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Financial Services Authority

**Bundled brokerage  
and soft commission  
arrangements:  
proposed rules**

March 2005





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This Consultation Paper sets out draft rules to give effect to the policy decisions published in Policy Statements 04/13 and 04/23 on bundled brokerage and soft commission arrangements.

We invite comments on this Consultation Paper by **31 May 2005**.

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# 1 Overview

## Introduction

- 1.1 In April 2003, we published Consultation Paper 176 ‘Bundled brokerage and soft commission arrangements’ (CP176). In that paper, we concluded that the use of soft commission and bundled brokerage arrangements resulted in incentive misalignments between investment managers and their clients – that is, conflicts of interest. This is due to the opaque nature of the arrangements under which investment managers make direct charges to the funds they manage, by way of dealing commission, to purchase goods and services in addition to execution. The lack of transparency and accountability mechanisms in the relationship between brokers and investment managers also makes it difficult for customers to judge whether their interests are being well served by their investment manager. Consequently, this meant market controls were weak.
- 1.2 Subsequently, we have refined and developed our thinking on these issues and we set out our proposed policy approach in two Policy Statements: Policy Statement 04/13 ‘Bundled brokerage and soft commission arrangements: Feedback on CP176’ (PS04/13) and ‘Bundled brokerage and soft commission arrangements: Update on issues arising from PS04/13’ (PS04/23).
- 1.3 We are now in a position to issue proposed rules addressing our concerns with soft commission and bundled brokerage arrangements. As we explained in PS04/13 and PS04/23, the industry has also been allowed space to tackle the identified lack of transparency and accountability. It has done this through developing an industry-led solution based on an enhanced disclosure regime. We are satisfied that the industry proposals (as explained in the second and third bullet points below in paragraph 1.4) provide credible means of addressing these problems.
- 1.4 Our proposed 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 these 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 a more level playing field in the production of research, whether within investment banks or by third parties.

1.5 We are confident that these measures will address the lack of transparency and associated accountability identified in CP176 and lead to improved management of conflicts of interest. They also demonstrate our intent to work, where possible, with the grain of the market in arriving at solutions to issues affecting firms and investors, particularly those in wholesale and institutional markets. Our approach of facilitating the development of an industry-led solution to a market failure is an example of successful partnership with the wholesale industry.

1.6 In the coming months, we will be working closely with the industry to develop measures to test whether the combination of our rules and the industry's solution will deliver our outcomes.

### **Summary of paper**

1.7 In this paper, we:

- summarise our proposals in PS04/23, the tenor of responses to PS04/23 and comment on the major issues raised by these responses (see Chapter 2);
- present proposed rules and guidance to give effect to our policy objectives (see Chapter 3); and
- discuss related issues and present our next steps on this project (see Chapter 4).

### **Who should read this paper?**

1.8 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.

1.9 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.

## **Next steps**

- 1.10 We invite comments on this paper by 31 May 2005. Following consultation, we plan to make final rules in the third quarter of 2005.

### **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 Consultation Paper. 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 with a third party.





# 2 Summary of proposals from – and feedback to – Policy statement 04/23

## Introduction and purpose

- 2.1 In May 2004, we published Policy Statement 04/13 ‘Bundled brokerage and soft commission arrangements: Feedback on CP176’ (PS04/13). In this, we set out our assessment of the responses to Consultation Paper 176 ‘Bundled brokerage and soft commission arrangements’ (CP176), together with key policy decisions. We concluded that our analysis of the potential for incentive misalignments and conflicts of interest to arise from these arrangements was basically sound. There was a general consensus that improvements in transparency and accountability were desirable, but we recognised that there were potential alternatives to our ‘rebate’ proposal in CP176<sup>1</sup> that could deliver this.
- 2.2 To address the concerns outlined in CP176, we concluded that we should limit investment managers’ use of dealing commission to the purchase of ‘execution’ and ‘research’. We were also persuaded to allow the industry space to tackle the lack of transparency and accountability, through the development of an industry-led solution based on an enhanced disclosure regime. In November 2004, we published Policy Statement 04/23 ‘Bundled brokerage and soft commission arrangements: Update on issues arising from PS04/13’ (PS04/23). In that paper, we set out our conclusions on the scope of the terms ‘execution’ and ‘research’, and the types of goods and services that should not be considered part of either and invited comments from interested stakeholders.
- 2.3 We also commented on the progress made by the industry in developing its approach to improved transparency and accountability, led by the Investment Management Association (IMA) and involving the National Association of Pension Funds (NAPF) and the London Investment Banking Association (LIBA). The objectives of this approach are to give investment management clients sufficiently meaningful information about the costs to them of

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<sup>1</sup> That is, that investment managers be required to value goods and services that can be softed or bundled and rebate an equivalent amount to their clients’ funds – see paragraphs 4.13 – 4.20 of CP176.

execution and research and to encourage the development of new payment and pricing mechanisms. We acknowledged that giving our views on what is ‘execution’ and ‘research’ would contribute to the development of this approach.

- 2.4 In PS04/23, we canvassed a number of related issues which would provide additional clarity to market developments. These included:
- the implications of our policy decisions for use of the term ‘soft commission’;
  - the standing of commission-sharing arrangements;
  - the scope of application of the revised regulatory regime and the industry’s disclosure proposals; and
  - an update on work underway on the governance of retail funds and on international co-operation.

### **Summary of proposals in PS04/23**

- 2.5 In PS04/23 we said that the use of dealing commission should be limited to the purchase of execution and research goods and services. This involves narrowing the range of services for which this is currently an appropriate payment mechanism under our existing soft commission regime<sup>2</sup>. This would set an ‘outer perimeter’, between ‘non-permitted’ goods and services on the one hand and execution and research services on the other.
- 2.6 In this chapter, we set out our response to the more significant comments expressed on our proposals set out in PS04/23 (NB: a summary of other comments and our response to them is at Annex 3). Of the 45 responses we received, the majority came from investment managers. We have included a list of non-confidential respondents in Annex 1. In addition, we have had a number of meetings with trade associations and firms since the publication of PS04/23 and have considered the views and comments made.
- 2.7 The vast majority of respondents agreed with our general approach to meeting our objective that investment managers should have better incentives to make efficient decisions about the purchase of trade execution and other services such as investment research. Most respondents also agreed with our thinking behind the meaning of non-permitted services, execution and research. Some respondents sought clarification, or disagreed with the perceived treatment of particular services. Comments on whether a particular service should be treated as a non-permitted service, an execution service or a research service, have been taken together.

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2 See COB 2.2.8R – COB 2.2.20R(1).

2.8 After considering the responses to PS04/23, we are satisfied that our general approach to limiting investment managers' use of dealing commission to the purchase of 'execution' and 'research' is sound. However, we are aware that further clarification of whether certain services should be classed as non-permitted services, execution or research would be useful and we have done this – either in this Consultation Paper or in the proposed rules.

### **Meaning of 'non-permitted services'**

2.9 In PS04/23<sup>3</sup>, we stated that all those goods and services we currently regard as outside our soft commission regime<sup>4</sup>, as well as some of those currently regarded as inside it<sup>5</sup>, should be classified as 'non-permitted services', mainly because they are not sufficiently connected with particular investment management decisions or transactions to be classified as execution or research goods and services. These included:

- services relating to the valuation or performance measurement of portfolios;
- computer hardware;
- dedicated telephone lines;
- seminar fees;
- subscriptions for publications;
- travel, accommodation or entertainment costs;
- office administrative computer software – for example, word processing or accounting programmes;
- membership fees to professional associations;
- purchase or rental of standard office equipment or ancillary facilities;
- employees' salaries; and
- direct money payments.

2.10 Many respondents agreed with our general approach. Some respondents commented that instead of distinguishing between non-permitted services, execution services and research services, we should instead set a distinction between non-permitted services and permitted services. One respondent suggested that we should allow investment managers to decide what services should be non-permitted services.

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3 See paragraphs 2.11 – 2.12 of PS04/23.

4 See COB 2.2.14G.

5 See COB 2.2.12R(4) and COB 2.2.13G(5)-(8).

**Our response:** 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.

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.

### *The scope of ‘execution’*

- 2.11 In PS04/23<sup>6</sup>, we said that we view ‘execution’ as consisting of services provided by a broker (or other execution venue) that meet two criteria:
- they are demonstrably linked to the arranging and conclusion of a specific transaction (or series of related transactions); and
  - they arise between the point at which the investment manager makes an investment decision and the point at which the transaction is concluded.
- 2.12 We said that the essential components of an execution service that may be recovered through commission charges include booking and processing of orders, and related costs arising directly from trading. In addition, a broker may provide active order management, carrying out programme trades and other complex trading strategies, and ‘working’ orders in tranches to minimise market impact costs. A broker may also choose to facilitate client orders by trading as principal.
- 2.13 We also discussed our thinking on how a number of services could be treated – including sales and trading advice, post-trade analytics, custody services, and clearing and settlement services. We acknowledged that there was scope for debate as to whether some services could be treated as execution.
- 2.14 We said that sales and trading advice could be an execution service if it could be attributed to a specific transaction (or transactions) after the point at which the investment manager makes an investment decision.
- 2.15 We also said that clearing and settlement services such as netting of positions to reduce costs, corresponding with sub-custodians on specific trades, and resolving and reporting failed trades, are all relevant to execution and could be included as an execution service. Where clearing and settlement – including any essential though temporary ‘safekeeping’ function – is an essential part of the broker’s service, we agree it should be considered part of execution.
- 2.16 Most respondents agreed with our general approach but several respondents either requested clarification on the treatment of certain services or commented that certain services should be classified as being execution services.

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6 See paragraphs 2.13 – 2.21 of PS04/23.

- 2.17 The issue that attracted most comment was the treatment of post-trade analytics. In PS04/23<sup>7</sup>, we said we would not generally expect to see this type of service classified as execution. Several respondents agreed with this view.
- 2.18 However, a number of respondents argued that post-trade analytical software should be allowed to be classified as an execution service as it facilitates best execution and it helps determine whether client objectives have been met. In addition, some respondents felt that we had classified post-trade analytics as a non-permitted service while others thought that it could be allowed as research.
- 2.19 Some respondents commented that post-trade analytics should not be treated as non-permitted services or that it should be counted as research.

**Our response:** We acknowledge that post-trade analytical software can assist in assessing whether best execution has been achieved, and may have considerable value to fund managers for that reason. However, we are not convinced that it forms part of execution. Value to investment managers is not a good reason for allowing something to be paid for by way of commission.

To the extent that analytical software meets our criteria of a 'research service' because it assists in the making of investment or trading decisions, it could be classified as such. In PS04/23 we did not say that post-trade analytics were definitely a non-permitted service, although they may well be classified as such depending on how they are used.

- 2.20 Clarity was requested on how market pricing and information services should be treated.

**Our response:** Market pricing and information services often contain a number of different components. Some of these components could meet our meaning of execution, some might meet our meaning of research and some might be classed as non-permitted services. Because of the diversity of these systems and their usage, we do not believe it would be helpful or appropriate for us to state what category they, or part of them, fall into. The principles under which services may be classified as research or execution are clear. We expect investment managers to determine whether particular goods and services they propose to acquire with commission are permitted services within the guidelines set by us and, if so, to disclose the costs of them. We also expect investment managers to be able to justify this decision if asked by their clients or by us.

- 2.21 Investment manager respondents made a number of comments on these proposals; for example:
- raw data feeds are used to determine best prices and should therefore be considered part of execution;

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7 See paragraph 2.16 of PS04/23.

- raw data feeds should be permitted as research services as they are necessary to make informed decisions;
- one respondent said that raw data feeds should not be counted as research; and
- some also argued that raw data that has been manipulated or which can be manipulated into research should be permitted.

**Our response:** In PS04/23, we indicated that research should not embrace raw data feeds<sup>8</sup>. We were referring to price feeds or historical price data that have not been manipulated or analysed in any way. 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.

On the issue of whether raw data feeds could be included as an execution service, we welcome comments on this as part of our consultation.

### *The scope of ‘research’*

- 2.22 On the meaning of the term ‘research’, in PS04/23<sup>9</sup> we said that such services should be capable of adding value by providing new insights that inform investment managers when making investment decisions about their clients’ portfolios. That is, the output (in whatever form):
- represents original thought – that is, the critical and careful consideration and assessment of new and existing facts – and does not merely repeat or repackage what has been presented before;
  - it has intellectual rigour and does not merely state what is commonplace or self-evident; and
  - it involves analysis or manipulation of data to reach meaningful conclusions.
- 2.23 We also discussed our preliminary views about a number of services – including sales and trading advice, data feeds and publicly available information. We acknowledged that it was arguable whether some services could be treated as research services.
- 2.24 We said that we consider that original written research, whether produced by analysts working for brokers or by independent providers, is likely to meet our proposed criteria. We would also expect discussions between the investment manager and the author of the research to be covered, provided that this discussion relates to the research.
- 2.25 We also said that original analysis and meaningful conclusions on investment decisions can be computer-generated (for example, where it is clear the design of the electronic process captures original intellectual ideas which determine the research product). In addition, we said that sales and trading advice that is

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8 See paragraph 2.24 of PS04/23.

9 See paragraphs 2.22 – 2.25 of PS04/23.

not explicitly execution-related might also be included as a research service, where the advice meets our proposed criteria.

2.26 Most respondents agreed with our general approach. However, several respondents either requested clarification on the treatment of certain services or argued that certain services should be classified as research services.

2.27 Some respondents argued that research can take many forms, including discussions between people. Some respondents asked whether we had said that only analyst research is acceptable, as opposed to research generated by investment managers. Another asked whether the distribution of third-party research would be permitted as a research service, when the original research has been added to in some way.

**Our response:** We did not specify in what form research needs to be given, as long as it meets the criteria set by our proposed rules. We also said we would expect discussions between the investment manager and the author of the research to be covered<sup>10</sup>.

2.28 Many respondents agree with us that original thought is vital to the concept of research. Only one respondent commented that the need for intellectual rigour and original thought is too subjective.

**Our response:** We believe that the need for original thought is essential to the concept of research and are not minded to change our position.

### *Improving transparency and accountability*

2.29 The vast majority of respondents expressed agreement with our approach and support for the market-led solution. One respondent said it may be less effective than the ‘rebate proposal’ from CP176<sup>11</sup> in addressing the concerns expressed in CP176 but it would have fewer unintended consequences.

2.30 There were, however, several respondents who commented on the scope of this regime. There were several aspects to this. One respondent argued that the IMA Disclosure Code was too detailed for retail clients. Another argued that managers of hedge funds should not have to comply with any disclosure regime because, unlike those dealing with pension fund interests, the clients in hedge funds are sophisticated investors and they are often based overseas. In addition, the respondent argued that existing disclosure to hedge fund clients is adequate. Other respondents were of the view that all investment managers should be treated the same, regardless of their size and for whom they act.

**Our response:** We believe that the issues being addressed by our proposed rules are wider than pension funds and that all clients of investment managers should receive information as to how dealing commission is being used on their behalf. We note these concerns that the IMA Disclosure Code may not be suitable for all

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10 See paragraph 2.23 of PS04/23.

11 See paragraphs 4.13– 4.20 of CP176.



investment managers and their clients. Our proposed rules, therefore, have been drafted at the level of principle which, while giving due prominence to the IMA Disclosure Code, provides sufficient flexibility for investment managers to determine the most appropriate means of compliance.

The IMA Disclosure Code is an industry-led initiative and we have not made compliance with it a regulatory requirement. Our proposed rules reflect our confidence in it and make it clear that compliance with it is an acceptable (although not necessarily the only) form of disclosure.

We expect investment managers to respond positively to requests from clients for disclosure in the form prescribed by the IMA Disclosure Code. Investment managers not using this form should be able to demonstrate why they believe that the level and content of disclosure to their clients is sufficient and appropriate.

- 2.31 Several respondents expressed concern that by making the split of commission spend between execution and research services more transparent, that this might inadvertently lead to increased VAT being paid.

**Our response:** HM Customs & Excise (Customs) are currently reviewing the new disclosure requirements to ascertain whether this creates any change to the liability of brokerage services. Early indications are that, as the rules focus on the disclosure between a fund manager and client, it is unlikely the VAT treatment would change. We anticipate Customs will confirm their position in due course.

- 2.32 It was argued that comparisons between clients with the same strategy would be a better approach than the industry's comparative disclosure regime.

**Our response:** We view this as a matter for the industry to consider in developing their market-led solution. If investment managers believe this information would be useful for clients, and as long as our rules are met, then they are free to provide such information. This may also be an area of the IMA Disclosure Code that may be reviewed and refined in the light of experience.

- 2.33 Some respondents said that requiring increased disclosure could increase transaction costs, especially for clients and small firms.

**Our response:** We do not expect the set-up and the maintenance of the disclosure regime to be cost-free. However, we are satisfied that the benefits to be gained by increasing transparency and accountability outweigh these costs. Moreover, industry respondents to CP176 argued that a solution based on transparency and accountability would be less costly than our original rebating proposal.



### *Commission-sharing arrangements*

- 2.34 In PS04/23<sup>12</sup>, we said we did not consider the use of commission-sharing arrangements (CSAs) inappropriate provided that:
- investment management clients understand their nature and purpose;
  - the commission flows generated are properly reflected in the industry's disclosure regime; and
  - they do not create new, unmanageable conflicts of interest for the investment manager.
- 2.35 Several respondents supported our approach in relation to CSAs. However, one respondent argued they were not a comprehensive solution to the problems we have identified with soft commission and bundled brokerage arrangements. Another respondent asked whether we intend that clients agree to each CSA that affects them. Some respondents asked for more clarity on what type of CSAs are acceptable.

**Our response:** We have not said that CSAs are the only way to address our concerns. However, we have said that they have the potential to form part of the market-led solution to deliver greater transparency and accountability in the use of dealing commissions and potentially better payment and pricing mechanisms.

We do not propose to require that clients agree to each CSA that affects them. However, we expect investment managers to inform their clients about them and to adequately disclose the commission flows arising from them.

We note that the 'IMA disclosure template' requires firms to separately disclose services such as research acquired from third parties (as opposed to executing brokers) and so will facilitate the examination of CSA arrangements.

Finally, all CSAs are different and should be assessed on a case-by-case basis with the scope of our proposed rules.

### *Scope issues*

- 2.36 On the intended scope of our regulatory regime and the industry's proposals for enhanced disclosure, in PS04/23<sup>13</sup> we said there are two elements to this: territorial scope, and coverage in relation to types of investment management firm and business.
- 2.37 Many respondents asked for clarity on the territorial scope of our proposed rules.

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12 See paragraph 2.41 of PS04/23.

13 See paragraphs 2.42 – 2.48 of PS04/23.

**Our response:** Our proposed rules will apply to investment management activity carried out in the UK. We cannot require overseas brokers to provide information on components of commission but we would expect investment managers seeking to manage conflicts of interest for their UK clients to ask for information on the split between execution and research services as they would from UK brokers.

- 2.38 We address the issue of which investment management firms are covered by our proposed rules and the enhanced disclosure regime in Chapter 3.
- 2.39 Several respondents asked for our views on whether our proposed regime applies to fixed income investments, with some respondents arguing that it should and others arguing that it should not.

**Our response:** We do not propose that our rules will apply to fixed income investments. However, if we find evidence that the same conflicts of interest are inherent in this market, we may revisit this position.

# 3 Our proposals for improving the regulatory regime

## Purpose

- 3.1 The purpose of this chapter is to explain our approach underpinning our proposed rule changes and to outline our conclusions on the industry proposals for improved transparency, accountability and clearer pricing and payment mechanisms.

## Introduction

- 3.2 As we stated in PS04/13<sup>14</sup> and reiterated in PS04/23<sup>15</sup>, in order to achieve our outcomes that investment managers should have better incentives to make efficient decisions about the purchase of trade execution and other services (such as investment research), and that they should be fully accountable to their clients for those decisions, we saw three complementary changes as necessary:
- investment managers' use of dealing commission should be limited to the purchase of 'execution' and 'research';
  - investment managers should give their clients better information about the respective costs of execution and research, and the overall expenditure on these services; and
  - investment managers should be encouraged to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately.
- 3.3 These changes will be affected by a combination of our proposed rules and the industry proposals. This will give investment management clients meaningful information about the costs to them of execution and research, which should – in turn – help facilitate the development of new payment and pricing mechanisms.

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14 See paragraphs 1.17 and 1.18 of PS04/13.

15 See paragraph 2.4 of PS04/23.

## **Industry-led solution on transparency and accountability**

- 3.4 One of our aims is that where investment managers pay for execution and research services with dealing commission, in accordance with our proposed rules, they must make adequate disclosure to their clients.
- 3.5 As mentioned in paragraph 2.2, we have allowed the industry space to develop an industry-led solution to secure improved management of conflicts of interest through increased transparency and accountability to clients and better payment and pricing mechanisms for both execution and research services. The IMA, in conjunction with LIBA and NAPF, has developed a set of proposals to deliver these outcomes. These proposals include:
- amendments to the existing IMA/NAPF Disclosure Code – including the use of a standard form of disclosure to clients and information about the investment manager’s approach to using commission to acquire execution and research services; and
  - a ‘Statement of Good Practice’, issued by LIBA, which provides good practice guidelines for brokers to identify the execution and research component of dealing commission.
- 3.6 This amended Disclosure Code will require firms to disclose the following information:
- descriptions of investment managers’ policies, processes and procedures in the management of costs paid on behalf of clients (‘Level 1 disclosure’); and
  - client specific information on how commissions paid have been generated and how they have been used, including a split between commission spent on execution on the one hand and research on the other. There will also be disclosure of the firm-wide pattern of trading and sources and uses of commission for all clients in that asset class, which will enable a client to compare the use of commission on their behalf with the use of commission for the rest of the firm’s clients (‘Level 2 disclosure’).
- 3.7 The Disclosure Code will require firms to make Level 1 disclosure annually and Level 2 disclosure at least six-monthly. We understand that investment managers will issue Level 2 disclosure reports to UK pension funds from the first quarter of 2006 and to other UK institutional funds from the third quarter of 2006. Level 1 disclosure reports will be issued in 2005.
- 3.8 The Disclosure Code has been jointly developed by IMA and NAPF and has been piloted among a sample of pension fund trustees who are satisfied that it has reasonable prospects of delivering our outcomes.
- 3.9 We have also considered it vital that this disclosure be backed up by improvements in payment and pricing mechanisms between brokers and

investment managers. As we stated in PS04/23<sup>16</sup>, we see a prior agreement between brokers and investment managers on what rates or amounts the investment manager expects to pay for execution over the coming period as necessary, and that this needs to be embedded in the commercial reality of broker-investment manager relationships. A joint LIBA and IMA working party has developed good practice guidelines to identify the execution and research component of dealing commission. A copy of this Statement of Good Practice is at: [http://www.liba.org.uk/publications/Final%20Good%20Practice/%20Statement\\_20050324.pdf](http://www.liba.org.uk/publications/Final%20Good%20Practice/%20Statement_20050324.pdf)

- 3.10 Together with our proposed rules, we are satisfied that the market initiative described above, led by IMA and together with NAPF and LIBA, is a sufficiently credible solution to the concerns we have with bundled brokerage and soft commission arrangements.
- 3.11 We expect that the Disclosure Code will become the standard means of disclosure of commission spend, particularly for UK institutional funds and retail funds. We also understand that some firms may use it for non-UK clients: if so, this is a commercial decision for investment managers to agree with their clients.
- 3.12 Our proposed disclosure rules (see below in paragraph 3.35) give weight to the acceptability of the IMA Disclosure Code. We expect investment managers to respond positively to requests from clients for disclosure in the form prescribed by the IMA Disclosure Code. However, we also recognise that in certain cases (e.g., where commission payments to third parties may be a very small element of transaction-related charges or for particular clients), use of the Disclosure Code may not be appropriate or proportionate. Our proposed rules are drafted in such a way that in these cases investment managers can agree with their clients other forms of disclosure of the costs of execution and research goods and services purchased through dealing commission. Investment managers not using the 'IMA form' should be able to demonstrate why they believe that the level and content of disclosure to their clients is sufficient and appropriate.
- 3.13 A copy of the Disclosure Code can be found at:  
<http://www.investmentuk.org/news/standards/pfdc2.pdf>

### **Structure and purpose of our proposed rules**

- 3.14 The overall aims of our proposed rules are as follows:
- to restrict the use by investment managers of dealing commission to the purchase of execution and research services; and
  - where investment managers pay for execution and research services with dealing commission, to secure disclosure of these payments to clients.

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16 See paragraph 2.31 of PS04/23.

- 3.15 As a general principle, we believe investment managers, with detailed knowledge of the precise nature and purpose of the particular services they acquire from brokers and others, are well placed to apply a principles-based approach to the acquisition of these services. Because of this, and because of the largely ‘wholesale’ nature of the participants involved, we have drafted high-level rules, which leave scope for the investment manager to make reasonable judgements on the use of dealing commission to pay for goods and services. It is our expectation that investment managers will be accountable to clients through the process of negotiating with brokers and third parties the nature and terms of acquisition and explaining these in the context of enhanced disclosure.
- 3.16 It should also be noted that the use of dealing commission to pay for execution and research goods and services is a permissive regime in the sense that we do not mandate that ‘research’ or any particular type of execution service be paid for with commission, and we emphasise that commission may not always be the most appropriate means of paying for these services. Even where investment managers do decide it is appropriate to use commission, they should be prepared to justify and document their decisions to pay for goods and services with dealing commission.
- 3.17 For the avoidance of doubt, we have indicated that compliance with the proposed rules will not put a firm in breach of the inducements rule in COB 2.2.3R (Prohibition of inducements) (see COB 7.18.14R).

*Scope of our proposed rules*

- 3.18 We propose inserting a new section into the Conduct of Business sourcebook (COB): COB 7.18, ‘Use of dealing commission’. It will apply to dealing commission charges incurred in the execution of customer orders relating to shares or other designated investments to the extent that they relate to shares (see COB 7.18.1R).
- 3.19 As stated above in paragraph 2.39, our proposed rules do not apply to fixed income investments. However, if we find evidence that the same conflicts of interest are inherent in this market, we may revisit this.
- 3.20 Also, our proposed rules apply only to arrangements where an investment manager receives execution or research goods and services from brokers and other firms which are paid for by way of a commission charge. They do not apply, for example, to an investment manager’s internally-generated execution and research (see COB 7.18.10G).
- 3.21 Consistent with our policy decisions outlined in Chapter 2, the rules do not generally prescribe what services are execution and research services. Rather, they set parameters within which investment managers can make judgements about how the services they purchase with commission should be classified.

We have provided guidance on what services cannot be purchased with dealing commission at all: that is, ‘non-permitted services’.

- 3.22 On the territorial scope of our proposed rules, this will be consistent with the general application of our conduct of business rules: that is, they will apply to firms authorised to carry on investment management business in the UK, regardless of the client’s location.

#### *Use of dealing commission - General requirement*

- 3.23 In COB 7.18.3R, we set out the requirements on an investment manager purchasing execution and research goods and services with commission payments that are passed on as a direct charge to its customers. As well as the requirement for these goods and services to be related to the execution of trades for customers or the provision of research, they must reasonably assist the investment manager in the provision of its services to customers and not impair their duty to act in the best interests of customers.

#### *Execution goods and services*

- 3.24 In COB 7.18.4E, we set out the tests for what we consider are permitted ‘execution’ goods and services (after this called ‘execution services’). These tests are substantially the same as those we set out in PS04/23, and explained above in paragraph 2.11.
- 3.25 For all execution services, investment managers should be able to justify, both to ourselves and to their clients, their decision to acquire a particular service with dealing commission and why it is an execution service. This is consistent with the obligations on investment managers under the IMA Disclosure Code.
- 3.26 When considering whether to class a service as an execution service, investment managers will find PS04/23 and this Consultation Paper (i.e., Chapter 2, Chapter 3 and Annex 3) relevant.
- 3.27 We have included guidance on post-trade analytics, such as software acquired by fund managers to analyse execution quality (see COB 7.18.6G). Generally, we do not believe it is appropriate for investment managers to use commission to pay for these goods and services, although we accept that these products can assist investment managers monitor the quality of execution they receive. As with a number of goods and services, there are arguments both ways, but our view is that clients are better served by not including them within the ‘execution’ category of permitted services.

#### *Research goods and services*

- 3.28 In COB 7.18.5E, we set out the parameters for permitted ‘research’ goods and services (after this, called ‘research services’). These are substantially the same as those we set out in PS04/23, and explained above in paragraph 2.22.



- 3.29 For all research services, investment managers should be able to justify, both to ourselves and to their clients, their decision to acquire a particular service with dealing commission and why it is a research service.
- 3.30 When considering whether a service is a research service, investment managers will find PS04/23 and this Consultation Paper (i.e., Chapter 2, Chapter 3 and Annex 3) relevant.
- 3.31 We have included guidance on price feeds and historical price data that have not been analysed or manipulated to reach meaningful conclusions (see COB 7.18.7G). We believe they should not be regarded as a research service for the purposes of our rules.
- 3.32 We have clarified that the term ‘research services’ for the purposes of these rules is not the same as the definition of ‘investment research’ in the Glossary, although there is a certain degree of overlap (see COB 7.18.9G).

#### *Non-permitted goods and services*

- 3.33 These are goods and services that are not sufficiently connected with particular investment management decisions or transactions to be classified as execution or research goods and services and therefore cannot be acquired with dealing commission. We outline these in COB 7.18.8G. This list is substantially the same as that set out in PS04/23, and explained above in paragraph 2.9, but with the addition of:
- publicly available information – for example, through the mass media, specialist journals or other publications, and associated subscriptions; and
  - custody services, other than those that are incidental to the execution of trades.

#### *Relationship with best execution*

- 3.34 In COB 7.18.11G, we point out that investment managers should not enter into arrangements that could compromise their ability to comply with their best execution obligations under COB 7.5.

#### *Disclosure requirements*

- 3.35 As both a regulatory measure and to assist the industry-led solution on transparency and accountability, our draft rules require investment managers to disclose to their clients details of execution and research goods and services purchased through dealing commission (see COB 7.18.12R). As noted in paragraph 2.30, our draft rules have been drafted at the level of principle to provide investment managers sufficient flexibility to determine the most appropriate means of compliance, while giving due prominence to the IMA Disclosure Code.



- 3.36 This disclosure must be made at least once a year. It would be acceptable to combine this disclosure with other disclosures required under COB: for example, periodic statements provided under COB 8.2.
- 3.37 The draft rules require an investment manager to inform its customers of the arrangements it has entered into that involve the use of dealing commission to purchase execution and research goods and services (see COB 7.18.12R). This is consistent with the prior disclosure requirements arising from Article 19(3) of MiFID<sup>17</sup> and the likely Level 2 measures on which CESR<sup>18</sup> has recently published its advice.
- 3.38 Firms will need to retain, for five years, records of disclosures made to customers (see COB 7.18.15R).

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?

### **Deletion of existing soft commission rules and consequential amendments**

- 3.39 Our proposed rules apply to the use of commissions to purchase execution and research services, regardless of the providers of those services. We therefore propose to remove the existing soft commission rules<sup>19</sup>.
- 3.40 We have also removed the definition of ‘soft commission agreement’ from the Glossary and made several consequential amendments to the Conduct of Business sourcebook, the Market Conduct sourcebook and the Glossary.

### **Timing and implementation of our proposed rules**

- 3.41 We propose that our rules will commence on 1 January 2006. We also propose a six-month transitional period, from the date the proposed rules come into force. In this transitional period, firms may continue complying with the existing soft commission rules<sup>20</sup> until the earlier of the expiry of any existing soft commission agreements or the end of this transitional period.

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?

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17 The Markets in Financial Instruments Directive (2004/39/EC).

18 The Committee of European Securities Regulators.

19 See COB 2.2.8R – COB 2.2.20R(1).

20 COB 2.2.8R – COB 2.2.20R(1).



# 4 Other issues and next steps

## **Retail fund governance**

- 4.1 Although Paul Myners' report<sup>21</sup> was essentially concerned with institutional investors, we identified in CP176 that the same conflicts of interest were present where investment managers were acting for retail clients – indeed many institutional investors participated in 'retail' investment vehicles such as unit trusts. We said we were concerned not to ignore this problem, but to look for a solution within the broader context of other initiatives impacting on the retail sector.
- 4.2 So, as foreshadowed in PS04/23<sup>22</sup>, we are considering further how the enhanced disclosure regime may operate to the benefit of investors in retail funds. We note the helpful recommendations in the IMA's review of fund governance in respect of 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 Quarter 3 this year.

## **International co-operation**

- 4.3 As mentioned in PS04/23<sup>23</sup>, 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 surrounding dealing commission and on ways we might be able to co-ordinate our efforts in this area. We believe that they are looking at outcomes that are not dissimilar to our own. As we have stated previously, however we do not think that implementation of our own programme and the SEC's are dependent on each other.

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21 'Institutional Investment in the United Kingdom: A Review', HM Treasury, 6 March 2001.

22 See paragraph 2.49 of PS04/23.

23 See paragraph 2.52 of PS04/23.

## **Interaction with MiFID**

- 4.4 We are conscious that, more or less during the same period in which we have carried forward our work on soft commissions and bundled brokerage arrangements, the MiFID has also been agreed. We believe our proposals are consistent with the requirements of the Level 1 Directive that firms should act honestly, fairly and professionally in the best interests of their clients; and that they should take all reasonable steps to prevent conflicts of interest from adversely affecting their client's interests (Articles 13.3 and 19.1).
- 4.5 We believe they are also broadly consistent with CESR's advice on Level 2 measures dealing with the treatment of inducements<sup>24</sup>.
- 4.6 There is also clearly a link between the best execution obligations in Article 21 of MiFID and our focus on soft commission and bundled brokerage arrangements. The MiFID provision is broadly consistent with the revised approach to best execution on which we consulted in CP154 in October 2002<sup>25</sup>. This reflected our view that best execution is as relevant to investment managers as it is to brokers, and is a particular expression of a manager's obligation to act in the best interests of its clients. This view is also reflected in CESR's consultation paper on best execution, which was published in March 2005<sup>26</sup>.
- 4.7 Seeking the 'best possible result' in accordance with Article 21 of MiFID means obtaining the best combination of price and costs subject to other considerations that are relevant to execution of a client's orders. So for an investment manager this means that the commission paid to brokers should be included in this assessment.

## **Performance indicators**

- 4.8 All sectors concerned with these proposals are interested in whether, together, they achieve the outcomes we desire, set out in paragraph 3.2 above. So we will review the effect and impact of these proposals on industry practice.
- 4.9 Over the next six months, we plan to develop measures to do this. Such measures will be sensitive to the industry's implementation timetable, and will also need to take into account the changes in market behaviour that are already taking place (i.e., that firms are becoming more transparent in their use of dealing commission to purchase services). At this stage, we believe it will be necessary to allow our rules and the industry-led solution to 'bed in' for a sufficient time, possibly two years, before being able to fully assess whether it has met our objectives.

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24 '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.

25 Consultation Paper 154, 'Best Execution', October 2002.

26 'CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments', Second Consultation Paper, The Committee of European Securities Regulators, March 2005.

- 4.10 In the shorter-term, we plan to monitor the take-up and use of the Disclosure Code and the LIBA Statement of Good Practice. Moreover, we expect the industry to do the same and to raise with us any significant issues arising from the adoption of these industry standards. We will work closely with the IMA, LIBA and NAPF in taking this forward.

### **Next steps**

- 4.11 Following consultation on our proposed rule changes, we will analyse responses and plan to make final rules in the third quarter of 2005.
- 4.12 We invite comments on this paper by 31 May 2005.



# List of non-confidential respondents to Policy Statement 04/23

Aberdeen Asset Management PLC  
Association of British Insurers (ABI)  
Association of Independent Research Providers (AIRP)  
Baillie Gifford & Co  
Barclays Global Investors Ltd  
Baring Asset Management  
Bloomberg LP  
BNY Securities Group  
Brewin Dolphin Securities Ltd  
Burvale Management Consultants Limited  
Clear Capital  
CSFB  
E\*TRADE Securities Limited  
Eden Group plc  
Elkins/McSherry LLC  
F&C Asset Management plc  
Fidelity Investment Service Ltd  
GCSC Information Services  
Goldman Sachs Asset Management International  
Hedge Fund Compliance Services Limited, London  
Henderson Global Investors

Hermes Pensions Management Ltd  
Instinet  
Invesco Perpetual  
Investment Counsel Association of America (ICAA)  
Investment Management Association (IMA)  
ITG Europe  
London Investment Banking Association (LIBA)  
M&G Investments  
Martin Currie Investment Management Limited  
Mercer Investment Consulting  
Morgan Stanley & Co Internal Limited/Morgan Stanley Securities Limited  
National Association of Pension Funds (NAPF)  
Pictet Asset Management UK Limited  
Redburn Partners LLP  
Reuters  
Rontech  
Schroders Investment Management Limited  
Scottish Widows Investment Partnership  
Standard Life  
State Street Global Advisors Limited  
The Alternative Investment Management Association Limited (AIMA)  
The Society of Pension Consultants (SPC)  
UBS AG  
VMR AG



# List of questions

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?

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?



# Summary of feedback from Policy Statement 04/23

## Introduction

- A3.1 In this Annex, we present details of those responses to PS04/23 and our feedback to them, which have not already been addressed in Chapter 2.

## Meaning of ‘non-permitted services’

- A3.2 Many respondents agreed with our proposals. However, some respondents asked for clarity on the treatment of investment conferences and seminars, specialist trade journals and dedicated phone lines to brokers. One respondent argued that research should include trade journals, entertainment and seminar fees where they believe that they add value.

**Our response:** As we said in PS04/23<sup>27</sup>, all these goods and services are likely to be relevant, in a broader sense, to an investment manager’s business. But we consider that the consequence of classifying them as ‘non-permitted’ goods and services (namely that investment managers will need to pay for them by means other than through dealing commission) is the appropriate result, bearing in mind our aim of reducing the scope for conflicts of interest to occur.

- A3.3 Some respondents have asked us to clarify whether we are imposing restrictions on the receipt of broker hospitality and entertainment.

**Our response:** In PS04/23, we did not say or imply that brokers cannot provide hospitality or other forms of entertainment to investment managers or other clients. What we did say is that investment managers cannot pay for travel, accommodation or entertainment costs with dealing commission. If they need to pay for these services, then they must do so by means other than commission.

Firms are also reminded of the general inducements requirements in COB 2.2.3R (Prohibition of inducements) in relation to the offering, giving, soliciting or acceptance of such services.

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<sup>27</sup> See paragraph 2.12 of PS04/23.

- A3.4 One respondent disagreed with our proposed treatment of valuation and performance services, suggesting that they should be allowed where they are used in assisting the provision of investment management services to clients.

**Our response:** As we stated in paragraph 2.12 of PS04/23, we consider that while valuation and performance services may be relevant to an investment manager's business, it is appropriate for them to be paid for by means other than through dealing commission.

### The scope of 'execution'

- A3.5 Some respondents asked how sales and trading advice should be categorised.

**Our response:** As stated in PS04/23<sup>28</sup>, we see trading advice as possibly falling within the meaning of 'execution' or of 'research' services, depending how it is used.

- A3.6 It was argued that the words 'broker or other execution venue' should be deleted from the definition of execution as it creates doubt about whether trading tool supplier neutrality is achieved.

**Our response:** We have considered this issue and although the majority of execution services will arise from brokers, it is possible that execution services could be provided other than from a broker or an execution venue. We have addressed this issue in our proposed rules.

- A3.7 It was argued that specialised order management systems and algorithmic trading systems should be permitted as execution services.

**Our response:** We have not said they are not execution services. Like all services, they will have to meet the meaning of execution to be classified as such.

- A3.8 One respondent argued that if a firm acts as a custodian as a result of a transaction, then this activity should be included as execution.

**Our response:** In PS04/23<sup>29</sup>, we said that if clearing and settlement, including any essential though temporary 'safekeeping' function, is an essential part of the broker's service, we see no reason why this should not be considered part of execution. However, custody services relating to designated investments belonging to, or managed for, customers which are not incidental to the execution of trades should not be included as execution services.

In addition, we believe that the following should not be included as an execution service:

- clearing and settlement services that are closely related to custody services, such as charges for failures by custodians to conduct efficient and timely administration required to avoid failed trades;

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28 See paragraphs 2.15 and 2.23 of PS04/23.

29 See paragraph 2.20 of PS04/23.

- expenses incurred by custodians in dealing with third parties, such as certificate and registration fees; and
- charges levied by central depositories on deposit or withdrawal of securities.

### **The scope of ‘research’**

A3.9 It was argued that the general purpose for which research may be used needs to be considered, not whether it is connected with a particular investment decision.

**Our response:** We did not say that research needs to be associated with a particular investment or trading decision. If it adds value when making these decisions and meets our other criteria, then it could be classed as a research service. Again, it is up to investment managers to justify that it should be classified as a research service.

A3.10 One respondent argued that our proposals might lead to a reduction in the quantity of research produced which might lead to a reduction in the overall quality of research.

**Our response:** As explained in paragraphs 2.56 – 2.59 of PS04/13, we do not accept that reducing the quantity of research produced automatically leads to a reduction in the quality of research consumed. Rather, we believe that our proposals may reduce the amount of poor-quality research in the market that we are told is widespread and will encourage investment managers to be more discerning in their consumption of these services, resulting in a better result for their clients.



# Cost-benefit analysis

## 1. Introduction

- A4.1 Sections 155 and 157 of the Financial Services and Markets Act 2000 require us to publish a cost-benefit analysis (CBA) of our proposed rules or proposed guidance on rules. The purpose of a CBA is to assess, in quantitative terms where possible and in qualitative terms where not, the economic costs and benefits of a proposed policy. Specifically, the requirement is that we publish ‘an estimate of the costs together with an analysis of the benefits’ with the proposed draft rules.
- A4.2 In the subsequent paragraphs in this section, we explain the process that led to the current proposals in this Consultation Paper, from the initial proposals we put forward in Consultation Paper 176 on ‘Bundled Brokerage and Soft Commission Arrangements’ (CP176). We modified our initial proposals in light of the responses to consultation, which raised concerns about cost-benefit impacts that were not initially identified.
- A4.3 We published CP176 in April 2003. In that paper, we concluded that a market failure exists in relation to the use of ‘bundled’ and ‘softed’ commission arrangements. Investors or fund trustees are unable to monitor their investment managers’ execution costs perfectly (including softed and bundled items) and these costs are passed directly on to investors. This creates potential conflicts of interest (a ‘principal-agent problem’). Softing and bundling agreements incentivise investment managers to make sub-optimal decisions on trading and consumption of non-execution services, which result in higher costs for investors.
- A4.4 To address this market failure, CP176 proposed two measures:
- limiting the range of goods and services beyond trade execution that could be purchased with commission. Specifically, we proposed excluding market

pricing and information services (MPIS), such as dealing screens, which account for between 50% and 57% of soft commission credits<sup>30</sup>; and

- requiring investment managers to value the goods and services that could still be softened or bundled, and rebate an equivalent amount to their customers' funds ('the rebate proposal').

- A4.5 The analysis of the costs and benefits of those proposals was undertaken by OXERA<sup>31</sup>. We published a summary of their findings in CP176 in April 2003.
- A4.6 In response to CP176, Charles River Associates (CRA), commissioned by the Investment Management Association (IMA), released a report in October 2003<sup>32</sup>. The report raised concerns about the international competitiveness of UK firms if the proposals in CP176 were implemented and the effect on the independent research market. It also proposed greater disclosure as a way of addressing our concerns with softening and bundling.
- A4.7 Subsequently, we commissioned Deloitte to assess the economic impact of implementing the proposals contained in CP176 on incumbent investment managers' ability to compete in the UK market. Their report was published separately in April 2004<sup>33</sup>.
- A4.8 Our proposals in this Consultation Paper contain our modified position, which is based on feedback we received to our initial proposals documented in Policy Statement 04/13, 'Bundled brokerage and soft commission arrangements: Feedback on CP176' (PS04/13). We also published our revised position in Policy Statement 04/23, 'Bundled brokerage and soft commission arrangements: Update on issues arising from PS04/13' (PS04/23).
- A4.9 Specifically we propose to:
- limit investment managers' use of commission to the purchase of 'execution' and 'research'; and
  - require investment managers to disclose to their customers details of how their commission payments have been spent.
- A4.10 We previously excluded all MPIS services from being paid for out of commission in CP176. However, we recognise that some MPIS services may be categorised as 'research' or 'execution' depending on how an investment manager has used MPIS in a given instance. In other words, investment managers should determine whether their use of MPIS for any client or transaction would be considered research or execution, within the descriptions given in our rules.

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30 OXERA broker and fund manager questionnaires, 2002.

31 OXERA, 'Cost-Benefit Analysis of the FSA's Policy Propositions on Soft Commissions and Bundling', March 2003.

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

33 Deloitte, 'An assessment of the economic impact of implementation of the proposals contained within FSA consultation document CP176 with reference to incumbent investment managers' ability to compete in the UK market', April 2004.



- A4.11 This CBA draws on work already carried out for us by OXERA and Deloitte. It also draws on the work carried out for IMA by CRA<sup>34</sup>. It assesses the incremental change in costs and benefits arising from our revised policy propositions, having the current rules as baseline. Following our standard approach to CBAs, these have been assessed based on six categories of market impact:
- direct or regulator’s costs – both one-off and ongoing;
  - compliance costs – both one-off and ongoing;
  - quantity of transactions;
  - quality of transactions;
  - variety of transactions; and
  - efficiency of competition.
- A4.12 The estimates of direct costs are our own. Assessments under the other headings are from various sources of information, including in-depth industry interviews and questionnaires among pension fund trustees, investment managers and brokers carried out by OXERA, Deloitte and CRA.
- A4.13 This CBA is presented in two parts. In Part 1, we analyse the costs and benefits of limiting the use of commission to the purchase of execution and research. Part 2 of this CBA analyses the costs and benefits of enhanced disclosure, as required under the approach now adopted by the industry, which requires investment managers to disclose to their clients how commission is spent.

## **2. Costs and benefits of our policy proposal (Part 1)**

- A4.14 Our first proposal (Part 1) limits investment managers’ use of commission to the purchase of ‘execution’ and ‘research’. This applies to research sourced from broker-dealers and from independent providers.
- A4.15 The following section summarises the costs and benefits of Part 1 according to the six impact headings outlined in paragraph A4.11. Where possible, costs have been quantified while benefits have been analysed.
- A4.16 Even though we have reduced the scope of our initial proposals, we still expect most of the economic mechanisms identified in CP176; but we also expect them to be less powerful. However, the narrower scope reflects the importance of investment research to investment managers and the desirability of ensuring that suppliers of research can compete on level terms. Hence, ultimately, we hope to have reached a more proportionate solution than our initial proposals in CP176.

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<sup>34</sup> Part of this CBA draws on work carried out for the IMA by CRA. We are grateful to them for allowing us to use their work. It also draws on the work carried out for us by Deloitte and OXERA.

## Direct costs

- A4.17 We estimate that the direct costs to us of implementing the necessary amendments to the current rules and guidance would be very small. There would be a one-off cost of £2,750<sup>35</sup> involved in amending the current rules. This would include staff familiarisation, and communication to and with the investment community, but our risk-based approach to monitoring firms' compliance would not need to change.

## Compliance costs

- A4.18 Investment managers and brokers would need to amend their list of approved services, then communicate the changes to relevant staff and train them on the new requirements. Such changes are likely to be straightforward and should not require any major alterations to the way companies comply with the current rules. We have updated OXERA's estimate of these one-off costs to £3.6 million<sup>36</sup>.
- A4.19 Once firms have made the necessary changes to their systems and procedures, they should not need to devote any additional resources to monitoring or advising on compliance with the new requirements. As such, the ongoing compliance costs are likely to be very small.

## Quantity of transactions

- A4.20 There are two effects of a narrower scope of allowable services that can be bought with commission on firms. The first is the reduced efficiency of providing certain services unbundled compared to providing them bundled: this may lead to fewer opportunities to share risk with brokers and to the loss of economies of scope (i.e., the cost of a bundle being less than the sum of the costs of the components). This may in turn increase investment managers' costs. This potential reduction in efficiency was the main reason for our decision to include research as a 'permitted service', following which we expect this cost to be minimal.
- A4.21 However, there will also be a reduction in investment managers' incentives to purchase additional services that may not be necessary for the performance of the fund (or that could reasonably be consumed in lower quantities), resulting in:
- investment managers reducing excessive consumption of services that were either 'softed' or 'bundled';

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35 Updated from CP176 to take account of inflation, previous figure was £2,600.

36 Updated to take account of inflation, previous figure was £3.3 million.

- the likelihood that investment managers reduce excess trading (churning)<sup>37</sup> in order to obtain soft credits for the purchase of services their clients' may not necessarily require; and
- increased cost consciousness of investment managers when paying for services with commission, particularly where those services can be readily bought for cash at prices set by market forces.

A4.22 This should result in increased efficiency, reflected on investment managers' decisions and on lower prices for these services, translating to lower charges to funds. Although the current proposals do not go as far as those in CP176, we envisage that some cost savings will still be made. Deloitte's analysis shows that 20% of respondents predicted an average 20% fall in quantity of services purchased if the original proposals were implemented. We have estimated the reduction in total expenditure at 4% by multiplying these two figures.

A4.23 Working<sup>38</sup> from OXERA's analysis, we estimated the proportion of total commissions generated by these services and multiplied this by the total value of commissions. By estimating the proportion of excluded services for each section and multiplying this by a likely reduction in expenditure mentioned above, we arrive at estimates for an overall reduction in expenditure. Please see Table 1 below.

**Table 1: Estimate of likely reduction of yearly expenditure of softed and bundled services (£ million)**

Total value of commissions		2.9 - 3.4 Bn £				
	Proportion of total commissions	Partial value of commissions (mn £)	Proportion of permitted services		Likely reduction of expenditure	Overall annual reduction in expenditure (mn £)
MPIS	2%	61 - 73	20%	}	4%	0.5 - 0.6
Other soft commissions	2%	59 - 71	36%			0.8 - 1.0
Bundled services	23%	659 - 786	4%			1.1 - 1.3
<b>Grand Total</b>						<b>2.4 - 2.8</b>

Source: OXERA and Deloitte reports.

A4.24 Based on our calculations in Table 1, we arrived at the overall yearly reduction of expenditure on these services of between £2.4 million and £2.8 million. It is important to note that these savings are on a yearly basis as opposed to the one-off compliance costs presented above. As an illustration, the 10 years net present value of this yearly reduction is between £19 million and £23 million<sup>39</sup>.

37 It is very difficult to estimate a reduction in churning, despite its great potential to reduce charges to funds. According to Deloitte execution services account for 73% of the total value of commissions, which means a yearly expenditure of £2.1 -2.5 billion.

38 It is difficult to predict the extent to which demand for softed and bundled services will fall based on our modified proposals. Our rules will be high-level and principle based. It will be left to investment managers to determine whether services are permitted to be paid for with commission within the confines of our rules. For MPIS, we estimate that 20% of services that are currently offered will now fall outside the scope of 'execution' and 'research'.

39 Using a 5.5% discount rate based on a 3.5% discount rate as indicated in HMT 'Green Book, Appraisal and evaluation in central government' and a 2% risk premium.

## **Quality of transactions**

- A4.25 This proposal will strengthen the existing trend for investment managers to select brokers based on their execution quality rather than on their bundled or softened arrangements. Investment managers will also have better incentives to make efficient decisions about the purchase of execution and other services, especially as they will have to consider whether they can pay for these services with commission.
- A4.26 It will also strengthen investment managers' sensitivity to the cost and quality of the services that cannot be purchased with commission but are still important to the quality of transactions and so put increased pressure on service providers to deliver better value for money.

## **Variety of transactions**

- A4.27 We believe that as a result of our policy proposals, investment managers will become more cost-sensitive in deciding what additional services to acquire. This will increase competition among the providers of these services, so they may become more innovative in trying to attract customers. This is likely to have a beneficial effect on the variety of services available (for example, as service providers respond to the change in demand).

## **Efficiency of competition**

- A4.28 Limiting the use of commission to buying execution and research services should lead to increased competition, creativity and innovation by providers of other services required by investment managers in attracting customers (see paragraph A4.27 above). It will also require effective pricing regimes and value for money options in the two types of services that can be paid for with commission, probably resulting in higher transparency of broker pricing and therefore increased competition.
- A4.29 We recognise that smaller or less efficient firms might be affected more by the increased competition. However, if the continued viability of some smaller investment managers depends on the artificial support from softening and bundling, it suggests those firms are not able to compete effectively. So their exit may be considered a net benefit to the industry/economy, as it should allow for the redirection of resources to more efficient and profitable activities.
- A4.30 There may be a short-term adjustment period, which could have an adverse effect on many smaller investment managers, especially if they rely more on services obtained through soft commission and bundling to compete with larger investment managers. According to the OXERA report<sup>40</sup>, commission rates are usually not agreed on a trade-by-trade basis between brokers and

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40 OXERA, 'An Assessment of Soft Commission Arrangements and Bundled Brokerage services in the UK', March 2003.

investment managers, but rather through negotiation for all the investment managers' trades. The commission rate agreed depends on the value of total trades sent by that investment manager in a certain period (often one year). If this is the case, then smaller investment managers may not be able to reduce their costs in the short term.

- A4.31 This may be a problem for smaller investment managers, since their level of funds under management may not justify renegotiation before the maturity date of the arrangement. However, as we will be giving a transitional period before implementing the proposals, we expect this potential cost to be minimal.
- A4.32 Restrictions to the range of services permitted to be purchased with soft commission may also disadvantage some execution-only brokers compared to full service brokers. This is because soft commission arrangements are of particular relevance to smaller brokers who may not have extensive in-house research capabilities and may not be able to benefit from economies of scale/scope. The use of bundling and more importantly softing makes it easier for them to compete with larger brokers on fees. This was another reason for the inclusion of research as a 'permitted service', as a result of which we expect this disadvantage to be very limited.
- A4.33 The international competitiveness of UK investment managers could increase. This is due to an expected increase in the quality and variety of the services acquired by investment managers, and to an expected reduction of their ongoing costs, at the expense of an initial and relatively small one-off cost. In this context, any regulatory arbitrage should be interpreted as an exit strategy of smaller or less efficient firms that are not able to compete effectively without the artificial support from softing and bundling.

## **Conclusion**

- A4.34 Limiting the use of commission to the purchase of execution and research should enhance trade execution quality and quality of transactions. It also addresses concerns about the potential to over-trade (churning) and over-consume services in return for soft credits. It is also likely to yield benefits in terms of increased efficiency of competition and enhanced international competitiveness of UK firms.
- A4.35 Summing up, we estimate a one-off compliance cost to industry of £3.6 million, in addition to our direct costs, which should be only a one-off cost of £2,750. These costs are set against annual costs savings due to a reduction in expenditure of softing and bundling services of between £2.4 million and £2.8 million. Table 3 gives a summary of costs and quantifiable benefits for Parts 1 and 2 of the policy.
- A4.36 Moreover, the estimates for the CBA are conservative, in that costs are likely to be over-estimated, whereas benefits are only partially quantified and are more likely to be under-estimated.

### 3. Cost-benefit analysis of disclosure (Part 2)

- A4.37 The IMA/NAPF Pension Fund Disclosure Code (which also applies to other funds) is an industry-led solution, under the IMA's initiative, in response to the market failure identified in CP176. The aim of the Code is to increase the quality of disclosure to clients by means of enhanced and comparative disclosure. IMA members account for about 70% of the market's funds under management<sup>41</sup>. Full compliance of its members with the code should ensure a market-wide implementation of this proposal (see paragraph A4.49 below).
- A4.38 The Code is presented as an evidential provision in the general guidance to our rules, so this part of the CBA assesses the incremental change in costs and benefits arising from its implementation, having the current rules as baseline. The magnitude of those costs and benefits depends on the extent to which this solution is taken-up. Given the wide support for the industry initiative, in the paragraphs below we assume full implementation of the Code.
- A4.39 However, we also recognise there is a risk of non-take-up and to control for this, we intend to conduct a 'performance review project' around two years after implementation. The aim will be to assess whether the industry-led solution of enhanced disclosure is effective in achieving our objectives or whether further intervention is necessary. This should ensure a high level of compliance with the Code.
- A4.40 The economic impacts and resulting benefits from enhanced disclosure are likely to be smaller and not as immediate as those identified in Proposal 2 of CP176. Despite being more effective in correcting the incentive misalignment, the rebate proposal relied on regulatory initiative, while the current solution relies on the initiative of market participants. However, by allowing the voluntary response from market participants to the identified market failure, we hope to achieve the same objectives with fewer costs to firms and a reduced risk of unintended consequences.

#### Direct costs

- A4.41 The FSA will incur one-off costs in terms of internal communication and familiarisation with the rules by staff. We estimate these costs at £5,500<sup>42</sup>. We also expect incremental ongoing costs of monitoring firms, which we estimate to be of the same magnitude as those estimated in Part 2 of CP176. This is because supervisors would have to ensure that appropriate disclosure solutions are in place and monitor compliance. We expect monitoring costs to be between £13,000 and £19,000<sup>43</sup>.

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41 IMA members have over £2,000 billion funds under management as estimated on the IMA website. This figure is divided by £2,857 billion, which is the total funds under management in the market in 1999 as estimated by International Financial Services in their 'Fund Management Brief' (September 2001).

42 Updated from CP176 to take account for inflation, previous figure was £5,200.

43 Updated from CP176 to take account for inflation, previous figures were £12,000 to £18,000.



## **Compliance costs**

- A4.42 Investment managers will incur costs from systems changes, management time and communication of the changes to clients. New client reporting and record keeping systems would be needed, so changing systems would constitute the greatest part of these costs. The continuing costs of comparative disclosure for investment managers will be in the area of administration. CRA estimate a one-off cost of £6.1 million and an ongoing cost of £4.3 million.
- A4.43 Since many investment managers already comply with the existing industry Disclosure Code for pension funds, they should be able to implement any changes at a reduced cost and/or quicker pace. They may only need to expand or adapt processes and procedures already in place. Therefore, investment managers' compliance costs may be lower than detailed in the preceding paragraph.
- A4.44 Brokers may incur some one-off costs from investment managers' requests to identify and assign the costs of execution and research services they provide. One-off compliance costs for brokers are estimated at around £6.2 million. Ongoing costs are likely to be dominated by the cost of running upgraded accounting systems and in handling occasional queries about the breakdown of costs of the package of brokerage services. It is estimated that these will add up to £2 million a year<sup>44</sup>.

## **Quantity of transactions**

- A4.45 Current mechanisms by which a client can monitor the expenditure of the investment manager are weak. The objective of enhanced disclosure is to prompt discussions between clients and their investment managers, leading to greater understanding and focus by clients on how commission is spent on their behalf.
- A4.46 Appropriate information provided to clients in a comparable format and in a timely manner could lead to the correction of the information asymmetry associated with softened and bundled services. However, this will depend on clients' energy, confidence and incentive to use the information provided to exert competitive pressure on investment managers.
- A4.47 Assuming that pressure is exerted on investment managers, enhanced disclosure is likely to have the effect of reducing over-consumption of services due to cost pass-through (see paragraph A4.22 above), by making investment managers accountable to clients for the spending of their money. It will improve investment managers' decision-making process, ensuring the purchase of these services only where there is a clear advantage of doing so or where there is at least a neutral effect on clients.

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44 Updated from CP176 to take account for inflation, previous figures were £6 million one-off and £1.9 million ongoing.

A4.48 We estimate a likely reduction in consumption of softened and bundled services of 7% by assuming a 10% reduction in demand for bundled services by UK investment managers as estimated by OXERA, multiplied by the 70% of funds under management represented by IMA members (please see Table 2 below).

A4.49 This figure is likely to be conservative, because non-IMA investment managers will have incentives to disclose the same type of information to their clients as IMA members, which should lead to further reduction in the consumption on these services. These incentives should arise from the similar level of disclosure requirements proposed in our rules or from competition if disclosure becomes a general market practice valued by investment managers' clients.

**Table 2: Estimate of likely reduction of yearly consumption of softened and bundled services (£ million)**

<b>Total value of commissions</b>		<b>2.9 - 3.4 Bn £</b>				
	<b>Proportion of total commissions</b>	<b>Partial value of commissions (mn £)</b>	<b>Proportion of permitted services</b>		<b>Likely reduction of expenditure</b>	<b>Overall annual reduction in expenditure (mn £)</b>
MPIS	2%	61 - 73	80%	}	7%	3.4 - 4.1
Other soft commissions	2%	59 - 71	64%			2.7 - 3.2
Bundled services	23%	659 - 786	96%			44.3 - 52.8
<b>Grand Total</b>						<b>50.4 - 60.1</b>

A4.50 Based on our calculations in Table 2, we arrived at the overall reduction of yearly expenditure on these services of between £50.4 million and £60.1 million. Again, it is important to note that these savings are on a yearly basis as opposed to the one-off compliance costs presented above. As an illustration, the 10 years net present value of this yearly reduction is between £400 million and £480 million<sup>45</sup>.

A4.51 Since the benefits of enhanced disclosure depend on clients' ability to pressure investment managers, it is recognized that the scale of benefits to retail funds (that is, collective investment schemes, investment trusts and funds of life insurers) is not likely to be as high, for some of them, as is expected for institutional funds. At least in theory, investment managers seeking to recover some of their costs are no longer able to direct the same level of trades from institutional funds to softing and bundling brokers. So they may have an incentive to direct to them an increased proportion of trades for retail funds, resulting in incremental costs to retail funds. To address this concern, we intend to do further work on strengthening the corporate governance of retail funds and we are aware of the IMA review in this area (see paragraphs 4.1 and 4.2).

<sup>45</sup> Using a 5.5% discount rate, based on a 3.5% discount rate as indicated in HMT 'Green Book, Appraisal and evaluation in central government' and a 2% risk premium.



## **Quality of transactions**

- A4.52 An enhanced disclosure regime will give the customer clear information to scrutinise investment managers' decisions, which should have a positive impact on the fund's performance. Clear payment and pricing mechanisms may also enable individual services to be purchased separately which may improve decision-making by investment managers in terms of the quality of services purchased.
- A4.53 Enhanced disclosure may also encourage best execution of transactions, greater transparency and in some cases the adoption of mechanisms such as commission sharing<sup>46</sup>. Some consolidation of trade execution could occur, as investment managers' trade with brokers who offer the greatest liquidity. These brokers would also tend to offer better prices for trades and lower levels of commission.
- A4.54 Enhanced disclosure should improve the market for independent research providers by encouraging broker to disclose of the costs of research services, as well as new and clearer pricing mechanisms such as shared commission.

## **Variety of transactions**

- A4.55 Increased competition and increased transparency should reduce market distortions between bundled and third party suppliers, leading to more creativity and foster innovation and market developments, as firms try to attract customers for their services. This should in turn increase the variety of transactions available to clients (of investment managers and/or brokers).
- A4.56 This is particularly true for the research market, where investment managers should require better value for money for the research they purchase. This should not only lead to an improvement in the quality of research but also to more innovative ways of providing it, resulting in an increased variety in this market. This should also reduce the identified problems associated with the current regime for bundled brokerage and soft commission arrangements in CP176<sup>47</sup>.

## **Efficiency of competition**

- A4.57 Most of the benefits of enhanced disclosure, as identified above, should result from increased efficiency in competition, which depends on market participants using the information provided to extend competition from management fees and trading performance to execution fees, quality and variety/innovation of services.
- A4.58 Increased competition could lead to inefficient firms leaving the market since they may not be able to compete effectively in this new environment. These exits may be considered a net benefit to the industry/economy, as they might allow for the redirection of resources to more efficient and profitable activities.

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46 See PS04/23, pages 14 and 15 for a fuller discussion on these arrangements.

47 See paragraphs 3.15-3.27 of CP176.

A4.59 The potential increase in competition could also increase the international competitiveness of UK investment managers. The effect of internal market competition should be a lower price and increased quality and variety of services offered to clients, in spite of the costs of providing disclosure. Any regulatory arbitrage should be interpreted as an exit strategy of less efficient firms that are not able to compete effectively in the UK.

## Conclusion

A4.60 Enhanced disclosure should increase competitive pressure on investment managers improving clients' ability to scrutinise and compare investment managers' use of commission. This may yield benefits in terms of the reduction of over-consumption and increased quality, variety/innovation and international competitiveness. It may also make investment managers more conscious of costs, driving them to increase pressure on brokers to provide effective pricing and valuation mechanisms for their execution and research services. This should allow investment managers to obtain better value for money and reduced costs for their clients.

A4.61 However, the scale of the benefits of disclosure will depend on the extent to which the industry's Disclosure Code is implemented and on the ability of clients to obtain and compare disclosure data when selecting investment managers. The reduced ability of retail investors to exert pressure on investment managers may limit the extent of the benefits available to them compared with the benefits that will potentially accrue to institutional investors.

A4.62 Summing up, there will be costs incurred from delivering enhanced disclosure. One-off compliance costs are estimated at £6.1 million for investment managers and £6.2 million for brokers. Ongoing costs are expected to be £4.3 million a year for investment managers and £2 million a year for brokers. Our £5,500 one-off and £16,000 ongoing costs are negligible in the context. These costs are set against savings due to a reduction in expenditure on softing and bundling services of between £50.4 million and £60.1 million yearly. Table 3 gives a summary of costs and quantifiable benefits described in Parts 1 and 2 of this CBA.

A4.63 Moreover, the estimates for the CBA are conservative, in that costs are likely to be over-estimated, whereas benefits are only partially quantified and are more likely to be under-estimated.

**Table 3: Summary of costs and quantifiable benefits, Parts 1 and 2**

	Part 1		Part 2	
	One-off	On-going	One-off	On-going
<b>Direct costs</b>	£ 2,750	-	£ 5,500	£ 16,000
<b>Compliance costs (Millions)</b>				
Investment managers	£3.6	-	£6.1	£4.3
Brokers		-	£6.2	£2.0
<b>Quantifiable benefits (Millions)</b>				
Reduction in expenditure of softed and bundled services	-	£2.4 - 2.8		£50.4 - 60.1

# Compatibility with our objectives and principles of good regulation

## Introduction

- A5.1 This section explains our reasons for concluding that the outlined proposals for changes to the rules governing bundled brokerage and soft commission arrangements are compatible with our general duties under section 2 of the Financial Services and Markets Act 2000 (FSMA) and with the regulatory objectives set out in sections 3 to 6.
- A5.2 The proposals set out in this Consultation Paper aim to meet our statutory objectives of market confidence and consumer protection. They also have some relevance to our objective of promoting public awareness.

## Market confidence

- A5.3 Our rules, along with the industry-led proposal in respect of enhanced disclosure, should contribute to our objective of maintaining confidence in the UK financial system by promoting competition. These moves should also improve transparency in the negotiation of dealing terms between investment managers and brokers. The result will be better alignment of incentives of investment managers to the interests of investors in the funds they manage.
- A5.4 Specifically, investment managers will have a greater incentive to use services acquired through commission arrangements as efficiently as possible. This should put pressure on brokers to make commission structures more transparent and flexible and to price non-execution services efficiently. As a result, brokers should compete both on the price of non-execution services and on their quality (e.g. investment managers will not choose to spend money on investment research they regard as of low quality).
- A5.5 The outcome should be a market with greater transparency and reduced costs, which are likely to increase the confidence of both private and professional investors in the investment management industry as a whole.

## **Consumer protection**

- A5.6 We believe that these proposals will deliver an appropriate degree of protection for consumers in various ways.
- A5.7 They will improve the transparency of charges clients pay for investing in managed funds, by requiring investment managers to detail how they spend commission payments. This should create greater competition among investment managers, resulting in more choice for clients and a reduced risk of them buying products that represent poor value for money.
- A5.8 Specifically, Part 1 of our policy (restricting the use of dealing commission to the purchase of execution and research) is likely to reduce the incentive for investment managers to select brokers on criteria other than their execution ability. It should also deter them from undertaking excessive levels of trading to generate commission to pay for services. The result will be cost savings to funds, which should be reflected in the investment returns to clients.
- A5.9 Part 2 of our policy, which is an industry-led solution requiring investment managers to disclose to clients how commission is spent, will increase competitive pressure on investment managers, if disclosure improves clients' ability to scrutinise and compare investment managers' use of commission. This way our policy will also ensure that investment managers are likely to be more conscious of costs and put pressure on brokers for clear payment and pricing mechanisms. It should ensure that costs are more transparent than at present and therefore subject to more effective competition.
- A5.10 However, disclosure of charges may not be enough by itself to protect investors. Its effectiveness depends on investors' energy, confidence and incentive to use the information provided to bring sufficient commercial pressure to bear on investment managers. Some private investors and some institutional investors, such as trustees of smaller pension funds, may not be able to exert such pressure. To address this, we have set up a retail governance project to look at strengthening the governance of retail funds. In addition, we have restricted the use of commission spend.

## **Public awareness**

- A5.11 Increasing the transparency of commission costs will improve the information available to clients about the costs of investing. This will enable them to assess more accurately the benefits and risks of investing in managed funds and therefore be able to make better-informed and more suitable choices.

## **Financial crime**

- A5.12 There is no material impact on the objective of reducing financial crime.

## Principles of good regulation

- A5.13 Under the requirement set out in section 2(3) of FSMA, in carrying out our general functions, we have to have regard to the specific matters set out below.
- (a) *The need to use our resources in the most efficient and economic way*
- A5.14 These changes would not materially affect our systems and processes for supervising firms. To the extent that they may make the market work better, they should reduce the likelihood of us having to intervene further in future.
- (b) *The responsibilities of those who manage the affairs of authorised persons*
- A5.15 The proposals place responsibility on managers of investment management firms to consider carefully what goods and services they need to support their operations and how they are paid for. Some firms might come under commercial pressure in the short-term because of the increased competition that transparency will bring because of enhanced disclosure. This increased commercial pressure should also help bring about better alignment of firm's commercial interests with their fiduciary responsibilities to clients. Similarly, managers of brokerage firms will need to be responsive to the needs of their clients for more information and possibly greater flexibility in the way they provide services, in order to compete effectively.
- (c) *The principle that a burden or restriction which is imposed on a person, or on the carrying out of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction*
- A5.16 We are proposing changes that require investment managers to disclose to their clients details of how commission is spent. These changes will place a burden on many investment management firms in terms of the additional time and resources required to implement and maintain these changes. However, the CBA shows that the proposals will secure a number of benefits. Although these are not all immediately quantifiable, they will nevertheless exceed the costs of implementing the proposals.
- A5.17 Over time, the markets for investment management and broking services should become more efficient, more competitive, and more attractive to investors. The incentives of firms and clients should align better, and they should consider the use of commission arrangements on execution and research, as well as the use of services other than those, only where there is a clear advantage of doing so or where there is at least a neutral effect on clients.

(d) *The desirability of facilitating innovation in connection with regulated activities*

A5.18 The proposed regime will require the disclosure of commission spends. We believe that these proposals will encourage innovation because they encourage increased competition. Competition not only reduces prices (costs) to clients, but also encourages ingenious ways of service delivery, pricing and product development.

(e) *The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom*

A5.19 We are aware that other countries are reviewing their softing and bundling rules and the aims of their work are believed to be similar to ours. The changes we are proposing will not adversely affect the competitive position of the UK. They will apply only to firms and investors dealing in investments in the UK. Investment managers will not be compelled to disclose information on commission spends to non-UK managed funds.

A5.20 In fact, we think that our proposals will bring benefits to the UK. They will create a stronger incentive for investment managers to exercise more effective control over demand for, and costs of, ancillary broker and third party services. They will improve transparency and accountability to underlying funds, both institutional and retail. They will also bring more effective competitive pressure to bear on total fund management costs. They will strengthen the incentive for investment managers to direct business to brokers on the basis of trade execution quality and cost rather than the range of additional services that brokers offer. And they will encourage consideration of the merits of alternative trade execution options. We believe that these developments will have a positive impact on the costs of investing and on investment returns. This should be attractive to both UK and overseas investors, and should therefore enhance the international competitiveness of UK markets.

(f) *The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions*

A5.21 Investment managers that rely disproportionately on services received from brokers in addition to execution may be placed at a competitive disadvantage to those that do not. There is a possibility that the increased competition would lead to the exit of some inefficient investment managers from the market. This would result in a net benefit in the sense that the resources of those firms can be redeployed more efficiently. There is little danger that competition between investment managers will decrease to any significant degree, as OXERA found the market concentration in fund management to be very low at present and likely to remain so, even if a few inefficient managers exit the market.



- A5.22 The proposed reduction in the range of services available through commission arrangements could affect the ability of brokers who do not produce in-house additional services to use such arrangements as a means of competing with full-service brokers in that market. However, the inclusion of research as a ‘permissible service’ will considerably limit this disadvantage and allow all brokers to compete on the price of their additional services.
- (g) *The desirability of facilitating competition between those who are subject to any form of regulation by us*
- A5.23 Investment managers will come under increasing pressure to control their commission spend, which should lead to more efficient decision-making and sharper competition among managers on the overall cost to clients of investing. Investment managers are likely to put pressure on brokers to make the structure of their commissions more transparent, which should make them compete more on overall service quality and price. This should increase the effectiveness of competition among brokers.
- A5.24 By requiring the costs of services bought with commission to be clearly identified, the level of competition in the market for additional services should increase. Investment managers will be able to buy more stand-alone products tailored to the structure of their investment portfolios. For example, proprietary research supplied by full-service brokers will become subject to the same disclosure rules as research from independent providers supplied through softing. This, combined with the enhanced incentive on investment managers to spend money on research as efficiently as possible, should result in a driving down of costs and pressure for higher quality research more closely aligned to investment managers’ needs. It should also result in greater use of independent research with reduced potential for conflicts of interest to arise. Similar effects should be apparent in the market for other types of good and services.
- (h) *Acting in a way which we consider most appropriate for the purpose of meeting our statutory objectives*
- A5.25 We have listened to the market and acknowledged that a market-led solution for disclosure, backed by a restriction of services that can be bought with commission, would be a moderation of the proposals in CP176 and could achieve similar benefits. We have aimed to reduce the costs imposed on firms and the risk of unintended consequences, ultimately hoping to have reached a more proportionate solution.
- A5.26 We have shown that we are willing to work with the grain of the market – monitoring firms’ adoption of information disclosure and enhancing clients’ ability to use that information effectively – to reach an achievable

and workable solution to an impediment to a properly functioning market. Therefore, we consider these proposals to be the most suitable to deliver an adequate level of client protection and market confidence and to promote competition, thereby delivering a more efficient market.



# Draft Handbook text – Conduct of business sourcebook

**CONDUCT OF BUSINESS SOURCEBOOK  
(AMENDMENT NO. ) (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 (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) of the Act (Rule-making instruments).

**Commencement**

- C. This instrument comes into force on [X] 2005.

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

- E. Changes to the Handbook text in Annexes A, B and C placed in bold square brackets, irrespective of whether the change takes the form of additional text or deletion of text, come into force on [commencement + 6 months]. Otherwise, the Annex comes into force on [commencement].

**Citation**

- F. This instrument may be cited as the Conduct of Business sourcebook (Amendment No. ) (Use of dealing commission) Instrument 2005.

By order of the Board  
[Y] 2005

## Annex A

### 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, the place where the change will be made is indicated and the text is not struck through.

Conduct of Business

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

1 Table

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies: The COB provisions in Table COB TR2 with the labels indicated		Transitional provision	Transitional provision: dates in force	Handbook provision: coming into force
...					
2.0	Technical timing provisions				
[2.1	<i>TTP1</i>	R	<p><del>Periodic disclosure of soft commission</del></p> <p><i>A pre-N2 firm will not contravene any of the provisions labelled TTP1 in Table COB TR 2 to the extent that it is able to demonstrate that, on or after commencement, it has made periodic disclosure required by COB 2.2.18R (Periodic disclosure), in relation to the period in which commencement falls, in accordance with the corresponding rule of its previous regulator.]</i></p>	<del>commencement to expiry of the relevant period</del>	<del>commencement</del>

...

3.2	TSP2	R	<p><u>Terms of business and client agreements</u></p> <p>(1) Subject to (2) and (3), a <i>pre-N2 firm</i> will not contravene any of the provisions in Table COB TR 2 labelled TSP2 to the extent that, on or after <i>commencement</i>, it is able to demonstrate that it has continued to use, or rely upon, <i>terms of business</i> (including a <i>client agreement</i>), [<del>or a soft commission agreement</del>] given to, or made with, a <i>client</i> before the end of the <i>transitional period</i> in accordance with the <i>corresponding rule</i> of its <i>previous regulator</i>.</p>	indefinitely	<i>commencement</i>
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...

3 Table COB TR 2 Rules benefiting from transitional relief (pre-N2 and ex-Section 43 firms)  
 This Table belongs to COB TR1.1 to COB TR3.10

3 Table

COB Rule	Rule Heading	Label ETPPTP	TSP	
...				
<del>[2.2]</del>	<del>Inducements and soft commission</del>			
<del>2.2.8R</del>	<del>Requirements when using a soft commission agreement</del>	<del>ETP1</del>		<del>TSP2</del>
<del>2.2.12R</del>	<del>Allowable benefits provided under soft commission agreement</del>	<del>ETP1</del>		
<del>2.2.16R</del>	<del>Prior disclosure</del>	<del>ETP1</del>		
<del>2.2.18R</del>	<del>Periodic disclosure</del>		<del>TTP1</del>	
<del>2.2.20R</del>	<del>Record keeping</del>		TTP1	

<u>2.2.20 R</u> <u>(2) and</u> <u>(3) I</u>				
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COB TP4

Transitional provisions

Conduct of Business

COB TP 4 Miscellaneous transitional rules applying to all firms

4 Table COB TP 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
...					
<u>16</u>	<u>COB 7.18.1R</u> to <u>COB 7.18.15R</u>	<u>R</u>	<p><u>Use of dealing commission</u></p> <p><u>An investment manager may comply with the rules and guidance in COB 2.2.8R to COB 2.2.20R(1) instead of the rules and guidance specified in column (2) until the earlier of:</u></p> <p><u>(1) the date of the expiry of any soft commission agreement that the firm has that complies with the requirements of COB 2.2.8R to COB 2.2.20R (1); and</u></p> <p><u>(2) [commencement + 6</u></p>	<u>[commencement – to follow]</u>	<u>[commencement + 6 months – to follow]</u>

			<u>months – to follow</u> ].		
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COB 1 General Application

1.3 General application: what?

...  
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-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~~]

...  
COB 2.2.8R to COB 2.2.19 R 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 make a record of each payment of disclosable *commission*, and must retain that record for a period of at least six years from the date of payment.
- (3) A firm must make a record of each benefit given to another firm ~~in accordance with COB 2.2.6G~~, and must keep that record for at least six years from the date on which it was given.

...

## COB 4: Accepting customers

...

### COB 4 Annex 2E

- 1 Table Content of terms of business provided to a customer: general requirements  
This table belongs to COB 4.2.11E

A firm's terms of business (including a client agreement) provided to a customer should, where relevant, include some provision about:

...

- [(14) ~~Use of soft commission agreement~~

~~If the firm is to be authorised under the terms of business to undertake transactions with or through the agency of another person with whom the firm has a soft commission agreement, the prior disclosure required by COB 2.2.16R (Prior disclosure).]~~

#### Use of dealing commission

If the firm 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).

...

## COB 5.10 Corporate finance business issues

...

- 5.10.2 Purpose  
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:
- ...

### Conduct of business

#### Dealing and managing

##### 7.18      Use of dealing commission

###### 7.18.1      Application

- R      (1)      This section applies to an *investment manager that 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*.

###### 7.18.2      Purpose

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 (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 the rule 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 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 the rule are met if the research:
- (a) is capable of adding value to the investment decisions by providing new insights that inform the investment manager when making investment 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, such as software used to analyse execution quality.

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, to the extent 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:
- (a) before conducting designated investment business for a customer;
  - and
  - (b) at least once a year afterwards;
- make adequate 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.
- 7.18.13    G      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

7.18.14 R 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) will have complied with COB 2.2.3R (Prohibition of inducements).

Record keeping

7.18.15 R An investment manager must make a record of each 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.

...

COB 10	Operators of collective investment schemes		
...			
COB 10.2	Application of general COB rules		
...			
10.2.5	R	Table	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		Modification
2.2	Inducements [ <del>and soft commission</del> ]		<del>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</del>
...			
7.18	<u>Use of dealing commission</u>		
...			

COB 10.6 Scheme documents for an unregulated collective investment scheme

...

10.6.8 E Table 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).

...

COB 11	Trustee and depositary activities		
11.5	Trustee firms which are not depositaries		
11.5.2	R	Table	Rules applicable to trustee terms 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	Inducements [ <del>and soft commission</del> ]		"Customer" means "trustee" or "trust" as appropriate

...

11.5.3	R	Table	Rules applicable to trustee terms 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 ...	Inducements [ <del>and soft commission</del> ]		"Customer" means "trustee" or "trust" as appropriate

Conduct of Business

Schedule 1

Record keeping requirements

	...				
1.3	G	Table			
	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	Date of periodic statement	3 years (from termination of

			agreements		relevant soft commission agreement)]
	...				
	<u>COB 7.18.15R</u>	<u>Periodic disclosure of arrangements entered into</u>	<u>Details of the receipt of appropriate execution or research goods and services</u>	<u>Date of provision of disclosure</u>	<u>5 years (from when the disclosure is provided).</u>
	...				

## Annex B

### Amendment to the Market Conduct sourcebook

In this Annex underlining indicates new text and striking through indicates deleted text.

MAR 3

Inter-Professional Conduct

...

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 commission~~].

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~~]).

...

## Annex C

### Amendment to the Glossary of definitions

In this Annex underlining indicates new text and striking through indicates deleted text.

...	
<i>material interest</i>	(in <i>COB</i> ) (in relation to a transaction) any interest of a material nature, other than: (a) disclosable <i>commission</i> on the transaction; (b) goods or services which can reasonably be expected to assist in carrying on <i>designated investment business</i> with or for <i>clients</i> and which are provided <del>[under a soft commission agreement</del> <u>or] in compliance with COB 7.18 3R (Use of dealing commission to purchase goods or services).</u>
...	
<del>[soft commission agreement</del>	<del>an agreement in any form under which a firm receives goods or services in return for <i>designated investment business</i> put through or in the way of another person.]</del>
...	



**ISBN: 1-84518-333-9**

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