4th Floor
Minster House
42 Mincing Lane
London EC3R 7AE

Becky Young
Policy, Risk and Research Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

9th October 2014

Dear Ms Young,

Wholesale sector competition review – Call for inputs

Overview

"Competition benefits society when individual and group interests and incentives are aligned (or at least do not conflict). Difficulties arise when individual interests and group interests diverge………..once we relax the assumption of market participants' rationality and willpower, then competition at times leaves consumers and society worse off."

(Professor Maurice Stucke[1])

CFA UK welcomes the FCA consultation document and the emphasis placed on competition in the wholesale sector. This response has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC). The PSMPC identifies and monitors key regulatory and best practice developments likely to affect CFA UK members. CFA UK members abide by a Code of Ethics and Professional Standards that focuses on placing client interests first; there is summary of the Code and Standards in Appendix 1.

In this reply, CFA UK has largely limited its submission to one that focuses on the approach the regulator uses to assess competition in the wholesale sector and the quality of execution and

[1] "HEARING ON COMPETITION AND BEHAVIOURAL ECONOMICS; DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS COMPETITION COMMITTEE, OECD July 2012. http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/COMP/WD(2012)12&docLanguage=En

dealing commissions. We may revisit the issue of competition in the asset management sector in the future and would be keen to share this information with the FCA.

Effective competition is essential if we are to have markets that function appropriately, a combination of high quality suppliers delivering the appropriate quality of goods and services that help consumers. According to the U.S Supreme Court[2] the virtues of competition are identified as –

- lower costs and prices for goods and services,
- better quality,
- more choices and variety,
- more innovation,
- greater efficiency and productivity,
- economic development and growth,
- greater wealth equality,
- a stronger democracy by dispersing economic power, and
- greater wellbeing by promoting individual initiative, liberty, and free association

For competition to be effective both the supply-side and demand-side need to interact appropriately. Rather than focus only on the number of suppliers and the amount of choices, the focus should be on the quality of suppliers and quality of choices. Achieving the benefits from competition is complicated by the fact that financial products and services are 'credence goods' so that in many cases it is difficult for consumers to know how beneficial that good will be at the point of purchase. While we can agree on the benefits of effective competition, how these benefits can be achieved is much more challenging, especially when one becomes too reliant on the view that wholesale market participants are 'rational' agents. The evidence demonstrates that market participants do not always act according to theory and so when assessing competition it is key that the regulator takes a more enlightened and practical approach.

[2] Ibid

CFA Society United Kingdom

Competition – multi-disciplinary approach is required

"…where firms are relatively more rational than consumers. Here rational firms can compete either to (i) help consumers find solutions for their bounded rationality and willpower or (ii) exploit consumers' bounded rationality or willpower."
(Professor Maurice Stucke[3])

The standard economics approach to competition is a good starting point but falls short of taking into account the reality of how firms and consumers make decisions and act on them. Key to this limitation is the fact that consumers and suppliers are not homo economicii. In our response[4] to "Journey to the FCA" CFA UK welcomed the regulator's intentions to use behavioural economics in its work and one area where this discipline would be valuable is in the area of competition. However we note that the FCA is revisiting issues that were present over 10 years earlier e.g softing and bundling and dealing commission; spinning and laddering (para 4.13) and Best Execution, which were first investigated by the FCA's predecessor after the bursting of the dotcom bubble.

The FCA's intention to use insights from behavioural economics should enable it to recognise and address the limitations of applying the standard economics paradigm to competition issues. Hopefully, using the insights from behavioural economics to analyse the FCA's enforcement actions will add another dimension to its analysis to help it determine why the forces of competition may not have been as strong as they might like.

---

[3] "HEARING ON COMPETITION AND BEHAVIOURAL ECONOMICS; DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS COMPETITION COMMITTEE, OECD July 2012.
http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/COMP/WD(2012)12&docLanguage=En

[4]CFA UK response "Journey to the FCA", February 2013
https://secure.cfauk.org/assets/2126/CFA_UK_response_Journey_to_the_FCA_SENT.pdf

Supply-side

"Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief...... the reason I was shocked because I'd been going for 40 years or so with considerable evidence that it (free market theory) was working exceptionally well."

(Alan Greenspan)[5]

Competition should force suppliers to compete on quality at an appropriate price. Understanding how firms compete should be key for the FCA to understand whether or not there are competition issues. Firms competing appropriately deliver consumers benefits. We would hope such firms would have an ethos of placing client interests first, have an interest in enhancing market integrity and have staff that adhere to high professional and ethical standards. The more successful firms should be able to distinguish themselves from their competitors in order to enjoy a dominant position. However, the power a dominant market position brings may be misused in structural, rather than one-off, incidents.

The post-crisis enforcement actions have shown that large firms have undertaken a variety of inappropriate actions over long periods of time. The FCA should answer why these firms acted as if the benefits from such behaviour outweighed any costs (i.e penalties, reputational damages, loss of business) from their poor conduct. The recent fine levied on Barclays[6], the latest in a long line of fines and penalties for that firm, demonstrates that the regulatory penalties are not a sufficient deterrent when weighed against the potential revenue from inappropriate conduct.

Competition, from the traditional economics perspective has resulted in a suboptimal outcome. The prospect of reputational damage or loss of business as a consequence of actions from the regulator has not been a strong enough deterrent. Business as usual sends a strong signal to serial offenders that the benefits of inappropriate conduct outweigh the costs and it is the consumer and society that are worse off. In the standard economics paradigm, such rent-seeking would be short-lived, but the reality is that it can take place for long periods of time.

---

[5] "Greenspan - I was wrong about the economy. Sort of", Andrew Clark and Jill Treanor, The Guardian, Friday 24 October 2008.
http://www.theguardian.com/business/2008/oct/24/economics-creditcrunch-federal-reserve-greenspan

[6] Barclays fined £38m for putting clients' assets 'at risk' ,
http://www.bbc.co.uk/news/business-29323483

Stucke[7] provides insights in to the types of unwelcome practices aimed at exploiting consumer behaviours, examples of which are given in appendix 2. The spate of enforcement actions evidences that the pressure of competition on firms can result in the following behaviours:

- Investing less in legal compliance[8] (or even ignoring it[9]) despite the increased likelihood of violations
- Mismanagement of conflicts
- Consumer detriment through misaligned incentives

Collusion undermines the competitive dynamic to the detriment of the market. As the benchmark scandals have demonstrated, more needs to be done by the regulator to understand why such practices persisted over such long periods of time.

Demand-side

"Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, 'I can calculate the movement of the stars, but not the madness of men'. If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: For investors as a whole, returns decrease as motion increases."

(Warren Buffet - Letters to shareholders, 2005)

The events leading up to and after the crisis demonstrated how sophisticated investors also succumbed to their behavioural biases. The hunt for yield regardless of risks, undertaken by both retail and institutional consumers, is a good example of how these biases manifested themselves.

Herding is common with investors piling in to funds or strategies that have experienced strong historic performance. The growing popularity of alternative assets, such as infrastructure, is an example. CFA UK advocates that the regulator should place more emphasis on the demand

---

[7] Is competition always good?; Maurice E. Stucke, Journal of Antitrust Enforcement, Vol. 1, No. 1 (2013), pp. 162–197,
http://antitrust.oxfordjournals.org/content/1/1/162.full.pdf+html

[8] HSBC Bank USA failed to provide adequate staffing and other resources to maintain an effective AML Program
http://www.worldcompliance.com/Libraries/WhitePapers/The_HSBC_AML_Settlement.sflb.ashx

[9] Exposed: The regime of fear inside Barclays - and how the boss lied and shredded the evidence, Mail Online, Simon Watkins, 20 January 2013
http://www.dailymail.co.uk/news/article-2265253/Andrew-Tinney-The-regime-fear-inside-Barclays--boss-lied-shredded-evidence.html

side. Markets would function better if consumers were a more effective source of market discipline on firms.

We would like to see the FCA help educate consumers to identify the right types of products, services and firms that are appropriate to their needs. This would help create consumers that are a more capable and effective source of market discipline on firms. One suggestion we made to the FCA was that the FCA's fees[10] for a firm could reflect past conduct and so enable firms with good conduct to distinguish themselves from those with poor conduct.

The FCA could help competitive forces if they could address the evidence showing that consumers often chase last year's winners. This can be at the expense of understanding the risks taken or the costs involved. Similarly consumers hang onto loss making investments and sell profitable investments too quickly (the disposition effect). CFA UK recognises that the FCA has tried to send strong messages about 'too good to be true opportunities' but loss-aversion still prevails.

Chapter 3

"They (High Frequency Traders) are much less of a villain than I thought. The system has let down the investor."

(Brad Katsuyama, CEO IEX)[11]

Q6. FCA welcomes responses on whether there are any competition issues associated with co-location.

Co-location has greater focus because the practice of High Frequency Trading (HFT) is gaining greater interest with regulators[12]. CFA UK is agnostic[13] to HFT as a practice per se, and recognises it as one that can encourage improvements in execution and support liquidity. But

---

[10] CFA UK proposal for raising fees from the industry January 2014

https://secure.cfauk.org/assets/3372/CFA_UK_fees_and_levies_proposal_for_2015SENT.pdf

[11] CFA Institute Policy Brief: HIGH-FREQUENCY TRADING Investor Issues and Perspectives
http://www.cfainstitute.org/ethics/Documents/policy-brief-hft.pdf

"The Wolf Hunters of Wall Street", Michael Lewis, New York Times magazine, March 31 2014. Adapted from 'Flash Boys: A Wall Street Revolt' by Michael Lewis.
http://www.nytimes.com/2014/04/06/magazine/flash-boys-michael-lewis.html?h&_r=0

[12] Exclusive: SEC targets 10 firms in high frequency trading probe - SEC document, John McCrank, Reuters, Thu Jul 17, 2014.
http://www.reuters.com/article/2014/07/17/us-sec-investigation-highfrequencytradin-idUSKBN0FM2TW20140717
[13] CFA UK Advocacy Newsletter #2
https://secure.cfauk.org/assets/3729/Advocacy_newsletter_Revised_1_July_2014.pdf

we do have concerns about how some market participants misuse it to 'front-run' orders which can undermine market integrity and act against client interests.

While we appreciate that exchanges can maximise commercial opportunities by allowing participants to co-locate their servers; the exchanges and the regulator need to be vigilant to ensure that co-location is not creating an inappropriate advantage that compromises client interests and market integrity. We would also hope that the regulator does not merely focus on equities alone, but rather on all products that are traded on exchanges as well as review the integrity of the market where HFT practices are applied.

Dark Pools

Linked to co-location is the issue of dark pools[14] which are attracting regulator attention overseas. A CFA Institute report on Dark Pools in U.S equity markets suggests, among other things, that improved reporting and disclosure around the operations of dark trading facilities is needed.

Insufficient information about the operations of dark pools or internalisation pools, the types of orders that are accepted within those systems and the process by which orders are matched, makes it difficult for investors to make informed decisions about whether or how to utilize dark trading facilities. It also makes it harder for regulators to monitor their growth and to evaluate how dark pools affect price discovery and liquidity. Dark trading facilities should, therefore, voluntarily reveal greater information about their operating mechanics and report more information on the volumes they execute. Such disclosures would improve transparency and enable all stakeholders to better understand their relative benefits and drawbacks.

Dark pools and co-location both relate to the quality of execution. We would urge that when looking at how transactions are executed the regulator's focuses on whether firms are gaining genuine competitive advantage to benefit their clients or are they exploiting their clients or the market when it comes to executing equity and non-equity transactions.

We would also make the following points:

---

[14] CFA Institute report Dark Pools, Internalization, and Equity Market Quality, 2012
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2012.n5.1
New York Attorney General Sues Barclays for 'Flash Boys' Style Securities Fraud, By Lianna Brinded , International Business Times June 26, 2014
http://www.ibtimes.co.uk/new-york-attorney-general-sues-barclays-flash-boys-style-securities-fraud-1454220

- Competition may be distorted by trading venue fees/incentives and guaranteed prices and trade facilitation by brokers
- Lack of transparency reduces ability to assess best execution in non-equity markets (by clients and clients of brokers i.e. asset management firms.) In this regard, initiatives underway through MiFID II, namely the creation of Organised Trading Facilities for non-equity financial instruments, which though a move in the right direction, must be evaluated over time for unintended consequences. The equity market experience of MiFID is instructive as to the unintended effects of competitive dynamics and broader market behaviours. Lack of standard relevant metrics across the asset classes to assess best execution – this may hinder competition in not allowing clients to see the best consistent liquidity providers
- Incentives provided by brokers may win loyalty from clients e.g. provision of DMA, free research, and EMS software or models/algorithms.
- While the proposed pre-trade and post-trade reporting initiatives under MiFID II are a move in the right direction for assessing effectiveness of competitive dynamics, a concomitant review of the permitted waivers should be initiated for integrating the lessons learnt under the previous MiFID regime.

Q11. FCA welcomes evidence on whether:

• ***sufficient incentives exist for asset managers to negotiate the best deal for investors in relation to areas such as:***
• dealing commission and research (including ***evidence on how competition is working among providers of research)***

CFA UK has responded to the issues set out in the Market for Research Paper and would refer the FCA to our response[15] and recent position paper[16].

CFA UK considers competition in the asset management sector as a key process to bring about benefits to clients and market integrity. We are keen to revisit this issue in the future and would hope to share any of our findings with the regulator.

---

[15]CFA UK response to 'The Market for Research' February 2014
https://secure.cfauk.org/assets/3372/The_Market_for_Research_CFA_UK_Position_Paper.pdf

[16] INVESTMENT RESEARCH VALUATION APPROACHES: A FRAMEWORK AND GUIDE FOR INVESTMENT MANAGERS AND ASSET OWNERS, CFA UK SEP 2014
https://secure.cfauk.org/assets/2670/0914___ResearchValuation___web.pdf

We trust that these comments are useful and would be pleased to discuss them in person.

Yours,

Natalie WinterFrost, CFA FIA
Chair Professional Standards &
Market Practices
Committee, CFA UK

Will Goodhart
Chief executive
CFA Society of the UK

Sheetal Radia, CFA FRSA
Policy Adviser
CFA Society of the UK

About CFA UK

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies.

CFA Society United Kingdom

Appendix 1 Code and Standards

CFA Institute

CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

PREAMBLE

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA®] designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

THE CODE OF ETHICS

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, competence, diligence, respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

STANDARDS OF PROFESSIONAL CONDUCT

I. PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct. Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation. Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing. Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability.

1. When Members and Candidates are in an advisory relationship with a client, they must:
   a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
   b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
   c. Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation. When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty. In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements. Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis. Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients. Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Participants in CFA Institute Programs. Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA Institute programs.

B. Reference to CFA Institute, the CFA Designation, and the CFA Program. When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

Appendix 2– Stucke insights

The following are examples of the sort of detrimental behaviour that can arise from exploiting behavioural finance:

- using framing effects and changing the reference point, such that the price change is viewed as a discount, rather than a surcharge;
- anchoring consumers to an artificially high suggested price, from which bounded rational consumers negotiate;
- adding decoy options to steer consumers to higher margin goods and services
- the sunk cost fallacy, that reminds consumers of the financial commitment they already made to induce them to continue paying instalments on items, whose value is less than the remainder of payments;
- using the availability heuristic to drive purchases, such as an insurer using an emotionally salient death (from 'terrorist acts') rather than a death from 'all possible causes';
- using the focusing illusion in advertisements (ie consumers predicting greater personal happiness from consumption of the advertised good and not accounting one's adaptation to the new product); and
- giving the impression that their goods and services are of better quality because they are higher priced or based on one advertised dimension.