



May 2003

BRIEFING

# FSA consultation paper 176

Bundled brokerage and soft commission arrangements

## Executive summary

The FSA has published a consultation paper (CP 176) on bundled brokerage and soft commission arrangements. CP 176 sets out the results of the FSA's review of the current regulatory regime for soft commission and bundled brokerage arrangements and recommends ways in which the regime could be strengthened. Comments on CP 176 should be sent to the FSA by 29 August 2003.

The Financial Services Authority (FSA) has published its long awaited consultation paper on bundled brokerage and soft commission arrangements (CP 176). Concerns about the conflicts of interest and market distortions arising from the use of such arrangements were highlighted two years ago by Paul Myners in his report on institutional investment. In July 2001 the FSA agreed with HM Treasury that it would review how well the current regulatory regime addresses these issues. CP 176 sets out the results of the FSA's review and its proposals to strengthen the regulatory regime in relation to soft commission and bundled brokerage arrangements.

The FSA's proposals, on which it is consulting, involve the following.

- Limiting the goods and services that can be bought with commission under soft or bundled arrangements. The FSA is proposing to exclude goods and services 'for which demand is reasonably predictable'. It has specifically identified market pricing and information services as falling into this category. According to independent research commissioned by the FSA<sup>1</sup>, these services account for between 50 per cent and 57 per cent of soft commission credits. The FSA is seeking views on whether other services, such as computer hardware and software and custody, should also be excluded.
- Limiting the ability of fund managers to pass-through automatically to customers' funds the

cost of any services other than trade execution. This is intended to provide greater transparency and accountability and would not necessarily require unbundling by service providers.

These proposals are not draft rules. The FSA is seeking views on them by 29 August 2003.

## Bundled brokerage and soft commission arrangements: current practice and rules

In bundled brokerage arrangements, a broker provides a fund manager with a package of services, including trade execution and services such as the provision of research materials or access to the broker's own investment analysts, for a single price. There are no specific regulatory rules on bundling, although bundled arrangements need to comply with a number of general FSA rules such as the Conduct of Business rule on inducements.

Under a typical soft commission arrangement, a broker agrees to pay for certain goods and services that are supplied directly to the fund manager (usually by a third party rather than the broker or one of its associated companies) in return for which the fund manager agrees to direct a certain level of business to the broker.

The FSA's Conduct of Business Sourcebook creates a specific regime for soft commission arrangements. The principal provisions are that:

- the soft commission agreement must be in writing;
- the broker must agree to provide best execution;

<sup>1</sup> The FSA commissioned independent economic consultants Oxford Economic Research Associates (OXERA) to carry out a study of bundled brokerage and soft commission arrangements in the UK.

- soft commission can only be used to acquire certain goods and services that will help the firm to provide investment management services to its clients; and
- the broker must obtain the client's prior consent to soft trades for his portfolio and provide periodic disclosure of commissions paid and the value of soft services received.

## Problems with the current regime

The FSA identifies four areas of concern with the use of soft commission and bundled arrangements under the current regime:

- lack of transparency – the use of commission by fund managers to obtain goods and services makes it difficult for customers to identify what services they are paying for and how much they are paying for them;
- over-consumption of additional services – because fund managers are not paying for services out of their own resources and because the amount they spend is unlikely to be subject to effective scrutiny by their customers, they may tend to buy more services than are strictly necessary and to pay more than is necessary for these services;
- excessive dealing – both fund managers and brokers have an incentive to maximise trading volumes, the former to obtain soft or bundled services and the latter to obtain commissions. This may result in excessive dealing in a customer's portfolio at the expense of fund performance; and
- quality of trading decisions and execution – fund managers may, under current arrangements, be incentivised to select brokers on the basis of the generosity of their soft or bundling arrangements rather than the quality of their trade execution.

The FSA concludes that normal market mechanisms constitute a weak control on the use of bundled and soft services and that the existing regulatory regime does not effectively address the problems created by the use of soft commission and bundled brokerage arrangements. Accordingly, the FSA concludes that amendments to the regulatory regime are required.

## Proposed reforms

The FSA is proposing two main reforms to the current regulatory regime. Both of these apply equally to bundled and soft goods and services.

### Restricting the purchase of bundled and soft goods and services

The first proposal is to restrict the range of services that a broker can offer in addition to trade execution. The FSA adopts the conclusion reached by OXERA that there is no economic justification for using commission payments to purchase goods and services for which demand is reasonably predictable. Accordingly, it is proposing that such goods and services should be excluded from the goods and services that may be purchased under soft or bundled arrangements.

The FSA proposes that the restriction should apply to market pricing and information services – these are, in the FSA's view, categories of service for which demand is reasonably certain. It considers that the exclusion would cover a range of technology services offered by third party providers, whether supplied to fund managers on a stand-alone basis (eg dedicated terminals) or integrated with in-house systems.

The FSA also identifies a number of other services that it considers fall into the category of services for which demand is reasonably predictable and therefore ought to be excluded from soft or bundling arrangements. These are: custody services, the provision of computer hardware and dedicated telephone lines and the payment of fees for seminars and publications. The FSA is consulting on whether these services ought to be excluded.

### Limiting cost pass-through for remaining bundled and soft services

The FSA's second proposal focuses on goods and services that may be purchased with commission (ie goods and services that are not excluded under the FSA's first proposal). These include, in particular, investment research. The FSA proposes that where a fund manager buys goods or services with a customer's commission, either on a bundled basis or under soft commission

arrangements, he must determine the cost of the goods and services and rebate an equivalent amount to his customer's fund. The object of this proposal is to ensure that there is no automatic pass-through of the cost of any services incurred on behalf of a fund other than trade execution. A fund manager may still buy goods and services other than trade execution for a customer with commission but he will be accountable to that customer for the amount spent. The fund manager could of course recover the costs of any such services from the customer either by increasing the management fee or under a separate agreement for the provision of the services.

The FSA recognises that there may be some practical difficulties in valuing the goods and services purchased with commission. In particular, bundled services that are provided by a broker in-house would not normally be separately priced. The FSA considers that, although not required by CP 171, the proposals may encourage the provision of services by brokers on an unbundled basis.

## Conclusions

The FSA regards the proposals in CP 176 as complementary to those in its recent consultation papers on best execution (CP 154) and investment research (CP 171). Together, they represent a significant challenge to existing ways of doing business for both the buy-side and the sell-side in the financial services industry. In particular, the proposal to require fund managers to rebate non-execution costs to customers' funds is controversial. Fund managers will be most obviously concerned by the proposals, which would entail a direct increase in their cost base. There may be an incentive to operate from other jurisdictions where soft commission arrangements continue to be permitted. Full service brokers will be concerned about the source of funding for research. In particular, fund managers who are effectively required to bear the cost of research may increasingly demand an execution-only service. Both brokers and fund managers may also doubt the practicality of being able to ascribe a cost to the different constituents of a bundled execution service.

For further information please contact	Mark Kalderon T + 44 20 7936 4000 F + 44 20 7832 7001 E mark.kalderon@freshfields.com
	Umesh Kumar T + 44 20 7936 4000 F + 44 20 7832 7001 E umesh.kumar@freshfields.com

