Policy Statement

05/9

Financial Services Authority

Bundled brokerage and soft commission arrangements

Feedback on CP05/5 and final rules

July 2005

Contents

This Policy Statement reports on the main issues arising from Consultation Paper 05/5 (*Bundled brokerage and soft commission arrangements: proposed rules)* and publishes final rules.

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1 Overview

Introduction

1.1 In Consultation Paper 05/5 '*Bundled brokerage and soft commission arrangements: proposed rules*' (CP05/5, March 2005) we set out our proposed rules for addressing concerns with soft commission and bundled brokerage arrangements.

1.2 Our basic analysis was that a market failure exists in relation to bundled brokerage and soft commission arrangements. The use of such arrangements to pay for goods and services other than execution lacks transparency. Investment managers then face conflicts of interest in their relationship with brokers, and are not directly accountable to their clients for expenditure on bundled and softed items. This lack of transparency makes it difficult for customers to tell whether the manager is acting in their best interests including obtaining sufficient value for money on their behalf.

1.3 Respondents to Consultation Paper 176 '*Bundled brokerage and soft commission arrangements*' (CP176, April 2003) expressed widely divergent opinions on the materiality of the market failure and the appropriate means of dealing with it, although there was broad consensus that present practice did not operate in the best interests of investment management clients and that transparency and accountability could and should be improved. In view of these responses, in March 2004 we announced proposals to restrict the scope of soft commission and bundled brokerage arrangements and, instead of the rebating proposal, to encourage industry-based solutions to enhance disclosure and accountability. The Investment Management Association (IMA), in partnership with the London Investment Banking Association (LIBA) and the National Association of Pension Funds (NAPF), was willing to lead the development and implementation of transparency and accountability measures.

1.4 In 2004, we set out those proposals in two policy statements, Policy Statement 04/13 '*Bundled brokerage and soft commission arrangements: Feedback on CP176*' (May 2004) and Policy Statement 04/23 '*Bundled*

brokerage and soft commission arrangements: Update on issues arising from PS04/13' (November 2004), including details of the proposed restrictions on the scope of soft and bundled commission arrangements – in effect, permitting execution and research services only – and the outcomes which we would expect the industry measures to achieve.

1.5 Our work on proposed rules to help address these issues has run in parallel with development by the industry of an enhanced disclosure regime to tackle the identified lack of transparency and accountability.

1.6 Our rules, together with the industry proposals, will:

- limit investment managers' use of dealing commission to the purchase of 'execution' and 'research' services;
- require investment managers to disclose to their customers details of how commission payments have been spent and what services have been acquired with them;
- embed in the commercial relationship between investment managers and brokers incentives to secure value for clients for execution and research spend; and
- promote competition between those who produce investment research by removing the regulatory distinction between research services provided by brokers along with execution (i.e., bundled services) and research services provided by third parties (i.e., softed services).

This Policy Statement

1.7 The consultation period for CP05/5 closed on 31 May 2005. We received 52 responses from firms, trade associations and other interested parties. We are grateful to the respondents, who are listed in Annex 1 to this Policy Statement, for taking the time to provide their views.

1.8 In this Policy Statement we set out the main points arising from the responses and our conclusions, together with the rules which have now been made by our Board.

Who should read this Policy Statement?

1.9 This paper will be of interest principally to investment managers, investment banks, brokers and the providers of services such as market information services and independent research. It will be of direct interest to institutional investors such as the trustees of pension funds.

1.10 It will also be relevant to retail fund trustees and depositaries, investors in retail products and to the providers of these products – such as unit trust managers, authorised corporate directors, other investment companies (including investment trusts) and life assurance companies.

Responses and our final policy approach

1.11 In CP05/5, we sought views on our approach to rule-making, namely:

- setting parameters for what should be treated as execution and what as research, leaving it for investment managers to make judgements about particular services; and
- requiring all investment managers to provide information to clients about services received, but giving them the flexibility to comply with this obligation through the IMA Disclosure Code or other appropriate means.

1.12 We received substantial support for our approach and so have decided to implement the rules largely as proposed. The rules to be made do not differ significantly from the draft instrument in CP05/5.

1.13 There were some points on which respondents sought clarification. The main issue was the treatment of post-trade analytics, which we indicated in CP05/5 that we did not consider as an execution service. In view of the interests of respondents, we have looked further at the point. We have noted that 'post-trade analytics' is a term used to describe many and varied products and services and there is significant product innovation on this area, with more complex products providing an array of services. We do not consider it appropriate to include all these on a blanket basis. However, there is limited scope for some of these products to be permissible as execution services. Further detail is provided in Chapter 2.

Implementation

1.14 The new rules and guidance are effective from 1 January 2006. However, there is a transitional period. Firms may continue complying with the existing soft commission rules[1] until the earlier of the expiry of any existing soft commission agreements or 30 June 2006.

Structure of this Policy Statement

1.15 The rest of this Policy Statement is structured as follows:

- Chapter 2 includes detailed feedback on the responses to our proposed rules;
- Annex 1 lists non-confidential respondents to our proposals; and
- Appendix 1 includes the final Handbook text.

1 COB 2.2.8R - COB 2.2.20R(1).

CONSUMERS

Investment managers of retail funds – such as unit trusts, open-ended investment companies, 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 such funds, whether directly or through PEPs and ISAs, have an interest in the issues covered in this Policy Statement. Also, retail customers with a direct relationship with investment managers will have an interest if their investment manager has bundled brokerage or soft commission arrangements.

2 Summary of responses

2.1 In this chapter we summarise the responses received to CP05/5 and reply to points raised.

2.2 In CP05/5, we asked two questions for comment. A number of respondents also commented on other aspects of our proposals.

> Q3.1: Do you agree with our approach of providing the relevant parameters but leaving it to investment managers to make judgements about particular services?

2.3 Most respondents supported our principles-based approach as it will enable firms to make decisions based on their particular circumstances. Respondents considered this to be a practical approach, particularly given the potential for continuing market innovation, and agreed that investment managers are best placed to assess whether, within the regulatory parameters, it is appropriate to pay for a particular service with commission.

2.4 However, some respondents were concerned that different investment managers may make different decisions on whether it is acceptable to use commission to purchase particular goods and services, which might impact on the values ascribed to execution and research in the disclosure to customers. This, in turn, may make it difficult for customers to make comparisons between investment managers.

Our response: The responses indicated that we are correct to apply high-level, purposive rules that leave the investment manager to make reasonable judgements on whether it is appropriate to pay for execution and research services with commission within this framework. We consider that investment managers are best placed to make these decisions, taking into account the individual circumstances of the firm and the use they make of those goods and services.

Importantly, it is our expectation that investment managers will be accountable to customers through the process of explaining these judgements to them in the context of enhanced disclosure.

As we said in CP05/5[2], we will examine in due course whether our rules are achieving the outcomes that we desire.

Q3.2: Do you agree with our approach of requiring all investment managers to provide information to clients about services received, but allowing investment managers the flexibility to comply with this obligation through the IMA Disclosure Code or other appropriate means?

2.5 Most respondents supported our principles-based approach and the flexibility it provides to investment managers to determine the most appropriate means of disclosure for their customers.

2.6 A few respondents said that different approaches will be used, which will make it difficult for customers to make comparisons between different investment managers. Some also suggested that we provide more information about where variations in disclosure would be acceptable.

2.7 Some respondents expressed concern that compliance with the IMA Disclosure Code will be too onerous and may not be the most appropriate means of disclosure in all circumstances, particularly for private customers where the costs of complying with the Code may outweigh the benefits of enhanced disclosure.

2.8 There were also questions about how our disclosure requirements apply to overseas customers. A related question was what disclosure requirements apply when a non-UK firm delegates investment management activity to a UK firm for the non-UK firm's customers.

Our response: The responses indicated that we are correct to give investment managers some flexibility to decide how best to comply with their disclosure obligation.

We expect that the IMA Disclosure Code will become the standard means of disclosure of commission spend for UK institutional and retail funds. We acknowledge that there may be circumstances in which it may not be the most appropriate means of disclosure: for example, in relation to private client mandates where the proportion of commission paid to third party brokers is small. The rules provide sufficient flexibility for investment managers in these cases to adopt alternative means of meeting their disclosure obligations provided they can show that the level and content of disclosure to their clients is sufficient and appropriate. The disclosure required under COB 7.18.12R could be included with other information provided to private customers such as periodic statements.

2 See paragraph 4.8 of CP05/5.

We acknowledge that the flexibility in the rules and limited guidance might lead to inconsistent approaches and create difficulties for customers, particularly the less sophisticated. However, we do not believe it necessary to provide further guidance in the rules on methods of disclosure. Instead, we will monitor this in our performance measurement work and in our continuing work with the IMA and NAPF.

We are aware that the Association of Private Client Investment Managers and Stockbrokers is drafting guidelines for its member firms on issues to consider when making disclosures to their customers. We see such industry initiatives as being potentially very useful.

For overseas customers, the same disclosure rules apply as for UK-based customers. Again, it is for investment managers to determine the most appropriate means of compliance.

For delegated arrangements of the sort described above, the identity of the UK firm's customers to whom disclosure is required will depend on the commercial arrangements in place. In general, the Conduct of Business sourcebook (COB) does not require firms to 'look-through' to underlying customers but this is a matter for the firms to decide.

As explained in CP05/5[3], we will examine in due course whether our rules are achieving the outcomes that we desire.

We have amended COB 7.18.12R and inserted COB 7.18.13E and COB 7.18.14G to clarify the requirements for prior disclosure on the one hand and periodic disclosure on the other. We expect firms to inform their customers (new and existing) of the arrangements they have entered into that involve the use of dealing commission to purchase execution and research goods and services (the 'prior disclosure' information) either with, or before, the first periodic disclosure made in 2006 or 1 July 2006, whichever is the earlier. While the appropriate method of making such a disclosure is for the firm to decide, it could do this by, for example, changing its terms of business.

2.9 We received a number of comments on several matters that were not expressly covered by the questions we asked.

Post-trade analytics

2.10 A large number of respondents argued that post-trade analytics should be allowed as execution services. The main reasons given for this were:

- such services promote best execution and feed into the execution process;
- such services assist in monitoring the effectiveness of conflicts management and in promoting competition between execution venues;

3 See paragraph 4.8 of CP05/5.

- if a service adds value to customers, then it should be allowed; and
- post-trade analytics can inform trading decisions as well as investment decisions.

2.11 Several respondents argued that analysis of trades by one broker for one manager should be classified as execution but third party services offering analysis of all trades undertaken for an investment manager should be non-permitted.

2.12 Some respondents argued that post-trade analytics encompass a broader range of services than just the software used to analyse execution quality. For example, the results obtained are often used as an input to pre-trade analysis. They suggested that COB 7.18.6G be amended so that software used to analyse execution quality is excluded as a permissible execution good or service, but that other post-trade analytics goods and services are permitted.

2.13 A small number of respondents argued that post-trade analytics should be allowed as research.

Our response: Given the comments by firms, we have reviewed this point further, particularly looking at the nature and extent of recent developments in the market for post-trade analytics products and services. We have noted that there is much product innovation in this market including increasingly complex, sophisticated and diverse products. Our view is that many of the new analytical IT products being developed (which are commonly called 'post-trade analytics') are not 'execution': for example, those products that provide information about the quality of markets generally (e.g., liquidity, market impact, comparisons of the trading of various brokers and the like against different benchmarks).

While acknowledging that many of these services are useful or important to investment managers, we are not persuaded that these are valid reasons for including them in the goods and services which can be acquired with commission. So, we are staying with our existing policy approach. But we do recognise that information about how well a broker conducted a particular transaction or series of transactions for an investment manager could fall within the execution parameter. We also consider that, as many of the vendors of these services are not brokers, it is important to provide equal regulatory treatment as between brokers and third party providers.

Following consideration of these responses on this issue, and because of the rapidly developing market in this area, we have amended the relevant guidance that was set out in CP05/5 (i.e., COB 7.18.6G) to remove the words "... such as software used to analyse execution quality." This amendment is consistent with our policy that the provision of information about how well a broker conducted a particular transaction or series of transactions for an investment manager could be a service within the execution parameter.

As we said in CP05/5[4], to the extent that analytical software meets our criteria for a 'research service', because it assists in the making of investment or trading decisions, it could be classified as such.

Raw data feeds

2.14 In CP05/5[5] we invited comment on whether raw data feeds (i.e., price feeds or historical price data that have not been manipulated or analysed in any way) should be allowed as execution services. Many respondents argued that they should. The main argument given for this is that they help inform execution decisions and help the investment manager to monitor best execution. It was also argued that they are a necessary input to the choices – between venues, brokers and trading mechanisms – that the investment manager makes in delivering best execution. In addition, some respondents said that execution services such as order routing systems are often reliant on the feeds.

2.15 A small number of respondents felt that raw data feeds should be included as research, as they help the making of investment decisions.

Our response: We continue to believe that raw data feeds should not be permitted as research services. Data that has been manipulated into some form of output may be research, as long as the tests set down in our rules are met.

While we accept that raw data feeds play a role in helping firms to achieve best execution, we do not believe that this automatically makes them an execution service that can be paid for with commission. If investment managers choose to pay for a service that they believe assists them fulfil their regulatory obligation of best execution, then they should consider the most appropriate way to do so.

So to the extent that a raw data feed meets our criteria for an 'execution service', it could be classified as such, but investment managers must be able to justify the decision to do so.

Meaning of research

2.16 Some respondents argued that the requirement for 'originality' of research is unnecessary, as it may prevent firms using commission to pay for material which contains a good deal of repackaged information.

2.17 Some respondents questioned why we referred only to making 'investment decisions' in the proposed rules while we said in the CP05/5 text that research could assist in the making of 'investment or trading decisions'.

2.18 Some respondents argued that investment-related seminars and specialist trade journals should be allowed as research services.

4 See paragraph 2.19 of CP05/5.

5 See paragraph 2.21 of CP05/5.

Our response: We continue to believe that 'originality' is an essential component of research which can be purchased with dealing commission. This is because we believe that research should provide new insights. We are seeking to exclude the mere repackaging of existing research. However, it should be noted that we are not seeking to exclude the use of existing material in research; we recognise that new insights can be drawn from existing material. Similarly, research produced by a UK research provider's sister company in another country and then passed on to the UK research provider's customers might be regarded as research – for example, if it was not generally available in this country already.

We have made amendments to COB 7.18.4E(1)(b) and COB 7.18.5E(1)(a) so that the references to 'investment decision' are now 'investment or trading decision'.

On the treatment of items such as investment-related seminars and specialist trade journals, our position stated in CP05/5[6] has not changed.

Scope of rules

2.19 Several respondents asked us to be clearer about the territorial scope of our rules.

Our response: Our rules will apply to investment management activity carried out in the UK. There is no difference between the territorial scope of these rules and the territorial scope of the rest of COB.

Permitted versus non-permitted services

2.20 Some respondents argued that any services not on the non-permitted list should be allowed to be purchased with commission as long as they meet the inducement rule and the investment manager is able to justify the purchase.

Our response: As explained in CP05/5[7], we consider that it is important to set out clearly what types of goods and services cannot be acquired with dealing commission. To do otherwise risks extending the 'permitted services perimeter' too widely and would be contrary to our objectives. Therefore, we are not amending the rules in the way suggested.

While it is the investment manager's responsibility to determine whether any particular service is a 'non-permitted', execution or research service, this needs to be done within the parameters that we have set to ensure consistency of approach among investment managers.

Responsibility of brokers

2.21 Some respondents asked what the responsibilities would be for brokers under COB 7.18. For example, some asked about the record-keeping requirements for decisions made, pursuant to the LIBA Statement of Good Practice, in

6 See paragraph A3.2 of CP05/5.

7 See paragraph 2.10 of CP05/5.

respect of the prior agreement between brokers and investment managers on what rates or amounts the investment manager expects to pay for execution over the coming period. A question was also raised on whether brokers would be held responsible in any way for investment managers' decisions to purchase goods and services with commission.

Our response: The rules in COB 7.18 apply to investment managers and not to brokers. So investment managers, and not brokers, are responsible for the decisions they make on the purchase of goods and services with commission. It should be remembered, however, that all firms are subject to the inducements rule in COB 2.2.3R and Principle for Business 1 which requires a firm to conduct its business with integrity.

In respect of the record-keeping requirements for brokers on the 'prior agreement' referred to above, we have not set any rules on this subject. Importantly, we are looking for a change in the conduct of discussions between brokers and investment managers around an explicit, if indicative, rate(s) for execution. We would expect such an important aspect of the commercial arrangements between brokers and investment managers to be recorded in a way that could, if required, be retrieved and compared to the actual rates or amounts paid for execution.

Cost-benefit analysis

2.22 We received some comments regarding our estimation of costs and benefits in CP05/5.

Our response: We believe that our analysis was sound. Moreover, many in the industry accept that the benefits of the enhanced disclosure approach and the tightening of the perimeter of acceptable services that can be purchased with commission is reasonable and preferable to the CP176 proposals.

VAT

2.23 Some respondents asked for more clarity on the VAT position: that is, whether making the split of commission spend between execution and research services more transparent might inadvertently lead to increased VAT being paid.

Our response: HM Revenue & Customs have confirmed that the VAT liability of brokerage services will remain unchanged following the introduction of the new

Retail fund governance

2.24 As stated in CP05/5[8], we are considering what further steps may be appropriate to help ensure that the enhanced disclosure regime brings benefit to investors in retail funds. We note the helpful recommendations in the IMA's review of fund governance about disclosure of dealing commission arrangements to trustees of unit trusts and depositaries of ICVCs. We will consider these, as well as arrangements for other retail fund structures. As stated in our Business Plan, we intend to publish proposals for consultation in the third quarter of 2005.

International co-operation

2.25 As mentioned in CP05/5[9], the US Securities and Exchange Commission (SEC) has established an internal task force, which is currently carrying out a review of 'soft dollar' arrangements. We continue to have discussions with the SEC staff on issues connected with dealing commission and continue to believe that they are looking at outcomes not dissimilar to our own. As we have stated previously, we do not think that implementation of the UK solution is dependent on publication of any SEC proposals for change in US requirements.

Interaction with the Markets in Financial Instruments Directive (MiFID)

2.26 We explained in CP05/5[10] the potential interaction between our proposed rules on soft commission and bundled brokerage arrangements and the requirements of MiFID, including the evolving Level 2 measures. We remain satisfied that our rules are consistent with the MiFID requirements including advice provided to the Commission by CESR[11] on Level 2 measures.

Performance indicators

2.27 We mentioned in CP05/5[12] that we are planning to develop measures to review the effect and impact of these proposals on industry practice. We will work closely with the IMA, NAPF and LIBA in taking this forward and we will be meeting them in the fourth quarter of 2005 to discuss our and their plans.

2.28 We intend to include in the FSA Business Plan for 2006/07 plans for performance assessment measures to assess whether our rules and the industry-led solution for enhanced disclosure have met our objectives. In the shorter term, our focus will be on securing changes to current practices as the new measures are introduced.

Changes to rules

2.29 The rules to be made do not differ significantly from the draft instrument in CP05/5.

8 See paragraph 4.2 of CP05/5.

9 See paragraph 4.3 of CP05/5.

10 See paragraph 4.4 of CP05/5.

11 'CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments: 1st Set of Mandates', The Committee of European Securities Regulators, January 2005.

12 See paragraph 4.9 of CP05/5.

Annex 1

List of non-confidential respondents to Consultation Paper 05/5

Aberdeen Asset Managers Ltd

Alternative Investment Management Association Limited (AIMA)

Association of British Insurers (ABI)

Association of Private Client Investment Managers and Stockbrokers (APCIMS)

Barclays Global Investors Ltd

Baring Asset Management

Beauchamp Financial Technology Ltd

Bloomberg L.P

BNY Securities Group

Brewin Dolphin Securities Limited

CFA Institute

Clear Capital

Duncan Lawrie Limited

Eden Group plc

Elkins/McSherry LLC

Ernst & Young

F&C Asset Management plc

FerFin

Fidelity International

Goldman Sachs Asset Management International

Goldman Sachs International

GSCS Information Services

Henderson Global Investors

Hermes Pensions Management Ltd

Independent Minds Ltd

Insight Investment Management (Global) Limited

Invesco Perpetual

Investment Adviser Association

Investment Management Association (IMA)

ITG Europe

Legal & General Investment Management Ltd

London Investment Banking Association (LIBA)

M&G Investment Management Limited

Martin Currie Investment Management Limited

Morley Fund Management

National Association of Pension Funds (NAPF)

National Consumer Federation

Pictet Asset Management UK Limited

RCM (UK) Ltd

Reuters Ltd

Schroder Investment Management Limited

Securities Industry Association

Standard Life Investments

Swisscanto Funds Centre Limited

T. Rowe Price

The Alliance in Support of Independent Research

The Quoted Companies Alliance

Threadneedle Asset Management Ltd

UBS Investment Bank

Universities Superannuation Scheme Limited

Virt-x Exchange Limited

Zurich Financial Services

Appendix 1

Final Handbook text

CONDUCT OF BUSINESS SOURCEBOOK (USE OF DEALING COMMISSION) INSTRUMENT 2005

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions:

(1) the following sections of the Financial Services and Markets Act 2000 ("the Act"):
- (a) section 138 (General rule-making power);
- (b) section 140 (Restriction on managers of authorised unit trust schemes);
- (c) section 156 (General supplementary powers);
- (d) section 157(1) (Guidance);
- (e) section 242 (Applications for authorisation of unit trust schemes);
- (f) section 247 (Trust schemes rules); and
- (g) section 248 (Scheme particulars rules); and

(2) regulation 6 (FSA rules) of the Open-Ended Investment Companies Regulations (SI 2001/1228).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force as follows:

(1) changes to the Handbook text placed in bold square brackets, irrespective of whether the change takes the form of additional text or deletion of text, come into force on 1 July 2006;

(2) otherwise, the instrument comes into force on 1 January 2006.

Amendments to the Handbook

D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Conduct of Business sourcebook (COB)	Annex B
Market Conduct sourcebook (MAR)	Annex C

Citation

E. This instrument may be cited as the Conduct of Business Sourcebook (Use of Dealing Commission) Instrument 2005.

By order of the Board
21 July 2005

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text. Further, in this Annex, changes to Handbook text placed in bold square brackets, irrespective of whether the change takes the form of insertion of additional text or deletion of text, come into force on 1 July 2006. Otherwise, this Annex comes into force on 1 January 2006.

The following amendment comes into force on 1 January 2006:

…

material interest	(in *COB*) (in relation to a transaction) any interest of a material nature, other than: (a) disclosable *commission* on the transaction; (b) goods or services which can reasonably by expected to assist in carrying on *designated investment business* with or for *clients* and which are provided or to be provided under a *soft commission agreement* or in compliance with *COB* 7.18.3R (Use of dealing commission to purchase goods or services).

The following amendments, taking account of the above amendment to the definition of 'material interest', come into force on 1 July 2006:

material interest	(in *COB*) (in relation to a transaction) any interest of a material nature, other than: (a) disclosable *commission* on the transaction; (b) goods or services which can reasonably by expected to assist in carrying on *designated investment business* with or for *clients* and which are provided or to be provided **[**~~under a *soft commission agreement* or~~**]** in compliance with *COB* 7.18.3R (Use of dealing commission to purchase goods or services).

…

[~~*soft commission agreement*~~	~~an agreement in any form under which a *firm* receives goods or services in return for *designated investment business* put through or in the way of another person.~~**]**

…

Annex B

Amendments to the Conduct of Business sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text. Where entire sections of text are being deleted or inserted, the place where the change will be made is indicated and the text is not struck through or underlined.
Further, in this Annex, changes to Handbook text placed in bold square brackets, irrespective of whether the change takes the form of insertion of additional text or deletion of text, come into force on 1 July 2006. Otherwise, this Annex comes into force on 1 January 2006.

1.3.5 G …

(3) offering, giving, soliciting or accepting inducements for the purpose of or in connection with activities falling within the scope of *COB* 2.2 (Inducements **[**~~and soft commission~~**]**) will apply in this context;

…

1.6.2 R Table Provisions of COB applied to stock lending activity.
This table belongs to *COB* 1.6.1R

COB	Subject
…	
2.2	Inducements **[**~~and soft commission~~**]**
…	

…

1.6.4 R Table Provisions of COB applied to corporate finance business
This table belongs to COB 1.6.3R

COB	Subject
…	
2.2	Inducements **[**~~and soft commission~~**]**
…	

...

2.2 Inducements **[**~~and soft commission~~**]**

…

The following provisions, COB 2.2.8R to COB 2.2.19R are deleted in their entirety; the text is not struck through.

COB 2.2.8R to COB 2.2.19R [deleted]

…

Record keeping

2.2.20 R (1) **[**~~A *firm* must make records of the reports sent to its *customers* as required by *COB* 2.2.18R and retain those records for at least three years from the date on which the *soft commission agreement* to which they relate is terminated.~~ [deleted]**]**

(2) A *firm* must [illegible]

5.10.2 G … It also supplements other provisions in the *Handbook* (see, in particular, *COB* 2.2 (Inducements **[**~~and soft commission~~**]**), *COB* 7.1 (Conflict of interest and material interest) and *COB* 7.16 (Investment research).

…

5.10.5 G …

(5) having internal arrangements under which allocation recommendations are not determined by the level of business which a *firm* does or hopes to do with any other *client* (see also *COB* 2.2 (Inducements **[**~~and soft commission~~**]**); for example:

…

After COB 7.17, insert the following new section, COB 7.18, which is not underlined:

7.18 Use of dealing commission

Application

7.18.1 R (1) This section applies to a *firm* that acts as an *investment manager* when it *executes customer orders* that relate to the *designated investments* specified in (2).

(2) The *designated investments* for the purposes of (1) are:

(a) *shares*; and

(b) (i) *warrants*;

(ii) *certificates representing certain securities*;

(iii) *options*; and

(iv) *rights to or interests in investments* of the nature referred to in (i) to (iii);

to the extent that they relate to *shares*.

Purpose

7.18.2 G *Principle* 1 (Integrity) requires a *firm* to conduct its business with integrity. *Principle* 6 (Customers' interests) requires a *firm* to pay due regard to the interests of its *customers* and treat them fairly. *Principle* 8 (Conflicts of interest) requires a *firm* to manage conflicts of interest fairly, both between itself and its *customers* and between a *customer* and another *client.* The purpose of this section is to ensure that an *investment manager's* arrangements in relation to dealing commissions are transparent and demonstrate accountability to *customers* where *commissions* are spent in acquiring services in addition to *execution*, and consequently that *customers* are treated fairly.

Use of dealing commission to purchase goods or services

7.18.3 R (1) An *investment manager* must not *execute customer orders* under arrangements coming within (2), unless the conditions in (3) are satisfied.

(2) The arrangements referred to in (1) are that the *investment manager*:

(a) *executes* its *customer orders* through a broker or another *person*;

(b) passes on the broker's or other *person's charges* (whether *commission* or otherwise) to its *customers*; and

(c) in return for the *charges* referred to in (b), receives goods or services in addition to the *execution* of its *customer orders*.

(3) The conditions referred to in (1) are that the *investment manager* has reasonable grounds to be satisfied that the goods or services in (2)(c):

(a) (i) are related to the *execution* of trades on behalf of the *investment manager's customers*; or

(ii) comprise the provision of research; and

(b) will reasonably assist the *investment manager* in the provision of its services to its *customers* on whose behalf the orders are being *executed* and do not, and are not likely to, impair compliance with the duty of the *investment manager* to act in the best interests of its *customers*.

7.18.4 E (1) Where the goods or services relate to the *execution* of trades, an *investment manager* should have reasonable grounds to be satisfied that the requirements of *COB* 7.18.3R are met if the goods or services are:

(a) linked to the arranging and conclusion of a specific investment transaction (or series of related transactions); and

(b) provided between the point at which the *investment manager* makes an investment or trading decision and the point at which the investment transaction (or series of related transactions) is concluded.

(2) Compliance with (1) may be relied upon as tending to establish compliance with *COB* 7.18.3R.

7.18.5 E (1) Where the goods or services relate to the provision of research, an *investment manager* will have reasonable grounds to be satisfied that the requirements of *COB* 7.18.3R are met if the research:

(a) is capable of adding value to the investment or trading decisions by providing new insights that inform the *investment manager* when making such decisions about its *customers'* portfolios;

(b) whatever form its output takes, represents original thought, in the critical and careful consideration and assessment of new and existing facts, and does not merely repeat or repackage what has been presented before;

(c) has intellectual rigour and does not merely state what is commonplace or self-evident; and

(d) involves analysis or manipulation of data to reach meaningful conclusions.

(2) Compliance with (1) may be relied upon as tending to establish compliance with *COB* 7.18.3R.

7.18.6 G An example of goods or services relating to the *execution* of trades that the *FSA* does not regard as meeting the requirements of *COB* 7.18.4E(1) is post-trade analytics.

7.18.7 G Examples of goods or services that relate to the provision of research that the *FSA* do not regard as meeting the requirements of *COB* 7.18.5E(1) include price feeds or historical price data that have not been analysed or manipulated to reach meaningful conclusions.

7.18.8 G Examples of goods or services that relate to the *execution* of trades or the provision of research that the *FSA* do not regard as meeting the requirements of either *COB* 7.18.4E(1) or *COB* 7.18.5E(1) include:

(a) services relating to the valuation or performance measurement of portfolios;

(b) computer hardware;

(c) dedicated telephone lines;

(d) seminar fees;

(e) subscriptions for publications;

(f) travel, accommodation or entertainment costs;

(g) office administrative computer software, such as word processing or accounting programmes;

(h) membership fees to professional associations;

(i) purchase or rental of standard office equipment or ancillary facilities;

(j) employees' salaries;

(k) direct money payments;

(l) publicly available information; and

(m) *custody* services relating to *designated investments* belonging to, or managed for, *customers* other than those services that are incidental to the *execution* of trades.

7.18.9 G The reference to research in *COB* 7.18.3R(3)(a)(ii) is not confined to *investment research* as defined in the *Glossary*. The *FSA's* view is that research can include, for example, the goods or services encompassed by *investment research*, provided that they are directly relevant to and are used to assist in the management of *investments* on behalf of *customers*. In addition, any goods or services that relate to the provision of research that the *FSA* regards as not acceptable under *COB* 7.18.7G or *COB* 7.18.8G should be viewed as not meeting the requirements of *COB* 7.18.3R(3), notwithstanding that their content might qualify as *investment research*.

7.18.10 G This section applies only to arrangements under which an *investment manager* receives from brokers or other *persons* goods or services that relate to the *execution* of trades or the provision of research. It has no application in relation to *execution* and research generated internally by an *investment manager* itself.

7.18.11 G An *investment manager* should not enter into any arrangements that could compromise its ability to comply with its best execution obligations under *COB* 7.5 (Best execution).

Prior and periodic disclosure

7.18.12 R (1) If an *investment manager* enters into arrangements for the receipt of goods or services that relate to the *execution* of trades or the provision of research in accordance with *COB* 7.18.3R (Use of dealing commission to purchase goods or services), it must in a timely manner make adequate:

(a) prior disclosure; and

(b) periodic disclosure;

to its *customers* of the arrangements entered into.

(2) The adequate disclosure in (1) must include details of the goods or services that relate to the *execution* of trades and, wherever appropriate, separately identify the details of the goods or services that are attributable to the provision of research.

Making prior and periodic disclosure in a timely manner

7.18.13 E (1) For the purposes of *COB* 7.18.12R, a *firm* should make prior and periodic disclosure to its *customers* in accordance with the requirements of this *rule*.

(2) For a new *customer*, the *firm* should make the prior disclosure before it conducts any *designated investment business* for him.

(3) For an existing *customer*, the *firm* should make the prior disclosure by the earlier of:

(a) 1 July 2006; and

(b) the date that the *firm* makes its first periodic disclosure to its *customers* in accordance with *COB* 7.18.12R.

(4) A *firm* will make periodic disclosure to its *customers* in a timely manner if it is made at least once a year.

(5) Compliance with (1) to (4) may be relied upon as tending to establish compliance with *COB* 7.18.12R(1).

7.18.14 G (1) The prior disclosure required by *COB* 7.18.12R(1) should include an adequate disclosure of the *firm's* policy relating to the receipt of goods or services that relate to the *execution* of trades or the provision of research in accordance with *COB* 7.18.3R (Use of dealing commission to purchase goods or services). The prior disclosure should explain generally why the *firm* might find it necessary or desirable to use dealing commission to purchase goods or services, bearing in mind the practices in the markets in which it does business on behalf of its *customers*. While the appropriate method of making such a disclosure is for the *firm* to decide, this could, for example, be achieved by a change to its *terms of business*.

(2) In assessing the adequacy of disclosures made by an *investment manager* under *COB* 7.18.12R, the *FSA* will have regard to the extent to which *investment managers* adopt disclosure standards developed by industry associations such as the Investment Management Association, the National Association of Pension Funds and the London Investment Banking Association.

Prohibition of inducements

7.18.15 R *COB* 2.2.3R (Prohibition of inducements) does not apply to an *investment manager* that complies with the requirements of this section in receiving goods or services in accordance with *COB* 7.18.3R (Use of dealing commission to purchase goods or services).

Record keeping

7.18.16 R An *investment manager* must make a record of each periodic disclosure it makes to its *customers* in accordance with *COB* 7.18.12R and must maintain each such record for at least five years from the date on which it is provided.

…

10.2.5 R Application of conduct of business rules

This table belongs to *COB* 10.2.1R

Application of conduct of business rules		
Chapter, Section or Rule	Description	Modifications
…		
2.2	Inducements **[**~~and soft commission~~**]**	**[**~~In the case of a *regulated collective investment scheme*, *COB* 2.2.8R(5) and *COB* 2.2.16R to *COB* 2.2.19R do not apply~~**]**
…		
7.18	Use of dealing commission	
…		

…

10.6.8 E Content of scheme documents

This table belongs to *COB* 10.6.7E

Content of scheme documents		
…		
(16)	**[**~~Use of soft commission agreements~~ ~~if the *operator* is to be authorised under the agreement or *instrument constituting the scheme* to effect transactions with or through the agency of another *person* with whom the *operator* has a *soft commission agreement*, the prior disclosure required by *COB* 2.2.16R;~~**]** Use of dealing commission if the *operator* receives goods or services in addition to the *execution* of its *customer orders* in accordance with *COB* 7.18 (Use of dealing	

	commission), the prior disclosure required by *COB* 7.18.12R (Prior and periodic disclosure).
…	

…

11.4.3 R Rules applicable to depositaries

This table belongs to COB 11.4.1R

Chapter	Description	Modifications
…		
2.1 to 2.4	Rules which apply to all firms	**[**~~*COB* 2.2.8R – *COB* 2.2.20R do~~ *COB* 2.2.20R does**]** not apply. …
…		

…

11.5.2 R Rules applicable to trustee firms which are not depositaries and to which COB 11.5.1R (1) applies

This table belongs to *COB* 11.5.1R (1).

Chapter	Description	Modifications
… 2.2 … 7.18 …	Inducements **[**~~and soft commission~~**]** Use of dealing commission	"Customer" means "trustee" or "trust" as appropriate “Customer” means “trustee” or “trust” as appropriate

11.5.3 R Rules applicable to trustee firms which are not depositaries and to which COB 11.5.1R(2) applies

This table belongs to *COB* 11.5.1R(2).

Chapter	Description	Modifications
… 2.2 **…** 7.18	Inducements **[**~~and soft commission~~**]** Use of dealing commission	"Customer" means "trustee" or "trust" as appropriate. “Customer” means “trustee” or

…		"trust" as appropriate.

COB TP 1.2 COB TR1 Transitional Rules for pre-N2 and ex-Section 43 firms at N2

1 Table

(1)	(2) Material to which the transitional provision applies: The *COB* provisions in Table COB ~~TR 2~~ TP 1.3 with the labels indicated	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
…					
3.2	*TSP2*	R	Terms of business and client agreements (1) Subject to (2) and (3), a *pre-N2 firm* will not contravene any of the provisions in Table *COB TP1.3* labelled *TSP2* to the extent that, on or after *commencement*, it is able to demonstrate that it has continued to use, or rely upon, *terms of business* (including a *client agreement*), **[**~~or a *soft commission agreement*~~**]** given to, or made with, a *client* before the end of the transitional period in accordance with the corresponding rule	indefinitely	*commencement*

			of its *previous regulator.*		

…

COB TP1.3 COB TR 2 Rules benefiting from transitional relief (pre-N2 and ex-Section 43 firms)
This Table belongs to *COB* TP 1.2

COB Rule	Rule Heading	Label ETP TSP	
		ETP	TSP
…			
[~~2.2~~	~~Inducements and soft commission~~		~~TSP2~~
~~2.2.8R~~	~~Requirements when using a soft commission agreement~~	~~ETP1~~	
~~2.2.12R~~	~~Allowable benefits provided under soft commission agreement~~	~~ETP1~~	
~~2.2.16R~~	~~Prior disclosure~~	~~ETP1~~**]**	

…

COB TP 4 Miscellaneous transitional rules applying to all firms
COB TP4.4

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
...					
17	*COB* 7.18.1R to *COB* 7.18.16R	R	Use of dealing commission In relation to any *soft commission agreement* an *investment manager* may have on 1 January 2006, the *manager* may comply with the *rules* in *COB* 2.2.8R to *COB* 2.2.20R(1) (instead of the *rules* specified in column (2)) until:	From 1 January 2006 to 30 June 2006	1 January 2006

			(1) the date of the expiry of that *agreement*; or (2) if earlier, 30 June 2006.		

…

COB Sch. 1.3 G

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
[~~COB 2.2.20R(1)~~	~~Periodic reports~~	~~Details of soft commission agreements~~	~~Date of periodic statement~~	~~3 years (from termination of relevant soft commission agreement)~~**]**
…				
COB 7.18.16R	Periodic disclosure of arrangements entered into	Details of the receipt of appropriate execution or research goods and services	Date of provision of disclosure	5 years (from when the disclosure is provided)
…				

Annex C

Amendment to the Market Conduct sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text. Further, in this Annex, changes to Handbook text placed in bold square brackets, irrespective of whether the change takes the form of insertion of additional text or deletion of text, come into force on 1 July 2006. Otherwise, this Annex comes into force on 1 January 2006.

3.4.14	G	A *firm* should take reasonable steps to ensure that it, or any *person* acting on its behalf, does not offer, give, solicit or accept an inducement if it is likely to conflict to a material extent with any duty which a recipient *firm* owes to another *person*. Inducement can include entertainment **[**~~and soft commissions~~**]**.
3.4.15	G	If a *firm* gives an inducement and the recipient, although a *market counterparty*, is acting on behalf of *customers*, the *firm* may be subject to the provisions of *COB* 2.2 (Inducements **[**~~and soft commission~~**]**).

…

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