UKSIP is a member society of

FSA Consultation Paper 176

Bundling and Softing

Response from
The UK Society of Investment Professionals

About UKSIP

The UK Society of Investment Professionals ("UKSIP") is a professional body whose main aim is to foster and maintain high standards of professional ability and practice in investment analysis, portfolio management and related disciplines. It currently has over 4,000 members, who work or have an interest in the UK financial services industry. UKSIP is the second largest member society worldwide of the Association for Investment Management and Research (AIMR®), and the largest in Europe. AIMR is a global non - profit organisation of more than 54,000 investment professionals, and is best known as the organisation that develops and administers the Chartered Financial Analyst (CFA®) Program.

UKSIP also oversees the Investment Management Certificate ("IMC"), the benchmark qualification for those working in investment management in the UK and currently held by over 12,500 investment professionals. UKSIP members who successfully completed UKSIP's former Associate examination can use the designation ASIP.

About this response

. This paper has been prepared in consultation with AIMR and incorporates comment from the wider UKSIP membership.

Executive Summary

In the context of CP 176 UKSIP supports the objectives of:

- efficient market pricing and practices
- high levels of market transparency
- a full range of high quality investment research
- a principles based regulatory regime supportive of workable market solutions.

However, UKSIP is concerned that investors, including ultimate beneficiaries, could be adversely affected by:

- potential loss of high quality investment research
- loss of coverage amongst some sectors and markets e.g. Smaller Quoted Companies
- deterioration in the quality of price formation
- detrimental impact on the UK as a leading world market.

To ensure that the above concerns do not materialise, UKSIP recommends:

- further regulatory encouragement for market driven solutions designed to promote improved transparency
- the commissioning of additional research by the FSA to establish the likely overall impact of the proposals
- that major regulatory change be introduced gradually, so that adverse impacts can be managed effectively.

Overview

1. UKSIP notes the view of the Financial Services Authority (FSA) that the issues related to commission arrangements raised by the Myners' Review (2.11) have a direct bearing on the statutory objectives of consumer protection and market confidence. In principle, UKSIP supports the FSA's concerns and the objective of ensuring that commissions paid by clients to investment managers are fully transparent so that the management fee and transaction costs can be separately identified. It is currently difficult for these clients to understand the payment for execution and for additional services and to consider whether fund managers are overtrading, over-consuming or paying the right amount for services provided. However, UKSIP is aware of the widely reported concerns that the research undertaken may not address sufficiently questions of market resilience or efficiency and thus future market confidence. Therefore, before significant changes are introduced, market practitioners need to be assured that the following concerns have been addressed: that research to date has been sufficiently thorough; that there is a need to consider further the consumers' point of view; that the initiatives proposed are achievable in one step. There is concern that without this further research a big bang approach would have unforeseen and undesirable consequences.

2. Some reduction in services received in connection with soft and bundled commissions could be achieved without harm, except to those service providers but there could come a point when a spend reduction would have a really adverse impact. Because the FSA's proposals could fundamentally change the economics of the industry, UKSIP would ask the FSA to understand, explain and justify the outcome. In UKSIP's view, OXERA's research does not accomplish this.

3. There is not always a ‘clean break’ separating all investment managers from their clients. As the FSA will be aware, from its “OPS membership” there remain a number of large UK pension funds with their own; ‘in house’ investment managers; these teams operate on a cost recovery basis. Traditionally, the securities volumes traded by these managers have been relatively low and hence the savings between bundled and net commission rates is unlikely to be significant. However, when the cost of paying for research explicitly is taken into account this may actually involve greater costs, since ‘in house’ investment managers rely extensively on bundled research when reaching many of their investment decisions. There is no reason why such costs should not be clear, but if that source of research were removed, it is unlikely that equivalent levels could be purchased, as trustee boards, which meet infrequently, would not be prepared to authorise this.

4. Whilst transparency of costs is an important objective, some managers argue that a reduction in the availability of research could reduce the quality of decision-making and impact on fund performance. This is because higher quality research could become a scarce commodity without bundling; lower quality research more akin to marketing, would continue unabated. This concern is clearly shared by the Forum Group to the European Commission and the following paragraph is taken from its Recommendations of 4 September 2003, page 27 *“…we have not yet seen material changes in the structure of the financial services industry, therefore currently the ability of independent stand-alone research firms to operate with full effect has not been proven, despite some successes. If bundling and/or investment banking subsidies were to be discontinued (and if more stringent rules on softing were adopted, further reducing fund managers’ budgets for spending on research), there is a danger that the volume of independent research produced might not immediately compensate for the reduced research output form integrated houses. This could also detrimentally reduce the level of information available to the retail market”*.

5. Market developments to improve transparency are taking place in connection with the Investment Management Association (IMA) Pension Fund Disclosure Code, drawn up jointly with the National Association of Pension Funds (NAPF) in 2002. IMA will be able to brief the FSA fully as to adherence; UKSIP understands that it is considerable and growing. Transparency for the industry is improving as more rigorous broker review processes develop. These could become a widespread industry practice and a standard process could be prescribed based on consultation by the FSA with the fund management industry. Furthermore, such a process could be audited.

6. The suggestion has been made that unbundling would facilitate a keener negotiation of fees with investment managers, without adversely affecting their investment performance on behalf of clients. UKSIP would draw attention to the impact of the growth in performance related fees which encourage managers to operate as efficiently as possible and to ensure that their business models are designed to achieve the best possible performance of assets under management.

7. Any short term reduction in costs resulting from unbundling are likely to be at the expense of longer term investment returns. Bundling currently works to the advantage of long term investors with relatively low transactions as they can benefit from the bundled research generally available. The Government and others are concerned to avoid short term investment horizons, if possible.

8. With regard to the payment of soft commissions this is a practice that, UKSIP understands, is progressively being avoided in the UK marketplace. There are, however, some clients who – for tax, budgeting and presentational reasons – actually prefer to use soft commissions. At one time, at least, a number of local authorities’ superannuation funds would have fallen into this category. Soft commissions and related arrangements are also, at present, the established method of

supporting and stimulating independent research.

9. Apart from the stated objectives in the Consultation Paper, it is not entirely clear to UKSIP whether the FSA might favour other, unspecified outcomes in addition. Does the FSA consider that the UK's investment management industry is too profitable or has a surplus of firms operating within it at present? OXERA research suggests that the UK market is very competitive. It is the view of UKSIP that, if market rationalisation is an objective of the FSA, there may be other ways to address the issue. Putting pressure on research costs in particular may well prove to be an inefficient mechanism to squeeze profitability of the fund management industry since it could also impact unfavourably on performance. It may potentially have far reaching unintended consequences. London is recognised as a major investment management centre and one where professional investors should be able to undertake the widest range of securities transactions for clients based on the best possible research.

10. Given the current depressed state of the financial markets due to a lack of confidence and the fact that there may be relatively little slack in the system at this time, UKSIP welcomed the comments made by Sir Howard Davies in Berlin on 5 June when he recognised the issue of competitive neutrality, the lack of market "modelling" to date and the possible impact that the proposals might have on the quality of available research. In this general connection, the growth of index tracking "passive" funds should not be overlooked. Index managers tend to add inefficiency to price formulation as their actions are driven by momentum, such as movements in various indices and the need to subscribe automatically to new issues. For them, the efficiency of pricing is effectively a "free good", but it must be paid for by others. Just because a commercial transaction between active managers or research analysts cannot be identified, that does not mean that the FSA's proposals will not impact on the transfer of value that has taken place. Such a transfer is clearly a product of dealing on the basis of good research and timely and accurate information flows. Private investors may also implicitly rely on expectations of an established degree of market efficiency. A significant reduction in available research could present problems to the London Stock Exchange in connection with price formulation and a general ability to be a source of capital investment. These are but two of the ways market confidence could be eroded.

11. UKSIP supports the argument that a strong regulatory regime is likely to encourage both investment confidence and firms to maintain their physical presence in such markets. Also, current suggestions that business could be driven overseas have been made in the past but have proved to be unfounded. Even so, the impact of the potentially major changes still warrant much more detailed assessment. It may be that the changes envisaged will reduce wastage or slack in the system and help the competitive position of the UK market place; indeed it is such issues that merit the most careful investigation.

12. On a particular but important issue the authorities, together with the companies concerned and investors, have been worried about the paucity of research available about Smaller Quoted Companies. Often only one broker may be making this available to the markets. Again, further research about the impact of proposed regulatory changes is recommended. This matter is also a concern of the Forum Group to the European Commission (Recommendations 4 September 2003) page 23.

13. It is also worth considering the nature of research in connection with market sentiment. On occasion – and sometimes for prolonged periods – industries or countries will be out of favour with investors. Who will pay for dedicated research in such circumstances? Any potential loss of research would also be detrimental to the UK Market and its participants, including individual investors, as sentiment concerning the industry or country recovers.

14. On a practical point, UKSIP would also wish to point out the enormous difficulties involved in isolating the transaction related element from the total commission spend. It is not a simple matter of looking at the apparent costs of 'execution only business'. These are rarely for the full range of share dealing expenses. Likewise, it is not straightforward to identify the unbundled cost of research. Often, before making investment decisions, managers will contact and sound out analysts and sales traders. Is this a research or dealing expense? Is broker research into execution a "research" or an "execution" cost? Will it be acceptable for different firms to reach different conclusions as to how to classify such expenses?

15. In summary, UKSIP believes that an adequate amount of broad ranging, high quality investment research helps to sustain informed investment decision making by investment managers and that this must not be undermined. There is a significant risk that the FSA's proposals, if all implemented at the same point in time, may have this impact.

Responses to detailed questions

Q3.1 Are there any types of commission arrangement, not described here, that affect the way in which, or the terms on which, fund managers arrange trade execution for their customers?

UKSIP feels that FSA has correctly described the various types of commission arrangement. The difficulty in identifying the transaction related element has already been explained above and the matter is further complicated by such items as market impact of transactions, spreads, fees and Stamp Duty. The investor already has the option of managing most of these. Globally, major clients and administrators are able to negotiate commission recapture with large securities houses and investment banks. Attempting to recapture in this way – or setting targets for directed trading – may be the least unsatisfactory way of attempting to move some of the research element back to clients.

Q3.2 What is your view of our assessment of the economic benefits of bundling and softing?

UKSIP believes that the economic benefits have not been adequately researched. The removal of bundling and softing - though perhaps appropriate in theory – could lead to a diminution in the availability of high quality investment research, in particular. It would also mean that investment managers who currently enjoy soft commission arrangements would need to purchase those items felt necessary for their business to continue. Insufficient research has been undertaken to make an adequate assessment of the financial capacity of managers in general to purchase such services and equipment and, at the same time, to remain competitive in the market place. Given the present large numbers of investment managers operating in the UK, some rationalisation may or may not be desirable. UKSIP's concern is that the extent and impact of any failure of investment management firms has not been adequately assessed as yet. The quality and range of investment research must, however, be maintained or improved.

Assessing the impact of the FSA's proposals is challenging because there are both tangible amounts and intangible issues to be considered. Each could have a varying impact on the different sectors of the investor/fund manager/broker matrix and on individual firms. The levels of disclosure for UK softed services are now high with brokers producing reports monthly and managers quarterly. Replacing softed or bundled existing levels of research is likely to be impossible. The reluctance of trustees, in the case of 'in house' managers, to pay for equivalent research has already been discussed. Similarly, investment management firms will be reluctant to pay for comparable levels. In both cases – but perhaps most particularly for 'in house' managers – the quality of investment decision making could be adversely affected.

Q3.3 *What is your view of our analysis of the effectiveness of the current regulatory regime?*

UKSIP believes that FSA is probably best placed to analyse the effectiveness of its own current regulatory regime and feels that the assessment offered in this Consultation Paper is accurate. As explained previously, the assessment chooses to ignore the economic model of the investment management firm. In the case of some managers, the loss of bundled commissions may result in lower service levels or threaten the viability of firms, dependent upon the extent to which they seek to replace bundled research with its "paid for" equivalent. It is difficult to argue with the FSA's conclusion in 3.45 but the consequences of removing bundling from the economic equation have not, in UKSIP's view, been sufficiently researched. Clearly the FSA, in support of the Myners' Review, believes greater transparency is a much needed development; UKSIP supports this objective but questions the FSA's current approach at the expense of all other alternatives.

Q4.1 What are your views on our proposed treatment of market pricing and information services?

An adequate level of information services must be available to investment managers to help to achieve the best possible performance for all their clients. From a purist regulatory standpoint, the FSA's propose treatment is correct. From a pragmatic standpoint – and bearing in mind the UK's competitive position – the proposed treatment could disadvantage the managers vis à vis competition in other markets with already less stringent requirements.

Q4.2 What is your view on our proposed treatment of other goods and services?

UKSIP finds it particularly difficult to argue the case for softing arrangements, particularly as these are being used less extensively in today's UK market place. UKSIP hopes that those using such arrangements will seek to explain their economic benefit and the extent to which their removal could reduce the level of competition in the investment management market place.

Q4.3 What is your view of our proposal that the cost of additional services should be rebated to customers' funds?

Substantial clients can negotiate recapture with brokers, whilst others could be empowered by greater transparency. Actual rebating is felt to be an impractical solution without further evidence of its impact.

Q4.4 Do you think that unbundling of broker services is a more attractive approach?

Both of the above propositions could have significant implications and UKSIP does not feel that either has been researched in sufficient detail to form a view on the economic implications for investment managers.

Q4.5 Do you agree that both of the proposals described should be implemented together?

UKSIP would favour an evolutionary approach to change rather than a "Big Bang" with its unpredictable consequences.

Q4.6 Do our proposals have other implications for fund management and broking that we have not described?

The wider implications of the FSA's proposals are likely to impose a higher burden on fund managers than on brokers. If fund managers incur higher costs and wish to maintain current levels of profitability, such costs will be passed back to the client, albeit that they will be transparent. A reduction in income received by some research houses seems likely.

One advantage of bundled research is that it is currently exempt from VAT. There is a possibility that the Exchequer might choose to levy such a tax where the investment manager specifically purchases research. The investment community is already concerned that stamp duty has an adverse impact on volumes of securities traded in the UK; any movement of investment houses from the UK to other financial centres would result in a further reduction in volumes traded and diminution of Exchequer revenues; this could provide a further stimulus for the imposition of VAT on purchased investment research. However, an alternative scenario - that the quality of research could improve, the sell side would control its costs better and independent analysts would flourish if bundling were disallowed or made more transparent - should not be overlooked. This reinforces the need for additional research by the FSA.

Q4.7 Do you agree with our assessment of the impact on the investment research market?

As described previously, the impacts could be various and far reaching. If, as some suspect, the UK is 'going it alone', it is at least worth considering why the UK alone seems to find established market practice unacceptable.

Q4.8 Do you agree that our proposals will reduce the demand for directed commission arrangements? If not, should we take specific action to address the potential distortions caused by these arrangements?

Agreed.

Q4.9 Have we correctly assessed the impact on the international competitiveness of the UK market?

Whilst investment mangers might choose not to pay for bundled research, it does add value to all market participants in terms of helping price formulation. Forcing out some research could have adverse impacts that, whilst they are hard to quantify, would affect some participants, private investors amongst them. There is some UK market sentiment that its international competitiveness will either be adversely affected; others argue that benefits would follow from the current proposals as a result of greater trust in the UK system. UKSIP is mindful, however, of the need not to undermine the UK market without the most careful assessment of costs and benefits. UKSIP believes there is a great deal more to be learnt concerning the possible market impact of the proposals.

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