Consultation Paper

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Financial Services Authority

Bundled Brokerage and Soft Commission Arrangements

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FSA®

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The Financial Services Authority invites comments on this Consultation Paper to reach us 29 August 2003. Comments or enquiries can be addressed to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

1.1. Commissions paid by fund managers to brokers for the execution of deals on behalf of their customers are a significant cost of investment fund management. In 2000, for example, UK fund managers paid about £2.3billion in commissions from their customers' funds to UK brokers. However, commissions may pay for more than the cost of trade execution. Estimates vary but as much as 40% goes on additional services such as investment research and market information technology, through 'bundled' (or 'full service') broking or 'soft commission' arrangements.

1.2. As with all charges, commission costs affect investment returns. But since commission is charged directly to customers' funds, transaction by transaction, the total cost to each fund, and the value of the additional services acquired, remain opaque. Fund managers can therefore pass on some fund management costs to customer funds with minimal scrutiny. This creates a significant conflict of interest for fund managers.

1.3. In 2001, Paul Myners reviewed institutional investment in the United Kingdom, for HM Treasury. He concluded that there was an incentive for fund managers to direct business to brokers to obtain additional services, rather than the most favourable trade execution terms for their customers, and that this represented an unacceptable market distortion.

1.4. This has a direct bearing on our consumer protection and market confidence objectives. So in July 2001, we agreed with HM Treasury that we would review how well our regulatory regime addresses the conflicts of interest and market distortions arising from bundled brokerage and soft commission arrangements. We have carried out this work in parallel with our other work on best execution and investment research, and this Consultation Paper (CP) sets out the results of our review.

1.5. We identify four areas of current concern:

- A system in which costs are opaque and accountability to fund management customers is deficient gives little comfort that the underlying conflicts of interest are being controlled effectively, or that dealing arrangements result in good value for money for investors;
- Bundled and soft commission arrangements create powerful incentives that have a strong influence on fund managers' trading decisions and the routing of business to brokers. In some circumstances, buying additional services may be a stronger driver for trading decisions than execution quality. This is particularly the case with soft commission arrangements where the commission rate can be higher than normal, but where the proportion of the commission spend taken up by soft services typically exceeds 80%. Such an arrangement seems bound to have an impact on execution quality;
- The control over these incentives exerted by normal market disciplines is weak and uneven. Competition between fund managers focuses on the mandate for the business and the size of the management fee, rather than commission costs. Although fund managers are judged on fund performance, isolating the effect on performance of bundling and soft commission arrangements from any other factor is well-nigh impossible. More disclosure can help, and we welcome the steps taken by the Investment Management Association and the National Association of Pension Funds to improve disclosure of transaction costs to pension funds. However, we are not convinced that more disclosure will be enough to address the issues. In the retail funds market we think it would have minimal impact;
- Bundled and soft commission arrangements create similar incentives and have similar economic effects, so treating them differently in regulatory terms is unhelpful and creates its own distortions.

1.6. We do not believe that our current regulatory regime addresses these issues satisfactorily, and conclude that further action is necessary. So we are consulting on two main measures:

- We propose to limit the goods and services, beyond trade execution, that can be bought in the first instance with commission or order flow. Specifically, we propose excluding market pricing and information services, such as dealing screens, which account for between 50% and 57% of soft commission credits. We seek views on whether this should include other services, such as computer hardware and software and other equipment, and custody.

- We propose that the cost of acquiring any other services in a package along with trade execution should not be passed through automatically by a fund manager to his customers' funds. This would apply in particular to the use of commission to buy investment research. This does not mandate unbundling by service providers, but focuses on greater transparency and accountability to fund management customers for the use of their funds.

1.7. We believe that these proposals will encourage competition and enhance the attractiveness of UK markets. They will:

- give fund managers a stronger incentive to control the demand for, and costs of, additional broker and third party services. They should also ensure that funding mechanisms do not distort the choice between independent and broker investment research;
- improve transparency and accountability to underlying customers, both institutional and retail, for the expenditure of fund assets. This should bring more effective competitive pressure to bear on total fund management costs;
- strengthen the incentive for fund managers to direct business to brokers on the basis of trade execution quality and cost, rather than the range of additional services that brokers offer. They will also encourage consideration of the merits of alternative trade execution options. This is in tune with our revised approach to best execution, as set out in CP154[1], which focuses on achieving the best overall outcome for the customer – including the costs of execution, and also
- reduce the incentive for larger institutional funds to seek some recovery of their commission outlay through commission recapture and directed commission arrangements.

1.8. To inform our policy thinking, we commissioned Oxford Economic Research Associates (OXERA), independent economic consultants, to carry out a study of bundled brokerage and soft commission arrangements in the UK[2]. OXERA's report provides an economic analysis of these arrangements, and their likely impacts on competition and incentive structures. This is an important study which we are publishing alongside this CP.

1.9. OXERA have also prepared an initial cost-benefit analysis of our policy proposals. This concludes that the benefits are likely to outweigh the costs. We include a summary of this analysis in our CP, and we are publishing the full analysis separately[3].

1 'CP154: Best Execution', FSA October 2002.

2 'An assessment of soft commission arrangements and bundled brokerage services in the UK', Oxford Economic Research Associates, March 2003.

3 'Cost–benefit analysis of the FSA's policy propositions on soft commissions and bundling', Oxford Economic Research Associates, March 2003.

1.10. We invite responses to our proposals by 29 August 2003. The Government has also recently announced the start of their two-year Review of industry progress on implementing the recommendations of the Myners report. This will cover measures to improve control over pension fund transaction costs. We will take account of the Review's findings, as well as responses to this CP, in developing appropriate amendments to rules and guidance for further consultation later in the year.

Consumers

Bundled brokerage and soft commission arrangements affect the management of retail funds, such as unit trusts, OEICs and investment trusts, as well as pension funds. Consequently, consumers with interests in these funds, whether directly or through PEPs and ISAs, will be affected by the issues set out in this CP. Our proposals will benefit consumers by ensuring that fund managers acting on their behalf have stronger incentives to obtain value for money, and to put in place dealing arrangements that clearly operate in the best interests of retail as well as institutional funds.

2 Introduction

Background

The Myners Review

2.1. In 2000, the Chancellor of the Exchequer appointed Paul Myners, then chairman of Gartmore Investment Management, to carry out a review of institutional investment in the UK. Mr Myners published his final report in March 2001[4]. This centred on the efficiency of investment decision making and the responsibilities of those involved, particularly pension fund trustees and their investment managers. However, the report also examined the way in which dealing commission is charged to a fund, when the fund manager buys and sells securities for the fund's portfolio.

2.2. Here, the report focussed on the disparity in the way that the main costs of managing a pension fund – management fees and dealing commissions – are treated[5]. Management fees are transparent to the customer; and indeed pension scheme trustees and their advisers subject them to considerable scrutiny and negotiation when appointing a fund manager. Dealing commissions, on the other hand, are not transparent, since they are invariably charged directly to the fund itself on a transaction by transaction basis. As a result, customers are less likely to know how much commission is charged to their funds in total, or how much of that commission is being used to buy services in addition to trade execution.

2.3. Mr. Myners was concerned that the lack of customer focus on commission costs provides an 'artificial bias' for fund managers to acquire additional services paid for through commission. This enables a fund manager to reduce his own operating expenses even after the management fee has been negotiated and agreed, and so increase the profit element of the management

4 'Institutional Investment in the United Kingdom: A Review' HM Treasury, 6 March 2001 (hereafter 'Myners Report')

5 'Myners Report', paragraphs 5.102-5.113

fee. Although the fund manager has some incentive to exercise control over commission costs, because of their adverse impact on investment performance, Mr. Myners did not think that this was powerful enough on its own to protect the customer's interests.

2.4. The report recommended that fund managers should absorb the costs of dealing by paying commission to brokers out of their own resources. Although these costs could be recovered through the management fee, the competitive pressure to keep these low would encourage fund managers to be more efficient in purchasing additional services, resulting in enhanced competition in the provision of those services and better overall value for money for customers' funds.

2.5. In response, the Investment Management Association (IMA) commissioned research from Professors Brealey and Neuberger of the London Business School, on the economic rationale for all-inclusive management fees[6]. They concluded that all-inclusive fees would address the particular problems identified by Mr. Myners, but were likely to create others of similar magnitude. In particular, by making the fund manager pay the whole commission charge out of his (fixed) management fee, there was a significant danger that fund managers might reduce their level of trading to sub-optimal levels in order to reduce their costs. This perverse incentive could therefore result in reduced investment performance for customers' funds.

2.6. However, there was general agreement that more could be done to make commission costs more transparent. The IMA and the National Association of Pension Funds (NAPF) have therefore jointly developed a voluntary Pension Fund Disclosure Code to standardise the way that fund managers report information on the direct and indirect costs of fund management to pension funds.

The Government's response

2.7. The Government accepted all of Paul Myners' recommendations in principle when the report was published. Following a short period of public consultation, HM Treasury issued a statement in July 2001 on how it intended to take forward the recommendations on pension fund transaction costs. The statement emphasised the Government's desire to see pension fund trustees and investment managers develop appropriate methods of ensuring fair treatment for customers, and open competition. It said that, in the Government's view, pension fund trustees "…should not without good reason permit soft commissions to be paid in respect of their fund's transactions."

6 'The Treatment of Investment Management Fees and Commission Payments: An Examination of the Recommendations contained in the Myners Report', Richard A. Brealey and Anthony Neuberger, for the Fund Managers' Association, October 2001.

2.8. In a statement in October 2001, HM Treasury set out the Government's formal response to the Myners Review as a whole. This included a final version of a set of investment Principles for pension fund trustees, which Mr. Myners had proposed in his report. On transaction costs, the Principles recommended that:
"Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they bear, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy – whether through direct financial incentives or otherwise – for ensuring that these costs are properly controlled without jeopardising the fund's other objectives."

2.9. The Government also accepted Paul Myners' recommendation that it should carry out a review of the market after two years, to assess what progress was being made in implementing his proposals, including the more effective control of transaction costs. The Government recently announced the start of this Review[7]. In respect of transaction costs, the Government review will not attempt to cover the ground covered in this CP, though it will look factually at progress on the principle that pension fund trustees should not permit soft commission arrangements without good reason.

Purpose of this paper

2.10. This paper is concerned with the responsibilities of fund managers to their customers when they transact deals in investments. In particular, it concerns arrangements between fund managers and brokers, through which goods and services in addition to the execution of customers' transactions are supplied to the fund manager.

2.11. The issues related to commission arrangements raised by Paul Myners have a direct bearing on our statutory objectives of consumer protection and market confidence. Bundled and soft commission arrangements, as identified, create powerful incentives that complicate the principal-agent relationship between a fund manager and its customers. The conflicts of interest involved raise doubts about the ability of fund managers both to obtain value for money when spending their customers' funds on acquiring additional broker services, and to trade for their customers on the most advantageous terms – that is, to deliver 'best execution'. In CP154, we pointed out the inherent tension between an approach to best execution that focuses on obtaining the best net outcome for a client, and dealing arrangements that bundle the cost of other services in with trade execution.

2.12. The HM Treasury statement in July 2001 therefore announced that we had agreed to bring forward our planned review of soft commission practices, to

7 Ruth Kelly's speech to NAPF conference, 12 March 2003.

run alongside our existing work on best execution. This review would also include an analysis of 'bundled', or 'full service', brokerage arrangements. It would consider whether there was a case for further regulatory action in relation to both practices.

2.13. To inform our work, we commissioned an independent study from Oxford Economic Research Associates (OXERA). It provides an economic analysis of bundled and soft commission arrangements and their related incentive structures, and their likely impacts on competition in the fund management and broking markets in the UK. The analysis in this CP draws on their findings, and we are publishing their report alongside this CP[8].

2.14. Although Paul Myners' report focussed on pension fund management, bundling and soft commission arrangements are a feature of the institutional fund management market in general. This includes the management of predominantly retail funds such as unit trusts, OEICS and investment trusts, as well as life insurance funds. At the end of 1999, institutional funds accounted for some £2,500billion, over 85% of funds under management in the UK. Pension and insurance funds each accounted for around 40% of this, with around 7% held by collective investment schemes and investment trusts[9]. Consumers with interests in any of these funds will almost certainly be affected by the operation of bundled brokerage and soft commission arrangements. Our review therefore covers the impact of bundling and softing on the full range of institutional fund management.

Structure of this paper

2.15. This CP presents the results of our review. In Chapter 3 we:

- describe the nature and significance of bundled and soft commission arrangements, and the associated practices of directed commission and commission recapture;
- analyse the regulatory and economic issues involved, and the extent to which these arrangements operate against the best interests of a fund manager's customers;
- describe the current regulatory regime and review its effectiveness at protecting those customers' interests, and
- draw conclusions on the case for further regulatory action.

2.16. In Chapter 4 we set out our policy proposals for strengthening the regulatory regime; and discuss the wider potential impacts of our proposals on the

8 'An assessment of soft commission arrangements and bundled brokerage services in the UK', Oxford Economic Research Associates, March 2003 (hereafter 'OXERA report').

9 'International Financial Services Fund Management Brief', September 2001 (cited in the OXERA Report, p7).

market in the UK, including their link to our work on best execution and investment research.

2.17. We commissioned OXERA to carry out a cost-benefit analysis (CBA) of the policy proposals set out in Chapter 4. The results of this analysis are summarised in Annex 1. OXERA's full analysis is being published with this paper as a separate document[10].

2.18. Annex 2 contains a statement of compatibility with our general duties under the FSMA. Annex 3 lists the questions on which we particularly welcome responses.

2.19. This CP does not contain proposed amendments to rules and guidance. These will be the subject of further consultation later in the year in the light of responses to this CP and the findings of the Government's post-Myners Review.

2.20. Responses to the proposals set out in this CP should be received by us by 29 August 2003.

10 'Cost–benefit analysis of the FSA's policy propositions on soft commissions and bundling', Oxford Economic Research Associates, March 2003 (hereafter 'OXERA CBA').

3 Bundled brokerage and soft commission arrangements: the regulatory issues

3.1. In 2000, UK institutional fund managers paid some £2.3 billion to UK brokers in commissions charged to their customers' funds. Estimates vary, but as much as 40% of this was probably spent on services additional to trade execution. OXERA estimate that soft commission credits amounted to around £160 million[11]. The cost of bundled services is more difficult to estimate, but OXERA suggest £500 million would probably be a conservative figure. Estimates from other sources indicate bundled research alone costs around £720 million a year[12]. This gives a total cost of between £660 million and £880 million for bundled and softed services ('additional services') paid for with commission or order flow, out of the assets of managed funds.

3.2. In this chapter, we examine the regulatory issues that arise from bundled brokerage and soft commission arrangements. In the following sections, we:

- analyse the nature of these arrangements, and their significance in the UK market;
- assess the arguments for and against these arrangements;
- discuss the extent to which the existing regulatory regime addresses the regulatory issues identified; and
- draw conclusions on the case for further regulatory action.

Types of commission arrangement

Full service broking or 'bundling'

3.3. In the institutional fund management market, the traditional model for commission payments is the full service broking agreement between a broker

11 OXERA CBA, table 3.2.

12 OXERA CBA, table 4.5.

and a fund manager. The broker receives 'hard commission' (i.e. an actual cash amount) from the fund manager at an agreed rate, on a transaction by transaction basis. In return, the broker supplies the manager with a package that includes both trade execution and other services, such as the provision of research materials, or access to the broker's own investment analysts. These other services are produced in-house, either by the broker or by another company in the same group, and cannot usually be purchased separately. Combining these additional services with trade execution in a single package and charging a single price for them is an example of the practice known as 'bundling'.

3.4. Where a fund manager receives additional services from the broker, he is effectively getting a partial rebate on the commission he paid for the broker's transaction service. Since, in most cases, no individual price is attributed to the constituent parts of a full broking service, their cost to the fund manager's customer is not transparent. The record of the transaction will state only the overall amount of commission charged at the agreed rate. The additional services are normally supplied on the understanding that the fund manager will direct some share of his trade execution business to the broker, although there will not necessarily be any explicit agreement about the total volume of business to be placed.

Soft commission arrangements

3.5. Soft commission arrangements grew up in the UK in the 1970s, in response to the minimum commission regime operated by the London Stock Exchange. Brokers competed by offering additional services to fund managers, to discount the cost to them of having to pay hard commission at a fixed minimum rate. The UK was following the example of the US market where 'soft dollar'[13] arrangements had also arisen in response to a fixed commission regime.

3.6. During that period, 'sponsoring' arrangements became quite common, whereby bought-in services, such as market information technology, were paid for indirectly through commission. The Stock Exchange revised its rules to regulate and define acceptable market practices. Permitted services were initially confined to research and portfolio measurement services. However, by the time minimum commissions were abolished in 1986, softing had become such a widespread practice that brokers were placed under competitive pressure to continue it, even though commercial negotiation with fund managers led to a decrease in commission rates[14].

13 In the US, the term 'soft' covers any services unrelated to execution that are supplied to fund managers in exchange for commission, whether or not they have an individual market price, or there is an agreement to secure a specified level of business. By contrast, the term 'hard dollars' is used in the US for services that are explicitly priced and paid for separately by the fund manager.

14 The US market reacted in a similar fashion when the SEC abolished fixed commissions in 1975.

3.7. Under the soft commission arrangements that are typical in the UK, 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. The total amount the broker will pay is agreed between the parties, and is dependent on the fund manager sending a specific volume of business to the broker. This is typically expressed as a fixed ratio between the amount of hard commission the fund manager will generate and the value of credits earned that can be set against the cost of the additional goods and services. This ratio is known as the 'multiple' or 'multiplier', although the figure is not necessarily stated explicitly in soft commission agreements. The OXERA report indicates that in 2000-2001 the average multiple was between 1.15 and 1.17[15]. So, for example, for every £115 of hard commission that a fund manager paid to a broker, the broker paid for goods or services to the value of £100.

3.8. Soft commission arrangements therefore imply a commitment on the part of the fund manager to direct a certain level of business to the broker. In practice, the arrangement is likely to be fairly flexible. The fund manager, for example, in planning how to cover his operating costs, will normally make an assumption about the overall value of the soft commission credits he expects to generate through the coming period, in order to pay for the services he plans to obtain. But if the volume of business is less than expected, the broker can protect himself by increasing the multiple: that is, if his commission revenue is lower than anticipated, he will spend a smaller proportion of it on additional goods and services supplied to the fund manager.

3.9. However, most brokers offer both full service and soft commission arrangements. A fund manager will typically deal with the same broker under both types of arrangement and, in this case, the commission rate is often the same. There may also be an implicit understanding as to the maximum proportion of trades that can be softed. But if trading volumes are lower than anticipated, the fund manager has some flexibility to switch trades to his soft account in order to generate the desired level of soft credits.

3.10. OXERA found that some 10% of all trades were softed in 2001[16]. Based on the average multiple for that year (1.17), soft commission credits therefore represented some 7% of all commission costs incurred, amounting to around £160 million. Of this, OXERA found that most - between 50% and 57% - went on market information technology (including market pricing and information) services. The next most popular services were research and analysis into companies and markets (25% - 30%), and computer hardware and software (for example, portfolio valuation and performance measurement

15 OXERA Report, table 4.1.

16 OXERA Report, table 4.1

software) (14% - 17%). Other softed services included advice on valuing and dealing in investments, custody services and fees for seminars and publications[17].

3.11. For ease of reference in the rest of this paper, the provision of services other than trade execution through bundled brokerage or soft commission arrangements will be referred to as 'softing' and 'bundling' respectively.

Directed commission and commission recapture

3.12. 'Directed commission' and 'commission recapture' arrangements are variants of bundled and soft commission arrangements. Directed commission is an arrangement under which the customer, for example a pension fund, instructs the fund manager to direct a certain proportion of the trades, and therefore commission, generated by the manager on the fund's portfolio to a specific broker. In return, that broker supplies services or cash rebates that exclusively benefit that portfolio.

3.13. Under these arrangements, the fund manager is acting on his customer's instructions, rather than exercising discretion in selecting a broker. There may, nevertheless, be an implicit agreement between the manager and the broker as to the rate of commission that will ensure the broker is adequately remunerated in exchange for facilitating the arrangement.

3.14. 'Commission recapture' is a similar concept. The customer (for example, the pension fund) appoints an intermediary (not the fund manager) to negotiate with one or more brokers, so that each broker pays to the intermediary a proportion of the commission they receive on the deals for that customer's fund. The intermediary then repays a proportion of the money received as a direct benefit to the customer's fund. The OXERA survey of pension fund trustees indicates that 6% of trades dealt on a commission basis are carried out under directed commission or recapture arrangements[18]. There are indications that the popularity of these arrangements is increasing in the UK, as it has been in the US.

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?

17 OXERA Report, figures 4.2 and 4.3. The ranges indicate differences in data from broker and fund manager surveys.

18 OXERA Report, paragraph 257.

Bundling and Softing: Regulatory Issues and Problems

3.15. Bundling and softing complicate the relationship between principal and agent that is central to fund management. They are a source of significant conflicts of interest. This is because they create incentives for fund managers to make trading decisions, or to engage in dealing arrangements, that do not necessarily serve the best interests of their customers. In this section, we analyse the regulatory issues that arise, drawing on the findings of the OXERA report.

Opacity

3.16. Bundling and softing enable fund managers to finance some of their management expenses by charging their customers in a way that is unnecessarily opaque. This makes it difficult for customers to identify which additional services are being bought with their money, or how much they are paying for them. Consequently, customers do not have enough information to judge whether they are getting good value for money.

Over-consumption of additional services

3.17. Because the pass-through of costs is subject to less scrutiny by customers, fund managers may spend more than they need to on services paid for with commission. As they are not paying for these services out of their own resources, they have less incentive to ensure that they get best value for money. As a result, they may be paying more than is necessary for these services. Also, they may 'over-consume' – that is, buy more of the goods and services than they need for efficient operation. For instance, firms subscribing to market information services may lease more hardware (terminals) than they need, or subscribe to a wider range of data than is strictly necessary for their purposes.

3.18. OXERA find some evidence for this in their surveys of brokers and fund managers. A significant proportion (31%) of fund managers indicated that they would spend less on additional services if they could no longer acquire them with soft commissions[19].

Excessive dealing

3.19. Bundling and softing create an incentive for the fund manager to undertake volumes of trading that may be motivated by a desire to obtain particular quantities of additional services, rather than to improve the performance of their customers' funds. Equally, brokers who are paid by commission have a clear interest in maximising trading volumes. Since customers' control of

19 OXERA Report, figures 2.12, 2.13, 2.14 and 4.6.

transaction costs is imperfect, trading volumes and commission rates could be higher than they need be.

3.20. The extent of this is hard to determine. However, OXERA's findings do not preclude the possibility that bundling and softing may contribute to 'overtrading'. Since trading volumes drive transaction costs, including but not limited to commissions, these may be higher than necessary, and this will impact on fund performance. So even a relatively small reduction in turnover could result in significant savings in total transaction costs to funds.

Quality of trading decisions and execution

3.21. Even if dealing volumes were optimal, a fund manager's approach to broker selection may be unduly influenced by the nature of commission arrangements. As a result, he may select brokers who offer generous bundling or softing terms but inferior execution quality, such as wider dealing spreads or higher commission rates. The need to generate commission in order to pay for additional services may also be a disincentive for a fund manager to consider other trade execution options, for example crossing networks or alternative trading platforms.

3.22. The precise impact of bundling and softing on execution quality is not easy to quantify. OXERA point to research carried out in the US, which shows that the execution quality of softing-only brokers tends to be worse than that of full-service brokers[20]. OXERA suggest that this may not be the case in the UK. However, they conclude that a more detailed analysis would be necessary to determine whether execution quality was in fact unaffected by bundling or softing.

The effectiveness of market controls

3.23. Bundling and softing thus create a misalignment of incentives between fund managers and their customers. We have considered whether the pressure on fund managers to produce good investment returns and the monitoring of fund performance by customers, together with the impact of competition in general, is sufficient to address these concerns.

3.24. Monitoring fund performance is a difficult issue. Many different factors affect performance[21], the impacts of which may be unpredictable or unobservable. Even experts are unable to judge whether a fund performed as well as it could have done over a given period[22]. Isolating the effect on performance of a specific factor, such as broker commission costs, from the impact of any other

20 OXERA Report, paragraph 266.

21 These include charges and fees, dealing spreads, hidden costs such as momentum effects, adjustments to the portfolio in response to external events, changes in the inherent risk or volatility of specific stocks or just random chance.

22 OXERA Report, paragraphs 178 (footnote 44) and 193.

factor, therefore, is likely to be difficult if not impossible - and more so for retail than for institutional customers. So monitoring of fund performance by fund management customers is unlikely to be an effective form of control on the incentive misalignments created by bundling and softing.

3.25. The effectiveness of competition is in our view limited precisely because of the opacity inherent in bundling and softing. So, for example, although there is strong competition on fund management fees this is less effective if customers cannot easily see the combined effect of explicit fees and opaque recharged expenses. If customers cannot easily observe the true price of fund management in total, they will not be able to determine rationally whether they should switch supplier. So although commission costs may be significant for some funds, they are likely on their own to have little or no impact on a customer's decision to appoint or sack a fund manager

3.26. Moreover, there is evidence of a high degree of price dispersion in fund management products with broadly similar service and distribution characteristics. This price dispersion is, in the most extreme cases, in the order of several hundred percent[23]. This suggests a market for fund management that is not as competitive as it might be.

3.27. Our view therefore is that market forces are likely to have little direct impact in controlling the incentive misalignments created by softing and bundling. OXERA also note that features of both the fund management and broking markets mean that inefficient market outcomes may prevail.

Other economic considerations

3.28. OXERA identify a number of potential economic benefits of bundling and softing[24]. In this section, we consider their significance in light of the previous discussion.

Bundling

3.29. Economic theory establishes that bundling has ambiguous effects. On the one hand, it forces consumers to buy goods or services they do not want in order to obtain the ones they do. However, on the other, bundling can have economic benefits. The main ones are:

- economies of scope in production: that is, costs are lower than they would be if the bundled services were produced separately;

23 See, for example, the PIA's 1999 Disclosure Report on Life Assurance, Unit Trusts, Investment Trust Savings Schemes and Personal Equity Plans, which shows very significant differences between Reductions in Yield for savings products not characterised by fundamental differences in quality.

24 OXERA Report sections 3.4-3.7 on bundling, and sections 4.5-4.7 on softing.

- efficient pricing methods: that is, prices reflect the willingness to pay of different groups of consumers, making recovery of fixed costs easier more economically efficient; and
- reduced transaction costs: that is, overall it is cheaper for consumers to buy in a bundle rather than seeking out services from several different suppliers.

3.30. OXERA's general conclusion is that in securities markets, evidence for the existence of these benefits is uneven. They see little economic justification for bundling trade execution with other services for which demand is relatively predictable and which have no direct connection to trading volumes, for example market price and information services, conferences and communications equipment. On investment research, they see the economic case as mixed: there may be a case for bundling access to a broker's analysts with trade execution, but this is less strong for written investment research. However, they also conclude that in the context of the principal-agent relationship between fund managers and their clients, there is little economic justification for passing costs through to customer funds on the same basis as trade execution[25].

Softing

3.31. Two main economic benefits may be claimed for softing. It can:

- ease market entry by smaller fund managers and brokers, increasing competition and choice; and
- facilitate market entry for third-party research providers, enabling them to compete with broker research (mitigating some of the negative effects of bundling).

3.32. In theory, softing can therefore mitigate some of the adverse effects of bundling, in particular by reducing the competitive advantage that brokers have in the provision of bundled services. However, OXERA conclude that evidence for these beneficial impacts is limited. On the first point, there is little evidence that softing actually does facilitate market entry for smaller brokers and fund managers. If it did, there is an argument that softing would actually be supporting less efficient firms. So it is not clear that in the absence of soft commission arrangements, the broking or fund management markets would be significantly less competitive[26].

3.33. In the investment research market, research bought with soft commissions only competes with broker research to a limited extent. A significant proportion of fund managers also buys independent research with hard cash.

25 OXERA Report, paragraphs 164-66, 198.

26 OXERA Report, paragraphs 237, 241 and 276.

We also know that some independent research is effectively provided under bundled arrangements rather than through formal soft commission agreements. So softing may mitigate some of the problems caused by bundling, but it seems likely it does so only to a limited extent[27].

Conclusion

3.34. Our general conclusion is that the economic benefits that are claimed for bundling and softing are unlikely to be realised, or may not be significant. Where economic benefits may exist, and where they are passed through to underlying customers, we think that regulation should not seek to outlaw them. However, for most bundled and softed services, there is no strong economic justification for passing the costs through to customers along with the costs of trade execution.

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

Effectiveness of the current regulatory regime

3.35. In this section we review the effectiveness of existing regulatory requirements relating to bundling and softing.

3.36. Our conduct of business rules effectively draw a distinction between bundled brokerage and soft commission. This is because the rules create a specific regime for soft commission arrangements, but are generally silent on the provision of bundled brokerage arrangements.

3.37. The soft commission regime was originally constructed on the basis that the inducements to place business with particular brokers were felt to be so strong that additional safeguards were called for. The principal provisions are that:

- a soft commission arrangement must be in writing;
- soft commission can only be used to acquire certain goods and services that will enhance the provisions of a firm's investment services to its customers;
- the broker must agree to provide best execution; and
- the firm must obtain the customer's prior consent to soft trades for his portfolio, and provide periodic disclosure of commissions paid and the value of softed services received.

3.38. In the light of OXERA's findings and the analysis in this chapter, and developments in securities' markets since the soft commission regime was first

27 OXERA Report, Paragraph 234, 235 and 276, and figure 3.4.

introduced, we believe that there is little justification for maintaining this distinction between soft commission and bundled brokerage arrangements.

3.39. First, as OXERA point out, soft commission accounts for around 7% of total commission payments. They indicate that this might be a larger figure were it not for the current regulatory regime: the relatively prescriptive approach serves to limit the services that can be softed. However, this means that the vast bulk of commission spend goes on bundled services and is not subject to any specific disclosure or accountability provisions. When the soft commission rules were first introduced in the early 1990s, the Securities and Investments Board felt that it would be likely to encourage a general move towards unbundling of broking services. There is no evidence that this has happened in the UK.

3.40. OXERA's findings also suggest that the impact of soft commissions is not limited to those customers who have given their consent to softing, and to whom the fund manager provides periodic disclosures. Many brokers offer both a soft and a bundled broking service. Typically, the commission rate will be the same for both. Assuming that the costs of providing softed goods and services are met wholly from commission revenue, those customers of a fund manager who do not wish to participate in soft commission arrangements could in effect be subsidising those who do. Conversely, any benefits provided by the softed services received are unlikely to be limited to those customers who are party to the soft commission arrangements. This indicates that the consent and disclosure elements of the soft commission regime are of limited impact in practice. These provisions also do not apply to managers of retail funds such as unit trusts and ICVCs, largely for practical reasons.

3.41. Furthermore, only a small proportion of soft commission business in the UK goes through dedicated soft commission brokers – unlike the US market. Most goes through brokers that offer both bundled and soft terms. This means that it is relatively easy for a fund manager to switch business between soft and non-soft accounts with the same broker. So the driver for the volume of soft business is likely to be the value of soft credits that a fund manager wishes to earn, taking into account the agreed multiple. The current regime offers no brake on this, and it is hard to see how a tie of this nature is compatible with the fund manager's duty to provide best execution.

3.42. One of the conditions for use of a soft commission agreement is that the broker should provide best execution to the fund manager. However, the primary obligation to deliver best execution rests with the fund manager. This applies to the execution of any customer orders, whether under bundled or soft commission arrangements. Also, as set out in CP154, we believe that the best execution obligation should focus on the achievement of the best overall result for the customer, including the costs of execution – which includes commission or any other charges payable to third parties. Specifying it as a condition of using soft commission arrangements therefore provides no additional safeguard, and is out of line with our best execution proposals.

3.43. The current regime also does not address the growth in recent years of commission recapture and directed commission arrangements. As discussed above, these create their own pressures for fund managers, and potentially create hidden cross-subsidies between a fund manager's customers.

3.44. So we believe that our current rules and guidance do not adequately address the key consumer protection issues raised by the practices of bundling and softing set out in this paper. There is consequently a need to strengthen the regulatory regime, in order to address the inherent conflicts of interest arising from bundling and softing and the lack of transparency in the way goods and services are paid for.

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

Conclusion

3.45. The existence of bundling and softing creates conflicts of interest between fund managers and their customers. They can encourage fund managers:

- to over-consume additional services, by purchasing either at an excessive price or in excessive quantities, or both, as this may improve their own profit while increasing the cost to their customers;
- to overtrade, to generate sufficient commission flow to pay for the bundled and softed services required by fund managers to run their business; and
- to base trading decisions on their need to continue the supply of bundled or soft services, rather than the most advantageous trading outcome for customers – inclusive of commission costs.

3.46. We acknowledge that bundling and softing may have some economic benefits. However, many are unquantifiable and, in respect of bundling, rather theoretical. In other cases, for example the softing of some third party services, the overall impact seems not to be very significant. Nevertheless, where economic benefits are meaningful and realisable in practice, and are passed on to customers, our view is that changes to the regulatory regime should not prevent them from being realised.

3.47. Normal market mechanisms are a weak control on the total cost of bundled and softed services. The lack of transparency and accountability in relation to commission costs makes it difficult or impossible for customers to establish whether the fund manager is controlling its conflicts of interest effectively, and is delivering value for money to their funds. On balance, given the size of the market for bundled and softed services, our view is that the misalignment of incentives between firms and customers is likely to be a cause of material disadvantage to the latter. This is likely to be more pronounced for retail, as opposed to institutional, funds because retail investors' monitoring of fund management costs is inherently weak.

3.48. We do not believe that the existing regulatory regime, or the voluntary industry initiatives to improve disclosure, are sufficient to address these issues. So we conclude that amendments to the regulatory regime are necessary to bring about a better alignment of incentives between fund managers and their customers. This should result in an environment in which the costs of managing and dealing for a fund are more visible, and customers are better placed to understand and assess them. In the next chapter, we outline proposals for how this could be achieved.

4 Our proposals for improving the regulatory regime

4.1. In this chapter we explain our proposals for addressing the regulatory concerns identified in Chapter 3. We then discuss their wider implications, including their impact on the UK broking and fund management markets, their relationship to our work on best execution and investment research, and the potential effects on the international position of the UK.

4.2. A cost-benefit analysis (CBA) of our main proposals has been carried out by OXERA. A summary of the main conclusions appears in Annex 1. We have published OXERA's full CBA report alongside this CP[28].

4.3. We propose two main measures for improving the regulatory regime.

Limiting the purchase of bundled and softed goods and services

4.4. The first measure is directed at the range of services that a broker can offer in addition to trade execution, which may induce a fund manager to act in ways that are not in his customers' best interests. OXERA conclude that there is no economic justification for using commission payments to purchase goods and services for which demand is reasonably predictable. We agree with this conclusion. Our first proposal therefore is that goods and services of this nature should be excluded from those that can be purchased with commission, whether under soft or bundled arrangements. The following sections set out the goods and services to which we propose that this restriction should apply.

Market pricing and information services

4.5. First, we propose that this restriction should apply to market pricing and information services. They cover a range of technology services offered by

28 See paragraph 2.17

third-party providers, whether supplied to fund managers on a stand-alone basis (e.g. dedicated terminals) or integrated with in-house systems.

4.6. Subscription costs for these services represent a substantial expenditure. OXERA estimate that they account for between 50% and 57% of soft commission credits (about £90 million in 2001). As indicated in Chapter 3, the ability of fund managers to buy these services through soft commission arrangements is a weak incentive to scrutinise prices and to ensure that the expenditure represents good value for money for their customers. It could encourage over-consumption and overtrading. Moreover, fund managers should be able to forecast with reasonable certainty their demand for these services - that is, the number of screens to be leased or the number and type of information services subscribed to - and the likely cost.

4.7. A further consideration is that the technology is capable of giving access to a wide range of information feeds, not all of which are necessarily related to the provision of investment services to customers. So, for example, fund managers may need to make a judgement about which parts of the service are directly relevant to the provision of investment services to customers, as required by the existing soft commission rules. Removing the ability of fund managers to purchase these services with commission will also remove the need to apportion benefits in this way.

4.8. In their cost-benefit analysis, OXERA estimate that a reduction of only 3% in the consumption of market information services will save UK funds a minimum of £2.8 million per year. Against this, there is likely to be a one-off compliance cost to the industry of around £3.3 million. Thus, only a small decrease in overall expenditure is needed to offset the costs of the proposal.

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

Other services

4.9. The same arguments, in respect of the predictability of costs, apply in principle to a number of other services currently available through softing, such as the provision of custody services, computer hardware and dedicated telephone lines, and the payment of fees for seminars and publications. OXERA's findings indicate that expenditure on these services accounts for up to 20% of soft commission credits, or between £25million and £30million a year. Again, demand for these services should be reasonably predictable and is unlikely to be dependent on variable factors such as dealing volumes. Our provisional view is that they should also be treated in the same way as market pricing and information services.

4.10. However, we seek views on whether there are benefits to be obtained from continuing to fund these services through commission payments. We particularly seek comments from firms who currently obtain them through soft or bundled arrangements.

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

Conclusions

4.11. These proposals would limit the current ability of fund managers to pass certain management costs through to their customers' funds in the form of commission payments. This should provide a more direct incentive for fund managers to consider what additional services are necessary for the efficient management of their customers' funds.

4.12. We also expect that this would bring increased pressure to bear on commission rates, so delivering better value for money to fund management customers for trade execution services.

Limiting cost pass-through for remaining bundled and softed services

4.13. Limiting the goods and services that can be purchased with commission, as outlined under our first proposal, will have most impact on the provision of softed services. However, as indicated in paragraph 3.1, most of the total amount of commission that is used to buy additional services is channelled through bundled brokerage arrangements. Most of this expenditure is likely to be on investment research. Our second measure focuses on delivering greater transparency and accountability in the use of commission to purchase all remaining additional services, whether this is formally through bundled or soft arrangements.

4.14. We propose that where a fund manager buys any other services additional to trade execution with his customers' commission, he should determine the cost of those services and rebate an equivalent amount to his customers' funds. This would not prevent these services from being provided, as now, together with trade execution, and being priced into the rate or amount of broker commission charged to the fund. But the fund manager would be required to determine the pro-rata cost to his customers' funds of the additional services and to repay to them an equivalent amount.

4.15. The effect of this proposal is that the automatic pass-through of commission to customers' funds would be limited to the cost of trade execution (although there might be a time delay between the charging of commission to funds and the calculation and payment of the rebate). It would remove the misalignment of incentives that bundling and softing currently create; and it would give fund managers a more direct incentive to exercise stricter control over the purchase of additional services that are currently acquired through bundled or soft arrangements.

4.16. Some practical issues may arise from this proposal, particularly in relation to the valuation of additional services. It would be for the fund manager to determine the cost to him of the additional services to be obtained. For services currently provided through soft commission arrangements, this should be relatively straightforward, as in most cases the services are already separately invoiced. This is unlikely to be common practice for bundled services, especially where they have only ever been provided by a broker on an 'in-house' basis.

4.17. In this case, the fund manager might look to his brokers to provide him with 'unbundled' services, each with a separate price, even if those services were not being sold on their own. So the fund manager might look to obtain a separate invoice for the goods or services provided, and pay the broker or third-party supplier directly, as he currently does for other management expenses. If unbundling were to occur, the commission rate charged to funds could be limited at the outset to that necessary to cover the cost of trade execution. This might be a more attractive option, since it would avoid the need to calculate and pay rebates to customers' funds. However, we believe it is for the market to determine whether this is best way forward.

4.18. If brokers did not provide unbundled prices, the fund manager might use a proxy figure to arrive at a suitable cost. For example, bundled research could in some circumstances be costed by comparison with the cost of purchasing research from an independent supplier with 'hard' money. This would also provide a control for the fund manager, should brokers supply what he felt to be unrealistic unbundled prices.

4.19. However, for the proposal to work, it would probably not be essential for the cost of each service to be determined separately. As indicated above, as long as the commission rate attributable to trade execution could be agreed, perhaps by reference to market rates for execution-only business, the difference between those costs and the total commission payable would represent the total cost of the additional services, whatever services were actually provided.

4.20. In their CBA of this proposal, OXERA estimate that if demand for additional services decreased by 10% a year as a result of stricter cost control by fund managers, there would be savings of between £50 million and £72 million a year for UK funds. Set against the estimated compliance costs to industry of £14.4 million to implement these requirements, and £3.2 million a year on an ongoing basis, this shows that the measurable benefits would outweigh the costs.

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

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

Relationship between the two proposals

4.21. We have formulated these two proposals on the basis that they will be implemented together. OXERA's CBA reflects this, although we have also considered the cost-benefit implications of implementing each proposal alone. In all three cases, we believe the incremental benefits will exceed the incremental costs.

4.22. There is some overlap between the effects of the two proposals. Under the second proposal, requiring the fund manager to rebate the costs of services additional to trade execution will create a stronger incentive to consume only those services that he needs and that represent good value for money for his customers. So applying this approach to market information technology and other services (covered under the first proposal), and continuing to allow them to be priced into commission rates, could deliver similar results.

4.23. However, as explained, we believe there is a strong case for restricting the goods and services can be obtained in the first instance with commission payments, whether through full-service brokerage or soft commission agreements. Under the second proposal, the cost of all remaining additional services will effectively be treated in the same way, irrespective of the arrangement through which they are obtained.

4.24. A key consequence of implementing the proposals together is that they will effectively remove the existing regulatory distinction between bundling and softing. This will have the important effect of creating a level playing-field between brokers selling their in-house services and third-party providers of the same kinds of service. Independent service providers, for example of investment research, should benefit from the creation of a market in which fund managers are incentivised to 'shop around' between both types of provider to obtain the best value for money.

4.25. Our preferred approach, therefore, is to see these proposals as complementary measures. Between them they will mitigate the misalignments of incentives between fund managers and their customers, and will create an environment in which bundling or softing do not operate to the detriment of fund management customers.

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

Wider implications of our proposals

Fund management and broking

4.26. Our proposals will increase fund managers' operating costs. However, the extent will depend on the volume of additional services that fund managers might choose to buy, and the price they are prepared to pay. Fund managers will have a stronger incentive to scrutinise both more carefully. We believe that competition will determine what is the optimal level of consumption of additional services, and that there is likely to be downward pressure on both demand and cost.

4.27. Fund managers might absorb any cost increases in overheads. Alternatively, they might seek to pass on some or all of any cost increases to their customers. Costs could be recovered either through an increase in the management fee, or through an explicit service fee or charge. However, this should be more transparent than the pass-through of commission costs. Explicit fees and charges also tend to be subject to greater scrutiny by clients. Unless the current levels of consumption of additional services are already optimal for funds, this is likely to constrain the extent to which managers can pass on increased costs in full. This, in turn, should encourage them to examine their spending on additional services more carefully. This should facilitate more effective competition for fund management business.

4.28. For brokers, our proposals do not make unbundling obligatory. Nor do they constrain the way in which brokers might choose to offer their range of services, or the prices to be charged. The focus of our proposals is on improving the transparency to fund management customers of the respective costs of trade execution and additional services where these are offered in a package. It is possible that, over time, brokers will develop more flexible arrangements: perhaps by offering a range of dealing services from execution-only to full-service, either as a bundle or on a tariff basis, with fund managers choosing the combination that suits them best. Again, this should facilitate effective competition for broking services.

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

Investment research

4.29. Commission is one of the main ways of funding investment research, whether produced by brokers or by independent houses. For bundled broker research, this could amount to anything between £500 million and £720 million per year[29]. Funding of third party, or independent, research through soft commissions is probably quite small by comparison. OXERA indicate that it accounts for around 25-30% of soft credits, or some £40 million[30]. OXERA also suggest that fund managers may be as prepared to fund third party research with hard cash as with soft commissions[31].

4.30. We recently published a consultation paper - CP171 - addressing the conflicts of interest that affect the production of sell-side investment research[32]. At the heart of this was concern about the effect those conflicts have on the objectivity of investment research, and therefore its quality and value to the market. So we proposed a number of measures aimed at strengthening firms' management of investment banking conflicts of interest.

4.31. We see the proposals in this CP as complementary to the measures set out in CP171. We believe that they are likely to have a positive impact overall on the investment research market by removing some important distortions. As indicated above, the distinction between bundled and soft commission arrangements will effectively disappear. With full cost transparency, the type of dealing arrangement will not distort the choice between independent and broker research. This would therefore remove any incentive that may exist at present to consume broker research in preference to independent research. It would also give fund managers a stronger incentive to scrutinise more carefully their demand for, and the quality and price of, investment research products whether provided by sell-side brokers or independent houses.

4.32. There may be a fall in demand for research, and this may impact on the sectors and companies that some brokers wish to cover. On the other hand, there is an argument that the distortions in the market for investment research mean that much sell-side research is duplicated and of poor or uneven quality. So our proposals are likely to stimulate demand for 'value added' products rather than routine research coverage, and so improve the overall quality of research produced.

4.33. As we have said, our proposals do not mandate unbundling of broker services. On the contrary, they leave scope for the market to determine what services should be offered and at what price. This should encourage competition on the basis of need, quality and price, and should not discriminate unfairly against either sell-side or independent providers.

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

29 See Chapter 3, paragraph 3.1; OXERA CBA Table 4.5 and paragraphs 157-161.

30 OXERA Report, paragraphs 211-2.

31 OXERA Report, figure 3.4 page 54.

32 CP171: 'Conflicts of Interest: Investment Research and Issues of Securities', FSA February 2003.

Best execution

4.34. We published a consultation paper last year, setting out a revised approach to best execution[33]. The proposals in this CP have a bearing on the approach to best execution set out in CP154. In that CP, we proposed that best execution should be about delivering the best overall net result for the customer. This should include consideration of the transaction costs borne by the customer, including commissions paid to third parties. We also proposed that firms should provide information to their customers on their execution arrangements including, for fund managers, how they select brokers. This should include disclosure of any incentives or conflicts of interest that might influence that choice. However, we also argued that there was an obvious tension between a 'best net result' approach to best execution and the use of commission to buy additional services as well as trade execution, particularly where costs were opaque and the value to underlying funds hard to determine.

4.35. We see the proposals in this CP as complimentary to those set out in CP154. By focussing on that element of commission that is directly related to trade execution, and by removing the incentive for trading decisions to be unduly influenced by decisions about the purchase of soft or bundled services, the proposals in this CP will contribute to the delivery of an approach to best execution that focuses on the overall net result for the customer, including transaction costs.

Directed commission and commission recapture

4.36. Our proposals could have an impact on directed commission and commission recapture arrangements, as described in Chapter 3. These arrangements are not expressly regulated under our existing rules.

4.37. OXERA suggest that directed commission does not create a conflict of interest between pension funds and their fund managers, since the funds benefit directly from the commission rebate[34]. Despite this, there is a potential conflict of interest with the fund manager's duty of best execution. The arrangement has the effect of focussing broker selection on the level of commission rebate that can be obtained rather than the broker's execution quality. There is also a risk that arrangements of this type may create cross-subsidy problems: brokers may charge higher rates to all customers, to offset the cost of rebating commission to some of them. Since it is mainly large funds that negotiate directed commissions, smaller funds are more likely to be disadvantaged by them. Even so, any fund that either chooses not to negotiate a commission rebate or is not able to do so, may be paying more commission than it should.

33 See paragraph 1.7.

34 OXERA Report paragraph 258.

4.38. Consequently, fund managers who are party to directed commission arrangements are subject to commercial pressure that may constrain their ability to deal for their customers on what they judge to be the best terms available. It could also compromise their duty to comply with the principles and rules that require firms to manage conflicts of interest between customers.

4.39. We believe that our proposals could reduce the attractiveness of directed commission arrangements. This is because the fund manager will have a stronger incentive to control commission costs more effectively, and so reduce the scope for a fund to be able to do so outside the fund manager-broker relationship. Limiting the automatic pass-through of commission costs to trade execution should benefit all customers' funds. Greater downward pressure on commission costs in general would also reduce the scope for individual rebates to be negotiated between a fund and a broker.

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?

Disclosure to customers

4.40. Our proposals may also lead to changes in disclosure requirements. For example where, under the second measure proposed, the cost of additional services is rebated to customer funds, those customers should at least be able to see the net amount of commission charged to their fund. There may be a case for disclosing both the gross amounts and the rebates, perhaps on a periodic basis, so that customers are given a clearer picture of the fund manager's use of their funds. This could be part of normal fund accounting arrangements.

4.41. We will consider this issue further in the light of responses to this CP.

Potential tax implications

4.42. The tax implications of these measures would have to be considered carefully, especially in relation to VAT, once we know the outcome of our consultation and any changes. The current VAT treatment of fund management fees and charges is not consistent but depends on the nature of the investment vehicle. Authorised unit trusts and open-ended investment companies are classed by HM Customs & Excise (HMCE) as "special investment funds", whose management fees do not attract VAT. Life assurance companies are also exempt in respect of fees for the management of pension fund assets. However, other fund management companies, including investment trusts, are required to pay VAT on their management fees. Commission payments to brokers that relate to buying securities in these vehicles do not attract VAT.

4.43. HMCE issued a consultation paper in November 2002, reviewing the VAT treatment of pension fund management. Their paper specifically considered the different treatment of pension fund management fees charged by life companies and other managers. It also sought views on whether investment trusts should be included in the definition of "special investment funds". The expectation, following the VAT recommendation in the Sandler Review35, is that changes will be made to create a level playing field between different types of investment vehicle, thus encouraging competition in the market for provision of savings and investment products. HMCE are currently considering responses to their consultation, and the outcome will inform our further development of policy in this area.

The international competitiveness of the UK

4.44. All major securities markets recognise the conflicts of interest and potential for market distortions inherent in bundled brokerage and soft commission arrangements, and thus regulate to mitigate these effects. The OXERA report compares regulatory requirements in the US, France and Germany36. The approaches taken are broadly similar, but not necessarily identical. Some jurisdictions (Hong Kong, for example) do not distinguish between bundling and softing in the same way as the UK.

4.45. The proposals in this paper would be a departure from the regulatory approach in other markets only to the extent that they address the conflicts of interest and potential market distortions more directly. In particular, they would signify less reliance on disclosure as the key means of addressing these issues. We have discussed earlier in this paper our reservations about the effectiveness of disclosure.

4.46. However, we note that in some jurisdictions there is increased focus on what the appropriate standards should be in this area. The Association for Investment Management and Research (AIMR), for example, has published standards of practice on soft commission. These emphasise two key principles; that brokerage is the property of the customer, and that the fund manager, as fiduciary for his customers, has a duty to seek best execution, minimise transaction costs, and use brokerage to benefit his customers. They also place increased emphasis on accountability to customers for their use of the customer's brokerage to acquire goods and services, whether these are proprietary broker services or provided by third parties. We fully support these sentiments. Also, on 12 March 2003, a sub-committee of the US Congress Capital Markets' Sub-Committee considered a number of mutual fund issues, including soft dollars. The issue is therefore likely to have an increasingly international flavour.

35 'Medium and Long-Term Retail Savings in the UK: A Review', HM Treasury, July 2002.

36 OXERA Report, Appendix 1.

4.47. We think that, over time, our proposals will bring benefits to the UK. They will create a stronger incentive for fund managers to exercise more effective control over the demand for, and costs of, additional broker and third party services. They will improve transparency and accountability to underlying funds, both institutional and retail, for the expenditure of fund assets, and bring more effective competitive pressure to bear on total fund management costs. They will strengthen the incentive for fund managers to direct business to brokers on the basis of trade execution quality and cost, rather than the range of additional services that brokers offer, and will encourage consideration of the merits of alternative trade execution options.

4.48. We believe that these developments will have a positive impact on the costs of investing and on investment returns. They will also help to create a climate that fosters innovation, promotes competition between firms and helps build a more efficient market. This should be attractive to both UK and overseas investors, and should therefore enhance the international competitiveness of UK markets.

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

5 Next Steps

5.1. The period of consultation for this paper ends on 29 August 2003. We will then prepare a further consultation paper, which will give feedback on this initial consultation and will contain draft Handbook text for the proposed changes. Publication of that paper is therefore likely to be in Q4 2003.

5.2. Following consultation, we expect to issue ‘made’ Handbook text in 2004. We will consider what transitional arrangements are appropriate as part of our consultation on the Handbook text.

Annex 1

Cost-benefit analysis

Introduction

A1.1. Sections 155 and 157 of the FSMA 2000 require us to undertake cost-benefit analysis of our proposed rules or proposed general guidance on rules, and to publish the results. The purpose of a CBA is to assess, in quantitative terms where possible and in qualitative terms where not, the economic costs and benefits of a proposed policy. Specifically, the requirement is that we should publish "an estimate of the costs together with an analysis of the benefits to accompany the proposed draft rules".

A1.2. Although we are not proposing draft rules or guidance in this CP, we decided that our policy proposals were sufficiently developed to make the preparation of a CBA practicable. Since the proposals represent a substantial modification to our current policies, the CBA should be of assistance to respondents in considering their likely impact.

A1.3. We commissioned Oxford Economic Research Associates (OXERA), a firm of independent consultants, to undertake the analysis of our policy propositions for soft commission arrangements and bundled brokerage services ('softing' and 'bundling'). The results of OXERA's CBA work are published in a separate report[37]. We concur with OXERA's estimates of the costs and benefits of our policy proposals. This Annex summarises the main findings of their work.

A1.4. OXERA also undertook for us a general study of softing and bundling, and the markets for brokers and fund managers in which these practices take place[38]. That study, which we are also publishing, should be seen as separate from the present CBA (although part of the data and information presented in the study are also used in the CBA). The FSA is entirely responsible for the policy proposals analysed in the CBA.

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37 See Paragraph 1.9.

38 See Paragraph 1.8.

A1.5. The CBA assesses the incremental change in costs and benefits of our policy propositions. Following our standard approach to CBAs[39], these have been assessed on the basis of six categories of market impact:

- direct or regulator's costs – both one-off and ongoing;
- compliance costs – both one-off and ongoing;
- quantity of transactions;
- quality of transactions;
- variety of transactions; and
- efficiency of competition.

A1.6. The estimates of direct costs are our own. Assessments under the other headings have been carried out by OXERA, drawing on various sources of information, including in-depth industry interviews and a questionnaire among pension fund trustees, fund managers and brokers.

Costs and benefits of our policy proposal (Part 1)

A1.7. Our first proposal ('Part 1') restricts the range of the goods and services that can be bought through bundled and soft commission arrangements. For the purposes of the CBA we have specified that market and price information services (e.g. dealing screens) can no longer be obtained through softing and bundling. Consequently, for fund managers this breaks the link between acquisition of these services and decisions about selecting which broker to deal through. If managers continued to buy these services they would have to pay for them from their own resources.

A1.8. The following section summarises the costs and benefits of Part 1 according to the six market impact headings outlined in paragraph 5. Where possible, costs have been quantified, while benefits have been analysed.

Direct costs

A1.9. We estimate that the direct costs to us of implementing the necessary amendments to the current rules and guidance would be of minimal significance. There would be a very small one-off cost (approximately £2,600) involved in amending the current rules, including staff familiarisation, but our current risk-based approach to monitoring of firms' compliance would not need to change.

39 'Practical Cost-Benefit Analysis for Financial Regulators', Central Policy, version 1.1, FSA June 2000.

Compliance costs

A1.10. Fund managers and brokers would need to review and amend their lists of approved services, then communicate the changes to relevant staff and train them on the new requirements. Such changes are likely to be straightforward and should not require any major alterations to the way companies comply with the current rules. OXERA estimate these one-off costs at around £3.3 million.

A1.11. Once firms have made the necessary changes to their internal systems and procedures, they should not need to devote any additional resources to monitoring or advising on compliance with the new requirements. As such, the ongoing compliance costs are likely to be negligible, if not zero.

Quantity of transactions

A1.12. Restricting the range of available services potentially has two effects on the quantity of transactions, both of which may be regarded as benefits.

A1.13. First, there should be a reduction in the excessive consumption of services by fund managers. In particular, fund managers may reduce their demand for market and price information services, once they can no longer obtain them through softing or bundling and have to meet the costs directly. This is because, beyond a certain amount of information, the marginal benefit of taking on additional information services diminishes to the point where the marginal costs are not offset. OXERA estimate that a 3% overall reduction in consumption of market information services by UK institutional fund managers is reasonable and would result in savings to funds of around £2.8 million a year.

A1.14. Second, the risk of excessive trading (churning) by fund managers in order to obtain more soft credits for information services may be reduced.

Quality of transactions

A1.15. Two benefits can be identified in the form of incentives that should improve the quality of transactions. First, the quality of market information services may increase over time as fund managers are likely to become more cost-sensitive in their decision to acquire market information services, and can be expected to put increased pressure on service providers to deliver better value for money.

A1.16. Second, we believe there is a risk that some fund managers may be incentivised to select brokers on the basis of the bundling or softing arrangements they offer, rather than their trade execution quality. We expect the proposal to enhance trade execution quality as this incentive is reduced.

Variety of transactions

A1.17. If, as a result of our policy, fund managers become more cost-sensitive in deciding to acquire market information services, this may have a similarly beneficial impact on the variety of services available, e.g. as service providers respond to the change in demand. There is evidence to suggest this is taking place already for other reasons, so the impact of our policy is difficult to quantify.

Efficiency of competition

A1.18. Fund managers can be expected to recover, for example through their management fee, the costs of the market information services they continue to use. These costs, by being transferred from the pass-through mechanism to the management fee, will be subject to greater scrutiny by investment management customers. Greater cost consciousness by all parties will increase the competitive pressure on fund managers and brokers. This should lead to a reduction in total management costs.

A1.19. We recognise that smaller fund managers might be affected more as these services are likely to represent a relatively larger proportion of their overheads. However, if the continued viability of smaller fund managers depends on the artificial support of softing or bundling, it suggests those firms are not able to compete effectively. Part 1 may also disadvantage some execution-only brokers compared to full service brokers, given that it restricts the range of services permitted under soft commission arrangements. However, OXERA have deemed this effect to be limited.

Conclusion

A1.20. Summing up, therefore, OXERA estimate that the reduction in excess consumption in market and price information services will save UK funds around £2.8 million per year at least. Against this, there is likely to be a one-off compliance cost to the industry in the order of £3.3 million, in addition to our direct costs which should be only a one-off cost of some £2,600. Thus, even a small decrease in fund managers' expenditure on market information services will offset the costs of Part 1.

A1.21. Moreover, these estimates for the CBA are conservative, in the sense that costs are likely to be over-estimated, whereas benefits are more likely to be under-estimated.

Costs and benefits of our policy proposal (Part 2)

A1.22. Our second proposal ('Part 2') is directed at the way in which services additional to trade execution are paid for. It would still allow such services to be acquired by softing and bundling if the manager chose, but he would then have to account to his customers for the cost of the services directly. The aim is to put pressure on fund managers to consider more carefully than they do now whether the services acquired provide value for money, to eliminate excess consumption, and to remove any incentive to over-trade.

A1.23. The following section summarises the costs and benefits of Part 2. As with Part 1, the significant costs have been quantified and the benefits have been analysed under the categories listed in paragraph A1.5.

Direct costs

A1.24. As Part 2 represents a more substantial and complicated change to existing policy and rules than Part 1, our one-off costs of internal communication, familiarisation etc. would be greater, though still of minimal significance – we estimate £5,200. The ongoing costs of our monitoring of firms would also be greater, probably in the order of £12,000 to £18,000 a year.

Compliance costs

A1.25. For fund managers, the majority of one-off compliance costs will relate to identifying the value of bundled services received (the value of soft commission credits should already be known), and allocating the value of both bundled and softed services between customers. We have assumed that these processes will require one-off changes to internal accounting systems which, together with other management, legal and compliance costs, amount to a total one-off cost of around £8.4 million. Recurring costs are likely to centre on additional administration, which OXERA estimate at around £1.3 million a year.

A1.26. For brokers, the most important source of one-off costs will be the need to identify and assign the costs of any bundled services they provide. Again, assuming a need for amendments to internal accounting systems, OXERA estimate the costs at around £6 million. Recurring compliance-related costs are likely to be dominated by administration and handling of queries, at an estimated ongoing cost of around £1.9 million a year. It is possible that some or all costs to brokers will be passed on to their customers, which does not affect the overall position of this CBA.

Quantity of transactions

A1.27. Part 2 potentially has a direct effect on bundled and softed services, and an indirect effect on transaction services. The direct effect should be a reduction in consumption of additional services, since marginal expenditure on these services would have to be taken out of the fund manager's management fee.

A1.28. Taking the example of research (which is the service most commonly obtained through bundling and softing), OXERA's evidence suggests that if fund managers had to pay for research with hard money, they would reduce their consumption of it to lower their own costs. Additionally, because in-house broker research is currently bundled and perceived as free by some fund managers, independent research may face a competitive disadvantage. If both independent research and in-house broker research had to be paid for in hard money, there may be an increase in the demand for independent research and a decrease in demand for in-house broker research.

A1.29. Based on the total commission revenue of UK brokers from UK institutional fund managers, OXERA calculate that a 10% decrease in the amount of bundled services paid for through commission could generate resource savings of between £50 million and £72 million to funds. In addition, a reduction in transaction volumes associated with Part 2 would provide substantial savings for investors with respect to items such as stamp duty and bid-offer spread. For any given decrease in trading, these savings for investors would be considerably larger than the resource savings associated with the reduction in consumption of additional services. But it should be noted that these savings for investors would be matched by costs to other groups.

A1.30. As with Part 1, the proposal may have an indirect effect by reducing incentives for fund managers to obtain more soft credits through over-trading. Although this benefit cannot be quantified at this stage, it will be substantially larger than for Part 1 since it covers all additional services, not just market information services.

Quality of transactions

A1.31. Because fund managers would have to pay for non-trade execution services, they should have increased incentives to ensure they receive good value for money when they purchase those services. This is likely to lead to an increase in the quality of these services and consequently potential cost savings to fund managers.

A1.32. There is also a possibility that bundling and softing will affect execution quality, and that Part 2 will reduce the incentive for fund managers to direct dealing orders to particular brokers for reasons other than their trade execution ability. This benefit can be expected to be substantially larger than under Part 1, although it cannot be quantified at this stage.

Variety of transactions

A1.33. In seeking better value for money in respect of additional services, managers are also likely to demand a greater variety in these services, which if it came should lead to greater value for money for fund managers.

Efficiency of competition

A1.34. The proposals should lead to a reduction in the total management costs paid by funds, resulting from increased transparency and hence increased competitive pressure on fund managers. In the brokerage market, more effective competition between full service brokers and other brokers should result as fund managers demand enhanced disclosure in relation to non-trade execution service costs. More effective competition in the brokerage market should benefit fund managers and investors in their funds.

A1.35. Since smaller fund managers may rely more heavily on softed and bundled services, there might be a differential impact on large and small fund managers that would alter the competitive dynamics of the market. However, OXERA find that this effect is likely to be offset by other, beneficial, factors and that the incremental costs of this effect should be very low.

Conclusion

A1.36. The reduction in excessive consumption of bundled and softed services is the only benefit of Part 2 that can be roughly quantified, but its likely order of magnitude is such that the costs of Part 2 are clearly outweighed. OXERA estimate the saving in total expenditure by fund managers on bundled services would be in the order of £50 million to £72 million per year. In addition, a reduction in transaction volumes associated with Part 2 would provide substantial savings for investors with respect to items such as stamp duty and bid-offer spread. Against this there is likely to be a one-off compliance cost to the industry in the order of £14.4 million, and then ongoing compliance costs in the order of £3.2 million per year. In addition, the direct costs of the regulator are estimated to be a one-off cost of £5,200 and ongoing costs of between £12,000 and £18,000 a year.

A1.37. In making these estimates for the CBA we have taken a conservative view; and only the quantified benefits are represented. Other non-quantified benefits can also be expected to be important, in particular the effects on the research market.

Compatibility with our general duties

Introduction

A2.1. This section explains our reasons for concluding that the outline proposals for changes to the rules governing soft commission arrangements are compatible with our general duties under section 2 of the FSMA 2000 and with the regulatory objectives set out in sections 3 to 6.

A2.2. Since we are not proposing specific changes to rules in this consultation, we do not have a legal obligation to publish a statement of compatibility at this stage. We have chosen to do so in the interests of transparency and regulatory best practice.

A2.3. The proposals set out in this Consultation Paper are aimed mainly at meeting our statutory objectives of market confidence and consumer protection. They also have some relevance to our objective of promoting public awareness.

Market confidence

A2.4. The proposals in respect of softing and bundling should contribute to our objective of maintaining confidence in the UK financial system by promoting competition and improving transparency in the negotiation of dealing terms between fund managers and brokers. The result will be a better alignment of the incentives of fund managers and the interests of investors in the funds they manage.

A2.5. Specifically, fund managers will have a greater incentive to use services acquired through commission arrangements as efficiently as possible. This should put pressure on brokers to make commission structures more transparent and flexible, and to price non-execution services efficiently. As a result, brokers should compete both on the price of non-execution services and in some cases their quality (e.g. fund managers will not choose to spend money on investment research they regard as of low quality).

A2.6. The outcome should be a market with greater transparency and reduced costs, which is likely to increase the confidence of both private and professional investors in the fund management industry as a whole.

Consumer protection

A2.7. We believe that our proposals will deliver an appropriate degree of protection for consumers in various ways.

A2.8. One aspect of our proposals is to improve the transparency of the charges which customers pay for investing in managed funds, by transferring certain costs from the pass-through mechanism to the management fee. This should create greater competition among fund managers (as identified by OXERA), resulting in more choice for customers and a reduced risk of them buying products that represent poor value for money.

A2.9. However, disclosure of charges is not enough by itself to protect private investors (and, indeed, some institutional investors such as trustees of smaller pension funds) since they are not able to bring sufficient commercial pressure to bear on fund managers. Thus, another aspect of our proposals is to reduce the misalignment of incentives between fund managers and customers of funds.

A2.10. Specifically, Part 1 of our policy (restricting the range of relevant services for bundling and softing) is likely to reduce the incentive for fund managers to select brokers on criteria other than their execution ability, and to deter them from undertaking excessive levels of trading to generate commission to pay for these services. The results will be cost savings to the fund which will be reflected in the investment returns to customers.

A2.11. Part 2 of our policy (requiring fund managers to meet the cost of non-execution services obtained through bundling and softing) will transfer the payment for those services out of the commission charge (which is passed directly through to the fund) into the fund manager's own account. This will reduce the incentive for fund managers to spend more than they need on such services, again resulting in cost savings to the fund and enhanced investment returns. If the manager seeks to recover the additional expense by increasing his fee, the cost to customers will nevertheless be more transparent than it is at present, and thus subject to more effective competition.

A2.12. In both cases, we will treat bundled services in the same way as those obtained with soft commission. This will ensure that customers receive the same degree of regulatory protection, irrespective of the mechanism by which the fund manager acquires additional services.

Public awareness

A2.13. Increasing the transparency of commission costs will improve the information available to consumers about the costs of investing. This will enable them to assess more accurately the benefits and risks of investing in managed funds and thus to make better-informed and more suitable choices.

Financial crime

A2.14. There is no material impact on the objective of reducing financial crime.

Principles of good regulation

A2.15. Under the requirement set out in section 2(3) of FSMA, in carrying out our general functions, we have had regard to the specific matters set out below.

(a) The need to use our resources in the most efficient and economic way

A2.16. These changes would not affect materially our systems and processes for supervision of firms. To the extent that they make the market work better, they should reduce the likelihood of us having to intervene further in future.

(b) The responsibilities of those who manage the affairs of authorised persons

A2.17. The proposals place responsibility on managers of investment management firms to consider carefully what goods and services they need to support their operations and how they are paid for. Some firms might come under short-term commercial pressure because their current ability to pass certain costs through to customers will be removed; managers of those firms will be prompted to develop charging structures that result in a better alignment of the firm's commercial interests with its fiduciary responsibilities to customers. Similarly, managers of brokerage firms will need to be responsive to the needs of their customers for more information and possibly greater flexibility in the way they provide services, in order to compete effectively.

(c) The principle that a burden or restriction which is imposed on a person, or on the carrying out of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction

A2.18. We are proposing changes that will place a burden on many investment management firms in terms of their reduced ability to pass on costs to their customers. However, CBA shows that the proposals will secure a number of benefits which, although they are not all immediately quantifiable, will nevertheless exceed the costs to firms of implementing the proposals.

A2.19. Over time, the markets for fund management and broking services should become more efficient, more competitive, and more attractive to investors. The incentives of firms and customers will be better aligned and softing and bundling should be used only where there is a clear advantage, or at least a neutral effect on customers, in doing so.

(d) The desirability of facilitating innovation in connection with regulated activities

A2.20. The proposed regime will allow softing and bundling to continue, thereby giving fund managers a degree of choice in how to obtain and pay for additional services for their customers, that would not have been available had we imposed a ban on these practices. The proposals are neutral in terms of their impact on innovation.

(e) The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

A2.21. Most major jurisdictions have rules on softing and bundling that are broadly comparable to those of the UK. The proposals will, however, introduce new specific controls that are not currently to be found in other jurisdictions, and these will apply to all firms and investors dealing in investments in the UK market.

A2.22. We think that, over time, our proposals will bring benefits to the UK. They will create a stronger incentive for fund managers to exercise more effective control over the demand for, and costs of, ancillary broker and third party services. They will improve transparency and accountability to underlying funds, both institutional and retail, for the expenditure of fund assets, and bring more effective competitive pressure to bear on total fund management costs, particularly if the cost of additional services is reflected in fund management fees or specific service-related charges. They will strengthen the incentive for fund managers to direct business to brokers on the basis of trade execution quality and cost, rather the range of additional services that brokers offer, and will encourage consideration of the merits of alternative trade execution options. We believe that these developments will have a positive impact on the costs of investing and on investment returns. This should be attractive to both UK and overseas investors, and should therefore enhance the international competitiveness of UK markets.

(f) The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions

A2.23. Fund managers that rely disproportionately on services received from brokers in addition to execution may be placed at a competitive disadvantage to those that do not. To the extent that some fund managers rely on their ability to pass through the costs of services obtained by softing and bundling in order to remain economically viable, the proposed rules may lead some of those managers to exit the market. For the same reason, some persons may be deterred from entering the market as managers. There is little danger that competition between fund managers will decrease to any significant degree, as OXERA found the market concentration in fund management to be very low at present and likely to remain so, even if a few inefficient managers exit the market.

A2.24. The proposed reduction in the range of services available through softing could affect the ability of brokers who do not produce in-house additional services, to use softing as a means of competing with full-service brokers in that market. However, the equivalent treatment of softing and bundling will create a level playing field in which all brokers will compete on the price of their additional services.

(g) The desirability of facilitating competition between those who are subject to any form of regulation by us

A2.25. Fund managers will come under pressure to control their expenditure on additional services, which should lead to more efficient decision-making and sharper competition among managers on the overall cost to customers of investing. Fund managers, in their turn, are likely to put pressure on brokers to make the structure of their commissions more transparent. As such, brokers should compete less with one another on the provision of additional services alone and more on overall service quality and price, compared with commissions for execution alone. This should increase the effectiveness of competition among brokers.

A2.26. By applying the same rules to softing and bundling, the level of competition in the market for additional services should increase. For example, proprietary research supplied by full-service brokers will become subject to the same disclosure rules as research from independent providers supplied through softing. This, combined with the enhanced incentive on fund managers to spend money on research as efficiently as possible, should result in a driving down of costs, pressure for higher-quality research more closely aligned to fund managers' needs, and greater use of independent research with reduced potential for conflicts of interest to arise. Similar effects should be apparent in the market for other types of goods and services.

(h) Acting in a way which we consider most appropriate for the purpose of meeting our statutory objectives

A2.27. As well as the proposals outlined in this consultation, we considered other options. We could have taken a more hardline approach by banning the practices of bundling and softing altogether. That would have resulted in firms losing out on the economic benefits which bundling can deliver in certain circumstances. A ban on softing would also be prejudicial to competition in the market for research, by disadvantaging suppliers of independent research who rely on softing as a distribution mechanism to compete with full service brokers.

A2.28. Alternatively, we could have taken a more laissez-faire approach, relying on a combination of industry initiatives for better disclosure and improved scrutiny of transaction costs as a result of new best execution requirements. That would have failed to take account of the limited ability of many customers to put pressure on firms to change their practices. It would also have relied on the assumption that the voluntary disclosure code would be fully adopted by all firms on a timely basis, which is by no means certain.

A2.29. We consider that the options put forward are the most appropriate in that they are stringent enough to deliver an appropriate level of consumer protection and market confidence, whilst providing enough flexibility to deliver the greatest benefits.

Annex 3

List of 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?

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

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

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

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

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

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

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

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

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

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?

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

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