed in Section 8 above, we have made a number of assumptions:

- Under strategies 1 (comply), 2a (source services from overseas) and 2b (partial relocation), no funds exit the UK, though under the latter strategies, some evasion of the Proposals occurs.
- Under strategy 2c (relocate), all equity FUM (54% of the total)[28] is initially assumed to exit the market along with half of the non-equity FUM held by those companies relocating, as some companies would withdraw from fund management in the UK altogether. However, in response to this exit, 10% of FUM is assumed to stay in the UK resulting from the migration of customers who wish to retain the UK-regulated status of their investment to fund managers that remain regulated by the FSA.
- Under strategy 3a (sale), the proportion of funds remaining in the market after accounting for Strategies 1-2c (96.5%-98.5%) are assumed to remain in the market to account on average for the strategies of the likely acquirers of companies choosing this strategy.
- Under strategy 3b (exit/close), 50% of FUM is assumed to exit the market as it is likely that a proportion of customers will respond to exit/closure by transferring to UK-regulated fund managers while others may exit or end their investments.

It should be noted that the ranged estimate of FUM exit shown below is sensitive to the above assumptions, each of which may be challenged. Our analysis is therefore arrived at

27 Fund Management, IFSL (2003).

28 Fund Management Survey, IMA (2002).

on the basis of a balance of probabilities, informed by the views of fund managers, brokers and other industry stakeholders, and internal knowledge and research.

Table 9.1 – Strategy adoption probabilities and estimated exit of FUM from the UK market

Segment /Strategy	FUM £bn	1. Comply	2a. Source services from overseas	2b. Partially relocate	2c. Relocate	3a. Sell	3b. Exit/Close
Traditional fund managers							
LargeUK	612	70% - 85%	15% - 25%	0% - 0%	0% - 0%	0% - 0%	0% - 0%
LargeNon-UK	328	45% - 55%	40% - 50%	0% - 10%	0% - 0%	0% - 0%	0% - 0%
Medium UK	307	90% - 100%	0% - 5%	0% - 0%	0% - 0%	0% - 7%	0% - 3%
MediumNon-UK	554	40% - 60%	10% - 30%	0% - 20%	5% - 15%	0% - 0%	0% - 0%
SmallUK1	57	60% - 80%	0% - 10%	0% - 0%	10% - 15%	0% - 8%	0% - 0%
SmallNon-UK1	26	40% - 50%	35% - 45%	0% - 0%	10% - 15%	0% - 5%	0% - 5%
SmallUK2	58	40% - 70%	5% - 10%	0% - 0%	5% - 10%	5% - 20%	5% - 15%
SmallNon-UK2	72	30% - 40%	15% - 25%	0% - 0%	20% - 30%	5% - 10%	5% - 20%
FUM sourced from FSA data	2,014	1,163 – 1,468	301 - 540	0 – 144	53 - 123	6 - 46	6 – 34
Rest of market exc. hedge funds	538						
Total FUM exc. hedge funds	2,551	1,474 – 1,860	382 - 684	0 - 182	67 - 156	8 - 58	8 – 42
Equity FUM exc. hedge funds	1,378	796 - 1004	206 - 369	0 - 98	36 - 84	4 - 32	4 – 23
Hedge Funds							
Adoption probabilities	49	65% - 90%	0% - 0%	0% - 0%	5% - 25%	0% - 5%	0% - 5%
FUM allocation	49	32 – 44	0 - 0	0 - 0	2 – 12	0 – 2	0 – 2
Equity FUM allocation	32	21 – 29	0 – 0	0 – 0	2 – 8	0 – 2	0 – 2
Total Market FUM	2,600	1,505 – 1,903	382 - 684	0 - 182	70 - 168	8 - 61	8 - 45
Total equity FUM	1,410	816 – 1,033	206 - 369	0 - 98	38 - 92	4 – 33	4 – 25
FUM lost from UK (£bn)							
Equity FUM lost	40.3 – 105.8	0.0 – 0.0	0.0 – 0.0	0.0 – 0.0	38.0 – 92.0	0.1 – 1.5	2.2 – 12.3
Other FUM lost	12.5 – 36.4	0.0 – 0.0	0.0 – 0.0	0.0 – 0.0	10.5 – 24.9	0.1 – 1.3	1.9 – 10.2
Total FUM lost from UK	**52.8 – 142.1**	**0.0 – 0.0**	**0.0 – 0.0**	**0.0 – 0.0**	**48.6 – 117.0**	**0.2 – 2.7**	**4.1 – 22.5**
FUM lost as % of market	**2.0% - 5.5%**						

Key: *Small 1 = Above average margins 2002/03*

Small 2 = Below average margins 2002/03

Source: Deloitte analysis

The analysis produces a range of potential FUM exit from £52.8bn to £142.1bn (2.0% to 5.5% of the market). This incorporates a central case estimate of £97.2bn of funds (3.7%) exiting.

The table below shows how this exit is distributed between market segments. It shows that of the above range that may be lost from the UK market, £24bn-£80bn is managed by the medium segment and £28bn-£62bn by the small segment (including hedge funds). The highest level of potential exit is among the small non-UK below average performance sub-segment (SmallNon-UK2), where an estimated range of between 16.5% and 31.4% of FUM may exit.

Table 9.2 Estimated exit of FUM by market segment

Strategy	2a. Source from overseas	2b. Partially relocate	2c. Relocate	3a. Sell	3b. Exit/Close
LargeUK	15% – 25%	0% - 0%	0% – 0%	0% – 0%	0% – 0%
LargeNon-UK	40% – 50%	0% - 10%	0% – 0%	0% – 0%	0% – 0%
Medium UK	0% – 5%	0% - 0%	0% – 0%	0% – 7%	0% – 3%
MediumNon-UK	10% – 30%	0% - 20%	5% – 15%	0% – 0%	0% – 0%
SmallUK1	0% – 10%	0% - 0%	10% – 15%	0% – 8%	0% – 0%
SmallNon-UK1	35% – 45%	0% - 0%	10% – 15%	0% – 5%	0% – 5%
SmallUK2	5% – 10%	0% - 0%	5% – 10%	5% – 20%	5% – 15%
SmallNon-UK2	15% – 25%	0% - 0%	20% – 30%	5% – 10%	5% – 20%
Hedge Funds	0% – 0%	0% - 0%	5% – 25%	0% – 5%	0% – 5%
Potential FUM exit (£bn)	**FUM exiting – strategy 2c**	**FUM exiting – strategy 3a**	**FUM exiting strategy 3b**	**Total FUM exiting**	**% of FUM exiting**
LargeUK	0.0 – 0.0	0.0 – 0.0	0.0 – 0.0	0.0 – 0.0	0.0% – 0.0%
LargeNon-UK	0.0 – 0.0	0.0 – 0.0	0.0 – 0.0	0.0 – 0.0	0.0% – 0.0%
Medium UK	0.0 – 0.0	0.0 – 1.2	0.0 – 5.8	0.0 – 7.1	0.0% – 1.8%
MediumNon-UK	24.4 – 73.4	0.0 – 0.0	0.0 – 0.0	24.4 – 73.4	3.5% – 10.5%
SmallUK1	5.0 – 7.5	0.0 – 0.3	0.0 – 0.0	5.0 – 7.8	6.9% – 10.8%
SmallNon-UK1	2.3 – 3.5	0.0 – 0.1	0.0 – 0.8	2.3 – 4.4	6.9% – 13.2%
SmallUK2	2.5 – 5.1	0.1 – 0.7	1.8 – 5.5	4.4 – 11.3	6.1% – 15.4%
SmallNon-UK2	12.6 – 19.0	0.1 – 0.4	2.3 – 9.1	15.0 – 28.4	16.5% – 31.4%
Hedge Funds	1.7 – 8.5	0.0 – 0.1	0.0 – 1.2	1.7 – 9.8	3.5% – 20.1%
Total/FUM (£000)	**48.56 – 117.0**	**0.2 – 2.7**	**4.1 – 22.5**	**52.8 – 142.1**	**2.0% – 5.5%**

Key: *Small 1 = Above average margins 2002/03*

Small 2 = Below average margins 2002/03

Source: Deloitte analysis

It should be noted that, as some of the FUM exit is accounted for by unprofitable (and potentially inefficient) firms, their exit may be considered a net benefit to the industry / economy, as it might allow for the re-direction of resources to more profitable activities. Offsetting this however, our analysis has been conducted at a particular point in time in a depressed market, such that these companies may return to or move into profitability as market conditions improve.

10. IMPACT ON THE UK ECONOMY

10.1 Introduction

In this section, we extend the analysis performed to estimate the impact on the fund management market to assess at a high level the potential impact of the Proposals on the UK Economy. This analysis is based on the estimated range of the percentage of total FUM leaving the UK following implementation of the Proposals.

10.2 Methodology

In order to estimate the wider impact of the Proposals, we first need to assess the total contribution of the fund management industry to the UK economy.

The contribution to the economy of each individual producer, industry or sector is measured using Gross Value Added (GVA), which, in this case, is calculated as the sum of the industry's profits and its total employment costs. The GVA of the fund management industry is indicatively estimated at Section 10.3 and the GVA loss resulting from the exit of funds estimated at Section 9 is shown at Section 10.4.

A change in the economic activity of an industry, such as the relocation or exit of a proportion of funds from the country, will have a direct impact on the economy and an indirect impact via its affect on closely related industries and other parts of the supply chain. Direct and indirect impacts are measured using economic multipliers.[29] We use an employment multiplier to estimate the wider economic impact in terms of GVA loss of an exit of funds and relate this to total economy GVA, and by extension to total economy Gross Domestic Product (GDP) at Section 10.5.

10.3 Calculation of industry-specific GVA

GVA may be calculated by adding the economic profit of an industry (as distributed among owners and shareholders) to employment costs (as distributed among employees). However, as noted at Section 6.8 above, financial data sourced from the FSA provides margins resulting from a level of earnings including depreciation. This has been used as a proxy for, and may overstate, measures of economic profit usually associated with GVA and is a key reason why our estimates of the value of industry GVA, and that of GVA lost, should be taken as indicative. Using the FSA database to arrive at an average margin, total profits in 2002/03 may be estimated at £1.82bn on an industry cost base of £11.48bn.

29 Induced effects resulting from changes in household expenditure may also be estimated using multipliers, however the accuracy of these may be considered to be less reliable and they are not published by the Office of National Statistics.

10 IMPACT ON THE UK ECONOMY

International Financial Services London (IFSL)[30] has estimated that employment costs are around 55% of total costs in the institutional market and 60% in the retail market. Accepting an IMA estimate[31] that the institutional market is nearly 15 times larger than the retail market, total institutional costs may be estimated at £10.76bn with employment costs accounting for £5.92bn, while retail costs can be estimated at £0.71bn with employment costs of £0.43bn. This gives a total employment cost for the industry of £6.35bn.

The GVA of the fund management industry, as the sum of total profits and employment costs, was therefore around £8.17bn in 2002/03, accounting for approximately 16.3% of the financial services industry and 0.9% of total economy GVA.

Table 10.1 - Calculation of industry-specific GVA

	£bn
Total costs (£bn)	**11.5**[1]
Institutional funds	10.8
Retail funds	0.7
From which we obtain:	
Total employment costs	**6.3**[2]
Institutional funds	5.9
Retail funds	0.4
Total profits	**1.8**
Fund management industry GVA (employment costs + profits)	**8.1**[3]
as % of financial services GVA	16.3%[4]
as % of the whole economy GVA	0.9%[5]

[1] The institutional market is assumed to be 15 larger than the retail market
[2] Employment costs are 55% of total costs in the institutional market and 60% in the retail market
[3] Total industry-specific GVA equals total industry profits + total industry employment costs
[4] 2002/03 financial services GVA was £50.1bn
[5] 2002/03 whole economy GVA was £909.8bn

Sources: FSA Database, IFSL, IMA, ONS and Deloitte analysis

10.4 Estimation of GVA lost

As described in section 9.2 above, we estimate that, if the Proposals are implemented as drafted, a range of FUM from 2.0% to 5.5% may exit the UK market. Estimates presented in the table below show that this would reduce GVA attributable to fund management by between 1.9% and 4.8%, partly due to a lower level of profitability amongst those that exit when compared with the industry average, as indicated by the segmental analysis of exit at Table 9.2 in the previous section.

[30] Fund Management, IFSL (2003).

[31] Fund Management Survey, IMA (2002).

Table 10.2 - GVA lost as a result of FUM exiting the market

	Low end (£m)	Central case (£m)	High end (£m)
Fund management GVA (= Total profits + Employment costs)		8,143	
Estimated profits lost	24	39	44
Estimated employment costs lost	128	236	346
Estimated GVA lost	152	275	390
GVA lost as a proportion of fund management GVA	**1.9%**	**3.4%**	**4.8%**

Source: ONS, Deloitte analysis

10.5 Estimation of wider economic loss using an employment multiplier

As noted above, direct and indirect impacts on the economy stemming from a change in activity in a particular sector may be measured using economic multipliers. There are three types of multipliers:

- output multipliers, measuring the effects of a change in demand;
- employment multipliers, measuring the effects of changes to employment; and
- income multipliers, measuring the effects of changes to income.

Table 10.2 above shows that the main result from an exit of funds from the UK will be a change to levels of employment in the industry. Though changes to output and income may occur, these are impossible to predict with any certainty. The Office of National Statistics (ONS) produces employment multipliers for each sector of the UK economy. Though a specific multiplier is not produced for the fund management industry, a multiplier can be estimated by weighting available financial services sector multipliers by their contribution to the sector's GVA. This is shown in Table 10.3 below.

Table 10.3 - Estimation of the employment multiplier

Industry	GVA (2003 prices)	% of total GVA	Employment multiplier
Banking and finance	£30,309,546,564	61%	1.86
Insurance and pension funds	£11,491,311,084	23%	2.92
Auxiliary financial services	£8,278,164,501	17%	1.86
FM industry employment multiplier (weighted average):			**2.10**

Source: ONS, Deloitte analysis

Application of this multiplier effect to the GVA loss shown in Table 10.2 results in a GVA loss to the wider economy of between £321m and £819m as shown in the table below.

Table 10.4 – Estimated lost GVA following application of an employment multiplier

	Low end (£m)	Central case (£m)	High end (£m)
Estimated GVA lost	152	275	390
Employment multiplier	2.1	2.1	2.1
Estimated GVA lost accounting for wider economic impacts	321	578	819

Source: ONS, Deloitte analysis

This level of GVA loss represents between 0.035% and 0.090% of UK economy GVA of £910bn in 2002/03. GDP is obtained from GVA by adding taxes paid to and subtracting subsidies received from the Government. As industry-level economic activity is not normally expressed in terms of GDP, the ratio of industry GVA lost to whole-economy GVA is more meaningful than comparing industry GVA with whole-economy GDP. However, this ratio has also been noted in the table below for completeness.

Table 10.5 – Estimated exit as a proportion of 2002/2003 GDP

	Low case (£m)	Central case (£m)	High case (£m)
GVA exiting the economy	321	578	819
2002/03 GVA		909,827	
Exit as proportion of 2002/03 GVA	0.035%	0.064%	0.090%
2002/03 GDP		1,054,061	
Exit as proportion of 2002/03 GDP	0.030%	0.055%	0.078%

Source: ONS, Deloitte analysis

APPENDIX 1

SUMMARY OF METHODS USED TO ESTIMATE THE SIZE OF THE MARKET FOR SOFTED AND BUNDLED SERVICES

A1 Introduction

This section summarises the three methods that were used to arrive at an estimate of the size of the market for softed and bundled services in 2002/03. These are "top-down" approaches which first estimate the total level of commissions paid by UK fund managers to brokers for UK and overseas equity trades. Total commissions can be multiplied by the proportion of commissions attributable to softed and bundled services (as calculated at Section 3.2 of the main report) to arrive at a value of commissions paid for softed and bundled services.

A1.2 Method 1: Value of equity trades

Introduction

This approach requires the estimation of the total value of non-proprietary equity trades (i.e. those placed by brokers for third parties such as fund managers) passing through both the London Stock Exchange (LSE) and exchanges in other geographic markets. The average level of UK commissions and a weighted average level of commissions paid on overseas markets can then be applied to this value to gain the value of total commissions paid by UK fund managers in the UK and overseas.

Data used

Data was obtained from the LSE showing that non-proprietary trades (i.e. those trades placed by brokers for third parties) in UK equities placed on the exchange totalled £1,112bn in 2003[32]. This total was reduced by 48.7% to account for the proportions of LSE trades carried out by brokers on behalf of overseas clients and on behalf of UK clients placing trades without the assistance of a fund manager (both private clients and companies)[33]. The exclusion of these trades results in an estimated value of non-proprietary trades in UK equities undertaken for UK fund managers of £570bn.

Elkins McSherry data was obtained showing an average UK commission rate for all equity trades in 2003 of 13.87bps. This was applied to the value of trades above to arrive at an estimate of 2003 commissions paid by UK fund managers for trades in UK equities of £0.79bn.

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32 Secondary Market Factsheet, London Stock Exchange, (December 2003).

33 Survey of London Stock Exchange Transactions 2000, London Stock Exchange (2000).

APPENDIX 1

To obtain a value for commissions paid by fund managers for trades in overseas equities placed on other exchanges, we used IMA data[34] reproduced below showing fund managers' allocation of equities by world trading region.

Table A1.1 – Fund managers' allocation of assets between equity markets 2002	Allocation (%)
UK	36%
Europe	17%
North America	31%
Japan	9%
Emerging Markets	5%
Other	2%
Total	100%
	Source: IMA

The table shows that, on average, 36% of fund managers' equity portfolios were held in UK equities, a large majority of which are traded on the LSE. The £570bn value of trades placed in UK equities on the LSE may therefore be assumed to represent around 36% of total trades placed by fund managers, with trades in overseas equities placed on other exchanges accounting for the remaining 64%. This gives an approximate value of trades placed on other exchanges of £1,014bn.

As with UK trades above, Elkins McSherry data was used to source average commission levels in world equity markets. The table below shows average commissions for the regions shown in Table A1.1.

Table A1.2 – Average commissions in world equity markets 2003	Average commission (bps)
UK	13.87
Europe	18.73
North America	21.32
Japan	13.05
Emerging Markets	34.78
Other	23.12
	Source: Elkins McSherry[35]

When the average commissions shown at Table A1.2 are weighted by the proportion of equities held in each region shown in Table A1.1, a weighted average overseas commission rate of 20.58bps results. When this is multiplied by the £1.01bn value of overseas trades, total commissions paid for trades in overseas equities of £2.09bn result. When added to UK commissions calculated above of £0.79bn, total commissions paid by UK fund managers to brokers may be estimated at approximately £2.88bn in 2003.

34 Fund Management Survey, IMA (2002). The IMA sample included responses from 55 member firms, accounting for 90% of assets managed in the UK.

35 The average commissions shown have been aggregated from country data supplied by Elkins McSherry. UK average commissions represent an average between buys and sells. We understand from Elkins McSherry that zero commission trades are included in the average but have no material effect upon it.

A1.3 Method 2: Imputed from stamp duty

Introduction

Fund managers must pay stamp duty of 50bps on the purchase of shares. As commission is charged on both purchases and sales of shares, if it is assumed that fund managers buy and sell equal amounts of shares, it may be further assumed that stamp duty receipts should have an approximate relationship to the total commissions paid to brokers for trades placed in the UK equal to:

Total commissions from UK trades = Stamp duty receipts x (Average commission rate x 2 / stamp duty rate).

Data used

Stamp duty receipts relating to equity trades settled through CREST[36] in financial year 2002/3 totalled £2.25bn.[37] Using the formula above and Elkins McSherry data on average UK commissions in 2003, commissions from UK trades may be estimated at £1.25bn as shown below:

£2.25bn[38] x (2 x 13.87bp / 50bp) = £1.25bn

If total commissions earned outside the UK are calculated as in method 1 above, totalling £2.09bn, total UK and overseas commissions may be estimated at £3.33bn in 2002/03.

A1.4 Method 3: Fund activity analysis

Introduction

Total commissions may also be estimated by taking the total equity funds under management in the UK and examining the trading turnover of these equities over a year in the world equity markets in which they are held to give a total value of equity trades. Average commissions data may then be used to arrive at total commissions paid on this value of trades.

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36 CREST provides settlement services for the London Stock Exchange, Irish Stock Exchange, virt-x and a range of Electronic Crossing Networks

37 Source: Inland Revenue.

38 We understand that intermediaries (e.g. brokers) generally benefit from relief for stamp duty and so intermediary trades should not inflate stamp duty receipts for the purposes of this approach. We further understand that trades placed by overseas institutions may be included in the value of receipts, but that these should be offset to some extent by stamp duty relief enjoyed by fund managers on Contracts for Differences (CFDs) including underlying equity trades. Data was not available to separate out these components of stamp duty take from total receipts.

APPENDIX 1

Data used

Total funds under management in the UK at the end of 2002 were £2,600bn[39]. Around 54% of UK funds are composed of equities[40] giving total equity funds under management of £1,404bn. These are allocated between equity markets as at Table A1.1 above. The turnover of equities placed in each market was obtained from statistics purchased from WM Company showing average activity levels of UK pension funds in each geographic region. Finally, average commissions in each region were again taken from Elkins McSherry data (see Table A1.2) to arrive at a total level of commissions paid for equity trades in each region. These are then added to arrive at a total level of commissions paid of £3.44bn in 2003. This approach is summarised in Table A1.3 below.

Table A1.3 Estimated commissions spend in world equity markets

bps	***Allocation (%)***	**Funds under management (£)**	**Activity level* (%)**	***Average commission (bp)***	***Total commission (bp)***
UK	*36%*	505	98%	*13.87*	0.69
Europe	*17%*	239	123%	*18.73*	0.55
North America	*31%*	435	160%	*21.32*	1.48
Japan	*9%*	126	146%	*13.05*	0.24
Emerging markets	*5%*	70	153%	*34.78*	0.37
Other	*2%*	28	153%	*23.12*	0.10
Total	*100%*	1,404			3.44

* Activity represents the element of turnover in excess of the net investment during the period (i.e. voluntary dealing). Formula = Purchases + Sales - | Net Investment | / Average Capital Employed.

| Net Investment | denotes the Modulus of the Net Investment (e.g. If Net Investment = -6,000 then | Net Investment | = 6000, If Net Investment = 6,000 then | Net Investment | also = 6,000.

Average capital employed is defined as the initial market value plus time-weighted investment (i.e. if the initial market value is 1,000 and there has been a net investment of 200 on day 3 of the month (taking a 31 day month) then the average capital employed = 1000 + ([31-3]/31 *200) = 1180.65.

Source: Deloitte fund managers questionnaire

[39] Fund Management, IFSL (2003).

[40] Fund Management Survey, IMA (2002).

APPENDIX 2

FUND MANAGERS' VIEWS ON THE FUTURE OF THE RESEARCH SECTOR

A2 Introduction

This section summarises the answers of respondents to our questionnaire focusing on questions aimed at forecasting the potential environment for the provision of research if the Proposals are implemented. We separated research, which may be received in written or verbal form, into the following categories:

Proprietary / non-proprietary - proprietary research is broadly defined as research that is requested by the fund manager on equities of their choice. This may be following advice from a broker, but the decision to source the research is taken by the fund manager. In contrast, non-proprietary research is pushed by the provider to the fund manager.

Type of provider - broker / independent research company or boutique.

Type of equity - main stocks / niche and small cap stocks

A2.1 Volume and value of research received

At present, research provided by brokers accounts for around 52% of all research sourced by volume, of which non-proprietary accounts for 33% and proprietary 19%. In-house research accounts for about 45% of research provision, while the remaining 3% is provided by independent research companies and boutiques.

In-house and proprietary research are highly valued due to their greater focus, while independent research is valued higher than material from brokers, particularly research on niche or small cap companies. Some fund managers indicated that they would buy more independent research if the supply was present in the market. Table A2.1 summarises the findings of the questionnaire on volume and value of research purchased.

Table A2.1 – Volume and value of research currently produced

		Proprietary				Non-proprietary				
	In-house	Broker /main stocks	Broker niche/ small-cap	Ind. main stocks	Ind. niche/ small-cap	Broker /main stocks	Broker niche/ small-cap	Ind. main stocks	Ind. niche/ small-cap	Total
Volume produced / sourced (as % of total)	45.2%	18.1%	0.4%	1.4%	0.2%	29.4%	3.7%	0.7%	0.8%	100%
Value (out of 100)	85	75	75	82	85	29	46	30	70	

Source: Deloitte fund managers questionnaire

We also asked fund managers how their take-up of research had altered over the past ten years and how they would envisage it changing after implementation of CP176. Analysis of responses to these questions is based on a smaller sample than that used for the table above as fewer firms felt confident in forecasting the future research environment, and fewer were able to provide historic data, than could indicate their current requirements.

Respondents' views on the volume and value of research provided 10 years ago are shown in the table below.

Table A2.2 – Volume and value of research produced 10 years ago

	Proprietary					Non-proprietary				
	In-house	Broker /main stocks	Broker niche/ small-cap	Ind. main stocks	Ind. niche/ small-cap	Broker /main stocks	Broker niche/ small-cap	Ind. main stocks	Ind. niche/ small-cap	Total
Volume produced / sourced (as % of total)	31.6%	9.9%	1.0%	0.4%	0.1%	49.6%	5.6%	0.6%	1.1%	100%
Value (out of 100)	77	56	25	35	35	40	50	0	62	

Source: Deloitte fund managers questionnaire

Over the past ten years, non-proprietary broker main stock research has fallen from 50% of volume produced to 29%, while production of in-house research has increased by 13 percentage points from 32% to 45%. Independent research has risen from 2.2% to 3.1% of the market, coinciding with an increase in its value to fund managers (and that of proprietary research in general) indicating that fund managers may now have more control over the type of research received.

Expected volume and value of research produced if the Proposals are implemented is shown in the table below.

Table A2.3 – Volume and value of research produced if the Proposals are implemented

	Proprietary					Non-proprietary				
	In-house	Broker /main stocks	Broker niche/ small-cap	Ind. main stocks	Ind. niche/ small-cap	Broker /main stocks	Broker niche/ small-cap	Ind. main stocks	Ind. niche/ small-cap	Total
Volume produced / sourced (as % of total)	64.6%	8.4%	1.0%	0.9%	0.8%	20.1%	2.9%	0.2%	1.1%	100%
Value (out of 100)	94	80	72	32	82	40	50	0	62	

Source: Deloitte fund managers questionnaire

Fund managers expect that implementation of the Proposals would result in a further shift towards in-house production, rising from 45% to around 65% of total research sourced, and that this would be valued more than at present. This rise is offset by a fall in market share attributable to broker-produced research from 52% to 32%, while independently produced research is expected to maintain its 3% share. A small rise in the share of niche and small-cap research is expected from 5.2% to 5.7%.

The results shown in Table A2.3 may not indicate that larger fund managers expect to produce much higher quantities of research in-house but rather that a higher proportion of a smaller total may be sourced in-house as the level of broker research produced decreases. Feedback from fund managers with limited or non-existing in-house capabilities suggests that they will adopt a wait-and-see strategy in order to understand changes brought about by the Proposals before committing to large investments in in-house provision.

A2.2 Potential free rider problems

When assessing the impact of unbundling on the demand for research, Charles River Associates[41] predicted a "significant free rider problem" resulting from the "inability of fund managers to effectively discriminate between those customers that are willing to pay for research and those that are not." It concluded that this combined with "an unwillingness for any increase in annual management charges to reflect the cost of advice" will mean that "the equilibrium level of research will fall below the optimum."

We asked fund managers to what extent they agree with the above argument. Out of 14 respondents that answered, 75% strongly agreed or agreed while 25% neither agreed nor disagreed. This level of acceptance of the argument was accompanied by comments such as "it would be extremely difficult to apply the knowledge and information gained from research or bundled services only to customers that have paid for these services when making investment decisions for the whole fund."

A2.3 Spending on research

In its CP176 cost-benefit analysis, OXERA commented that "total spending on research may fall, but spending on in-house research, and the type of third party research currently paid for with hard money, is likely to increase proportionally, if not absolutely. As a result, general competitive conditions are likely to improve, which should be advantageous to the customers of research services."

We asked respondents what their level of agreement with the above statement is. 23% of respondents strongly disagreed, and a further 38% disagreed, while 31% neither agreed nor disagreed, and 8% strongly agreed.

Comments received suggest that fund managers doubt that smaller companies would be able to either set up in-house research capabilities or buy sufficient quantities of unbundled research from brokers and independent providers.

41 "An assessment of the proposed changes to regulation of bundled brokerage and soft commission arrangements", Charles River Associates Ltd, (October 2003).

A2.4 The future of the independent research sector

We asked respondents if they agree with OXERA's argument that "when research is purchased with hard cash rather than bundled, the independent research sector will be able to flourish as it will compete on a level playing field and, in particular, be able to provide better quality research in small cap and niche stocks."

In total, 27% of respondents agreed with the statement, 20% neither agreed nor disagreed, and 53% disagreed or strongly disagreed. Those disagreeing suggested that, depending on the form of implementation of Proposal 1, independent researchers could lose access to soft credits but, as fund managers may prefer not to use hard money to source bespoke research, commission sharing agreements might become the only source of income for the independent sector.

APPENDIX 3

THE FUND MANAGERS QUESTIONNAIRE

This section contains the questionnaire that was sent to fund managers.

APPENDIX 3

Deloitte.

Fund Managers Questionnaire

Impact of FSA Consultation Paper CP176 on Incremental costs and competitiveness

January 2004

This questionnaire has been compiled by Deloitte to solicit the opinions of Fund Managers relating to the impact on their costs and competitiveness of the proposals contained within FSA Consultation Paper CP176. Responses to the questionnaire should be sent to:

Calum Thomson
Partner
Deloitte & Touche
Stonecutter Court
1 Stonecutter Street
London
EC4A 4TR

Questions relating to the content of the questionnaire can be addressed to:

Calum Thomson
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or

Chris Moore
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APPENDIX 3

INTRODUCTION

The FSA has asked us to examine the impact of CP176 on the UK Fund Management industry. They have specifically requested that we assess incremental costs that may arise as a result of the regulation and strategies that may be followed by the industry to mitigate extra costs. They are also interested in the extent to which any extra costs can be passed through to trustees and other clients.

GENERAL QUESTIONS

Throughout this survey, two types of commission arrangements are referred to:

- **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 ('soft dollars') which can then be used to purchase services such as research and information services.
- **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 services, chiefly research, from the broker.

Please note that the questions below are not in strict numerical order as they have been selected from a larger pool. Those questions excluded from the questionnaire may be discussed with you separately at a later date.

Part A: Background information
Name of firm and business unit: ....

Participants at meeting

Name	Position

Where questions below do not state that data from a specific year should be used in your answer, please include data from the latest available year. Please give the year you will use below and state whether this is a calendar year or a financial year.

Year .... calendar year / financial year (please erase)

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

Part B: General questions

B.1 Please complete the following table showing the trend in commission paid to brokers over the last five years

bps	2002	2001	2000	1999	1998
Commission received on standard trade					
Commission received on programmed trades					
Commission received on difficult trade (e.g. including working the trade)					
Average commission received					

B.2 Can you provide an explanation of the trend shown and the extent to which specific events caused step-changes in commission paid?

B.4 Please complete the tables below showing trades with, and commission paid to, UK and overseas brokers in the past three years.

	2002		
(£)	UK regulated brokers	Overseas regulated brokers	TOTAL
Trades by value			
Commission paid			
Commission paid where softed credits received			
Value of soft credits received			
Commission paid where bundled services received			
Estimated value of bundled services received			

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2001			
(£)	UK regulated brokers	Overseas regulated brokers	TOTAL
Trades by value			
Commission paid			
Commission paid where softed credits received			
Value of soft credits received			
Commission paid where bundled services received			
Estimated value of bundled services received			

2000			
(£)	UK regulated brokers	Overseas regulated brokers	TOTAL
Trades by value			
Commission paid			
Commission paid where softed credits received			
Value of soft credits received			
Commission paid where bundled services received			
Estimated value of bundled services received			

B.5 Do you have any comments regarding the proposed implementation of CP176 over and above those included in your response to the FSA consultation? (please attach separate sheet with comments)

B.6 If CP176 is implemented, how do you believe this would change your trading behaviour? For example:

- would the number of trades carried out rise / fall?
- which type of stocks would be responsible for this rise/fall?
- would you re-focus onto different types of stocks?

Trading volumes +/- ....%

Reasons / stocks affected:

Other impacts:

B.7 If CP176 is implemented, do you anticipate receiving:

a) bundled execution and non-execution services, rebating the non-execution element of these to customers.
b) separated execution and non-execution services, where non-execution services are purchased for a single bundled price;
c) a menu of separately priced execution and non-execution services (e.g. the tariff pricing model);
d) a mixture of the above depending on broker / client?
e) some other arrangement (please specify).

Please state anticipated percentage of each and state if this would depend on the client (e.g. institutional / retail)

a.......... b.......... c.......... d.......... e)..........

Please explain your answer:

B.8 Who would drive this decision? (e.g. broker, fund manager, client)

B.9 Would you anticipate explicitly charging for non-execution services when you invoice clients or making an adjustment to your management fee? Please state if this would depend on the client (e.g. institutional / retail)

B.10 Who would drive this decision? (e.g. fund manager, client).

APPENDIX 3

B.11 To what extent would you agree with the cost of components of a bundled / softed trade booked with UK / overseas brokers (as published by OXERA in its analysis for the FSA on the costs and benefits that might accrue from CP176)?

Breakdown of commissions paid

	OXERA analysis	UK brokers	Overseas brokers
Average commission rate	14bp		
Execution only (electronic trading platform)	5-8bp		
Working a trade	2-5bp		
Soft commission	1bp		
Bundled services	3bp		

Please explain your answer

B.12 If the proposals contained in CP176 were implemented such that softed services currently received were further restricted and the price of non-execution services was unbundled from execution services, please indicate in the table below the extent to which you believe a fall in broker commissions will offset the value of softed credits and bundled services.

Total value of softed services received	From Table C.4
Estimated fall in broker commission to compensate (£ or %)	
Estimated value of bundled services received	From Tables C.4 and C.9
Estimated fall in broker commission to compensate (£ or %)	

Please explain your answer, where possible giving examples from previous price negotiations.

B.14 Could you provide examples and supporting evidence of when brokers were able to impose unilateral changes to the terms of their contracts with fund managers and/or increase their charges / not pass through costs in the past? Why were fund managers not able to constrain these changes?

B.16 With respect to current developments in the Fund Managers market (e.g. step out arrangements), to what extent have you taken these up and what influence will they have on the proposals contained in CP176 if implemented?

1. Questions relating to Proposal 1 in CP176

1.a Please complete the table below to show **for UK-reglated business** :

- the value of services received through or paid for using soft credits (£); and
- the percentage of services received by value that were purchased or provided by the issuer of the soft credits (e.g. if 50% were provided by the broker and a further 20% purchased by the broker on your behalf, 70% of services were purchased or provided by the issuer of the credits).

Please note:

- The value of research received through or paid for using soft credits is covered later at question R.f and should not be included here.
- If insufficient information is available to disaggregate the services received / paid for using soft credits, please complete the "total" rows only.

	2002	2001	2000
Market Pricing and Information services (e.g. terminals)			
% purchased or provided by issuer on your behalf			
Hardware software & other equipment			
% purchased or provided by issuer on your behalf			
Valuation and performance measurement services			
% purchased or provided by issuer on your behalf			
Other services			
% purchased or provided by issuer on your behalf			
Total value of services received			
Total % purchased or provided by issuer on your behalf			

APPENDIX 3

1.b What is the percentage of brokers you trade with that provided you with these services in the last financial year? [i.e. number of brokers providing you with these services divided by the total number of brokers you trade with]

1.1 MPIS (Market Pricing Information Systems, e.g. Bloomberg)

1.1.1 In the last year, which MPIS services do you receive through softing arrangements?

1.1.4 Has your take-up of these services (through both softed and non-softed arrangements) altered over the past 3 years?

1.1.5 If CP176 is implemented, please indicate:

- How the quality of these services may change;
- (taking into account any changes in quality) how the average price of these services to you may change (e.g. new price – value of soft credits previously used);
- whether you will be able to pass the cost of these services through to your clients, and
- (taking into account the above) the quantity you would expect to purchase relative to the quantity currently obtained.

	Service 1	Service 2	Service 3	Service 4	Service 5
Average quality	up / down /same	up / down /same	up / down /same	up / down /same	up / down /same
Average price	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. -10%)					
Cost recovery	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. 100% recovery)					
Amount purchased	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. +10%)					

Please detail reasons and (to the extent possible) supply evidence supporting your answer.

1.2 Hardware, software & other equipment

1.2.1 In the last year, which hardware, software & other equipment do you receive through softing arrangement?

1.2.4 Has your take-up of these services (through both softed and non-softed arrangements) altered over the past 3 years?

1.2.5 If CP176 is implemented, please indicate:

- How the quality of these services may change;
- (taking into account any changes in quality) how the average price of these services to you may change (e.g. new price – value of soft credits previously used);
- whether you will be able to pass the cost of these services through to your clients, and
- (taking into account the above) the quantity you would expect to purchase relative to the quantity currently obtained.

	Service 1	Service 2	Service 3	Service 4	Service 5
Average quality	up / down /same	up / down /same	up / down /same	up / down /same	up / down /same
Average price	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. -10%)					
Cost recovery	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. 100% recovery)					
Amount purchased	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. +10%)					

Please detail reasons and (to the extent possible) supply evidence supporting your answer.

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1.3 Valuation and performance measurement services

1.3.1 In the last year, which valuation and performance measurement services do you receive through softing arrangements?

1.3.4 Has your take-up of these services (through both softed and non-softed arrangements) altered over the past 3 years?

1.3.5 If CP176 is implemented, please indicate:

- How the quality of these services may change;
- (taking into account any changes in quality) how the average price of these services to you may change (e.g. new price – value of soft credits previously used);
- whether you will be able to pass the cost of these services through to your clients, and
- (taking into account the above) the quantity you would expect to purchase relative to the quantity currently obtained.

	Service 1	Service 2	Service 3	Service 4	Service 5
Average quality	up / down /same	up / down /same	up / down /same	up / down /same	up / down /same
Average price	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. -10%)					
Cost recovery	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. 100% recovery)					
Amount purchased	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. +10%)					

Please detail reasons and (to the extent possible) supply evidence supporting your answer.

2. Questions relating to Proposal 2 in CP176

2.a On average, what percentage of total commission paid corresponds to the following elements of a typical trade?

Element of trade	Percentage of commission
Trade (execution-only)*	%
Softed services	%
Bundled services (e.g. working trade)	%
TOTAL COMMISSION	100%

* e.g. straightforward trade that could be executed by execution-only broker

2.b With reference to your answer above estimating the proportion of broker commission currently accounted for by bundled services, on average, to what percentage of the bundle you receive in a typical trade do the following bundled services correspond? (Please complete the following table)

APPENDIX 3

	% of bundle received	Is it inseparable from trade?	Will incur a charge if unbundled?	Comments
Working a trade	%	Yes / No	Yes / No	
Trade advice	%	Yes / No	Yes / No	
Broker advice/research: proprietary MAIN STOCKS	%	Yes / No	Yes / No	
Broker advice/research proprietary NICHE / SMALL-CAP	%	Yes / No	Yes / No	
Independent/boutique proprietary. MAIN STOCKS	%	Yes / No	Yes / No	
Independent/boutique proprietary. NICHE / SMALL-CAP	%	Yes / No	Yes / No	
Non-proprietary. MAIN STOCKS	%	Yes / No	Yes / No	
Non-proprietary. NICHE / SMALL-CAP	%	Yes / No	Yes / No	
Conferences	%	Yes / No	Yes / No	
Equipment: proprietary	%	Yes / No	Yes / No	e.g description
Equipment: non-proprietary	%	Yes / No	Yes / No	e.g description
Access to IPOs	%	Yes / No	Yes / No	
TOTAL	**100%**			

2.c Can you provide extra detail on other services received that are currently bundled with execution?

2.1 Of the non-execution services you indicated at 2.b that: a) were over 2% of an averaged bundled trade and b) would incur a charge following the implementation of CP176 (either individually or as part of a bundle of non-execution services), please indicate:

- how the quality of these services to you may change;
- (taking into account any changes in quality) how the average price of these services to you may change (e.g. new price – value of soft credits previously used);
- whether you will be able to pass the cost of these services through to your clients, and
- (taking into account the above) the quantity you would expect to purchase relative to the quantity currently obtained.

Where anticipated impacts of implementation are identical for different non-execution services, please aggregate these in a single table and state the services included in the table (e.g. if you believe the price, quantity and quality impact on two or more types of research listed above will be the same, these can be consolidated in the same table). Please provide any additional comments beneath each table.

Service(s):

	Service 1	**Service 2**	**Service 3**	**Service 4**	**Service 5**
Average quality	up / down /same	up / down /same	up / down /same	up / down /same	up / down /same
Average price	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. -10%)					
Cost recovery	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. 100% recovery)					
Amount purchased	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. +10%)					

Comments:

Service(s):

	Service 1	**Service 2**	**Service 3**	**Service 4**	**Service 5**
Average quality	up / down /same	up / down /same	up / down /same	up / down /same	up / down /same
Average price	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. -10%)					
Cost recovery	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. 100% recovery)					
Amount purchased	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. +10%)					

Comments:

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Service(s):

	Service 1	Service 2	Service 3	Service 4	Service 5
Average quality	up / down /same	up / down /same	up / down /same	up / down /same	up / down /same
Average price	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. -10%)					
Cost recovery	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. 100% recovery)					
Amount purchased	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. +10%)					

Comments:

Service(s):

	Service 1	Service 2	Service 3	Service 4	Service 5
Average quality	up / down /same	up / down /same	up / down /same	up / down /same	up / down /same
Average price	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. -10%)					
Cost recovery	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. 100% recovery)					
Amount purchased	(% change)	(% change)	(% change)	(% change)	(% change)
(e.g. +10%)					

Comments:

R. Research costs resulting from the implementation of CP176

R.a Can you categorise the types of research, as you understand them, by source (e.g. broker, independent researchers, etc.) and other appropriate classifications (e.g. proprietary / non-proprietary, verbal / written)?

R.b (In the light of the previous answer) Do you consider non-proprietary circulars sent by brokers and others to all clients to be research? Please explain your answer.

R.c – R.e Please populate the landscape tables relating to this question on pages 27 and 28

Instructions
The tables ask about the production, consumption, price and value of research. The 1st table asks about research as currently produced, the 2nd table deals with research produced historically, and the third table asks you to predict production and consumption patterns if the proposals in CP176 are implemented. To guide the population of rows in the tables:

Volume produced/sourced (% of total): This is the quantity of research that you acquire from different sources, totalling to 100%
Volume used (% of total): This will differ from the above percentages if some of the research received is not used
Value (out of 100): Some types of research received will be valued more than others (e.g. in-house research may be thought to have a value of 90, but non-proprietary broker research a value of 50).
Level of production (relative to your needs): e.g. "too little" or "too much" of each type of research
Over or under-consumption in the market: In your opinion, would the market work better if some types of research were more heavily consumed / not consumed as much (e.g. answer "over" or "under" where appropriate)
Average price: Are some types of research over-priced affecting their consumption (e.g. state "too high" where appropriate)

Please provide any additional comments relating to your population of the tables underneath the third table.

R.c – R.e Please provide any additional comments relating to your population of the tables R.c – R.e.

R.f Please complete the table below to show:

- The value of research services received through soft credits;
- The percentage of services received that were purchased or provided by the issuer of the soft credits

	2002	2001	2000
Value of soft credits spent on proprietary research (broker:main stocks)			
(% purchased or provided by broker that issued soft credits)			
Value of soft credits spent on proprietary research (broker: niche / SC)*			
(% purchased or provided by broker that issued soft credits)			
Value of soft credits spent on proprietary research (ind./boutique: main stocks)			
(% purchased or provided by broker that issued soft credits)			
Value of soft credits spent on proprietary research (ind./boutique: niche / SC)			
(% purchased or provided by broker that issued soft credits)			
Value of soft credits spent on non-proprietary research (main stocks)			
(% purchased or provided by broker that issued soft credits)			
Value of soft credits spent on non-proprietary research (niche / SC)			
(% purchased or provided by broker that issued soft credits)			
Value of soft credits spent on other research			
(% purchased or provided by broker that issued soft credits)			
Total value of soft credits spent on research			
Total % purchased or provided by broker that issued soft credits			

* SC= Small Cap

Please provide any comments relating to your population of the table.

R.i What percentage of research that you currently source is related to specialist or small-cap stocks?

R.j When assessing the impact of unbundling on the demand for research, Charles River Associates predict a "significant free rider problem" resulting from the "inability of fund managers to effectively discriminate between those clients that are willing to pay for research and those that are not." They conclude that this combined with "an unwillingness for any increase in annual management charges to reflect the cost of advice" will mean that "the equilibrium level of research will fall below the optimum." Please indicate your level of agreement with the above argument.

Strongly agree	Agree	Neither agree nor disagree	Disagree	Strongly Disagree

Please explain your answer:

R.k Please indicate your level of agreement with the following statement from Oxera's Cost / Benefit analysis of CP176:

"Total spending on research may fall, but spending on in-house research, and the type of third party research currently paid for with hard money, is likely to increase proportionally, if not absolutely. As a result, general competitive conditions are likely to improve, which should be advantageous to the customers of research services."

Strongly agree	Agree	Neither agree nor disagree	Disagree	Strongly Disagree

Please explain your answer:

R.1.1.a How much do you currently spend on in-house research p.a. Please disaggregate your answer to include staff, space, materials and other costs.

APPENDIX 3

R.1.2 If the proposals in CP176 are implemented, do you envisage setting up / increasing an in-house research capability? (please state which and any measure of the scale of set-up or increase)

R.1.4 If you do envisage setting up / enhancing your in-house research capability, can you list the incremental activities and costs involved in the set-up / enlargement of your in-house research team?

One-off activities	Associated costs

R.1.5 Do you anticipate that these will result in the recruitment of new staff? If yes, please expand your answer to include numbers of staff / estimate of salaries.

R.2.1 Noting your answers above in relation to research, how would you expect research on small cap stocks to be affected by a) further restrictions on softing and b) unbundling/rebating? Where possible, please provide evidence in support of your answer.

R.2.2 Please state your level of agreement with the following statement:

"When research is purchased with hard cash rather than bundled, the independent research sector will be able to flourish as it will compete on a level playing field and, in particular, be able to provide better quality research in small cap and niche stocks."

Strongly agree	Agree	Neither agree nor disagree	Disagree	Strongly Disagree

Please explain your answer

R.2.4 Can you provide evidence from previous regulatory decisions / cost shocks in support of your views above?

R.3.2 If the services above that you currently receive with execution services were separated from these and purchased as a package of non-execution services what percentage of your expenditure on these services would you expect to recover from clients by way of increased management fee or explicit charges?

...%

Please explain your answer

APPENDIX 3

3. Increased transaction costs arising from unbundling

3.1.1 If proposal 1 of CP176 is implemented, what incremental activities / procedures would you adopt to source equipment, research and conferences from **new** providers?

Note: negotiation of prices with present providers is examined in a later section.

MPIS:

Hardware / software:

Valuation & Performance Management services:

Other (if material):

3.1.2 If proposal 2 of CP176 is implemented, what incremental activities / procedures would you adopt to source equipment, research and conferences from **new** providers?

Note: negotiation of prices with present providers is examined in a later section.

Equipment:

Research:

Conferences:

Other (if material):

3.1.4 Do you anticipate that the above incremental activities and costs will result in the recruitment of new staff? If yes, please expand your answer to include numbers of staff / estimate of salaries.

4. Process costs associated with unbundling, rebating and ending of softed ties

<u>4.1 Cost of calculation of unbundled prices</u>

4.1.1 Please populate the landscape table relating to this question on page 29.

Please complete the table listing any incremental activities and costs you anticipate will result from the need to calculate the price of currently bundled or softed services **with your current service providers**.

4.1.2 Do you anticipate that these incremental activities and costs will result in the recruitment of new staff? If yes, please expand your answer to include numbers of staff / estimate of salaries

<u>4.2 Cost of invoicing</u>

4.2.1 Can you describe any modifications that would need to be made to your invoicing system to accommodate the proposals in CP176.

4.2.2 Please populate the landscape table relating to this question on page 29.

4.2.8 Do you anticipate that the above incremental activities and costs will result in the recruitment of new staff? If yes, please expand your answer to include numbers of staff / estimate of salaries.

4.2.9 To the extent that different contractual and invoicing procedures are currently operating for different trades (e.g. principal, agency, single stock, large / small cap), how would calculation / negotiation of prices and subsequent invoicing for unbundled services impose a significantly greater administrative / IT burden than negotiation of these and other trade types?

4.2.10 Can you supply evidence relating to the last time that pricing mechanisms with brokers (and if applicable, clients) changed significantly and the implications this had in terms of the price calculation / negotiation and invoicing activities and costs as detailed above?

Price calculation

Invoicing

The following questions should only be answered if, following the proposed implementation of CP176, you would continue to receive bundled execution and non-execution services and rebate the non-execution elements of these to clients' funds (see previous answer to question B.7)

4.2.11 The cost of an unbundled trade is £8, of which the execution element can be valued at £5 and the non-execution element at £3. Your broker charges a bundled price of £7. How much would you rebate to your client to cover the non-execution element?

4.2.12 Do you currently pay out rebates to clients (e.g. to funds for miscalculated invoices)? If so, approximately how many rebates do you issue a year? Can you quantify the costs of issuing these?

4.2.13 Please populate the landscape table relating to this question on page 30.

End of questions on rebating.

4.3 Cost impact of extension of VAT to unbundled / unsofted services

4.3.1 What is the VAT impact from the unbundling of non-execution services as you understand it?

4.3.2 Are there any ways in which a) Fund Managers in general may be able to mitigate against this charge b) you would anticipate mitigating against the charge (e.g. price/commission structure / tax advice/explicit pass-through to clients)?

4.3.3 Can you quantify any incremental activities / costs associated with the above methods of mitigation? Can you explain how these are over and above activities normally undertaken?

4.3.4 Do you anticipate that the above incremental activities and costs will result in the recruitment of new staff? If yes, please expand your answer to include numbers of staff / estimate of salaries

4.4 Cost impact of increased client management

4.4.1 Over and above client relationship activities and costs included above, do you anticipate any incremental client relationship activities and costs from the new regulation? Could you quantify these?

APPENDIX 3

<u>4.5 Cost recovery</u>

4.5.1 Thinking about costs associated with the incremental activities discussed above under the following headings:

- Transaction costs with new service providers
- Price re-negotiation with present providers
- Incremental invoicing costs
- Costs associated with the extension of VAT to non-execution services
- Incremental client management costs

What percentage of these costs would you be able to pass through to clients by means of one or more explicit charges or raising your management fee? …….%

Please explain your answer (include whether this percentage differs by type of client)

<u>C. Other information</u>

C.1 Please populate the landscape table relating to this question on page 31.

Instructions

Please complete the table as fully as possible. If you are unable to disaggregate to the types of clients included in the table, please supply aggregated information and indicate how this is aggregated.

For fixed expenses, please consider only those costs whose level does not depend on the amount of business on the books. This will include overheads such as the cost of management, premises, basic audit fees, website development etc. The remaining expenses, such as salaries of non-managerial staff, mailings, telephone etc. whose consumption does depend on the amount of business, should be classified as variable

C.2 Please populate the landscape table relating to this question on page 32.

C.5 Please fill in the following table showing the anticipated effect on your revenues, gross margins, net margins, and market share if you were to raise management fees to clients by 5% , 10%, 3 basis points and 6 basis points.

	Institutional clients				Retail clients			
	Up 5%	Up 10%	Up 3bp	Up 6bp	Up 5%	Up 10%	Up 3bp	Up 6bp
Revenues								
Gross margin								
Net margin								
Market share								

Please explain your answer.

C.9 In the light of your analysis of the possible implications associated with implementation of the proposals contained in CP176, could you provide a description of the extra activities that you would undertake to mitigate against the possible extra costs associated with it?

C.10 Have you looked at the possibility of moving your Head Office or some/all Fund Management divisions / activities away from the UK in the last 5 years? If so, what were the factors taken into account in this review and what were the conclusions?

C.11 In the light of your answers above, can you provide any instances where you believe fewer activities will be undertaken / fewer costs incurred as a result of the implementation of CP176. Please quantify these if possible.

Activities foregone	Cost savings (£)

APPENDIX 3

R.c Please complete the following table with reference to your current take-up of research services.

Current situation	Proprietary					Non-proprietary					Total
	In-house	Broker main stocks	Broker niche / small cap	Ind./ boutique main stocks	Ind./ boutique niche / SC	Broker main stocks	Broker niche / small cap	Ind./ boutique main stocks	Ind./ boutique niche / SC	Others	
Volumes produced / sourced (% of total)											100%
Volumes used (% of total)											100%
Value (out of 100)											
Level of production (relative to your needs)											
Over- or under-consumption in the market											
Average price											

APPENDIX 3

R.d Please complete the following table with reference to your take-up of research services 10 years ago

10 years ago	Proprietary					Non-proprietary					Total
	In-house	Broker main stocks	Broker niche / small cap	Ind./ boutique main stocks	Ind./ boutique niche / SC	Broker main stocks	Broker niche / small cap	Ind./ boutique main stocks	Ind./ boutique niche / SC	Others	
Volumes produced / sourced (% of total)											100%
Volumes used (% of total)											100%
Value (out of 100)											
Level of production (relative to your needs)											
Over- or under-consumption in the market											
Average price											

R.e Please complete the following table with reference to your take-up of research services if the proposals in CP176 are implemented

If CP176 is Implemented	Proprietary					Non-proprietary					Total
	In-house	Broker main stocks	Broker niche / small cap	Ind./ boutique main stocks	Ind./ boutique niche / SC	Broker main stocks	Broker niche / small cap	Ind./ boutique main stocks	Ind./ boutique niche / SC	Others	
Volumes produced / sourced (% of total)											100%
Volumes used (% of total)											100%
Value (out of 100)											
Level of production (relative to your needs)											
Over- or under-consumption in the market											
Average price											

APPENDIX 3

4.1.1 Please complete the table listing any incremental activities and costs you anticipate will result from the need to calculate the price of currently bundled or softed services **with your current service providers**.

High-level activity	**Incremental activities**	**Associated time and costs**

4.2.2 Please complete the following table explaining any cost impact of incremental invoicing activities resulting from implementation of CP176

	Incremental administrative activities & costs	Incremental IT activities & costs
One-off modifications to present system		
Ongoing incremental administrative / system costs		

4

4.2.13 Please complete the following table detailing incremental costs and activities arising from extra rebating to clients' funds.

	Incremental activities	Incremental costs
Additional administrative activities		
Additional IT / systems activities		
Other		

APPENDIX 3

C.1 Please complete the table below giving details of funds managed, fees and overheads

	UK pension	UK life	UK retail					Overseas clients	Other	TOTAL
			IFAs	Private client (own)	Private client (external)	Direct	Fund supermarkets			
Funds under management (£)										
Annual new business (£)										
Average funds lost / realised p/a										
Number of clients										
Average management fee for existing business (%)										
Additional fees (%) e.g. performance related										
Average fee for new business (%)										
Average initial commission levels (%)										
Fixed expenses / overheads in respect of acquiring new business (£)										
Variable expenses / overheads in respect of acquiring new business (£)										
Fixed expenses / overheads in respect of ongoing business (£)										
Variable expenses / overheads in respect of ongoing business (£)										

C.2 On average, what proportion of your clients have switched to / away from you in the last three years?

	UK pension	UK life	UK retail					Overseas clients	Other	**TOTAL**
			IFAs	Private client (own)	Private client (external)	Direct	Fund supermarkets			
Switched to										
Switched from										