

17 December 2004

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Dear Paul

**BUNDLED BROKERAGE AND SOFT COMMISSION ARRANGEMENTS  
FSA Policy Statement PS04/23**

1. PS04/23 provided for comments to be made to FSA by 17<sup>th</sup> December 2004. This letter sets out the views of the IMA on behalf of its members.
2. There are a number of aspects of the policy statement that IMA welcomes:
  - The proposal to remove the language of 'soft' in regulation. This is consistent with the FSA's concentration on the substance of what commission can be used to pay for – execution and research – and a welcome move away from the previous concentration on the form that payment mechanisms to third parties might take.
  - The clarification of the FSA's position on 'commission sharing' and its commitment to remove the current regulatory uncertainties in this area. As the IMA has previously pointed out, simply clarifying UK regulation may not be sufficient for commission sharing to provide the potential benefits that FSA has now recognised if its status in other jurisdictions, particularly the USA, is significantly different from that in the UK.
  - The recognition of the issues surrounding the scope of any proposals, in particular issues in relation to client domicile (2.45).

However, some scope issues remain, for example client type and investment firm type (2.46 and 2.47) on which FSA intend to consider further in the context of the drafting of rules. It will be important that the resolution of these issues does not lead to an unlevel playing field between types of investment firms competing for the same type of client business.

3. We appreciate the emphasis that the FSA gave in the accompanying press release to the work of the IMA, LIBA and NAPF on behalf of the industry in 'engaging well to develop a solution which meets the need'. This timely comment will be helpful in consolidating progress.

4. Our remaining comments concern primarily the definitions of execution and research. In general we would support the approach taken in PS04/23 of presenting

a list of items that cannot be paid for out of commission, and of setting out principles to be used in determining what can be paid for out of commission under the headings of 'execution' and 'research'. COB rules expressed as principles as opposed to prescriptive lists would be least likely to incur unintended consequences, for example through inhibiting competition or innovation. A potential downside of the approach is that it could result in uncertainty about the regulator's intentions, leading risk averse firms to make sub optimal choices. Examples of where PS04/23 might risk slipping from principle to prescription are provided below.

## **The Scope of Execution and Research**

### *Services provided by a broker*

4. PS04/23 views 'execution' as consisting of services provided by a broker (or other execution venue) that meet two criteria:

- That they are demonstrably linked to the arranging and conclusion of a specific transaction (or series of related transactions); and
- They arise between the point at which the fund manager makes an investment decision and the point at which the transaction is concluded.

5. From a fund management perspective, there are four steps from investment decision to the achievement of the goal of best execution:

- an investment decision (to buy, sell or hold a particular security);
- a trading decision covering trading mechanism, trading counterparty, and timing (the how, where and when decision);
- the trade (the exchange of securities and cash), and;
- assurance of trading quality.

The last three of these provide the components of the delivery of best execution. Services that support these activities are part of execution and, in principle, should be payable out of commission. They are related to the arranging and conclusion of specific transactions.

6. In 2.13 to 2.15, PS04/23 suggests that only where services are 'provided by a broker' that their cost can be met out of commission. This is in sharp contrast with the treatment of research, where the provider can be either a broker or a third party, and the third party service can be contracted either by the fund management firm or by the broker. To restrict the provider of services that might qualify as execution to those solely supplied by a broker would seem to be at odds with the criteria of 2.13, and inconsistent with the treatment of research. It would also be inconsistent with the stance previously taken in PS04/13 as reported in 2.34.

### *Real time prices and trading information*

7. Real time price information and real time trading information are among the necessary inputs to the choices between venues, brokers and trading mechanisms that the dealing desk in a fund management company makes in delivering best execution. The information required is not generic, but is specific to individual securities and to the execution of the particular trade or trades. The data are also necessary elements in establishing whether best execution has been achieved, particularly relevant where part of the delivery of best execution has been delegated to a broker.

### *Analysis of trading costs*

8. Pre- and post-trade analytical services perform similar roles, but in addition post-trade analysis is an input into pre-trade analysis of where, how, and when to place a trade or trades in a particular security. The stance taken in 2.16 against the inclusion of post-trade analytical services in execution services that are payable out of commission seems at odds with the FSA's desire to increase competition in the provision of execution services. For example, it would work against increased competition between brokers for execution taking the form of providing a quality assurance service to clients on the trades done by the executing broker on their behalf. Market innovation of this type could lead to an improvement in the efficiency of execution if it led to a greater uptake in the use of more sophisticated techniques supporting the analysis of trading costs across the market as a whole.

### *Domestic competition issues*

9. Not all of additional services supporting best execution will necessarily be funded out of commission by every firm. There will be a range of business models across firms: some firms may choose to fund some services which support execution themselves out of the asset management fee, others may fund via current 'soft' arrangements and others may use a mixture of the two. And this is what we should expect to see, particularly where the supply comes as a fixed cost. Larger firms will have the business volumes to support a choice of in-house provision: smaller firms will be seeking to change fixed into variable costs by getting the service from an outsourced provider. Differences in business models are clearly visible in relation to research, and apply equally to execution services. Application of the principle that only research and execution are payable out of commission should not prevent the continuation of different business models in respect of services that support execution and research, nor should it restrict innovation in business models. Were it to do so, the unintended consequence would be to reduce domestic competition and increase concentration.

### *Broker Services*

10. We concur with the view expressed in 2.15 that not all broker activities are separate services in their own right. FSA identify sales and advice as not a separate service. Other examples would also include brokers circulars (perhaps best regarded as marketing and advertising overhead) and corporate access.

### *The Scope of 'research'*

11. Subject to the comments made in paragraph 10 above, we are broadly content with an approach that defines research in terms of value added. Fund managers would only pay for something that added value (they might receive things that do not, but in these cases they would not regard themselves as paying for them). However the description of what constitutes value added is incomplete. For example, the cleaning up of data from disparate sources creates value added without necessarily adding original thought: providing the means to see through the fog is valuable in itself without the necessity of it revealing something new.

## **Future consultation on rule changes**

12. We note that the FSA's views as expressed in PS04/23 remain preliminary and less than comprehensive (1.6) and will be covered in more detail when they consult on rule changes next year. This may constrain the pace at which the industry can implement at a practical level the changes it has planned, and many may prefer to wait for the detailed proposals on rules before they are prepared to commit financial and real resources on the scale required to implement the changes in reporting that the industry is committed to achieving.

## **Third Party Commission Recapture**

13. Commission recapture<sup>1</sup> is a process through which a client obtains, usually via a third party consultant, a rebate from a specified broker on the commission paid in respect of that particular clients trades. The client or his agent would then approach his fund manager and attempt to agree a target level of trades to be allocated to that particular broker.

14. Commission recapture creates additional conflicts of interest for fund managers, first in relation to best execution, where client pressure to direct brokerage to particular brokers can compromise achievement of best execution, and second, in relation to their obligation to treat all clients equally. Effectively a client with such a third party commission recapture programme is gaining the benefits of additional broker services but being allowed to opt out of paying for them.

15. In May, PS04/13 concluded that the FSA would adopt a wait and see approach. Further clarification of the FSA's view would be useful.

Gordon Midgley  
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<sup>1</sup> This is not be confused with arrangements made between fund managers and brokers directly which provide a mechanism for capping the amount of commission paid to a broker for non-execution related services and which rebate commission paid in excess of the cap to all clients. These may also be referred to as in-house commission recapture.