Another Wave of Regulatory Anxiety

- Mutual fund reform—industry can't dodge everything
  Regulators and legislators continue to pressure on the industry (but not on enthusiasm for the stocks) with proposed rules for mutual funds. To date, there are four bills pending. Also, the SEC and ICI have a hand in this, as do outspoken industry critics and state AGs.

- Mutual Fund Reform Act of 2004—not good for business
  This is the most wide-ranging and potentially damaging bill, in our view. Emphasis on total transparency (including transaction costs), eliminating asset-based distribution fees (including the 12b-1), and much tighter governance rules. We view it as an unlikely final solution, but scary anyway. Other proposals are more moderate degrees of bad for asset managers and brokers, in our view.

- Items on the agenda
  1) Distribution (directed brokerage, revenue sharing, 12b-1 fees, and disclosure); 2) soft dollars and bundled brokerage; 3) governance.

- May impact margins, but keep it in perspective
  Common sense will prevail, in our view (it all doesn't pass, nor should it). That said, each proposal eats into margins at some level. Asset managers are impacted with brokers to a lesser degree. Companies are changing behavior before rules call for it. But keep it in perspective, asset manager margins are strong, as are flows—they'll live. Nonetheless, until resolved, with valuations not overly attractive, this gives us another reason to prefer brokers and universal banks over asset managers.
Another Wave of Regulatory Anxiety—How Much Will Stick?

Asset Managers and Brokers—Crawling a Wall of Worry

The sky’s not falling, but... We don’t want to be alarmist—asset managers took in $216 billion in long-term mutual fund flows in 2003 and another $37 billion (estimated) this January—but we definitely have concerns over the recent direction of some proposals in asset management land and their potential impact on both the asset management (primary) and brokerage (secondary) industries.

Election year rhetoric is heavy. While regulatory scrutiny gained traction with market timing and late trading revelations, it has recently moved far past this and into the realm of potential significant industry reforms. To that end, multiple parties have recently put forth public statements, proposals, and concept releases as a means to “fix” the mutual fund industry by increasing transparency around fund costs, fees, turnover, revenue-sharing arrangements, eliminating areas of potential conflicts, and meaningfully enhancing fiduciary governance at the mutual fund level.

So what? Despite the regulatory and headline risks, the asset managers performed well in 2003 and have continued their run into 2004, driven by asset appreciation, strong flows, and good expense controls. The question is: Should the investor be worried about coming changes? We don’t have a crystal ball, but we doubt the industry can side step this wave without some impact on returns. At the minimum, soft dollar usage will likely be significantly constricted, directed brokerage with customers’ commissions will likely be a thing of the past, disclosure will likely be significantly enhanced, and there will likely be greater scrutiny on fund governance. However, some of the proposals go way beyond just these items, looking to end revenue sharing, unbundle research, spotlight management fee setting, and eliminate 12b-1 fees. The point is, the pending changes will be anywhere from a little bad for margins to something more severe (though we believe distribution—i.e., the brokers—continue to get paid regardless).

Potential financial impact—a big question mark at this point. With so many possibilities out there, it’s tough to tell what the financial impact will ultimately be. Further, the industry will obviously adapt its product, pricing, and expense structures to minimize impact and maintain margins. What we can say is: 1) the brokers and asset managers will likely have to find a way to divide (or recoup) a smaller pie and; 2) the brokers will continue to get paid, one way or another, for distribution, though the implications for the cash equity business continue to be poor. Coping mechanisms for the asset managers include further back-office rationalization, consolidation of product and broker lists, lowered consumption of research and third-party services (Do you really need a Bloomberg on every desk?), and compensation reform. Two interesting side bars: 1) companies are already altering their business practices without any rule/law changes in place...
at least a dozen companies have ended soft dollars recently); and 2) it certainly appears hedge funds have dodged the bullet thus far on this regulatory wave and potentially retain or expand their regulatory advantage.

**Theme on winners and losers is the same—bigger is better.** Scale, multi-channel distribution, strong performance, competitive fee structures, brand, and expense control should continue to dominate investors’ thinking. Drilling down, we’d add in a slightly higher discount rate (until this is resolved) on asset managers with a heavier percentage of long-term retail mutual assets as a percentage of total assets—Franklin Resources, T. Rowe Price, Waddell & Reed, and Janus are all in this camp, but none are above approximately 60%—and on asset managers with higher (than average) fees without corresponding outperformance. In our view, increased scrutiny by the fund boards, managements, clients, and consultants will have more of an equalizing effect than in the past.

In this report (the fifth in a continuing series), we want to give you information on:

(1) What potential changes are on the table;

(2) The somewhat competing legislation and rule-making agendas of the ICI, SEC, the House, and the Senate;

(3) Potential financial fallout for the asset managers and brokers; and

(4) Our point of view on the winners and losers in the new world.

**Documents of Interest**

From the SEC:


http://www.sec.gov/rules/proposed/33-8364.htm

http://www.sec.gov/rules/concept/33-8349.htm

From the ICI:

http://www.ici.org/issues/timing/index.html

The Mutual Fund Reform Act of 2004:


A Cacophony of Voices

Everyone’s got an opinion. In our latest attempt to decipher the multiple moving parts of the structural landscape and regulatory environment for the asset managers, we outline: 1) recent stances on key issues by the ICI; 2) recent rule changes and concept releases from the SEC related to disclosure, governance, fees, and mutual fund transaction costs; and 3) the Mutual Fund Reform Act of 2004 (MFRA)—the most aggressive proposed legislation coming out of the Senate in a long time (it blows away the United Kingdom’s FSA CP 176). Not surprisingly, John Bogle calls the MFRA, the “gold standard” of regulation. While we have our views on why MFRA won’t and shouldn’t pass in its current form, we believe many of the reforms have a decent shot at being implemented (or being made into rules) in one bill or another and we would also be remiss to not point out what a significant impact (but, to be clear, only in the worst case) it could have on profitability for both the brokerage and asset management industries. (See Table 1 for a brief summary of key provisions of the major initiatives and Tables 5-7 for a more detailed comparison and a detailed blow-by-blow of the ICI, SEC, and MFRA proposals/concept releases.)

Three Different Approaches

Similar objectives, different solutions. While the ICI has made suggestions on many topics, such as how to curtail late trading (4:00 p.m. rule) and market timing (mandatory five-day, 2% redemption fee), its more controversial proposals include urging the SEC to dramatically curtail the use of soft dollars by all investment advisers, including paying for third-party research, and banning mutual funds’ use of “directed brokerage.” MFRA, for its part, takes a more aggressive stance calling for the elimination of 12b-1 fees, directed brokerage, soft dollars, and other revenue-sharing arrangements, and also calls for unbundling of commissions, standardizing fund expense and transaction cost disclosure, and clearly tightening fund governance issues. The SEC is taking a more collaborative approach with the industry. Initiatives are focused on disclosure (at point of sale and ongoing) and enhanced governance (especially fund boards). The Commission’s concept release questions if mutual funds should be required to quantify and disclose to investors the amount of transaction costs they incur (implicit and explicit), includes them in its expense ratios and fee tables, or provides additional quantitative or narrative disclosure about its transaction costs. The Commission is also considering potential changes to rule 12b-1, directed brokerage, and rules on disclosure/rationale for investment contracts.
### Table 1: Major Initiatives Summary

<table>
<thead>
<tr>
<th>Basic Stance</th>
<th>Incrementally Tough on the Industry?</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>H.R. 2420</strong> Focused on minimizing trading abuses, increasing basic disclosures, and increasing board independence/accountability</td>
<td>Not really - We view the changes proposed as a done deal with or without this legislation.</td>
<td>Passed in the House. Sitting in the Senate.</td>
</tr>
<tr>
<td><strong>ICI</strong> More impactful proposals center around: 1) restricting the use of soft dollars significantly, 2) eliminating using soft dollars for third-party research, and 3) banning directed brokerage. Governance stance is consistent with above.</td>
<td>Modest margin squeeze as some soft items move to cash payments. Soft dollar and directed brokerage stance is harder on independent research providers and smaller asset managers.</td>
<td>Proposal is out in the public domain.</td>
</tr>
<tr>
<td><strong>MFRA</strong> The most wide-ranging and potentially damaging bill. Major emphasis is on making all charges transparent and either: 1) due at the time of purchase—(i.e., loads); or 2) present in the “investment cost ratio,” which would include the investment management fee and a transaction cost estimate. As such, MFRA seeks to eliminate 12b-1 fees, directed brokerage, and soft dollars, and unbundles research and traditional revenue sharing—all while mandating that any new types of fees be approved by the SEC. Additionally, it pushes more fiduciary responsibility for fee justification and more on mutual fund boards.</td>
<td>Absolutely. The fees this bill would potentially eliminate total up to an estimated $16 billion (at the high end). Would likely cause a rethinking of business models, product offerings, distribution, and a reduction in margins.</td>
<td>Referred to Senate Banking Committee. Key point: This is a Senate bill but does not come from the banking committee, which has jurisdiction.</td>
</tr>
<tr>
<td><strong>SEC</strong> The SEC is taking a more collaborative approach with the industry. Initiatives are focused on disclosure (at point of sale and ongoing) and enhanced governance (especially fund boards). Questioning if mutual funds should be required to quantify and disclose to investors the amount of transaction costs they incur (implicit and explicit), include them in their expense ratios and fee tables, or provide additional quantitative or narrative disclosure about their transaction costs. The Commission is also considering potential changes to rule 12b-1, directed brokerage, and rules on disclosure/rationale for investment contracts.</td>
<td>Depends on what’s adopted. More focus on governance as it relates to fee setting and negotiation would be interesting. Don’t underestimate the effect of giving fund boards &quot;teeth.&quot;</td>
<td>Concept release re: fee disclosure stuff is out for comment thru February 23, 2004.</td>
</tr>
</tbody>
</table>

Note: There are at least two other bills in the Senate currently, both of which largely resemble H.R. 2420.

Source: UBS

**Who’s Going to Flinch First?**

A game of chicken. The race right now, in our view, is between the ICI/SEC/SIA and Congress, but resembles a game of chicken. On the one hand, if the SEC/ICI/SIA can put forth meaningful enough proposals for change, they may stave off congressional attempts to further legislate the mutual fund industry. However, “meaningful” may come at a meaningful price to the industry. On the other hand, we get the feeling from recent congressional hearings that there is a genuine lack of trust in the industry and we believe, heavy lobbying efforts notwithstanding, that legislation could have some large teeth—unlike the last wave of proposals that kind of lost steam late last year with the rise in the market. Thus, either way, the operating environment for asset managers (and, to a lesser extent, brokers) is likely to become more challenging going forward. We summarize some of the key issues in Table 2.

We think it’s likely that the industry and SEC will act quickly to keep control of their domain rather than face Congress’s wrath.
Table 2: Key Issue Summary

<table>
<thead>
<tr>
<th>Paying for Distribution</th>
<th>1) Can you pay for distribution via: a) directed brokerage; b) revenue sharing; c) 12b-1 charges; 2) If yes on any of the above, how, how often, and where will it be disclosed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Soft Dollars</td>
<td>1) Stay or go, by component. For software/hardware and services, for broker-supplied research, for third-party research (via step-out payments, for your Bloomberg; 2) If yes on any of the above, how, how often, and where will it be disclosed?</td>
</tr>
<tr>
<td>Transaction Costs</td>
<td>1) What’s disclosed—up-front distribution fees, management fees, asset-based distribution fees, all trading costs (implicit and explicit); 2) Where and how often it’s disclosed—at time of sale, in fundholder statements, in annual reports to shareholders, in prospectus, or fully loaded into the fee and expense ratio; 3) How it’s disclosed—on the actual dollar amount by customer, on a standardized amount.</td>
</tr>
<tr>
<td>Fund Governance</td>
<td>1) Percentage of required independent directors; 2) Mandatory independent chairmen; 3) Sarbanes-Oxley-like controls; 4) Certification by independent directors.</td>
</tr>
</tbody>
</table>

Source: UBS

**Potential Financial Impacts—Not for the Meek**

“**Institutionalizing**” of the retail business remains a possibility. While the outcome and effects are difficult to quantify, there are some potential systemic effects including: 1) increased scrutiny on total fees and expenses—including a tighter range of “softable” expenses and strict focus on all other expenses; 2) decreased turnover at the average mutual fund (driven by stricter governance, less market timing, and full fee disclosures); 3) increased importance of performance (more fiduciary scrutiny and disclosure by third-party distributors—you don’t get sued for selling a great performing product (such as American Funds); and 4) fuller disclosure of things such as portfolio manager compensation. We think this institutionalization of the retail side of the business most definitely pressures margins over time, especially for smaller shops. We believe the worst-case scenario would be, with fund directors and maybe even brokers playing the role of the consultant in the institutional space, increased transparency has the potential to bring greater fee competition to the retail side of the business—something the industry has been able to mostly avoid to this point.

**Fee Socialism Unlikely, but Don’t Underestimate Tougher Governance**

Strong governance may create fee pressure. One of the more interesting potential outcomes of current scrutiny, in our view, revolves around proposed changes to mutual fund governance. We believe it is unrealistic to assume that disclosure alone will drive retail investors to shop or change their consumption patterns. Supporting this, the SEC has mentioned, in testimony, a recent survey that found that 75% of respondents could not accurately define a fund expense ratio and 64% did not understand the impact of expenses on fund returns. In our view, a primary goal of regulators and legislators is greater fee competition and they believe they can get it through both increased disclosure *and* greater fund board responsibility. We believe strengthening board independence, information flow, audit committee requirements (in line with Sarbanes-Oxley), and fiduciary responsibility could (we stress “could”) add an additional pressure to retail fund

Depending on the size and channel strategy of the asset manager, the effects of change may be anywhere from mild to harsh

Tighter governance may make it harder to post below-average performance while charging above-average fees
advisers via the “the institutionalization of retail,” as directors (and possibly advisers) feel pressure to exert more muscle and play an institutional consultant-like role. Further, by streamlining the process for firing an adviser (MFRA), boards could have an enhanced ability to strong-arm fund managers. Also, by requiring board members to certify everything from brokerage costs to management fees at the fund could cause a seismic change in the composition of mutual fund boards—meaning we could understand why many current board members would want to step down (too low pay for greater responsibility) and how this could create an atmosphere of adverse selection for those looking to opt into a fund board (someone who wants the money and/or control). We believe the manager’s most important tools will be good performance and style consistency, but not all funds will be fortunate enough to have that.

**Bottom-Line—it’s Not a Near-Term Plus**

Don’t push the sell button too quickly. It seems clear to us from each of the proposals now being floated and the recent testimony of regulators and industry experts that: 1) it will be more costly to run an asset manager going forward—no matter which pieces get passed; 2) pricing pressure on the retail side of the business is likely to show its head after 20-plus years of hibernation; and 3) both brokers and asset managers will need to rethink the economics of their relationships. Further, we believe while some of the proposed changes would cause pain for the industry, we view (some of) them as reasonably positive for the end-customer (or at least fair), and will be interested to see whether the asset managers and brokers can adapt to the new environment and find a way to make lemonade out of these lemons.

**Keep it in Perspective**

With 35%-plus operating margins (in a tough market), extremely high returns on capital, no credit risk, strong current flows, and, ironically, increasing barriers to entry, the asset management business is not irreparably broken, in our view. We believe it is just further down the road to maturity with an increasing emphasis on management and strategy. The severity of any potential impact is obviously tied to which components of the current proposals make it into law and how quickly, if any, do things like pricing pressure show up.

**Are Estimates on Target?**

Based on potential changes, are current estimates too high? While the market is doing well and the industry continues to take in strong net new money into actively managed equity products, we highly doubt the market has any increased costs/lower revenues baked into its models related to these issues—meaning the risk is to the downside, all else being equal. Time will tell, but we are considering current risks when setting our numbers and selecting stocks, and we are particularly aware, with the group selling at 18.4 times 2004 estimates. Remember, we recently baked in $50 million in increased out-of-pocket costs for Franklin Resources in 2004 related to the elimination of certain soft-dollar activities and the likely need to pay some cash for distribution that was being obtained via commissions in the past.
Winners and Losers

The current backdrop is a downer for the whole industry and “winner” is thus a relative thing, at least in the short term. Incrementally, however, legislation and rule making is worse, in our view, for: 1) retail-oriented companies; 2) companies and funds with higher relative costs; 3) lower starting margins; and/or 4) less cost flexibility. Examples could include smaller fund complexes (and funds), high turnover funds, and load funds. (See Table 4 for a summary.)

Table 3: Winners and Losers in Asset Management

<table>
<thead>
<tr>
<th>Pressured</th>
<th>Neutral to Positive</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Retail mutual funds</td>
<td>1. Institutional funds</td>
</tr>
<tr>
<td>2. Poor performers</td>
<td>2. Low-cost providers</td>
</tr>
<tr>
<td>3. Smaller fund managers (and smaller funds)</td>
<td>3. Directly marketed funds</td>
</tr>
<tr>
<td>4. Funds (and fund groups) with high turnover</td>
<td>4. No-load and lower expense ratio funds</td>
</tr>
<tr>
<td>5. Load funds</td>
<td>5. Strong performers with a clear value proposition</td>
</tr>
<tr>
<td>6. Subadvisors</td>
<td></td>
</tr>
</tbody>
</table>

Source: UBS

Potential Effects on the Asset Managers

- **Margin pressure.** Operating costs for the average asset manager would likely rise as formerly softed and/or bundled costs would be run through the P&L. Additionally, asset managers will likely be shouldering a greater out-of-pocket burden for distribution costs going forward.

- **Running the business becomes as important as running the money.** We would expect more holistic scrutiny and strategic thinking at the business level as markets mature and operational complexity increases (i.e., more consideration of internal versus external research, trading frequency and costs, performance measurement, compensation, and marketing/positioning). Of note on compensation, we don’t want to step on any toes, but a recent McKinsey report suggested that the compensation level per dollar of long-term assets is 30% lower in Europe than in the United States.

- **Passing through costs explicitly to clients would be tough.** In our view, given the competitive landscape in the asset management business, we think it’s highly unlikely that the average asset manager would be able to fully recoup these higher operating costs through either a higher management fee or separate “other fee.” Note: Under MFRA, any new/additional fees would have to be approved by the SEC.

- **Research consumption patterns would likely change—buffet versus à la carte.** If they have to pay out-of-pocket for nonexecution products and services, we think the asset managers would cut consumption on items such as research and more diligently scrutinize outside investment research and product spending, paying for only value-added counterparts. Backing this up,
according to a survey in the United Kingdom (by consultant OXERA), 31% of fund managers would reduce their “intake” if they needed to pay out of pocket (we think this number is actually too low).

- **Could provide a tailwind for passive and quantitative managers.** From both a cost and positioning perspective, a reduction of soft dollars, fee/governance scrutiny, and transaction cost reporting represents a potential boon for index, ETF, and quantitative managers, as increased transparency would theoretically push investors toward more “efficiently run” products.

- **Hedge funds too? Probably not.** At this point, hedge funds have been left completely out of this mess and regulators seem content with the idea that qualified investors can protect themselves. As such, while its naive to think ethical standards don’t apply, the bottom line is that the hedge fund community, so it seems, will not find itself required to reduce soft dollar expenses (which can be very large on this side of the fence), creating another advantage (this time regulatory) for this product relative to the mutual fund.

- **Does scale become a bigger differentiator?** It’s possible that all but the largest asset managers will have a difficult time fully staffing research in a world where the sell side pulls back and must be paid for in hard dollars. Additionally, we believe larger asset managers, as of today, soft dollar only 10-15% of commissions versus 40-50% for some smaller managers, thus easing potential business and research transitions for large managers. The one area that could work against the largest managers, ironically, is the likely move toward paying cash for distribution.

- **Bigger should continue to be better—fill-in acquisitions increasingly likely.** As a consequence of increased costs on the buy side, we believe scale would be a heightened imperative. We would also view fill-in acquisitions as more likely as smaller managers become more realistic in their valuation expectations for and the need to present scale and a rounded product set to the marketplace.

**Potential Effects on the Brokers**

- **Profitability likely to face ongoing pressure.** Despite the cyclical improvement in the equity markets, the combination of the buy side’s focus on best execution, increasing adoption of direct access and other automated trading technologies, and the pending regulatory changes leading to the possibility of the elimination of revenue sharing for distribution and softing, unbundling of services, lower fund turnover, and the elimination of 12b-1 fees are all areas or potential areas to place ongoing pressure on a portion of the brokers’ businesses.
Electronic trading gains momentum. The brokers will likely need to accelerate their efforts in program trading, electronic market making in both the cash and derivatives businesses, and produce bona fide direct market access front-end systems as the buy side becomes more accountable for its order flow. This likely leads to further cost rationalization in the equities business, even with a cyclical uptick in the markets (something we’ve definitely seen over the past few weeks even).

Are softing and directed brokerage words of the past? In a word, yes.

What about the load? Interestingly, there’s all this scrutiny over the 12ish basis points that the buy side pays the broker distributors for access to its advisor staffs, yet there’s been relatively little attention paid to the 575 basis points that investors are paying for advice in the load. If the regulators really eliminated the 12b-1 fee, it’s possible that the brokers and asset managers would move away from pushing B and C shares and refocus on the traditional load product given its straight-through compensation structure for the selling broker. This obviously is one of those potential unintended consequences of overregulation as A shares are not necessarily the right product for all investors. Yes, this is an issue for the asset managers too, but the load is a pass-through expense paid to the broker and it could very likely see either lower sales and/or follow-on price compression.

Unbundling—buffet style to à la carte. If the unbundling of sell-side services occurs, the buy side’s consumption pattern will likely change. Similar to eating habits, if you are forced to pay à la carte on your personal account, you will likely be more focused on what you are consuming and the cost than you would be if it were at an all-you-can-eat buffet-style special or billed on your business account. This process will likely force the rationalization of sell-side products and services, pricing, and resources as only the strong survive in an à la carte environment.

Potential elimination of revenue sharing and 12b-1 fees. We believe in paying for distribution and revenue sharing, but paying for distribution beyond the loads with fund assets falls in the gray area and, therefore, will likely be eliminated. With nearly two-thirds of 12b-1 fees ending up in the hands of the brokers, the elimination of these fees would obviously be a negative (though we’d keep it in perspective given their relatively modest contribution when looking at the big picture).

Client profitability more important than ever. Given the pressures on the top line from lower commissions and fees from clients, the focus on resource allocation and client profitability, while difficult in practice, will be more important than ever, in our view. While it’s not easy coming up with the correct client coverage strategy, we think the brokers must go down the path of customer segmentation and tiering of resources. Whether it be diverting more attention to the largest customers and/or potential commission dollars
as opposed to chasing an II strategy with the belief that revenues will follow, or focusing more on the mid-sized accounts that can’t fund their own full-scale research platform and gladly pay the bill, the key will be ensuring client profitability (there’s no more free lunch) as companies cost out their platforms. While this is extremely difficult in practice, the only good news here is that buy-side customers are more likely than ever to cooperate in the process given their increased need to justify who they pay and why.

- **Ongoing focus on operating efficiencies.** Despite the cyclical improvements in the equity markets, the ongoing structural changes in the industry are forcing brokers to focus on operating efficiencies, whether it be technology enhancements to drive efficiency gains or more headcount reductions in cash equities to reduce comp levels. Despite the equity market and trading volume pickup in recent months, the sell side is reacting proactively to pending structural changes, with many firms, including Goldman Sachs, Merrill Lynch, and Deutsche Bank, trimming their equity departments in the past few weeks.

- **Scale matters more than ever.** With increasing costs related to the heightened regulatory environment and the possibility of higher costs and lower commission rates from pending regulation, the brokers with scale and operational efficiencies will be at a competitive advantage more so than ever. Additionally, for the smaller niche firms, some of the pending regulatory changes may force them to outsource some services (like trading at the boutique research shops), in order to focus on their core competencies, yet maintain profitability.

- **Keep it in perspective.** The brokers’ business models are not one-dimensional. Despite the potential pressures in the cash equity research and sales and trading businesses, and to a lesser extent the retail businesses, the brokers are more diversified, with investment banking, fixed income trading and underwriting, and other noncash equity-related capital market businesses contributing to the overall pie. Additionally, as cash equities is one business that has been under great pressure on the profitability side because of a combination of both structural and cyclical issues for some time, further structural change could actually ultimately result in better profitability as excess is removed from the system.

In Tables 4-6, we give you a breakdown of the viewpoints by bill/initiative. Following that, we give more detail (and our viewpoints) on initiatives put forth by the ICI, MFRA, and SEC.
### Table 4: Differing Views on Fees and Expenses

<table>
<thead>
<tr>
<th></th>
<th>ICI</th>
<th>H.R. 2420 (aka &quot;Baker Bill&quot;) - S.1971 (Introduced by Senators Corzine and Dodd)</th>
<th>The Mutual Fund Reform Act of 2004 (Introduced by Senators Peter G. Fitzgerald (R- Illinois), Carl Levin (D-Michigan), and Susan Collins (R-Maine))</th>
<th>SEC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Directed Brokerage/Pay to Play</strong></td>
<td>Recommending that it be banned</td>
<td>Must state whether in fundholder statements commission paid is for: 1) research; or 2) distribution of funds.</td>
<td>Ban</td>
<td>Seeking comment. Slanted toward banning directed brokerage. Comments due within 60 days.</td>
</tr>
<tr>
<td><strong>Revenue Sharing</strong></td>
<td>Not addressed</td>
<td>Must disclose to fund boards (at least annually): 1) any fees paid to advisers for fund distribution; 2) any directed brokerage arrangements; 3) soft dollar arrangements. Also, a summary of same must be included in fundholder annual report.</td>
<td>Only out of investment manager's fee.</td>
<td>Disclosed</td>
</tr>
<tr>
<td><strong>Soft Dollars</strong></td>
<td>1) Tighten usage rules; 2) eliminate step-out payments for third-party research, computer hardware and software, and news services.</td>
<td>One year of study.</td>
<td>1) Eliminate soft dollars, as defined; 2) mandate unbundling of research.</td>
<td>Further study</td>
</tr>
<tr>
<td><strong>12b-1 Fees</strong></td>
<td>Pro</td>
<td>Clarify definition of &quot;no-load&quot; where 12b-1 fees are levied.</td>
<td>Eliminate, along with all asset-based fees.</td>
<td>Seeking comment on appropriateness of 12b-1 fees as a substitute for sales loads, on the possibility of taking all distribution-related costs of shareholder accounts (as opposed to out of assets), and on whether it continues to serve a worthwhile purpose. Comments due in 60 days.</td>
</tr>
</tbody>
</table>

Source: UBS
## Table 5: Differing Views on Disclosure

<table>
<thead>
<tr>
<th></th>
<th>ICI</th>
<th>H.R. 2420 (aka &quot;Baker Bill&quot;) - S.1971 (Introduced by Senators Corzine and Dodd)</th>
<th>The Mutual Fund Reform Act of 2004 (Introduced by Senators Peter G. Fitzgerald (R- Illinois), Carl Levin (D-Michigan), and Susan Collins (R-Maine))</th>
<th>SEC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At Point of Sale</strong></td>
<td>Not addressed</td>
<td>Disclosure (ala the SEC) likely though standards have yet to be set for the appropriate language and document.</td>
<td>1) Source and amount of compensation to adviser has to be given to client at or before the transaction.</td>
<td>See <a href="http://www.sec.gov/rules/proposed/33-8358_attach.pdf">http://www.sec.gov/rules/proposed/33-8358_attach.pdf</a> for proposed solutions. To include comparison metrics and potential conflicts of interest.</td>
</tr>
<tr>
<td><strong>Operating Expense</strong></td>
<td>Supports SEC stance</td>
<td>Yes, in quarterly statement or other periodic report to fund holders (per $1,000 invested).</td>
<td>1) Expense and transaction cost ratio to be disclosed in annual reports and prospectuses; 2) actual dollar cost estimates must be disclosed prominently, at least annually, on shareholder statements; 3) no new fees allowed approved by congressional commission.</td>
<td>On semiannual reports - Based on $1,000 account, showing results on actual performance and on hypothetical 5% annual return.</td>
</tr>
<tr>
<td><strong>Transaction Costs/Turnover</strong></td>
<td>Not addressed</td>
<td>Turnover rate - Yes, in quarterly statement or other periodic report to fund holders that also allows for relative comparisons. Additionally, a nine-month study of how to disclose transaction costs explicitly would be undertaken.</td>
<td>1) Explicit trading cost estimates that take into account commissions and bid/ask spread. Part of &quot;Investment Cost Ratio&quot; that includes transaction costs and operating expenses. 2) Turnover ratio in prospectus.</td>
<td>Seeking comments. Considering additional disclosure and clarification. Comments due February 23, 2004.</td>
</tr>
</tbody>
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Source: UBS
## Table 6: Differing Views on Governance

<table>
<thead>
<tr>
<th></th>
<th>ICI</th>
<th>H.R. 2420 (aka &quot;Baker Bill&quot;) - S.1971 (Introduced by Senators Corzine and Dodd)</th>
<th>The Mutual Fund Reform Act of 2004 (Introduced by Senators Peter G. Fitzgerald (R- Illinois), Carl Levin (D-Michigan), and Susan Collins (R-Maine))</th>
<th>SEC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board Independence and Accountability</strong></td>
<td>1) Support independent directors holding a super-majority (66%), but do not support the requirement for having an independent chairman; 2) support Sarbanes-Oxley-like audit committee standards.</td>
<td>1) Strengthen definition of director &quot;independence&quot;; 2) strengthen audit committee standards; 3) calls for 66% independent directors; 4) certification.</td>
<td>1) Institute Sarbanes-Oxley-style provisions for independent accounting and auditing, chief compliance officers, compliance certifications; 2) strengthen fiduciary duty for negotiating fees and evaluating distribution and marketing plans; 3) independent board chairman; 4) 75% independent directors; 5) facilitation of the process for firing a fund adviser; 6) chief compliance officer; 7) independent board member approval of portfolio manager comp; 8) whistleblower protection.</td>
<td>Under study. 1) Considering independent chairman and 75% board independence; 2) considering making directors explain in annual reports why they recommended approving management fees paid to the adviser.</td>
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<tr>
<td><strong>Compliance Officer</strong></td>
<td>Not addressed</td>
<td>Yes.</td>
<td>Certification by independent board members.</td>
<td>Further study</td>
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<td><strong>Soft Dollars</strong></td>
<td>1) Tighten usage rules; 2) eliminate step-out payments for third-party research, computer hardware and software, and news services.</td>
<td>One year of study.</td>
<td>1) Eliminate soft dollars, as defined; 2) mandate unbundling of research.</td>
<td>Further study</td>
</tr>
</tbody>
</table>

Source: UBS
ICI Proposals

Key Points and Our Commentary

While the ICI has made suggestions on many topics, such as how to curtail late trading (4:00 p.m. hard cutoff rule) and market timing (mandatory five-day, 2% redemption fee), its most controversial proposals revolve around dramatically curtailing soft dollar usage and banning mutual funds’ use of directed brokerage.

Restricting the Use of Soft Dollars

The ICI believes a much narrower definition of what is “softable” would help eliminate potential abuses. Accordingly, “routine expenses like computers, software, and investment publications” would be banned. According to the ICI’s comments, it thinks the SEC should also “significantly curtail the research that can be acquired with soft dollars.”

Our View

*It feels like a done deal.* We think this is a done deal with some companies already going down the path—a few are just eliminating soft dollars for computers and services and others are eliminating soft dollar usage completely.

- **Eliminating soft dollars for third-party research.** The ICI’s proposal “urged the SEC to prohibit all investment advisers, including fund managers, from using soft dollars to acquire any research products and services from third parties.” Further, it proposed to “limit the use of soft dollars to the narrow category of proprietary research that reflects unique intellectual content (no, that’s not the same as saying ‘jumbo shrimp’). The ICI said it is not questioning the value of third-party research, just the manner in which it is paid for. “The ICI board acted to make sure that most research is paid for directly by investment managers from their management fees, not from shareholder assets.”

Our View

- **Tough on the little guy.** They appear to be anticompetitive against smaller asset managers that can’t fund their own research.

- **Tough on independent research.** They’re also anticompetitive against independent research providers. This appears to be inconsistent with the SEC research settlement with the brokers. Aggregator trading desks like Soleil are a potential answer, but they provide only agency trading, which is a disadvantage. Also, we’re not sure we understand the distinction between good research provided by a boutique and good research provided by large broker-dealers and the proposed different payment mechanisms. There’s also the issue of the research settlement and whether this proposal goes against the spirit of ensuring a healthy/available amount of independent research. In essence, the ICI proposal would unbundle the boutiques, but allow full-service firms to stay bundled.
Banning Directed Brokerage

In the ICI’s words, “While this practice is subject to strict regulations, the rules permit fund companies to consider the fact that a brokerage sells its mutual funds when choosing a broker to execute its portfolio trades (brokers, on the other hand, are not allowed, under NASD rules, to take potential brokerage into account when deciding which funds to sell or feature).” The ICI concluded that “directed brokerage” raises questions about whether fund managers’ trading decisions are affected by considerations other than shareholders’ best interests.

Interestingly, some major companies are already embracing the ICI’s proposals. While this might not be a fair example, as the ICI’s chairman (Paul Haaga) is also the executive vice president and director of Capital Research, we doubt it will be the last large firm to adapt its policies. The following is taken straight from the American Funds Web site:

“Our distribution company (not the funds themselves or their shareholders) makes payments to help our major broker-dealers defray some of the expense of training and educating their financial advisers about the American Funds, our organization and our investment philosophy. This helps financial advisers make the best investment recommendations possible. We believe this practice—which is described in general terms in each fund’s prospectus and statement of additional information, and which is consistent with SEC and NASD rules—has contributed to helping fund shareholders meet their investment goals.

Please note that in accordance with SEC and NASD rules and as disclosed by the funds, American Funds’ investment adviser, Capital Research and Management Company, has, until recently, taken into account sales of fund shares in selecting broker-dealers to execute portfolio transactions subject to best execution. We no longer take sales of the American Funds into account in selecting broker-dealers to execute portfolio transactions for the funds. This is consistent with a recent proposal by the ICI to the SEC that it modify its rules so that funds would no longer be allowed to consider sales in allocating portfolio transactions.”

Our View

- **Say goodbye to directed brokerage.** We think eliminating commission payments for distribution is a done deal.

- **Cash is king.** Paying cash and fully disclosing is a more likely scenario, but some current proposals such as MFRA of 2004 ban this too (sort of). While we have a problem with not being able to charge explicitly for access to a distribution channel, this does bring up significant questions, such as what is distribution worth and how do the buy side/sell-side relationships change in the future.
Don’t forget about the up-front sales load. We find interesting that all this focus on payments for distribution centers on the approximate 10-12 basis points that the asset managers are paying for distribution, as opposed to the 575 basis points that end-customers pay for “advice” in the load.


Mutual Fund Reform Act
Key Points and Our Commentary

The following are paraphrased remarks by Senator Fitzgerald (one of the sponsors of the MFRA) at the November 2003 mutual fund hearings: “The mutual fund industry has become the world’s largest skimming operation” preceded by describing the industry as wrought with “excessive and opaque fees.”

The MFRA is divided into four titles: Title 1 (fund governance); Title 2 (fund transparency); Title 3 (fund regulation and oversight); and Title 4 (studies). It was put forth by Senators Fitzgerald (R – Illinois), Collins (R – Maine), and Levin (D – Michigan). Importantly, this bill comes out of the Governmental Affairs subcommittee on Financial Management (the Senate Banking Committee under Senator Shelby has final jurisdiction on the issue, as we understand it). Since this bill is new and points to many of the worst-case scenarios for the industry, we thought we’d take a more in-depth look at the major sections below.

Title 1—Fund Governance
Key Provisions

- Strengthens the fund advisers’ fiduciary duty regarding negotiating fees and providing fund information; and

- Institutes Sarbanes-Oxley-style provisions for independent accounting and auditing, codes of ethics, chief compliance officers, compliance certifications, and whistleblower protections.

Our View

- Negotiating standards make sense—to a point. Mandating and enforcing tougher standards for negotiation makes sense to us at the surface. However, we believe the heterogeneity of the product likely limits comparisons to fees by style box and fund size.

- Not a commodity product. Who’s to say you shouldn’t pay more in fees for a five-star manager? This is a key problem with fee benchmarking in asset management. We’re not dealing with a commodity product. (Last time we checked, a Rolls Royce cost quite a bit more than a Hyundai. Even though they both get you from point A to B.)

- Tough governance cool, but could have unintended consequences. It’s hard to argue against tougher governance. There’s a fine line, however, between ensuring fair treatment for fund holders and creating a governance quagmire where the only people willing to put themselves at risk by serving are those looking for a paycheck and/or those who will look to scrutinize every decision made by the adviser.
Bottom line. At a minimum, we’d expect tougher advisory contract negotiations—with a lopsided effect. This is potentially hardest on those with: 1) above-average fees relative to style box and fund AUM; 2) poor performance; and 3) lack of clear value proposition (i.e., differentiation).

Title 2: Fund Transparency

Key Provisions

- Standardizing computation and disclosure of fund expenses and transaction costs, which yield a total investment cost ratio and tell investors actual dollar costs;

- Providing disclosure and definitions of all types of costs and requiring that the SEC approve imposition of any new types of costs;

- Disclosing broker compensation at the point of sale; and

- Disclosing and explaining portfolio turnover ratios to investors.

Our View

- Echoes the calls for clear disclosure. A key tenet of the MFRA is putting all actual fees together for investors in one place. This to us seems a reasonable request and outcome, though the industry may disagree on the cost of putting together such information. If passed, this would most definitely enhance competitiveness, in our view.

- Quantifying total costs is a speculative task. Trying to quantify transaction costs is inherently difficult. Taking—types of transactions (agency versus principal), explicit versus implicit costs, and asset class/liquidity—into consideration developing a “standardized” manner for computing all-in transaction costs seems unlikely.

- A turnover rating is more likely. Turnover ratings (high, average, low) by fund type seem more practical and likely, in our view. Under this scenario, there would probably also be additional disclosure on the dilution caused by turnover in the prospectus or other statement.

- Taking away power to set new types of fees—significant. Many clients have said to us, “The industry will just find another way to extract economic value from fund holders.” The MFRA would try to squash that possibility by mandating that all new fees be approved by the SEC. This is significant in that it would eliminate some of the wiggle room currently enjoyed by the industry.

- Point-of-sale broker compensation disclosure. We think this is pretty much a done deal and it echoes the sentiment of the SEC and other bills. If combined with a 12b-1 ban or overhaul, eliminating B and C shares, ostensibly could turn the retail business on its ear (and/or push more wrap-type relationships).
Will disclosure alone really change anything? It is unrealistic to assume that disclosure alone will drive retail investors to shop. In fact, the SEC cited a recent survey that found that 75% of respondents could not accurately define a fund expense ratio and 64% did not understand the impact of expenses on fund returns. In our view, regulatory and legislative parties want greater fee competition and think increased disclosure and greater board responsibility will drive it. We believe strengthening board independence, information flow, audit committee requirements (in line with Sarbanes-Oxley), and fiduciary responsibility could (we stress “could”) add an additional pressure to retail fund advisers via a theme we term, “The Institutionalization of Retail” as directors (and possibly advisers) feel pressure to exert more muscle and play a institutional consultant-like role. That said, we think proposals calling for the board to certify results might be pushing it (it might be hard to find suitable persons to serve on boards). Note: Several legislators recently wrote to Chairman Donaldson, opposing a potential SEC mandate for an independent chairman.

Title 3: Fund Transaction Simplification

Key Provisions

- Eliminating asset-based distribution fees (rule 12b-1 fees), the original purpose of which has been lost and the current use of which is confusing and misleading—and amending the Investment Company Act of 1940 to permit the use of the adviser’s fee for distribution expenses, which locates the incentive to keep distribution expenses reasonable exactly where it belongs—with the fund adviser.

- Prohibiting shadow transactions—such as revenue sharing, directed brokerage, and soft-dollar arrangements—that are riddled with conflicts of interest, serve no reasonable business purpose, and drive up costs.

- “Unbundling” commissions, such that research and other services, heretofore covered by hidden soft-dollar arrangements, will be the subject of separate negotiation and a freer and fairer market.

- Requiring enforceable market timing policies and mandatory redemption fees—as well as provision by omnibus account intermediaries of basic customer information to funds to enable funds to enforce their market timing, redemption fee, and breakpoint discount policies.

- Requiring fair value pricing and strengthening late trading protections.

Our View

- Title 3 = ouch! No 12b-1 fees, soft dollars, revenue sharing, or directed brokerage. While we think the latter items are headed for the fee graveyard, the abolition of 12b-1 fees would be surprising.
Adios 12b-1 fees? This is possibly the biggest red flag in the entire bill. 12b-1 fees, estimated at $10 billion per year, are a dominant form of payment for distribution in the broker/intermediary, supermarket, and 401(k) channels (payment to platform provider). Contrary to popular opinion, 12b-1s don’t solely aid load funds (funds can charge up to 25 basis points and retain the “no load” moniker—allowing no-load funds to sell through supermarkets and retirement channels). If it were to be abolished, both B and C share classes would likely cease to exist and supermarkets/401(k) platforms could look to take a chunk of the asset manager’s fee. While asset managers could theoretically raise fees to counteract related expense pressure, we find this unlikely (though strong performers might have more luck).

Phase-out would likely cause some information systems havoc. Given the prevalence of the 12b-1 fees throughout the mutual fund universe, changing the game would probably necessitate some one-time cap ex throughout the value chain—asset managers, brokers, transaction processors, and platform providers—to adapt.
SEC Rulemaking and Concept Release

Key Points and Our Commentary

Over the past week or two, the SEC adopted several new mutual fund rules and amendments related to costs, performance, and portfolio investment disclosure. In addition, the Commission has put out a few concept releases related to fund governance, directed brokerage, and improving disclosure of mutual fund transaction costs. Overall, we’d say that the SEC is very well versed on each of these topics and is attempting to balance the need for more fee and expense transparency while being mindful of the complexities associated with identifying and measuring transaction costs. To that end, we think that the SEC is acting in a very rational direction with a far more conversational tone, as opposed to oppositional.

In particular, the Commission is considering whether mutual funds should be required, among other things, to: 1) quantify in some meaningful way and disclose some or all of their portfolio transaction costs without including these costs in their expense ratios and fee tables; 2) quantify some or all transaction costs and include them in expense ratios and fee tables; 3) provide other quantitative information about the level of transaction costs; or 4) some combination of the above. That said, make no mistake about it, we doubt any good comes of these concept releases and pending rule changes, more likely just varying degrees of bad.

Nonetheless, we fine it very interesting to see such short comment periods (four to five weeks) for such serious and far reaching topics that the SEC has put forth and can only assume that it is attempting to work with the various industries in constructing a viable compromise to current rules in an effort to avoid the potential for over legislation by government.

Enhanced Disclosure (Rule: Compliance Within 120 Days)

This amendment will require mutual funds to disclose: 1) the dollar cost associated with an investment of $1,000 based on actual expenses for the period covered by the report; 2) the dollar cost associated with a $1,000 based on the actual expense ratio for the period and an assumed return of 5% per year; and 3) the expense ratio and end of period account values for an initial investment of $1,000. See http://www.sec.gov/rules/proposed/33-8358 Attach.pdf for some examples of proposed display.
Our View

Better fee disclosure—a good thing. Fee disclosure on shareholder statements based $1,000 account makes some sense and has been supported by the ICI. While some argue that an actual customers’ exact dollar fee disclosure is necessary, the industry has countered, claiming it would be too costly to provide (cost to implement would likely fall on the fund holders). This seems like a bit of a stretch as it seems easy enough to multiply an account value (or average account value) by the estimated operating expenses. Also, in reality, showing a $1,000 investment impacted by $25 might not be overly impactful to a customer, even if prominently disclosed.

What about turnover? Glad you asked. More prominent disclosure on turnover is missing, but is being reviewed.

Transaction Cost Disclosure (Proposal)

The Securities and Exchange Commission is seeking public comment on a number of issues related to the disclosure of mutual fund transaction costs. Comment is being sought on:

1. Whether mutual funds should be required to quantify and disclose to investors the amount of transaction costs they incur, include transaction costs in their expense ratios and fee tables, or provide additional quantitative or narrative disclosure about their transaction costs;

2. Whether mutual funds should be required to record some or all of their transaction costs as an expense in their financial statements; and

3. They are also seeking comment on: a) alternatives for quantifying transaction costs; b) alternatives that provide additional information about the level of transaction costs; and c) responsibilities in the review of transaction costs by fund directors.

Our View

Quantifying total costs is a speculative task. Trying to quantify transaction costs is inherently difficult. Taking—types of transactions (agency versus principal), explicit versus implicit costs, and asset class/liquidity—into consideration developing a “standardized” manner for computing an all-in transaction costs seems unlikely.

More likely is a turnover rating. Turnover ratings (high, average, low) by fund type seem more practical and likely. Under this scenario, there would probably also be additional disclosure on the dilution caused by turnover in the prospectus or other statement.
Disclosures/Rationale From the Board of Advisors (Proposal)

The Commission proposed amendments to its rules and forms that would improve the disclosure that mutual funds and other registered management investment companies provide to their shareholders regarding the reasons for the fund board’s approval of an investment advisory contract. The proposals are intended to encourage fund boards to consider investment advisory contracts more carefully and to encourage investors to consider more carefully the costs and value of the services rendered by the fund’s investment adviser. These enhancements would require the following (paraphrased from the SEC release):

- **Selection of adviser and approval of advisory fee.** The proposals would clarify that the fund should discuss both the board’s selection of the investment adviser and its approval of amounts to be paid under the advisory contract.

- **Specific factors.** The fund would be required to include a discussion of: 1) the nature, extent, and quality of the services to be provided by the investment adviser; 2) the investment performance of the fund and the investment adviser; 3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; 4) the extent to which economies of scale would be realized as the fund grows; and 5) whether fee levels reflect these economies of scale for the benefit of fund investors.

*Comparison of fees and services provided by adviser.* The fund’s discussion is required to indicate whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (e.g., pension funds and other institutional investors).

**Our View**

- **Could put a continuing lid on fees.** Mandating that directors discuss their rationale for keeping/paying an advisor in the public domain would likely enhance a push toward retail fee compression.

Proposal on Banning on Directed Brokerage (120-Day Comment Period)

The Commission proposed an amendment to rule 12b-1 under the Investment Company Act of 1940 that would prohibit open-end investment companies (mutual funds) from directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. The Commission also asked for comment on the need for additional changes to rule 12b-1.
The proposed rule amendment would:

- Prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker-dealer;

- Prohibit “step-out” and similar arrangements under which a fund directs brokerage commissions to selling brokers that do not execute fund portfolio securities transactions as compensation for selling fund shares; and

- Require funds that use a selling broker-dealer to execute portfolio securities transactions to adopt, and the fund’s board of directors (including its independent directors) to approve, policies and procedures reasonably designed to prevent: 1) the persons who select executing broker-dealers from taking into account brokers’ distribution efforts; and 2) any agreement under which the fund is expected to direct brokerage commissions for distribution.

**Our View**

- *Say goodbye to directed brokerage.* We think eliminating commission payments for distribution is a done deal.

- *Cash is king.* Paying cash and fully disclosing is a more likely scenario, but some current proposals such as MFRA of 2004 ban this too (sort of). While we have a problem with not being able to charge explicitly for access to a distribution channel—this does bring up significant questions such as, Does the value of distribution channel and how, if any, buy side/sell side relationships change in the future?

**Proposal on 12b-1 Fee Changes**

The commission also is requesting comment on the need for additional changes to rule 12b-1. Included in the inquiry are: 1) the current practice of using 12b-1 fees as a substitute for a sales load; 2) an alternative approach to rule 12b-1 that would require distribution-related costs to be deducted directly from shareholder accounts rather than from fund assets; and 3) a request for comment on whether rule 12b-1 continues to serve the purpose for which it was intended, and whether it should be repealed.

**Our View**

- *Who knew 12b-1 fee scrutiny would be so high?* While the SEC tone seems much lighter than MFRA, it appears that 12b-1 distribution fees are going to get a hard look one way or another. As we said earlier, changes in rules on 12b-1 could cause a major rethinking of the business (not necessarily bad, but change does create risk/volatility).
Statement of Risk

The asset management industry faces a variety of risks. Principal risks include revenue exposure to various asset markets, slowing organic growth, increasing cost pressures, and increasing regulation.

Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

This report has been prepared by UBS Securities LLC, an affiliate of UBS AG (UBS).

Companies mentioned

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<th>Company Name</th>
<th>Reuters</th>
<th>Rating</th>
<th>Price</th>
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Price(s) as of 18 February 2004. Source: UBS.

1. UBS Securities LLC makes a market in the securities and/or ADRs of this company.

3a. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company or one of its affiliates within the past 12 months.

3b. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company or one of its affiliates within the past three years.

7. UBS AG, its affiliates or subsidiaries beneficially owned 1% or more of a class of this company’s common equity securities as of last month’s end (or the prior month’s end if this report is dated less than 10 days after the most recent month’s end).

8. UBS Limited acts as broker to this company.

10. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company.

12. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company within the next three months.
Global ratings: Definitions and allocations

<table>
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<tr>
<th>UBS rating</th>
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<th>UBS rating</th>
<th>Definition</th>
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<th>Coverage</th>
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<td>FSR is &gt; 10% above the MRA, higher degree of predictability</td>
<td><strong>Buy 2</strong></td>
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<td><strong>Sell</strong></td>
<td>11%</td>
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1: Percentage of companies under coverage globally within this rating category.
2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 December 2003.

KEY DEFINITIONS

**Forecast Stock Return (FSR)** is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

**Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).

**Predictability Level** The predictability level indicates an analyst's conviction in the FSR. A predictability level of ‘1’ means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of ‘2’ means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

**Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

**Rating/Return Divergence (RRD)** This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

**US Closed-End Fund ratings and definitions are:** Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

**UK and European Investment Fund ratings and definitions are:** Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

**Core Banding Exceptions (CBE):** Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.