Final report

An assessment of the proposed changes to regulation of bundled brokerage and soft commission arrangements

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Executive summary

S.1 The IMA has commissioned CRA to undertake an independent appraisal of both the potential impact of the FSA's proposals set out in CP176[1] and the cost-benefit analysis undertaken for the FSA by OXERA[2]. In particular, CRA was asked to examine in more detail: how these proposals might be implemented in practice; how the detail of their rules could affect the market outcome; and whether there were alternative proposals also worthy of further consideration.

S.2 This report is not intended to replicate the FSA's research but to provide more evidence to be considered in its own detailed cost-benefit analysis. It does not discuss, for example, the quality of competition in the UK fund management and broker markets, for these are areas where the FSA found no real concerns.

High level analysis

S.3 Before turning to our evidence-based analysis of CP176 it is important to consider the proposal in a larger perspective. A central idea that underlies the FSA/OXERA position is that there are fundamental problems that arise for trustees when they outsource fund management. These problems revolve around conflicts of interest for the fund managers in their use of research and delivery of best execution. However, if these problems were actually so severe, the question arises as to why many more pension funds do not carry out management in-house? Certainly many funds are of a sufficient scale to do this. The fact that most pension funds, even large ones, choose not to manage in-house, raises doubts about the significance of these perceived problems in the relationship between fund managers and trustees.

S.4 The FSA/OXERA solution is to impose a different contractual relationship and, indeed, one that is untested. Yet, if they were to see this as beneficial, pension fund trustees are already free to choose the contractual form proposed by the FSA. If there were benefits to the proposed contractual form why has this not arisen as the norm in what is, after all, hardly a new industry? There is, at present, no evidence that even more sophisticated trustees have moved to, or attempted to move to a contract of this type.

S.5 Market-based arrangements that aim to address the trade-off between the objectives of best execution and research remuneration have been developing in recent years. Some of these are internal systems and some are formal arrangements with brokers (e.g., commission sharing). These market initiatives carry few or none of the risks that are evident when contractual arrangement are determined by regulation.

S.6 It is possible that only the more sophisticated might exploit some of these arrangements. Accordingly, in the case of pension trustees greater disclosure

[1] "Bundled brokerage and soft commission", Consultation Paper 176, April 2003. Financial Services Authority.

[2] "Cost-benefit analysis of the FSA's policy propositions on soft commissions and bundling" April 2003. OXERA. We refer to this as OXERA (2).

requirements may be required to reduce any disparity between more and less sophisticated trustees. In the case of retail funds, increasing the responsibility and independence of trustees may be required, these initiatives do not carry the risks evident in CP176.

Evidential analysis

S.7 However, not all of the analysis above is testable. The body of this report therefore focuses on areas where we were able to establish with some degree of confidence the areas in which problems might arise and the net benefit or cost of the FSA's proposals and a potential alternative.

S.8 Accordingly, the report centres on concerns surrounding the mechanics of the market interactions between pension funds and fund managers. To address their concerns the FSA has designed two proposals that were reviewed by OXERA in their cost-benefit analysis.

S.9 We extend OXERA's work to examine the current market conditions, the likely impact of CP176 if implemented and an alternative to be called "Comparative Disclosure". The aim is fully to understand the present market environment and the extent and nature of any structural flaws. This allows a thorough analysis of the potential impacts of both the FSA's proposals and CRA's alternative.

S.10 Before analysing the FSA's proposals for change, it was important to conduct an extensive review of the present market environment, both to understand the nature and extent of any existing structural flaws and also their interaction with current industry developments. This principally involved examining:

- The roles of the key market players –trustees, fund managers and brokers - their responsibilities and priorities; and
- The various methods used to purchase research – the central focus of CP176.

S.11 To facilitate our analysis we surveyed formally both fund managers and pension fund trustees. Our analysis largely supports the findings of OXERA's initial report[3] that current arrangements might be perceived to be imperfect. That is, the incentives on fund managers to monitor the level of research might be weak. While some of these problems may be significantly mitigated by current trends, our evidence is that some action might be warranted.

S.12 In particular, soft commissions may offer direct benefits to the fund manager, thus giving rise to potential incentive problems and bundled brokerage may potentially discourage fund managers from exercising sufficient scrutiny over the costs of research.

[3] "An assessment of soft commission arrangements bundled brokerage services in the UK" April 2003. OXERA. We refer to this as OXERA (1)

S.13 However, there is, at the same time, a strong incentive on fund managers to maximise net performance and the evidence that the perceived problems are significant is not conclusive.

Market outcomes and cost-benefit analysis

S.14 Analysis of the likely market outcomes shows that although the impact of FSA's Proposal 1 is likely to be moderately beneficial, even here further research is required. Prior to proceeding with this proposal the FSA needs to make an accurate assessment of the size of the market for electronic pricing services and to develop an understanding of the likelihood of fund managers restructuring their operations to reduce the effectiveness of the proposals.

S.15 On the other hand our conclusions regarding Proposal 2 are quite different to those of OXERA and the FSA. The probable consequences of Proposal 2 are sub-optimal consumption of research leading to sub-optimal levels of trading, increased spreads and less effective stock selection. Our evidence points to the likelihood that the costs associated with the first two of these outweighs the benefits of reduced expenditure on research by £146 million per year. Taking into account compliance costs, the net ongoing cost of Proposal 2 is £159 million.

S.16 We have made a number of conservative assumptions to arrive at this figure but we have been unable to put a value on the most worrying potential consequence – that significant parts of the funds management industry may move some of their activities abroad. Accordingly we believe that this net cost is a lower bound and the true cost could be substantially higher.

S.17 Similar conclusions can be drawn from the analysis of the retail fund market. Again the effects of Proposal 2 bring similar risks, but in this case without the benefits.

Conclusions

S.18 In conclusion, the aims and likely impact of these proposals therefore seems clear. There are potential areas of imperfect contracting between the principal market participants, and these may lead to potentially misaligned incentives. Yet the actual significance of these sub-optimal mechanisms is not proven.

S.19 Furthermore, the details of the FSA's proposals do not fit the needs of the market, and actually lead to the risk of severe detriment – mainly borne by ultimate investors.

S.20 On the other hand greater disclosure in the pension fund market and greater responsibility and independence in the retail fund market address the perceived problems without introducing significant risk.

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Section 1 Introduction

1.1 The IMA has commissioned CRA to undertake an independent appraisal of both the potential impact of the FSA's proposals set out in CP176[4] and the cost-benefit analysis undertaken for the FSA by OXERA[5]. In particular, CRA was asked to examine in more detail how these proposals might be implemented in practice, how the details of their rules could affect the market outcome, and whether there were alternative proposals also worthy of further consideration.

1.2 This report is not intended to replicate the FSA's or OXERA's research[6], but to provide more information to be considered in its own detailed cost-benefit analysis. It does not discuss, for example, the competition in the UK fund management and broker markets, for these are areas where the FSA found no real concerns.

1.3 The body of this report focuses on areas where we were able, with confidence, to establish empirical evidence on the impacts of CP176. Accordingly, this report primarily centres on concerns surrounding the interactions between pension funds and fund managers. However, before turning to our evidence-based analysis of CP176 it is important to consider the proposal in a larger perspective.

High level analysis

1.4 Over many years the contractual relationships between trustees, fund managers and brokers have developed. In the UK the success of these relationships is evidenced by the success of the UK fund management industry relative to competing markets. In any set of relationships there is a potential for conflicts of interest. However, in reality many of these conflicts have little or no effect if the relationships are ongoing, i.e. if the relationships are repeating games.

1.5 The essence of the FSA/OXERA position is that there are fundamental problems that arise for trustees when they outsource fund management. However, many funds are of a sufficient scale to manage their funds in-house. The very fact that in-house management is less common suggests that such perceived problems in the relationship between fund managers and trustees are not significant.

1.6 The FSA/OXERA solution is to impose a different contractual relationship that has never been tested. If there was any benefit to the contractual form they promote it is reasonable to assume that these would arise in practice either by regulation in some jurisdiction or through the initiative of more sophisticated trustees. It is telling that such contractual forms are not observed in practice.

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[4] "Bundled brokerage and soft commission", Consultation Paper 176, April 2003. Financial Services Authority.

[5] "Cost-benefit analysis of the FSA's policy propositions on soft commissions and bundling" April 2003. OXERA. We refer to this as OXERA (2).

[6] "An assessment of soft commission arrangements bundled brokerage services in the UK" April 2003. OXERA. We refer to this as OXERA (1). Indeed, much of our analysis supports the finding in OXERA (1).

1.7 Market-based arrangements that aim to optimise better the objectives of best execution and research remuneration have been developing in recent years. Some of these are internal systems and some are formally arrangements with brokers (e.g., commission sharing). These market initiatives carry little or none of the risks that are evident when contractual arrangement are determined by regulation.

1.8 It is possible that only the more sophisticated trustees might exploit some of these arrangements. Accordingly, in the case of pension trustees greater disclosure requirements may be required to reduce any disparity between more and less sophisticated trustees. In the case of retail funds increasing the responsibility and independence of trustees may be required, as with the market-based developments, these initiatives do not carry the risks evident in CP176.

Evidential analysis

1.9 To address perceived problems in the relationships between trustees and fund managers the FSA has designed two proposals:

- **Proposal 1**: defines a list of services, the most important of which is market pricing information, that must be paid for directly by the fund manager and can only be recouped through an explicit charge to the ultimate consumer. Many of these services were historically paid for through ‘softing’. It is worth noting that this proposal is often incorrectly described as prohibiting softing. In fact, it simply prevents certain services from being paid for by a charge directly to the fund.

- **Proposal 2** requires fund managers to estimate the amount of services they consume, in addition to trade execution, which are paid for through commission. This amount must be negotiated with the ultimate client and otherwise rebated entirely to the fund. This proposal does not prevent bundling *per se*; it just prevents it being paid directly by commission, which the FSA refers to as a cost pass-through.

1.10 These proposals were reviewed by OXERA in their cost-benefit analysis and this report is designed to expand on their work to examine the current market conditions, the likely impact of CP176 if implemented, and an alternative – Comparative Disclosure. The aim is fully to understand the present market environment and the extent and nature of any structural flaws.

1.11 This report demonstrates that although the current market arrangements are imperfect, the situation is improving. In addition it shows that, despite some clear examples of misalignment of incentives, their extent and significance are hard to establish. It also demonstrates the impact of Proposal 1 is likely to be moderately beneficial, although further research is required, but the probable consequences of Proposal 2 are sub-optimal consumption levels of research, leading to a reduction in market efficiency. These market outcome conclusions are also strengthened and supported by a detailed cost-benefit analysis.

1.12 This report’s analysis is underpinned by information drawn from a wide variety of sources, including a series of structured interviews with trustees, fund managers,

brokers, independent research houses and information providers. These were conducted between July and August 2003, and followed up by a detailed postal survey to fund managers and a telephone survey to pension trustees. Details of the survey samples can be found in Annex 1.

Current market environment and incentives

1.13 Section 2 of the report reviews the present market environment both to understand the nature and extent of any existing structural flaws and also their interaction with current industry developments. It starts by examining the roles, responsibilities and priorities of the key market players – the trustees (see "The activities undertaken by pension trustees"), fund managers (see "The activities undertaken by fund managers") and brokers (see "The activities undertaken by brokers").

Market participants

1.14 Pension fund trustees put a great deal of weight on net performance in the monitoring and selection of funds. However, the effectiveness of the various approaches used by pension fund trustees to monitor the performance of fund managers is shown to be imperfect. In regard to transaction costs, monitoring is improving in line with increasing trustee sophistication and the more widespread use of services such as transaction cost analysis.

1.15 The key tasks of the fund manager relevant to this analysis are portfolio selection and managing the acquisition of best execution and research services. It is clear that while net performance is an inexact barometer of a fund manager's competence, it is nonetheless also regarded by fund managers themselves as the primary means of generating and retaining business. Moreover the interaction between the fund manager and broker is multi-dimensional, including not only transaction services and the monitoring of best execution, but also research, which itself involves a number of interlinking aspects.

1.16 Brokers complete the list of primary market participants. They provide the transaction services and research demanded by fund managers. Furthermore the research produced by brokers is both a service to their clients and an input to their own market making activities, something that has important consequences for both the costs and volume of the research produced.

Payment mechanisms

1.17 Within Section 2, "Mechanisms for paying for additional services" discusses the current methods of payment for services in the market and the possible structural flaws that result. Despite being significantly mitigated by current trends, these are shown to combine with the various processes used to pay for services in the market – such as soft commissions and bundled brokerage – to create the possibility of misalignment of incentives for the fund manager acting as an agent for the trustees.

Principal-agent problems

1.18 The final part of Section 2 – "Incentive misalignment" – deals with our analysis of the FSA/OXERA model that suggests the current arrangements could lead to a

principal agent problem resulting in a misalignment of incentives. It shows that soft commissions can lead to an incentive to pay too much for market pricing services and bundled brokerage can encourage fund managers to exercise insufficient scrutiny on the costs of research. However, at the same time, there are significant constraints on the extent of this behaviour. It is clear that these problems may arise, but the evidence that they are significant is not conclusive.

The FSA's proposals and an alternative

1.19 Section 3 – "The FSA's proposal and an alternative proposal" – looks at how the proposals might actually work in practice. It is important to set out the rules, as we understand them, in order to evaluate their likely effect. We also present the alternative proposal – "Comparative Disclosure" – which we tested in our surveys of fund managers and pension fund trustees.

Market outcomes of the proposals

1.20 Section 4 – "Market outcomes" – evaluates the possible market outcomes of implementing the FSA's proposals. To do this we apply the same model that OXERA used to analyse the current market but, especially in regard to Proposal 2, we come to very different conclusions.

1.21 The analysis demonstrates that, for the pension market, the impact of Proposal 1 is likely to be moderately beneficial, although further research may reverse this and is certainly required before the Proposal could be implemented.

1.22 However, the likely consequences of Proposal 2 are sub-optimal consumption of research leading to sub-optimal levels of trading, increased spreads and less effective stock selection. Our evidence points to the likelihood that the costs associated with the first two of these outweighs the benefits of reduced expenditure on research by £146 million per year. Taking into account compliance costs, the net ongoing cost of Proposal 2 is £159 million.

1.23 We have made a number of conservative assumptions to arrive at this figure but we have be unable to put a value on the most worrying potential consequence – that significant parts of the funds management industry move some of their activities abroad. Accordingly we believe that this net cost is a lower bound and the true cost could be substantially higher.

1.24 Separately, in Annex 2, we draw similar conclusions from our analysis of the retail fund market. Again the effects of Proposal 2 bring similar risks, but in this case without the benefits.

Cost-benefit analysis

1.25 These market outcome conclusions are then strengthened and supported by a detailed "Cost-benefit analysis" in Section 5. The cost-benefit analysis was carefully designed to incorporate recent developments in the market that might impact the potential effects of the FSA's proposals:

- Improved internal mechanisms within fund managers for managing the potential conflict between best execution and rewarding research;
- Market structures, such as commission sharing or broker segmentation, that allow commission to be shared between the broker executing the trade and those providing research services;
- Increased use of transaction-cost analysis to mointor the performance of fund managers in managing costs;
- Improved trustee activism prompted by regulatory intervention (e.g. the Myners Review) and training provided by fund managers;
- Increased regulatory disclosure, through the NAPF/IMA Pension Disclosure code; and
- The likely consequences of the proposals made in the FSA consultation paper, CP 171.

1.26 This CBA confirms the themes of Section 4: adopting Proposal 2 would address some of the factors leading to over-consumption of research, but is likely to over-correct and damage market efficiency by suppressing the level of research consumed to below optimal levels.

Conclusions

1.27 The aims and likely impact of these proposals therefore seems clear. There are potential areas of imperfect contracting between the principal market participants, and these may lead to misaligned incentives. Yet the significance of these sub-optimal mechanisms is not proven.

1.28 Furthermore, the actual details of the FSA's proposals do not appear consistent with the actual needs of the market, and actually lead to the risk of severe detriment – mainly borne by ultimate investors.

1.29 On the other hand greater disclosure in the pension fund market and greater responsibility and independence in the retail fund market address the perceived problems without introducing significant risk.

Section 2 The market for services additional to trade execution for pension funds

2.1 Before analysing the FSA's proposals for change, it was important to review the present market environment both to understand the nature and extent of any existing structural flaws and also their interaction with current industry developments. This section describes this analysis and explains how, although it is clear that there are incentive problems within the market mechanics, these have been significantly mitigated by current market trends.

2.2 This chapter therefore first examines the roles of the key market players – the trustees, fund managers and brokers - their responsibilities and their priorities. It demonstrates how their actions, along with market developments, combine to produce market conditions, which are imperfect but improving.

2.3 The following section discusses the various methods used to purchase services within the market – the central focus of CP176. It shows that there are indeed some inherent problems with these procedures, and, although there are certain constraints, these are insufficient to ensure complete efficiency.

2.4 The chapter concludes with an analysis of the misalignment of incentives highlighted by the FSA. Firstly, it examines consequences arising from the use of soft commission by fund managers. Second, it discusses the incentives effects arising from cost-pass through of services additional to trade execution. In both cases, there is some evidence of a potential misalignment of incentives.

2.5 This chapter focuses on the pension fund market, as this is clearly the central concern of the FSA's analysis. In Annex 2 to this report we review the retail collective investment market.

2.6 Even when looking at the pension fund market in isolation, it is important to consider the different sub-markets involved. In particular, attention needs to be paid to the different ultimate consumers, for the UK fund management sector does not only manage UK funds, in 2002, for example, it managed £1,331 billion from within the UK and £912 billion from outside.

The activities undertaken by pension trustees

2.7 This section discusses the role and responsibilities of pension fund trustees. It examines their wide remit, and through this the effectiveness of the various approaches used to monitor the performance of fund managers. It shows that while these processes are imperfect, they are improving in line with increasing trustee sophistication and the more widespread use of services such as transaction cost analysis. It concludes that, although the level of monitoring by trustees is sub-optimal, any analysis of their interaction with fund managers and brokers needs fully to take into account these important trends.

2.8 The role of the pension trustee, who has responsibility for monitoring the way in which pensioners' assets are managed, has come under increasing scrutiny since the

Myners' Review.[7] Their remit involves an array of tasks of which the most important are:

- Asset allocation;
- Supervising administrators;
- Ensuring compliance with statutory regulation;
- Administration of a scheme;
- Appointing fund managers to undertake investment services; and
- Monitoring their performance.

2.9 However, the evidence from trustees suggests that they perceive the decision regarding allocation strategy as the most important task with reviewing scheme/portfolio performance the second most important task.[8]

2.10 Clearly pension fund trustees do not undertake their tasks in isolation.[9] It is common to employ the services of an investment consultant and other third party services to assist in each of these tasks.

Appointing fund managers to undertake investment services

2.11 One of the key roles for the trustees of a pensions fund is in the appointment of their fund managers. As set out in the OXERA report[10], trustees base their decision on a range of factors, of which the three most important are respectively: a fund manager's philosophy, his expertise and previous performance. Fee arrangements was the fifth most important factor, one place above the issue of whether the fund manager was based in the UK.

2.12 The rates of brokerage commission and any policy on soft commission arrangements were the least most important factors reported. The justification for this ordering is self evident from OXERA's analysis. Based on the assumptions set out in (OXERA (1) Footnote 47 page 58) increasing the commission level by 40% reduces the net return on the fund from 6.97% to 6.95%. In contrast, if the AMC were 40% higher this would reduce returns 6.78%. This has almost ten times the impact of the change in commission. Therefore the focus on the annual management charge is a rational response reflecting the importance of the charges and does not reflect any particular focus on the annual management charge *per se*.

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[7] Institutional Investment in the United Kingdom: A Review. Paul Myners' report to the Chancellor of the Exchequer, 6 March 2001. http://www.hm-treasury.gov.uk/media//843F0/31.pdf. See also the HM Treasury response to the subsequent consultation. http://www.hm-treasury.gov.uk/documents/financial_services/securities_and_investments/fin_sec_broking.cfm

[8] "Taking the temperature of the UK pension fund industry" Instinet May 2003.

[9] Indeed they are obligated to get third party advice in the Pension Act 1995.

[10] OXERA (1) p. 18

2.13 Equally importantly for our assessment of the impact of the FSA's proposals are trustees' views on the location of fund managers. According to OXERA "whether the fund manager is based in the UK is not an important factor when selecting a fund managers for a particular fund." [11]

Monitoring performance

2.14 Trustees regularly monitor the performance of the assets for which they are responsible through a variety of means:

- Regular reports assessed by the trustees themselves, third party service providers and their fund managers;
- Comparison to internally managed funds and across fund managers; and
- Comparison to passive managers and/or benchmarks.

2.15 The great majority of pensions funds focus on net fund performance. However, in addition to monitoring the level of overall returns and comparing this to the performance of similar funds, trustees monitor the underlying activity of the fund manager through monitoring the fund's transaction costs.

2.16 The importance of this scrutiny should not be understated. Evidence set out in OXERA (1) shows that switching costs appear relatively low and there are few barriers to trustees switching between fund managers. If performance is unsatisfactory for a period of time, then trustees will change fund managers.

Monitoring transactions costs

2.17 There is, however, considerable variation in the extent to which trustees monitor transactions costs:

- Only 55% of funds require their managers to split out transaction costs (this rises to 58% for large funds, i.e. over £1 billion but is lower for public funds);
- Only 41% of managers break down commissions incurred by each broker employed; and
- 47% neither compare costs themselves nor require managers to demonstrate this.

2.18 However, there are a number of market based reasons for believing this level of monitoring will increase in the future: the increasing role of transaction analysis, the Pension fund disclosure code, increasing trustee sophistication and third parties negotiating commission recapture on the behalf of trustees.

The increasing role of transaction analysis

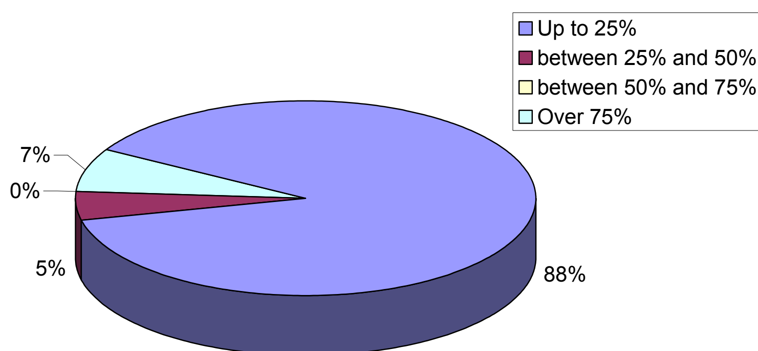
2.19 The role of transaction cost analysis is increasing in importance. For example, providers such as Plexus and Elkins McSherry offers to help pension trustees by

[11] OXERA (1) p. 14

providing a report that will "enable the user to monitor individual manager and broker costs on a country by country basis. The analysis contains information on the market impact, commissions and fees for each portfolio, which is then compared to a universe of similar costs. This enables the user to evaluate trading costs for the entire fund and to use the information to directly reduce those costs."[12]

2.20 This is supported by evidence from the IMA Fund Management Survey which shows that for the great majority of fund managers up to 25% of their clients are already using transaction cost analysis (see Figure 1). Moreover, this appears to be increasing quickly with 64% of fund managers seeing an increase over the last year and 83% expecting an increase over the next year.

Figure 1: Usage of transactions cost analysis



Source: Question 10 IMA Asset Management Survey 2002

2.21 It is likely that this underestimates the level of scrutiny, for in many cases this analysis will be carried out for pension fund trustees by their investment consultants.

Pension fund disclosure code

2.22 In response to the Myners report the NAPF and IMA formed a joint working party to examine the disclosure of information. The objective is to increase transparency so that pension fund trustees can better assess the costs and charges levied on their funds. To facilitate this, the disclosure code provided qualitative information (Disclosure level 1) and quantitative information (Disclosure level 2).[13] The code is

[12] Source: The WM website at http://www.wmcompany.com/page.php?page_id=PFS_Trading_Costs&cat=vrpm

[13] "Investment Management Association Pension Fund Disclosure Code" May 2002

voluntary, but fund managers can only claim compliance if it is implemented in full. By July 2003, however, the level of compliance by fund managers was 94%.[14]

2.23 The two levels of the Disclosure Code provide the following information:

- Level 1: an annual assessment of the house policies, process and procedures; and
- Level 2: a six monthly assessment of client specific information.

2.24 Level 1 Disclosure is intended to help the trustee understand the policies of their fund manager. In many cases these will already be well known but this attempts to level the playing field between sophisticated and less sophisticated trustees by informing them of a range of policies regarding:

- Where deals are transacted and the process by which these are chosen;
- How the particular broker was selected and the resulting implications for the volume of business transacted;
- How commissions are negotiated, in terms of their level, the policy towards soft commissions and commission recapture;
- How conflicts of interest are managed; and
- The policy on using external research and how it is funded.

2.25 Level 2 Disclosure provides quantitative information relevant to the particular fund. In particular, it provides detailed information on the fees currently being charged to the fund, the classification of transactions according to whether they are subject to commissions or not and whether commissions are softed or subject to commission recapture.

2.26 This is presented both in aggregate form and individually for all significant counter parties (i.e. >5% of transactions volumes). Table 1 below sets out how this is presented.

[14] Press Release issued by the IMA 1 July 2003. Note also that this supports voluntary codes as an effective substitute to compulsory regulation.

Table 1: Quantitative information presented in Disclosure Level 2

Counterparty	Trading volume for period			Commissions and fees paid during period			
	Total	Traded net	Subject to commissions	Total	Under softing arrangements	Under directed or recapture arrangements	Other
	£0	£0	£0	£0	£0	£0	£0
1							
2							
9							
10							
Others > 5%							
:							
Others (total)							
Total							
% age Guidance Notes:	100%	[ ]%	[ ]%	100%	[ ]%	[ ]%	[ ]%

Source: IMA/NAPF pensions disclosure code

2.27 Although, it is still too early to assess the effectiveness of the disclosure code, the early signs are promising. Based on evidence from the CRA Pension Fund Trustee Survey we found that over 85% of trustees were aware of the code, with 77% saying this had increased the information available to them. More importantly, however, 85% of these thought this would increase their ability to scrutinise the performance of their fund manager while 94% (of the 77%) agreed it would increase their understanding of the costs charged to the fund.

Increasing trustee sophistication

2.28 As the Myners Review illustrated convincingly, the expertise of trustees varies significantly from fund to fund. The report found that "many trustees are not especially expert in investment:

- 62% of trustees have no professional qualifications in finance or investment;
- 77% of trustees have no in-house professionals to assist them;
- More than 50% of trustees received less than three days' training when they became trustees;
- 44% of trustees have not attended any courses since their initial 12 months of trusteeship; and
- 49% of trustees spend three hours or fewer preparing for pension investment matters."

2.29 The overall picture remains broadly the same today. Information from Watson Wyatt showed that 31% of trustees had no relevant qualification and only 41% had a "tentatively related management or investment management qualification". But this does not mean progress has not been made.

2.30 A NAPF survey reports that 80% of trustees show improved investment competence in the last two years (with the majority of improvement arising from improved information and training). Since the publication of the Myners Review the amount of training has increased for around 50% of pension funds.[15] However, whilst training has increased the average still remains only just over three days per annum. There is therefore evidence of some improvement following Myners but it is clearly slow progress.

Third parties negotiating commission recapture

2.31 In a competitive market we would expect to see a number of mechanisms by which any excess charges would be traded away. In fact, this is exactly what we do see with organisations such as Frank Russell organising commission recapture arrangements.

2.32 Commission recapture describes a situation where a third party is appointed who has a contract with the brokers at the request of the client. The broker then pays the client some of the commission back when they trade. This results in the pension fund having an incentive to "direct" trade to particular brokers.

2.33 Directed commission is where the client tells the fund manager with whom to transact the business. There are differing views of this because of the danger to best execution.

2.34 However, it is clear from the CRA Pension Fund Trustee Survey that commission recapture is rare and isolated to the bigger funds.

Conclusion regarding the role of pension trustees

2.35 The scrutiny imposed by trustees on fund managers is increasing substantially. This is the result of regulatory intervention (the Myners Review), voluntary regulation (the Pension Fund Disclosure) and mechanisms that allow competition to operate more effectively (e.g. transaction cost analysis, commission recapture). However, it is still clear that:

- Monitoring performance through net performance is likely to be imperfect;
- Only some trustees currently monitor transaction costs charged directly to their fund;
- The monitoring of annual management fees is more intensive than that of transaction costs. However, it is unclear that this is based on any prejudice to the AMC but rather reflects the relative importance of these costs in respect to overall net performance; and
- Third parties are assisting pension funds in recovering excess commission costs but this covers only some parts of the market.

[15] Instinet p4

2.36 In conclusion, this suggests that there is likely to be insufficient monitoring of transactions costs by smaller pension funds and public funds but that market changes are ameliorating the problem.

The activities undertaken by fund managers

2.37 This section discusses the role and responsibilities of fund managers. First it points out that while net performance is an imperfect measure of fund managers' skills, it is nonetheless regarded by fund managers themselves as the primary means of attracting new and retaining existing business. Second it shows that the relationship between the fund manager and broker is complex, and encompasses not only transaction services and the monitoring of best execution, but also research which itself involves a number of overlapping issues.

2.38 Fund managers provide a range of services to the clients:

- Portfolio selection and strategy;
- Managing research inputs;
- Ensuring 'best' trade execution[16]; and
- Administration.

2.39 The fund manager undertakes these responsibilities on behalf of the clients (represented by the pension trustees in this case).

Portfolio selection and strategy

2.40 The primary role of fund management is to deliver net performance subject to the risk preferences of their customers. Fund managers compete primarily on net performance and their ability to explain variations in short term net performance. Although, as set out above, net performance is 'noisy' measure of fund management skill, it is the primary basis on which funds are selected and deselected.

2.41 The fund manager is directly remunerated on their performance through their annual management charge (or performance related charges), which is related to the value of the fund and therefore fund performance. In addition, the impact of net performance on new business represents another important justification for the focus fund managers place on net performance. In order to maximise their own returns, the fund manager therefore has an incentive to maximise performance of their funds through: the use of high quality research; efforts to minimise administrative costs; and processes that ensure the best execution possible.

Managing research necessary for assessing investment opportunities

2.42 Fund managers generally undertake some research internally but are also consumers of the research services of bundled brokers and independent research houses.

[16] Where best execution is defined a "well informed trade execution decisions made with the intention of maximising the value of client portfolios under the particular circumstances at the time".

2.43 To understand the motives for this we need to define the components of research carefully. Research is not a single product but must be decomposed into its constituent parts. Our categorisation includes:

- The creation of new trading ideas leading directly to investment strategies. Fund managers suggest that 35% of trades occur directly as a result of interaction with the broker[17];
- Research setting out the changing market conditions and new information released into the market. This is valuable in terms of providing the basic inputs to be used in internal research, for example information about the performance of companies. In addition, research includes information reflecting the market understanding of the environment which can be used in an assessment of how the market will react;
- The medium by which it is communicated: phone calls, meetings, conferences and written documentation, i.e., broker reports and circulars; and
- Finally, the research can be solicited, with the fund manager asking the broker to look into particular issues or unsolicited with the broker effectively 'pitching' an idea to a fund manager.

2.44 In many cases, research brings new information to the market that can be exploited in many potential areas by different types of investors. This type of research has a significant fixed cost to produce but low marginal cost to disseminate. Once it has been released it is then disseminated largely based on who values it most. This is best demonstrated by the value of the first call from a broker. This provides a company with the information first, making the information proprietary for a limited period.

2.45 In recent years hedge funds, who are able to take long and short positions with respect to particular trading opportunities, have been willing to pay more than traditional managers for a given value of trades, resulting in hedge funds often receiving the first call. However, although of lower value, further calls are made reflecting brokers' assessments of the value of their business relationships with the fund manager.

2.46 On the other hand, some research is basic with many users requiring identical information. Brokers or third party researchers most efficiently provide this to fund managers. In other words, it would not be efficient to undertake this research on a proprietary basis. This is true even of fund managers with significant internal research capabilities, for example, Fidelity or Capital International who are also significant users of external research.

2.47 While the proportion of internal versus external research varies across firms, few or none use one to the exclusion of the other. It is clear therefore that internal research is to some degree both a substitute for external research and a complement. The

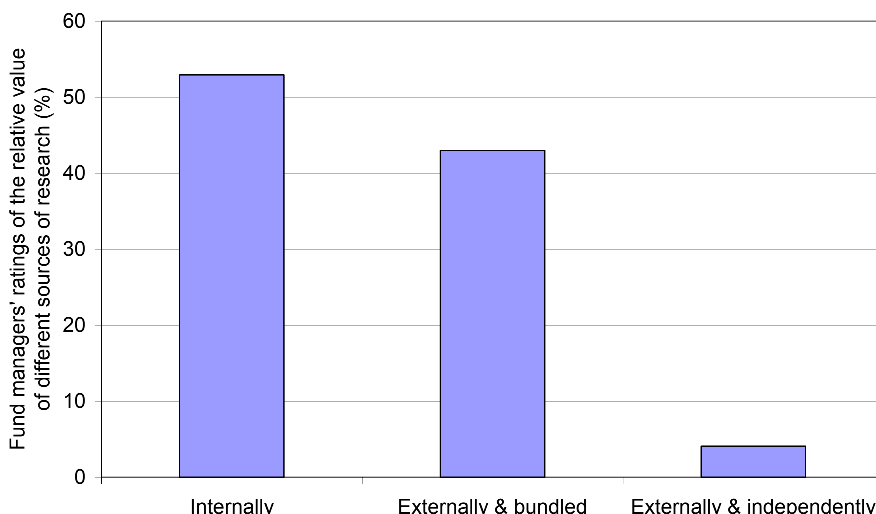
[17] CRA Fund Manager Survey.

extent to which this is this case varies from fund to fund and, for any given fund manager, depends on the weight they put on the external products available.

2.48 Evidence from the interviews undertaken for this project suggests that predominantly internal research should be seen as a complement to external research with the two roles performing slightly different functions. Internal research is used for investigating proprietary information and validating external research, while external research is vital to understanding how the market views new information. An efficient industry will therefore have a healthy internal and external research market.

2.49 This is entirely consistent with both the OXERA assessment of the relative importance of different sources of research[18] and evidence from CRA's own survey. This shows that by far the most important source of research is in-house research, followed by full service brokers with equal values being placed on third party research provided through soft commissions or hard cash (see Figure 2).

Figure 2: The value of rival research sources



Source: CRA Fund Manager Survey

2.50 The quality of research is closely scrutinised. Sophisticated systems are employed with staff asked to assess the quality of research provided.[19] This process is often a formalised voting system where fund managers are asked to assess the research capabilities of rival brokers over a period of time. A common process would have an annual review with votes reflecting a number of attributes. For example:

- The quality of the general sales contact;
- The value of the research; and

[18] OXERA (1) p 65.

[19] As noted in OXERA(1) p 33.

- The applicability to the investment strategy of the fund.

2.51 Often the approach is to allow fund managers who are also analysts to vote and they roughly weight the votes according to the market capitalisation of their sector, although there will often be some top-level adjustment. However, the exact structure varies between companies with some also giving dealers a vote. The resulting list is then passed to dealers as an aspirational target within best execution.

Acquiring trading services: Best execution

2.52 The regulatory obligation to ensure best execution means a high priority is placed on compliance monitoring and scrutiny of the performance of brokers. It is therefore unsurprising that OXERA found 88% of fund managers routinely assess the quality of execution. The systems for managing best execution were described in the OXERA report[20]:

- Firms commonly have a centralised trading desk separate from fund managers. Industry sources suggest this represents approximately 70% of fund managers and is focused on the largest ones;
- Brokers are placed on an approved list of those who have passed the necessary risk assessment. This list often includes a considerable number (i.e., over 100) of brokers. OXERA reports that listing and delisting is a common occurrence; and
- When instructed by the fund manager, the trading desk will then trade on the basis of best execution.
- External vendors such as Plexus or Elkins McSherry are used to assess whether best execution has been achieved.

2.53 It is clear, however, that the concept of best execution is not straightforward. Indeed, best execution needs to take account of the liquidity of the trade, the resulting cost of the commitment of capital by the broker and advice on working the trade to minimise market impact costs. These costs need to be accounted for in the costs of trading if best execution is to be achieved.

2.54 However, it is also true that fund managers take into account other factors when deciding which broker to use. When choosing a broker, fund managers look at execution quality, availability of in-house research, expertise, access to in-house analysts, as well as commission rates.[21] This in itself does not contradict best execution. If the broker is as good as executing the trade, then it is reasonable for the manager to consider other aspects.

2.55 Equally, it would be wrong to focus too much attention on one element of the transactions cost. For example, the division between spreads and commissions is largely arbitrary. Whether costs are priced into the spread (i.e. on net trades) or

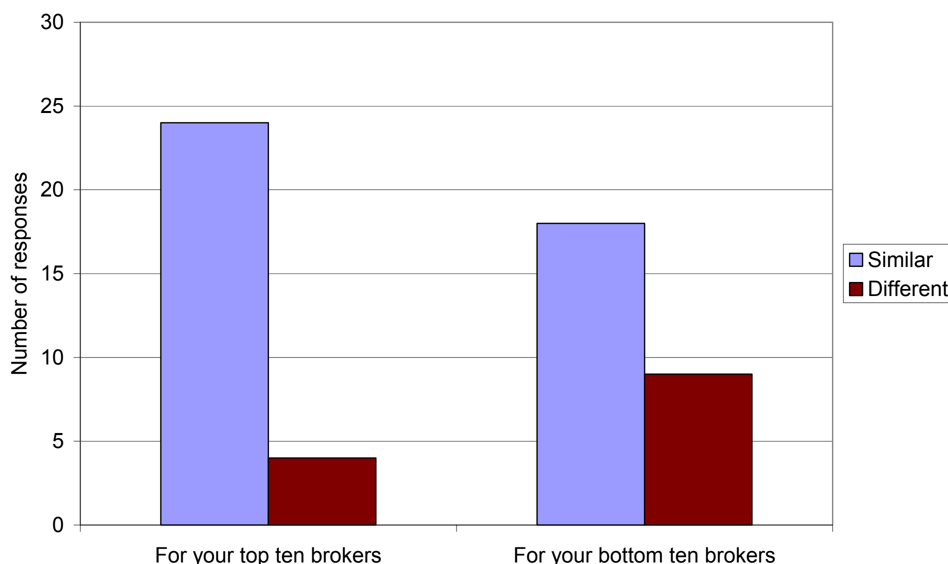
[20] OXERA (1) p 32.

[21] OXERA (1) p 34.

recovered through explicit commission charges often depends on whether the broker is committing capital. Given that fund managers tend to have standard rates across brokers, best execution or the search for the best price, should lead to lowest overall costs.

2.56 For any particular trade the fund managers have an obligation to find best execution. However, as described above, fund managers also rank brokers in terms of their ability to provide high quality research and set targets regarding the commission flows this warrants. It is quite possible therefore that the broker offering the best execution is not the same as the broker providing the best research.

Figure 3: Comparison of ranking of brokers in terms of execution and research capabilities



Source: CRA Fund manager Survey

2.57 Indeed, evidence from the CRA fund manager interviews supports the existence of this conflict of interest. As we might expect, a fund manager's largest brokers are assessed as similar in terms of their quality at execution and research capabilities. However, there are a number of other brokers used by fund manager who may be good at execution or research. This is demonstrated by the greater dissimilarity between rankings on the basis of best execution and on their research capabilities (see Figure 3). Even aspirational targets may therefore be of concern and have an impact on the desire to trade with particular brokers.

2.58 Different fund managers control this problem in a number of different ways. One of the traditional methods is to use commodity transactions, for which there is said to be little variation in the executing ability between brokers, to provide trading revenue as a reward for high quality research provision. For example, although research may be provided on a small cap company, the fund manager might direct trades in a very liquid stock, such as BT, allowing the small broker to be remunerated. This, it is argued, means the trade is being executed at a cost similar to the cost that would have arisen if it had occurred with the broker with the best execution capabilities.

2.59 In recent years, we have also seen a number of new developments that contribute to managing the conflict of interest. There are a number of variations, but the core idea remains the same throughout:

- Trades are executed purely on the basis of best execution. This may result in a reduction in the number of brokers used as fund managers seek efficiencies through consolidating order flow;
- There is an agreement between the fund manager and the core brokers regarding the allocation for the core broker and the fund available for reallocation. This ‘pot’ is held by the broker;
- The allocation of the pot is determined by a formal voting system by fund managers regarding research quality; and
- The pot is transferred from the broker to providers of research according to the voting system.

2.60 The various schemes differ in a number of respects, including the structure of the voting system and the extent to which monetary value is weighted by the vote. There is one example that is the closest to allocating budgets to fund management teams but even in this case it is clear that the allocation “is an art not a science” and there will be considerable adjustments made to equate votes to monetary value.[22] Equally, the schemes vary in their interpretation of the definition of softing. There are implications of these arrangements falling within the definition of softing in terms of their taxation and disclosure. Finally, they vary in terms of the possibility of rebates. In one of the arrangements we have examined a rebate is automatically repayable to the fund and is shared across all clients agreeing to the arrangement.

2.61 Currently only 27% of fund managers use systems that allow commission to be redirected from the broker executing the trade to the provider of research. However, this is anticipated to increase over time. Over 70% of fund managers not using these systems are thinking of utilising them in the future.

2.62 Equally, if firms were to adopt commission-sharing arrangements, they anticipate this would have a significant impact on the way they trade. For example 76% of fund managers believe it would change with whom they trade and 36% believe it would change the level of commission payable.

Conclusion regarding the role of fund managers

2.63 Fund managers compete primarily on the basis of net performance. Even, small changes in net performance over a period of time, which are not adequately explained, can mean the difference between retaining and losing fund management mandates. However:

[22] Applying a monetary value to votes is clearly theoretically attractive as it allows us to judge the amount of research in addition to the relative value of research. However, there are clearly situations where the value of research needs to take account of the value to multiple participants and will not be accurately reflected by adding up the votes.

- Net performance reflects not only the fund manager's skill but also chance and even many years of data on performance are insufficient to discriminate perfectly between fund managers who are efficient and those who are not;
- Fund managers may have conflicting objectives in attempting to obtain best execution and remunerate brokers for the research they provide. This problem has been managed in different ways:
    - Separation between best execution and allocation of research through centralised dealing desks. However, there would appear to be issues remaining around the provision of research by smaller brokers; and
    - In response, systems have been created that allow allocation of commission to providers of research independent of trade execution. In addition, this allows the benefits from buying research efficiently to be allocated across all participating funds (unlike commission recapture).

2.64 Whilst systems used to allocate commission to reward research and trade execution vary so significantly between fund managers, there is the potential for trades to be allocated on the basis of research capability rather than trade execution.

The activities undertaken by brokers

2.65 This third section discusses the activities and services of brokers, and describes how they provide the transaction services and research demanded by fund managers. The market for transaction services is highly competitive and brokers produce research simultaneously as a service to their clients and an input to their own market making activities. This is shown to have important consequences for both the costs and volume of the research produced

2.66 Brokers generally provide both trade execution and research services. However, the particular bundle of services offered to each fund manager will vary depending on their value to the broker. This is sometimes formalised in terms of fund managers being offered a differentiated service (gold, silver and bronze levels for example).

2.67 More commonly it is reflected in a negotiation between the fund manager and the broker regarding the level of business that might be expected and the corresponding level of service.

Trading services

2.68 Brokers compete with a range of alternative channels, competing to provide best execution. The range of trading mechanisms is increasing with the evolution of crossing networks[23] and the increased usage of execution only services. Survey results suggest alternative channels represented 11% of trades in 2002[24], with 93% of

[23] An electronic execution venue for fund managers that enables them to match buyers and sellers orders in securities directly with other fund managers. Commissions are typically lower while market impact and bid/ask spread are removed altogether for small trade sizes.

[24] IMA Asset Manager Survey 2002 question 7, 8 and 9.

fund managers believing that this level will increase or stay consistent and only 7% that it will fall.

2.69 However, although brokers compete with execution-only channels they also provide additional services through:

- Providing liquidity by committing their own capital to the trade. This allows fund managers immediacy with the resulting risk falling onto the broker; and
- Working the trade. That is, providing services to minimise market impact costs and reduce the costs of the transaction.

2.70 Care needs to be taken to consider the full diversity of services provided by different brokers. For smaller stocks, for example those listed on AIM, there will often only be one broker covering the company – often but not necessarily the company's broker. This broker has an advantage in trading as they often have unique information regarding the stock (for example, they know who has bought stock in the past).

Providers of research

2.71 In addition, brokers provide research to fund managers by disseminating market information, facilitating meetings with companies representing particular investment opportunities, constructing client specific strategies, and undertaking bespoke tasks requested by the fund manager. The balance of this package of services will vary depending on the value of the client relative to the trade and the value that the fund managers places on the service.

2.72 Evidence from qualitative interviews with brokers supports the development and provision of research as a common cost to the broker, in particular:

- It is shared with the investment banking operations of the bank, and in fact it will be used in assessing the opportunities for transactions;
- It is used as a marketing tool; and
- It is an input into proprietary trading and market making.

2.73 Information is also garnered through broking activity that is used in both broker research and other areas. This provides a clear economy of scope in the provision of brokerage services and research.[25]

2.74 In some cases, the distinction between research and trading advice becomes particularly difficult. For example, analysts will often provide access to research and give advice on working the trade to minimise trading costs. The distinction between a sales agent and researchers often therefore becomes quite blurred.

[25] Economies of scope are looked at in more detail throughout OXERA (1), for example pages 48-52; with a more theoretical description give on pages 119-120.

2.75 It is also clear that if brokers do not receive sufficient remuneration for their research services, they will withdraw the relevant level of provision from a fund manager. However, the services that will be provided will reflect their value and cost to produce. Therefore, it is unsurprising that fund managers still receive brokers' circulars or broker reports even if they conduct little business with a particular broker, as these services largely represent marketing by brokers at a very low marginal cost.

2.76 It is therefore a complex issue of cost allocation that is required for brokers to estimate how much it costs to provide research for different purposes. There is no right answer (in either practice or theory) to the question of how this allocation should be undertaken. This is further complicated if the onus is on the fund manager to ascribe a value.

Conclusion regarding the activities of brokers

2.77 Investment banks compete with each another regarding the price at which they trade and the quality of their research services. In general, if they do not offer best execution, they will lose volume. It is clear that:

- In terms of trade execution they compete with an increasing number of alternative trading mechanisms.
- In terms of research, they compete with one another and a fringe of independent research institutions.
- The costs of research are shared with the other activities of the investment bank, mainly proprietary trading and investment banking.
- The provision of trading services reduces the costs of attaining some forms of research that are applied in other areas. To this extent they share economies of scope.

2.78 It is clearly efficient for investment banks to undertake and disseminate basic research. However, the costs of this research are difficult to quantify. A proportion of the cost is shared by the other activities of the investment bank.

2.79 However, recent developments suggest that the market for broking is becoming more focused on larger brokers and systems are being devised to remunerate research traditionally undertaken by smaller specialised brokers. This suggests:

- Efficiencies are being exploited; and
- It might be possible to distinguish between the prices for trade execution and research.

The role of third parties

2.80 For the purposes of this investigation we are interested in two types of third party provider. Firstly, information providers such as Reuters, Bloomberg and Thomson Financial, and secondly, providers of independent research.

Providers of information services

2.81 Fund managers rely on electronic providers for asset pricing data. The principal providers of timely price data are Reuters, Bloomberg and Thomson Financial. That said the market is somewhat more complicated.

- The typical products of all three include a range of services above and beyond price data. News and research are the most prominent examples; and
- Some brokers provide electronic pricing data that is a substitute for the services of the traditional providers.

2.82 Accordingly, competition is not restricted to the three principal providers who are themselves in competition with:

- 24 hours news channels;
- "Hard copy" providers of research; and
- Brokers.

2.83 Competition between providers is on the basis of price, quality and coverage. Over recent years prices have been relatively stable while continuous development has improved quality and coverage.

Independent research in the UK

2.84 In the UK, the market for independent research is relatively immature. We have found two types of independent research company:

- Economic research – as provided by Lombard, Smithers and Capital Economics; and
- Independent equity research.

2.85 Independent equity research is a very small market indeed. The largest player is currently Arrete, set up in 2000. This has grown to 11 analysts focusing on the Internet/Telecoms area. However, given there are only a small number of participants in the market, there currently appears to be some difficulty in selling independent research.

2.86 Evidence based on interviews with the existing independent research firms suggests the market is currently limited by the lack of individuals with a reputation sufficient to charge for research services.

Mechanisms for paying for additional services

2.87 This section moves from the behaviour of the market participants to the forms of contact that exist between them and how their activities are remunerated. It centres on two main methods of payment for services, soft commission and bundling, and describes how they work in practice.

2.88 The focus of the regulatory debate is on mechanisms by which the activities of fund managers and brokers are remunerated by the pension fund. In particular the use of:

- **Bundled commission**: full service brokerage bundles the activities of trade execution with the provision of additional services such as research. This is paid for through a single commission rate for executing trades, resulting in the appearance that research is provided for free. This cost has traditionally been deducted directly from the fund without requiring the pension fund to agree to a particular level or value.

- **Soft credits**: An alternative mechanism for paying for additional services is the provision of soft commissions. These are agreed in advance between the fund manager and the broker and earned through trading. These are used to pay for particular FSA approved services from third party providers.

Paying for bundled services through commission

2.89 The vast majority of external research is paid for through bundled commission. The market works through fund managers setting a level of commission for bundled services, this will commonly be the same across all brokers used by the fund manager. This will be negotiated when particular trades arise, alternatively, the broker will offer differential levels of additional services.

2.90 Evidence from our qualitative interviews suggests that the relationship is somewhat dynamic. When the level of trading reaches a level where the fund manager believes they have paid sufficiently for additional services, the fund manager may choose to execute trade on execution only channels or negotiate trades at a discounted rate.

2.91 Alternatively, if the broker believes they are getting insufficient volumes resulting from the arrangement, they will lower service levels to the fund managers. In this way the level of bundled services is adjusted to reflect the incentives on both sides.

Soft commissions

2.92 Just over half of fund managers use soft commissions. It is generally accepted that soft commissions are used to acquire a range of services but are most important for:

- Market pricing information such a Reuters and Bloomberg;
- Performance measurement; and
- Research.

2.93 The current level of softing varies significantly between fund managers, but on average this accounts for about 7% of total commissions.[26] In recent years, there has been a substantial decline in the use of softing. In the CRA Fund Manager Survey, 65% of fund managers say the acceptability of softing has reduced. It is anticipated this trend will continue to occur.

[26] IMA Fund Manager Survey question 9.

2.94 The reason for this lies partly in regulatory action such as the Myners Review but also market forces. The market itself was already moving away from softing with a number of fund managers choosing not to trade using softing commissions. For example, recent entrants to the UK market have chosen not to conduct business through soft commissions believing this will help them create a trusted brand. Equally some trustees have requested that their fund managers do not use soft commissions when trading on their behalf.

2.95 However, it is important to note that evidence suggests that the use of softing is not reflected in the resulting charging structure. It appears that fund managers who do not choose to use softing are not able to charge a higher annual management charge and trustees who do not allow softing do not pay either a lower level of commission or a higher AMC.

2.96 Equally, although softing may have a tarnished reputation, the use of commission to pay for third party providers has been actively encouraged by the regulator. The FSA itself has been assisting independent research houses avoid being tarnished with the reputation for softing. In particular, they have provided a letter setting out the following:[27]

> *"The definition of a "soft commission agreement" in the Glossary to the FSA Handbook requires there to be an agreement in any form between firms where one firm receives goods or services in return for designated investment business put through or in a way of another person.*
>
> *I understand that XXXXX proposes to provide research to XXXXX. XXXXX will then use its brokers in the normal course of its business, but will mark relevant deals with "XXXXX deals". This will flag to the broker that the deal in question is triggered by consideration of XXXXX's research. The broker will (or may) then enter into a commission sharing arrangement with XXXXX. XXXXX will be under no obligation to provide details of XXXXXX deals to XXXXXX itself. However, I imagine that XXXXXX will request this as a means to reconciling the relevant deals with the payments received from the broker.*
>
> *Importantly, there will be no obligation, express or implied, on XXXXX to place any volume of deals with any broker or any group of brokers. As such, there is no risk that XXXXX might feel obliged to place deals with particular brokers for which the broker is not "best", in order to fulfil the quota of deals to pay for research.*
>
> *An arrangement such as I have described above would not amount to a "soft commission agreement".*

Incentive misalignment

2.97 To finish our assessment of the current market we assess the possible misalignment of incentives for the fund manager acting as an agent for the trustees. It demonstrates that, although soft commissions can offer direct benefits to the fund managers, and thus give rise to a possible misalignment of incentives, there are, at the same time, significant constraints on the extent of this behaviour. It also shows that in the case of bundled brokerage the incentive problem may lead to the fund manager exercising

[27] FSA Letter provided by a number of industry participants.

insufficient scrutiny on the costs of research. Yet, while it is clear that these problems may arise, the evidence that they are significant is not conclusive.

2.98 Given the incentives as described above and the current method of remuneration the FSA has assessed there to be a significant principal-agent problem that is leading to a misalignment of incentives.

Soft commissions

2.99 The FSA has argued that because the costs of market pricing services are paid directly through commission deducted from the fund, the fund manager has insufficient incentive to scrutinise the use of these services resulting in over consumption and over paying.

2.100 In particular, any excess consumption in the amount of services purchased through soft commission only has an indirect impact on the fund manager (as it results in a lower fund value due to lower performance and hence lower charges) but a direct impact on the fund. Therefore, the incentive to manage the level of market pricing services, for example, is diminished as the cost of scrutiny falls directly on the fund manager but the returns are diluted. In effect both the resulting level of commission and the consumption of services are too high.

2.101 Secondly, as different brokers offer different softing arrangements, this could affect fund managers choice of who to trade with – potentially at the cost of giving up best execution.

2.102 There are a number of mechanisms that could reduce the incentive for any bias in this direction in addition to the separation between dealing activities and aspirational targets described above.

Internal constraints on the use of soft commission

2.103 The great majority of fund managers (80%) have internal constraints on the use of soft commissions. This may be expressed as a nominal amount but usually as a maximum percentage of gross commissions (in most cases between 10 and 20%). In addition, to these global constraints others may be applied to particular funds. However, in practise these constraints are very rarely binding.

The use of hard cash in combination with soft commission

2.104 A final constraint on the incentive to use soft commissions is if they were used only as a part payment for particular products. If this is the case, the fund manager would still be responsible for purchasing the marginal services and these would only be purchased if the benefit were positive. There is, then, no incentive for the fund manager to spend hard cash on services that reduce net performance.

2.105 Evidence from the CRA Fund Manager Survey finds that about 56% of fund managers do not purchase any single service entirely through soft commissions. The remaining 44% of fund managers do buy some services in their entirety through soft commissions. These are commonly market pricing services.

Bundled brokerage and cost pass through

2.106 OXERA and the FSA argue, that bundled brokerage and cost pass through leads to the fund manager having an incentive:

- To exert too little scrutiny on research costs leading to excessive research;
- To over trade in order to acquire additional services;
- To trade with the wrong participants leading to higher costs of trading than would otherwise be the case; and
- To buy from bundled suppliers and neglect more efficient research providers lowering the quality of research.

2.107 OXERA and the FSA suggest that this lack of incentive arises from a principal agent problem that arises because the incentives of the fund manager and the pension fund are not perfectly aligned. Actions taken to increase the performance of the fund directly affect the return to the fund but only a proportion of this is passed to the fund manager. This along with the noise in performance data means that the net performance incentive is imperfect, as stated above.

2.108 This results in an incentive for the fund manager to put too little effort into scrutinising the quality and quantity of research acquired is too high.

Testing OXERA's analysis of the principal agent problem

2.109 CRA research suggests that the importance placed on net performance is supported by strong evidence:

- Fund managers see net performance (and the explanation of its deviation) as the principal basis of competition both for current and new business; and
- Trustees focus on net performance in their appraisal

2.110 Net performance also affects fund managers profitability through that the AMC and performance related charges. Therefore, we should not underestimate the degree to which there is incentive alignment between fund managers and their clients. Indeed this would provide sufficient incentive to monitor research appropriately if scrutiny of the quantity of research purchased is costless to the fund manager, i.e. the fund manager would have no incentive to buy too much research if it did not impose a cost on them other than through net performance.

2.111 However, if there is a cost saving to the fund manager through purchasing too much research, either through lowering the direct costs to the fund manager or reduced cost in managing the level of research there is in principle a problem to be addressed. CRA accept that if such a cost is significant the principal agent problem addressed by OXERA may exist. In essence the direct incentive to save a cost (scrutiny) may well be stronger than the profit incentive that comes less directly through net performance.

2.112 In addition, there is weak evidence that this distorts trading behaviour:

- Survey evidence suggests that bundling research may result in sub-optimal trading decisions associated with smaller brokers. In our survey of fund managers we asked whether the rankings of trading volumes and value of research were the same or dissimilar. If they were the same then there would be no potential for misalignment of remuneration of research and best execution. However, these appear to be dis-similar for smaller brokers. This at least provides the opportunity for a problem;
- There is also survey evidence that the use of bundled brokerage has resulted in trading with too many participants – potentially at the cost of best execution. This is illustrated by over 75% of fund managers believing that adopting commission sharing would have a significant impact on who they trade with;
- There is, however, no support for over trading with commission sharing having no impact on the number of trades. Over trading reduces net returns to a greater extent than simply increasing the rate of commission. That is, as the level of additional services could be financed through a higher commission on a lower trading volume, there is no justification for believing that a principal agent problem will lead to over trading. No evidence has been presented that there is churning in the UK.

Conclusions regarding the scale of any 'perceived' problem

2.113 The extent to which this is a problem in practice or if there are any proposals that are net beneficial is a matter of evidence.

2.114 Reviewing the activities of trustees, fund managers and brokers illustrates that the market for bundled services is not perfect, in particular:

- Net performance does not allow trustees easily to fully differentiate between high cost and low cost fund managers of the same quality. It is clear that even large changes in charges result in only small changes in net performance that will easily be obscured by random variation in returns;
- Monitoring of transactions costs will always be imperfect and is still only undertaken by a proportion of the market; and
- It is therefore possible that this results in insufficient scrutiny of additional services, i.e. in particular research costs for smaller brokers.

2.115 However, there is good reason to believe these problems are small and decreasing:

- Evidence that costs are often paid partly through softed commission and partly by hard cash implying little incentive to indulge in excess consumption;
- A number of market trends alleviating the principal agent problem:

- Improving trustee sophistication due to pressure arising from the Myners Review increasing scrutiny and the use of information already provided by the fund management industry;
- Increased use of transaction cost analysis;
- Impact of voluntary regulation, in particular, the Pension Disclosure code; and
- Market innovation such as commission sharing or broker segmentation.

2.116 However, if there are regulatory interventions that further reduce any potential problem (however, small) at little cost they must be considered by the industry as a positive intervention.

Section 3 The FSA's proposal and an alternative proposal

3.1 In order to test the FSA's proposals in CP176, where the rules are only briefly described, we need to make certain assumptions about how these might work in practice.

3.2 In some cases, there is considerable uncertainty about how the rules will be implemented. Where this causes ambiguity we have made a central assumption and this is then tested within the cost-benefit analysis.

3.3 Where the FSA has not stated a policy we assume the current rules remain in place. For example, we assume that both client-directed commissions and commission recapture are permitted to continue.

Proposal 1: Limiting bundling/softing of predictable costs

> *"Goods and services of which demand is necessarily predictable should be excluded from those that can be purchased with commission, whether under soft or bundled"*

3.4 This proposal will mean that a number of services that are currently allowed under the softing rules will have to be paid for through hard cash. In particular, this will cover:

- Market pricing and information services (e.g. dedicated terminals or integrated with-in house systems);
- Computer hardware associated with specialised computer software or research services;
- Dedicated telephone lines; and
- Payment for seminars and publications.

3.5 This will be in addition to the services already prohibited. The firm will be free, however, to try to recover this cost through a higher annual management charge or an explicit charge agreed by the client.

3.6 The proposal covers all mandates operated by UK fund managers and the UK branches of overseas firms.

3.7 The proposal applies equally to retail and institutional portfolios.

3.8 Where services are also used for international business outside of the FSA's jurisdiction, the cost of services used in UK trades will be apportioned according to a rule disclosed to the client.

Proposal 2: Rebating the cost of bundled services

> *"To ensure greater transparency and accountability in the use of commission, the fund manager buying additional services to trade execution should determine the cost of services and rebate an equivalent amount to customer funds."*

3.9 This regulation will separate total commissions into those that are directly related to trade execution and those that are "additional" to trade execution, such as: general advice, telephone calls with sales person in the research department, access to market and industry information, investment analyst reports, priority calls from brokers or access to IPOs. These "additional" services can be bought via a commission paid by the fund manager to the broker and charged directly to the portfolio. However, a rebate will need to be made to the account.

3.10 The rebate can be calculated in a number of ways, but responsibility lies with the fund manager. For example, the valuation of additional services could be derived from any of the following: a process based on softed invoices, where allowable; the broker providing unbundled prices (even if not sold unbundled); the broker breaking out only cost attributable to execution; a fund manager's own model; or the use of proxies from independent suppliers.

3.11 We assume this will not apply to activities directly related to managing trades to ensure best execution, such as electronic trade confirmation services, fund managers receiving advice on trade execution from the trader or the cost of capital employed by brokers in executing trades.

3.12 Proposal 2 applies to the same fund managers as Proposal 1. The fund manager must be satisfied on reasonable grounds that commission paid under the agreement will be sufficient to cover the value of "additional" bundled services and the costs of execution. However, the rebate will need to cover costs of services beyond trade execution, i.e. fund managers will not be able charge zero price for research but will have to assign a fair value to these services. However, as this is not directly related to trading this would be liable for VAT.

3.13 Marketing by brokers will be allowed as a cost by brokers, which will not fall under CP176, but is likely to be subject to scrutiny if abuse arises.

Comparative Disclosure

3.14 It is useful to compare the FSA's proposals in CP176 to alternative proposals that might meet the perceived problems at a lower cost. To ensure a fair assessment, we need to specify these alternative rules in the same level of detail and subject them to the same testing procedure. Concern has been expressed on the following points:

- Commission costs, which are insufficiently scrutinised such that competitive pressure is exerted on bundled services;
- The significantly varying levels of sophistication and responsibilities of trustees, which reduces the effectiveness of disclosure; and
- Bundled services that lead to distortion in the incentives for best execution.

3.15 An alternative solution that addresses these concerns would therefore (1) promote processes that might address any conflict between research and best execution; and (2) provides relative information to clients using benchmarks. Accordingly, we call this "Comparative Disclosure".

3.16 The objective would be to (1) provide 'useful' information to the trustee; (2) provide information enabling trustees of differing levels of sophistication to get a similar level of service; (3) prompt trustees to question commission and its relation to net performance; and (4) provide benchmarks of average commission levels (and its constituents) to trustees rather than simply asking them to decide whether or not to pay for particular services.

Comparative Disclosure

3.17 This will apply to all mandates operated by UK fund managers and the UK arm of overseas fund managers as in Proposal 1 and 2 above, but because all costs remain bundled with trading they will not be liable for VAT. This would apply equally to retail and institutional portfolios.

Changes to Level One disclosure

3.18 In addition to the current disclosure set out in Level 1 of the IMA/NAPF disclosure code we will include a section on the remuneration of research in particular, processes that might address any conflict between research and best execution.

3.19 Commission sharing might be an example of a system that does resolve this conflict – although this will depend on its design and application. However, internal controls within fund management firms may be sufficiently robust.

3.20 In addition, funds managers would be asked to detail the outcome of systems that ensure both best execution and appropriate remuneration for research. In other words, we have suggested anonymous rankings of:

- The proportion of trading volume that goes to each of their providers of bundled research; and
- The proportion of bundled research provided by each of their brokers by volume of trading.

3.21 This would enable trustees to observe whether there is a risk that trade counter party might have been driven by research rather than best execution. Finally, any rebate received from the fund manager by the broker would also need to be disclosed.

3.22 All of the following would also need to be disclosed: the rules the fund manager relies on for apportioning costs between institutional and retail portfolios and between other portfolios; any rebates negotiated from brokers for additional services and how they are refunded to portfolios.

Changes to Level Two disclosure

3.23 The services where softing is prohibited will remain the same. However, firms will still have to disclose the proportion of commission costs that relate to trade execution and additional services. This will apply both to trades paying bundled commission and to those that are softed. The definition of "additional" services to trade execution will be the same as in Proposal 2. The valuation of services will still be the

responsibility of the fund manager, who will be free to use the same potential methodologies for valuation as in Proposal 2.

3.24 As in Proposal 2, commissions allocated to research will not be allowed to cover costs of services beyond trade execution, i.e., fund managers will not be able to allocate zero price for research but will have to assign fair values to these services. Where services are also used for international business outside of the FSA's jurisdiction, the cost of services used in UK trades will be apportioned according to rules disclosed to the clients.

3.25 In addition to the disclosure set out in Step 2 of the IMA/NAPF disclosure code an additional table (see Table 2) defines the format for comparative disclosure, comparing the portfolio to the average across all portfolios provided by the fund manager.

3.26 We also consider whether comparing the portfolio to the average in the industry would be meaningful or feasible.

Table 2: Comparative Disclosure

Counter party	Trading volume for period			Commissions and fees paid during the period					
	Total (£)	% Traded net	% Subject to commissions	Total (£)	Under softing arrangements		Other – including bundled		
					Trade execution (%)	Other services (%)	Trade execution (%)	Bundled services (%)	Execution only (%)
1									
2									
:									
10									
Total									
Company wide comparator									

Source: CRA

3.27 Managers will be free to provide further information on the style, market or other characteristics of a portfolio that might help to explain deviations from the average.

Encouraging trustee scrutiny

3.28 Finally, we wanted to test mechanisms for encouraging trustee scrutiny beyond the provision of information. In the case of unit trust companies we investigated whether imposing the board structure of US mutual funds would be an appropriate intervention, or alternatively whether it was possible to encourage competition between trustee companies. These proposals are relatively 'green' but reflect the need to design specific policies to address issues arising in the retail sector.

Current unknowns: Convergence of international regulation

3.29 A significant unknown at present is the issue of whether any other financial regulators will chose to adopt plans similar to those proposed by the FSA.

3.30 The Annex to this report discusses publicly available information on the position of major financial regulators. However, it is not possible to judge with any certainty whether or not other countries will adopt the FSA's proposals, either immediately or in the near future. Public evidence would appear to suggest co-ordination in unlikely.

3.31 This could have significant impact on the analysis of the market outcome. In particular, we need to consider whether firms might believe it advantageous or possible to avoid regulation resulting from CP176 by locating their activity in other jurisdictions. We therefore consider two scenarios in our cost-benefit analysis. Firstly, that the FSA chooses to adopt this regulation in isolation. Secondly, that all other countries adopt similar regulation to Proposal 1 and Proposal 2.

Section 4 Market outcomes

4.1 Before turning to the cost-benefit analysis (that attempts to quantify and aggregate the overall impact in terms of social welfare), it is useful to consider how the proposals will work in practice. The objective is to understand the incentives of different participants, and thus their likely behaviour, and then assess how this might allow us to determine the market equilibrium. This draws heavily on results from the CRA Fund Manager Survey and the CRA Pension Fund Trustee Survey.

4.2 Where there are significant uncertainties we may need to consider a number of potential equilibriums. The task is then to identify the likelihood that a specific market equilibrium might occur.

Analysing the market outcome of Proposal 1

4.3 The FSA suggests that "predictable" inputs ought to be paid for explicitly by the fund manager and not directly out of client funds. This is in line with the analysis of Brealey and Neuberger, who argue that trading costs are unpredictable and therefore should not be included in the annual management charge.[28]

4.4 The impact of Proposal 1 will mostly affect electronic market pricing services that have traditionally been paid for by soft credits, but also includes computer hardware, dedicated phone lines, and seminars.

4.5 The primary impact of Proposal 1 is that it makes market pricing services a direct cost to the fund manager. For the 45% of fund managers who do not currently use soft commissions this will clearly have no impact. All other fund managers, however, will have to choose whether they are willing to pay for these services through hard cash in the future.

4.6 Evidence from the CRA Fund Manager Survey suggests this would raise fund managers' costs by 4.5%. However it is true that a fund manager would be able to reduce the impact of this cost increase through (a) raising charges; (b) reducing the consumption of services that were previously acquired through softing; or (c) avoiding the implications of the regulation in a manner unintended by the FSA.

Impact on charges

4.7 Our survey results suggest that 73% of fund managers believe that they would not be able to raise prices to cover the cost of market pricing services due to:

- The danger of a perceived price increase, even if it was offset by a reduction in the cost of commission;
- Buyer power residing with the fund, which would not allow additional charges. Evidence from our interviews with fund managers suggests that few recent price

[28] "Treatment of investment management fees and commission payments: an examination of the recommendations contained in the Myners report", October 2001, Brealey and Neuberger.

increases have been allowed and indeed that there is actually pressure for price reductions;

- The current economic climate and the low (in some cases negative) returns obtained by funds during the bear market, which would make any increases difficult to justify;
- The impossibility of fund managers co-ordinating price rises, as competition dictates they keep rates in line with those available on the market, and even if this were not the case, co-ordination would be unacceptable in competition terms; and
- There is currently little variation in the charges of fund managers who and do not choose to use soft commissions. Equally, pension funds that don't allow their fund managers to use soft commissions appear to pay similar charges and commissions. Following the introduction of Proposal 1, they might rightly ask why an increase in charges is necessary now when it was not in the past.

4.8 There is therefore good reason to believe that there will be little variation in the AMC and instead we should expect to observe changes in the actual demand for services.

Impact on the demand for services previously acquired through soft commissions

4.9 Unlike bundled services, softed services have a going price (in the shape of the invoice received from the third party provider[29]) and most fund managers do not anticipate this price changing following the introduction of Proposal 1.[30] Therefore, fund managers have a good estimate of the prices that might be charged in the future.

4.10 Asked whether this would result in lower quantity of services such as market pricing information, 30% said this would reduce their demand for such services. On average they thought this reduction would be 17.5%.

4.11 Furthermore, only half of that 30% thought that the quality of market pricing services consumed would be affected. This would seem therefore to corroborate the FSA's findings that the proposals may reduce demand for these services, but that there may in fact currently be excess consumption.

Impact on trading behaviour

4.12 We find that fund managers do expect the proposals to influence with whom they trade and the level of commission they spend.

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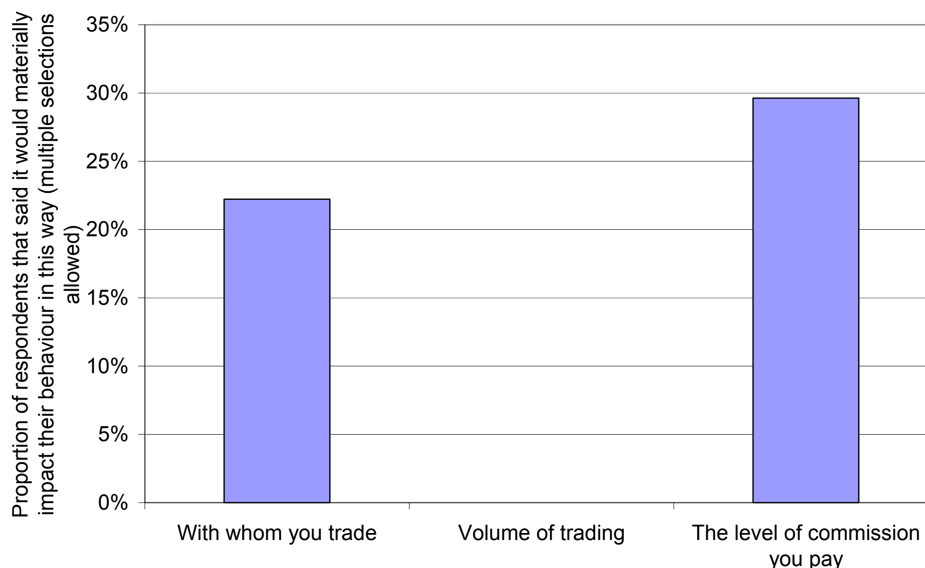
[29] In the UK, the invoice must go directly to the fund manager who can then ask the provider of the softed credits to pay for it. In the US, for example, invoices can go directly from the third party provider to the broker.

[30] It was possible that the price could have been higher or lower following Proposal 1. For example, through softing brokers may have been able to negotiate a bulk discount resulting in lower prices. Alternatively, as this was paid through softed commissions market pricing providers might have used the opportunity to inflate the cost.

Figure 4: The impact of Proposal 1 on trading behaviour



Source: CRA Fund Manager Survey

4.13 CRA's evidence appears to support the conjecture that current softing arrangements do impact on trading behaviour. The impact of Proposal 1 would be to reduce trading with brokers who have offered soft commissions and focus primarily on brokers offering the greatest liquidity.

4.14 However, we do not anticipate that the overall volume of trading will be affected.

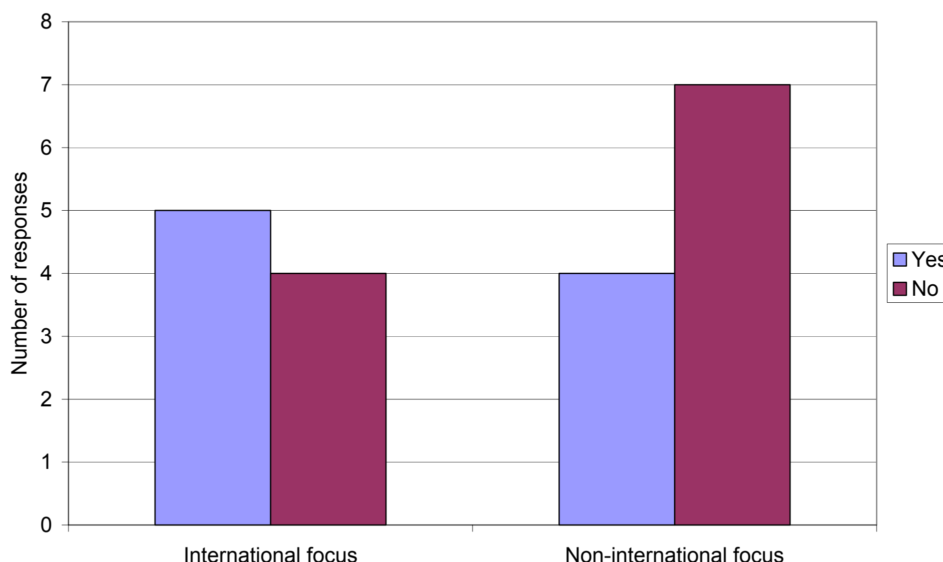
Unintended consequences

4.15 As discussed in chapter 2, fund management services are traded internationally often involving global companies competing for business in many locations. There is therefore at least the possibility that fund managers will be able to mitigate any impact from Proposal 1 through:

- Using market pricing services softed from other jurisdictions; and
- Moving the domicile of activities outside the FSA's regulatory responsibility.

4.16 Evidence from the CRA Fund Manager Survey suggests that a minority of respondents would consider such strategies (see Figure 5). 30% would consider using terminals softed from other jurisdictions, while 45% would consider relocating their own activities. As might be expected the latter issue is strongly influenced by the focus of business activities. Fund managers with more international clients are clearly much more likely to consider relocation.

Figure 5: Consider relocation of activities



Source: CRA Fund Manager Survey

4.17 In contrast, the ability to use terminals appears to be dependent only on having international presence rather than size. Clearly, if other locations implemented similar regulations, or if there were effective rules on the allocation of market pricing costs to particular jurisdictions, such regulatory arbitrage would be prevented.

Conclusions regarding Proposal 1

4.18 Proposal 1 would appear therefore to lead to little impact on the level of charges but a reduction in the demand for softed services would probably occur, reducing excess consumption and resolving any related broker selection biases.

4.19 Based on survey evidence, international fund managers would consider changing domiciles to avoid the impact of CP176. However, as this issue only represents 5% of costs, it is more likely that this will simply lead to further erosion in fund manager profitability rather than any significant move to other jurisdictions.

4.20 In summary, our view on the desirability of Proposal 1 is based on the cost benefit analysis (see Chapter 5) rather than on any belief that a serious market problem will arise if implemented.

Analysing the market outcome of Proposal 2

4.21 The outcome resulting from Proposal 2 is significantly more difficult to determine, as all fund managers, to a greater or lesser degree, use full brokerage to acquire research services. They will be able to continue to buy services in this way in the future, but will need to negotiate with the fund to recover these costs.

Impact on charges

4.22 Unlike services traditionally consumed through softing, there is little understanding of the costs of services acquired through full service commission. The responsibility

for setting the price of research will fall on the fund managers. However, they will be able to use a number of reference points to determine the cost of research:

- Independent provision (although as these cannot benefit from economies of scope they are likely to represent an upper bound);
- Their own internal research costs;
- Estimate derived from brokers; and
- Internal models.

4.23 We need therefore carefully to consider how the price for research services will be derived. In the first instance, the fund manager will want to pass all the costs of research onto the fund.

4.24 In other words, if we use OXERA's example[31] of a fund with a value of £200m, with turnover of 40% per year and a commission rate of 14bp, this results in total dealing costs of £112,000[32]. Using OXERA's estimate of the allocation to research of 3bp, this gives a total allocated to research of £24,000[33]. Accordingly, if the management fee is 28bp (i.e. £560,000[34]) and this was charged directly to the fund the increase in the annual management charge would be 4.3%[35].

4.25 Evidence from fund managers, however, suggests there will be considerable resistance to increasing prices. On average only 25% of funds are assumed to be willing to pass on the costs through higher charges. From a strict economic viewpoint this is perhaps unsurprising as fund managers think it will be extremely difficult to charge explicitly for research.

The free rider problem

4.26 A number of pieces of evidence point to the likelihood that free riding by some trustees will lead to an unwillingness to pay for research, resulting in significant under-consumption of research. The CRA Pension Fund Trustee Survey shows that:

- Trustees do not currently understand the role of research in the investment process: 42% are not aware that research is purchased on their behalf, while another 30% understand the need for research but not do not believe they are paying for it; and
- Of those who do understand that they are paying for advice, 85% believe they are already doing so through the annual management charge.

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[31] OXERA (1) p58

[32] £200m × 40% × 14bp = £112,000

[33] £200m × 40% × 3bp = £24,000

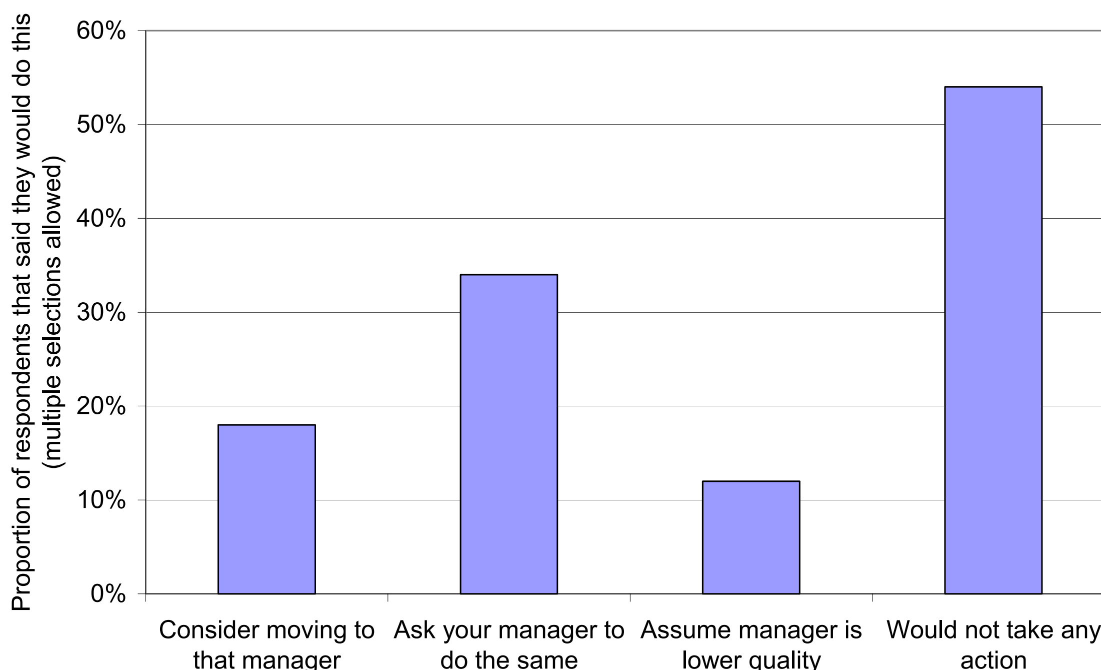
[34] £200m × 28bp = £560,000

[35] £24,000 ÷ £560,000 ÷ 100 = 4.3%

4.27 Based on interview evidence, a significant number of trustees believe they should not be paying for research. Some have given reasons such as "only 'internal' research is valuable as external research is non-proprietary" and research is already paid for by "large funds".

4.28 It is also likely, at least initially, that not all fund managers will pass on the cost of research. In the eventuality of competition between fund managers to absorb the cost of research, more than 30% of trustees suggested they would either consider changing managers or ask their current manager to also absorb the cost.

Figure 6: Behaviour of trustees faced by an alternative fund manager absorbing the cost of research (multi-code answer)



Source: CRA Pension Fund Trustee Survey

4.29 This evidence from trustees would be more helpful if fund managers could effectively discriminate between those clients that are willing to pay for research and those that are not. The evidence from the CRA Fund Manager Survey suggests that fund managers are not fully prepared to do so:

- The majority of fund managers will continue offering the same service to trustees who do not allow charges to be raised. In any case, best execution makes discrimination difficult unless managers can offer distinctly different services, such as pooled investments, to clients that are unwilling to pay for research;
- The inability to co-ordinate price increases means that some fund managers may not increase the AMC; and
- This increases the incentive for funds to 'wait and see' if refusing to allow a higher AMC affects their standard of service.

4.30 Taken together this evidence points to a significant free rider problem and an unwillingness for any increase in annual management charges to reflect the cost of advice. There is therefore a real chance that the equilibrium level of research will fall below the optimum.

4.31 If it is not possible to pass on prices, fund managers will necessarily look at strategies for minimising the need to increase charges. One of the simplest solutions would be to inflate the costs of trade execution, i.e. 100% of the commission being allocated to trade execution. This works to the fund managers' advantage as they can continue to pay for research through commission deducted directly from the fund.

4.32 The degree to which this will be possible will depend on the relevance of external comparators, such as execution only, but, as set out in Chapter 2, brokers also provide services that are additional to execution, such as liquidity and assistance working the trade. It will therefore be difficult to determine if the cost of trade execution is too high.

<u>Impact on the demand for services acquired through full service brokerage</u>

4.33 Evidence from the CRA Fund Manager Survey suggests that this would necessarily result in a significant reduction in the demand for full service brokerage. In particular, fund managers believe that this will encourage execution only transactions and result in a significant reduction in the overall level of research. Again we should question whether this is consistent with the economic incentives.

The principal agent problem and amplified effect

4.34 In Chapter 2, CRA accepted that if there is a cost to scrutinise research (or a saving in direct costs) then under-investment in scrutiny by fund managers could lead to over-consumption of research. CRA also accept, that imposing the cost of research directly on fund managers will reduce the consumption of research.

4.35 However OXERA have provided no evidence or theoretical model to establish that the resulting level of consumption will converge towards the optimal level at which client net performance is maximised.

4.36 Indeed, the same model would seem to predict that imposing the full cost of research on fund managers would have the perverse effect of pushing consumption <u>below</u> the net performance maximising optimum.

4.37 For example, in the same way that fund managers might benefit under the current regime from buying too much research, they will be able to benefit under CP176 by buying too little. This will have an impact on net performance but the impact on the returns to the fund manager will be diluted compared to the effect on the fund itself.

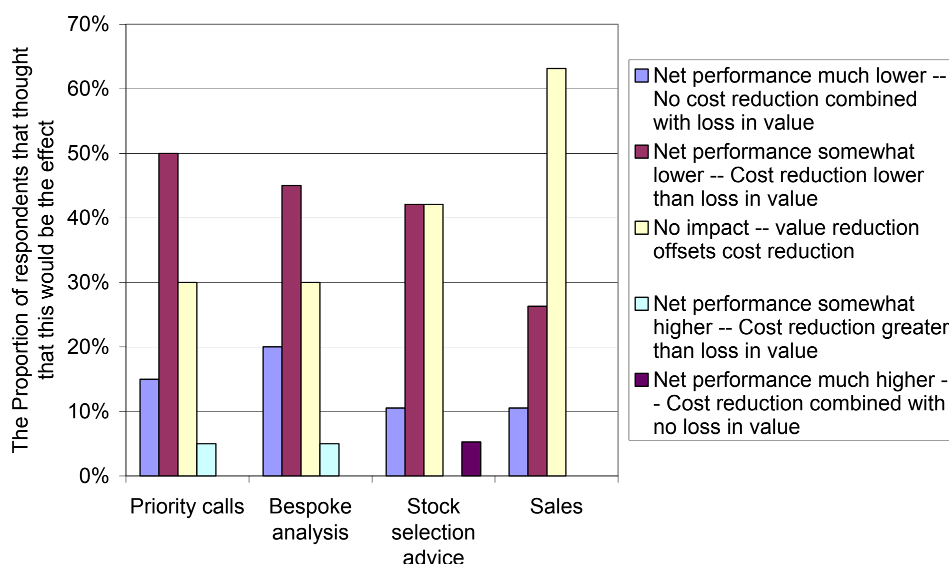
4.38 Indeed, given the costs of managing the level of research are likely to be small compared to the cost of research itself, the incentive to 'shirk' by consuming too little research will be amplified.

4.39 If this is the case then it must also be true that imposing a far larger direct cost on fund managers will provide an incentive to reduce consumption by far more than any excess consumption arising today, i.e. if we use the FSA's example of 10% excess consumption, consumption under CP176 would fall by far more than 10% below the optimal level of research.

4.40 Evidence from our fund manager survey suggests this might be focused on particular sectors, with fund managers universally believing that it will lead to a substantial reduction in research into smaller companies.

4.41 However, even if we accept that research will fall by only 10%, it is still necessary to investigate the impact on net performance. We therefore investigated the impact of reducing different elements of research. Clearly, if there is over-consumption, a reduction of 10% should increase net performance and if too little research is purchased this should reduce net performance. If the optimal level is purchased this should lead to a small (or marginal) decrease in net performance (assuming 10% is small which is questionable). Figure 7 and Figure 8 illustrate the results.

Figure 7: Impact of a 10% reduction in the provision of research

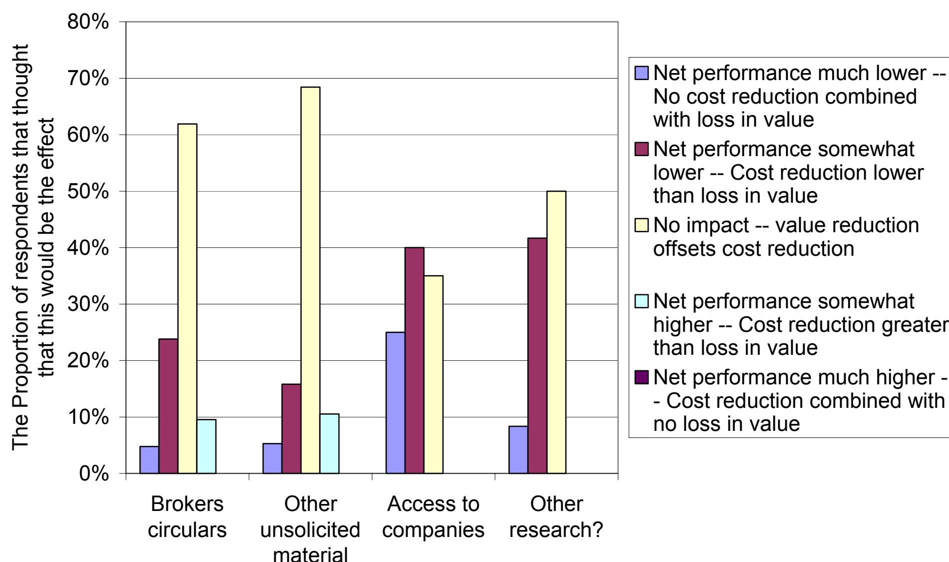


Source: CRA Fund Manager Survey

4.42 This suggests that fund managers expect that a reduction in priority calls, bespoke analysis, stock selection or sales calls would actually reduce net performance or at best leave it unchanged (i.e. the reduced cost is just outweighed by the reduced performance).

4.43 However, a minority believe that a reduction in paying for brokers' circulars and other unsolicited material would increase net performance.

Figure 8: Impact of a 10% reduction in the provision of research



Source: CRA Fund Manager Survey

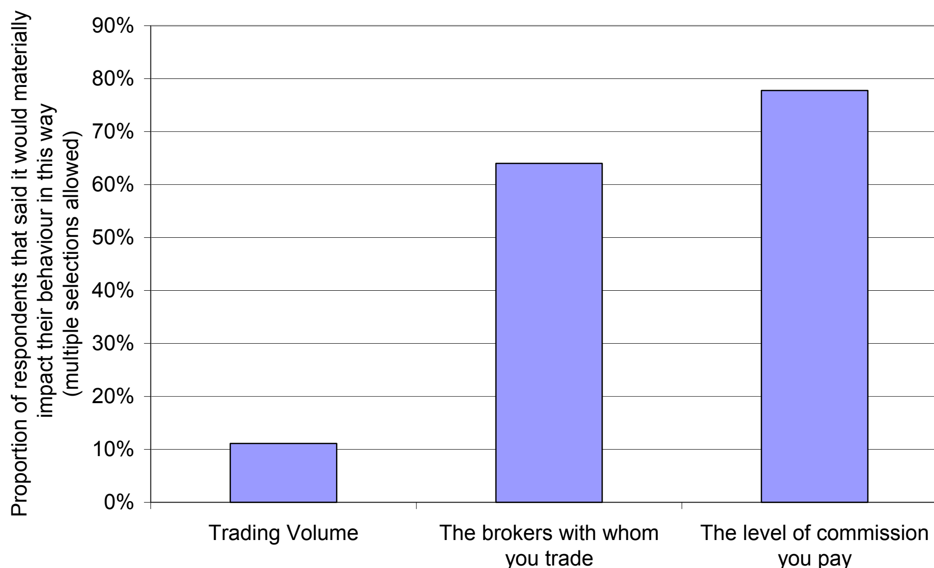
4.44 In many ways, this is unsurprising. Brokers' circulars and unsolicited material are effectively perceived by fund managers as marketing, necessary for the brokers to advertise their expertise but largely unvalued by the fund manager. However, as the cost of dissemination of broker circulars is low, it seems relatively unlikely that it will be this element that is reduced.

Impact on trading behaviour

4.45 Results from the CRA Fund Manager Survey suggest that implementing Proposal 2 will have significant impact on the trading behaviour of fund managers, in particular:

- It will alter with whom they trade (see Figure 9);
- They will choose to use execution-only trades more often;
- The focus of trading will concentrate away from small stocks and towards the larger brokers; and
- The market will, to some extent, move to net, reducing the observed level of commission.

Figure 9: Impact on behaviour from implementing Proposal 2



Source: CRA Fund Manager Survey

4.46 There is considerable concern that a reduction in research would lead to a fall in market efficiency. Research identifies trading opportunities, and with too little research there will be an inefficient allocation of capital and the costs of investing will rise. 88% of fund managers surveyed believe that a reduction in market efficiency would result from Proposal 2. Among those predicting widening spreads, estimates are as large as 15%. However, as described above this would be focused on small- and mid-cap stocks.

Unintended consequences

4.47 Given the evidence available, the unintended consequences of Proposal 2 could take a number of forms:

This could lead to migration abroad as described for Proposal 1 above

4.48 Much of the analysis has focused on UK fund managers, UK pension funds and brokers based in the UK. However, this does not reflect the operation of the market. As OXERA[36] point out the international ramifications could be important as UK pension funds may engage fund managers from abroad and vice versa. OXERA's own evidence suggests that location is not a significant issue in fund manager selection. Yet it is important to consider the competitive impact on the provision of fund management for domestic versus international players. UK fund managers attract business from pension funds based abroad, and, clearly, UK fund managers are competing with international fund managers for these mandates.

4.49 Given the amount of business conducted on an international basis, it does not appear reasonable to assert "these interactions with foreign markets complicate the analysis

[36] OXERA (1) p8

of soft commissions and bundled brokerage services in the UK alone,"[37] and purely focus on the relationships between UK pension funds and UK fund managers or UK brokers and UK fund managers.

4.50 In particular, we have not included in the analysis to date:

- The ability of the industry to mitigate costs by moving overseas. As OXERA correctly report, just over half of UK fund managers have investment management operations in other countries as well as the UK.[38] Furthermore these managers account for two-thirds of assets under management. Equally, foreign ownership of fund managers is considerable: foreign-owned fund managers account for 40% of assets managed in the UK; and
- The impact on the competitiveness of the UK industry vis-à-vis international competitors. As described earlier, 40% of UK mandates by value are on behalf of overseas clients.

4.51 Indeed, OXERA concludes that the geographic scope of the market for fund managers is international. However, they do not go on to the natural conclusion that impact on the UK market could lead to a loss of business or migration.

This could lead the market going net

4.52 Broker commission is often charged when the broker is acting as the agent of the fund manager, i.e. where the broker executes the trade on behalf of their client. Where the broker is taking a position, by providing capital for the trade, then the trade is remunerated through the spread, i.e. the price of the trade and associated bundled services is paid net.

4.53 Trades attracting commission represent only about 60% of all equity trades (by value).[39] Therefore 40% of equity trades are already transacted net. Furthermore, trades on the bond market (fixed interest rate securities) are commonly on a net basis. Therefore, it is at least possible that brokers would choose to start trading net for all equity transactions.

4.54 Indeed, 87% of fund managers Proposal 2 move will increase the amount of business that is conducted net.

4.55 However, this seems unlikely. As the responsibility for allocating the costs of research falls on the fund managers, it will be in their interests to ensure that the market remains gross. There will therefore be relatively little incentive for the broker to go entirely net as this would result in making the task of the fund manager significantly harder.

[37] OXERA (1) p9

[38] OXERA (1) p14 reporting information from the IMA "Fund management survey 2000".

[39] OXERA (1) reporting data from "Survey of London Stock Exchange Transactions 2000"

This could reduce the demand for independent research

4.56 There is considerable concern by the independent research community that CP176 Proposal 2 will pose an increased barrier to developing the sector. In contrast to the FSA's view that it will place these issues on a level playing field, there is a worry that bundled providers will exaggerate the cost of trade execution in bundled services, effectively cross subsidising bundled research and reducing the margin available for truly independent research houses.

4.57 The net effect of a mechanism that encourages independent research but reduces the pool of funds for remunerating such research is difficult to determine. For the component of research that is chargeable to the fund, the fund manager will now be able to purchase this from independent providers on the same terms as if it was bundled. This is supported by survey evidence from fund managers who believe this will increase their use of independent research. However, given the incentives to inflate the cost of trade execution this will disadvantage the independent sector relative to today.

Conclusions regarding Proposal 2

4.58 The evidence above suggests that rather than solve the principal agent problem identified by OXERA, Part 2 of CP176 would lead to some very undesirable outcomes. Taken together the evidence of a reduction in market efficiency and net performance suggests that the proposal will lead to consumption of research at a level below equilibrium. This is a possibility that was entirely discounted in the FSA's CBA and therefore needs to be considered very carefully. In particular, we have identified two mechanisms that could result in a sub-optimal level of research:

- Free riding by some trustees (initially) will prevent fund managers from recovering the cost of research that ought to benefit a number of clients. This will provide an incentive to fund managers dramatically to reduce the level of research purchased on behalf of clients as a whole; and
- It is suggested by the principal agent problem discussed in Chapter 2 that under investment in scrutiny by fund managers leads to over consumption of research. However within the bounds of plausible assumptions, this model would predict that imposing the full cost of research on fund managers would have the perverse effect of pushing consumption significantly below the net performance-maximising equilibrium.

4.59 The evidence suggests that Proposal 2 would result in:

- A relatively small impact on charges;
- A significant probability that the level of research will fall below the optimal level. This probability is significantly higher for particular sectors (small companies). This will result in less trading, high spreads and lower quality stock selection;

- A strong probability that some business will relocate. This is significantly higher for firms focused on providing fund management services to overseas clients; and

- A reduced pool of funds to pay for independent research.

4.60 Ultimately our view of Proposal 2 comes down to the Cost Benefit Analysis (see Chapter 5)

4.61 However, even if Proposal 2 were to fail the CBA, we still need to investigate whether there are alternative proposals that can remove any potential problems resulted from the principal agent problem without the same market risks.

The market outcome arising from Comparative Disclosure

4.62 The alternative proposal increases disclosure in the level of commission and the areas in which it is spent. OXERA has argued that even with the disclosure of commission costs by fund managers it is "unlikely that this would result in the same pressure as that on management fees in the negotiation between the pension fund and fund manager. Commission costs can only be monitored retrospectively and their order of magnitude is relatively small." However these arguments do not appear to stand up to inspection:

- The average amount spent on commission relative to other fund managers can be assessed retrospectively and a comparison made between funds and fund managers. Most importantly, fund selection is a repeated game so evidence on a year by year basis can constrain behaviour;

- Moving the cost of commission into the annual management charge would not make it any larger; and

- It is the very fact that it is small that it is likely to have a second-order impact on trustees' choice of fund managers.

4.63 CRA evidence suggests that there are significant benefits to Comparative Disclosure.

Increasing the understanding of the current arrangements

4.64 A significant concern is over trustees who may not understand the costs deducted from their fund and therefore believe they are receiving services for free, as set out in OXERA:

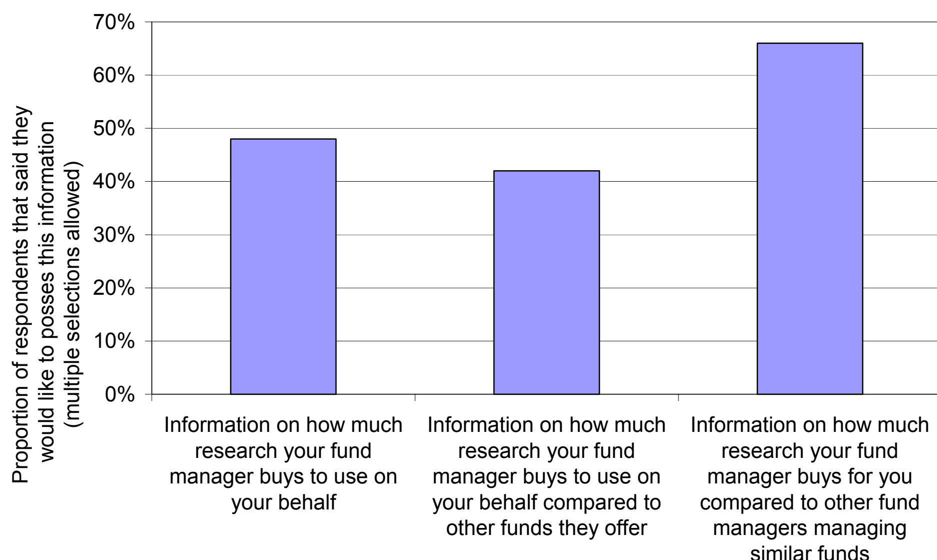
> *"It may make it more difficult for independent research providers to sell their research when fund managers already receive research for free from brokers".*[40]

4.65 Clearly the research is not provided for free and it is important that trustees understand this before they are given the choice of whether or not to purchase it. A

[40] OXERA (1) p3

significant number of trustees have indicated that they would favour this type of information (see Figure 10).

Figure 10: Information that is valuable for trustees



Source: CRA Pension Fund Trustee Survey

Improved systems

4.66 Responses to the CRA Fund Manager Survey suggest that such information would improve the process used to manage the perceived conflict of interest between best execution and remunerating those providing the best research:

- 58% of fund managers believe Comparative Disclosure would increase the likelihood they would use ‘commission sharing’ arrangements in the future;
- 62% think it would encourage more formal mechanisms to manage the ‘perceived’ conflict of interest between research and best execution.

4.67 It appears that Comparative Disclosure would solve a current market problem with regard to the policies by which fund managers ensure best execution and acquire best research:

- Currently 68% of trustees do not understand the policies of their fund managers; and
- In contrast, fund managers believe that 76% of clients do understand their internal policies.

Responses to the alternative proposal Comparative Disclosure

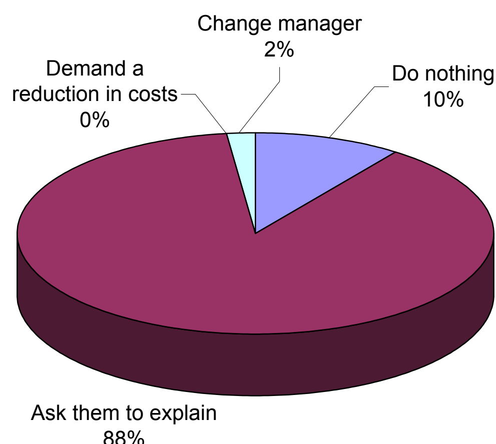
4.68 Both managers and trustees believe that the impact of disclosing higher than average costs allocated to research will lead to discussion regarding any differences. Fund managers believe they will be able to maintain commission where they can justify performance.

4.69 However, it is clear that comparative disclosure is anticipated to have a significant impact on the structure and level of charges. This is in contrast to the view that disclosure is not a strong enough market mechanism. For example, evidence from the CRA Fund Manager Survey shows:

- 52% of fund managers believe such disclosure will result in no change;
- 17% believe it will lead to convergence; and
- 30% expect an absolute decline.

4.70 Responses to the CRA Pension Fund Trustee Survey suggest that Trustees are very likely to increase the scrutiny of research cost under this alternative. In response to questions about the reaction of trustees to above average research costs, 88% said they would expect an explanation (see Figure 11).

Figure 11: Reaction of trustees to above average research costs



Source: CRA Pension Fund Trustee Survey

Conclusions regarding Comparative Disclosure alternative

4.71 Comparative Disclosure most importantly provides an incentive to control costs and make sure any deviations from comparators are explained. It does not, however, set up the potential for the equilibrium level of research to drop to zero – unlike Proposal 2.

4.72 Disclosure also appears attractive from a regulatory perspective as it educates trustees about the use of commission spent on their behalf, thereby increasing scrutiny of research costs.

4.73 It is designed to allow evaluation against a meaningful comparator, rather than requiring an apparent increase in charges that trustees may be unwilling to consider.

4.74 There are no detrimental competition effects, as disclosure can be applied in a market-specific fashion.

4.75 It does not impose a particular contractual relationship on the market but allows these to be market determined.

4.76 Overall, Comparative Disclosure would appear to have a potentially beneficial effect without the large market risk associated with Proposal 2.

Section 5 Cost-benefit analysis

5.1 The cost-benefit analysis undertaken for this project builds on the CBA prepared by OXERA[41] and sets this beside an alternative proposal based on additional disclosure of the relationship between fund managers and brokers.[42]

5.2 For the purposes of this exercise a number of assumptions were made regarding the ultimate shape of CP176 and, where there are alternative assumptions, these were tested in the cost-benefit analysis. The assumed rules were set out in Chapter 3 and the impacts on the CBA will be discussed below.

5.3 This report does depart from the methodology used by OXERA in one respect. Whilst OXERA made the same assumption of a "general compliance culture",[43] we have attempted to capture whether firms would be able to avoid complying by perfectly acceptable changes to their business model. This is, however, the only divergence from the approach used by OXERA in attempting to quantify costs and benefits under the following categories:

- 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.

5.4 Given that the FSA has chosen to set out its own direct costs for the purposes of this CBA, these have not been re-estimated but employed in the analysis below.[44]

5.5 This chapter draws heavily on the results from the CRA Fund Manager Survey, the CRA Pension Fund Trustee Survey and the market outcomes chapter.

[41] This follows the methodology set out in "Practical Cost-Benefit Analysis for Financial Regulators", Central Policy, version 1.1, June, FSA.

[42] The analysis undertaken by CRA and NERA regarding CP166 have demonstrated the strength of setting alternative proposals out side by side in the consultation process.

[43] "Cost-benefit analysis of the FSA's policy proposals on soft commissions and bundling" April 2003. OXERA p ii

[44] However, given past experience of cost-benefit analysis the direct costs do appear to be surprisingly low.

Assessment of Proposal 1

Direct or regulator's costs – both one-off and ongoing

5.6 Given the FSA has estimated its own direct costs, these were not re-estimated for Proposal 1 or Proposal 2, and it is therefore accepted that these will have one-off costs of £2,600 and on-going costs of £6,240.

5.7 It seems likely, however, that these are underestimates, as this only assumes an additional 12 minutes a firm in terms of supervision a year. The evidence from interviews suggests that the definition of market pricing services may not be entirely straightforward given the packages of services offered today. Therefore, there may be many occurrences in the future when the distinction between market pricing services and research delivered by electronic means needs to be assessed, and this is likely to increase direct costs.

5.8 Equally, although it is possible to identify terminals situated in London, the feasibility of using terminals based in other jurisdictions using a global agreement with the information provider needs to be considered. If the FSA were to supervise whether UK fund management activities are using a 'fair' allocation of pricing services this would again make the role of supervision considerably less straightforward. However, although these costs are likely to be higher than the FSA has identified they are unlikely to be significant in terms of the overall cost-benefit analysis.

Compliance costs

5.9 The estimates of compliance costs in each of the three different proposals are based on questions asked in the CRA Fund Manager Survey.[45] Each respondent had to specify the source of the cost as well as an actual value. This allows the origin of the costs to be specified as well making consistency checks easier. These costs were then scaled up to derive industry wide estimates, looking at both one-off and on-going costs.

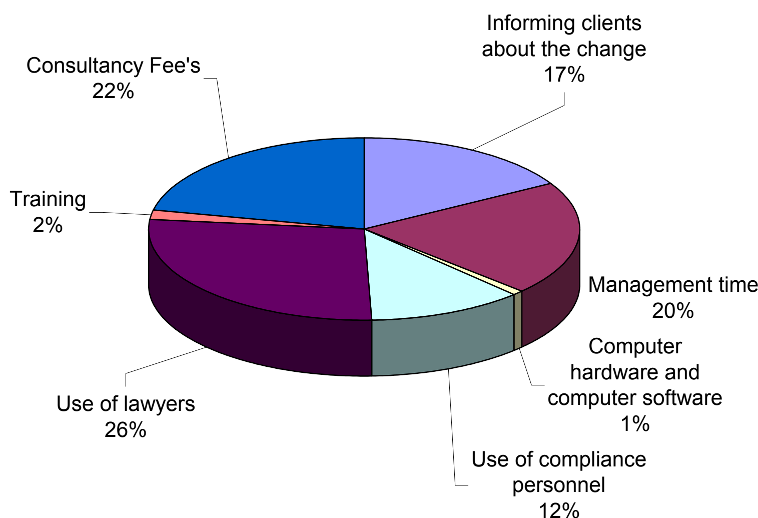
5.10 For Proposal 1, it is estimated that one-off compliance costs would amount to approximately £3.6 million, while that on-going costs would be near to zero. These estimates are broadly similar to those presented by OXERA, who also predicted zero on-going costs, although they calculated one-off costs to be slightly lower, at around £3.3 million.

5.11 Figure 12 shows how this one-off compliance cost estimate is composed, in terms of the various different sources of cost that fund managers identified. The informing of clients and management time constitute the greatest proportion of these costs, with the use of consultancies and lawyers playing a secondary role. Informing clients includes dealing with client inquiries, talking to brokers and reprinting literature.

[45] As has been found in previous cost benefit analysis, there is more confidence regarding the relative size of the compliance costs than the overall magnitudes.

Management time consists of making decisions about implementing changes, and then overseeing how these are instituted.

Figure 12: Composition of one-off costs of Proposal 1



Source: CRA Fund Manager Survey

5.12 The report estimates that there will be negligible on-going costs as a result of Proposal 1. The vast majority of respondents to the CRA Fund Manager Survey estimated no ongoing costs as a result of this proposal; a minority identified some small computing costs, but these were unimportant in terms of their scale, and given the weight of evidence were assumed to be insignificant.

Quantity of transactions

5.13 This analysis of the impact of Proposal 1 found only one quantity impact regarding the amount of market pricing and information services. The OXERA report also identified the potential for a reduction in overtrading. The evidence from this analysis suggests that overtrading does not occur and that Proposal 1 would have no impact the level of trading.

The demand for services previously acquired through soft commission

5.14 As set out in Chapter 4, the CRA Fund Manager Survey has identified that Proposal 1 would reduce the demand for market pricing and information services. The evidence finds that 30% of fund managers who use softing would reduce the demand for these services after the introduction of Proposal 1. This is a very similar result to that found by OXERA.

5.15 However, to establish whether this results in any corresponding benefits it was important to investigate the impact of this reduction. As argued above, even if the level of demand for services is above the optimal level, this does not mean that these services yield zero benefits. The report therefore needs to investigate:

- The magnitude of any reduction in services demanded;[46] and
- Whether this reduction in services has an impact on the services fund managers provide to their consumers, in particular whether it impacts on their ability to manage the client's funds in the optimal fashion.

5.16 Based on the CRA Fund Manager Survey, the evidence finds that fund managers, who would reduce their demand for market pricing services, would reduce their expenditure by 17.5%. This would therefore reduce demand for market pricing services significantly more than was predicted in the FSA's own analysis.

5.17 However, it is very important to consider all of the ramifications arising from this reduction in demand. In practice, 50% of those reducing demand believe this will not impact on the quality of these services and therefore will not have any impact on the quality or efficiency of the provision of their fund management services. Equally, the other 50% believe both that there would be a detrimental impact on the quality of the market pricing services they use (i.e. there is a loss of benefit) and this would affect the fund management services received by the end-consumer.

5.18 In the cost benefit analysis it was necessary to treat these two groups differently. For those who can reduce demand with little or no change in quality, it is possible to treat the reduction in market pricing services as a dead weight cost. Therefore there is a clear benefit through reduced consumption of the order of £2.3 million per year. The calculation of which is set out in the table below.

5.19 For the remainder, the benefit arising depends on the value of lost services and corresponding impact on net performance. It is likely that this will result in a net benefit but this will be second order (i.e. the difference between the cost saving and the reduced value of these services). This impact is therefore exceedingly difficult to quantify and we leave this as an unquantified benefit that would need to be taken into account – but only if the cost benefit analysis was negative.

[46] OXERA make an assumption that this would represent a reduction of 10%.

Table 3: Calculating the benefits from reduced consumption of market pricing services

Item	Detail
Total UK fund manager expenditure on market pricing services (through softing)	£90 million[47]
Percentage of fund managers who use softing who would reduce their consumption following Proposal 1	30%
Estimated reduction in demand	17.5%
% for whom quality of services remains the same	50%
Increase in benefit derived from reduction in dead weight costs (£90 million × 30% × 17.5% × 50%)	£2.3 million

Source: CRA analysis

5.20 In the cost-benefit analysis below, we include a benefit of £2.3 million to reflect the reduction in soft services but we also include a cost of approximately £2.3 million, to reflect a reduction in quality of services resulting in a reduction in performance.

5.21 This results in an on-going benefit derived from the reduction in excess market pricing services of around £2.3 million each year. This is of a similar order of magnitude to that reported in OXERA's CBA of Proposal 1.

Reduction in excessive trading

5.22 As stated above, there is no evidence that suggests that softing has resulted in over trading.

5.23 This is also consistent with the separation between the decision on trading and the availability of soft credits. It is very unlikely that it will be known that a trade will be softed when the decision to trade is made.

5.24 Most importantly, evidence from the CRA Fund Manager Survey, suggests that CP176 Proposal 1 is likely to have an impact on trading itself but not on the level of trading.

5.25 Even from a theoretical position it seems unlikely that this would result in an excessive level of trading. This report therefore does not agree that there will be any benefit arising from a reduction in over trading, and so therefore there is no benefit derived in terms of changes to the level of trading.

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[47] The size of the market according to market participants is significantly smaller than the estimate provided by OXERA. The estimates range from 30 to 60 million.

Quality of transactions

5.26 This report has not attempted to investigate the competitive nature of provision for market information services. The OXERA report did not find any evidence that there were concerns from a competition perspective. However, in the course of this investigation, it became clear from interviews with information providers that competition already focuses on price to a large degree. Even at an artificially higher level of demand, there will be competition between providers to offer these services for the best price and therefore there is no evidence that Proposal 1 would lead to any benefit from this source.

5.27 The impact of Proposal 1 will mean that a broker's willingness to offers soft credits terms will no longer be relevant when considering where to conduct trades. This is confirmed by evidence from the CRA Fund Manager Survey suggesting that Proposal 1 would change who fund managers trade with and this would impact the level of commission. It is not possible to identify if there is any detriment to the current trading regime or whether the change in commission will simply offset any increase in costs falling directly on the fund manager.

5.28 However, the evidence does suggest there will not be any corresponding change in the charges, and this appears to pass additional benefits to the ultimate consumer.

Variety of transactions

5.29 As set out above, this report has not attempted to investigate the competitive nature of provision for market information services. There is no evidence of there being any concerns from a competition perspective. It is clear, from the interviews with information providers that competition already focuses on innovation in services, through package design (i.e. offering global contracts), or medium as well as price and therefore there is no evidence that Proposal 1 would lead to any benefit from this source.

Efficiency of competition

5.30 Given that the overall market is assumed to be competitive, it seems unlikely to have a substantial impact on the efficiency of competition in the market for market pricing services.

5.31 This report finds that the arguments regarding barriers to entry of small fund managers and the level of competition between execution only and bundled brokers also appear to be relatively unsubstantial. For example, there is no strong evidence that other forms of credit cannot support new entrants to the fund management industry. Equally, the ability to soft research allows execution only brokers to compete on a level playing field with bundled brokers.

5.32 However, there are two areas where Proposal 1 might change the nature of competition.

- Through increasing transparency on particular components of the charges; AND
- Impact on the competition for international mandates.

The transparency of the charges

5.33 Proposal 1 will reduce costs charged directly to the fund and allow firms to recover this through an additional charge or the annual management charges. It seems unlikely that these costs will be more transparent to the final consumer if, as is likely, they are subsumed in the overheads of the fund management business.

5.34 It is also likely that the focus on transaction costs is rising and additional scrutiny will occur anyway as current reforms to the market develop.

5.35 Finally, it is also questionable that the focus on softing will increase by moving it from commission into the annual management charge. The focus on softing is consistent with this reflecting its size rather than where it is recorded.

Competition for international mandates

5.36 It is currently unclear, whether the UK will push forward with Proposal 1 in isolation or whether other countries may be encouraged to adopt similar proposals. From public sources the evidence would appear to support the former rather than the later however. It is still important however to consider both of these possibilities:

5.37 If the FSA adopts Proposal 1 in isolation, the UK fund managers will be offering different terms to their international competitors. In particular, they will look expensive in terms of their overall management charge if they choose to increase it or will make a lower margin. This ability to pass on any increase would be substantially lowered, as fund managers in other countries will not need to disclose the same information.

5.38 If there were a higher focus on the annual management charge, this would therefore seem to put UK fund managers at a competitive disadvantage. However, these effects seem unlikely to be large, apart from small fund managers who conduct the majority of their business overseas. For these fund managers it is possible that there will be a strong case for relocation. This needs further investigation by the FSA before this proposal is adopted.

5.39 Clearly, if all countries were to adopt Proposal 1 any issues of competitive advantage would be removed.

Summary of costs and benefits from Proposal 1

5.40 In summary, the costs and benefits of Proposal 1 are finely balanced. There are substantial one-off compliance costs, however, these are likely to be outweighed by on-going benefits. Given how close the CBA results are and that these have not incorporated any costs resulting from potential detrimental impact on international competition, the FSA will need:

- To investigate the impact on competition or get international regulatory agreement before taking this proposal forward; and
- To establish with more certainty the true size of the market for electronic pricing services.

Table 4: Summary of costs and benefits arising from Proposal 1

	Type of cost	Magnitude	Type of benefit	Magnitude
Direct or regulators costs	Design and Implementation (one-off)	£2,600		
	Ongoing Costs	£6,240		
Compliance Costs	Ongoing Costs for fund managers	£0		
	One-off costs for fund managers	£3,600,000		
Quantity of Transactions			No evidence of excessive trading	
			Reduction in excessive consumption of market and price information services	£2,362,500
	Potentially offsetting cost resulting from lower quality market pricing information	£2,362,500	Reduction in excessive consumption of market and price information services	£2,362,500
Quality of Transactions			Providers of information services	No evidence of competition issues
			Increased quality of trade execution	Unquantified positive
Variety of Transactions			Providers of information services increase quality spurring better fund management	No evidence of competition issues
Efficiency of Competition			Increased transparency resulting in greater scrutiny of research through focus on AMC	Not quantifiable; incentives in the right direction but small
	Competition for international mandates harmed if adopted in isolation	Unquantifiable cost		

Source: CRA analysis

5.41 In summary, based on the quantified benefits and costs, this results in a one-off cost of £4 million and an on-going benefit of £2 million per year.

Assessment of Proposal 2

Direct or regulator's costs – both one-off and ongoing

5.42 As the FSA recognise the direct costs resulting from Proposal 2 are likely to be more significant than Proposal 1, this analysis again, uses the FSA's internal estimates of a one-off cost of £5,200 and an on-going cost of between £12,000 and £18,000.

5.43 Considering fully how the regulation could be implemented in practice, these again appear likely to be underestimates. For example, there will be issues regarding whether the methodologies used to estimate additional services, and separate these from trading services, are adequate.

5.44 It is equally possible that there will be concern regarding whether the estimated cost of additional services reflects its value, i.e. trade execution will be over-stated. As set out above this will be extremely difficult to supervise but equally cannot be left to market forces (where the incentives are toward overstatement). Therefore, the FSA may need to consider how this would be monitored.

5.45 However, these costs are unlikely to impact on the overall conclusions of the cost benefit analysis, so further consideration has not been given to direct costs.

Compliance costs

5.46 This report finds that the compliance costs resulting from Proposal 2 are significant, and differs considerably from that of OXERA. While the one-off cost estimate of £16.1 million is notably larger than their £8.4 million; it is in our on-going cost estimate that differs most. While OXERA predicted firms would face a moderate continuing cost of £1.9 million per year, this report forecasts that as a result of this proposal, fund managers would face recurring costs in the region of £11.2 million.

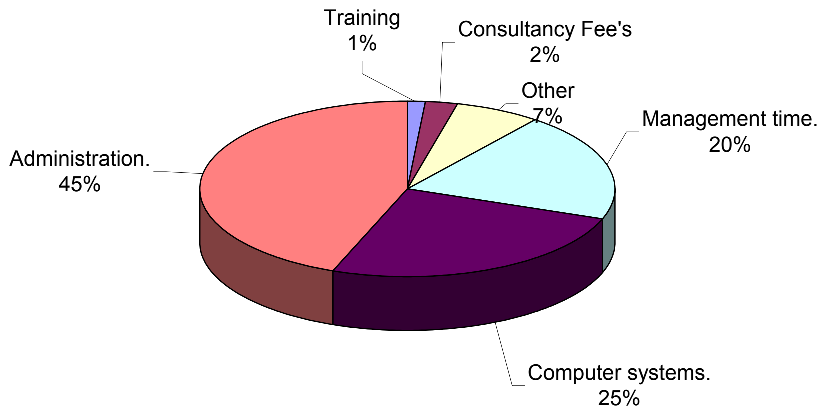
5.47 The on-going costs are considered first and Figure 13 shows how they are composed. Administration constitutes the greatest proportion, with almost all survey respondents identifying this as a sizable source of ongoing costs. This reflects the processes needed within fund managers to split trading costs from additional services. As set out above, there will be considerable freedom to adopt different methodologies, each of these will need to be monitored and be seen to be compliant.

5.48 Computing and management costs will also be significant: almost all respondents identified these, and there was broad agreement across the whole range of fund sizes.

5.49 Care was also taken to understand how these costs varied between firms of particular sizes. This is extremely important when scaling up the results from the CRA Fund Manager Survey to the industry as a whole. In particular, how these costs fall on smaller managers needs considerable care.

5.50 In respect of one-off costs: it is clear that firms will face substantial compliance expenses in a whole host of areas; informing clients, computer systems, compliance personnel, management time and the use of lawyers.

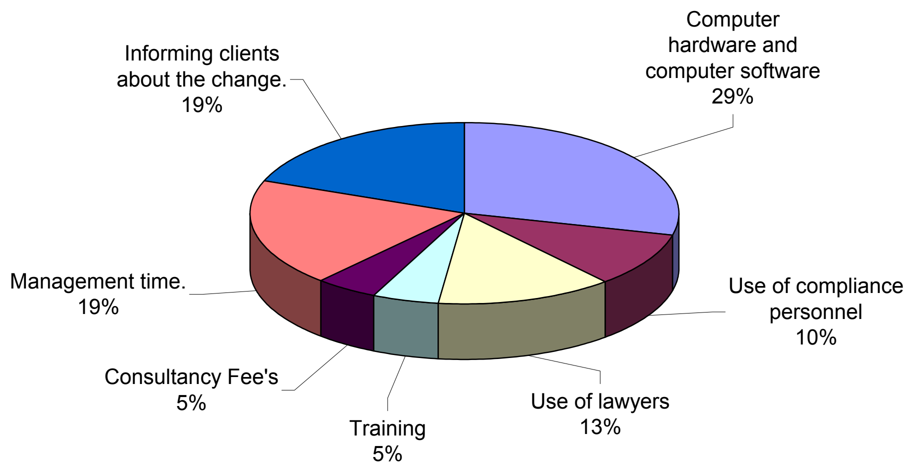
Figure 13: Composition of on-going costs of Proposal 2



Source: CRA Fund Manager Survey

5.51 For the purposes of this analysis, a quantitative survey of the broking community was not undertaken. This report therefore accepts the FSA results regarding compliance costs for brokers.

Figure 14: Composition of one-off costs of Proposal 2



Source: CRA Fund Manager Survey

Quantity of transactions

5.52 There are two primary issues to consider regarding the quantity of transactions. Firstly, whether there would be a reduction in the demand for bundled services, primarily research and secondly, whether this would have an impact on trading behaviour.

Impact on the demand for bundled services

5.53 As set out in the previous chapter, the evidence suggests that moving the remuneration of research from commission to an explicit charge could fundamentally change the behaviour of trustees and fund managers.

5.54 This would appear to reduce the demand for research services through two channels:

- This would lead to a significant reduction in demand for bundled services as fund managers are not able to charge for it and are unable to pay for it through reduced profitability. This is described as the free-rider problem above; and
- In addition, using the same model as adopted in the FSA's analysis, fund managers would have an incentive to buy less research if Proposal 2 was implemented.

5.55 This is supported by evidence from the CRA Pension Fund Trustee Survey and the CRA Fund Manager Survey.[48] Considerable care, however, needs to be taken to convert changes in the demand for bundled services into their impact on welfare.

5.56 As argued above with respect to Proposal 1, it cannot be assumed that any reduction in expenditure equates to a benefit to investors. There are again three substantive issues:

- Any reduction in research will have a corresponding loss of benefits (for example, materialising as widening spreads, lower trading or worse stock selection). Otherwise, it would have to be assumed that any research above the optimal level of research has zero value. This is inconsistent with orthodox views of market efficiency.
- The economic incentives would appear to suggest that the level of research is likely to fall substantially below the optimum. Indeed, it is possible that, due to incentives to 'shirk' and the free rider problem, that this effect will be significantly larger than the incentive to buy too much research. Therefore, it is conservative to assume that any change in the demand for research goes below the optimal level. Furthermore, the evidence suggests the level of research could fall substantially further.
- The research services that brokers would choose to cut following a reduction in revenue may not be the ones initially anticipated. There is a general perception that there is excess research in the form of brokers circulars and unsolicited calls.

[48] Even if this impact were initially small the free-rider effect would propagate it around the market.

However, it is important to take into account that the incremental cost of disseminating broker circulars is very small and these form a significant part of brokers marketing activities. Given the structure of costs for these services and its position as one of the weapons used to compete for market share, it is unlikely that they will choose to substantially reduce this component.

Accounting for the value of research

5.57 To illustrate this point, in the CBA below, the same examples as the FSA were used. Looking at total broker commissions and then using the FSA's estimate of the proportion of commission that represents bundled services, produces an estimate of between £500 and £720 million[49]. If this were reduced by 10%, this would represent as an upper-bound a reduced cost of £72 million.

5.58 However, to include this in the cost benefit analysis we would need to estimate the benefits that this reduction in research would sacrifice. Clearly, it is possible that these benefits are equal to the reduced cost. This would then entirely offset any reduced expenditure (and there would be no excess consumption). However, the evidence does suggest there is an incentive to buy too much research, so this is unlikely.

5.59 Alternatively, if the value of all research above the optimum was zero, i.e. it was entirely a dead weight cost, then the reduced consumption would equate directly the benefits. As stated above this is inconsistent with orthodox views on market efficiency. Accordingly the value must be greater than zero.

5.60 In practice, given that it seems there is too little incentive to scrutinise research, it is likely to be somewhere between these bounds and the reduction in research to the optimal will have a corresponding net benefit. This would however, be significantly less than £72 million. Estimating the value of the excess research is highly problematic so in the CBA below we have attempted to put value of some components of this costs: widening spreads, lower trading volumes for example.

Reduction in demand below the optimal level

5.61 Even with cautious assumptions any benefits from reduced excess consumption will be offset by a reduction in research below the optimal level. These are the assumption used in the best case CBA of Proposal 2.

5.62 It is also possible that Proposal 1 has far reaching significant unintended consequences. Firstly, the level of research could fall not by 10%, which the FSA have categorised as a small reduction in research, but could be much higher, say, 20-30% below the optimal. The worst case CBA of Proposal 2 considers the impact of a larger reduction in research.

[49] Updating this to reflect the current level of trading would lower this estimate significantly. In addition, anecdotal evidence suggests the level of commission is also likely to have fallen. However, to be conservative we have chosen to adopt the FSA upper-bound estimate.

Trading behaviour

5.63 As set out above, the analysis suggests there is no evidence of excess trading. Therefore, no benefits resulting from a reduction in trading are included.

5.64 However, this is not to say that Proposal 2 will not have an impact on trading. Indeed, the evidence above suggests that up to 30% of trade are motivated directly by interaction with brokers. A reduction in research efforts will lead to a smaller number of trades as more opportunities are missed.

5.65 10% of fund managers believe this will reduce their trading by a significant amount. There is almost universal support that this will lead to a reduction in trading opportunities in the small and mid-cap companies.

5.66 Assuming a 10% reduction in trade in small companies, there is therefore a not unsubstantial reduction in benefits arising from missed trading opportunities. This results in a cost of £20.5 million per year. The calculation for this is set out in the table below. However, it is important to consider the impact on net value to the investor rather than the reduction in trading alone. The calculation below uses the transactions costs as the value of the trade.

Table 5: Calculating the benefits from reduced trading in small and mid cap stocks

Item	Detail
Total trading (managed in UK)	£1,100 billion
Small cap & FTSE 250 as % of total turnover	13%
Average transaction costs	1.4%
Proportion of fund managers reducing trades	10%
Reduction in trading	10%
Loss of benefits per year	£20 million

Source: CRA analysis

Quality of transactions

5.67 It is also possible that the reduction in research will result in the average quality of the remaining research rising. This is to be expected. However, it is again important to account for the small but presumably not insignificant costs of fund managers managing and scrutinising the level of research.[50]

[50] If this was a small cost, fund managers would already be undertaking measures to manage research costs. However, they must also be less than the net cost of the excess research that would be undertaken in the absence of scrutiny.

5.68 Equally, the average quality of trades may decrease following the introduction of Proposal 2. As research identifies trading opportunities, a reduction in research will lead to less trades but also an increase in the spread of the trades that do take place.

5.69 Based on the experience of fund managers, any impact on spreads is likely to be in the small and mid-cap companies and is possibly substantial. For example, the average change in spreads from the CRA Fund Manager Survey is 15%. Applying this to the current level of trading this would represent an on-going cost of £276 million per year. The method of calculation is set out in the table below.

Table 6: Calculating the costs from increased spreads in small and mid cap stocks

Item	Detail
Total trading (managed in UK)	£1,100 billion
Small cap & FTSE 250 as % of total turnover	13%
Average spreads	1.26%
Increase in spreads	15%
Loss of benefits per year	£270 million

Source: CRA analysis

Variety of transactions

5.70 The impact of Proposal 2 will lead to a reduction in research and the ideas that lead to trading opportunities. Therefore a reduction in the variety of trades is expected. In particular, this will reduce research into small companies, raising barriers when they wish to raise capital.

5.71 Secondly, the impact of Proposal 2 could have exactly the opposite effect on new providers of research to those set out in CP176. The proposals in CP176 are said to put independent providers onto a level playing field. But as set out in the previous chapter, Proposal 2 could lead to an over estimate of trading costs and too little value being placed on independent research. This is unlikely to represent a significant cost in the medium term, as the independent sector is so small. However, it is also likely to prevent the independent sector from growing significantly.

5.72 Given the business model for independent providers for research in the UK is still largely unproven, this cost is exceedingly hard to quantify.

Efficiency of competition

5.73 Given that the overall market is assumed to be competitive, it seems unlikely to have a substantial impact on the efficiency of competition in the market for trading services, research or fund management services.

5.74 However, as in Proposal 1 two impacts on competition can be identified: the impact of moving the cost of research from commission to an explicit charge may increase transparency; and the impact on international competition.

Transparency

5.75 This report has argued that scrutiny by pension funds depends on the size of the cost rather than the way it is presented.

5.76 In addition, there are a number of trends in the reporting of transactions costs that, by themselves, will lead to increasing scrutiny.

5.77 However, there will be clear advantages from Proposal 2 if they make trustees aware of the services they are acquiring and how they pay for them. However, the argument above suggests that trustees may be too sensitive to these costs lead to an over-reaction. Therefore any benefits arising from this are likely to small.

International mandates

5.78 The impact of Proposal 1 was small and isolated to small players focused on international business. Proposal 2 will impact all UK fund managers and will reflect a significant impact in terms of annual management charge or a reduction in research services. Given the FSA's belief that the sensitivity to the annual management charge is much higher than commission, a significant impact on competition between UK fund managers and providers from other jurisdictions can be expected.

5.79 The analysis implies therefore that this will have a significant impact on the demand for UK fund management services.

5.80 However, it is unclear, whether this will result in a fall in demand favouring providers in other countries or whether this would result in a movement of UK fund managers towards providing their services under alternative regulatory regimes.

5.81 The size of this effect will depends on whether the FSA chooses to implement Proposal 2 in isolation or this is co-ordinated across countries.

Summary of costs and benefits from Proposal 2

5.82 In summary, the costs and benefits of Proposal 2 are substantially negative even when conservative assumptions about the reduction in bundled services are made. There are substantial one-off compliance costs, but these are not the determining factor because the detrimental impacts on the quantity and quality of transactions overwhelm the net benefits by themselves.

5.83 Furthermore, the significant potential cost if there was substantial transfers of mandates overseas has not been quantified.

Table 7: Summary of costs and benefits arising from Proposal 2 (conservative assumptions)

	Type of cost	Magnitude	Type of benefit	Magnitude
Direct or regulators costs	Design and Implementation	£5,200		
	Ongoing Costs	£15,000		
Compliance Costs	One-off compliance costs to brokers	£6,000,000		
	Ongoing compliance costs to brokers	£1,900,000		
	Ongoing Costs for fund managers	£11,229,000		
	One-off costs for fund managers	£16,122,000		
Quantity of Transactions	Reduction in number of trades (10% reduction in number of trades in Small/Mid cap) resulting from less interaction between brokers and fund managers	£20,000,000	No evidence of excessive trading	
Quality of Transactions			Reduction in over consumption of bundled services (10%)	£72,000,000
			Reduced cost arising from research below the optimum	£72,000,000
Variety of Transactions	Increased effort assessing value of research	Small positive		
Efficiency of Competition	Reduced demand for full services trades, less information regarding small and mid cap resulting in higher spreads	£270,000,000		
	Less research in parts of the market and less independent research	N/A		

5.84 In summary, based on the quantified benefits and costs, this results in a one-off cost of £22 million and an on-going cost of £159 million per year.

5.85 However, to illustrate the scale of potential negative outcome resulting from Proposal 2 a more extreme but still plausible scenario is described where the demand for research services has fallen by 30% rather than 10% below the optimum. This will have a corresponding impact on the volume of trading and spreads.

Table 8: Summary of costs and benefits arising from Proposal 2 (possible scenario)

	Type of cost	Magnitude	Type of benefit	Magnitude
Direct or regulators costs	Design and Implementation	£5,200		
	Ongoing Costs	£15,000		
Compliance Costs	One-off compliance costs to brokers	£6,000,000		
	Ongoing compliance costs to brokers	£1,900,000		
	Ongoing Costs for fund managers	£11,229,003		
	One-off costs for fund managers	£16,122,482		
Quantity of Transactions	Reduction in number of trades resulting from less interaction between brokers and fund managers	£60,000,000	No evidence of excessive trading	
Quality of Transactions			Reduction in over consumption of bundled services (10%)	£72,000,000
			Reduced cost arising from research below the optimum	£216,000,000
Variety of Transactions	Increased effort assessing value of research	Small positive		
Efficiency of Competition	Reduced demand for full research services resulting in higher spreads	£810,000,000		
	Less research in parts of the market and less independent research	N/A		

Source: CRA analysis

5.86 In summary, based on the quantified the benefits and costs, this results in a one-off cost of £22 million and an on-going cost of £595 million per year.

Comparative Disclosure

Direct or regulator's costs – both one-off and ongoing

5.87 This analysis uses the same direct costs for comparative disclosure as employed for Proposal 2. The current proposal does not assume that there is compulsion by the regulator. However, the regulator will still need to monitor any voluntary regulation to see if it has the anticipated effect or whether there is a need for further regulatory intervention.

5.88 The issues around the estimation of research costs and the issues of potential under-reporting remain the same.

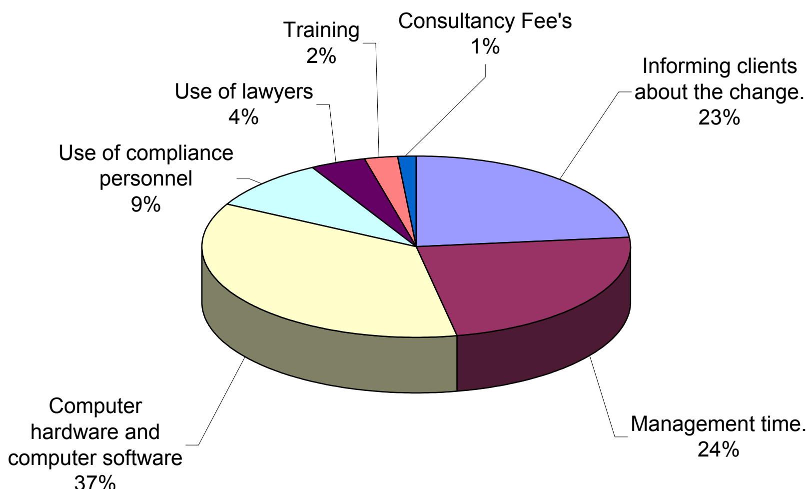
5.89 Again therefore we use their estimates – of a one-off cost of £5,200 and an on-going costs of between £12,000 and £18,000 – are used. As noted earlier, these costs are relatively small and are not likely to be significant in comparison to the other costs; hence more detailed estimates have not been sought.

Compliance costs

5.90 The analysis estimates the compliance costs of our alternative proposal in the same manner as the FSA's proposals were examined, using details provided in responses to the CRA Fund Manager Survey. This allows a fair comparison of the results of this proposal and those of the FSA. This evaluation shows that there are significantly lower compliance costs associated with comparative disclosure than the FSA's Proposal 2, but they are higher than Proposal 1.

5.91 The graph gives a breakdown of where the one-off costs arise; i.e., mainly from computer systems, management time and the need to inform clients of the changes. The cost of updating computing systems constitutes the greatest part of this; this is because new client reporting and record keeping systems would be needed which would require firms to devote a significant proportion of their IT resources to make the required changes.

Figure 15: Composition of one-off costs of Comparative Disclosure



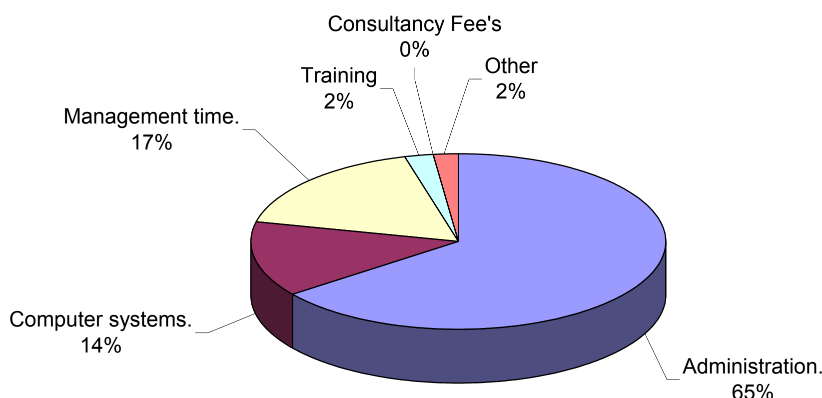
Source: CRA Fund Manager Survey

5.92 It is clear that for the continuing costs of comparative disclosure, the area where fund managers will face the greatest burden is in the area of administration, with this accounting for the majority of the costs that they identified. Management time and computing costs were again picked out as also being significant.

5.93 Looking more closely at how these proposals will affect fund managers in practice, it is possible to see where these administrative costs arise. Firms will have to direct senior administrators to spend a significant proportion of their time conducting the on-going data gathering and reporting that are necessary as a result of this proposal.

5.94 However, there are corresponding cost reductions compared to Proposal 2, as they do not need to negotiate with clients over the recovery of these costs but report and explain.

Figure 16: Composition of on-going costs of Comparative Disclosure



Source: CRA Fund Manager Survey

5.95 This results in a one-off cost of £6.1 million and an on-going cost of £ 4.3 million.

<u>Quantity of transactions</u>

5.96 The objective of disclosure is to lead to a greater understanding and focus by trustees on how commission is spent on their behalf. This will increase the focus on the cost of research. Survey evidence suggests this will prompt discussions between trustees and their fund managers.

5.97 Those with a higher level of research spending relative to the benchmark will need to explain why they are above the average. In cases where fund managers are not able to justify any differential due to objectives of the fund or the way is it is managed, this will lead to a reduction in commission and a corresponding reduction in the amount spent on research. In aggregate, it seems likely that the demand for research will fall correspondingly.

5.98 However, the objective is for funds to focus on appropriate comparators (internal or external) and this will lead to people looking at the average for similar types of fund rather comparing to zero (as arguably Proposal 2 will). Therefore, although there is a risk of going below the optimum level of research, it is significantly less likely.

5.99 Indeed, the incentives of the fund manager will still be to buy at least the most efficient level of research as this improves net performance and their ultimate remuneration. Therefore the incentives to buy the right amount of research will be held in check by the disclosure to pension fund trustees while fund managers will still have the incentive to use research to maximise investment returns.

5.100 Therefore in the cost benefit analysis below, we assume this will reduce research by the FSA's 10% above the optimum with a corresponding benefit. Using the same assumptions as the FSA this derives a benefit of £72 million.

5.101 However, again any reduction in demand must be treated with caution. This does not equate to a benefit unless the value of these services is truly zero. This seems very unlikely and there is therefore an unquantified cost resulting from the lost value of these additional services.

5.102 As this will not lead to a significant reduction in research below the optimal level it is not expected that this will have a significant impact on the volume of trading.

Quality of transactions

5.103 Improved disclosure in Level 1 and Level 2 will encourage better processes to deal with any potential conflict arising from best execution and remunerating research. This will encourage greater transparency and in some cases the adoption of mechanisms such as commission sharing.

5.104 According to evidence from the fund manager survey, this will affect who is traded with and the level of commission. Trade execution will consolidate to some extent as fund managers trade with those offering the greatest liquidity. This will result in a benefit in terms of the price at which trades are conducted and the level of commission. However, we are not able to quantify these benefits.

5.105 This will encourage a market trend that is already occurring through the introduction of commission sharing. This will clear the hold-up caused by regulatory uncertainty. Therefore although, this is a benefit, this should really be calculated as bringing forward benefits that are likely to arise in the future anyway.

5.106 As the price of research is more easily justified and systems such as commission disclosure are encouraged allowing third parties to be remunerated through shared commission, this should improve the market for independent providers.

Variety of transactions

5.107 There is a danger with comparative disclosure that inappropriate comparators are used and this leads to reduction in variety as fund managers are driven to adopting similar investment strategies. This is a potential risk and would become more extreme if an external comparator was adopted. Further testing with pension trustees is required to quantify this risk.

5.108 Equally, this is likely to lead to some consolidation in the market for broking, with the market polarising between small niche players and larger players. Although, this will lead to some market disruption, it is not clear that brokers offering a distinctive service will not be able to compete. Equally, interview and survey evidence suggests that commission-sharing arrangements are being adopted by a variety of brokers and this in itself will not distort competition.

5.109 However, after a period of transition it should encourage the demand for alternative providers of research services, as it will stop the problems associated with the current softing regime.

Efficiency of competition

5.110 The impact on the efficiency of competition is likely to be smaller in Comparative Disclosure than Proposal 2.

5.111 As the incentives to overstate the price of trade execution are reduced this should not have same negative impact on the provision of independent research as Proposal 2.

5.112 The separation of those who provide high quality execution and those offering high quality research will encourage competition (without assuming that these are better provider together or separately).

5.113 Most importantly, the risks associated with structural changes such as those suggested in Proposal 2 will be limited. As this proposal focuses on the provision of information it need not affect the services of UK fund managers to overseas clients. They will continue to compete on a level playing field and being able to exploit the natural advantages of trading in the UK.

Summary of costs and benefits from Comparative Disclosure

5.114 In summary, the evidence shows that Comparative Disclosure dominates Proposal 2. It has smaller compliance costs and the potential to deliver real benefits in terms of greater scrutiny on the amount of research services consumed and the removal of remaining tensions between best execution and paying for research.

Table 9: Summary of costs and benefits arising from Comparative Disclosure

	Type of cost	Magnitude	Type of benefit	Magnitude
Direct or regulators costs	Design and Implementation (one-off)	£5,200		
	Ongoing Costs	£15,000		
Compliance Costs	Ongoing Costs for fund managers	£4,293,477		
	One-off costs for fund managers	£6,142,486		
Quantity of Transactions	Reduced benefit arising from research above the optimum	Unquantified cost	Reduction in over consumption of bundled services (10%)	72,000,000
Quality of Transactions			Improved best execution benefiting from greater liquidity	Not quantifiable; incentives in the right direction
Variety of Transactions	Potential problem as fund managers are driven to adopt the same investment strategies	Unquantified cost	Improved research through improved flexibility to reward good research	Not quantifiable; incentives in the right direction
Efficiency of Competition			Increased transparency resulting in greater scrutiny of research through focus on disclosure	Not quantifiable; incentives in the right direction
	Competition for international mandates unharmed		Independent research enhanced	Not quantifiable; but small positive

Source: CRA analysis

5.115 In summary, based on the quantified benefits and costs, this results in a one-off cost of £6 million. In addition, there will likely be a net on-going benefit but these are not quantified.

5.116 In addition, it appears to be moving the market in the direction the FSA would like to see. The impact of comparative disclosure would encourage greater understanding of trustees in the use of their commission payments but without the risk of asking them to make decisions where are in a significantly better position to advise them.

Annex 1 Interviews and survey conducted for this project

Fund Manager Survey

A.1 The CRA Fund Manager Survey questioned fund managers in detail on their current activities related to softed services and bundled activities. It examined the nature of their relationship with brokers and trustees, and went on to pose numerous hypothetical questions in order to understand the possible responses of the industry to various forms of legislation

A.2 The survey was sent to 76 fund managers in an attempt to gain as large a sample size as possible. Responses were received from 30 firms that collectively account for over £850 billion of funds under management in the UK. The breakdown of these responses in terms of size is presented below.

Table 10: Breakdown of CRA Fund Manager Survey responses by value of assets

Value of Assets controlled	Number of Responses from Fund Managers
>£20bn	16
£10-20bn	5
£5-10bn	4
<£5bn	4
Undisclosed	1

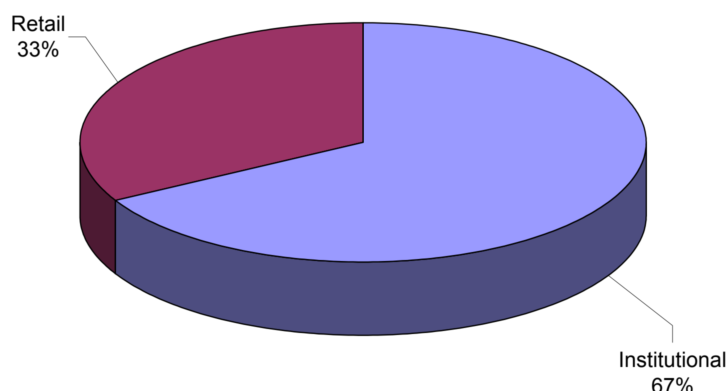
Source: CRA Fund Manager Survey

A.3 What is important is perhaps not the exact composition, but that the responses cover a sufficiently wide variety of fund managers of different sizes and types allow reasonable conclusions to be drawn from the results. In fact, even considering the ideal sample to have is a complex matter: on one hand a large number of small firms is required to reflect the average size of fund managers, but on the other hand most assets are managed by a small number of large firms.

A.4 In reality the sample comes somewhere satisfactorily in the middle, with a reasonable spread of the large and small. The survey statistics presented throughout this report are generally presented on the basis of the sample as a whole, not broken down into subsections. Splitting the results into too many categories necessarily sacrifices some explanatory power and reliability, often for little gain in understanding. However, it was checked that all the important results presented in the report hold for the entire variety of fund managers.

A.5 As well as considering the nature of our sample in terms of the size of the fund manager, several other factors were considered to ensure our results featured no bias. Responses were received from fund managers with differing degrees of international clients, various compositions in terms of institutional/retail, and a representative number of firms that do not use soft commissions at all. This is shown below:

Figure 17: Proportion of respondent's funds that are from retail or institutional clients

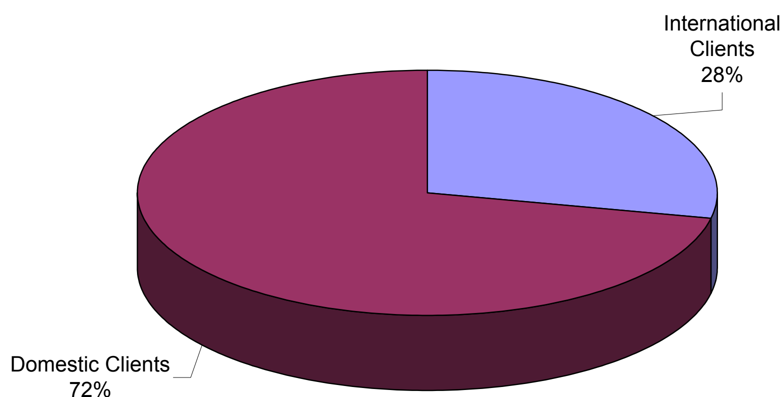


Source: CRA Fund Manager Survey

A.6 Here it is clear that a third of respondent's funds were managed on behalf of retail clients, which is slightly above the industry average of around 13%[51]. However, this need not be a concern for three reasons; firstly the sample is broad enough not to be excessively affected by this. Secondly, the composition is still broadly accurate; with institutional clients still significantly the most important. Thirdly, there was a particularly interest in analysing the effects of the proposed legislation on the retail market because, as noted elsewhere, this is one area that has been neglected by the FSA (see Annex 1). The aim was to build upon the OXERA examination of retail funds through a quantitative analysis, which these responses allow.

[51] OXERA (1) Table 2.1, Page 7 and CRA Calculations

Figure 18: Proportion of respondent's funds that are from international or domestic clients



Source: CRA Fund Manager Survey

A.7 Here it is clear that 28% of the funds managed by respondents are from international clients; this corresponds closely to the industry average of 21%[52]. Hence we can be confident that any results in our survey that are dependent upon the location of a fund manager's clients are accurately indicative of the industry of a whole.

A.8 The calculation of compliance costs used data obtained directly from fund managers, and here the structure of the sample was of great importance as compliance costs might be expected to differ depending upon a fund manager's size. The data received was scaled up to be representative of the industry, and did so in a way that took explicit account of the composition of the sample, the industry, and the way the relationship between size and costs was analysed.

Trustee Survey

A.9 To understand the impact of CP176 on pension fund trustees CRA undertook in-depth interviews. However, from a small number of qualitative interviews it is not possible to understand the variety of pension funds. Therefore, CRA commissioned Continental Research to undertake a survey of 50 pension fund trustees, partly as a response to worries over the sample.

A.10 The trustees were questioned about how they interact with their fund managers, their opinion gauged on the usefulness of several legislative options, and more questions were asked to give an indication of their level of understanding about the use of soft commissions and bundling. The details are presented below.

[52] OXERA (1) Table 2.1, Page 7

Table 11: Breakdown of CRA Pension Fund Trustee Survey interviews by size of fund

Size of Fund	Number of Trustees Interviewed
>£1bn	9
<£1bn	40
Refused to Disclose	1

Source: CRA Pension Fund Trustee Survey

A.11 Again, this survey was controlled to ensure that it was representative not only by size, but by the amount invested in the UK, the proportion invested in equities and the amount that is actively managed.

Annex 2 The market for services additional to trade execution for retail funds

A.12 In the cost benefit analysis (see Chapter 5) we have focussed on an analysis of the incentives on brokers, fund managers and trustees in the context of the management of pensions funds.

A.13 In this Annex, we draw a distinction between institutional and retail funds due to the different nature of the clients they serve, and the different manner in which they operate. A policy aimed at institutional funds could have significant consequences for the retail market, so this needs to be considered carefully.

A.14 In order to consider whether the FSA proposals will affect retail funds in the same way we also need to understand the basis of competition in the retail market and the degree of scrutiny on these funds. Below we discuss how this differs to the situation of institutional funds.

A.15 We do not repeat the role of brokers and third party information providers in the provision of services to retail consumers as they appear to treat fund managers acting on behalf of retail funds in the same manner as those for institutional investors.

The role of the fund manager

A.16 Fund managers manage the assets of retail consumers in a similar fashion to that of institutional funds invested through a pension fund. The structure of remuneration is broadly similar, with the incentive of the fund managers aligned (at least to some extent) through the annual management charge (although due to higher administrative and distribution costs this is often considerably higher) and the importance of net performance in determining new business. In the same fashion, commission is charged directly to the fund and this is used to remunerate brokers for trade execution and additional services.

A.17 The determinants of competition are common between the institutional and retail market place, with net performance consistently being more important than charges. Evidence suggests that charges are less important in determining demand in the retail market than the institutional market. However, due to a number of regulatory interventions it seems likely that charges are becoming (or will) an increasingly important element of competition.

A.18 An important point, that needs consideration is that most fund managers manage both institutional and retail funds, so it therefore seems too simplistic to talk simply of retail or institutional fund managers. Figure 17 above shows the proportion resulting from the CRA Fund Manager Survey.

A.19 However, we can still draw a distinction between these two areas as fund managers can, and do, treat these two types of client differently; and their reaction to CP176 could differ for the two groups. Therefore it is still useful to talk as if retail and institutional funds were managed by separate entities. Most importantly,

if it became beneficial for fund managers to entirely focus on one part of the market, we would expect to see this increase.

A.20 If we examine the relationship between fund managers and brokers it is therefore unsurprising that we see that the same commission terms are used for both institutional and retail clients. This is because, as OXERA points out[53], no distinction is made between the two types of client; brokers don't know whom they are ultimately trading for as many fund managers have both retail and institutional clients.

A.21 However, we do find differences in the amount of softing undertaken for retail and institutional clients. Interview and survey evidence supports that unlike the institutional market where softing is slowing disappearing, this has not been the case in the retail market. For example, when we look at changes in softing in the past 5 years for various fund managers, we see a relationship between the level of softing and the share of their business that is retail. On average, fund managers with a greater proportion of retail business report a greater rise (or lesser fall) in softing relative to total commission than those managers with a lesser proportion of retail business. Therefore here we do see an effect upon fund manager behaviour of the differences that exist between the retail and institutional markets; it appears that softing is easier with retail clients.[54]

The role of financial advisers

A.22 Retail consumers often invest directly in collective investment schemes and insurance products. However, the majority still use a type of financial adviser who will have access to considerable more information that a retail consumer. Available evidence still supports past performance as the most important factor in determining fund choice. Although, there is some evidence that the importance of charges is rising, this is still not the primary determinant of fund choice. Currently, it is highly unlikely that the financial advisers will be aware of the performance of the fund manager in terms of managing transactions costs.

A.23 There are two areas where this might increase in the future:

- The use of external fund links: in this case products such as fund of funds puts an intermediary between the retail consumer and the fund manager. To the extent they invest in funds provided by other fund managers, they will have an incentive to maximise the returns of the fund and will work on the retail consumers behalf;
- The importance of panels in the selection of IFAs: it is now common place that independent advisers choose from a panel when providing advice. The

[53] OXERA(2) page 8

[54] Interestingly, the different between retail and institutional clients was recognised in changes to the regulation of softing. In particular, the disclosure of softing to retail funds was abandoned presumably as it was assessed that this information was of little value to retail consumers or their advisers.

panel selection exercise will examine each product in detail with increasingly sophisticated assessment criteria. The level of scrutiny is therefore considerably closer to that achieved in the institutional environment.

A.24 However, even with the trends described above the scrutiny on behalf of retail consumers appears significantly less than that of institutional investors and will remain so for the foreseeable future.

The role of retail trustees

A.25 It is important to remember that there is no equivalent to the pension fund trustee in the retail market. Pension trustees represent the interests of the investors to the fund manager, are an important intermediary between the two sides.

A.26 However, although at first glance one would assume they are similar, the responsibilities of retail and pension fund trustees are very different. This is even enshrined in the regulatory framework surrounding their duties. Whilst the Pension Act governs pension fund trustees, the trustees of collective investment schemes are governed by the Financial Services and Markets Act, which sets out their very specific duties.

A.27 As described in section 2.1, pension fund trustees have a responsibility - using expert advice – to monitor a fund manager's performance, and his charges, to ensure that the pension fund gets the best deal possible. They may criticise fees, and could remove fund managers who fail to deliver sufficient returns.

A.28 Retail trustees have no duty to explicitly examine performance, or to get involved in the details of how the fund's money is invested. They have legal duties to monitor that the fund manager acts in line with the law; they may for example insist on the proper disclosure of information to investors, but it is not their duty to use this information to then criticise fund managers. They can be characterised as having more of a passive, enabling role in the process of scrutiny – as opposed to pension fund trustees who have a far more active role.

The role of international competition

A.29 We also need to consider the international effects on the retail market of the proposed changes, and to do this we need to take particular account of UCITS.[55] When using UCITS to sell into the rest of Europe, a UK domiciled UCITS will use the same prospectus in all the countries it sells into that it does in Britain. Therefore it will use a common charging structure in each country. Therefore, competition between countries applies some market discipline to the UK market. In principle, if price rose to high in the UK we would expect to see UCITS used to sell foreign funds into the UK.

[55] UCITS is Undertaking for Collective Investment in Transferable Securities. A financial product registered as a UCITS may be sold across the European Union.

A.30 However, in reality few European UCITS are actually sold into the UK, the trade in financial products flows almost entirely the other way, from Britain into Europe. Also, few British UCITS are actually registered in the UK; for historical (largely based around tax) reason most are domiciled abroad in places such as Luxembourg and Dublin.

Market effects regarding retail funds

Proposal 1 effects

A.31 Our conclusions on Proposal 1 for pension funds were predicated on the evidence that fund managers would not be able to increase charges to take account of the additional costs that they would be responsible for and would accordingly reduce consumption.

A.32 Given the closer relationship between trustees and retail fund managers we are less clear that this would be the outcome in the retail market. This leads to the first plausible possible outcome for the retail market – that CP176 has no impact on the level of consumption of market pricing services and therefore has no benefit. In this case a CBA of the retail market in isolation would surely fail to demonstrate a net benefit.

A.33 On the other hand, international competition may force managers to offer offshore funds. This would bring a distinct cost to the economy and would increase the likelihood that no net benefit arises for Proposal 1 in the retail market.

Proposal 2 effects

A.34 Our conclusions on Proposal 2 for pension funds were predicated on the evidence that trustees were not universally prepared to pay for the cost of research and that fund managers would not be prepared to discriminate between those trustees that would be prepared to meet the cost and those that were not.

A.35 Again, given the relationship between retail trustees and the fund managers this effect is unlikely to be observed. Indeed the most likely outcome is that trustees will be happy to accept changes to charges in order to meet the cost of research.

A.36 Again this leads to the first plausible possible outcome for the retail market – that Proposal 2 of CP176 would have no impact on the level of consumption of research and therefore no benefit. Again, in this case a CBA of the retail market in isolation would surely fail to demonstrate a net benefit.

A.37 Furthermore, international competition may also force managers to offer offshore funds. If investors pay more attention to the observably higher management charges of UK funds than they do to the difficult to observe but higher commission charges of their competitors then there is a clear of funds relocating.

Comparative Disclosure effects

A.38 In the pension fund market we find that Comparative Disclosure has net benefit. However there are additional difficulties that arise in the retail market:

- Who is the information to be disclosed to? and
- How will they increase the incentive on fund managers to purchase the optimal level of research?

A.39 A number of ways to increase scrutiny in retail fund were examined in the CRA Fund Manager Survey. There is clear support for a greater emphasis on independent directors as seen in the US, with 84% of fund managers believing this would encourage greater scrutiny. This appears consistent with the belief that disclosure alone is unlikely to work in the retail market.

Conclusions regarding retail funds

A.40 In conclusion, the same issues around the scrutiny of transactions costs hold in the retail market as they do in the institutional market. In fact, there is good reason to believe scrutiny is likely to be significantly less as it is clear that:

- Retail trustees do not fulfil the same role as pension trustees in monitoring and scrutinising fund manager performance;
- There is relatively less scrutiny on charges let alone transaction costs. Charges are an increasingly important dimension of the choices of retail consumers and their advisers, but there is still significantly less scrutiny of charges from retail consumers than in the institutional market. There is clear evidence in this by looking at the wide variation in charges in the retail market compared to the institutional market;
- Although cross-border competition has been encouraged through UCITs, the constraints imposed by this are relatively small.
- For this reason, it is unsurprising that softing is higher in retail funds and whereas the level of softing has been falling in the institutional market, this trend is much less pronounced in the retail market. However, there are reasons to believe the level of scrutiny might be increasing:
    - Brokers do not know whether retail or institutional customers are making trades. They are therefore offered the same commission rates. Any scrutiny by institutional investors is therefore to the benefit of retail consumers;
    - Increasing sophistication of financial adviser and those responsible for products being placed on IFA panels; and
    - Increasing use of external fund managers, with the providers acting as an intermediary for the retail consumer.

A.41 However, on balance the level of detriment in the retail market appears to be higher but any benefits that could potential arise out of CP176 in the pensions market appear to be absent in the retail market.

A.42 We note that the direction taken in the US is towards greater independence in the management of mutual funds. We believe that the FSA and/or HM Treasury should be considering a similar approach in the UK.

Annex 3 International convergence in the treatment of soft commissions and bundling

A.43 Currently, there is no international agreement on the regulation of soft commissions and bundling. Moreover, it remains uncertain whether international convergence in this area is likely to occur in the future. There seems to be convergence on some minimum standards with respect to disclosure and transparency of soft commission arrangements in the member states of the European Union and in Australia. However, there is a lack of rules on how exactly soft commissions should be disclosed in practice (i.e. amount, process etc.).

A.44 There appears to be no publicly available information to suggest that other major countries are contemplating similar regulations to those outlined in CP176. We first look at statements being made by the SEC to determine whether there is any indication of intentions in the US and then turn to European regulators. We also include Australia, although for the purpose of CP176 this is not considered an alternative jurisdiction.

Regulations in the US – statements by the SEC

The current situation

A.45 OXERA (1) goes into a great deal of detail on the historical background and development of the current softing regulation in the US[56]. Here we will simply review the major relevant piece of existing legislation, which is that many soft dollar arrangements are protected by section 28(e) of the Securities and Exchange Act of 1934.

A.46 This creates a "safe harbour" permitting money managers to pay more than the lowest available commission if the money manager determines in good faith that the amount of commission is reasonable in relation to the value of the brokerage and research services provided. This shifts the responsibility to advisory clients (such as fund boards of directors and pension plan officials) to supervise their money manager's use of soft dollars and the resulting conflicts of interest, based on disclosure that the clients receive from the money manager.

Legislation currently under consideration

A.47 There is currently a major piece of legislation under consideration in the US that specifically addresses softing and related issues: The Mutual Funds Integrity and Fee Transparency Act of 2003. This will likely shape the nature of the regulation of softing in the US for the foreseeable future. The major points contained in it are:

- Fund managers must provide an estimated dollar amount of operating expenses borne by each shareholder.

[56] OXERA (1); pages 98-107

- Details of portfolio transactions costs, including commissions, must be set forth in a manner that facilitates comparison among investment companies.
- Information on a company's policies with regard to soft dollar arrangements must be disclosed. Investment advisors must provide the fund's board of directors annually with a report on research services obtained as a result of transactions with brokers.
- The board of directors would be able to have no more than one third of its members as interested parties (the definition of which has also been addressed), and an interested person cannot serve as chairman.
- A fiduciary duty would be established on the part of the board to supervise the direction of the company's brokerage to ensure this is in the best interests of the shareholders.
- Finally, the Act requires the SEC to conduct a study, within 18 months, on the use of soft dollars which must address recent trends in their use, the types of services provided and the extend to which their use impairs the ability of investors to monitor expenses. Finally, this must address whether the "safe harbour" should be repealed or modified.

The view of the SEC on the need for legislation[57]

A.48 Not only do the answers given here provide us with the current thinking of the SEC on the issue of softing, and more generally of mutual fund governance, they are also heavily indicative of the likely direction of future legislation in this area in the US. The main points made were:

- The SEC supports the goals of the bill, and particularly that of enhancing disclosure. However, with respect to some provisions the commissions believes the Bill should preserve its flexibility to determine appropriate standards.
- The SEC is concerned about the growth of soft dollar arrangements and admits, "Soft dollar arrangements involve the potential for conflicts of interest between a mutual fund and its investment advisor". They "agree that fund directors and investors should be provided with better information about soft dollar arrangements".

[57] We have two good sources of information for the current view of the SEC towards softing, and specifically the changes proposed in this bill. Paul F. Roye, Director of the Division of Investment Management of the SEC, appeared before the House subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises during June 2003 to give testimony regarding the view of the SEC on the proposed changes. He was also responsible for leading the SEC's response, issued only a few days before his testimony, to a series of questions posed by Richard Baker, head of the aforementioned committee. These questions focussed on a range of issues including the use of soft commissions, the wider level of fee transparency, mutual fund governance and fund distribution issues.

- But it argues, “These types of conflict, however, are generally managed by fund boards of directors. Fund independent directors are in a better position to monitor the adviser’s direction of the fund’s brokerage than are fund investors”. This is the reason why the Commission has historically not required fund prospectuses to disclose specific information about soft dollar arrangements.
- While defending this view, they do admit, “investors can benefit from improved information about a fund’s policies and practices with regard to soft dollar arrangements”.
- The SEC says that it “has long been committed to full disclosure of mutual fund costs”. Here it supports the disclosure of the dollar amount of operating expenses borne by shareholders, saying this should help address concerns that investors may not fully understand recurring mutual fund fees. Similarly, they conclude the information on transactions costs that the Bill would require should provide investors with a better understanding of these costs.
- In fact, the SEC was already considering similar disclosure requirements. This would take the form of the disclosure of the cost in dollars associated with an investment of $10,000, based on the fund’s actual expenses and returns for the period. A second value would also be disclosed; this would be calculated similarly, except it would use an assumed return of 5% per year in order to allow comparison of the level of expenses of different funds. The Commission is still reviewing comments on this proposal.
- In contrast, recent staff responses received by the Commission suggest that disclosure alone might not be adequate. In addition, the SEC argues that “disclosure, however, has its limitations” because “most clients may find it difficult to evaluate soft dollar practices based on (sometimes lengthy) narrative discussions of practices that may or may not occur in the future”
- They conclude that, “without ongoing quantitative information about soft dollar practices and their effect on brokerage decisions…even the most knowledgeable advisory clients…will find it difficult to effectively supervise their advisers’ use of brokerage”. They continue to say that they “are not sanguine that enhanced disclosure alone will provide sufficient transparency to permit advisory clients to supervise their money managers’ use of soft dollars”.
- Even if quantitative information could be provided, they argue, most clients would not get involved sufficiently to protect their interests. If some clients do effectively restrict the use of softing, advisers may compensate by increasing softing for other clients. They also note “greater transparency of brokerage costs is unlikely to help an investor evaluate a fund adviser’s conflicts in using soft dollars.”
- They support the Bill’s provisions regarding a study of soft dollar arrangements, particularly the inclusion of section 28(e) in the required report.

They admit "it may be appropriate to reconsider section 28(e) or, alternatively, to amend the provision to narrow the scope of this safe harbour".

- In line with their belief in the importance of a fund's board, the Commission supports the amendments in the bill that require each adviser to an investment company to submit a report to the board on a number of issues, including softing. They also support the recognition of the fiduciary duty of boards in ensuring brokerage is directed in the best interests of fund shareholders.
- The Commission supports the goal behind increasing the number of independent directors, which is to give shareholders a greater voice. They note this could create some additional costs, but say the benefits of such a standard make it worthwhile. They note there may be no need to require an independent director as with 2/3 of the board they would be empowered to choose one if they so wish.

Summary of US changes

- The above changes are in respect to the retail mutual fund market not the pension market. In that sense the analysis of the SEC is identical to CRA's. Disclosure is beneficial but not sufficient and therefore greater trustee independence may be required.
- However it is notable that there is currently no suggestion that the solution is to alter the means by which research is paid for.

Regulations in Europe

A.49 At EU level, the Committee of European Securities Regulators (CESR) has developed joint rules of conduct for the investment industry. These rules also include a transparency requirement for soft commission arrangements. However, it remains to be seen to what extent the standards of the CESR, which were published in 2002, will be implemented in national regulation or even legislation. In the following, the current rules on soft commissions and bundling and – where applicable – recent developments in this area will be presented for several European countries and the European Union as a whole.

France

A.50 In France, soft commissions are allowed as long as they are not in the form of cash and do not compromise the best execution practice of fund managers and brokers that is legally required. Also, soft commission arrangements must help to improve the quality of fund managers' services, must not lead to an increase in broker fees, must not lead to a decrease in the quality of the intermediaries' services and must not be a determining factor for the fund manager's choice of broker.[58]

[58] Association Française de la Gestion Financière (AFG), UCITS professional ethics, available at http://www.afg-asffi.com/afg/uk/publication/download/1_ucits_professional_ethics.pdf, p.11, para.20

A.51 French regulation also requires soft commission arrangements to be transparent. In their annual report of funds, fund managers must indicate the amounts and terms of calculating expenses or administrative or financial management commissions collected by the manager or the depositary. Management commissions must be broken down with complex terms of calculating, especially for commissions that include a variable element. If fund managers have soft commission arrangements with intermediaries, the "importance and the beneficiaries of the broker fees paid by the intermediaries in the form of "soft commissions" must be disclosed.[59]

Germany

A.52 In Germany, investment companies are generally required to act in the best interest of their customers. Soft commission arrangements are dealt with in a Guideline on sections 31 and 32 of the Securities Trade Law ("Wertpapierhandelsgesetz", WpHG), which was published by the financial services regulator BAFin in 2001.[60] The guideline requires investment firms to disclose at least in a general way any kick-back arrangements and monetary payments or payments in kind, e.g. research results, that they receive in direct or indirect connection with customer transactions. On customers' request, these arrangements and payments must be explained in detail.[61] The guideline does not define the "general way" in which disclosure must at least be made.

A.53 According to OXERA's assessment of soft commissions and bundling prepared for the FSA, the BAFin intends to publish non-statutory rules of conduct for the investment industry as a means of self-regulation. These rules of conduct will also address soft commission issues.[62] However, there is no information publicly available on this yet.

Italy

A.54 In Italy, investment management companies are required by a resolution of the regulator CONSOB to act in the interest of investors and the integrity of the securities market. The CONSOB regulation of 1998 does not address soft commissions and bundling explicitly, but it requires investment managers to "operate so as to keep down the costs borne by investors and to obtain the best

[59] Association Française de la Gestion Financière (AFG), UCITS professional ethics, available at http://www.afg-asffi.com/afg/uk/publication/download/1_ucits_professional_ethics.pdf, p.12, para.25

[60] Compare unofficial text of BAFin Guideline of 23 August 2001 on the details concerning sections 31 and 32 of the WpHG relating to the commission business, proprietary trading on behalf of a third party and agency business of investment services institutions, available at http://www.bafin.de/richtlinien/rl01_01.htm#1.2

[61] BAFin Guideline of 23 August 2001 on the details concerning sections 31 and 32 of the WpHG relating to the commission business, proprietary trading on behalf of a third party and agency business of investment services institutions, available at http://www.bafin.de/richtlinien/rl01_01.htm#1.2, section 1.2

[62] OXERA (1) para.374

possible result from each investment service, taking into account the level of risk chosen by the investor."[63] Hence, the Italian regulator is able to deal with soft commission and bundling arrangements to the extent that they might lead to higher costs for investors. The CONSOB regulation applies to Italian as well as EU and non-EU investment firms and banks that are authorised to supply investment services in Italy.[64]

Switzerland

A.55 The Swiss investment funds law ("Anlagefondsgesetz") requires fund directors ("Fondsleitung") and their appointees to act exclusively in the interest of investors. Fund directors and their representatives are prohibited from accepting retrocessions or any other benefits in excess of their standard commissions.[65] The law does not address soft commissions explicitly.

A.56 In August 2000, the Swiss Funds Association (SFA) published a code of conduct that has been recognised by the authority for bank supervision (Eidgenössische Bankenkommission) and is mandatory for all Swiss funds and representatives of foreign funds that are offered in Switzerland. One explicit aim of the code of conduct is to ensure a common interpretation of the rules laid out in the Swiss investment funds law (Anlagefondsgesetz), which is merely a framework law and leaves room for interpretation.[66]

A.57 In Article 10 of its rules of conduct, the SFA requires the directors of a fund to ensure that all retrocessions – in the form of soft commissions or as services that are paid for by soft commissions – benefit the fund directly or indirectly. Examples of such retrocessions are financial analyses and market or stock price information systems. Fund directors must clearly state and keep on record a policy on how retrocessions that result from stock exchange transactions carried out for the fund may and should be used. Moreover, fund directors must come to a corresponding agreement with the responsible fund managers and must supervise that those adhere to the fund's soft commission policy.[67]

[63] CONSOB Regulation 11522 of 1 July 1998 implementing the provisions on intermediaries of Legislative Decree 58 of 24 February 1998 as amended by CONSOB Resolutions 11745 of 9 December 1998, 12409 of 1 March 2000, 12498 of 20 April 2000, 13082 of 18 April 2001 and 13710 of 6 August 2002, article 26, English translation (unofficial version) available at http://www.consob.it/produzione/english/Regulations_pdf/reg11522e.pdf

[64] CONSOB Regulation 11522 of 1 July 1998 implementing the provisions on intermediaries of Legislative Decree 58 of 24 February 1998 as amended by CONSOB Resolutions 11745 of 9 December 1998, 12409 of 1 March 2000, 12498 of 20 April 2000, 13082 of 18 April 2001 and 13710 of 6 August 2002, article 25, English translation (unofficial version) available at http://www.consob.it/produzione/english/Regulations_pdf/reg11522e.pdf

[65] Anlagefondsgesetz, article 12, available at http://www.admin.ch/ch/d/sr/9/951.31.de.pdf

[66] Swiss Fund Association, http://www.sfa.ch/?site=2

[67] Swiss Fund Association, Verhaltensregeln für die schweizerische Fondswirtschaft vom 30. August 2000, available for download at http://www.sfa.ch/download.php?id=24

A.58 Contrary to the regulatory plans in the UK, it seems that the Swiss fund industry assigns the responsibility for a transparent treatment of soft commissions primarily to fund directors and not to fund managers.

European Union

A.59 According to our information, there are currently no plans at EU level to amend the community legislation covering investment managers and pension funds.[68] As stated in OXERA's assessment of soft commissions and bundling for the FSA, the Committee of European Securities Regulators (CESR) has published rules for the harmonisation of conduct of business rules under Article 11 of the European Investment Services Directive in 2002. The CESR distinguishes rules of business conduct in transactions with retail investors on the one hand and with professional and counter party customers on the other hand. Accordingly, the Committee has published two different regimes.[69]

A.60 According to the CESR's definition, pension funds and management companies of pension funds are covered by the CESR's proposal for the professional and the counter-party regimes, which was published in July 2002.[70] The CESR's proposed rules of conduct require investment firms to act in the best interest of their (professional) clients:

A.61 An investment firm must at all times act honestly, fairly and professionally in accordance with the best interests of its [professional] customers and the integrity of the market.[71]

A.62 On inducements, which include soft commissions according to the CESR's definition, the proposal states the following.

A.63 An investment firms' directors, partners, employees and tied-agents may offer or receive inducements only if they can reasonably assist the firm in the provision of

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[68] There has been political agreement on a new directive on the activities of institutions for occupational retirement provision, i.e. pension funds (compare press release of the European Commission, Occupational pensions: Commission welcomes Council's definitive adoption of the Pension Funds Directive, available at http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.getfile=gf&doc=IP/03/669|0|AGED&lg=EN&type=PDF). However, the European Commission's proposal does not address soft commissions and other inducements.

[69] Compare p.2 (Foreword) of Committee of European Securities Regulators, A European Regime of Investor Protection – The Professional and the Counterparty Regimes, July 2002, available at http://www.europefesco.org/v2/default.asp.

[70] Committee of European Securities Regulators, A European Regime of Investor Protection – The Professional and the Counterparty Regimes, July 2002, available at http://www.europefesco.org/v2/default.asp. See p.11 of the document for a list of categories of investors who are considered to be professional. The regime applicable to investment services provided to non-professional retail customers was adopted in April 2002.

[71] Committee of European Securities Regulators, A European Regime of Investor Protection – The Professional and the Counterparty Regimes, July 2002, available at http://www.europefesco.org/v2/default.asp, para.

services to its customers. Where inducements are received disclosure of such inducements must be made to the customer on his request.[72]

A.64 The CESR document does not provide any information about the way in which such disclosure should be made.

A.65 The aim of the CESR's standards of business conduct was to initiate a process of convergence of business regimes in Europe. The rules and requirements set out in the proposals are intended to provide investment companies, investors and other interested parties with on overview of the standards the CESR members expect investment firms to meet. The CESR requirements can therefore be seen as European-wide minimum requirements.

A.66 It is interesting to note that under the CESR's professional regime, disclosure of inducements must only be made on the customer's request. This is a weaker requirement than under the retail regime of business conduct. In paragraph 6 of the retail regime, the CESR guidelines request that investment firms must always disclose inducements to the customer, without a need for customers' request. In their assessment for the FSA of soft commissions and bundling, OXERA quote the retail regime requirements for inducements.[73] However, these do not apply to business between pension funds and fund managers.

A.67 On 4 September 2003, the European Commission's Forum Group published a report on the regulation of financial analysts in the EU. The report also deals with soft commissions and bundling.[74]

A.68 In its report, the Forum Group, who seems to have only an advisory function, states that soft commission and bundling practices are currently under review in some EU member countries (there is explicit reference to the FSA plans). However, the group holds that soft commissions should continue to be allowed, at least until the likely market consequences of a regulatory change become clearer. In the meantime, the group calls for requirements that soft payment contracts should be transparent and approved by interested third parties, in particular the customers of fund managers.[75]

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[72] Committee of European Securities Regulators, A European Regime of Investor Protection – The Professional and the Counterparty Regimes, July 2002, available at http://www.europefesco.org/v2/default.asp, para.6

[73] OXERA, An assessment of soft commission arrangements and bundled brokerage services in the UK, April 2003, available at http://www.fsa.gov.uk/pubs/cp/cp176_oxera_assessment.pdf, p.112, para. 384

[74] Forum Group to the European Commission services, Financial Analysts: best practices in an integrated European financial market, available at http://www.europa.eu.int/comm/internal_market/en/finances/mobil/finanalysts/docs/fin-analysts-report_en.pdf

[75] Forum Group to the European Commissions services, Financial Analysts: Best practices in an integrated European financial market, p.39, available at http://www.europa.eu.int/comm/internal_market/en/finances/mobil/finanalysts/docs/fin-analysts-report_en.pdf

A.69 In general, the group concluded that regulatory change in the areas of soft commissions and bundling is likely to have a significant impact on the industry:

- By removing a subsidy from the investment research business, unbundling might, in the short term, result in higher direct cost of research users and ultimately investors.[76]
- By increasing the transparency of research cost, unbundling might encourage analysts and portfolio managers to use research that is more precisely targeted to their needs and to outsource research on a competitive basis.[77]
- Unbundling is likely to reduce competition distortions between independent and integrated research providers. The latter often receive funds from other profit centres within their company.[78]
- The regulatory investigations of soft commission practices (e.g. in the UK) might reduce business for independent research providers who predominantly rely on soft arrangements. Regulatory change, on national or EU level, should therefore be implemented gradually and on a deferred basis to allow research providers to adjust to the new rules and potentially renegotiate existing soft contracts.[79]

A.70 The general conclusion of the Group seems to be that more research and discussion are needed before any regulatory change with respect to soft commissions and bundling should be made. However, the Group's members agree that soft commission arrangements should be transparent and be disclosed to customers. There is no information about which form such disclosure should take.

[76] Forum Group to the European Commissions services, Financial Analysts: Best practices in an integrated European financial market, p.39, available at http://www.europa.eu.int/comm/internal_market/en/finances/mobil/finanalysts/docs/fin-analysts-report_en.pdf

[77] Forum Group to the European Commissions services, Financial Analysts: Best practices in an integrated European financial market, p.39, available at http://www.europa.eu.int/comm/internal_market/en/finances/mobil/finanalysts/docs/fin-analysts-report_en.pdf

[78] Forum Group to the European Commissions services, Financial Analysts: Best practices in an integrated European financial market, p.39, available at http://www.europa.eu.int/comm/internal_market/en/finances/mobil/finanalysts/docs/fin-analysts-report_en.pdf

[79] Forum Group to the European Commissions services, Financial Analysts: Best practices in an integrated European financial market, p.47, available at http://www.europa.eu.int/comm/internal_market/en/finances/mobil/finanalysts/docs/fin-analysts-report_en.pdf

Other jurisdictions

Australia

A.71 Regulations in several European countries and at EU level request that investment firms should inform customers about any inducements and soft commissions they might receive. However, there is usually a lack of information about how such disclosure should be made.

A.72 In Australia, the Australian Securities and Investments Commission (ASIC) published a model for fee disclosure in July 2003 that includes detailed specifications for the disclosure of soft commissions. In general, the aim of the ASIC model is to provide a guide of good practice for issuers of investment products in Australia, who are legally required to disclose their fees (and other product information) in a Product Disclosure Statement (PDS) for investment products in Australia.[80]

A.73 The model is intended "to cover all financial products with an investment component" and has been developed in close consultation with the investment industry. It aims at improving the quality of fee disclosure, especially by making fees more transparent and comparable. The ultimate goal is to enable consumers to make informed decisions.[81] ASIC hopes that the industry will implement the fee disclosure model by 11 March 2004.[82]

A.74 The ASIC suggests a standard format in which fees[83] should be displayed in a PDS. "Significant fees" (establishment fees, contribution fees, withdrawal fees, termination fees, ongoing fees etc.) should be presented in an at a glance table. The table should show what the fee is levied for, the amount (preferably in dollars or, if it is a percentage-based fee, illustrated by a dollar example) and how and when the fee is charged.[84]

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[80] Australian Securities and Investments Commission, A model for fee disclosure in product disclosure statements for investment products, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Fees_disclosure_report.pdf/$file/Fees_disclosure_report.pdf, p.2

[81] Australian Securities and Investments Commission, A model for fee disclosure in product disclosure statements for investment products, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Fees_disclosure_report.pdf/$file/Fees_disclosure_report.pdf, p.6

[82] Australian Securities and Investments Commission, A model for fee disclosure in product disclosure statements for investment products, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Fees_disclosure_report.pdf/$file/Fees_disclosure_report.pdf, p.5

[83] In the report, the term "fee" includes fees, charges, costs and expenses.

[84] Australian Securities and Investments Commission, A model for fee disclosure in product disclosure statements for investment products, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Fees_disclosure_report.pdf/$file/Fees_disclosure_report.pdf, p.13 and 23

A.75 In a second table, a "break down of ongoing fees" (for administration, investment management, expense recovery etc.) should be provided, also stating the amount of the fee and how and when it must be paid.[85]

A.76 Finally, the ASIC model suggests a third section to present "important additional disclosure items" that warrant disclosure, but cannot easily be displayed in table format. Beside more detailed information and dollar examples of fees, this section should also present information about adviser remuneration and soft commissions. According to the ASIC model, investment companies should provide a description of the amount or range of adviser fees, whether there are any soft commission arrangements, whether commission arrangements can be negotiated, and whether rebate arrangements are available. The ASIC believes that the disclosure of adviser remuneration at all stages of the investment decision process and thus also in the PDS will benefit consumers. Investment companies might give a worked example of adviser commissions.[86]

Conclusion on international convergence

A.77 Overall, there is mixed evidence for international convergence in the treatment of soft commissions and bundling.

A.78 Recent publications suggest that there are efforts at the EU level to harmonise rules for investment companies' conduct of business. However, the agreed rules provide only minimum standards and are much weaker than the FSA's plans for the regulation of soft commissions and bundling. The CESR's proposal for a business regime for transactions with professional investors, which include pension funds, only requires fund managers to disclose soft commissions and other inducements on investors' request. In its report on financial analysts in Europe, the Forum Group to the European Commission mentions that some member states plan to introduce new regulations on soft commissions and bundling, but the FSA plans are the only example that is given. Also, it seems that the stricter regulation of soft commissions and bundling is seen with some reluctance by the Forum Group.

A.79 In most of the countries analysed in this section, investment companies must disclose soft commission arrangements. Such rules exist in Australia, France, Germany, and even Switzerland. However, there are differences in the way such disclosures must be made. In Switzerland, it is the fund directors' responsibility to ensure that the fund's policy with respect to soft commissions is specified, disclosed to investors and adhered to by fund managers. In Germany, it is

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[85] Australian Securities and Investments Commission, A model for fee disclosure in product disclosure statements for investment products, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Fees_disclosure_report.pdf/$file/Fees_disclosure_report.pdf, p.13 and 24

[86] Australian Securities and Investments Commission, A model for fee disclosure in product disclosure statements for investment products, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Fees_disclosure_report.pdf/$file/Fees_disclosure_report.pdf, p.16, 26 and 27

investment firms and fund managers that are required to inform their customers about any (in-kind) payments they receive "at least in a general way". Further explanation must be provided only on the customer's request. Contrarily, the Australian Securities and Investments Commission has published a detailed guideline on how to disclose fees, including soft commission arrangements. To our knowledge, there are no such detailed specifications available in Europe.