

Tough on softing

June 2004

The FSA's feedback on responses to its Consultation Paper 176 – Bundled Brokerage and Soft Commission Arrangements – demonstrates that industry lobbying can be successful in influencing the FSA's views on significant proposals. Nevertheless brokers and fund managers now have a relatively short time in which to agree upon and make significant changes to reporting systems and cost structures, and also to determine their own strategy for research.

The FSA has issued its Policy Statement¹ on Consultation Paper ('CP') 176 'Bundled Brokerage and Soft Commission Arrangements'. CP176 provoked an extreme reaction within the fund management and broking sectors of the industry because of the far-reaching impacts of its proposals, particularly in respect of the cost implications for fund management firms and the effects on demand for research from brokers. There were over 140 responses to the CP and the lobbying has succeeded in persuading the FSA to withdraw its most controversial proposal, the so-called 'rebate' proposal, at least in the short term.

The original proposals

CP176 set out the FSA's proposals for making fund managers more accountable to their customers in respect of some of the costs that are currently passed on direct to customers' funds via dealing costs and soft commissions.

There were two main proposals in CP176:

- Narrowing the range of permitted 'softed' goods and services specifically to exclude market pricing and information services and other services such as computer hardware, custody fees etc. Firms would therefore have to pay for these services themselves; and
- Requiring fund managers to evaluate the costs of research and services other than pure execution costs which are currently 'bundled' within commissions paid to brokers, and to rebate this amount to customers' funds. This proposal is known as the 'rebate' proposal.

"Softing" is the practice where one party, in exchange for business provided by another, provides services or products but not money. For example, in exchange for sending a specific volume of business to a broker, the broker will pay certain bills of the fund management company, usually market pricing screens, investment research and software. "Bundling" is the practice where the fund manager's

¹ Policy Statement 04/13, dated 7 May 2004

payment to the broker is inclusive of trade execution costs and other services from the broker, including research and access to analysts.

The revised proposals

The FSA says there was a consensus amongst respondents to CP176 that present practice does not operate in the best interests of fund managers' customers and that transparency and accountability could and should be improved. There was less agreement on how this should be achieved. Not surprisingly, fund managers proved generally hostile to the rebate proposal whereas representatives of their customers, particularly the National Association of Pension Funds ('NAPF'), showed a clear preference for introducing this proposal.

On the basis of responses to CP176 and other discussions with stakeholders, the FSA's revised proposals are as follows:

- **Restriction of commission services**

The range of goods and services that fund managers can buy with their customers' funds through commission is to be limited to execution and research. Firms will therefore have to meet all costs such as dealing screens, market pricing services, and custody fees themselves, whether these were previously softened or absorbed in brokers' bundled costs. The FSA plans to discuss definitions etc with the industry and consumers in the coming months and to consult on the proposed rules changes during 2004 with implementation of revised rules expected in 2005;

- **Enhanced disclosure**

Enhanced disclosure should be made to fund managers' customers, including information about the respective costs of execution and research paid for on their behalf by their fund manager and the overall expenditure on those services, i.e. a fund by fund breakdown and an average across the firm. Fund managers will be reliant on brokers to provide the information to be disclosed, i.e. the pricing of the separate elements of trade execution and research within bundled commission payments. This proposal is based on a suggestion put forward by the Investment Management Association (IMA) and will expand on the existing Pension Fund Disclosure Code agreed with the NAPF. The IMA successfully persuaded the FSA that enhanced and comparative disclosure would deal adequately with its concerns about market failure but at less cost than the rebate proposal. However, the FSA warns that the industry will have to develop this disclosure proposition further itself: the FSA will assess its progress at the end of this year. If they judge that disclosure is not meeting the aims of greater transparency or the industry is not reacting sufficiently quickly, there is the threat that the FSA will reconsider introducing the rebate proposal; and

- **Promotion of unbundling**

The FSA is encouraging fund managers to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately, ie effectively encouraging unbundling to take place without specific regulatory intervention.

Alongside the above proposals, the FSA is to review the governance arrangements of retail funds to see if there are ways in which retail consumers' economic interests can be better served. This could include assessing if trustees' and depositaries' roles should be expanded to cover oversight of commission rates or identifying 'champions' to protect the interests of retail funds.

Important factors in FSA's decision not to progress with rebate proposals were:

- the potential negative impact on independent research providers; the FSA went so far as to say that the rebate proposal was 'likely to put most of them out of business'; and
- the findings of the research used by FSA to support their conclusions which indicated that smaller fund managers would be disproportionately affected by the proposals and this would cause some of them to exit from the market through sale, closure or relocation.

Next steps

Fund management firms will need to implement the enhanced disclosure proposals quickly in order to convince FSA that the industry can address the transparency issues without the requirement for regulatory intervention and the potential resurrection of the rebate proposal. In order to make the enhanced disclosures they will need information from their brokers and this means that brokers will have to quickly identify and establish the data and systems to generate the required reports. The IMA and the London Investment Banking Association ('LIBA') have established a working group to consider the implications of the proposals for fund managers' relationships with brokers and brokers' involvement in the assessment of the various elements of bundled commissions. The IMA is also working on the detail of what the enhanced disclosure document will look like in practice.

A further consultation paper is expected later this year to contain the draft rules restricting soft commissions and bundling to execution and research costs. Those rules are not expected to take effect until 2005, however, it must be anticipated that certain clients, including pension fund trustees and other proactive institutional clients, will begin to demand the early adoption of this proposal.

Respondents to CP176 were worried about the jurisdictional scope of the proposals, particularly for clients based overseas, and the FSA has confirmed that it will address this in the future in the context of the adoption in the UK of the Markets in Financial Instruments Directive.

On the thorny issue of whether there would be VAT implications of separate charging of brokers' fees between execution and other services, the FSA will continue its discussions with representatives of HM Customs and Exercise but says 'we do not believe tax considerations are fundamental to our market failure analysis'.

Brokers will need to consider carefully how to analyse their charges between execution and research, and what model for the provision of research they should

Financial services bulletin

adopt in the future. They may seek to absorb all such costs within their spread - 'net pricing' - though the FSA does not expect that this will be the case. Many may pull out of certain areas of research altogether. Now is the opportunity for strategic positioning.

Contacts

For further information, please speak with your usual PricewaterhouseCoopers contact or one of the following:

Fund Management		
Roger Turner	roger.turner@uk.pwc.com	020 7804 3249
Karen Jordan	karen.Jordan@uk.pwc.com	020 7212 4947
Brokers/Dealers		
John Tattersall	john.h.tattersall@uk.pwc.com	020 7212 4689
Stuart Crotaz	stuart.crotaz@uk.pwc.com	020 7213 8576

PwC's UK Financial Services Regulatory Consulting Group is comprised of over 100 partners, directors, managers, and staff dedicated to providing pro-active regulatory advice to authorised firms and other financial institutions within the UK, Europe, and elsewhere. Our team blends the experience of former senior regulators, compliance managers, industry personnel and staff with an assurance/client facing background, to provide clients with an unparalleled knowledge of the regulatory rules, codes of conduct and the prudential supervisory framework

This bulletin is produced periodically to address important issues, affecting the financial services industry. If you wish to receive it by e-mail or if any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to

Kirsty Parker
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY

Or send an email to:
kirsty.parker@uk.pwc.com

PricewaterhouseCoopers (www.pwcglobal.com) is the world's largest professional services organisation. Drawing on the knowledge and skills of more than 125,000 people in 142 countries, we build relationships by providing services based on quality and integrity.

("PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.