Consultation Paper

176 newsletter

Financial Services Authority

Bundled Brokerage and Soft Commission Arrangements

April 2003

About this newsletter

This newsletter provides a summary of FSA Consultation Paper 176

This paper is particularly relevant for fund managers and their customers, brokers and the providers of 'softed' goods and services

- You can download CP176 from our website – see details below

Alternatively, to order hard copies of the Consultation Paper:

- Phone our helpline on **0845 608 2372**, quoting reference CP176
- Copies are available at £10 each
- Please allow five working days for delivery

Useful links

CP176: Resource Page	**http://www.fsa.gov.uk/pubs/cp/176/**
Other recent FSA publications	**http://www.fsa.gov.uk/pubs/**
Email the author of this CP	**cp176@fsa.gov.uk**

Subscription

For information about subscribing to receive FSA newsletters, please visit: http://www.fsa.gov.uk/pubs/subs/ or phone the Subscription Department on 0845 608 2372

To subscribers of the paper version of the FSA Handbook of Rules and Guidance:

Please note that the FSA has appointed The Stationery Office (TSO) to publish the hardcopy FSA Handbook including the UKLA Sourcebook and to service the subscriptions to these publications. They will shortly be sending renewal notices to all current subscribers and order forms to FSA regulated firms. They will be offering annual subscriptions including all relevant updates. For further information on these and other FSA publications, please call **0845 608 2372**.

For a full copy of the Consultation Paper: Call 0845 608 2372 and quote CP176

The Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Main switchboard: 020 7676 1000
Fax: 020 7676 1099
Website: http://www.fsa.gov.uk/
CP176 Resource page: http://www.fsa.gov.uk/pubs/cp/176/
Email: cp176@fsa.gov.uk

Executive summary

Commissions paid by fund managers to brokers for to execute deals for their customers are a significant extra cost of investment fund management. In 2000, for example, UK fund managers paid about £2.3billion in commissions from their customers' funds to UK brokers. However, commissions may pay for more than the cost of trade execution. Estimates vary but as much as 40% goes on additional services, such as investment research and market information technology, through 'bundled' (or 'full service') broking or 'soft commission' arrangements.

As with all charges, commission costs affect investment returns. But since commission is charged directly to customer funds, transaction by transaction, the total cost to each fund, and the value of the additional services acquired, are still not clear. So, fund managers can pass on some fund management costs to customer funds with minimal scrutiny. This creates a significant conflict of interest for fund managers.

In 2001, Paul Myners reviewed institutional investment in the United Kingdom, for HM Treasury. He concluded that there was an incentive for fund managers to direct business to brokers to obtain additional services, rather than the most favourable trade execution terms for their customers, and that this represented an unacceptable market distortion.

This has a direct bearing on our consumer protection and market confidence objectives. So in July 2001, we agreed with HM Treasury that we would review how well our regulatory regime addresses the conflicts of interest and market distortions arising from bundled brokerage and soft commission arrangements. We have carried out this work in parallel with our other work on best execution and investment research, and this Consultation Paper (CP) sets out the results of our review.

There are four areas of concern:

- A system in which costs are opaque and accountability to fund management customes is deficient, gives little comfort that underlying conflicts of interest are being controlled effectively, or that dealing arrangements result in good value for money for investors.
- Bundled and soft commission arrangements create powerful incentives that have a strong influence on fund managers' trading decisions and the routing of business to brokers. In some circumstances, buying additional services may be a stronger driver for trading decisions than execution quality. This is particularly the case with soft commission arrangements where the commission rate can be higher than normal, but where the proportion of the commission spend taken up by soft services typically exceeds 80%. Such an arrangement seems bound to have an impact on execution quality.
- The control over these incentives exerted by normal market disciplines is weak and uneven. Competition between fund managers focuses on the mandate for the business and the size of the management fee, rather than commission costs. Although fund managers are judged on fund performance, isolating the effect on performance of bundling and soft

commission arrangements from any other factor is well-nigh impossible. More disclosure can help, and we welcome the steps taken by the Investment Management Association and the National Association of Pension Funds to improve disclosure of transaction costs to pension funds. However, we are not convinced that more disclosure will be enough to address the issues. In the retail funds market we think it would have minimal impact.

- Bundled and soft commission arrangements create similar incentives and have similar economic effects, so treating them differently in regulatory terms is unhelpful and creates its own distortions.

We do not believe that our current regulatory regime addresses these issues satisfactorily, so we are consulting on two main measures:

- We propose to limit the goods and services, beyond trade execution, that can be bought in the first instance with commission or order flow. Specifically, we propose excluding market pricing and information services, such as dealing screens, which account for between 50% and 57% of soft commission credits. We seek views on whether this should include other services, such as computer hardware and software and other equipment, and custody.

- We also propose that the cost of acquiring any other services in a package along with trade execution should not be passed through automatically by a fund manager to his customers' funds. This would apply in particular to the use of commission to buy investment research. This does not mandate unbundling by service providers, but focuses on greater transparency and accountability to fund management customers for the use of their funds.

We believe that these proposals will encourage competition and enhance the attractiveness of UK markets. They will:

- give fund managers a stronger incentive to control the demand for, and costs of, additional broker and third party services. They should also ensure that funding mechanisms do not distort the choice between independent and broker investment research;

- improve transparency and accountability to underlying customers, both institutional and retail, for the expenditure of fund assets. This should bring more effective competitive pressure to bear on total fund management costs;

- strengthen the incentive for fund managers to direct business to brokers on the basis of trade execution quality and cost, rather than the range of additional services that brokers offer. They will also encourage fund managers to consider the merits of alternative trade execution options. This is in tune with our new approach to best execution, as set out in CP154[1]. This approach focuses on achieving the best overall outcome for the customer

- reduce the incentive for larger institutional funds to seek some recovery of their commission outlay through commission recapture and directed commission arrangements.

OXERA Research

To inform our policy thinking, we commissioned Oxford Economic Research Associates (OXERA), independent economic consultants, to carry out a study of bundled brokerage and soft commission arrangements in the UK[2]. OXERA's report provides an economic analysis of these arrangements, and their likely impacts on competition and incentive structures. This is an important study which we are publishing alongside this CP.

1 CP154: 'Best Execution', FSA, October 2002

2 'An assessment of soft commission arrangements and bundled brokerage services in the UK', Oxford Economic Research Associates, March 2003.

OXERA have also prepared an initial cost-benefit analysis of our policy proposals. This concludes that the benefits are likely to outweigh the costs. We include a summary of this analysis in our CP, and we are publishing the full analysis separately[3].

We welcome your views

We invite responses to our proposals by 29 August 2003. The Government has also recently announced the start of their two-year Review of industry progress on implementing the recommendations of the Myners report. This will cover measures to improve control over pension fund transaction costs. We will take account of the Review's findings, as well as responses to this CP, in developing appropriate amendments to rules and guidance for further consultation later in the year.

Consumers

Bundled brokerage and soft commission arrangements affect the management of retail funds, such as unit trusts, OEICs and investment trusts, as well as pension funds. So, consumers with interests in these funds, whether directly or through PEPs and ISAs, will be affected by the issues in this CP. Our proposals will benefit consumers by ensuring that fund managers acting on their behalf have stronger incentives to obtain value for money, and to organise dealing arrangements that are clearly in the best interests of retail as well as institutional funds.

Copies of this Consultation Paper are available for download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 29 August 2003.

You can send your response by electronic submission using the form on our website at http://www.fsa.gov.uk/pubs/cp/176/, by e-mail cp176@fsa.gov.uk or in writing to:

Ashley Kovas
Business Standards Department
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7676 5724
Fax: 020 7676 9717
E-mail: cp176@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

3 "Cost–benefit analysis of the FSA's policy propositions on soft commissions and bundling", Oxford Economic Research Associates, March 2003.

For a full copy of the Consultation Paper: Call 0845 608 2372 and quote CP176

The Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Main switchboard: 020 7676 1000
Fax: 020 7676 1099
Website: http://www.fsa.gov.uk/
CP176 Resource page: http://www.fsa.gov.uk/pubs/cp/176/
Email: cp176@fsa.gov.uk