Policy Statement

04/13

Financial Services Authority

Bundled brokerage and soft commission arrangements

Feedback on CP176

May 2004

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This Policy Statement reports on the main issues arising from responses to Consultation Paper 176 (*Bundled brokerage and soft commission arrangements)*.

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1 Overview

1.1 The review of institutional investment in the UK, prepared by Paul Myners for HM Treasury and published in 2001, identified problems arising from the use of bundled brokerage[1] and soft commission arrangements[2] by asset managers. Given that we had work planned on the related issue of best execution, we agreed with HM Treasury that we would investigate those matters further and make proposals for regulatory change if necessary.

1.2 In April 2003 we published a Consultation Paper, CP176 – *Bundled brokerage and soft commission arrangements*, together with research commissioned from independent economic analysts OXERA. Our basic analysis was that a market failure exists in relation to these arrangements. The use of 'bundled' or 'softed' commission arrangements to pay for goods and services other than execution lacks transparency. Fund managers who use these arrangements face conflicts of interest in their relationship with brokers, and are not directly accountable to their clients for expenditure on bundled and softed items. The lack of transparency makes it difficult for customers to tell if the manager is acting in their best interests or obtaining sufficient value for money on their behalf.

1.3 To address this market failure, CP176 proposed two measures:

- limiting the range of goods and services that could be purchased with commission; and
- requiring fund managers to value the goods and services that could still be softed or bundled, and to rebate an equivalent amount to their customers' funds ('the rebate proposal').

1 'Bundled brokerage' is an arrangement in which a broker provides a client (e.g. a fund manager) with a combination of trade execution services and other services, such as investment research, paid for through commission. The components of the 'bundle' are not usually offered or priced as separate services. There is an expectation, but no obligation, that the fund manager will deal through the broker.

2 Under a soft commission arrangement, the fund manager receives goods and services (usually from third parties) which are paid for by the broker. There is an explicit prior agreement that links the value of the softed goods and services to a specified volume of commission from dealing orders.

This Policy Statement

1.4 This paper provides feedback on the responses to the analysis and policy proposals in CP176. It also sets out our future policy direction and desired regulatory outcomes, and explains how we plan to work with the market by providing an opportunity for the industry to develop an effective means of delivering those outcomes.

Who should read this paper?

1.5 This paper will be of interest to a wide variety of investment firms including fund managers, brokers and the providers of services that are presently softed, such as market information services and independent research. The paper will be of direct interest to institutional investors such as the trustees of pension funds.

1.6 It will also be relevant to retail product providers, such as unit trust managers and trustees, authorised corporate directors (ACDs) and depositaries of open-ended investment companies (OEICs), other investment companies (including investment trusts) and life assurance companies.

CP176: Responses and feedback

1.7 CP176 generated nearly 150 written responses from firms, organisations and individuals, and we are grateful to all who responded. Our thinking has also been influenced by numerous discussions with stakeholders both during and after the formal consultation period, and by the lively public debate stimulated by the publication of CP176.

1.8 It is clear that there are widely divergent opinions among respondents on both the materiality of the market failure and the appropriate means to deal with it. Even within industry sectors, the diversity of opinion has been marked. For example, views on the appropriateness of soft commission arrangements differ significantly among fund managers. Some regard the practice as benign, perhaps even to be encouraged; others believe that it is malign, not in the interests of investors and should be banned.

1.9 Despite the wide divergence in opinion, there was a consensus that present practice does not operate in the best interests of fund managers' clients and that transparency and accountability could and should be improved. There was less agreement on how this should be achieved. We were pointed towards market developments such as 'commission sharing arrangements' as evidence of the willingness in principle of some brokers to unbundle their presently bundled services, and of fund managers to explore the merits of separating decisions on execution from the purchase of research.

1.10 Fund managers proved generally hostile to the proposal in CP176 that they should make rebates to customers' funds, arguing that it would lead to significant unforeseen consequences. In particular, they suggested the cost impact would be great enough to constrain UK firms in their ability to compete internationally, with a possible shift of fund management business to overseas jurisdictions.

1.11 We took this as a serious point, and we appointed Deloitte & Touche LLP (Deloitte) to carry out further research into the cost impacts likely to arise from the CP176 proposals, and to assess the consequences for the competitive position of UK fund managers. Their report is published alongside this Policy Statement.

1.12 The Deloitte report indicates that the CP176 proposals would not have a significant impact on the competitiveness of the UK fund management industry as a whole. Most firms, including all those with £50bn or more under management, could be expected simply to comply with the new regime. However, based on firms' profitability levels for the year 2002/03, Deloitte forecasts that some medium-sized and smaller fund managers would probably exit from the market through sale, closure or relocation; between 2.0% and 5.5% of funds under management (as at the end of 2002) could be affected.

1.13 Deloitte also predicts that implementation of both proposals could deliver net savings to clients' funds, through reduced consumption of bundled services and lower commission costs. Deloitte estimates an annual impact on clients' funds ranging from a net loss of £26.1m to a net gain of £288.4m. These are significant sums, and if this magnitude of savings were to be achieved, there could be important benefits for UK funds and their investors.

1.14 We received a number of consultation responses from independent research firms. Their principal concern was that we should avoid action that would put them at a further competitive disadvantage to providers of bundled research (typically the large investment banks). We are sensitive to the concerns of this sector.

1.15 Also, some respondents told us that advances in technology have blurred the distinctions between research and market information services. Leading providers offer a combination of these services through a single electronic interface. They were concerned that our proposals might discriminate against these services in favour of traditional research formats, such as analysts' reports. We note this concern.

1.16 We received relatively few responses from the customers of fund managers. However, those that did reply, including the National Association of Pension Funds (NAPF) and trustees of individual schemes, showed a clear preference for introducing the rebate proposal.

Proposals

1.17 We remain clear about the outcomes to be achieved, and look for the following outcomes:

- fund managers have stronger incentives to make efficient decisions about trade execution and the purchase of ancillary services such as investment research; and
- fund managers are fully accountable to their clients for those decisions, and the consequent expenditure of their clients' funds.

1.18 To deliver these outcomes, we see three complementary changes as necessary:

- that the range of goods and services that fund managers can buy with their clients' funds through commission should be limited to execution and research;
- that fund management clients should be given, through enhanced disclosure, clear information about the respective costs of execution and research paid for on their behalf by their manager, and the overall expenditure on these services; and
- that fund managers should be encouraged to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately. We believe that the existence of such mechanisms will facilitate better decision-making.

1.19 We have been persuaded through the consultation process that there is scope for market-led solutions to contribute to delivering the outcomes we seek. The consultation response from the Investment Management Association (IMA) suggested that a new system of 'comparative disclosure' would deal adequately with the market failure, at less cost than the rebate proposal. We have decided to allow the industry an opportunity to develop this disclosure proposition further, as part of the solution.

1.20 It is important that through improved disclosure, institutional customers such as pension fund trustees get the information they need to put pressure on their managers, as appropriate, over the control of costs. We believe, however, that by itself disclosure is unlikely to be an effective solution for investors in retail funds, who may lack the knowledge to understand it and who are unlikely to be able to muster sufficient pressure to use it as a lever for change. So – as we indicated in the Policy Statement[3] on the new CIS Sourcebook, published in March 2004 – we will look carefully at the arrangements for retail fund governance to see if there are ways in which retail consumers' economic interests can be better served, and to reinforce the principle that fund managers should act in their customers' best interests.

3 Policy Statement 04/7: The CIS sourcebook – A new approach, March 2004.

1.21 For fund managers to provide effective disclosure and to make effective and efficient purchasing decisions, they will need to price the execution and research elements of bundled payments separately. We are aware that they may be dependent on brokers to provide this information and to facilitate the separate purchase of each element. There are signs that the market is beginning to move in this direction, and we think we should encourage an evolutionary approach to unbundling. But if this does not happen, further intervention may be necessary.

Next steps

1.22 We have decided to set a challenging timetable to the industry to achieve our objectives. We acknowledge that it will take time to develop, implement and assess the effectiveness of a fully-functioning disclosure regime. However, we intend to assess the industry's progress towards development of a workable and adequate regime at the end of 2004. Our action beyond that point will depend on the results of that review. If we judge that disclosure is not going to support our desired outcomes, we will reconsider regulatory intervention, including implementation of the rebate proposal in CP176.

1.23 Our proposal to limit the availability of bundling and softing arrangements to the provision of investment research will require us to define both the scope of execution costs and investment research for this purpose. We plan to discuss these issues with the industry and consumers in the coming months and to consult on the proposed rule changes required during 2004.

CONSUMERS

Managers of retail funds, such as unit trusts, OEICs, investment companies (including investment trusts), and life and pension funds, are commonly party to bundled brokerage and soft commission arrangements. So, consumers with interests in these funds, whether directly or through PEPs and ISAs, have an interest in the plans described in this Policy Statement.

2 Feedback on main issues consulted on in CP176

2.1 In CP176, we examined problems arising from the use of bundled brokerage ('bundling') and soft commission arrangements ('softing') in relation to managed investment funds. Commissions paid by fund managers to brokers, on trades executed for their clients, are a significant cost of fund management. We estimated that up to 40% of aggregate commissions may pay for additional services (such as investment research and market information technology) rather than trade execution. As with all charges, commission costs affect investment returns. But as commission is usually charged directly to clients' funds, transaction by transaction, the total cost to the fund and the value of the softed or bundled services acquired are in most cases opaque.

2.2 We identified four areas of concern over bundling and softing:

- Because the costs of these arrangements are opaque, investors lack the information to judge whether fund managers are acting in their best interests. As a result, the manager's accountability to customers, for expenditure which their fund bears directly, is deficient.
- The use of bundling and softing causes conflicts of interest for fund managers over trading decisions, and in the routing of business to brokers. For example, a manager may be motivated to trade with a particular broker in order to gain access to the broker's other services rather than to obtain best execution. This may result in excessive consumption of services such as investment research (in terms of quantity or price), over-trading, or poor execution decisions.
- Customers and competitors do not exert sufficient market power to control fund managers' behaviour in this area. Many customers will lack the bargaining power necessary to obtain information that would enable them to monitor effectively their fund manager's expenditure of their assets.
- The differing regulatory treatment of bundling and softing is inappropriate, given their similar economic effects.

2.3 We concluded from this analysis that there was evidence of a market failure. Control of conflicts of interest was deficient, and the opacity of the arrangements meant that investors had insufficient information to judge whether they were getting good value for money from expenditure on ancillary services provided with trade execution. We proposed to address these issues through additional regulatory measures, and put forward two specific proposals in CP176:

- to limit the goods and services, beyond trade execution, that could be bought with commission (or order flow) – this would prevent the softing of goods and services for which demand is reasonably predictable[1]; and
- in the case of those services that could still be softed or bundled, managers would be required to determine the cost of any non-execution services acquired with commission and to rebate an equivalent amount to customers' funds.

2.4 We requested OXERA to undertake research into the effects of soft commission and bundled brokerage on economic incentives and competition. We published their report[2] alongside the Consultation Paper, together with an outline cost benefit analysis of the specific proposals (also prepared by OXERA).

2.5 This paper provides feedback on the issues raised in responses to the Consultation Paper; sets out our conclusions; and explains what the next steps will be.

Responses to CP176: general observations

2.6 The publication of CP176 stimulated a lively debate, and we extended the original consultation period to give stakeholders more time to consider the issues and prepare responses. We received written responses from 143 organisations, firms and individuals, and acknowledge our thanks to all those who replied. These included around sixty responses from asset management firms; thirty from brokers, exchanges and other providers of securities trading services; thirteen from pension fund trustees and their advisers; and eleven from independent providers of third-party services to investment managers, notably providers of investment research and market information services. Twenty responses came from trade associations representing all of these sectors, and from consumer organisations. The remaining responses came mostly from other authorised firms and from private individuals. A list of respondents (excluding those who asked for their response to be treated as confidential) appears in Annex 1.

1 See CP176 paragraph 4.4 for a fuller explanation.

2 *An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK*, Oxford Economic Research Associates, March 2003.

2.7 Our thinking has also been informed by numerous discussions with stakeholders both during and after the formal period for consultation. In June 2003 we organised a well-attended and successful seminar at which representatives of the fund management, broking, investment research and pension fund sectors were able to present and debate their views. We have discussed the issues raised by CP176 with trade associations and many individual firms, in bilateral and 'round table' meetings.

2.8 The responses, both formal and informal, revealed a wide range of opinions on most of the issues raised in CP176. These frequently reflected specific sectoral or commercial interests, although many respondents also provided detailed and thoughtful analyses of the broader issues and we are grateful for this. The IMA commissioned research from Charles River Associates (CRA)[3] to appraise the potential impact of our proposals on fund managers.

2.9 The publication of CP176 took place at a time when both fund managers and brokers were searching for answers to issues arising from recent stockmarket weakness. Brokers were re-examining the economics of their equity trading operations and their relationships with their institutional clients. Fund managers were looking for ways to cut the costs of trading without compromising the quality of trade execution. Developments in the US – both the 'global settlement' in relation to investment research, and the more recent investigations into abuses in the mutual fund industry – have focused attention more broadly on the risks to investors arising from poor management of conflicts of interest.

2.10 Against this background, the debate around CP176 has given greater prominence to market developments whilst also acting to some degree as a spur to firms to re-examine current business models. Some firms have also begun to plan, or indeed initiate, changes in order to adapt to an environment in which conflicts of interest will come under much greater scrutiny. We have taken account of these market developments as well as the consultation responses, in our consideration of the issues raised by CP176 and the policy options for addressing them.

Key issues arising from the consultation

2.11 In Annex 2 of this paper, we provide a detailed account of the feedback received in response to each question asked in CP176. In the following sections, we present the feedback more thematically, focusing on the key issues that respondents raised, our analysis of those issues, and our conclusions.

3 *An assessment of the proposed changes to regulation of bundled brokerage and soft commission arrangements*, Charles River Associates Limited, October 2003.

Bundling and softing: regulatory issues and problems

2.12 In CP176 we sought views on our analysis of the benefits and drawbacks of bundling and softing as market practices. Respondents expressed a wide spread of views, which can be categorised under four broad headings, as follows.

A. Those in favour of action against both bundling and softing

2.13 Such respondents (mainly pension fund trustees) endorsed the concerns expressed in CP176. They agreed that both practices hinder competition; give rise to conflicts of interest; introduce opacity to fund management and broking operations; compromise the manager's ability to achieve best execution; and cause commission levels to be unnecessarily high. Some argued that there was no place at all for these practices and an outright ban would be an appropriate regulatory response.

2.14 Over a third of all respondents, representing a cross-section of pension fund trustees and consultants, asset managers, and execution service providers, expressed support for action to limit the goods and services that may be bundled or softed.

2.15 The arguments were that such a step would:

- improve transparency and accountability, because current disclosure requirements do not go far enough in revealing costs to customers;
- impose stronger cost disciplines on fund managers, who would seek to maximise the value of services that could no longer be softed; and
- remove incentives on fund managers to favour certain brokers purely in order to fulfil softing commitments.

2.16 There was however some concern about the definition of terms used in CP176, such as excluding the softing of services with 'predictable costs'. Respondents also questioned whether it was possible to draw a distinction between execution services, investment research and market information, including where provision of such information is associated with a wider set of services.

2.17 Other respondents pointed out that a number of fund managers have already stopped softing (at least for their institutional clients), and many pension fund trustees no longer permit it in their mandates. These trends are taken by respondents to mean that soft commission is disappearing of its own accord, lessening the need for regulatory action.

B. Those in favour of maintaining the current regulatory approach for both practices

2.18 Among these were the majority of asset managers, and a number of brokers providing integrated services. The main argument here was that all

commission costs are borne by the fund and thus have a direct impact on its investment performance. Because this is the key measure by which a manager is judged, it is strongly in his interests to manage costs carefully to avoid under-performance against the fund's benchmark. So, the manager is strongly motivated to use bundled and softed goods and services only where he genuinely believes they add value for the client.

2.19 Bundling and softing were also defended on the grounds that they promote competition by enabling managers to keep fund management fees low, and that managers – in particular, smaller fund managers – gain access to a wide range of goods and services from which they (and their clients) might not otherwise benefit.

C. Those supporting the continuation of bundling, but not of soft commission

2.20 These were mostly asset managers and brokers. The main argument was that softing involves an explicit prior commitment to direct a certain amount of execution business to a particular broker. It therefore has an undue influence on the fund manager's decisions about where to place orders, and it incentivises over-trading in order to generate sufficient soft credits. Bundled broker services, by contrast, involve no prior commitment to trade with a broker, so it is claimed there are no incentive misalignments.

2.21 Defenders of bundling also argued that research is a component of trade execution and ought legitimately to be paid for in the same way. Brokers provide a range of services, any one of which may be put to use in a particular trading situation, so in an ongoing client relationship it is logical to charge a single price for the whole. A further argument is that bundling allows clients to benefit from brokers' economies of scale by paying a lower overall price for an integrated range of services than they would if each service were priced and paid for separately.

D. Those supporting the continuation of soft commission, but not of bundling

2.22 A number of arguments were advanced here. First, softing is said to be more transparent than bundling, because softed goods and services have an explicit price set by third-party suppliers, and current rules require disclosure of softing arrangements to clients. Second, it provides a means of paying for market information services and independently-produced investment research other than with hard cash. This is beneficial both to firms providing those services and to brokers providing trade execution. Softing allows both parties to combine their services and distribute them in a way that imitates the integrated broking service offered by investment banks, thus facilitating competition between large and small firms.

2.23 Respondents also claimed that softing encourages innovation, and assists the start-up of new fund management operations by allowing them to subsidise certain costs that would otherwise have to be met as business overheads, or passed on to customers through higher than average management fees.

The order of magnitude of bundling and softing

2.24 Many respondents questioned the significance of bundling and softing, and specifically the estimates of market size produced by OXERA[4]. They said the findings demonstrate that softing represents only a small segment of overall commission – around 1 basis point (bp) out of an average commission rate of 14bp – and that this indicates the effectiveness of current regulations.

2.25 There are, in fact, no figures readily available to show conclusively how much commission is paid by client funds managed by UK fund managers, nor how much of that commission was spent on goods and services other than execution. However, work commissioned from Deloitte & Touche LLP (Deloitte) explored this issue further, and their findings confirm the order of magnitude of bundling and softing. OXERA also concluded that around 3 basis points of the average UK equity commission rate are attributable to bundled goods and services.

2.26 Deloitte estimates the size of the market for goods and services acquired with soft commission in 2002/03 to be in the range of £105m to £125m, compared with OXERA's £160 million in 2000. For bundled services, Deloitte estimates the size of the market at between £653m and £780m in 2002/03, compared with OXERA's estimate of between £500m and £720m in 2000. This puts the combined total for bundled and softed services at between £758m and £905m – within OXERA's estimated range of £660m to £980m. It confirms OXERA's finding that bundled services represent a much larger share of the market than services acquired with soft commission – OXERA estimated some three times as much in value, Deloitte estimates a factor of six times as much.

2.27 We conclude that the size of the market is significant, in that a significant amount of commission payments made from clients' funds return opaquely to the manager in the form of bundled and softed goods and services. The magnitude of these figures supports our view that fund managers may be unduly influenced by the availability of bundled and softed goods and services, to the detriment of best execution.

4 OXERA's analysis indicated that commission rates have fallen steadily over several years. They estimated that in 2000 soft commissions represented 6.8% of all commission on UK equity business (in other words, 1 basis point (0.01%) of the average 14bp commission rate is attributable to softing).

Conclusions on the market failure analysis

Transparency and accountability

2.28 We believe there is a general consensus that transparency and accountability for the expenditure by fund managers of their clients' commissions could and should be improved. We acknowledge that a degree of disclosure already applies to softed services, but we do not accept the argument, made by some advocates of soft commission, that softing is already "fully transparent". There may be a degree of transparency between brokers and fund managers, but evidence suggests it does not feed through in a meaningful way to fund management clients. In any event, it is not true of bundled services.

2.29 A number of fund managers have asserted that the opacity of bundling and softing need not be a cause of detriment to customers, because competition in respect of investment performance focuses the manager's mind on control of costs. But the CP176 proposals were based on the principle that customers have a right to know what charges are levied on their fund by the manager. During the consultation, some pension fund trustees told us they were unaware that fund managers were receiving benefits in exchange for commission payments. Additional scrutiny by customers may result in actions that lead to enhanced investment performance.

2.30 We note that fund managers seek, where necessary, to give effect to customers' wishes not to be included in soft commission arrangements. In such cases, those customers are not given prior or periodic disclosure[5] in respect of the arrangements. We believe however that a customer's refusal to participate in softing arrangements may be illusory in many cases where the firm engages in softing for other customers. Fund managers typically agree terms with executing brokers on a 'house' basis and customer orders are frequently aggregated. If the manager engages in softing for any clients, it seems reasonable to conclude that all are in effect included in the arrangement. In addition, goods and services received in exchange for soft commission are, in general, used for the benefit of clients as a whole, rather than being restricted to the 'softing' clients.

2.31 Many respondents argued that enhanced transparency could deliver a number of benefits for fund managers and their clients, which would address the market failure identified in CP176. These included:

- better management of costs;
- more effective customer scrutiny of fund management activity;
- an uncompromised focus on best execution;

5 COB 2.2.16R – 2.2.19R.

- stronger competition for non-execution services;
- a reduction in the production of unwanted research; and
- in the longer term, better value for money for customers.

We agree that these are all very desirable benefits and accept that enhanced transparency has the potential to deliver them. We return to the ways in which enhanced transparency could be brought about in paragraph 2.77 below.

Impact on consumption of bundled and softed goods and services

2.32 We noted in CP176 that the fund manager's incentive to obtain best value for money is weakened when goods and services are paid for through commission. The result may be that the manager buys more goods and services than he needs, or pays an excessive price for them. We believe that this analysis remains sound. There is also a growing body of opinion (including, more recently, among some US fund managers) that the costs of third-party services should be treated as a normal fund management overhead and not funded through commissions. We agree, in relation to goods and services other than investment research.

2.33 For research, the analysis is more complicated. Some people told us that there is probably excessive coverage in some market sectors (although it is difficult to determine what the 'right' amount is). There is currently very little hard information available on price, so it is difficult to make conclusive statements about whether prices paid are excessive. But, by the same token, this makes it difficult for fund managers to analyse what they are paying for with commission (for example, many assume bundled research is a 'free good') or to judge whether it represents value for money.

2.34 Deloitte's findings broadly support the notion that, given greater choice over the way that research is provided, some cost savings in the provision of research may result. Their report indicates that, if the rebate proposal were implemented, fund managers would expect to pay on average around 8% less for research received. When lower demand is also factored in, the value of research services received would fall by between 9% and 15%.

Impact on trading volumes

2.35 Most respondents disagreed that bundling and softing cause over-trading. But we agree with those who say that it can – for example, under soft commission arrangements tying managers to direct particular volumes of business to a broker. Such commitments make it more difficult for the manager to fulfil best execution obligations and may induce him to carry out transactions that add no value to the fund. However, it is almost impossible to provide any meaningful quantitative measure, because of the significant discretion enjoyed by a fund manager in deciding whether or not to trade. This makes it difficult to judge what the appropriate amount of trading might be.

Impact on trade execution decisions

2.36 We conclude that fund managers' trading decisions are influenced to some degree by the desire to obtain bundled and softed services, including research. There is little argument that commission payments are used to compensate brokers both for their research and their execution services. For example, the larger fund managers have sophisticated broker evaluation systems that focus as much on the broker's research output as on execution performance, and brokers set much store by these assessments. It is more difficult to assess the extent to which this results in poorer execution decisions than would otherwise be the case.

2.37 Some respondents argued that fund managers do not necessarily make full use of the variety of trading methods and execution venues available, which their clients might expect of a firm that was appropriately focused on delivering best execution, rather than the acquisition of other goods and services. And some fund managers (and brokers) accept that separating decisions about purchase of execution services from purchase of research (for example, through commission-sharing arrangements) is a positive move (see paragraphs 2.84 to 2.90 below). At the same time, some brokers are developing new trading options for some managers which provide a wider variety of execution methods and tariffs, as opposed to the traditional bundled offering. We conclude that measures to separate decisions about purchase of execution services from purchase of investment research are likely to have a positive effect on the quality of decision-making in both areas.

Conclusion

2.38 We continue to believe that our concerns about both soft commission and bundled brokerage are valid. There is broad consensus on some parts of our analysis – notably the case for greater transparency – though less so on over-consumption, over-trading or mis-directed execution. It is important to note that 'hard' data, demonstrating conclusively the existence or absence of these effects, or their significance, is difficult to come by.

2.39 We note the CRA research commissioned by the IMA recognises that incentive misalignments, imperfect information and investor detriment are likely to occur as a direct result of bundling and softing arrangements. In particular, CRA concur with OXERA's findings about weak incentives on fund managers to monitor the level of research. They note that softing gives rise to potential incentive problems, and bundling could discourage fund managers from exercising sufficient scrutiny over the costs of research.

2.40 In the next section, we consider the main objections raised to the appropriateness of the policy proposals in CP176 for addressing these issues.

Assessment of the policy proposals in CP176

2.41 Most respondents opposed, or expressed reservations about, our policy proposals, in particular the rebate proposal. The main objection was that our proposals did not take fully into account the broader structural impacts of change and could have unintended adverse consequences for UK fund management and equity trading. The costs of intervening in the market would therefore be disproportionate to the benefits to be gained.

2.42 Key concerns of many respondents were that our proposals would adversely affect:

- competition between firms in the UK market;
- the ability of UK fund managers to compete internationally;
- the supply of, and demand for, investment research;
- equity trading, leading to a shift to less transparent methods of trading; and
- the tax treatment of bundled goods and services.

We discuss each of these aspects in paragraphs 2.43 to 2.71 below.

Competitiveness of UK firms

2.43 Concerns about the impact on the competitiveness of UK firms have two dimensions: competition between firms within the UK market, and the ability of UK firms to compete internationally.

2.44 On the domestic front, the main argument was that all fund managers would incur higher costs if the CP176 proposals were implemented, but that smaller firms would be disproportionately affected, because they would be less able to absorb the costs or else less successful at passing them on to clients. In consequence, they would be forced out of the market, thus reducing choice for consumers.

2.45 On the international front, the argument was that our proposals would:

- make it more difficult for UK fund managers to win and retain foreign mandates;
- allow firms with international capability to conduct regulatory arbitrage, giving them an unfair advantage over UK-only firms;
- deter fund management start-ups in the UK (especially hedge fund managers); and
- incentivise some firms to relocate part or all of their UK operations to other jurisdictions.

2.46 These possible effects were of concern to us. We commissioned Deloitte to examine the claim that the CP176 proposals would result in UK fund managers incurring significant additional costs that would constrain their ability to compete with non-UK fund managers. Their findings are published alongside this Policy Statement.

2.47 Deloitte evaluated potential changes to commission levels and patterns of demand for non-execution services, and fund managers' ability to recover incremental costs from customers. From this, they were able to quantify the potential cost impacts of the CP176 proposals on UK fund managers both as a whole, and by market segments. By analysing the range of possible strategies that managers might adopt in response to these costs, and assessing the likelihood of these happening, Deloitte were able to gauge the significance of the impact of the proposals on the competitiveness of UK fund managers.

2.48 Overall, the Deloitte report indicates that the CP176 proposals would not have a significant impact on the competitiveness of the UK fund management industry as a whole. This is because on average, costs would not rise as significantly as was suggested, and the ability of fund managers to pass costs through to clients would be greater than was suggested. After an exhaustive study, Deloitte concludes that between 2.0% and 5.5% of funds under management (£53bn to £142bn at the end of 2002) would probably be affected through the exit strategies of relocation, transfer by sale of the funds to firms regulated outside the UK, or closure of the funds or firms concerned. This represents between 0.035% and 0.09% of UK GVA[6] for 2002/03.

2.49 Deloitte concludes that of the funds affected by the exit strategies described above, between £24bn and £80bn is currently managed by medium-sized firms (those with funds under management of between £5bn and £50bn) and between £28bn and £62bn by small firms (those managing less than £5bn of funds). Deloitte estimates that no firms with more than £50bn of funds under management would exit from the market. Of the funds managed by small firms that might exit from the market, it is notable that Deloitte identifies the greater part (between £19bn and £40bn of funds managed) as relating to firms that reported below-average financial performance in 2002/03.

2.50 Deloitte estimates that there is considerably more scope for fund managers to raise their management fees than industry respondents have suggested, because some fall in commission levels should occur, so avoiding any significant negative impact on customers' funds. The net impact on fund managers' margins is likely to be far less dramatic than predicted by some respondents.

6 Gross Value Added (to the economy). Deloitte suggests that, as industry-level economic activity is not normally expressed in terms of Gross Domestic Product (GDP), the ratio of industry GVA lost to whole-economy GVA is more meaningful than comparing industry GVA lost with whole-economy GDP.

2.51 Deloitte has prepared a forecast of the hypothetical impact if the CP176 proposals had been implemented in 2002/03, a very difficult year for firms. After factoring in the extent of likely cost recovery, changes to the size of the market in bundled and softed services, and changes in purchasing patterns, Deloitte forecasts that each of the three size segments of fund management firms would still have reported positive margins on average. This forecast suggests that firms have some scope to absorb the impacts of the proposals, countering claims that they would put many firms out of business or prompt a mass exodus from the UK.

2.52 Deloitte predicts a remarkably high proportion of firms would be able to adopt the 'default' strategy of simply complying with the proposals, and not making radical changes in their business model. This suggests those firms are confident of their ability to do so. Deloitte forecasts low levels of exit from the market for most of the industry segments examined. It predicts, for example, that no large firms with over £50bn of funds under management (UK or non-UK) would relocate, sell, exit or close as a result of the proposals being implemented. This is also generally the case among medium-sized, UK-focused managers, and the financially better-performing managers in the smaller sector.

2.53 In addition, net savings to clients' funds resulting from a change in the structure of the market may have a significant bearing on competitiveness. These savings would come from two sources – a reduction in consumption of bundled services, and a fall in commission costs exceeding the amount recovered by managers (for example through increased fees). Deloitte estimates an annual impact on clients' funds ranging from a net loss of £26.1m to a net gain of £288.4m, mostly from the implementation of the rebate proposal.

2.54 Relative to the overall size of the market for bundled and softed services cited in paragraph 2.26, these are significant sums. If this magnitude of savings were to be achieved, there could be important benefits for the UK industry. Firms that complied simply by implementing the rebate proposal would pass on the benefits to their customers, making them more attractive and strengthening their market position. Customers of firms exiting the market might be disadvantaged, and might choose to re-invest through UK regulated fund managers. Moreover, there is the prospect of a net inflow of funds from overseas customers attracted by the competitive, transparent pricing in the UK market.

Investment research

2.55 The second structural issue concerns the impact of the CP176 proposals on the investment research market. The basic argument is that the proposals would compel fund managers to bear costs which they could not recover. They would therefore spend less on research. This would lead to less research

coverage by brokers, resulting in less efficient trading with a consequent drag on funds' investment performance.

2.56 Many respondents argued that there would be a disproportionate impact on the mid-cap[7] and smaller company market. This was based on the assumption that the most likely reaction of brokers to a fall in revenues would be to cut back their coverage of these companies and sectors and to concentrate on leading stocks (e.g. in the FT-SE 100). This, in turn, would lead to less trading in the shares of smaller companies, damaging price formation and the ability of some corporates to raise capital through the equity markets.

2.57 We do not find these arguments convincing. First, we do not think that fund managers, if faced with an increase in costs, would be unable to recover any of the increase from clients. It is well understood by institutional clients that active fund management requires a flow of investment ideas and the manager needs to draw on research from many different sources to inform his decision making. Clients seeking the levels of performance that active management promises should, and do, expect to pay for it accordingly.

2.58 This is borne out by the findings of the Deloitte research. Though highlighting the difficulties in predicting the future for the research market, Deloitte concurs on balance with aggregate estimates provided to them by fund managers, that expenditure on research services would fall by around 9% to 15%. They find no evidence to predict a fall in quality. However, the average fall in expenditure may hide increases in costs for certain fund managers and decreases for others. Those who may need to pay more for research include medium-sized and large managers that make the greatest use of analysts from multiple brokers, and small managers that rely on idea generation from prime brokers.

2.59 Second, the assertion that it would be undesirable for fund managers to spend less on research assumes that the present level of consumption is optimal. Given the widespread view that there is superfluous or poor-quality research output in the market, we do not think that assumption is persuasive. So while brokers might cut back on their research coverage, the precise impact of that move is harder to assess. It is possible that coverage of smaller companies would be more severely affected than other sectors. But responses suggest that this is unlikely to be the reaction of all brokers.

2.60 Given the active fund manager's continual search for stocks with real long-term growth potential, we believe there will always be a demand from the buy-side for coverage of small-cap and mid-cap stocks. Even if some large brokers were to retrench their coverage in some areas, we are sceptical that

7 That is, companies with a medium market capitalisation.

this would materially affect liquidity in small-cap securities or reduce small companies' access to capital.

2.61 However, we accept that implementation of the CP176 proposals could have a significant impact on independent research providers, especially in the short term. For most independent providers, commission flows are their main source of revenue. There are reckoned to be about 120 independent research providers in the UK. Most concentrate on niche industries and small-cap or mid-cap companies, particularly in specialist sectors such as technology or pharmaceuticals. Preventing fund managers from paying for research with commission (soft or otherwise) would almost certainly put them at a competitive disadvantage compared with the larger brokers, and would be likely to put most independent providers out of business.

2.62 We are not persuaded by arguments that the impact of the CP176 proposals on investment research would be wholly negative. For the main market sectors, we believe the natural market forces of supply and demand would ensure that sufficient research coverage is maintained, and that more transparent pricing would, in time, produce a better-functioning market. We accept, however, that in the short to medium term there would be a period of adjustment. Fund managers wishing to pass on the costs of research to their clients would need time to obtain consent and implement the changes, during which they might well reduce their expenditure. There would also be a period of considerable uncertainty as brokers and managers alike tried to establish market prices for various types of research coverage.

2.63 We said in CP176 that investment banks and independent research providers currently operate on an unlevel playing field, created in part by the differential regulatory treatment of bundling and softing. We accept that implementing both the CP176 proposals could also have an adverse impact on the independent research sector.

Equity trading

2.64 The third area of potential structural impacts is equity trading. A widely-held view is that the CP176 proposals would lead to an increase in 'net trading' or 'net pricing' in equities, furthering an existing trend in the market. Many respondents saw this as an undesirable outcome. Where the commission element – including the cost of bundled or softed goods and services – becomes fully subsumed within the price spread, opacity is increased, making it harder for clients to scrutinise those costs. Clients may then lose out on any cost efficiencies. Execution, it is argued, would become increasingly concentrated in the hands of the larger integrated brokers; competition would become weaker; and there would be a reduction in capital provision, lowering market efficiency.

2.65 A further alleged impact of the CP176 proposals is that dealing spreads would widen – either as a direct response by brokers, to maintain their margins in the face of increased administration costs; or indirectly, to accommodate increased risk from weakening confidence in stock pricing as a result of reduced research coverage.

2.66 We do not find these arguments persuasive. They are based on assumptions about strategies that brokers and fund managers might adopt to avoid compliance with the CP176 proposals. The underlying assumption is that the cost impact of the proposals would be significant enough to prompt firms to react in this way. The Deloitte research suggests that this is unlikely to be the case. It also notes that fund managers and brokers each have an interest in maintaining the transparency of the market, and concludes that fund managers in particular would resist such a move.

2.67 In addition, other economic controls, such as competition from alternative execution venues or trading platforms, may currently act as constraints on spreads in equity markets. There is no obvious reason why they should not continue to do so.

2.68 Given a combination of competition in the market, fund manager resistance and the greater potential for brokers to respond in other ways, we do not believe our policy proposals would result in an increase in net trading. We acknowledge that regulatory changes can have different short-term and long-term impacts on market practice. But we do not accept that changes aimed at increasing transparency and accountability would necessarily result in more opaque or less efficient markets. As with investment research, we believe that competition in the market for trade execution services is likely to counter such pressures.

Taxation issues

2.69 The principal concern here is that the CP176 proposals would effectively separate the supply by brokers of execution services from the supply of research and other services; and that this would crystallise a liability for VAT on the latter that does not currently exist. Generally, the supply of execution services for buying and selling securities is exempt from VAT, while the supply of advice and other forms of intermediation is not. In practice, VAT is not levied on brokers' bundled commissions, even though they may represent payment for the supply of other services in addition to execution.

2.70 We accept that implementation of the CP176 proposals could affect the tax treatment of non-execution services. The precise impact is difficult to assess. We understand that this could vary, depending on the precise arrangements for the supply of non-execution services, the geographical locations of the service provider and recipient, and the liability to tax of the particular fund

management service and the underlying fund. Deloitte provides a more detailed explanation of these points in its report.

2.71 We will consider further the VAT implications of our policy conclusions. We have met representatives of HM Customs and Excise to explain our thinking, and we will continue to discuss with them the impact of policy changes on their approach to revenue collection. However, we do not believe tax considerations are fundamental to our market failure analysis.

Other concerns about the rebate proposal

2.72 In addition to the points discussed above, many respondents were concerned that rebating would prove costly and complex, and doubted whether it could in fact be implemented or operated successfully. Some argued that fund managers would still face a conflict of interest over the calculation of the rebate, and might be tempted to abuse the lack of an established pricing structure for individual broker services by minimising the amount rebated. Some fund managers in turn cited the risk that brokers would be unable or unwilling to cost their services, so that the manager might inadvertently apply inaccurate or subjective rebates to funds.

2.73 A further argument was that the widely differing mandates of fund management clients might make rebating impractical or inequitable. For instance, it was argued that it would be unfair in principle for a client in a UK-only fund to bear the cost of research on non-UK securities, which would rule out aggregating all research costs and then charging them pro rata across all clients. On the other hand, to calculate the rebates individually across a large client base could be hugely complicated and time-consuming. The process could be complicated further if some clients agreed to pay an explicit fee for research while others did not.

2.74 One respondent thought that rebating could work if implemented across all major markets, but that there was little or no hope of harmonising tax and legal issues to make this a realistic possibility. Others were concerned that CP176 gave little or no indication of the likely scope of the rules, and that they might no longer be able to supply services to overseas clients through bundled or softed arrangements, even where this was still legitimate in the client's home jurisdiction.

2.75 We acknowledge that implementing the rebate proposal would involve detailed consideration of scope, application and method, as these comments indicate, and that CP176 did not explore these issues. However, they do not in our view present a convincing case that rebating would ultimately be impracticable.

Alternative approaches proposed by respondents

2.76 Many respondents to CP176, though critical of the proposals for regulatory change, offered constructive alternative suggestions for improving transparency and ensuring that commission was well spent. The most important of these are discussed below.

Enhanced disclosure

2.77 Enhanced disclosure by fund managers to their clients received widespread support, especially among fund managers, as a more proportionate approach to tackling the market failures described in CP176. This would put the onus on firms and their senior managers to provide adequate information to clients, but would at the same time uphold the principle that customers should take appropriate responsibility for their decisions.

2.78 Of the ideas for enhancing disclosure, the most constructive was the 'comparative disclosure' proposal put forward by the IMA, and drawn from the CRA research. It would be an extension of the existing joint IMA / NAPF Disclosure Code for pension fund trustees which came into full effect in July 2003.

2.79 The Disclosure Code currently requires fund managers to provide trustees with fund-specific information on certain aspects of commission costs. Specifically, they must issue half-yearly statements showing the percentage amount and the value of:

- trades executed net of commission;
- trades executed with commission;
- trades subject to soft commission arrangements; and
- trades subject to commission recapture or directed commission arrangements.

2.80 As proposed, comparative disclosure would provide information to trustees, on a fund by fund basis, on the proportions of commission spent on execution and research. This would cover all commission-bearing trades, and so would apply equally to bundled and softed services. It would also provide trustees (and their advisers) with a figure for the average commission rate across all portfolios managed by that manager. This would give them a benchmark against which to measure their own fund's commission level and obtain an explanation for any significant deviation from the average.

2.81 Whilst such disclosure is neither without its problems nor cost-free, we see this as a positive development. We believe that it can be developed so as to form part of a regulatory and market-driven solution to the problems

discussed in CP176. We say more about the role of disclosure, and the factors that bear on its success, in Chapter 3.

Enhanced retail fund governance

2.82 Many respondents agreed that increased disclosure would be unlikely to empower retail fund investors, because of their relative lack of knowledge and bargaining power. Retail investors may need a champion to interpret data provided under any regime that relies on disclosure, and to engage with the fund manager in challenging costs. The IMA suggested that for authorised unit trusts and OEICs, there may be scope to enhance the role of the trustee and depositary in exercising oversight of the fund manager's control of dealing and commission costs.

2.83 We agree that this proposal merits further consideration, and describe in Chapter 3 how we plan to take this forward.

Commission-sharing arrangements

2.84 We have also been asked to consider the merits of commission-sharing arrangements (CSAs), colloquially known in the UK as 'step-outs', as a means of introducing greater transparency to the use of commission to purchase investment research. In a CSA, the executing broker agrees that part of the dealing commission it earns will be redirected to one or more third parties, nominated by the fund manager, as payment for non-execution services, primarily research, that they have provided to the manager. Several investment banks, and some of the larger fund managers, have already set up CSAs or are planning to do so.

2.85 Advocates of CSAs claim that they go some way to meeting our objectives. First, they would help fund managers to separate decisions about purchase of research from decisions on purchase of execution services. In this way, they provide a degree of unbundling, so increasing transparency in the fund manager – broker relationship. The fund manager can continue to buy research from providers across the market, but can limit the number of counterparties he deals with, keeping only those who provide superior execution. This, it is claimed, will enable the manager to exercise better control over the purchase of trade execution services, and will reduce the risk that the fund manager's choice of broker may be unduly influenced by access to non-execution services.

2.86 Second, it is claimed that using a CSA would make it easier for fund managers to determine and control their expenditure on non-execution services. Because the CSA does not place any obligation on the fund manager to direct a certain volume of business to the broker, it is said to provide a similar degree of transparency to a soft commission arrangement (as compared with a bundled

full-service broker arrangement) but without the obligation on the manager's part to execute deals to any specified extent.

2.87 We see some merit in these arguments. However, CSAs have potential disadvantages. We understand that participating brokers would expect to secure an increase in order flow, to compensate for the reduction in the amount of commission retained. And only the broker's largest and most active clients are likely to deliver a substantial increase in trade volume. Furthermore, a widespread use of CSAs could result in order flow being concentrated in the hands of a small group of large brokers, which could have implications for market efficiency. Larger brokers might also restrict CSAs to their most profitable clients. In these circumstances, the execution services of smaller brokers could become uncompetitive, while smaller fund managers could struggle to deal on competitive terms through large brokers.

2.88 Another possible weakness is that the position of the executing broker's proprietary research is largely unaffected. The CSA does not make the consumption of such research by the fund manager any more transparent. The arrangement might result in only a small proportion of total commission being paid away to third parties, which means that CSAs alone would be unlikely to level up the playing field between proprietary and independently-produced research.

2.89 Also, some people have criticised CSAs as being soft commission agreements under another name. Their concern is that the fund manager will continue to treat commission as a 'pot' of money to be allocated amongst brokers according to the manager's perception of the broker's quality of service. CSAs enable a manager to divide up the 'pot' in a different way but do not put pressure on him to consider whether the total expenditure represents value for money.

2.90 We think these criticisms are significant enough to conclude that CSAs can only be a partial solution to the market failure we described in CP176. However, we acknowledge that they are an established feature of the market, albeit on a small scale in the UK. We do not propose to prohibit them, so long as they are subject to an appropriate degree of transparency. In Chapter 3 we say more about how CSAs might form part of a market-led solution.

General conclusions on policy options

2.91 Having taken into account all the consultation responses, the discussions with interested parties, and current market developments, we set out in this section our general conclusions on the issues raised in CP176.

2.92 We continue to believe that the CP176 proposals would address the market failure identified in the paper. We acknowledge, however, that they could (as indicated by the Deloitte research) have a disproportionately severe impact on

the smaller sectors of the fund management market, particularly the less profitable small firms. They could also have a severe impact on the independent research market, particularly in the short term.

2.93 It is nevertheless clear that many industry participants see soft commission as being of limited importance to their business; do not regard traditional business models as sacrosanct; and see merit in separating decisions on trade execution from decisions on acquisition of investment research. Importantly, we believe that regulation should not discriminate between the means by which research is obtained – whether through soft commission or bundled brokerage arrangements.

2.94 We are reluctant at this stage to ignore the shift in opinions in the market (partly in response to market conditions, partly precipitated by the debate around CP176 itself) and to impose regulatory changes that could stifle current market developments. We are therefore persuaded not to proceed with implementing the rebate proposal at this time. We will wait for other options to be explored and tested before making a final decision.

2.95 In the following chapter, we explain what options for change we intend to pursue.

3 Policy proposals and next steps

Future policy direction and outcomes

3.1 We concluded in Chapter 2 that there was a degree of consensus on our basic analysis of the problems arising from bundling and softing. There was less agreement on the appropriateness of the particular policy proposals in CP176 for addressing those problems. In this chapter we explain what regulatory outcomes we believe we should pursue, and the mix of regulatory and market-driven measures we will explore to deliver them.

3.2 We remain clear about the outcomes we wish to see. They are that fund managers:

- have stronger incentives to make efficient decisions about trade execution and the purchase of ancillary services such as investment research; and
- are fully accountable to their clients for those decisions, and the consequent expenditure of their clients' funds.

3.3 To deliver these outcomes, we see three complementary changes as necessary:

- that the range of goods and services that fund managers can buy with their clients' funds through commission should be limited to execution and research;
- that fund management clients should be given, through enhanced disclosure, clear information about the respective costs of execution and research paid for on their behalf by their manager, and the overall expenditure on these services; and
- that fund managers should be encouraged to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately. We believe that the existence of such mechanisms will facilitate better decision-making.

3.4 Delivery of these options will require some changes to current FSA rules and guidance in due course. However, we have been persuaded through the consultation process that there is also potential for market-led solutions to contribute to delivering the outcomes we seek. We explain below how we think this work should be taken forward.

Limiting the use of commission

3.5 We have concluded that we should limit the use of commission[1] to the purchase of trade execution and investment research. We think this should apply to research sourced both from broker-dealers and from independent providers. This reflects the importance of investment research to fund managers and the desirability of ensuring that suppliers of research can compete on level terms.

3.6 The key issue is how 'execution' and 'research' are to be defined for this purpose, with a particular focus on the borderline between research and other non-execution services. In CP176, we based our proposals on the existing rules and guidance in the Conduct of Business Sourcebook[2], which distinguishes between 'research, analysis and advisory services' and other types of service such as 'market price services', 'electronic trade confirmation systems' and 'electronic dealing or quotation systems'.

3.7 A number of representations have been made to us that there is no longer a clear distinction between these types of service in the market. Advances in technology and the rapid expansion of electronic delivery of information mean that a single service provider may offer written research and detailed statistical analysis of the market, together with a dealing and confirmation system, through a single interface. Defining which elements can legitimately be labelled 'research' may not be straightforward.

3.8 There are, however, arguments for making the category of 'research' narrower rather than broader. For example, where goods and services have a price in the open market, or where the demand for goods and services is predictable, the argument that they should be acquired with dealing commission is less convincing. Before bringing specific proposals forward for consultation, we intend to discuss the definitions of research and execution further with the industry in the coming months.

3.9 Services that constitute neither execution nor research would, in future, have to be treated like any other fund management overhead, and be paid for in hard cash. We expect this approach to have a substantial impact on soft

1 In this context, 'commission' includes all arrangements in which goods and services are supplied to a fund manager in consideration of a volume of order flow. This would include deals traded 'net' (at no commission).

2 COB 2.2.12R – 2.2.14G.

commission in its current form. It will reduce the scope for funding more quantifiable management overheads through commissions, particularly where those services can be readily bought for cash at prices set by market forces. This will directly address concerns about poor cost control, and the potential for over-consumption, of those services.

Providing better information to customers and encouraging unbundling

3.10 We concluded in Chapter 2 that there was a general consensus that increased transparency about the costs of execution and research was desirable and that it could bring about a better alignment of the interests of fund managers and their customers. So where commission continues to be used to purchase execution and research – however those terms may be defined – we see a role for enhanced disclosure to fund management clients to deliver greater accountability. We have been told that this is an area in which industry-led solutions may be better placed to deliver results than prescriptive rule-making.

3.11 As discussed in Chapter 2, the IMA's 'comparative disclosure' initiative suggests that the existing IMA / NAPF Disclosure Code could be expanded to show, on a fund by fund basis, the breakdown of payments between the costs of execution and the costs of research. We see this as a positive step, because it would effectively require the same apportionment of costs between execution and research as the rebate proposal, though the cost of research could still be passed through directly to the funds. Most importantly, this would apply whether the research was purchased from brokers or independent houses.

3.12 A key element of a successful disclosure regime is how payments will be broken down between execution and research. Although it will be for fund managers to provide this breakdown to their clients, they will be reliant on brokers, in their turn, to support them by providing meaningful information. We believe that clear payment and pricing mechanisms, enabling individual services to be purchased separately, will facilitate this.

3.13 There are signs that the market is beginning to move towards separating the costs of execution and research, and facilitating the separate purchase of each. We know from the consultation responses that a proportion of industry participants support this in principle. We believe that some brokers are willing to adapt their business models to accommodate clients who have asked for it. A wider use of CSAs ('step-outs') may provide one basis for this, because they allow a certain degree of separate purchase of research and execution services. Also, the use of CSAs requires the fund manager to ascribe a value to third-party research, which may include the proprietary research of other brokers. This could in time help fund managers to put a value on the executing

broker's proprietary research, where currently this is included in a bundled payment.

3.14 We welcome the IMA's initiative in making the comparative disclosure proposal. We see it as a potentially effective way forward, provided there is a genuine commitment by all relevant industry sectors to developing meaningful disclosures. We set out below what we see as the essential criteria for the development of a meaningful enhanced disclosure regime to deliver the outcomes discussed above.

Success criteria

3.15 The information to be made available to clients needs to satisfy two key criteria. First, it must serve to improve the quality of the dialogue between client and fund manager about how to manage the costs that the client bears directly. Second, it must be sensitive to the fact that fund management clients vary greatly both in their level of sophistication and the degree of responsibility they have. So, disclosure must take account of clients':

- incentives – their appetite to obtain and review information;
- degree of understanding – using appropriate benchmarks and comparators;
- capability – it should engender confidence in clients to act on it; and
- capacity – it should enable clients to secure a change in their manager's behaviour where necessary, or switch providers if appropriate.

3.16 The information provided must also meet other tests if it is to fulfil the criteria set out above:

- scope – all fund management mandates, retail and institutional, and all types of fund, whether segregated or pooled, should be included;
- focus – separate costs for execution and research (however defined) should be identifiable;
- quality – the data presented should be clearly articulated, and supplied to a satisfactory standard and degree of accuracy;
- standardisation of definitions – there should be enough information of the right type to enable meaningful comparisons to be made, ideally both between funds and between managers;
- frequency – information should be up to date, and supplied on a timely basis; and
- usefulness – information should be relevant and capable of being acted upon, to facilitate effective client monitoring of costs.

Timing

3.17 We acknowledge that a fully-functioning disclosure regime of this nature will take time to establish. We will also want to monitor its effectiveness in practice. This could take up to three years. However, in the short term, we expect to see rapid progress towards the development of an enhanced disclosure regime. By the end of 2004, we will want to be satisfied that industry proposals are on track to provide the outcomes we seek.

3.18 To meet that target, we expect at least a trial programme, involving a number of fund managers and clients, to be up and running by the autumn. Through recent informal discussions with the IMA, NAPF and the London Investment Banking Association (LIBA), we are encouraged that the fund management industry understands the importance of leading a co-operative effort to deliver a timely outcome.

3.19 If, at the end of 2004, the results fall short of expectations, we may need to review our policy options. Ultimately, if industry-driven solutions cannot deliver the outcomes we seek within a reasonable time, we will need to reconsider the case for direct intervention through rule-making.

'Unbundling' in the longer term

3.20 In time, we expect to see a market develop in which there is:

- on the one hand, a clear distinction between execution services and investment research within the currently bundled payment; and
- on the other hand, a distinction between research and other non-execution services that are paid for with 'hard' cash.

This should enable fund managers to make clearer decisions about each type of service – the level of service required and how much they are prepared to pay for it – and then select the most suitable provider in the market.

3.21 Decisions about one type of service should not be dependent on gaining access to another service offered by the same provider. For example, a manager should not choose a broker to execute a deal, merely in consideration for research which that broker provided. In this way, fund managers will have clearer incentives to consider the widest possible range of execution options, and to obtain research from across the marketplace irrespective of what other services the research provider may offer. And the emergence of market prices for research, especially for products where none currently exists, should make for a more efficient research market.

3.22 An evolutionary approach to separate pricing can be expected to avoid the imposition of excessive costs or damage to competition. So, we think we should, at this point, look to go with the grain of market developments. If this

does not happen, some further encouragement or intervention from us may be necessary.

Other initiatives

3.23 There are some other strands of work being undertaken by us and by other agencies which, although not aimed primarily at addressing bundling and softing, are nevertheless likely to impact in the medium to long-term on the objectives discussed above.

Retail fund governance

3.24 In our Policy Statement on the new rules for authorised collective investment schemes, about which we consulted through CP185, we said that, based on discussions with stakeholders during the consultation on CP176, we intend to do further work on strengthening the corporate governance of retail funds as a means of sharpening the accountability of fund managers.

3.25 This may entail the development of an investors' champion, to receive and assess disclosures from the fund manager on behalf of the fund's investors as a whole.

3.26 The IMA has started its own review in this area, and we will take this into account as appropriate in our work on this issue. We may also wish to consider the position of other types of retail managed fund, such as investment trusts and the funds of life assurers. Cost benefit analysis will be particularly important, as those bearing increased governance obligations might expect increased remuneration for taking on additional responsibilities, and this would have an impact on total fund charges.

Best execution

3.27 A further means of encouraging moves towards the outcomes identified above is by placing greater emphasis on identifying and controlling the costs of execution, as opposed to the costs of additional goods and services. In CP154[3], we recommended a new policy approach which concentrated on delivering the 'best net result' for clients. This recognised that, in today's markets, identifying and minimising trading costs – including, but not limited to, commissions – is as much a part of delivering best execution as a search for the best price.

3 CP154: *Best Execution*, October 2002.

3.28 This approach is reflected in the best execution standards agreed in the Markets in Financial Instruments Directive (MiFID)[4], which entered into force in April 2004 and will replace the Investment Services Directive[5]. In line with the Lamfalussy process, details have still to be determined in the level 2 'implementing measures', and the Committee of European Securities Regulators (CESR) is currently working on its advice to the European Commission on the content of those measures.

3.29 Focus on best execution will be complementary to the thrust for transparency and accountability in commission costs. We believe it will provide a further incentive for fund managers to identify and control the execution element of commissions, and to seek cheaper execution methods for some trades. Together with enhanced disclosure, this should reduce the scope for execution decisions to be unduly influenced by decisions about purchase of other services.

Conflicts of interest affecting analyst research

3.30 Since CP176 was published, we have finalised our policy on managing conflicts of interest in relation to the production of investment research[6], on which we consulted in CP205. We have focused our attention on research which is held out as impartial by the firm publishing or distributing it. This is likely to exclude a considerable amount of essentially promotional material. Where the research is represented (or likely to be perceived by recipients) as impartial, the firm must have a policy for identifying and controlling any conflicts of interest that might affect its production.

3.31 In implementing these rules and guidance, sell-side firms will consider the nature of any research they produce, and its target audience, to determine whether it is within the scope of the rules. This may lead them to treat all their research on the same basis, or they may consider that some of their output is impartial while some is not. Consequently, buy-side firms will be in no doubt of the status of the research they receive. As it is reasonable to assume that managers will place a greater value on impartial research, the distinction in status should make it easier for managers to decide what type of research they need and in what quantity. It should also encourage the treatment of research as a distinct commodity from execution services, and contribute to the emergence of prices for various kinds of research.

Scope of the policy approach

3.32 We are aware that the issue of scope is of particular interest to fund managers with both UK and non-UK customers, and many respondents to CP176 asked

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4 Directive 2004/39/EC.

5 Directive 93/22/EEC.

6 Policy Statement 04/6: *Conflicts of Interest in Investment Research*, March 2004.

for more information on this point. Our general view, at the time CP176 was published, was that the application of any rules would be compatible with other parts of the regulatory regime for the conduct of designated investment business in the UK. We would consider at a later date whether there was a case for applying the regime to a broader or narrower definition of business.

3.33 Although our views have not changed in principle, the adoption of MiFID means that the scope of the entire UK conduct of business regime is likely to be the subject of review in the next year. We will consider this issue in the context of our ongoing work on how the Directive is to be implemented.

International co-operation

3.34 The regulatory treatment of bundled and softed services is becoming an increasingly high-profile issue in the US. The exposure of abuses in the financial sector over recent months has prompted a wide-ranging review of actual and potential conflicts of interest in the industry.

3.35 The US Congress is presently considering several Bills, of which the 'Baker Bill'[7] is the most prominent, that seek to reform the industry through legislative change. The Baker Bill is aimed at greater transparency of mutual fund expenses, including 'soft dollar' arrangements, and improvements in mutual fund governance. It would require the Securities and Exchange Commission (SEC) to review the 'safe harbour' for soft dollar arrangements granted under section 28(e) of the Securities Exchange Act 1934.

3.36 A number of witnesses have testified to Congressional committees on soft dollar issues in recent months, with some calling for complete repeal of section 28(e). We are aware that a fund management firm which is a major UK player has recently proposed, in a public submission to the SEC, enhanced disclosure of a breakdown of commission flows.

3.37 The SEC has not waited for legislative change in order to institute a review of softing. Chairman Donaldson announced in April 2004 that he has set up an internal Task Force, bringing together staff from various divisions and offices, to review soft dollar arrangements. He said that this task force will work to understand how softing is used in the US market and to consider the pros and cons of various reform approaches. These may include narrowing the definition of permissible 'research'; considering whether the costs of execution and research should be quantified and how they may be made transparent; and reviewing whether the legislative 'safe harbour' should be repealed.

7 H.R. 2420 The Mutual Funds Integrity and Fee Transparency Act 2003. The House of Representatives approved the Bill in November 2003 and it is currently before the Senate Banking Committee.

3.38 We have been in regular contact with SEC staff on this subject over the last year, and we will continue to pursue opportunities to share ideas and discuss ways in which we might be able to co-ordinate our efforts.

3.39 The International Organisation of Securities Commissions (IOSCO) has also undertaken work relevant to this issue. Its Technical Committee has released a paper which examines international regulatory standards on fees and expenses in investment funds.[8] The report emphasises the importance to investors of information about fees and expenses in making investment decisions, and also the importance of transparency as a driver of competition between fund operators. It acknowledges that commission arrangements may not accord with the duty of best execution and proposes standards in relation to the use of both soft and hard commissions.

3.40 We are participating in IOSCO's work in this area and welcome the publication of this paper, which emphasises the information needs and expectations of retail investors.

Next steps

3.41 We expect to begin discussions with trade associations and other key industry participants on the issues set out in this chapter shortly after this Statement is published. Our aim is to conclude the period of informal consultation by August or September, although we will give priority to the development of the industry's comparative disclosure initiative.

3.42 We envisage that some limited rule-making will be necessary to set the framework for the outcomes discussed in this chapter, and to remove or revise existing rules and guidance accordingly. Assuming that the work on comparative disclosure progresses along the lines set out in paragraphs 3.17 – 3.19, we would look to publish a Consultation Paper with draft rule changes in 2004, and to finalise the changes to Handbook text early in 2005.

8 *Fees And Commissions Within the CIS And Asset Management Sector: Summary Of Answers To Questionnaire*, Report of the Technical Committee of IOSCO, October 2003. Available from www.iosco.org.

List of non-confidential respondents

3i Investments plc

AB Compliance Ltd

AEGON Asset Management

AIMR European Advocacy Committee

Alliance in Support of Independent Research

Alliance Trust plc

Allianz Dresdner Asset Management

Alternative Investment Management Association (AIMA)

Arete Research Services LLP

Artemis Investment Management Ltd

Association of British Insurers (ABI)

Association of Foreign Banks (AFB)

Association of Independent Research Providers (AIRP)

Association of Private Client Investment Managers and Stockbrokers (APCIMS)

Association of Solicitor Investment Managers (ASIM)

Atlantic Equities LLP

AXA Investment Managers Ltd

Baillie Gifford & Co

Bank of New York

Barclays Global Investors Ltd

Baring Asset Management

Britannic Asset Management Ltd

British Bankers' Association (BBA)

Brooks MacDonald

Cambrian Capital Partners LLP

Cancer Research UK Pension Scheme

David Cardale

Castle Investment Consultants

Cazenove & Co Ltd

Cazenove Fund Management Ltd

Charles Stanley & Co Ltd

Citigroup Global Markets Ltd

Close Investment Ltd

Coal Pension Trustee Services Ltd

Collins Stewart Ltd

Commission Direct Inc

Credit Suisse Asset Management

Credit Suisse First Boston (Europe) Ltd

CrossBorder Capital Ltd

Crown Agents Asset Management Ltd

Delaware International

Deutsche Asset Management Ltd

Deutsche Bank

DSG Asia Ltd

E-Crossnet Ltd

E*Trade Securities Ltd

F&C Management Ltd

Family Assurance Friendly Society Group

Fidelity Investments Ltd

Financial Services Consumer Panel

Fox-Pitt, Kelton Ltd

Futures and Options Association (FOA)

Goldman Sachs Asset Management International

Paul Goldschmidt

Hewitt Bacon & Woodrow Ltd

Insight Investment Management Ltd

INVESCO UK Ltd

Investment Counsel Association of America

Investment Management Association (IMA)

ISIS Asset Management plc

ITG Europe

Howard Jones

Jupiter Asset Management

KBC Peel Hunt Ltd

Lake Asset Management Ltd

Legal & General Investment Management

Lehman Brothers International (Europe)

Lincoln Financial Group

Geoff Lindey

London Investment Banking Association (LIBA)

London Stock Exchange

LRT Pension Fund Trustee Company Ltd

M&G Investments

Majedie Asset Management

Managed Funds Association

Marathon Asset Management Ltd

Marshall Wace Asset Management Ltd

Martin Currie Investment Management Ltd

John McMahon

Mercer Investment Consulting

Merrill Lynch International

Merrill Lynch Investment Managers Ltd

Morgan Stanley & Co International Ltd

Morgan Stanley Investment Management

Morgan Stanley Quilter

Morley Fund Management Ltd

Roger Morton

National Association of Pension Funds (NAPF)

National Consumer Federation

Nationwide Building Society

Office of Fair Trading (OFT)

Olympus Capital Management Ltd

Oriel Securities Ltd

Max Palmer

Park Place Capital Ltd

Pension Services Ltd

Pictet Asset Management UK Ltd

Pricepro Analysis Ltd

PricewaterhouseCoopers LLP

Professional Investment Tools Ltd

Quoted Companies Alliance

Railways Pension Trustees Co Ltd

Reuters Ltd

RMC Group Pensions

Rontech Ltd

Royal London Asset Management Ltd

Schroder Investment Management Ltd

Securities Institute

Smithers & Co Ltd

Société Générale

Society of Pension Consultants (SPC)

Southern Electric Group Pension Scheme

State Street Global Advisors Ltd

Svenska Handelsbanken

T. Rowe Price

Taube Hodson Stonex Partners Ltd

Threadneedle Asset Management Ltd

True Research Ltd

UBS Global Asset Management (UK) Ltd

UBS Investment Bank

UK Society of Investment Professionals (UKSIP)

Universities Superannuation Scheme Ltd

virt-x Exchange Ltd

Watson Wyatt Investment Consulting

Weiss Asset Management

West LB

Williams de Broë Plc

Responses to questions in CP176

Q3.1. Are there any types of commission arrangement, not described here, that affect the way in which, or the terms on which, fund managers arrange trade execution for their customers?

1. Respondents described several other trading and commission arrangements, including:

- principal trading, where the broker is rewarded through higher commission for accepting the risk associated with dealing as principal (i.e. taking the securities onto its own book) as well as providing services such as research and execution;
- cross-trading arrangements, where the broker matches buy and sell orders without going to the market;
- net trading, where all trading is conducted on a 'net of commission' basis, with a resultant widening of the bid-offer spread for a security;
- programme trading, where the broker quotes a price to deal a 'basket' of securities as a single transaction;
- the use of prime brokers by hedge fund managers – in these arrangements, additional services such as stock borrowing and custody are often provided by the prime broker;
- commission sharing, 'step-out' or 'give-up' commission arrangements (an arrangement between a broker and a fund manager relating to full-service dealing commission paid to the broker for provision of execution services). The broker agrees that the commission it earns will be shared with one or more third parties, nominated by the fund manager, who have provided the manager with non-execution services – most commonly, independent research.

2. Some respondents took the opportunity to express views on the arguments set out in paragraphs 3.3 – 3.14 of CP176, in particular on which factors are considered by brokers and fund managers when making trading decisions. Many of the respondents, particularly fund managers, also expressed the view that commission is not the most important factor in determining which broker is selected.

Our response: We are grateful to respondents for the additional information provided in this area. Our proposals will take these trading and commission arrangements into account.

Q3.2. What is your view of our assessment of the economic benefits of bundling and softing?

3. The responses to this question were mixed and, to a large extent, divided on industry lines: for example, many fund managers were in favour of retaining the ability to make bundled and (to a lesser extent) soft commission arrangements, whereas pension fund trustees generally favoured a restriction or abolition of these activities. Independent research providers and service providers were generally in favour of not changing the rules on bundling and softing in a way that might affect them adversely.

4. Many respondents said that the trading process could be made more transparent and favoured an increase in disclosure to customers. Some argued that soft commission arrangements were more transparent than bundled arrangements and that softing should therefore be encouraged for services which are presently bundled. Others, however, viewed them as essentially similar practices which should attract the same regulatory approach.

5. Several respondents argued that a principle-based solution to any perceived problems with bundling and softing would be preferable to a rule-based solution.

6. In paragraph 3.34 of CP176, we concluded that the economic benefits claimed for bundling and softing are unlikely to be realised, or may not be significant. The main arguments expressed in favour of our assessment, or in disagreement with it, are explained below.

Arguments favouring our assessment

7. Generally, pension fund trustees agreed with our assessment of the limited economic benefits of bundling and softing. Some support was also found from fund managers, but mainly in respect of softing.

8. It is argued that there is a tendency for fund managers to over-consume research when it is available within a bundled brokerage package. Unbundling would therefore lead to more focused consumption and more efficient production of research.

9. Bundling and softing prevent efficient competition from developing; increase transaction costs; create conflicts of interest; and introduce opacity into fund management and broking operations. They compromise a firm's ability to achieve best execution, as fund managers might have an incentive to place business with a broker who might not necessarily provide best execution but who does offer better additional services. An incentive to over-trade may be created where a fund manager is trying to achieve a certain level of trading with a broker in order to obtain bundled or softed benefits.

Arguments disagreeing with our assessment

10. The respondents disagreeing with our assessment of the economic benefits of bundling and softing included fund managers, independent research providers and service providers.

11. Many of these respondents thought the case we made in CP176 did not demonstrate that bundling and softing cause sufficient detriment to investors to justify regulatory intervention. In particular, it was argued that there is no evidence of over-trading or over-consumption of research. The primary consideration of fund managers when placing dealing orders is to obtain best execution, not the bundled or softed services available from brokers. Also, if over-trading occurred it would increase costs, which would harm the fund's investment performance. The need to achieve good performance is more important to the fund manager than any benefits obtained through bundling and softing.

12. Some complained that OXERA's research was flawed in its scope and methodology, or relied on out-of-date information, and they felt that little or no reliance should be placed on it. Some argued that we understated or ignored the economic benefits of bundling; or else that the alleged benefits of unbundling were based on misunderstandings or untested assumptions (e.g. that clients are willing to pay separately for each service, or that the market for independent research is economically viable in the long term).

13. It was also said that our conclusions were not consistent with OXERA's findings that the potential detrimental effects of softing and bundling may be relatively small, and that to do nothing in the way of changing regulations was a policy option.

14. It was argued that any benefits arising from the changes proposed would not be proportionate to the costs involved. The amount of commission attributable to payment for bundled and softed services is small and is falling, and there are cheaper and more efficient ways to achieve our objectives, such as increased disclosure to clients.

15. Bundling and softing facilitate competition in the fund management industry, as they effectively subsidise the start-up costs for small fund managers. They

deliver benefits to customers as they enable fund managers to gain access to a variety of research and other services. It was also argued that research is a legitimate cost associated with trade execution, and it should therefore be possible to pay for it through execution charges.

16. Some service providers might find it more difficult to sell their products if they were not provided through soft commission arrangements. This might have a correspondingly negative impact on trading decisions made by fund managers. Managers might also have to increase their fund management fees to recoup the cost of purchasing such services.

17. Some respondents, including several fund managers, did not agree with our views on bundling, but agreed that softing could be restricted or ended.

Our response: We acknowledge that there are conflicting views in this area. However, we believe that OXERA's work was thorough in its scope and method, and evidence purporting to show otherwise has not persuaded us that their original analysis of market failure was incorrect. We took due account of what OXERA said when preparing CP176. Their remit was to carry out an economic analysis of softing and bundling, and the conclusions they reached, including the option of 'doing nothing', are seen from an economic perspective. This is an important consideration in policy-making, but it is by no means the only one.

We have to determine what is appropriate to our statutory objectives to maintain market confidence and protect consumers, which require us to weigh other considerations than just economic ones. We have noted that many respondents, even some of those hostile to our specific proposals, have acknowledged the need for action of some kind.

Q3.3. What is your view of our analysis of the effectiveness of the current regulatory regime?

18. Responses to this question were mixed and, to a large extent, divided along industry lines. For example, many fund managers thought that the current regulatory regime was effective, while pension fund trustees thought it did not go far enough to protect customers. Some respondents expressed the view that the current regime is little understood by trustees and is open to abuse from fund managers.

19. Some respondents said that bundling and softing are essentially similar practices which should attract the same regulatory approach. Conversely, others argued that they should be treated differently, because bundling serves to improve fund performance whereas softing is undertaken by fund managers as a means of reducing their direct costs. It was also argued that softing involves an agreed level of commission to be directed to a certain broker, leading to conflicts of interests that do not exist with bundling. In contrast,

yet others said that bundled commission arrangements are often less transparent than soft commission arrangements.

20. Some respondents said that restrictions should be placed on bundled and softed services, but argued that research should be treated as a special case. Independent research providers said that independent research should be encouraged and provided on an 'equal' basis to brokers' bundled research.

21. Many respondents said that the trading process could be made more transparent and favoured an increase in disclosure to customers. Respondents claimed that the voluntary IMA / NAPF Disclosure Code is already having a positive impact, improving the awareness of clients and encouraging a fall in commission rates; they were concerned that we should allow the Code sufficient time to prove its worth before imposing mandatory requirements. There were a good number of suggestions about ways in which the Code might be enhanced or extended, to provide sufficient information to meet our objectives.

22. The NAPF and other respondents expressed concerns that improved disclosure, though desirable, would not be sufficient by itself to correct the market failures identified in CP176. Other respondents referred to the risk of overloading customers with information, and in some cases proposed that disclosure obligations on fund managers should be balanced by higher standards of expertise among pension fund trustees and better advice from their consultants.

Our response: We acknowledge that there are conflicting views on similar treatment of bundling and softing. However, we remain of the view that they should be subject to the same regulatory treatment. Both of them promote a lack of transparency and accountability, and both affect relationships between fund managers, brokers and providers of ancillary services. To take regulatory action against soft commission alone, as some have suggested we should do, would be to intervene in only a small part of the market for brokerage services, at the risk of damaging existing transparency and competition.

Conversely, in directing our attention to bundled brokerage services, we must avoid solutions that simply replicate the potential distortions specific to soft commission. Here, fund managers are affected by the commitment to direct a particular value or proportion of dealing orders to a broker in order to secure soft credits. And although soft commission may be more transparent than bundling, it is still an opaque arrangement compared to hard cash expenditure.

We have accepted the calls for increased and improved disclosure of commission arrangements. We note, though, that disclosure is a means to an end, not an end in itself. It can be an effective solution to customer needs, but only if its recipients are able to understand it and can take timely and effective action based on it. We indicate in Chapter 3 the standards we will expect of disclosure solutions developed by industry

participants, especially fund managers, and emphasise the importance of being sensitive to customers' differing levels of sophistication and responsibility.

We have also taken account of calls for appropriate restrictions on softing, and are proposing that the provision of research should be permitted under both bundled and softed arrangements.

Q4.1. What are your views on our proposed treatment of market pricing and information services?

Q4.2. What is your view on our proposed treatment of other goods and services?

23. Given that many respondents made similar responses to these related questions, we have grouped them together for the purposes of this Policy Statement. The main arguments expressed in favour of and against our proposals are set out below.

Arguments favouring our proposals

24. Those respondents supporting our proposals were largely made up of pension fund trustees. It was argued that the proposals would increase transparency and accountability to customers, because softing hides costs from customers and weakens the incentive for fund managers to manage costs. The proposals would also provide a stronger incentive to fund managers to manage conflicts of interest effectively. This, it is argued, is because removing the ability to obtain softed services would in turn reduce any incentive for fund managers to over-trade or to place agreed levels of business with brokers.

25. The proposals might help to increase competition in the fund management and broking industries. A more transparent pricing structure might lead to more rigorous assessment of costs and the removal of subsidies provided to service providers, encouraging fund managers to pay only for services that they rate as useful.

Arguments against our proposals

26. Those respondents disagreeing with our proposals were largely from the fund management industry.

27. It was argued that the proposals would have a neutral or adverse impact on costs to clients, with little indication that any benefits from the proposal would be sufficient to compensate for this. For example, respondents said there is no guarantee that the proposals would improve fund returns. Fund managers would seek to recover the costs of softed services through higher management fees.

28. The proposals would not benefit the production or the consumption of investment research. Rather, they might lead to a decrease in both, as research would not be subsidised through other services and it is not certain that fund managers would always pay for research if it had to be bought for 'hard' cash. Softing was also said to facilitate competition between research produced by brokers and research produced by third parties.

Mixed responses

29. There were also a number of other responses which commented on this area, offering a wide variety of views. Broadly, these responses fell into the following categories:

30. Our proposals are not radical enough: for example, some respondents said that we should ban softing altogether. They argued that a ban would not have a significant negative effect on the UK's international competitiveness and would not cause a decrease in the supply of independent research.

31. Restricting softing is desirable in principle, but there are problems with doing it in practice. For example, it was argued that the UK should not act unilaterally in this area, and also that softing is useful as a means of funding high-quality independent research.

32. Softing should be permissible for certain types of business or in certain circumstances. In particular, respondents often said that softing should be allowed to obtain research. Some pension funds employing in-house fund managers argued that softing directly benefits their scheme members and enables them to claw back commission. Some respondents said that softing should be allowed if the clients agree to it, or if it can be verified that the softed services benefit clients directly.

33. Other arrangements, such as commission sharing arrangements, were also suggested as possible replacements for soft commission.

Our response: We are proposing in this paper that we will restrict the bundling and softing of services other than those associated with execution and research. We will discuss with the industry how these terms should be defined before formally consulting on rules and guidance to implement the restriction.

Q4.3. What is your view of our proposal that the cost of additional services should be rebated to customers' funds?

34. In contrast to the mixed responses to questions Q4.1 and Q4.2, a majority of respondents (some 60%) argued against this proposal, although 25% of respondents did not comment on it directly. The main arguments expressed in favour of and against our proposals are set out below.

Arguments favouring our proposals

35. Those respondents supporting our proposals were largely made up of pension fund trustees. They said that rebating would increase cost transparency for fund managers as the costs of different services provided to them by brokers would be apparent. It would place stricter disciplines on fund managers to exercise control over the purchase of additional services currently acquired through bundled services. In addition, it would be likely to help resolve conflicts of interest that arise in a fund manager's dealings with customers, as there will be more incentive to limit purchase of services that the manager might not necessarily want or need.

36. There were also several responses which said that the proposal was acceptable in principle, although it would costly and complicated to implement.

Arguments against our proposals

37. Those respondents disagreeing with our proposals were drawn largely from the fund management industry, but also included independent research providers.

38. Respondents said that an insufficient case has been made for intervention of this kind. In particular, it would be too difficult and costly to implement and it would lead to unwarranted interference in contractual arrangements between firms. The costs involved in setting up and administering the system would not be proportionate, given the ratio of commission cost to overall trading costs. Fears were also expressed that separate pricing of each service would add to the time and costs of negotiating dealing terms, and would cause higher prices overall. These might be reflected in higher commission rates, or else the increased costs would be cross-subsidised or recouped in some part of the value chain that was more opaque to clients.

39. It was argued that the proposal would not enhance transparency or accountability, since pension fund trustees are not sophisticated enough to assess the value of research. Respondents also said that it would not be a cost-effective way of achieving transparency.

40. The proposal would not remove conflicts of interest, as fund managers might be conflicted over the calculation of the rebate. Rebates would be based on subjective estimates of costs and there is little correlation between the cost of a service and its value to clients. It was also argued that the proposal would create a disincentive for fund managers to trade for clients.

41. The proposal would have detrimental effects on competition as it would reduce the profitability of fund managers and might make the UK a less attractive place for asset managers, especially hedge fund managers, to start up business. Some respondents argued that it might precipitate a

concentration of trading in the hands of a few integrated firms (i.e., firms that carry out both broking and market-making). It was also claimed that the cost impact of the proposal on a fund manager's expenditure base could lead to an increase in regulatory capital requirements, thus creating a higher barrier to market entry.

42. The proposal would not increase the production or consumption of research, but would in fact lead to an under-consumption of research as fund managers might not be prepared to pay for it from their own resources. If the consumption of research declined, then it is likely that the number of analysts producing research might decline, with a corresponding decrease in research quality. It was also argued that rebating would not create a level playing field between broker-produced research and independent research, as integrated firms could still subsidise their own research.

Our response: Because we intend to pursue other means of achieving our objectives, such as encouraging the use of increased disclosure, we have decided not to pursue this proposal at this stage. We will consider reverting to it, however, if market-led solutions do not appear likely to achieve our desired outcomes.

Q4.4. Do you think that unbundling of broker services is a more attractive approach?

Arguments in favour of unbundling

43. Those respondents supporting unbundling included representatives of pension fund trustees, consumer and public interest bodies, and some independent research providers and execution service providers. The main arguments in favour of unbundling were as follows.

44. Unbundling would increase transparency and accountability to investors, on the grounds that the current system is opaque and hides the costs of services from those who pay for them (i.e, the customer). As a result, bundling weakens the fund manager's incentive to manage costs. In an unbundled environment, clients – given adequate transparency – would be able to evaluate the manager's value-for-money judgements and monitor the effectiveness of his decision-making.

45. Unbundling would incentivise greater competition and help to correct incentive misalignments for fund managers, as it would reduce conflicts of interest that may affect the fund manager's choice of broker. It should also help fund managers to make rational choices about execution and to ensure that best execution is achieved.

46. Unbundling might lead to a reduction in the amount of unwanted investment research produced, which in turn would reduce the costs of producing research, thus benefiting both the production and consumption of research. It

was also claimed that independent research providers would be rewarded accordingly for producing higher-quality research. A differential pricing of research might develop, allowing fund managers to pay for the research that they wanted. Independent research providers would be able to compete on a level playing field with research providers such as investment banks.

Arguments against unbundling

47. Those respondents who disagreed with unbundling were mainly fund managers and brokers, but also included some independent research providers. The main arguments expressed against unbundling were as follows.

48. Bundling is not a cause of detriment and there is no need for regulatory concern over this issue. Fund managers ensure that the best interests of the customer are paramount. Brokers are chosen not on what bundled services they provide, but on whether they can achieve best execution. Bundling does not lead to over-trading.

49. Some respondents claimed that bundled commissions are fully disclosed to and understood by customers. It was also argued that bundled commission arrangements need not be opaque, especially if commission sharing arrangements are used. Pension funds employing in-house fund managers argued that bundling directly benefits scheme members, as all benefits accrue to the client and thus there is no conflict of interest.

50. Some benefits of bundling have been under-estimated or overlooked. For example, economies of scale enable brokers to offer a wide range of services within a bundle. Also, it facilitates the production and distribution of research across the market.

51. Regulatory intervention is the wrong way to achieve our desired outcome, as imposing rules would increase costs and would be less effective than market-led solutions.

52. There are practical difficulties associated with unbundling, such as how research would be valued and the risk that the valuation might be based on arbitrary figures. There might be difficulties if orders had to be split between UK and non-UK clients. Many respondents were concerned that the costs of non-execution services, if unbundled, would become subject to VAT.

53. Several respondents said that unbundling was desirable in principle, but might cause detriment in practice; for example, less research might be produced, particularly for small capitalisation stocks.

54. It is also worth noting that several respondents thought unbundling was a simpler and more attractive option than rebating the cost of additional services to customers' funds.

Our response: We believe that the separate pricing of bundled services is a necessary step, particularly in the absence of rebating as a necessary control mechanism. Our work on best execution will also place a greater emphasis on the costs of execution, as opposed to the costs of additional goods and services. We believe this approach will provide a further incentive for fund managers to identify and, where possible, to negotiate down the execution element of commission payments, and to seek cheaper methods of execution for some trades. Together with enhanced disclosure, this should reduce the scope for execution decisions to be unduly influenced by decisions about purchase of other services.

Q4.5. Do you agree that both of the proposals described should be implemented together?

55. Many respondents to this question, particularly those in the fund management industry, were not in favour of implementing the proposals in CP176 together. Indeed, many of them believed that neither proposal should be implemented.

56. Overall, more respondents were in favour of placing additional limitations on softing than pursuing either the rebate proposal or measures to bring about unbundling.

57. Some respondents expressed the view that if our rebating proposal were adopted, then our softing proposals would become superfluous.

Our response: As outlined above, we do not intend to pursue the rebating proposal at this stage. However, we intend to impose some additional restrictions on softing, as well as encouraging unbundling in the market. We will give the industry the opportunity to create its own disclosure arrangements to ensure that customers know what they are paying for.

Q4.6. Do our proposals have other implications for fund management and broking that we have not described?

58. Most respondents to this question believed fund managers would react to CP176 proposals by cutting their consumption of bought-in services, particularly independent investment research. It is feared there would be an increase in the cost of capital as a result, because the equity market would have less information available to price securities effectively, and volatility would rise. Many stated that the impact upon smaller capitalised companies could be particularly damaging, constraining their ability to raise capital and to provide liquidity for their investors. Others believed the proposals would be likely to encourage the concentration of execution, to the detriment of smaller and developing fund managers.

59. Some respondents believed that the proposals would encourage equity markets to adopt the approach followed by the fixed income market, where services are paid for in the spread. They expressed concern that net trading might result in greater opacity. Some respondents, particularly brokers, stressed that the proposals would involve complex additional administration on their part to

support fund managers in unbundling prices and calculating rebates. According to some, the extra burden of creating and running a separate UK-only commission model alongside an international version would add to their costs.

60. Few respondents, particularly independent research providers and trading platforms, believed that implementing the CP176 proposals would result in increased transparency, or would lead fund managers to use their resources more efficiently. A few argued that brokers should compete on their ability to deliver high-quality execution services, not on the attractiveness of their softing and bundling arrangements.

61. We received representations from some industry participants that the proposals in CP176 were not appropriate to them, as their particular structures and market practices, or their differing customer base, enabled them to avoid the lack of transparency and conflicts of interest that our proposals sought to address. For example, some fund managers specialising in managed portfolios for private clients pointed out that they offer a fully transparent charging structure which is negotiated with the customer on a personal basis. In some cases, they offer customers the option to pay a higher management fee inclusive of dealing charges, so that there is no pass-through of additional costs to the client's portfolio.

62. There are also a number of firms who offer both stockbroking and portfolio management services to their private clients, who thus execute most client deals in-house. They argued that since fund manager and broker are in this case one and the same, it would be unfair to subject them to the requirements designed to manage conflicts of interest in a relationship at arm's length.

Our response: Despite most market participants being in favour of increased transparency, we acknowledge that there are conflicting views on the implications of CP176 for fund managers and brokers. We have considered all these views and have noted the particular interests that industry respondents were seeking to defend. We have also noted the concerns of smaller firms that the proposals did not take account of their markets and business practices. We believe that the way forward we are proposing will enable firms to develop proportionate solutions suited to their clients' particular needs. We will maintain a dialogue in the coming months with any firms and trade organisations who continue to have concerns about sectoral impacts. We address the issue of net trading in paragraph 2.64.

Q4.7. Do you agree with our assessment of the impact on the investment research market?

63. Most respondents believed that the proposals would have a damaging impact on the market for investment research. In particular they would, according to some, result in a reduction in the amount of independent research carried out and a decline in coverage of smaller capitalised companies. Consequently, there would be an over-concentration of investment in the most widely-followed stocks and an under-analysis of others, leading to a loss of market liquidity and higher costs

of capital. Many believed there would be an immediate, though temporary, decrease in hard funds available for research, as the market adjusted to a new regulatory environment and fund managers renegotiated contracts with brokers.

64. Some respondents reported that CP176 has stimulated, or has been consistent with, a number of changes in the industry. The proposals aim to give fund managers a stronger incentive to monitor costs of third-party services, in particular investment research. The fall in equity markets and the resulting decrease in margins have led fund managers to place greater scrutiny on their use of commission. Others emphasised the need to establish a clear mechanism for identifying the true cost of investment research.

65. Some respondents dismissed our suggestions that there is over-supply and over-payment of research in the marketplace, mostly because they felt CP176 failed to discriminate between the different types of research available. Buy-side, sell-side and independent third-party research are not substitutes. Proprietary research is done within individual firms or through specifically commissioned projects from third-party research providers; its value to the fund manager depends on its quality and its exclusivity to him. Sell-side research is generally more widely available.

66. These respondents believed that the issue of over-supply may be relevant to sell-side research, which is distributed regardless of its actual utilisation by fund managers and is perceived by many as a free good. On the other hand, buy-side and independent research involve a cost to fund managers and are produced or purchased only as needed.

67. A few respondents thought CP176 a halfway solution for the market for investment research and that a more drastic approach should be adopted. To improve the objectivity of research and solve the conflicts of interest inherent to the investment banking model, the FSA should require the separation of execution from research so that global banks turn their research departments into economically-independent subsidiaries.

Our response: Different industry reactions provide different perspectives on this question; we have found all of the responses useful and informative. We continue to believe that a level playing-field between bundled and independently-produced research would enable fund managers to buy research on the basis of value for money rather than convenience. This would result in increased competition in the market for investment research, so stimulating the supply of products that cater to the requirements of fund managers. We will seek to avoid taking action that would be beneficial to one group of research providers at the expense of another.

Q4.8. Do you agree that our proposal will reduce the demand for directed commission arrangements? If not, should we take specific action to address the potential distortions caused by these arrangements?

68. Many respondents said that commission recapture and directed commission arrangements are examples of the way commercial forces operate to drive down costs. They are a conscious decision by the client to determine which brokers should handle trades; in turn the broker supplies services or rebates cash directly to the client. It was felt that directed commission arrangements are part of a healthy and competitive marketplace; they promote increased market transparency to a greater degree than either bundling or softing, and allow funds to combine best execution with reduced commission expenses.

69. On the other hand, some fund managers agreed that directed commission is likely to affect the manager's ability to achieve best execution, and one said that it was in that respect worse than either soft commission or bundled brokerage. There was some support – mainly from fund managers – for a complete ban on both directed commission and commission recapture.

70. Some respondents thought our proposals might reduce the demand for directed commission arrangements, as they are likely to give fund managers a stronger incentive to control commission costs, and so reduce the scope for negotiations outside the fund manager / broker relationship. Moreover, directed commission arrangements might become less attractive to fund trustees as they would be perceived to impair the fund manager's ability to fulfil his duty of best execution. Others disagreed that the proposals would reduce demand. One respondent said that as long as commission recapture is available, there will be no real incentive for commission rates to fall.

71. In order to address the potential distortions caused by these types of arrangement, most respondents suggested that we should encourage greater disclosure by fund managers and brokers. A number of ways were suggested; for example, to require fund managers to provide detailed and audited information about the components of commission costs; also, to require disclosure in the prospectus of authorised unit trusts and OEICs. These mechanisms would emphasise the fiduciary duties incumbent on fund managers.

72. A few respondents, especially independent research providers, believed that there would be no need for directed commission arrangements if the automatic pass-through of costs to customers' funds were disallowed.

Our response: We note the wide measure of disagreement among respondents about both the benefits and drawbacks of these arrangements, and the likelihood of demand for them decreasing as a result of our proposals being implemented. We will wait to see whether other initiatives, notably the further development of best execution policy and the introduction of an enhanced disclosure regime, lead to changes in the use of these arrangements. We can then review whether there is a case for regulatory action.

Q4.9. Have we correctly assessed the impact on the international competitiveness of the UK market?

73. Many respondents disagreed with our assessment of this issue, and said that the potential for unanticipated adverse consequences for UK firms is considerable. They believed that we should not implement proposals of this type on our own, as they would damage the UK market by imposing higher costs and implementing a stricter regulatory regime than those of other major markets.

74. Firms with overseas operations would have scope for regulatory arbitrage as they could circumvent our proposals by using their non-UK operations to access bundled or softed services. They might also be able to do this at a lower cost, giving them a competitive advantage over firms based entirely in the UK. The proposals would make it harder to win and retain mandates from overseas investors, which would have a negative impact on the growth of the UK asset management industry.

75. The same respondents believed the proposals would also be likely to put start-ups and smaller businesses at a competitive disadvantage by raising the barrier to market entry. Some respondents told us that this is particularly relevant for hedge fund managers, who are highly mobile and could easily avoid some of the CP176 implications by relocating to other jurisdictions.

76. There was a consensus view in favour of a synchronisation of regulatory efforts between the FSA, the Securities and Exchange Commission (SEC), the International Organisation of Securities Commissions (IOSCO) and the Committee of European Securities Regulators (CESR), to avoid regulatory arbitrage and subsequent detriment to the UK financial industry. There needs to be a global agreement with all regulators, resulting in a level playing field for UK fund managers.

Our response: We understand the concerns of the respondents, and we have commissioned a study by Deloitte & Touche to look at them in detail. Their report is being published alongside this Policy Statement and we comment on it in Chapter 2 of this Statement.

We acknowledge the desirability of maintaining a dialogue with fellow regulators on these issues. We will continue to raise the issue internationally.

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