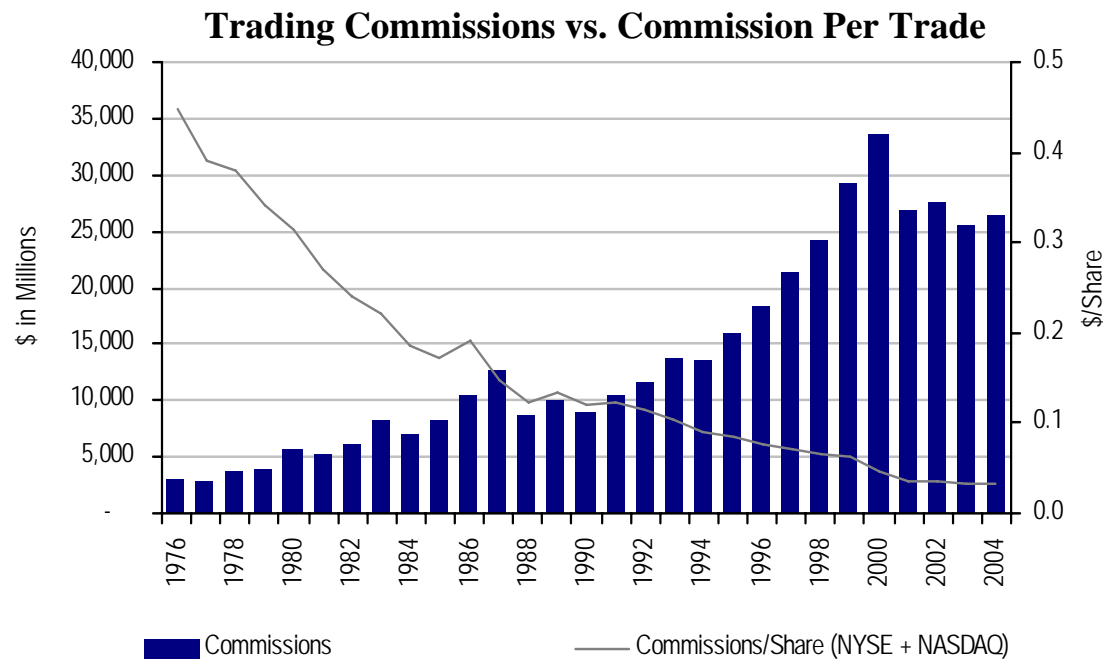


Unbundling's Doorstep: How Did We Finally Get Here?

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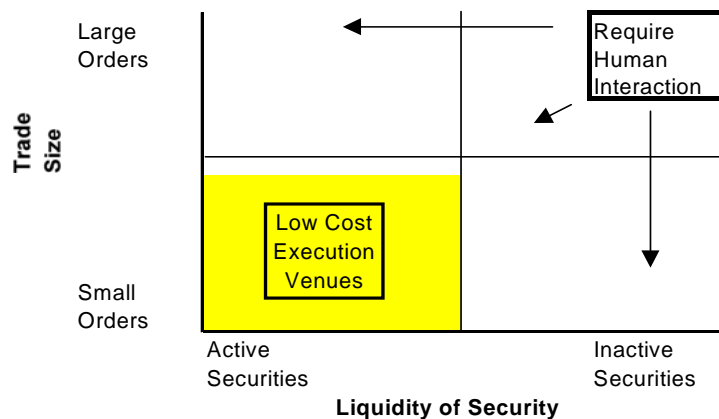
Prelude To Unbundling

- ◆ Excess capital and competition have been eating into equity margins since May Day of 1975
- ◆ The industry was able to “make it up on volume” for about 25 years
- ◆ But the market downturn, moderating volumes and increased electronification have squeezed the business

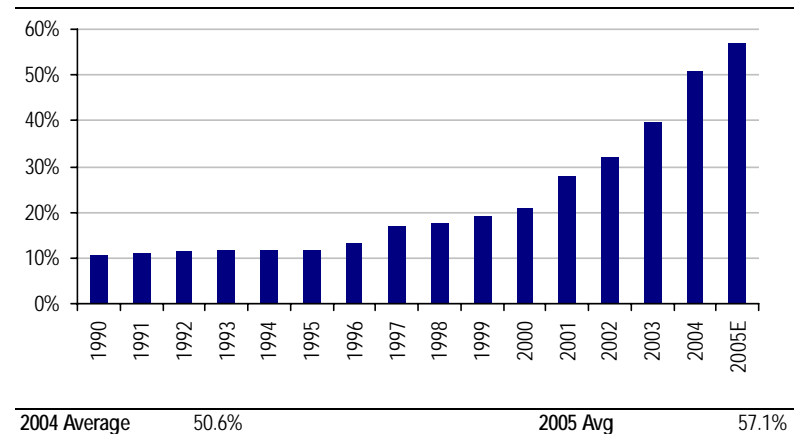


Prelude To Unbundling

- ◆ New technology & low cost execution → increase usage of ECNs, Program Trading, Algorithms and DMA → further commission pressure
- ◆ Increased regulatory scrutiny post accounting scandals, topped off with the investment banking / research settlement
- ◆ Brokers increasingly focused on business and client profitability
- ◆ Soft dollar scrutiny heats up on the buy side



Program Trading as a % of NYSE Volume



Unbundling Starts To Take Center Stage

- ◆ SEC has had a few sweeping probes into soft dollars over time – looking for infractions – relatively clean bill given
- ◆ Market timing & late trading were the last straws
- ◆ The FSA's CP 176 (following the Myners report) really got the unbundling conversation started in early 2003
- ◆ Primary motivations were: improving transparency, conflict removal and getting “value for money” when using the client's commission dollars
- ◆ FSA thought bundled & soft commission arrangements provided a bias for managers to reduce their own operating expenses by using commissions to acquire additional services
- ◆ FSA's ideal scenario would be for managers to charge one price & pay cash for everything they use – but that's not practical and not what they suggested

FSA's CP 176 – May 2003

◆ CP 176 Addressed Four Specific Concerns

1. Transparency around execution costs and quality is lacking
2. Conflicts may be affecting execution quality – boutique example
3. Better disclosure wouldn't be enough
4. Regulation should be consistent

◆ FSA's Original Proposal

1. Limit the goods/services, beyond trade execution that can be bought with commissions or order flow – exclude the 55% of soft credits that are market pricing and information services
2. Sell side research shouldn't necessarily be a pass-through expense to the client - payment for advisory services should be justifiable

◆ Main concerns over CP 176 were

1. Produces uneven implications across the buy and sell sides
2. Regulatory arbitrage: could put the UK at a competitive disadvantage
3. There could be unintended consequences (liquidity, information flow, quantity / quality of research provided...)
4. Shouldn't the focus be on performance?

SEC US Had More Of A Disclosure Focus – June '03

- ◆ Regulatory scrutiny heated up in the US in June of '03 with the SEC, the GAO and the House Subcommittee on Capital markets all putting out comments on mutual fund fees, disclosure, and governance.
 - Focus was different than CP 176 and less “disruptive”
 - Key issue was raising the disclosure of total fees & expenses, potentially transaction costs, PM comp, rev share arrangements, breakpoints ... including where to disclose them
 - Also proposed governance changes like super-majority of independent directors, annual review of fees & expenses and independent chairman
 - Softer on softing – **no call for unbundling**, just better disclosure and another “study”
- ◆ While tamer, the threat is the potential institutionalization of the retail business
 - Sarbanes Oxley-ization of the mutual fund board is powerful
 - Fund directors and even brokers could play the role of the consultant
 - Increased compliance costs are here to stay

November '04 – The FSA Got Softer

- ◆ Following 12-18 months of noise, the FSA released PS 04/23 – commentary following CP 176 – the outcome was palatable
- ◆ Defined what is research, what is execution and what should not be softable
- ◆ Importantly, all research (including the boutiques) and execution could still be paid for in commissions
- ◆ Research was defined as...
 - Represents original thought – that is, the critical and careful consideration and assessment of new and existing facts-and does not merely repeat or repackage what has been presented before
 - It has intellectual rigor and does not merely state what is commonplace or self-evident
 - It involves analysis or manipulation of data to reach meaningful conclusions

July '05 – Unbundling, On Some Level

- ◆ While PS 04/23 was just commentary, the FSA issued policy statement PS 05/9, which specified services that could not be softened, and suggested that managers break down commissions paid for execution and those paid for research (effective Jan 1, 06)
- ◆ Some managers have made decisions ahead of potential rule changes in the US in order to eliminate any perceived conflicts (like no longer softing boutique research)
- ◆ Accountability, transparency and scrutiny from all constituents (clients, consultants and regulators) can force unbundling, without any law changes
- ◆ Consumption patterns change as managers move from **all-you-can-eat buffet environment to an a la carte world**

October '05 – The SEC Speaks

- ◆ SEC proposed its official interpretation of proper client commission practices – in a nutshell, there were 3 steps:
 1. Is the product / service eligible for softing?
 2. Does the product / service provide assistance in the investment decision process?
 3. The money manager must make sure that the commission paid is reasonable in light of the value of products or services provided by the broker

While the SEC did not call for unbundling, it did say this:

“Fiduciary principles require money managers to seek the best execution for client trades, and limit money managers from using client assets for their own benefit. Use of client commissions to pay for research and brokerage services presents money managers with significant conflicts of interest, and may give incentives for managers to disregard their best execution obligations when directing orders to obtain client commission services as well as to trade client securities inappropriately in order to earn credits for client commission services.”

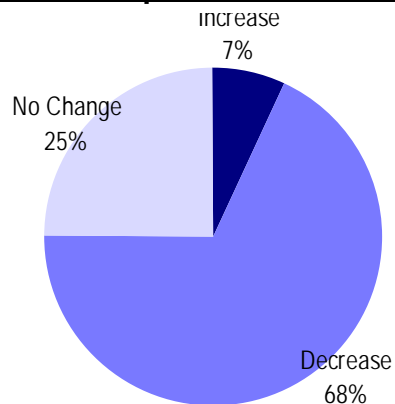
However, the SEC goes on, *“The determinative factor is not the lowest possible commission cost, but whether the transaction represents the best qualitative execution for the managed account.”*

Unbundling – No More Theories – October ‘05

- ◆ Fidelity & Lehman accelerate the pace of change
- ◆ Hard dollar component, not likely to see a ton of followers
- ◆ But determining the split and supporting the value for money concept will likely be the norm
- ◆ Concept assumes you get the true split (research vs execution)you won't
- ◆ Also, if DMA / low touch is price for pure execution, can it be used to pay for research too?
- ◆ Has bundled commissions lead to underpayment for research?
- ◆ Likely Fido is talking to more brokers and Lehman is talking to more asset managers – deals are likely like snowflakes
- ◆ Further unbundling (hard dollar or not) could have material implications for the brokers and asset managers

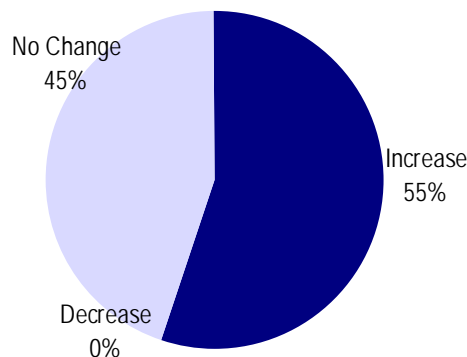
So Now What?

Expected Impact of FSA's New Regulations on Buyside Trading Activity



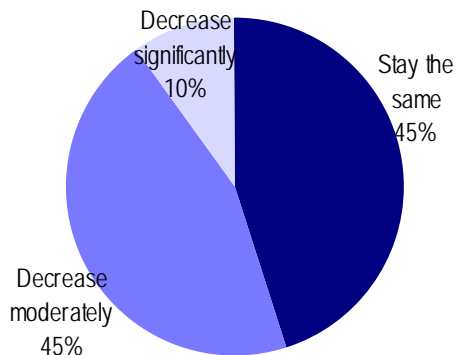
of Executing Brokers

Source: Greenwich Associates

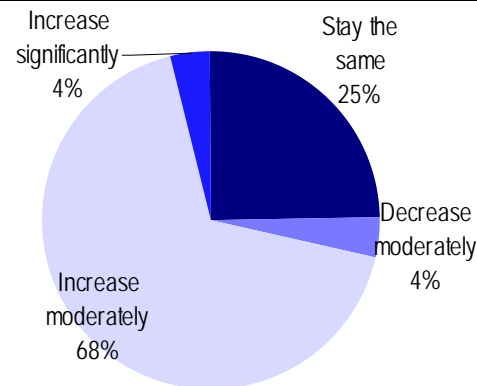


Use of Self-Directed Electronic Trading

Expected Impact of FSA's New Regulations on Research Consumption



Full-Service Broker Research



Independent Research*



Note: Based on 28 responses for number of executing brokers and 29 for use of self-directed electronic trading. Data may not total 100 due to rounding. Excludes uncertain or no answers. *Including sector or country research specialists.