

# Whatever Happened to CP 176?

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Only 18 months ago commentators were heralding the FSA's Consultation Paper 176 (CP176) as "The Next Big Bang". The set of regulations proposed by the FSA, following Paul Myners's report on institutional investment in 2001, aimed to prohibit soft-commissioning (softing) and bundled brokerage (bundling) in an attempt to resolve the potential conflicts of interest between fund managers and their clients.

Now, the obvious questions are (i) why did the original aims of the FSA not culminate in the Big Bang predicted such a short time ago? and (ii) what impact will the changes that do have to be implemented by June this year have on the industry?

## **Bundled brokerage and soft commissioning unbundled**

In March 2000, the Chancellor of the Exchequer commissioned Paul Myners to conduct a review of institutional investment in the UK. Published in 2001, The Myners Report highlighted concerns over conflicts of interest and market distortions caused by softing and bundling.

In these bundled arrangements, a broker provides a fund manager with a number of services in one package which

comprises the actual execution cost and additional services, such as research materials and equipment. There were, at that point, no definite rules on the bundling of services.

Soft commission arrangements entail a broker paying for goods or services that are supplied directly to the fund manager, in return for an agreed amount of business to the broker. There were, however, rules surrounding this practice. The principal provisions from the FSA's Conduct of Business Sourcebook were mainly that the broker must agree to provide best execution and that softing could only be used to acquire goods and services that would aid the provision of investment management services to end-clients. Moreover, the fund manager was obliged to obtain the client's prior consent to softing and to periodically disclose the commission paid and the value of the services received.

## The problems with softing and bundling

Paul Myners's report briefly addressed these arrangements and the original CP176 built upon this, setting out to strengthen the regulatory regime in relation to softing and bundling. The FSA identified four key areas of concern:

- 1) The lack of transparency surrounding softing arrangements meant that customers found it very difficult to identify which services they were paying for and how much they were paying for them.
- 2) The over-consumption of additional services caused by the fact that fund managers did not pay for services from their own pocket and because many trustees did not effectively scrutinise their managers' spending. It was not uncommon for managers to purchase more services than were necessary and to pay premium prices for them.
- 3) As brokers and fund managers had an incentive to maximise trading volumes; fund managers to obtain softened or bundled services and brokers to obtain commissions, excessive dealing at the expense of a fund's performance could result.
- 4) The quality of execution and trading decisions could be questioned because fund managers could be tempted to pick certain brokers on the basis of generous softing and bundling practices, rather than on the ability to provide best execution.

In all, OXERA<sup>1</sup> estimated that these practices cost UK investors £500 million to £720 million each year.

### Industry complaint

The FSA decided to combat these problems in a two-pronged attack. Firstly, they aimed to restrict the purchase of bundled and softened goods. Secondly, and more controversially, the FSA proposed a rebate which required fund managers to value the goods and services that could still be softened or bundled and to "rebate an equivalent amount to their customers' funds" (04/13).

The original CP176 (April 2003) generated much interest and a predictable split in the City; The National Association of Pension Funds (NAPF) agreed with the FSA proposals, whilst the Investment Management Association (IMA) viewed them as pretty ridiculous, particularly the rebate proposals.

In October 2003, the IMA reacted by saying that "there are alternative market solutions available that do not carry the substantially negative consequence of the FSA proposals". The Investment Adviser Association expressed "serious concerns regarding the proposal to require rebates" and commented that "a disclosure regime would more appropriately address the FSA's concerns".

In response, the FSA went into a period of lengthy industry consultation. The IMA, the London Investment Banking Association and the NAPF were the main participants in these discussions. As a result, "the industry has been allowed space to tackle the identified lack of transparency and accountability. It has done this through developing an industry-led solution based on an enhanced disclosure regime" (05/05).

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### Lobbying and its result

The end result, after heavy lobbying, fell short of achieving the original aims of banishing softing and bundling from the industry. The new rules oblige investment managers to reveal information through a Code of Disclosure that was produced jointly between the IMA and NAPF. The Code aims to<sup>2</sup>:

- 1) Limit investment managers' use of dealing commission to the purchase of 'execution' and 'research' services;

<sup>1</sup> OXERA is an independent economic consultancy that was hired by the FSA to complete a Cost Benefit Analysis of soft commissioning and bundled brokerage.

<sup>2</sup> When these final rules were introduced in July 2005, the timeline was for these regulations to be introduced in January 2006. However, "there is a transitional period. Firms may continue complying with the existing soft commission rules until the earlier of the expiry of any existing soft commission agreements or 30 June 2006" (05/9).

- 2) Require investment managers to disclose to their customers details of how these commission payments have been spent and what services have been acquired with them;
- 3) Embed in the commercial relationship between investment managers and brokers incentives to secure value for clients for execution and research spend;
- 4) Promote competition between those who produce investment research by removing the regulatory distinction between research services provided by brokers along with execution (i.e. bundled) and research services provided by third parties.

The first point on restricting commission to purchase only research, thus excluding many different goods, such as trading screens and subscriptions, will have a major effect as many of the benefits of choosing certain brokers disappear - as does the effective subsidy on the over-consumption of some luxury products.

### Implementation

At the time of writing, with 6 weeks to go until the final deadline of the end of June 2006, one executive at a major investment bank revealed that just over half of his firm's clients have signed Commission Sharing Agreements in

preparation for the new arrangements. Since these clients tend to be the larger fund managers, they represent the majority of the bank's trading business.

Under Commission Sharing Agreements fund managers can ask brokers to re-direct some of the commission paid by the fund manager to reward, say, an independent provider of research. "Softing with another name" one buy-side participant called the agreements, predicting that the industry will quickly move from this "half-way house" to a "fully unbundled world".

At one of the world's largest fund management firms, a senior executive said "we have been buying trading services and research separately for years. We felt that buying the best research and the best execution services separately gave us a strategic advantage. In a way, we are disappointed to lose our advantage through industry wide adoption".

### Myners's ten questions

Paul Myners was reported to be disappointed with the industry reaction to his investigation and, in order to help trustees perform their jobs, and to pave the way for an increased schema of disclosure and transparency, came up with ten questions (reproduced in Figure 1 ) that end clients should ask fund managers to ensure necessary transparency.

**Figure 1**

1. What is your best view of the level of transaction costs – including not only commission but also market impact and opportunity cost - borne by our fund during the reporting period?
2. What action have you taken to minimise transaction costs while still dealing effectively?
3. Please explain any major differences between the level of costs incurred by you on our behalf and those incurred by other managers as reported in reputable surveys.
4. Were commission rates uniform across all transactions, and if not, what determines the commission rate on a transaction? Explain trend rates on these.
5. Which dealing venues and methods did you choose for our portfolio, why, and how did your choices affect our dealing costs?
6. Which brokers did you deal through and how did you select them?
7. Where you are not using an execution-only broking service, please list other services that you buy or benefits that you receive from the broker concerned (such as research and access to IPOs). Please explain how you evaluate the benefit these generate for us relative to the cost.
8. If you make use of both external research and in-house research, explain what distinguishes the former, for which we pay an additional charge, from the latter, which is covered by your management fee, and how you decide which to use.
9. Explain your rules on entertainment of your staff by brokers and those with whom you transact on our behalf where we bear the cost. Make available the records you keep, your policy guidelines and the approximate number, type and overall value of the events attended.
10. If you wish to make a case for soft commission arrangements, explain how our interests are better served by the broker providing you with services rather than securing lower commission costs for us.

**The on-going effects**

Some commentators have expressed disappointment that what seemed originally like tough regulatory action to end softing and bundling, after lobbying, was diluted to a disclosure code and 10 questions.

However, the debate and the resulting spotlight into this area of the fund management industry have resulted in a much more educated set of clients that will, in the future, ask much tougher questions more often.

**Client pressure and competition are likely to act as drivers for more effective and efficient execution arrangements and more objective measurement of trading results**

Client pressure and competition are likely to act as drivers for more effective and efficient execution arrangements and more objective measurement of trading results (see Figure 2). In addition, we can expect much greater scrutiny of the effectiveness of research. Technology, including FIX, will play a much greater role in all these areas and the results will be fed back into the purchasing process.

Separating the purchase of research and trading will improve the purchase and, in turn, the quality of both.

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Whilst not producing the Big Bang changes originally predicted, The Myners Report and CP176 initiated a wave of change in the industry. The result of this will be that, in a few years' time, we will look back and wonder at the arcane way that research and trading services were bought and paid for. **FIX**

**Any thoughts on this or other articles?**

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**Figure 2**

Measuring	To find	By
Research	The long term effectiveness of ideas provided by research, whether produced by brokers, independently or in-house.	Using applications like StreamVPN and YouDevice.
Execution	Pre-trade estimates of trading costs and the anticipated best way of executing orders.	Looking more closely at the trading arrangements of fund managers and brokers, the number of trading destinations available to them and the technology used to make decisions quickly in a fast-moving environment.  Using Pre-Trade Analysis applications, Smart Order Routing Software and, of course, FIX.
Trading Costs	Post-trade, the actual cost of executing orders through different traders, brokers, in different sectors, stocks, circumstances, etc.	Using TCA products and services much more frequently than today.