

04/13  
newsletter

## Financial Services Authority

# Bundled brokerage and soft commission arrangements

## Feedback on CP176

May 2004

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# Overview

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<sup>1</sup> and soft commission arrangements<sup>2</sup> 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.

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.

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’).

## This Policy Statement

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?

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.

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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.

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

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.

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.

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.

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.

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.

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.

## Rebates to customers' funds

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.

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.

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.

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.

## Proposals

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.

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.

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.

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<sup>3</sup> 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.

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

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.

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

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.

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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