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ABI RESPONSE TO CESR'S CONSULTATION PAPER: CESR'S DRAFT TECHNICAL ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF THE DIRECTIVE 2004/39/EC ON MARKETS IN FINANCIAL INSTRUMENTS: ASPECTS OF THE DEFINITION OF INVESTMENT ADVICE; BEST EXECUTION; MARKET TRANSPENCY: SECOND CONSULTATION PAPER MARCH 2005 CESR/05-164

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1 INTRODUCTION

1.1 The Association of British Insurers (ABI) welcomes the opportunity to respond to the CESR Consultation Paper of March 2005.

1.2 The ABI is the trade association for the UK's authorised insurance companies. Its membership, some 400 companies, provides over 94% of the insurance business undertaken by such companies.

1.3 They provide a diverse range of protection, investment and pension products to institutional and retail clients within both the UK and outside. In the course of their business ABI members manage assets of the order of £1,100bn (€1,600bn) across all asset classes of which equities and fixed interest are the largest.

1.4 Insurers are also concerned that firms of advisers who offer insurance products under the Insurance Mediation Directive and investment products under the Markets in Financial Instruments Directive should not face inconsistent regulatory requirements.

1.5 We have responded below to questions and aspects of the draft advice that are of interest to ABI members. But in summary the key points we wish to make to CESR are:

- An additional suitability obligation should not be added in relation to lending to retail clients;
- The definition of investment advice should not include generic advice;
- The benefit to investors of competition between execution venues; and
- The value of institutional investors of an unconstrained environment for programme trades.

2 GENERAL OBLIGATION – LENDING TO RETAIL CLIENTS

2.1 *CESR Questions for comment: Do you agree with the proposed advice in this area, including the proposed limitations on the scope of the obligation? Do market participants consider that investment firms have to obtain the necessary information about the retail client's investment objectives in addition to his financial situation?*

2.2 The ABI do not agree with the proposed advice, as we do not consider that CESR has set out a case for Level 2 advice in this area.

2.3 We support the Level 1 general obligation on firms to act fairly, honestly and professionally in accordance with the best interests of the client. This is comparable to the existing requirement on all ABI members (as regulated by the Financial Services Authority (FSA)) to treat their customers fairly. However, we are surprised that CESR have chosen (at the second consultation stage) to propose new advice on the specific issue of lending to retail clients for the purpose of investing in financial instruments.

2.4 No evidence is presented that this practice is either prevalent or a source of consumer detriment requiring regulatory intervention. We do not therefore believe that a cost-benefit case has been made for level 2 advice in this area. Nor is reference made to the interaction between this requirement and the Consumer Credit Directive, which is the more appropriate place for addressing any need for additional consumer protection measures in relation to lending.

2.5 The introduction of a requirement to conduct an additional suitability test on the transaction is a significant and potentially burdensome proposal. The Article 19 requirements on firms providing investment advice to obtain information regarding the client's financial situation and objectives, and to make suitable recommendations, should provide satisfactory investor protection without additional rules. The ABI also believes the introduction of a mandatory suitability requirement where lending occurs would cut across the political agreement made at Level 1 that non-advised transactions are not required to be subject to information and suitability obligations.

2.6 If CESR do advise the Commission that lending to retail clients should be subject to suitability obligations, we agree that it should not apply to professional clients, and an exemption should apply to late payments. However, the ABI urges CESR not to provide specific advice in this area.

3 THE DEFINITION OF INVESTMENT ADVICE

3.1 *CESR questions for comment: Do you believe that investor protection considerations require the application of the above conduct of business requirements from the point at which generic advice is provided or do you believe that sufficient protection is provided in any event to allow the definition of investment advice to be limited to specific recommendations? Do you believe that considerations relating to the scope of the passport and the scope of the authorisation requirements point towards the inclusion or exclusion of generic advice from the definition of investment advice?*

3.2 Taking account of the interests of consumers, the ABI urges CESR to exclude generic advice from the definition of investment advice in its advice to the Commission. We do not think the implications for the scope of the passport require a different approach.

3.3 Based on the UK experience, we do not think a broad definition of investment advice is necessary to protect investors. In most circumstances, professional investment advice will start with a general discussion about the client's financial circumstances and priorities, ('generic advice') which then leads to a specific recommendation. CESR's commentary appears to assume that part of the service will not be subject to regulatory protection, because it could be categorised as generic advice and distinct from the specific advice that is offered immediately afterwards. However, we expect that in the event of a recommendation being made, the earlier discussion would be subject to regulation, as part of the requirement to gather information about the client and assess suitability. We also agree with CESR that implicit specific recommendations would and should be caught by the narrower definition. CESR has not presented evidence of a significant investor problem that needs to be addressed by a broader definition.

3.4 Furthermore, we think inclusion of generic financial advice within the definition of investment advice would significantly extend the scope of the Directive, and would be contrary to Level 1 which is restricted to regulation of investment services. In attempting to define investment advice to cover advice that does not include specific recommendations, the unintentional consequence could be to restrict the provision of generic advice services directed at consumers who currently do not have access to any form of financial advice. In the UK, the ABI is supporting the FSA's work in seeking to expand the provision of this form of generic advice, which helps consumers identify their financial priorities, such as debt repayment or pension saving. The FSA is exploring different delivery and funding

options, but it is possible that commercially and/or consumer funded generic advice may expand in the next few years. There is no perceived need to regulate this form of generic advice, but if CESR opt for the broader definition of investment advice, it may become necessary. Regulation would add to the cost of generic advice and constrain market development.

3.5 The ABI therefore recommends a narrower approach should be taken to the definition of investment advice, in line with the views of the majority of respondents to CESR's previous consultation and the approach taken at Level 1.

4 BEST EXECUTION

General Comments

4.1 The comments set out below are from the viewpoint of ABI members that provide the services of portfolio management and/or order reception and transmission.

4.2 We find much to support in the consultation paper, in particular: -

- that best execution is a process rather than a point at time activity; and
- the general tendency to a non-prescriptive approach recognising the differences between financial instruments and markets.

Our members concur with the comments in respect of non-equity markets in paragraph 43-45 consequently we question the assertion in paragraph 46 that there is a "pressing" requirement with respect to the application of Article 21 to non-equity markets at Level 3. We would review this opinion if market failure could be demonstrated

We take the view that Level 2 measures should, at the most, be 'light touch'. The prime driver in this area should be the client's mandate.

If more than a principles-based approach, i.e. Level 1, is deemed necessary then the advice proffered by CESR in Box 2 and Box 3 is considered acceptable.

More of issue is Box 4, the information to be provided to clients. We question the value, from the investor protection viewpoint, of a plethora of detailed information, essentially of a backward-looking nature which is not directly relevant to a client's own business.

We agree that firms need to articulate their best execution policy clearly to their clients. We would expect this to be one of the points of detailed negotiations between fund managers and their clients in respect of portfolio management contracts. We believe that competitive pressure between fund managers will largely ensure adequate disclosure in that respect.

We expect that in most cases this disclosure would be of a generic nature and, for UK firms undertaking portfolio management, that the Enhanced Disclosure Code (developed from the IMA-NAPF Disclosure Code) will adequately meet the purpose.

Some fund management firms may choose to list all execution venues accessed directly or indirectly. Given the implicit nature of the portfolio management contract, ie the discretion given to the fund manager by the client, we believe this choice should be left to the firm.

These comment are amplified by our response to individual questions set out below.

Specific Questions

30. Questions for Comment:

a) *How do firms compare venues (or intermediaries) that offer inducements with those that do not?*

We interpret this question to exclude advertised commercial arrangements which provide incentives or payment by execution venues for order flow. Setting this aside ABI members will compare venues on the basis of their stated execution policy and any specific requirements set by clients. Given ABI members firms' principal client base, life and pension funds, there will be a presumption towards long term consistent execution quality. To the extent that inducements enter into the assessment equation they would need to accommodate to these long term criteria. Where such inducements fall into the area of unbundling and soft commissions please see our response to 30 b)

b) *Where the fees and commissions that firms pay to execution venues or intermediaries include payment for goods or services other than execution, please indicate the circumstances in which firms might determine how much of these commissions represents payment for goods or services other than execution? Under what circumstances do firms consider the entire commission as payment for execution?*

We are concerned that the complex issues of unbundling and soft commissions have been brought into the consultation at such a late stage. They require more measured consideration. We would urge CESR to await the outcome of development work being undertaken in the UK before consulting further and taking a position on these issues. As one measure of its complexity we attach for illustration in Appendix 1 the ABI response to the FSA consultation on these matters. CESR might wish to consider proposed developments in the UK, the Enhanced Disclosure Code, as a pilot project in this context

Requirements for Selecting and Reviewing Execution Venues

56. *Question for Comment: Please suggest situations and circumstances in which a firm might satisfy the requirements of Article 21 while using only one execution venue.*

Excluding situations where a financial instrument is only available from one execution venue, e.g. exchange-traded derivatives, situations and circumstances where using only one execution venue satisfies Article 21 will be met only where one or a combination of the following are fulfilled:-

- a client's directions
- the firm's stated best execution policy
- costs

Having said that, in most cases best execution will necessitate access to various execution venues.

Costs

Question for consultation: Do market participants consider that the distinction between internal and external costs is relevant? Does the investment firm have to take into account also internal costs? If so, which ones?

A whole suite of factors are likely to be relevant to the selection and review of execution venues and will vary dependent on the type of client and the financial instrument(s) in question. Cost is likely to be one of these factors and, in certain circumstances, a distinction between external and internal costs may be relevant. However, we would agree with the view that, whatever the circumstances, a firm should give primacy to commercial viability in accessing venues and that access should not be mandated in Level 2 text.

Assessment of Execution Venues

82. *Question for Comment: How do you assure that your execution arrangements reflect current market developments? For example, if you do not use a particular execution intermediary or venue, how would you know whether they have started to offer "better execution" than the venues and intermediaries that you do use?*

ABI members are commercially driven to provide consistent long term execution quality. Thus assessment and review of execution venues will be a continuous business process. The competition dynamic also manifests itself in particular through our members' institutional clients where their own self interest and resources, such as access to investment consultants, gives them some scope for independent monitoring of best execution.

Data Availability for Venue Assessment

87. *Question for Comment: Are intermediaries likely to inform investment firms that manage portfolios or receive and transmit orders about material changes to their business?*

Execution venues and other intermediaries have a vested interest in securing order flow consequently ABI member firms are content that they receive frequent and appropriate information from these sources.

Information to Clients

110. *Questions for Comment:*

a) *Please identify and estimate the specific costs that investment firms will incur to identify the execution venues and intermediaries that have executed or received and transmitted their client orders and to collect historical information about what portion of their client orders they directed to each such venue or intermediary. For example, what costs would be associated with determining what percentage of client orders an investment firm directed to each venue or intermediary it used in the last 12 months, based on both the number of trades and the value of trades?*

As a trade association ABI does not collect this type of information on its members' commercial activities. We believe that members who have modern information systems (IMS) and have prepared for the Enhanced Disclosure Code for their portfolio management business could supply some of this data. However, as noted in 4.1 we would question the value of such information to individual clients.

b) *Please explain what competitive disadvantage or other damage to their commercial interests firms would experience if they were to publish the*

percentage of their business that they direct to different execution venues and intermediaries.

There is a proprietary element to this data which might be of interest to a firm's competitor. Perhaps more important, in certain circumstances, publication of such data might be to the detriment of a firm's clients through reducing the benefits they have gained from contracting with the firm.

c) *If firms are required only to make this information available upon request, would that address respondents' concerns about overwhelming clients with too much information?*

Whilst this question might obtain a positive response it has to be borne in mind that processes and systems would have to be put in place to collect, manipulate and distribute such data, at a cost to be covered by all clients.

d) *Please suggest approaches to focus this information. For example, should this information be disclosed for each execution venue, for different types of instrument, country-bycountry, etc?. Should firms should break out this disclosure for different business lines (e.g.retail versus institutional). How?*

Such an approach would further aggravate the cost issue raised in 110 c) above.

e) *Should there be information for execution venues that investment firms access indirectly? And, if so, should it be on the main intermediaries to whom the firms usually entrust the execution of their orders?*

We expect that in setting up portfolio management contracts these matters would be the subject of detailed discussion. However, as with execution venues accessed directly, we do not believe that listing venues accessed indirectly, on an up-to-date basis, necessarily provides value to individual clients. Any requirement, if deemed necessary, should be limited to venues accessed directly and provided as part of the regular updating of clients on execution policy.

f) *Please provide specific information about why, in less liquid markets, this sort of disclosure actually might be misleading. Is such disclosure about equity transactions more meaningful or useful than disclosure about transactions in other types of instruments?*

Other markets are less commoditised then equity markets with execution often provided by dealers. For example 42 members of ISMA have committed to making prices in some 11,000 Eurobonds but each bond has an average 2-3 dealers and these may change on a fairly frequent basis.

Applying an equity style model to other markets might have negative competitive consequences for such markets in Europe.

Proposal 2 in the Concept Paper: Trading Venue Selection and Review

115. *Question for Comment: With respect to the fourth disclosure suggested by respondents, CESR requests further comment on whether investment firms that execute client orders directly or indirectly should be required to disclose information about their error correction and order handling policies.*

This is already a requirement for ABI members in other business lines. Experience there suggests that, if action is deemed necessary, CESR takes a proportionate approach with a de minimums concept so that the costs of error correction do not outweigh the financial benefit to clients.

Proposal 5 in the Concept Paper: Timing

126. *Questions for Comment:*

a) *How might an investment firm gain the necessary consents required under Article 21(3) of the Directive as part of a voice telephone communication?*

b) *What impact would there be on cross-border business and distance marketing if investment firms are not permitted to obtain the client consents required by Article 21 using voice telephone?*

c) *Can respondents suggest a different approach than the one used in paragraph 5 of the advice under Article 19(3) that would permit investment firms operating via voice telephone to satisfy the objectives of Article 21's consent requirements?*

d) *How might firms evidence that they had obtained client consent if they obtained that consent via voice telephone?*

We note in paragraph 125 the stress on retail clients. Our members' business portfolios are dominated by institutional business and portfolio management services are unlikely to be provided until satisfactory documentation is in place.

Information about the Relative Importance of the Factors for Retail Clients

129. *Question for Comment: Should investment firms that do not consider speed to be an important factor in the execution of retail orders be required to highlight this judgement?*

We do not believe this is necessary. A firm's business model should be apparent from its statement of execution policy and will be part of the discussion before a contract for portfolio management is entered into.

5 MARKET TRANSPARENCY

General Comments

5.1 The comments set out below are from the viewpoint of ABI members that provide the services of portfolio management and/or order reception and transmission.

5.2 ABI members are clear in their view that the competition of recent years between execution venues, introduced by MTFs and systematic internalisation has been to the advantage of investors. They would not welcome developments which distorted unduly the competitive environment in which these venues operate.

5.3 Consequently, whilst in most circumstances advocates of greater transparency – subject to the primary need of adequate market liquidity – we would urge CESR to avoid imposing abrupt changes, particularly in respect of pre-trade transparency requirements for systematic internalisation and the ability of such providers to withdraw quotes.

5.4 In the pre-trade transparency context we consider that a limited pilot project, as suggested by other parties, has considerable merit.

5.5 In terms of the withdrawal of quotes we believe there should be a level playing field between venues and therefore suggest the deletion of the last three lines of paragraph 84.

5.6 For ABI members programme trades are a significant mechanism for delivering value to their clients. We are concerned that the wording of paragraph 103, the addition of the €3 million minimum, would require institutional investors to change their business processes potentially to the detriment of their clients.

Q3.12 Do you have further comments on the proposals for the obligations of systematic internalisers?

In respect of paragraph 103 we note that CESR has inserted a €3 million market value to the definition of programme trade. In its first consultation paper CESR identified the reasons for exempting portfolio trades from pre-trade transparency obligations as being impractical for systematic internalisers within Article 27. It was acknowledged that firms normally tender for such business on the basis of indicative information as to stocks

with pricing at a percentage of the aggregate mid-market value. The application of Article 27 to such trades would reduce the attraction of the technique to institutional investors at a cost to their ultimate beneficiaries.

The value of the exemption from pre-trading transparency is diminished by a €3 million minimum. The validity of programme trades as an investment tool exists irrespective of aggregate market value. We would urge CESR to remove the minimum market value criterion.

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CP176: BUNDLED BROKERAGE AND SOFT COMMISSION ARRANGEMENTS – ABI RESPONSE TO FSA CONSULTATION PAPER

INTRODUCTION

1.1 The FSA published in April 2003 its Consultation Paper dealing with provision of "bundled" services by broking firms and soft commission arrangements. The consultation paper makes proposals which come in two parts, the first relating to the range of goods and services that may be softed or bundled and the second to the manner in which such goods and services are paid for.

1.2 This paper is the response of the Association of British Insurers whose 400 Members as managers of long-term and general insurance funds have some £1,000 billion of funds under management including some £350 billion in the equity securities of UK companies. In addition they manage a further £90bn of non-insurance and other third party funds. Our Members therefore have a strong interest in ensuring that the management of insurance funds is performed on a cost-effective basis that, in looking to maximise investment performance after allowing for costs, optimises the use of services provided by sell-side brokers and other third parties. These attributes mean that insurers are well-positioned both to achieve similar objectives on behalf of funds they manage for third parties and to assess the overall merits of the FSA's proposals for reform under CP176.

1.3 Our members welcome the opportunity to respond to the proposals that the FSA has put forward to deal with supposed conflicts of interest facing fund managers in the use they make of services provided by brokers or paid for out of commission income generated on sales and purchases of securities by the funds being managed.

1.4 The insurance industry, comprising as it does both proprietary and mutual companies, is also well-placed to recognise whether principal-agent conflicts of interest are present which would colour their views of whether problems exist which need to be rectified. It should also be noted that the industry is characterised by a principal (the life company) that is itself a professionally-staffed financial entity. This means that it is better placed than many other funds, for example company pension schemes with trustees drawn from the ranks of scheme members to scrutinise the endeavours of its agent, the fund management function

or entity. If our Members considered that incentive misalignments existed between fund management and fund perspectives they would take steps to eliminate them.

1.5 We have uncovered no evidence among our Members with their various perspectives, proprietary and mutual, or as between fund management and life company, to indicate that the second and more radical part of the FSA's proposals enjoy support in quarters that would be beneficiaries of change if the concerns outlined in the consultation paper were justified. Nor do they accept the central thesis of the consultation paper that there is no incentive on fund managers to control dealing costs. Rather, such costs are a direct deduction from fund performance bottom line against which the fund manager, whether of insurance or non-insurance funds, is rightly assessed. This direct deduction against fund value is a very powerful incentive to control dealing costs.

GENERAL COMMENTS

Softing and bundling

2.1 Broadly speaking, bundling relates to services provided by the broker whereas softing will relate to services provided by third parties. We note, however, that there is a further category, that of commission recapture which is conceptually related to softing but involves the provision of no additional services and crystallises in repayments of monetary value.

2.2 As regards the comparative merits of bundling and softing a distinction of principle exists insofar as softing appears to create a fixed liability that has to be paid out of future broking commissions. This is not the case, for example, with receipt of bundled investment research where services are provided at the instigation of the broker in expectation of future business.

2.3 We believe there to be a strong argument in favour of the economic benefits of at least some elements of bundling but that equivalent arguments are much more difficult to make in the case of softing. Nevertheless, the principled differences of softing and bundling probably do not vary greatly. We consider it would therefore be reasonable for the regulatory regime, as the FSA proposes, to treat consistently both bundling and softing and to distinguish, instead, the goods and services that may be provided through those routes from those which may not. As outlined below, investment research should be identified as a service which may be received by fund managers and remunerated through commission payments paid by the fund.

Provision of investment research

2.4 We consider that no convincing evidence has been provided to suggest that overall economic efficiency is impaired either through the bundling of research, or through its remuneration through sell-side commission income. Our attached analysis of the OXERA research findings examines this is in more detail. The FSA appears to accept the first position but not the second. However the costs and inherent bureaucracy of the FSA's proposal for dealing with this latter aspect outweigh its supposed benefits. There could be other unintended consequences such as to reduce further the availability of research on small cap stocks which, in turn, would make them less able to raise capital in a cost-effective manner.

2.5 Better education of fund trustees, and perhaps improved quality of advice from consultants, is one part of what we would see as a far better and more cost-effective 'solution' re bundling. It is, however, the fund managers who maintain the business relationship with brokers and they will be best placed to monitor effectiveness as well as the costs involved. It is the fund managers who need to analyse these parts of their business model and who therefore are best place to make use of information regarding comparative costs of various bundles of services.

2.6 The case for transparency of costs and, where practicable, the components of these costs, is a strong one irrespective of how those costs are then paid for. At present it is implicit in contracts between fund managers and clients that investment research costs are met out of commissions paid by the fund. If these implicit terms are to be varied there need to be compensatory changes to other aspects.

2.7 Given the OXERA finding that the market in fund management services is a competitive one, any regulatory interference in the implicit contractual arrangements to mandate a change in allocation of costs between the parties to those contracts would be unreasonable, economically detrimental to the industry and, in the longer run, to the interests of its clients. We think it right that the long-term interests of users of the fund management market are paramount but this will not be achieved through distorting in the short-term the balance of market equilibrium in the industry.

2.8 Investment markets and practices within them evolve over time. Where more efficient methods of operation can be devised it is likely that these will be found through interplay of market forces. The step-out arrangements devised by Gartmore have already been publicly reported upon. Considerable efforts are also being made by a number of the leading investment management groups to explore both greater transparency of costs and also the feasibility of disaggregating existing bundles of services. If increased efficiencies in the provision of sell-

side services are achievable these efforts seem to us to be the most promising route towards securing them. It would therefore be helpful for the regulatory framework, as well as encouraging enhanced transparency to facilitate this process through an appropriate regulatory response. The aim should be to facilitate such market-driven solutions though not to second-guess them.

The scale of the FSA's concern and the efficient market perspective

2.9 The focus of the consultation paper is on costs that represent a small fraction of funds under management or of the value of shares being traded. These costs have fallen over recent years. They are, however, increasingly dwarfed by the impact of stamp duty on share purchases in the UK of 0.5%. This is a tax on the very functions which drive market efficiency. Stamp duty should be either reduced or abolished as part of any reduction in the scope for provision of softed or bundled services.

The Sandler perspective

2.10 The logic of the FSA's proposals as published would be to reallocate costs from where, we believe, they most appropriately fall, i.e. on share trading where and when undertaken, to the annual management fee. This would clearly have an adverse impact on the ability of product providers to meet the 1% cap of annual management fees. This would further increase the need for this cap to be raised in order to avoid distortion of the market.

The way forward

2.11 We consider that the right way forward would be to identify those services that it is permissible to receive in bundled form and where there is a cogent rationale for receiving in this way and being remunerated as now through commission payments. Provision of research services would be justified on these grounds though changes to the actual schedule of permitted services should be a matter for further consultation. Taking forward this regulatory approach would then avoid any need to take forward the inappropriate proposals on apportionment and reallocation of costs of bundled services.

SPECIFIC COMMENTS

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?*

We have no particular observations to make.

Q 3.2 *What is your view of our assessment of the economic benefits of bundling and softing?*

The consultation and the research findings of OXERA suggest that softing has few overall economic benefits or disadvantages. We would broadly agree with this analysis and on this basis see little merit in defending softing as traditionally understood. With little economic justification for the activity, the negative perceptions surrounding softing have already led to a decrease in its incidence in the UK investment markets.

We are much less convinced by the FSA's apparent conclusions in respect of bundling which we do not believe are supported by the OXERA research. OXERA's conclusions are mixed.

We consider that there are three important strands of thought which have been given inadequate recognition:

- Firstly, the traditional view of the role played by sell-side research is that it is partly in the nature of informative marketing material, albeit high-grade, which is produced by broking houses as a natural response to competitive market forces. It is no more rational to require consumers of broking services to "pay" for such material up-front than to require potential consumers of any other product to pay for advertising or marketing material received on either a solicited or unsolicited basis.

- Secondly, the consultation paper fails to address the fundamental objection raised in response to the Myners recommendation on absorption of brokerage costs, i.e. that it is wholly unreasonable to expect the agent to pay variable costs incurred by the agent in pursuit of advantage for the principal.

- Thirdly, the very low marginal costs as a proportion of total costs to the originator means that unit cost charging will be a less than ideal way of defraying overall costs of production. From a broader perspective the current arrangements, which involve a wide dissemination of research thereby enhancing market efficiency, may well maximise beneficial externalities.

The consultation paper seems to take as read that consumption of investment research by fund managers is fixed and predictable and that it is not related to trade execution volume. This implicit assumption is simplistic at best. The consultation paper also fails entirely to analyse what in this context is actually meant by "consumption". The traditional view of the role of sell-side research supposes that consumption should, as now, be recognised and apportioned pro-rata to the value of the trading volume which it generates. The FSA's view, by contrast, is that "consumption" is

entirely unrelated to trading volume. We do not consider the latter view to be sustainable.

The best view is probably that demand for research has both a fixed component and a variable one. The notional variable component must, as outlined above, be paid for as a cost at point of trading by the within commission cost. The fixed component could be paid either as now out of commission or as an up-front charge but, even if the latter, it still does not logically follow that this cost ought to fall on the fund manager rather than the fund.

Where the consultation paper and OXERA particularly fail in their analysis is to consider the value of research and how this may best be remunerated. The value of services that are not in the nature of standardised commodities cannot be accurately predicted in advance of their production and receipt by the user. This suggests that the most economically efficient means of remunerating research, even the notional fixed component of demand, would be at the discretion of the fund manager in response to the perceived value of the service "consumed". The most obvious means for achieving this is through commission payments on trades undertaken. The traditional manner in which this is provided for is through setting target levels for the proportion of brokerage to be directed to particular brokerage houses reflecting perception of overall value obtained from sell-side services.

What, in principle, brokers should be remunerated for in respect of their research offerings is volume times value. This suggests quite strongly that the current regime is economically efficient. Whether further enhancements can be secured through the development of step-out arrangements may in due course become apparent.

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

Effectiveness of the current regime seems reasonably good. However we agree that the public perception regarding soft commission is more problematic and that this justifies change.

We do not agree that fund managers purchase services at excessive prices or that they overtrade in order to access bundled services. The OXERA analysis provides no evidence to give credence to such concerns. However we would more readily agree, at least in principle, that there is some risk that fund managers could be induced to base trading decisions on the need to continue the supply of softed services. It would generally be possible for fund managers to pay the costs from the fund manager's resources in the event that commission payment outturn proved too low and scrupulous managers would adopt this course of action. However, we suspect that others might not. It would be preferable to avoid this difficulty arising. Reform of softing practices would help achieve this.

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

We accept the basic thrust of the FSA's proposals re market pricing and information services – that these should not be softed. A regulatory approach to enforce this would be consistent with the grain of evolving UK market practice. We would be opposed, however, to the FSA unilaterally imposing restrictions on UK fund managers in respect of non-UK business that would place them at a disadvantage versus their overseas competitors. If it believes that proposals in this area are worth developing, we would urge the FSA to engage at an early stage with its counterparts in other jurisdictions to encourage similar changes at a global level.

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

We would accept similar conclusions regarding the inappropriateness of computer hardware and custody services being softed. As regards the cost of custody services, however, these should probably fall on the fund and not the fund manager.

We are not wholly convinced of the case for a blanket ban on dedicated phone lines to brokers paid for by brokers out of commission income if the purpose of this is facilitate access to trade execution. As regards access to seminars we are not convinced of the case for a bar on this being provided to clients by brokers. These events can be useful and it would be hard to frame appropriate regulation. The provision and take-up of such services is a matter of commercial and business judgment as to the devotion of time and resources.

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

We reject the proposal that a regulatory requirement be introduced to require costs of other services received by fund managers to be rebated to funds. In summary our objections are that:

- it is inappropriate in principle for the reasons outlined in our response to Q 3.2,
- it would be costly, unwieldy and bureaucratic in practice.

In addition, there is a failure properly to recognise that a significant proportion of the cost of providing full-service brokerage, such as dedication of capital by broking firms in support of their investment clients' trading needs, require proper remuneration and that the right place for this to fall is on transaction value.

Calculation of the notional cost of services provided in bundled form could well prove a wholly artificial process. This is not to say that fund managers should not be seeking to ascertain and understand for themselves and for their clients the likely costs and benefits of purchasing differing bundles of services. We support moves toward securing a high measure of transparency and believe regulatory efforts should be focused on this objective.

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

The FSA's proposal is better in theory and would be less damaging than a requirement for full unbundling but in practical terms they are both inappropriate.

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

We believe that these matters would be best dealt with through a one-step change involving distinguishing services that can be bundled or softed from those which may not. Investment research needs to be identified as a service which may be received by fund managers and remunerated through commission payments paid by the fund. If, instead, the FSA elects to distinguish between bundling and softing it should implement its proposals on softing alone. The specific proposal on unbundling regarding reallocation of cost of commission should not be taken forward in any event.

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

It is possible that the proposals could lead to changes in equity trading with an increased prevalence of net trading. It is difficult to estimate the probability of this happening but the risk will be of partial movement in this direction that may have an adverse impact on liquidity and transparency for market users.

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

We are more doubtful of the supposed benefits regarding improvement in the quality of investment research. If there is scope to reduce the overall cost of investment research to the fund manager and fund taken together, this will be most effectively pursued through enhanced transparency. If the OXERA estimate of the total cost of providing sell-side research is correct we would expect enhanced transparency to lead to significant rationalisation and cost reduction through enhanced transparency alone. Moves in the direction of artificial unbundling would, conversely, be likely to be counterproductive in securing greater efficiency in the supply and dissemination of investment research.

The consultation paper itself makes no reference to OXERA's finding that there is a risk under the FSA's proposals of a bias towards under-consumption of research. As we outline in our comments on the cost-benefit analysis, we believe this risk and, in turn, the likely adverse impact of the proposals on the investment research market, have been significantly under-estimated.

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?*

We have no specific comments to make.

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

The potential for unanticipated adverse consequences is considerable and this must be recognised. Overseas competitors with a larger proportion of non-UK business would probably find it easier to access to bundled services from international securities houses at low cost than their UK competitors and achieve an advantage thereby. It is too early to seek to predict how and to what extent UK firms will seek to counter this, for example through relocating parts of their trading activities to other jurisdictions. UK insurers may face somewhat lesser pressures in this regard, at least to the extent that the fund manager and fund are within the same group ownership structure and the proportion of third-party fund management business is modest, but they will not be immune.

ADDENDUM

ABI COMMENTS ON COST-BENEFIT ANALYSIS OF THE FSA'S POLICY PROPOSITIONS

GENERAL COMMENTS

1.1 The Association of British Insurers believes it important that new regulation that would have a material impact on the conduct of financial services business should only be introduced where the benefits would outweigh the costs. The FSA has recognised the significance of its CP176 proposals in this regard through commissioning at this stage a cost-benefit analysis and the ABI is pleased to have the opportunity to comment on this.

1.2 We welcome the recognition (in paragraph 10 of the CBA report) that insurance funds are reasonably protected from cost-pass through from external fund managers. For the various reasons also noted in our main response the insurance industry is therefore well-placed to comment on the overall net cost or benefit that would be likely to accrue to funds and their beneficial owners from the FSA's proposals.

1.3 We would support the essence of the Part 1 proposals for a narrower recasting of the range of goods and services permitted under bundling and softing arrangements. It should be noted that the OXERA analysis does not suggest, however, that this is justified on the basis of a conventional cost-benefit analysis. The main OXERA report appears to demonstrate that there are no material adverse costs or other implications stemming from the use of softing but, equally, that there are no obvious benefits. Whilst we consider that regulatory prohibition on market practices are undesirable unless it can clearly be shown that the costs outweigh the benefits, we doubt that the interests of the fund management industry and its customers are assisted by the existence of softing arrangements or receipt of bundled services in the nature of market pricing information services.

1.4 Where there exists a perception of a problem and there is no good economic case for the existence of those arrangements, as with most traditional softing practices, it is better that practices are changed. Very different considerations apply in respect of what the consultation paper characterises as "bundled services". Our main comments are therefore directed exclusively at the cost-benefit analysis and conclusions drawn therefrom in respect of Part 2 of the FSA's policy propositions, i.e. to require separate estimation of the value of bundled services and the recrediting of these notional amounts to client funds.

1.5 At a general level it is noteworthy that Paragraph 2 of the CBA Executive Summary characterises the intention of the proposals as being to enable market forces to determine if the costs of services should be recovered through an increase in the management fee or some other explicit charge. It is unclear, though, why regulation should be used to prevent market forces being used to determine client preferences for retaining the present arrangements. If market participants, both fund managers and clients, were convinced by the benefits of the FSA's policy proposition on fund managements that the benefits of change outweighed the costs it would be likely that fund management mandates would migrate to the new basis.

1.6 Paragraph 8 of the Executive Summary is surprising on two grounds:

- It asserts, without substantiation, that "it is well recognised that there is an incentive misalignment between fund managers and their clients". We disagree that a material misalignment exists and are unconvinced that alternative arrangements exist which would further reduce this. Indeed we believe the Part 2 proposal creates a new incentive misalignment which is substantially greater than any which currently exists.

- It fails to recognise that if concerns exists as to the size of dealing costs that the direct monitoring of these is the most sensible course of action. It is right that monitoring of fund performance is the right bottom line measurement by which fund managers should be held to account. But if, as the FSA's paper proposes, it is the costs associated with transactions that are the concern it would seem that those costs should be specifically monitored.

SPECIFIC COMMENTS

<u>The market for sell-side research</u>

2.1 <u>Paragraph 11</u> asserts that the argument of unpredictability of consumption cannot be readily applied to bundled and softed services in the same way as trade execution. This is probably true with regard to infrastructure such as IT systems. However, this is not the case in respect of sell-side research to the extent that this generates trading decisions.

2.2 <u>Paragraph 12</u> of the OXERA report recognises that that there are certain economic justifications for the bundling of services by brokers including economies of scope in production, reduced transaction costs for consumers, efficient pricing methods and the technical difficulty of unbundling. If it is justifiable for the producer to provide a service free at the point of delivery, it is unclear what economic sense exists in forcing the recipient to pay for it on a different basis. If it is suggested that it is because of the existence of a principal-agent relationship this is tantamount to requiring such principals to accept a sub-optimal

outcome. It is through maximising the interest of fund and fund manager taken together that the fund manager best serves the interest of the fund.

2.3 No evidence is provided to back up the assertion in Paragraph 17 that estimates of costs of the proposal are more likely to have been overestimated and benefits underestimated. The supposed benefit of savings on research costs (£50 to 72 million) is implausibly large and of the order of 20 times the amount identified as a potential saving under Part 1 in respect of market pricing information services (£2.8 million).

Incentive misalignment

2.4 We disagree with the assertion made in Paragraph 20 that there is no incentive on fund managers to exercise control over dealing costs. Such costs are a direct deduction from fund performance bottom line which the fund manager is rightly assessed against.

2.5 The report correctly recognises in Paragraph 138 that there is a risk of under-consumption of bundled services under the Part 2 proposals but then asserts that this would only be the case if demand for the service cannot be reasonably predicted in advance. This is not a sustainable argument since even if the "correct" level of consumption could be determined in advance the requirement that the fund manager absorb the cost creates a genuine incentive misalignment; reduction in the actual expenditure outturn (whether justified or not) would represent a straight transfer from client funds to the fund manager's profit.

2.6 This is an incentive misalignment that is qualitatively far more significant than any existing incentive misalignment that the Part 2 proposals are designed to eliminate. This being the case the likely costs of possible under-consumption of research feel as if they must be higher than the possible savings on excess consumption of bundled services which has no equivalent impact on bottom-line profit for the fund manager. No such cost is estimated and used in the cost-benefit analysis.

Costing, pricing and valuation of research services

2.7 Paragraph 149 suggests that the Part 2 proposal is to make the marginal cost of bundled and softed research a 'hard' cost to fund managers. This is incorrect as the proposal is to make average total cost not marginal cost the monetary amount to be absorbed by the fund manager. Since the marginal value of additional research is claimed to be very low it is hard to see why fund managers should be thought likely to seek to obtain such marginal research though engaging in additional trading the cost of which (15 basis points on OXERA's numbers but also an effective 25 basis points stamp duty even before allowance is made for other, potentially larger, execution costs) is far higher than the supposed 'cost' of the research.

2.8 Paragraph 151 The fact that expenditure on in-house buy-side research is of the same order of magnitude as sell-side research indicates that total demand for research is higher than that provided purely by the sell-side and is clearly suggestive that there is not excess consumption. Since expenditure on buy-side research is easier for fund managers to vary, in as much as sell-side research is not separately charged for, this can be seen as the marginal expenditure which would be unlikely to be incurred by fund managers if their research needs were already fully satisfied by the sell-side.

2.9 Paragraphs 156 – 157 If larger fund managers are more likely than their smaller brethren to use execution-only brokerage, then the execution-only rate is presumably that typically paid by a somewhat larger than average fund management client while the full-cost brokerage service is presumably that typically paid by a smaller than average fund manager. The real gap in comparative prices which could be obtained by the same fund manager, whether large or small, could reasonably be expected to be rather less than the average differential across all fund managers based on brokerage commissions actually incurred.

2.10 Paragraph 160 The OXERA report calculates the entire incremental cost of full service brokerage over and above execution cost alone to be £500 million whereas it claims that the total cost of providing sell-side research is £720 million. This surprising state of affairs suggests one of two things. Fund managers either

- do not consume anything like £720 million of sell-side research in which case the argument underlying the proposals that there is excess consumption is unfounded, or

- obtain this research at well below cost price thereby substantially reducing the overall underlying cost of fund management to the benefit of their clients.

2.11 Paragraph 162 The estimate of 10% as the level of excess consumption of sell-side research (which itself is significantly exceeded by the apparent margin of error in calculating the cost of sell-side research as discussed above) is clearly and simply an unsubstantiated figure. However, it is this figure alone which is used to validate the supposed benefits of the Part 2 proposal. For the reasons outlined above, we do not believe any evidence can be educed for 'excess consumption' of sell-side research even if it were the case that consumption of research itself could be readily measured. From the fund management/ client perspective, research is consumed if it is paid for. The less valuable the research the less likely it is to be paid for under current arrangements. This is an economically efficient process that rewards research on its merits out of commission income it fairly generates.

Fundamental flaw in CBA methodology adopted

2.12 The critical flaw in the CBA calculation of alleged benefits from reduction in over-consumption of bundled services is the treatment of the entire notional reduction in cost on these as a benefit. Such services would indeed be excess if the marginal benefit did not exceed the cost. But elimination of the relevant cost eliminates also the benefit that would have been obtained. Hence if the benefits were only 95 per cent of the costs then elimination of those costs would be justified but would create a net benefit of only 5 per cent of costs saved. On the OXERA numbers, for example, even if there were £50 million of excess research consumed (which we do not accept), the net benefit falling to be included in the cost benefit analysis would be just £2.5 million per annum. Such a benefit would be outweighed merely by the on-going compliance costs of £3.2 million identified by OXERA.

Concluding comment

2.13 If there is indeed too much research produced and disseminated it is likely to be because investment houses are prepared to devote resources to it in excess of what fund managers are prepared to consume. If there are problems caused by this it is likely to be in respect of quality and independence of the actual research product and not that this is provided at a high price. The FSA has already consulted through CP171 on conflicts of interest and it is likely that further consideration of the subject matter of that consultation will be more fruitful and, at least from the regulatory perspective, that improvements should be sought.

10/10/03

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