OLIVER WYMAN

sifma®

Invested in America

Financial Services

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Standard of Care Harmonization

Impact Assessment for SEC

NYC-FMJ001-001

Contents

Section 1

Executive summary

Summary findings (1)

- Oliver Wyman collected data from a broad selection of retail brokerage firms to assess the impact of significant changes to the existing standard of care for broker-dealers and investment advisors
  - A total of 17 firms provided data
  - These institutions serve 38.2MM households and manage $6.8TN in client assets
  - The survey captures approximately 33% of households and 25% of retail financial assets in the US
- The primary issue at stake in the SEC 'standard of care' study is how to better protect the investor while preserving choice of relationship, product access, and affordability of advisory services
- The key insight from the survey is that broker-dealers play a critical role in the financial services industry that cannot be easily replicated with alternative services models
- Wholesale adoption of the Investment Advisers Act of 1940 for all brokerage activity is likely to have a negative impact on consumers (particularly smaller investors) across each of the following dimensions
  - Choice
  - Product access
  - Affordability of advisory services

Continued…

Summary findings (2)

Potential impact of rulemaking on retail investors

Choice	▪ Reduced access to the preferred 'investment and advisory model' for retail investors – 95% of households hold commission-based brokerage accounts today – The fee-based advisory platform is far less popular (only 5% of households) – The 'preference' for brokerage accounts is evident across all wealth segments but strongest for smaller investors with less than $250K in assets
Product Access	▪ Reduced access to products distributed primarily through broker-dealers – Municipal and corporate bonds represent ~15% of assets held by retail investors – These products (among others) are generally offered on a 'principal basis' – Restricting principal or proprietary offerings will limit investor access to these products <u>and</u> possibly limit financing options for municipalities or corporates at current pricing
Affordability of Advisory Service	▪ Reduced access to the most affordable investment options – Fee-based services are 23-37 bps more expensive than brokerage[1] – For an investor with $200K in assets, this translates to $460 in additional fees – The cost of shifting to fee-based pricing alone would reduce expected returns by more than $20K over a 20 year horizon (assuming 5% annual returns) ▪ And the indirect costs of additional compliance, disclosure, and surveillance may have an even greater impact on consumers → we estimate that 12-17MM small investors 'at the margin' could lose access to current levels of advisory service if even 2 additional hours of coverage and support is required per client

1. Cost expressed as a percentage of assets under management in basis points (1bp = 0.01%)

Section 2

Methodology and source data

Oliver Wyman collected data from 17 SIFMA member firms to support the impact assessment

Purpose of study

- The impact assessment that follows was designed in response to the SEC request for comment on the upcoming study of the standard of care obligations for broker-dealers and investment advisers
- Oliver Wyman gathered data from 17 SIFMA member firms to provide relevant market data for the SEC study
- The study is intended to help
  - Identify the investor segments most likely to be affected by changes to the standard of care
  - Understand the cost to the consumer (choice, product access, transaction costs) of potential changes
  - Understand the one-time and ongoing costs of compliance for advisory and brokerage firms
  - Estimate the broader market / economic impact of any changes, particularly for capital formation

Note on survey methodology

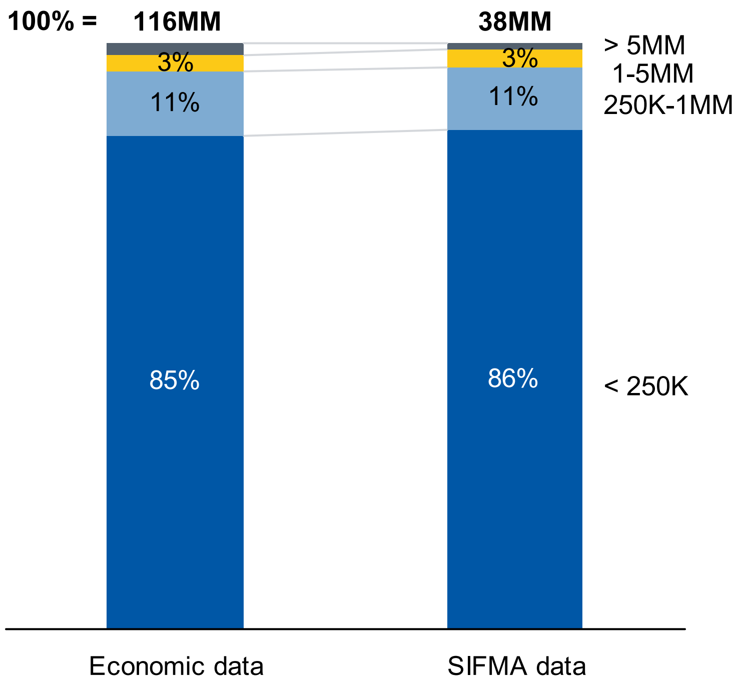
- 17 member firms participated, representing $6.8TN in assets (approximately 27% of total U.S. household financial assets) across 38.2MM households
- To obtain a fairly representative sample of the industry, data on asset management accounts, investor profiles, and cost structure was gathered from a diverse set of brokerage firms

Note on confidentiality

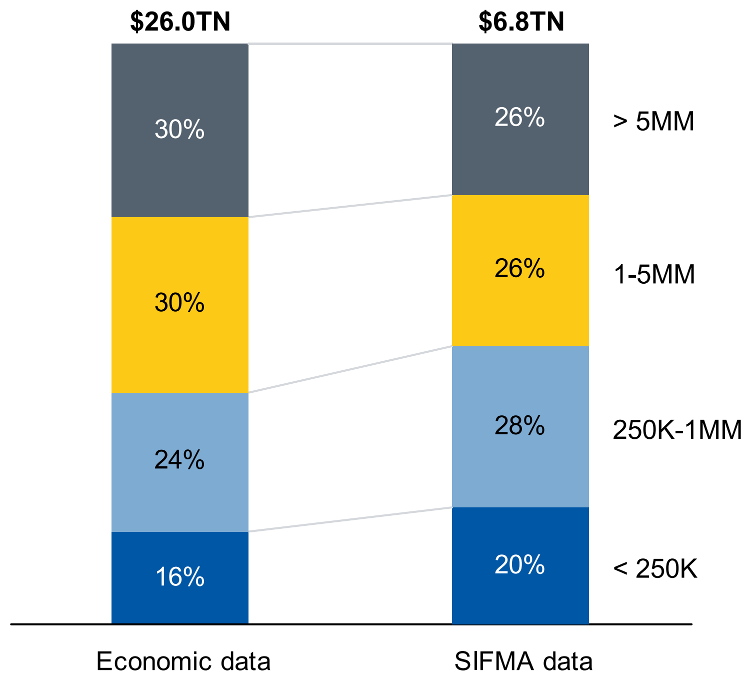
- Due to the highly sensitive nature of firm-specific information, all data is presented in aggregated form

The survey proved to be highly representative of the investor population as a whole, capturing 33% of households and 27% of financial assets

Investors by wealth segment[1]
Number of U.S. households, 2009



Assets by wealth segment
Investable assets, 2009



Note: Economic data includes all investable assets whereas SIFMA data refers to managed assets, SIFMA data skews toward investors with <$1MM in assets

1. Wealth segments based on client assets under management

Source: SIFMA member data, 2007 Federal Reserve Survey of Consumer Finances, Oliver Wyman analysis

Section 3

Background and context

Regulators have wide discretion in establishing a uniform ‘standard of care’ for the IABD industry

- Regulators have a range of options in establishing a uniform ‘standard of care’ for broker-dealers and investment advisers in the United States
  - Limited changes to current model
  - A ‘standard of care’ with disclosure / consent to conflicts that preserves commission-based brokerage
  - Wholesale adoption of the Advisers Act of 1940 for all broker-dealers and investment advisers
- A major shift in the ‘standard of care’ will impact individual investors in several ways
  - Choice of advisory model
  - Access to investment products
  - Cost of investment and advisory services
- Beyond these direct costs to the consumer, we also anticipate broader economic costs to the industry as a whole
  - Broker-dealers and investment advisory firms will all face one-time and ongoing costs to comply with new fiduciary, disclosure, and surveillance requirements → these may be passed on to investors
  - Potential limitations on product accessibility for retail investors will place constraints on capital formation and issuers’ ability to finance at attractive rates

Our analysis will focus on the relative impact of two possible scenarios for harmonization of the standard of care

Activity	Rule making scenarios		
	STATUS QUO WITH GREATER DISCLOSURE *Harmonized standards that preserve existing practices but require greater disclosure*	**FIDUCIARY DUTY WITH CONSENT TO CONFLICTS** *Fiduciary standard for advisory activity that preserves commission-based brokerage model*	**ADOPTION OF ADVISERS ACT OF 1940** *Fiduciary standard for advisory activity with fees based on assets under management*
Investment planning	▪ Suitability for resultant securities transactions	▪ Best interest of the client with disclosure / consent to conflicts	▪ Best interest of the client
Asset allocation advice	▪ Suitability for resultant securities transactions	▪ Best interest of the client with disclosure / consent to conflicts	▪ Best interest of the client
Advice on client holdings	▪ Best interest of the client (advisory services) <u>or</u> suitability (brokerage services)	▪ Best interest of the client, at point of sale or ongoing depending on relationship	▪ Best interest of the client
Proprietary product sales	▪ Best interest of the client (advisory services) <u>or</u> suitability (brokerage services)	▪ Best interest of the client with disclosure / consent to conflicts	▪ Not available
Principal transactions	▪ Best interest of the client (advisory services) <u>or</u> suitability (brokerage services)	▪ Best interest of the client with disclosure / consent to conflicts	▪ Trade-by-trade prior consent required
IRA / retirement accounts	▪ Best interest of the client (advisory services) <u>or</u> suitability (brokerage services)	▪ Best interest of the client <u>or</u> solely in the interest of the client, depending on relationship	▪ Solely in the interest of the client

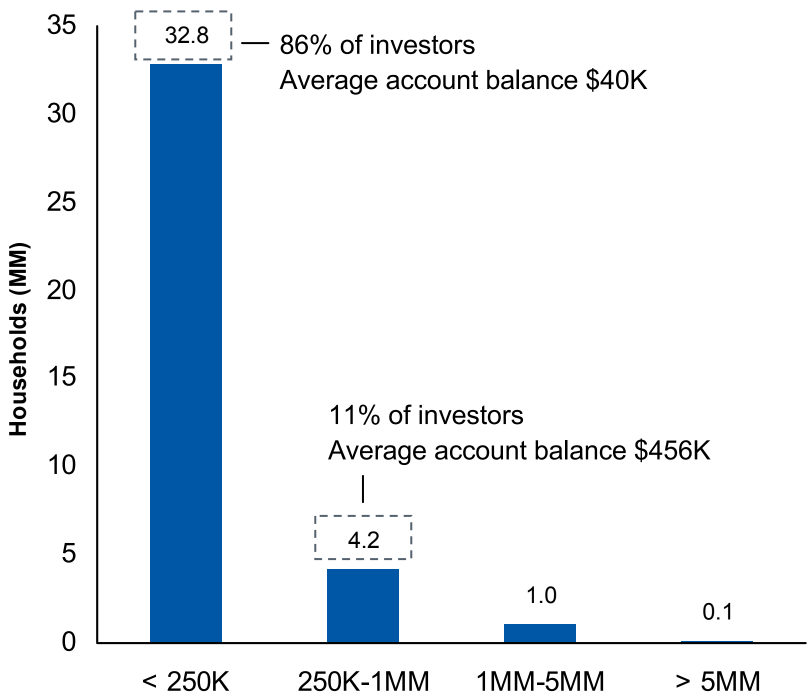
Baseline for impact analysis

Section 4

Impact on choice

The vast majority (97%) of the US investor population holds less than $1MM in assets with a broker-dealer or investment adviser

Investor landscape (survey population)
Number of investors by wealth segment[1], 2009



Client assets under management

	< 250K	250K-1MM	1MM-5MM	> 5MM
	$1.3TN	$1.9TN	$1.8TN	$1.8TN

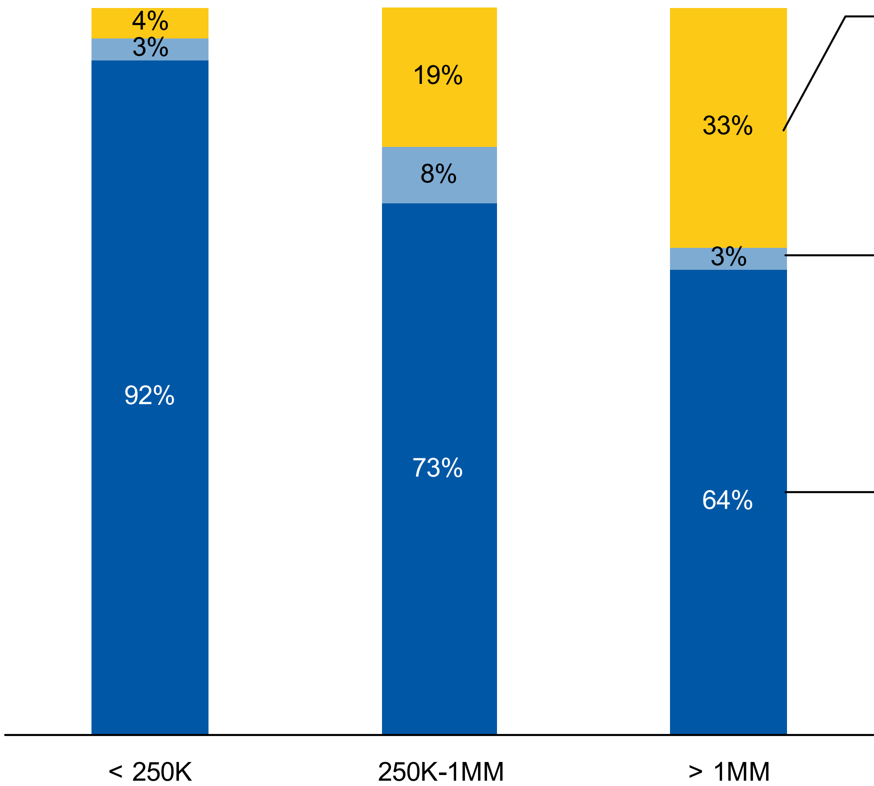
Key observations

- 97% of investors in the survey (37.0MM) hold less than $1MM in assets with broker-dealers or investment advisers
- Despite the heavy skew toward small clients, total assets are evenly distributed across the wealth spectrum ($1.3-1.9TN in all groups)
- Average account balance for investors in the lowest wealth segment is $40K → this is the segment most likely to be affected by a significant increase in costs

1. Wealth segments based on client assets under management
Source: SIFMA member data, 2007 Federal Reserve Survey of Consumer Finances, Oliver Wyman analysis

Across wealth segments, less than 5% of investors use fee-based accounts alone to serve their investment needs

Channel preference (survey population)
Number of households by relationship model, 2009



1 Mix of commission- and fee-based accounts

- As wealth increases, more investors use a hybrid model of fees and commissions-based management

2 Fee-based accounts

- Only 1.3MM investors (4% of total) hold AUM solely under fee-based management
- Fees-only management is the least common channel across all wealth segments

3 Commission-based accounts

- Over 30MM households hold assets solely in commission-based accounts; 27MM of these are from the lowest wealth segment
- Investors in the lowest wealth segment have a much stronger skew towards commissions-only management than any other wealth segment

Source: SIFMA member data, 2007 Federal Reserve Survey of Consumer Finances, Oliver Wyman analysis

The current model offers investors a wide range of advisory service, product access, and pricing options

Key Attributes	Account Types			
	Fee-Based	**Fees and Commissions**	**Commission-Based** *Advised*	**Commission-Based**[1] *Non-Advised*
Share of population	4%	7%	← 88% →	
Advisory needs	▪ Broad, portfolio-based financial planning and investment advice	▪ Broad, portfolio-based financial planning and investment advice plus product-specific advice	▪ Product-specific advice, access to principal products	▪ Uncertain
Investment activity	▪ Combination of active and passive, depending on client needs	▪ Active investment	▪ Combination of active and passive, depending on client choice	▪ Combination of active and passive, depending on client choice
Level of service	▪ Highest → ongoing advice and account surveillance	▪ Highest → ongoing advice and account surveillance	▪ Balanced → point in time advice on specific products	▪ Limited service
Typical holdings	▪ Investable assets only	▪ Investable assets ▪ Cash and equivalents ▪ Concentrated positions with special requirements	▪ Investable assets ▪ Cash and equivalents ▪ Concentrated positions with special requirements	▪ All investable assets ▪ Cash and equivalents
Cost	▪ Highest cost ▪ Range = 67-117 bps[2]	▪ Balanced cost ▪ Range = 43-99 bps[2]	▪ Balanced cost ▪ Range = 38-94 bps[2]	▪ Lowest cost, depending on trading activity
Common investors	▪ Affluent and HNW	▪ Affluent and HNW	▪ All investors	▪ Predominantly lower net worth investors

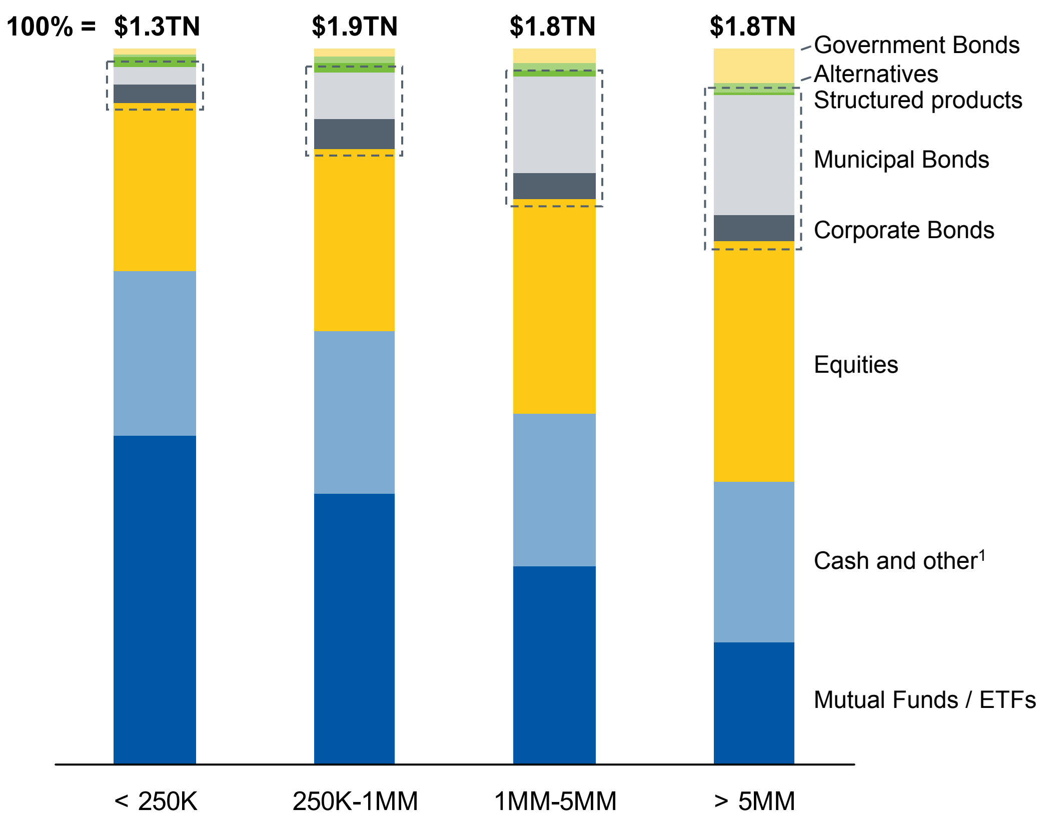
1. Non-advised accounts (e.g. self-directed online) were not targeted in this study but represent a significant subset of commission-based accounts
2. Range dependent on wealth segment (high end of the range reflects pricing for lowest wealth segment)

Section 5

Impact on product access

Direct holdings of individual securities (such as municipal bonds) represent an important element of investment strategy across all wealth segments

Asset allocation (survey population)
Allocation of assets (%) by wealth segment, 2009



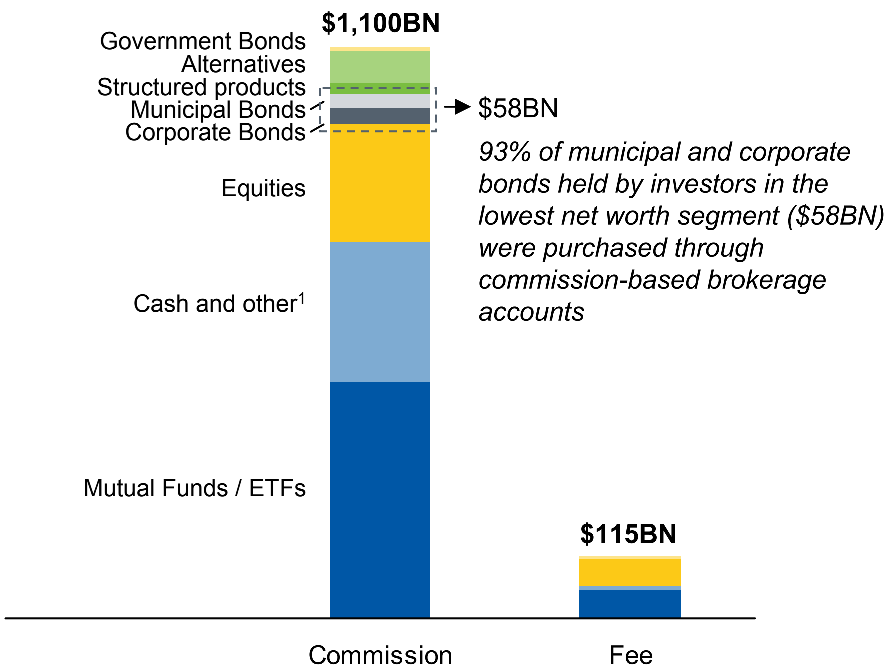
1. Includes cash, currencies, money market funds, etc
Source: SIFMA member data, Oliver Wyman analysis

Key observations

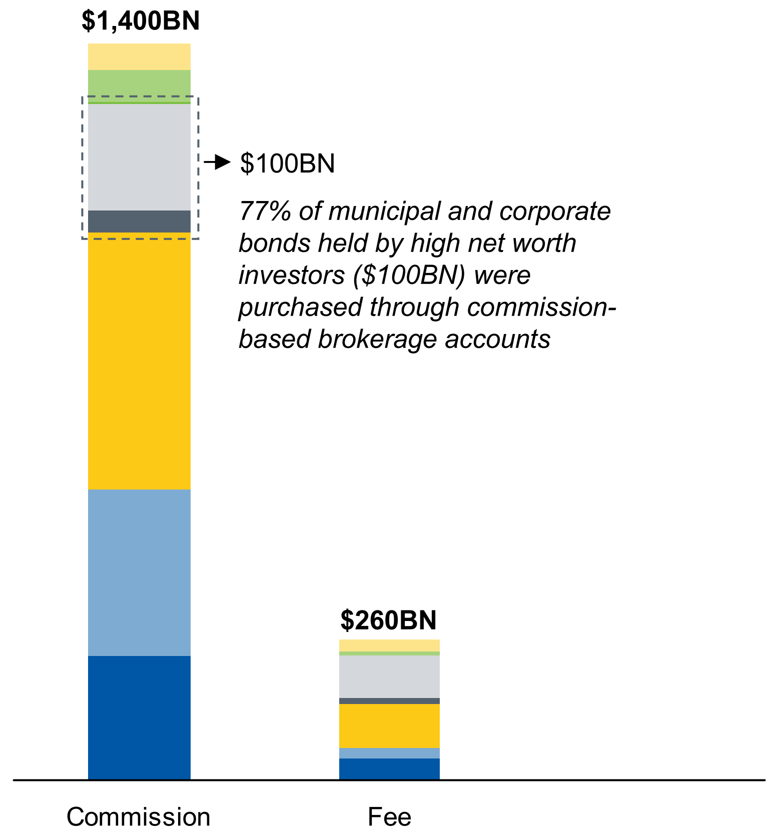
- Investors across all wealth segments have at least 30% of their portfolio in direct holdings of individual securities
- Municipal and corporate bonds offer tax and diversification benefits that investors may be unable to access via funds
- Across all investors, municipal and corporate bonds represent 13% of total wealth and 18% of invested assets (excluding cash)
- Allocations to municipal and corporate bonds range from 7% of investable assets for low net worth accounts to as high as 26% for high net worth accounts

Commission-based brokerage is the primary channel for accessing these products today, especially for investors in the lowest wealth segment

Low Net worth investors (<250K AUM)
Product access by account type[2]



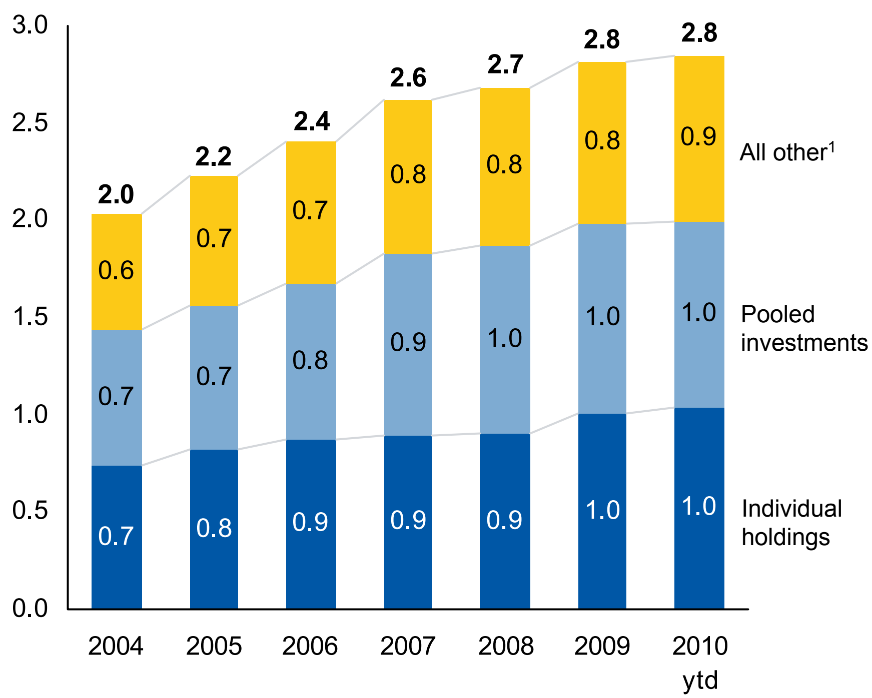
High Net Worth Investors (>5MM AUM)
Product access by account type



1. Cash and other includes cash, currencies, money market funds, etc.
2. Non-discretionary, commission accounts and discretionary, fee accounts
Source: SIFMA member data, Oliver Wyman analysis

Individual investors hold 70% of municipal debt in the US today, both through direct and pooled investments

Investor demand for Municipal Securities
Holdings of Municipal Securities by segment, $TN



Individual holdings (% of total outstanding)							
Direct	37%	37%	36%	34%	34%	36%	36%
Indirect	34%	33%	34%	36%	36%	35%	34%

1. Other sectors include corporates, financial institutions, broker-dealers, and foreign entities
Source: Federal Reserve

Key observations

- The municipal securities market has grown steadily over the past several years and now provides nearly $3TN in financing for state and local governments
- Municipalities in the U.S. have issued ~$400BN debt annually over the past five years through these instruments
- The market is dominated by individual investors who hold ~ 70% of outstanding debt, split across direct exposures and pooled investments
- Financial institutions are relatively minor players in the space, collectively holding less than 30% of total assets (including broker-dealer inventories)
- A significant shift in the 'standard of care' required for origination and distribution of investments sold on a principal basis (as Munis are) could have a significant market impact along 2 dimensions
  - Access and cost for retail investors
  - Low cost financing for municipalities

Broker-dealers play a key role in the Munis market, providing individual investors with direct and cost effective access to new issuances of these securities

Channels

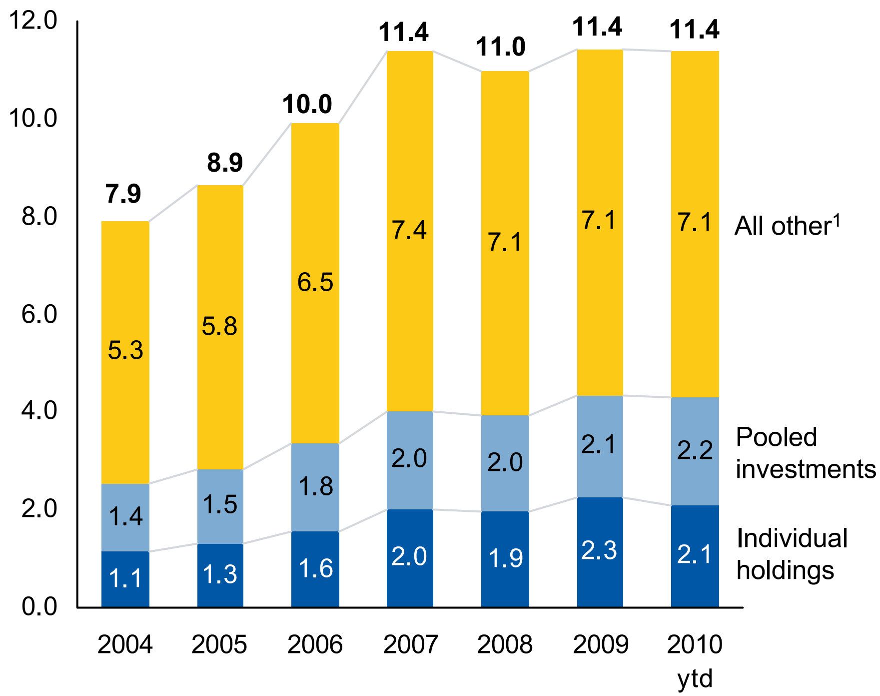
	Retail Investors
Primary market	▪ Transaction costs are built into the 'discount' or underwriting fees paid by the issuer ▪ Investors have access to securities with no explicit mark-up during limited retail order periods
Secondary market	▪ Securities trade on the secondary market and prices fluctuate to reflect supply and demand ▪ Investors have access to securities through broker-dealers who act as principals and build inventory (mark-up paid by investors)
Pooled investment funds	▪ Securities are bought and sold by broker-dealers on behalf of pooled investment funds ▪ Investors pay the funds' asset management / advisory fees in addition to transaction costs / sales loads passed on by the fund

Role of the broker-dealer

- Direct, affordable access to municipal bonds for retail investors via primary and secondary principal trading desks → mutual funds are an alternative channel to Munis but at higher cost as management fees erode returns (~1% management fees vs. 4-5% average yield)

Individual investors are also important participants in the corporate bond market

Investor demand for Corporate and Foreign Bonds
Holdings of Corporate and Foreign Securities by segment, $TN



Individual holdings (% of total outstanding)							
Direct	14%	15%	16%	18%	18%	20%	18%
Indirect	18%	17%	18%	18%	18%	18%	19%

1. Other sectors include corporates, financial institutions, broker-dealers, and foreign entities
Source: Federal Reserve

Key observations

- Corporations and foreign entities rapidly increased issuance of new debt between 2004-2007 and have maintained annual new bond issuance of ~ $11TN since the financial crisis
- Individual investors (via direct holdings or pooled investments) are the largest single class of investor in the corporate and foreign bond market
- Individual investors hold $4.3TN or nearly 40% of outstanding debt today
- In absolute terms, individual investors' share of the corporate securities market is larger than municipal securities
- Capital formation for US corporates is driven in large part by individual investment

Broker-dealers anticipate retail demand for corporate bonds and hold inventory to quickly, efficiently, and cost effectively meet client needs in the secondary market

Channels

Channel	Retail Investors
Primary market	▪ Predominantly institutional market ▪ Retail investors have little to no access to primary issuance
Secondary market	▪ Primarily over-the-counter market → broker-dealers provide main point of access for retail investors to these securities ▪ Investors pay upfront mark-ups but no ongoing management fees that are likely to erode returns
Pooled investment funds	▪ Securities are bought and sold by broker-dealers on behalf of pooled investment funds ▪ Investors pay the funds' asset management / advisory fees in addition to transaction costs / sales loads passed on by the fund

Role of the broker-dealer

- Direct, affordable access to corporate bonds for retail investors via secondary principal trading desks → principal traders anticipate retail demand and build inventory that meets specific investment needs of clients

Section 6

Impact on cost

We have profiled three typical investors within each wealth segment to evaluate the potential costs of broad application of the Advisers Act of 1940[1]

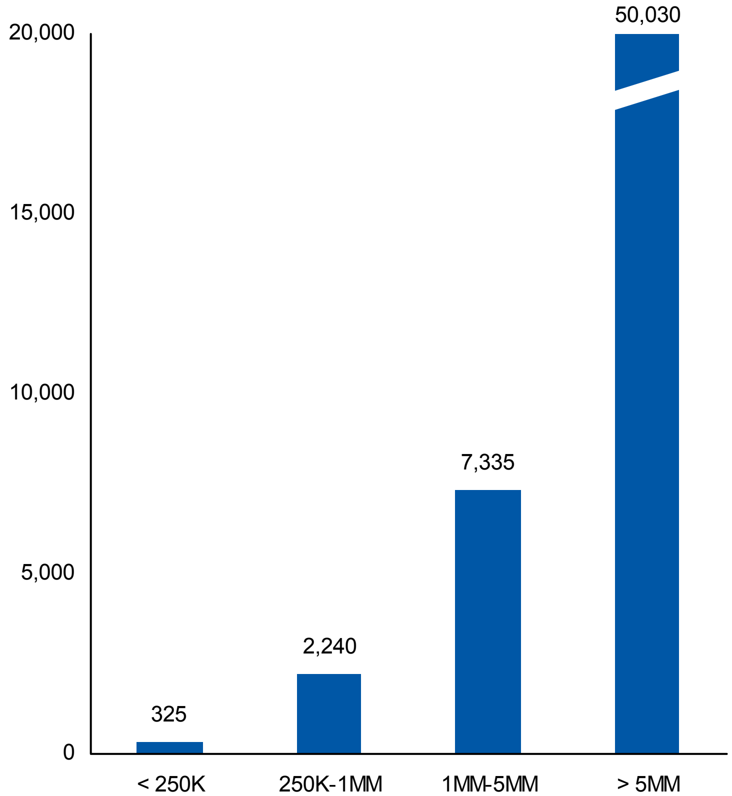
A	**'Small Investor' with commission-based accounts** *77% of all investors*	▪ $200K in assets held exclusively in commission-based accounts ▪ Passive investor with less than 10 trades per year (~50% of investors in <$250K segment) ▪ Pays 94 bps or $1,890 in commissions per year ▪ Holds $132K (68% of assets) in mutual funds and cash / cash equivalents ▪ Significant direct holdings (31% of assets), mainly in equities ▪ Limited investments in alternatives, fixed income, and structured products
B	**'Affluent Investor' with commission-based accounts** *7% of all investors*	▪ $500K in assets held in commission-based accounts ▪ Active investor with more than 10 trades per year (~75% of investors in $250K-1MM segment) ▪ Pays 53 bps or $2,650 in commissions per year ▪ Holds $292K (59% of assets) in mutual funds and cash / cash equivalents ▪ Holds $117.5K (23% of assets) in equities ▪ Hold $90.5K (18% of assets) in fixed income, structured products and alternatives
C	**'High Net Worth Investor' with commission-based accounts** *2% of all investors*	▪ $10MM in assets held in commission-based accounts ▪ Active investor with more than 10 trades per year (~75% of investors in >$1MM segment) ▪ Pays 38 bps or $38,000 in commissions per year ▪ Mutual funds and cash / cash equivalents together are $4.1MM (41% of assets) ▪ Equities are largest part of portfolio, with $3.3MM invested (33% of assets) ▪ Fixed income, structured products and alternatives represent $2.6MM (26% of assets)

1. Asset allocation based on observed average asset allocation for each wealth segment
Source: SIFMA member data, Oliver Wyman analysis

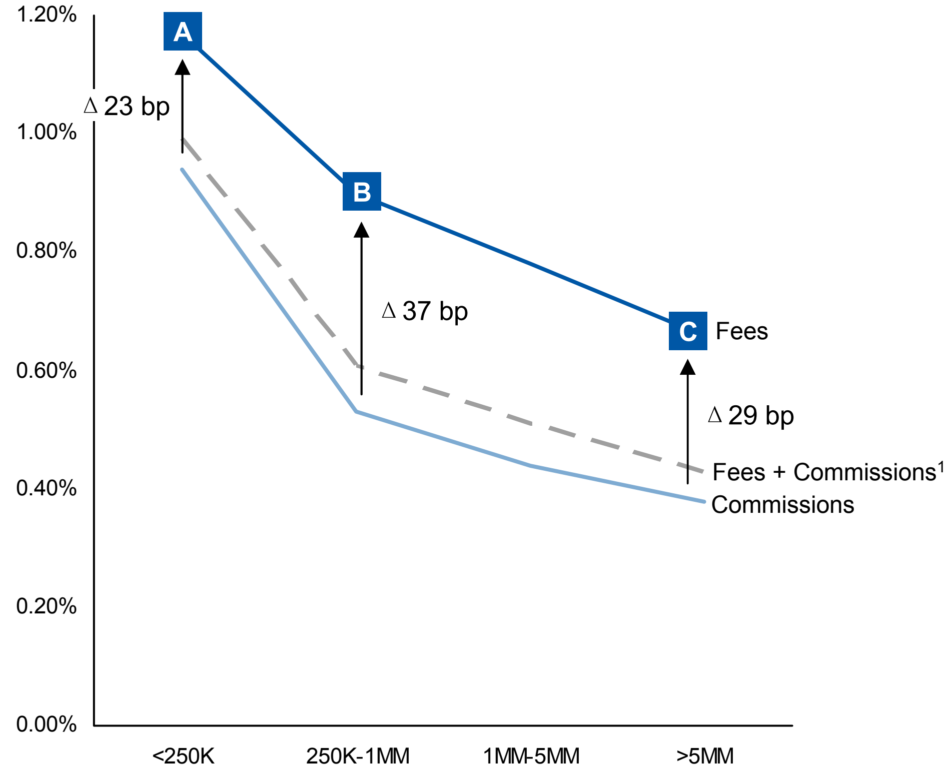
Commission-based accounts provide the most cost effective option for investors across the wealth spectrum today

Financial cost to consumer

Average annual fees and commissions, 2009



Average annual fees and commissions as % of AUM, 2009



1. Based on existing balance of assets between fee-based and commission-based accounts

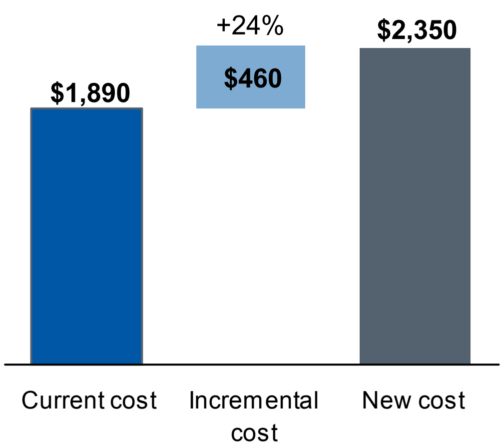
Source: SIFMA member data, Oliver Wyman analysis

A broad shift to fee-based advisory would substantially increase costs across all wealth segments

Potential impact on advisory fees and expected returns

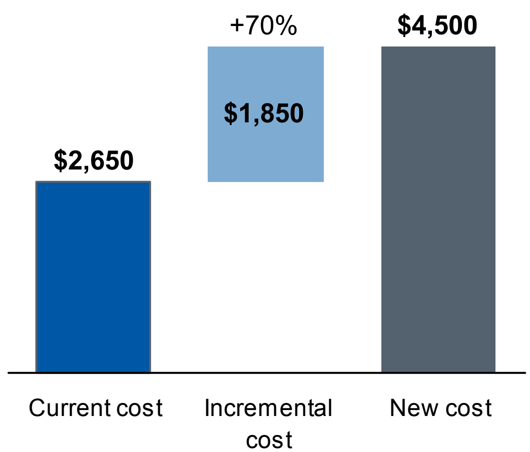
Pro forma impact of transition to fee-based accounts at current pricing, annual advisory costs[1]

A Small Investor



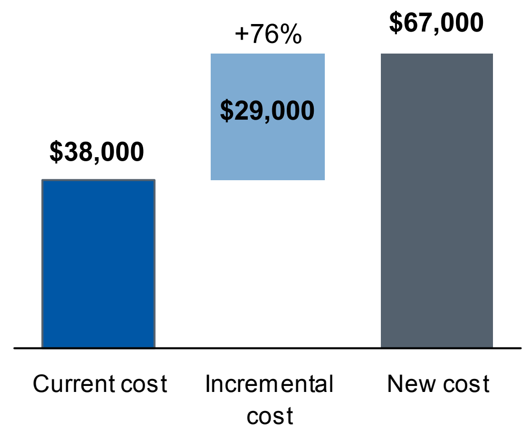
Gross Expected Return[1]	5.00%
- Current Cost	0.94%
Current Expected Return	4.06%
- Incremental Cost	0.23%
New Expected Return	**3.83%**

B Affluent Investor



Gross Expected Return[1]	5.00%
- Current Cost	0.53%
Current Expected Return	4.47%
- Incremental Cost	0.37%
New Expected Return	**4.10%**

C High net worth Investor



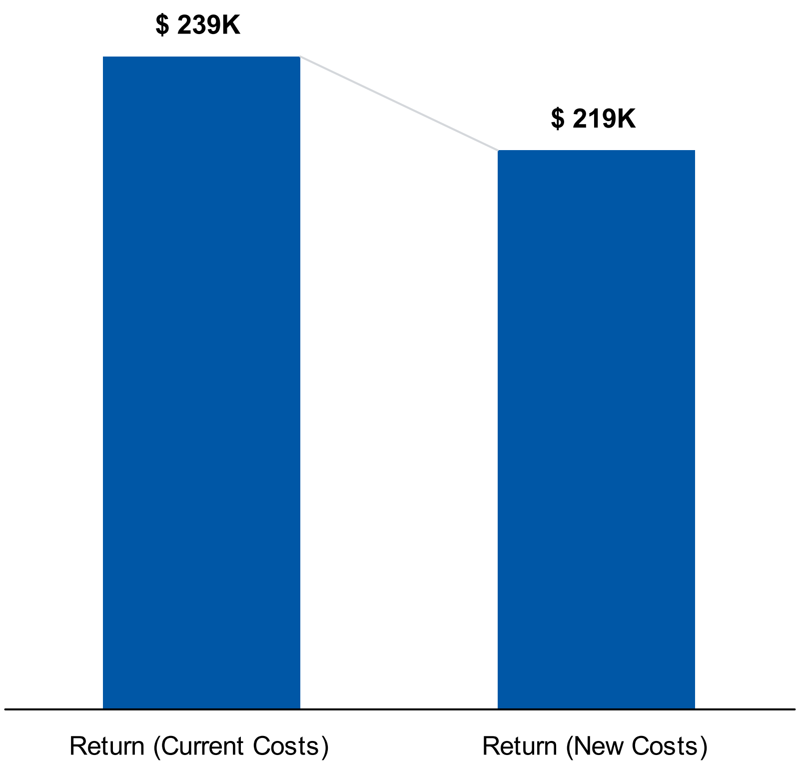
Gross Expected Return[1]	5.00%
- Current Cost	0.38%
Current Expected Return	4.62%
- Incremental Cost	0.29%
New Expected Return	**4.33%**

1. Assumes current pricing for commission- and fee-based accounts hold for all investors
2. Illustrative, not based on observed annual returns

Sources: SIFMA data, Oliver Wyman analysis

The shift to a fee-based model would reduce cumulative returns to 'small investor' (with $200K in assets) by $20K over the next 20 years

Impact of cost on investor returns
Expected investment gains on $200K portfolio, 2010-2030[1]



Key observations

- The average investor in the lowest wealth segment trades relatively infrequently over the course of the year
- As a result, a fee-based cost structure is generally more costly for these 'passive investors' and the incremental costs (+23 bps) erode returns
- For 'small investor,' a fee-based model results in a cumulative reduction in investment gains of $20K over 10 years, roughly 10% of the initial investment
  - 'Small investor' would pay ~ $59K in commissions over the course of 20 years through commission-based brokerage accounts
  - Under a fee-based advisory model, 'small investor' would pay an additional $13K in fees and lose $7K in investment gains as a result of lower principal balances each year

1. Assumes initial investment of $200K in a balanced portfolio reflecting typical, balanced asset allocation for lower net worth investors with <$250K AUM; based on constant annual returns of 5%, not adjusted for inflation; commissions deducted from principal balance starting at year end

However, the costs of complying with and / or demonstrating compliance with the new standard of care will place additional pressure on pricing

Increased activities required by shift in 'standard of care'

- Adviser training
- Increased legal and compliance
- Increased risk management and oversight
- Production and mailing of additional disclosures
- Initial client consultation
  - Review relationship
  - Obtain formal consent for existing strategy
- Investment strategy and plan
  - Evaluate portfolio
  - Assess investment objectives
  - Agree on new investment plan for client
- Documentation of client discussions
- Ongoing account surveillance

Incremental cost of compliance
Annual costs expressed as bps over assets

Additional hours	1	2	3	4	5
Estimated cost	**$200**	**$400**	**$600**	**$800**	**$1,000**
A Small investor ($200K)	10bps	20bps	30bps	40bps	50bps
B Affluent investor ($500K)	4bps	8bps	12bps	16bps	20bps
C HNW investor ($10MM)	2bps	4bps	6bps	8bps	10bps

Focus of analysis on following slides (conservative estimate)

Methodology for calculating hourly rate

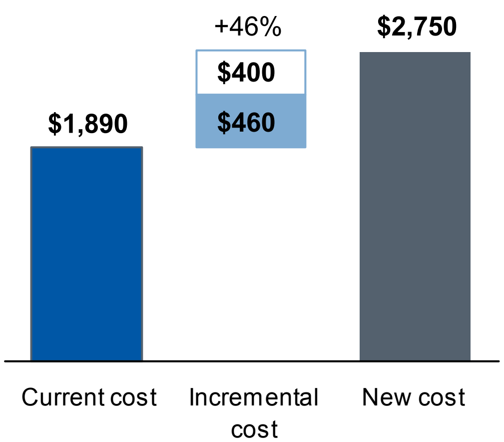
- Median income for investment advisers estimated at $173K[1]
- Adviser compensation represents 42% of fully loaded costs based on SIFMA member data
- Given 2,000 working hours per year, average hourly rate of service is $200 / hour

1. Based on 2010 annual compensation survey by Registered Rep
Source: SIFMA member data, Oliver Wyman analysis

These incremental costs will disproportionately impact investors with smaller investment portfolios

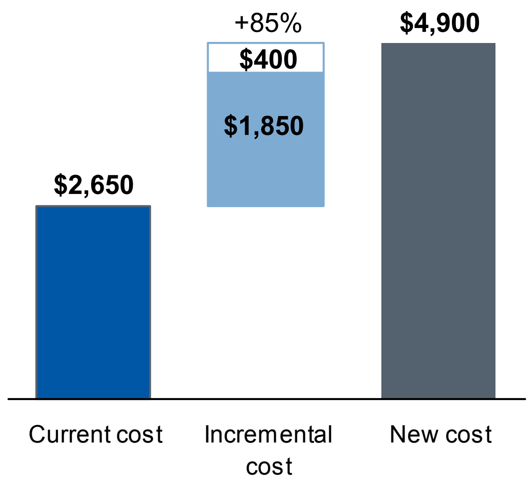
Potential impact on advisory fees and expected returns
Pro forma impact of transition to fee-based accounts at new pricing, annual advisory costs

A Small Investor



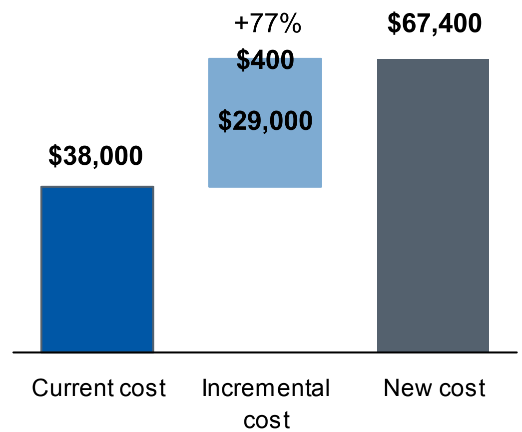
Gross Expected Return[1]	5.00%
- Current Cost	0.94%
Current Expected Return	4.06%
- Incremental Cost	0.43%
New Expected Return	**3.63%**

B Affluent Investor



Gross Expected Return[1]	5.00%
- Current Cost	0.53%
Current Expected Return	4.47%
- Incremental Cost	0.45%
New Expected Return	**4.02%**

C High net worth Investor



Gross Expected Return[1]	5.00%
- Current Cost	0.38%
Current Expected Return	4.62%
- Incremental Cost	0.29%
New Expected Return	**4.33%**

1. Assumes pricing for commission- and fee-based accounts rises to account for additional activity
2. Illustrative, not based on observed annual returns
Sources: SIFMA data, Oliver Wyman analysis

Consumers may also face significant adviser capacity constraints that will limit the availability of service under the new standard of care

Capacity analysis

Current state

Investors with <$250K in commission accounts	28.4MM
Average commissions/investor	$268
Hourly rate for asset management services	$200
Time spent per investor	1.3 hours
Time spent on all investors with <$250K AUM	38.1MM hours
Minimum number of required advisers	19K

Impact of additional service requirements

+ 2 hours per investor

Current utilization levels	70%	80%	90%	100%
Implied capacity (MM hours)	54.4	47.6	42.3	38.1
Implied capacity (total investors, MM)	16.3	14.3	12.7	11.4
Coverage gap (total investors, MM)	12.1	14.2	15.8	17.0
Additional advisers needed	20K	24K	26K	28K

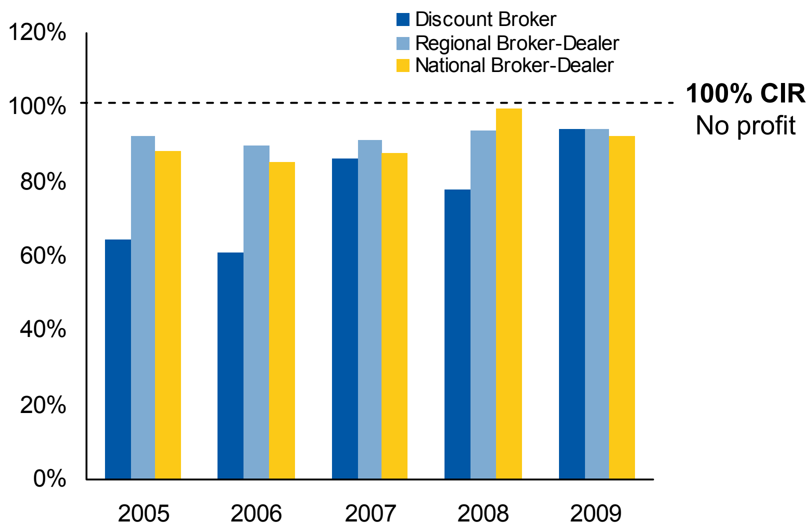
Implications

- Given current resources, we estimate that 40-57% of investors in the lowest wealth segment can be covered if advisers are required to spend 2 additional hours with each investor
- We estimate that 20-28K additional advisers will be needed to serve the ‘uncovered’ investors in our sample population → our sample population is 33% of US investors, which suggests that 60-84K new advisers may be needed
- Faced with this, the brokerage and investment advisory industry can respond in one of three ways
  - Increase workforce and raise prices
  - Increase workforce and absorb new costs
  - Reduce coverage for lower net worth investors whose ‘personalized investment’ advisory needs will exceed capacity
- While the autonomy provided by self-directed accounts is desirable for certain investors, market data suggests that investors with advised accounts
  - Make more sophisticated investment decisions
  - Achieve higher average investment returns

Source: SIFMA member data, Oliver Wyman analysis

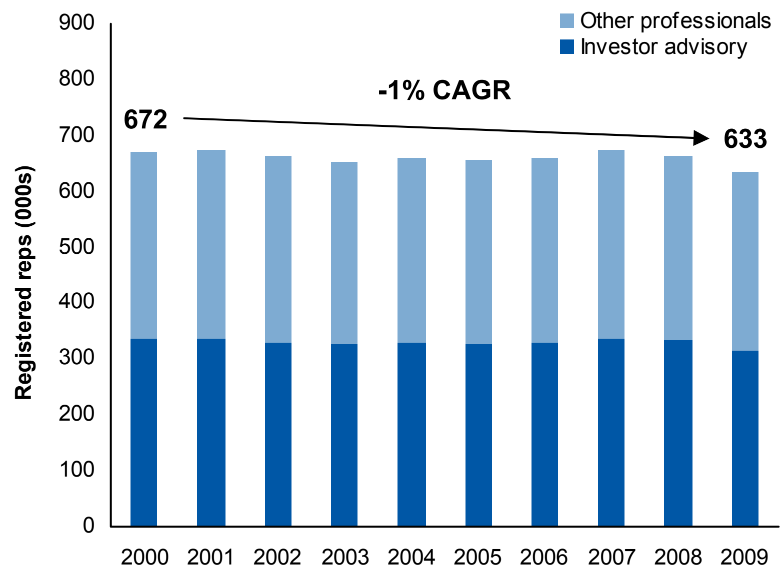
Current economics of the IA/BD industry suggest that investors will need to accept higher costs or turn to alternative service models for investment

Industry profitability
Total costs before tax over total revenues[1]



Operating margins across the industry are thin and have deteriorated since 2005, leaving little room to absorb additional cost

Industry capacity
FINRA registered representatives (000s)[2]



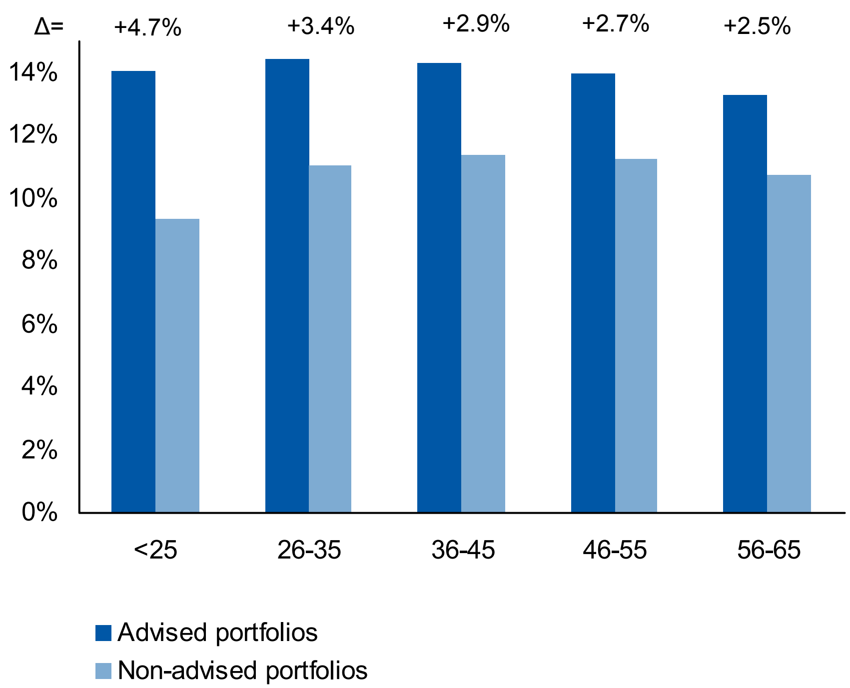
Industry headcount has been flat to negative over the past ten years; the additional capacity required to cover small clients would be difficult to provide (at least in the near term)

1. Public data for companies within the SNL National Broker-Dealer, Regional Broker-Dealer, and Discount Broker indices
2. Figures overstate actual industry capacity (approximately 50-60% of individuals who hold Series 7 licenses do not advise investors, but serve in other capacities e.g. legal, compliance, etc.)

Sources: SNL Financial, FINRA

And several recent studies suggest that investors without access to advisory services may be disadvantaged and fail to realize investment goals

Impact of professional financial advice[1] on portfolio returns
401k returns by age segment, 2006 data



Key observations

- Participants in 401k plans administered by Schwab achieved returns that were 3.3% higher on average if some level of financial advice was provided
- In addition to higher portfolio returns, professional financial advice had an impact on several dimensions
  - Savings rate → 70% of participants who received financial advice doubled their saving rates from an average of 5% to 10% of pre-tax income
  - Portfolio diversification → Participants who received financial advice held positions across 8 asset classes on average vs. self-directed investors who held positions in 3.7
  - Investor confidence → Of participants who received advice, 29% were confident of having adequate funds to retire vs. 16% of investors who did not

1. Use of advisory services for >1 year, 'advisory services' include personalized investment advice online, via phone, or in person
Source: Charles Schwab studies on 401(k) portfolio returns (2007) and impact of professional advisory relationships in 401(k) plans (2010)

Appendix

MiFID Investor Protection

In 2007, the Markets in Financial Instruments Directive (MiFID) made significant provisions for ‘investor protection’

MiFID provisions

- Regulation of alternative trading systems
  - Regulation of multi-lateral trading facilities
  - Treatment of systemic internalisers, or principal traders, as mini-exchanges
- Increased pre and post trade transparency for all trading facilities
- Passporting or development of a single market for transactions in financial instruments across a number of European Union member states
- Requirement to enhance corporate governance structures to accommodate an independent compliance function
- Investor protection
  - Appropriate client categorization and client order handling
  - Best execution requirement for all trades on behalf of clients
  - Robust record keeping systems for periodic statements, transaction reporting, and client contracts and agreements

MiFID relative to Advisers Act of 1940

- MiFID provisions covered a narrower range of activities and imposed a less onerous standard of care than the ‘best interest’ standards that would be required if the Advisers Act were adopted

	MiFID	
	Suitability	**Best interest**
Investment planning	✓	×
Asset allocation advice	✓	×
Advice on client holdings	✓	×
Proprietary product sales	✓	×
Underwriting	Not covered	
Principal trading	✓	×
IRA / retirement accounts	✓	×

Although less onerous than the ‘standard of care’ currently under consideration in the US, MiFID studies nonetheless show the impact of similar compliance costs on asset management firms

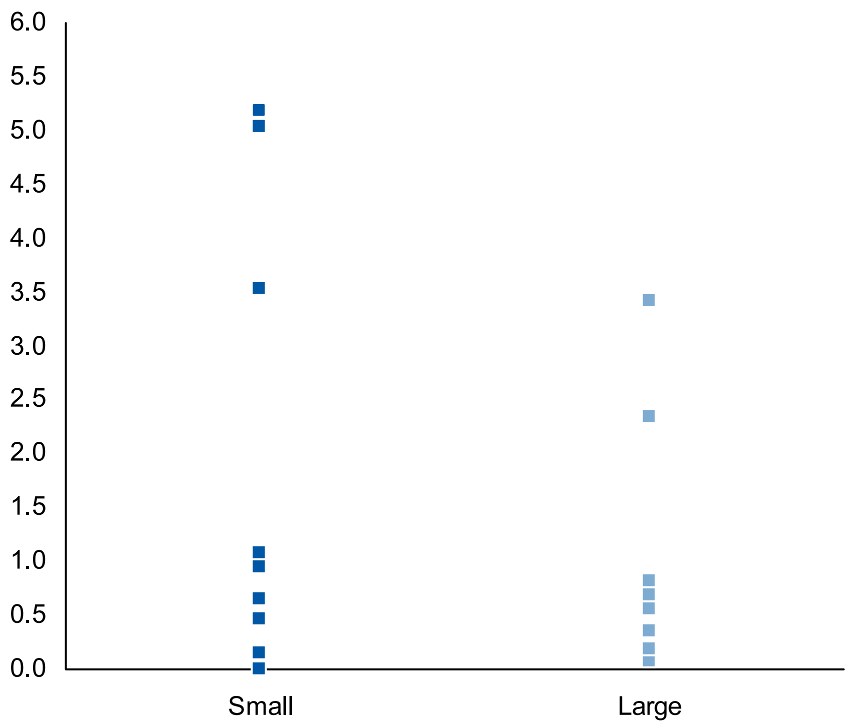
The FSA's impact studies on MiFID identified investor protection provisions as the greatest contributors to compliance costs

	Activity	Objective	Cost Factors	Cost Drivers
Client Acquisition	**Classifying client base**	Categorizing clients according to size of portfolio, # trades, etc.	System/process to capture client data Client data collection	Fixed cost # clients, length of client discussions
	Suitability/ Appropriateness	Understanding needs, objectives, risk profiles, experience and expertise of clients	System/process to capture client data Client data collection Updated risk information on products	Fixed cost # clients, level of existing data # products offered
Client Management	**Consent/ Disclosure**	Disclosing information on suitability, best execution policy, conflicts of interest policy, principal trading, etc.	One time client agreements/contracts Routine disclosure	Response rate, # of clients # clients, frequency of disclosure
	Maintenance of client portfolios	Upholding suitability requirement to maintain AUM in appropriate investments	Monitoring client accounts	# clients, # products offered
Order Execution	**Best execution**	Achieving optimal mix of price, speed and likelihood of execution	Regular reviews of execution venues Disclosure to prove best execution policy	# monitored execution venues # clients, frequency of disclosure
	Conflict of Interest	Identifying/addressing conflicts, actively managing potential issues before they become conflicts	Maintaining Chinese Walls Documentation/database	# departments, level of principal trading # products offered
	Documentation of trades	Demonstrating compliance with suitability and best execution requirements	Electronic/voice storage Paper document storage	# trades, # clients, required level of detail # trades, # clients, required level of detail

Source: Implementing MiFID for Firms and Markets, FSA Consultation Paper 2006

Smaller firms with a large retail client base incurred higher one-off costs of compliance as a percentage of operating costs

One-off compliance costs of MiFID by firm size[1]
One-off costs as a percentage of operating costs, 2007



Determinants of one-off costs

- The study found that client profile is the most important determinant of costs, with retail clients incurring significantly more costs than institutional clients
- The biggest one-off costs arose from investment in IT and revisions of CRM systems to reflect new data points, especially for certain retail segments
- A significant portion of one-off costs were fixed, irrespective of firm size and number of clients
- Impact studies indicated that small firms would be unable to sustain large fixed costs of compliance and exit the industry
- In absolute terms, average one-off costs were ~€1 MM for a small firm and ~€4 MM for a large firm
- There is high variability in the level of one-off costs amongst smaller firms depending upon
  - Extent to which firms serve retail clients
  - Ability of firms to make large upfront investments

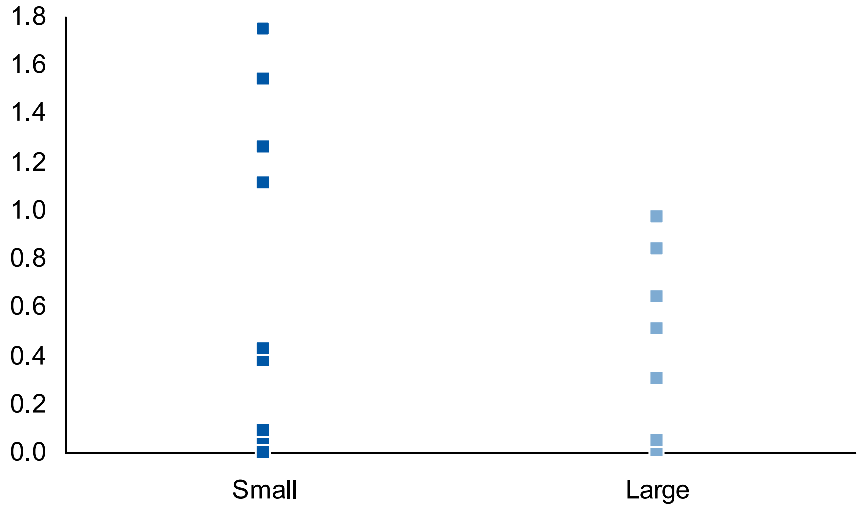
1. Firms with fewer than 100 employees were classified as “Small”
Source: Europe Economics Study, 2007

Due to their inability to make sizeable upfront investments, smaller firms typically also sustained higher ongoing costs of compliance as a percent of operating costs

On-going compliance costs of MiFID
European asset managers by firm size[1], 2007

	Small	Large
Additional staff	70%	18%
Internal reporting	9%	12%
IT	4%	30%
External reporting	12%	17%
Training	2%	7%
Audit	2%	16%

Ongoing compliance costs of MiFID by firm size
Ongoing costs as a percentage of operating costs, 2007



- Whereas larger asset managers complied with MiFID by investing in automated systems, smaller firms increased headcount
- There is a trade-off between one-off and on-going costs, e.g. for smaller firms the option of updating IT systems might have been too expensive, thus on-going costs of sustaining a larger workforce are much higher
- The smallest firms in the study had no specialist compliance functions prior to MiFID, and required significant resources to cover compliance activities

1. Firms with fewer than 100 employees were classified as "Small"
Source: Europe Economics Study, 2007