

U.S. Equity Trading Business Falling Short of Expectations in 2010

U.S. institutions that began 2010 with optimistic forecasts for their domestic equities business should be recalibrating their trading strategies to account for a dramatic reduction in industry-wide trading volumes.

The results of Greenwich Associates latest U.S. Equity Investors Study reveal that the amount of brokerage commissions paid by U.S. institutions on trades of domestic equities decreased 13% to an estimated \$12.1 billion from Q1 2009 to Q1 2010 on an “apples-to-apples” basis. Despite that falloff, U.S. institutions entered this year predicting that commission payments would surge in calendar year 2010 in step with expected strength in both stock market performance and trading volume. Buy-side traders at U.S. institutions projected a 15% increase in their commission pool for 2010, with hedge funds predicting a 20% increase in the amount of commissions paid to brokers on trades of domestic stocks.

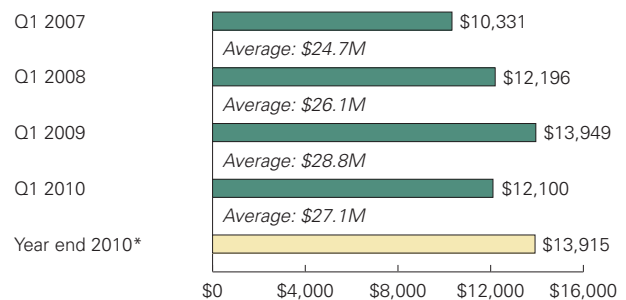
“As we reach the mid-way point in the second quarter of 2010 it’s become evident that, not only will equity commissions fail to reach those growth targets, the commission pool might actually be contracting,” says Greenwich Associates consultant Jay Bennett.

A contraction in institutional commission payments indicates two things: 1) Trading volumes have fallen off significantly, and 2) Resource-constrained U.S. buy-side institutions are doing everything possible to reduce trading costs. There’s little doubt that the first factor has been in evidence so far this year: Consolidated trading volumes in NYSE listed stocks in the first quarter were off significantly from Q1 2009. As for the latter point, the average “all-in” commission rate paid by U.S. institutions to brokers on individual trades of domestic stocks dropped from 2009 to 2010, in part due to the fact that institutions continue to shift trades from traditional “high-touch” execution to lower cost electronic and portfolio trading platforms.

“The fact that actual institutional commission payments are falling short of projections will create obvious pressures for equity brokers, but there will be ramifications for institutions as well,” says Greenwich Associates consultant John Colon. “Specifically, they will have less currency than they had expected to pay for sell-side research and other services. At a time when sell-side firms are being extremely diligent about rationalizing their resources, institutions will need to make sure their trading operations are working in tight concert with portfolio managers and traders to

preserve important sell-side relationships and ensure that the firms providing the most valuable research and other services are getting compensated. A failure to effectively coordinate this process could put essential services and research at risk at a moment of scarce resources for many buy-side institutions.”

Total Estimated Commissions Generated in U.S. Equities



Note: In millions. Based on 256 respondents willing to disclose commissions in 2007, 255 in 2008, 298 in 2009, and 257 in 2010. *Average expected change in U.S. equity commission pool by year end 2010, based on 244 respondents.
Source: 2010 U.S. Equity Investors Study

Decline in Commission Rates

The average “all-in” blended commission rate paid by U.S. institutions to brokers on trades of domestic shares decreased to 2.78 cents-per-share in 2010 from 2.90 cents in 2009. These average rates take into account commissions on single-stock, program and direct-market-access electronic trades. Among the most active institutional traders — those generating more than \$50 million in brokerage commission per year — average rates fell to 2.45 cents-per-share from 2.67 cents and hedge funds paid the lowest average rate at 2.47 cents, down from 2.78 cents last year.

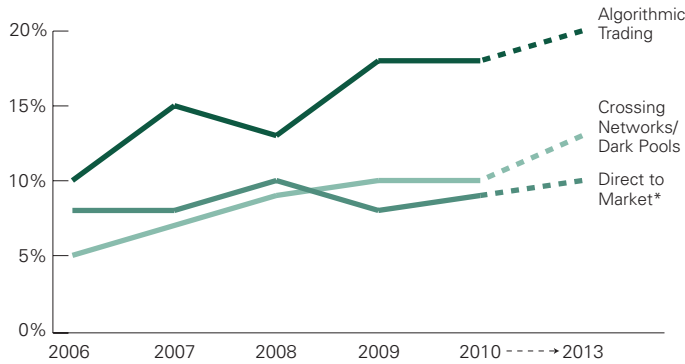
Contributing to the decline in average commission rates was the continued drive among U.S. institutions to shift trading volume to electronic systems. U.S. institutions

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executed 37% of domestic equity trading volume through electronic single-stock trades in 2009–2010, up from 36% the prior year. Among larger commission accounts the proportion of trading executed electronically reached 44% of volume.

U.S. Equities — High Touch vs. Electronic Mix

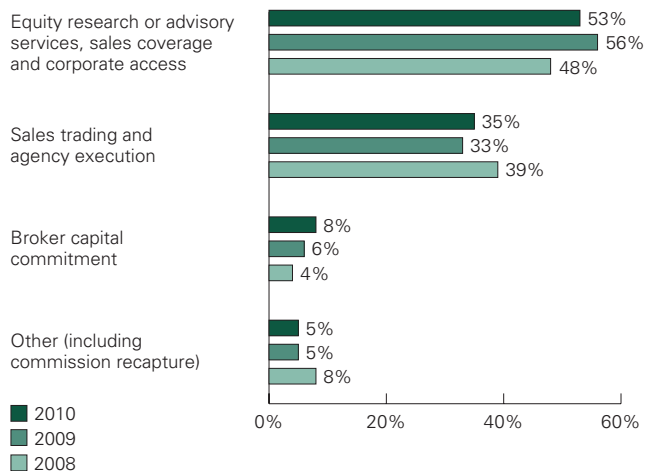


Note: Based on 264 respondents in 2006, 257 in 2007, 241 in 2008, 267 in 2009 and 250 in 2010. Source: 2010 U.S. Equity Investors Study
*Self-directed single-stock trades

Institutional Research Spend Hits \$6.4 Billion

U.S. institutions made modest adjustments to their commission allocations templates in 2010, shifting commission payments from research and related services to execution. The typical U.S. institutions used 53% of its domestic equity commission payments to compensate brokers for research/advisory services, sales coverage and the facilitation of access to corporate management teams; that share was down slightly from 56% of commission allocated to these products and services in 2009. Meanwhile, the share of commissions used to compensate brokers for sales trading and agency execution increased to 35% from 33%. The shift in commission allocations in the direction of sales trading and execution was even more pronounced among the largest and most actively trading institutions.

Breakdown of Commission Payments on U.S. Equity Trades



Note: Percentages are weighted by commission value. Based on 233 respondents in 2008, 242 in 2009 and 222 in 2010. Source: 2010 U.S. Equity Investors Study

The 53% of total U.S. equity commission payments allocated to sell-side research and related services represent approximately \$6.4 billion. Institutions used about 27% of that amount to compensate sell-side firms for direct analyst service, 19% to reward brokers for the facilitation of access to corporate management teams, 14% to compensate sponsors of research conferences and 12% to pay brokers for sales service. “Institutions are now using a combined one-third of their research commissions to compensate brokers for directly arranging meetings with company management teams or for running conferences that provide opportunities for face time with corporate management,” says Greenwich Associates consultant John Feng. “Hedge funds have upped that share to roughly 40%.”

Proportion of Research Allocation for Specific Research, Sales Services and Corporate Access Services

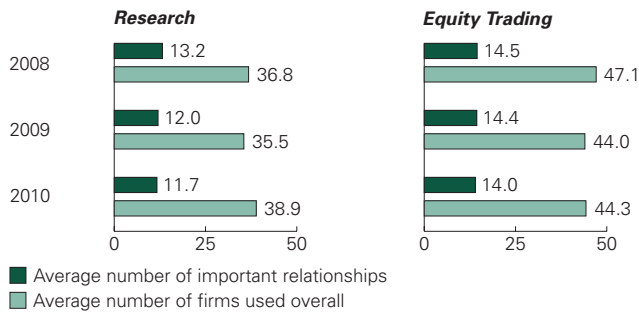


Note: Based on 137 respondents in 2009 and 146 in 2010. Source: 2010 U.S. Equity Investors Study

Although institutions in past years have expressed their intention to reduce the number of firms they use as providers of research and related services, that number actually increased to an average 39 in 2010 from almost 36 in 2009. Approximately 30% of institutions say they'll cut back in the future. (A slightly higher proportion — 36% — expect to reduce the number of brokers used for U.S. equity trading in the coming year from the current average of approximately 44.)

Bulge bracket firms with full research and investment banking capabilities continue to capture 55% of the \$6.4 billion spent by institutions on research related to domestic equities. Mid-size and regional brokers collect another 21% and boutique broker-dealers capture 14%. Third-party independent research providers or consultants without

Number of Brokers Used for U.S. Research vs. Equity Trading



Note: For research, based on 230 respondents in 2008, 207 in 2009 and 219 in 2010. For equity trading, based on 272 respondents in 2008, 287 in 2009 and 285 in 2010. Source: 2010 U.S. Equity Investors Study

investment banking capabilities capture about 10%. A significant share of the commissions paid to independent research providers is flowing through Commission Sharing Arrangements (CCA/CSAs). Half of U.S. institutions are currently employing CCA/CSAs as part of their domestic equity trading businesses — with expectations that nearly 75% will have adopted a CCA/CSA by year-end 2010 — and about 22% of commission payments on domestic stock trades are now paid through CCA/CSA trades.

(For details on the expansion of CCA/CSAs in the U.S. institutional market, please see the Greenwich Associates Report, *In Domestic Equities, CCA/CSA Use Tops 50% of U.S. Institutions.*)

Consultants Jay Bennett, John Feng and John Colon advise on the institutional equity markets globally.

Methodology

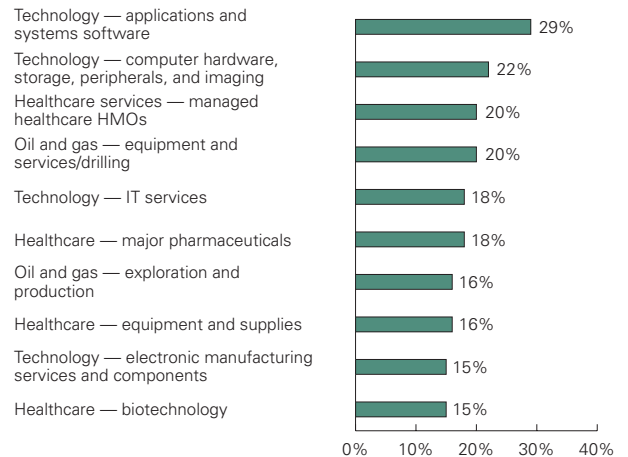
Greenwich Associates interviewed 219 U.S. equity fund managers about the research and sales services they receive and 286 U.S. equity traders about the trading services they receive from their brokers in the United States. They were also asked about current market practices, trend, and compensation. Interviews were conducted between December 2009 and February 2010.

The findings reported in this document reflect solely the views reported to Greenwich Associates by the research participants. They do not represent opinions or endorsements by Greenwich Associates or its staff. Interviewees may be asked about their use of and demand for financial products and services and about investment practices in relevant financial markets. Greenwich Associates compiles the data received, conducts statistical analysis and review for presentation purposes in order to produce the final results.

Institutions Predict Best Performing Equity Sectors for 2010

Technology will be the best performing sector of the U.S. stock market for the remainder of 2010, according to the estimates of U.S. institutional portfolio managers. Approximately 30% of portfolio managers predict that Technology: Applications and Systems Software will be one of the best performing sectors over the period and 22% believe those honors will go to Computer Hardware, Storage, Peripherals and Imaging. The following shows the sectors on which U.S. portfolio managers are most bullish for 2010.

Institutions' Picks for Top 2010 Performance



Note: Percent citing sector as one of 3-4 best performers in next 12 months. Based on 153 respondents in 2010. Source: 2010 U.S. Equity Investors Study

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GREENWICH REPORT — CONFIDENTIAL



6 High Ridge Park Stamford CT 06905 USA

Tel: 203 625 5038/800 704 1027

Fax: 203 625 5126

email: ContactUs@greenwich.com

www.greenwich.com