

**Notification and justification for retention of the FSA’s requirements on the use of dealing commissions (“Provisions”) under Article 4 of Directive 2006/73/EC (“Level 2 Directive”) implementing Directive 2004/39/EC (“Level 1 Directive”).**

1. Under soft commission and bundled brokerage arrangements goods and services are supplied to a portfolio manager in return for business put through a broker. The FSA introduced the use of dealing commission provisions in January 2006 in order to address specific market failures arising out of these arrangements that were not adequately addressed by its general provisions on inducements. This paper explains how the Provisions satisfy the requirements of the Article 4 test. It is structured as follows:
  - Explanation of how the Provisions go beyond the requirements of the Level 2 Directive;
  - A description of the specific risks to investor protection and to market integrity addressed by the Provisions and explanation why they are not adequately addressed by the Level 2 Directive;
  - Explanation of why the Provisions are proportionate; and,
  - Explanation of why the Provisions do not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive.
2. The FSA will apply a modified version of the Provisions after 1 November 2007 to ensure consistency and a clear relationship with the inducements provisions that will apply under MiFID.
3. Unless indicated otherwise, references in this notification to the rules of the FSA are references to rules in Policy Statement 07/14: Reforming Conduct of Business Regulation.<sup>1</sup>
4. This notification replaces the notification made by the United Kingdom on 31 January 2007 in relation to the same subject matter.

*In what way are the Provisions additional to those in the Level 2 Directive?*

5. The ways in which the Provisions are or could be said to be additional to those in the Directive are:
  - (1) The Provisions limit a portfolio manager’s use of dealing commission to the purchase of 'execution' and 'research' services – that is, they impose restrictions on the type of goods and services that may be paid for out of client dealing commissions (“**Services Restriction**”)<sup>2</sup>. The Services Restriction builds upon the restrictions on the types of inducements that may be accepted by firms under Article 26(b) of the Level 2

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<sup>1</sup> [http://www.fsa.gov.uk/pubs/policy/ps07\\_14.pdf](http://www.fsa.gov.uk/pubs/policy/ps07_14.pdf) . Defined terms are shown in italics in that consultation paper. Where amendments to defined terms are proposed, these changes are shown in Annex A to the legal instrument attached to the policy statement. Where no changes are proposed to those defined terms, they should be read in accordance with the existing FSA glossary, which can be accessed at <http://fsahandbook.info/FSA/html/handbook/Glossary>.

<sup>2</sup> COBS 11.6.3R to 11.6.5E.

Directive and is or could be seen as more restrictive than them. To the extent that it is, it is an additional requirement to those in the Directive.

(2) The Provisions require a portfolio manager to make an adequate prior disclosure to customers of the firm's policy relating to the receipt of goods or services that relate to the execution of trades or to the provision of research (“**Prior Disclosure**”)<sup>3</sup>. Disclosure by a firm under the Prior Disclosure requirements will constitute the general summary disclosure of permitted benefits required by the final paragraph of Article 26 of the Level 2 directive. The Prior Disclosure requirements provide more focus around the way in which the summary disclosure should be made in the context of the receipt of execution and research services. However, they still only require the disclosure to be made at an "adequate" level of detail and do not require comprehensive *ex ante* disclosure of such benefits.

(3) The Provisions require a portfolio manager to make an adequate disclosure at least once a year of the details of the goods and services received by the investment firm that relate to the execution of trades or the provision of research (“**Periodic Disclosure**”)<sup>4</sup>. No such periodic disclosure is required by Article 26 of the Level 2 Directive.

6. Articles 30 and 33 (Information about the firm and its services for retail clients and potential clients, and, Information about costs and associated charges), and Section 4 (Reporting to clients) and Section 5 (Best Execution) of Chapter III "Operating conditions for investment firms" of the Level 2 Directive are also relevant to the Provisions.

*What are the specific risks to (i) investor protection or to (ii) market integrity that the requirements address that are not adequately addressed by the Level 2 Directive?*

7. In 2003 the FSA conducted a review of bundled brokerage and soft commission arrangements. Market failures identified from the Myners review of institutional investment in the UK related to the use of 'bundled' and 'softed' commission. Under soft commission and bundled brokerage arrangements goods and services – such as investment research, seminars, external publications and data price feeds - are supplied to the portfolio manager in return for business put through a broker. The broker's charges are higher in order to offset the services that are supplied to the portfolio manager. Such arrangements incentivise portfolio managers to over trade and obtain poor execution in order to generate soft commission credits and over-consume associated services and non-execution services such as investment research and data services, which result in higher costs for investors.
8. Under the regulatory requirements then in place such arrangements were disclosed in general terms to the portfolio manager's client and the charges passed on directly to end-investors. This lack of transparency created information asymmetries that made it difficult for clients to tell whether the portfolio manager was acting in their best interests including obtaining sufficient value for money on their behalf.

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<sup>3</sup> COBS 11.6.12R & 16R.

<sup>4</sup> COBS 11.6.15R, 16R & 18E.

9. The specific risks to investor protection and to market integrity resulting from such arrangements that are not adequately addressed by the Directive are:
- (1) the risk that end-investors will suffer higher charges than they should as a result of the distortions in the market for which there are no adequate correcting mechanisms;
  - (2) the lack of transparency in the goods and services paid for by customers out of dealing services.
10. The FSA's current provisions as described in paragraph 5 above seek to address these specific risks. There are two main effects of the way in which the Services Restriction restricts the range of services that can be purchased with client dealing commissions. The first is the possible reduced efficiency of charging for certain services unbundled compared to bundled. But, the services that the Services Restriction prevents portfolio managers from purchasing with client dealing commissions have low economies of scope with execution. This implies that excluding them would not add significant costs to investment firms, but will generate savings to consumers. The second and more significant effect, and one of the purposes behind the Services Restriction, is a reduction in portfolio managers' incentives to purchase additional services that may not be necessary. Such a reduction results in:
- the reduction of excessive consumption of services that would otherwise be 'softed' or 'bundled';
  - the likelihood that portfolio managers reduce excessive trading because they are no longer able to obtain credits for services their clients may not necessarily require; and
  - increased cost consciousness of portfolio managers when paying for services with commissions.
11. The more focused requirements for the content of the summary disclosure of inducements bring some additional costs for portfolio managers. However, benefits should arise from:
- increased competitive pressure on portfolio managers, if as a result, investors better scrutinize and compare portfolio managers' usage of their commission; and
  - increased pressure on brokers to provide effective pricing and valuation of their execution and research services, thereby making portfolio managers more conscious of costs and the need to obtain better value for money from brokers. The use of Periodic Disclosure in addition to Prior Disclosure is necessary to ensure this pressure is maintained on an on-going basis and also to enable disclosure to include concrete details of the softened services received rather than purely generic information, thereby increasing transparency.
12. Article 26 of the MiFID Level 2 directive sets out three criteria that a payment or receipt needs to meet to be accepted:
- it must be designed to enhance the quality of the relevant service to the client;

- it must not impair compliance with the firm's duty to act in the best interests of the client; and
  - the arrangements must be disclosed to clients, in at least summary form, prior to the provision of relevant investment or ancillary services.
13. This provision of MiFID does not specifically focus on the application of these principles in the relevant fields. We do not believe a general approach alone will adequately address the failures in the UK market identified above in relation to the use of dealing commission and therefore feel it is necessary to build upon these general requirements in this area. In particular there is a wide range of services that an investment firm may claim would be permitted under Article 26 to receive from a broker and that could be paid for out of dealing commission charged to clients. Such services might include seminars, external publications and data price feeds. These are services which, prior to the introduction by the FSA of its own restrictions, were provided by brokers to portfolio managers out of dealing commissions that were recharged to clients. Article 26 is cast at similar level of generality to the FSA provisions that were then in place. Given the strong incentives for portfolio managers to reduce their out of pocket expenses and for brokers to seek to attract order-flow it is evident that in the absence of specificity provided by the Services Restriction, reliance on article 26 would not be sufficient to address the market failures. Further, the MiFID provisions do not specifically cover the requirement for disclosure to clients of the goods or services that relate to execution of trades and the provision of research. Our experience indicates that solely imposing requirements at the level of detail of MiFID would not address the market failures and it is therefore necessary to flesh out the general MiFID provisions with more specific requirements.
14. The third test might be said to allow the firm to rely on a high level initial disclosure, which would be supplemented only where clients requested further information. Simply covering this under the general disclosure of the firm's inducements and other arrangements would reduce its impact on the information asymmetries when compared to a separate and detailed disclosure focussed on use of dealing commission arrangements.
15. The absence of a requirement for periodic reporting would reduce the incentives given to firms and to their clients by the Periodic Disclosure requirement.

*In what way are the risks of particular importance in the circumstances of the market structure of the United Kingdom?*

16. Recital 10 to the Level 2 Directive clarifies that the market structure of the Member State in question includes the behaviour of firms and consumers in that market.
17. A number of research exercises have been carried out in the UK market to assess the extent of and the economic effects of soft commission and bundled brokerage arrangements. The FSA, in developing its proposals, has also issued 3 detailed consultation papers directed at UK market participants and held extensive discussions over a number of years with those participants to understand the issues and economic effects and how they might best be addressed in the circumstances of the structure of the UK market. The Annex to this Notification and Justification lists the FSA-produced reports and other relevant research material. We are able to provide hard

copies of the material on request. As explained in summary below this gives good reason to conclude that the specific risks addressed by the requirements are of particular importance in the circumstances of the market structure of the UK.

18. In 2003 the FSA carried out a review of soft commission and bundled brokerage arrangement in the UK and has published a research report on soft commission and bundled brokerage services dated April 2003 prepared by the research company OXERA. The review showed there to be significant market distortions in the UK. If these were permitted to be retained then costs to investors, including consumers would be higher than necessary, tending over time to reduce overall levels of investment and savings. For example, the research commissioned by the FSA noted commission credits of £90 million annually were spent on market and price information services. The report provided evidence of over consumption, noting that only about 50% of portfolio managers would continue to purchase these market and price information services following the new provisions and, of those, about 30% said that they would buy less of the services. It is clear also therefore that the market failures would persist and would not self-correct.
19. And, to put the Provisions into further context commissions paid by portfolio managers to brokers for the execution of deals on behalf of their clients are a significant cost of portfolio management. In 2000, UK fund managers paid about £2.3 billion (about €3.3 billion) in commissions to UK brokers in commission charges from their customer funds. The value of soft commission credits provided is estimated at around £160 million.
20. The FSA will be carrying out a post-implementation review of the Provisions but this will not be complete until 2008. An accurate assessment of the effect in practice of the requirements is therefore not available, although within the UK they are now accepted as standard practice. It is evident however that as a result of the FSA introducing the provisions some portfolio managers have ceased to use soft commission and bundled brokerage arrangements while others have restricted their use of soft services in accordance with the Provision.
21. The impact of these measures is amplified by the fact that the fund management industry is of vital importance to the well being of the UK financial services industry and to consumers. For example, assets under management by UK-based fund managers amounted to about £2,800 billion<sup>5</sup> as at 31 December 2005 (about €4,000 billion), covering pensions funds, insurance funds, collective investment schemes, investment trusts, private clients and other products.

*Why are the requirements proportionate?*

22. As described above the Provisions were introduced because the general FSA provisions on inducements (which are cast at a similar level of generality to those under Article 26 of the Level 2 Directive) and soft commission were inadequate to address the market failures in this area. Before introducing the Provisions the FSA considered whether alternative measures would be a more proportionate way of

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<sup>5</sup> Publication by Investment Management Association – "Asset Management Survey" published July 2006

addressing the market failures but concluded that the Provisions were the most proportionate.

23. For example, an alternative the FSA considered but rejected was for portfolio managers to rebate the costs of services, other than execution, back to the client where the payment of these services was made from client dealing commissions. This would prevent these services from being provided together with trade execution, and being priced into the rate or amount of broker commission charged to the fund. The FSA rejected this idea after consultation with industry on the basis that this proposal did not take fully into account the broader structural impacts of change and could have unintended adverse consequences for UK portfolio management and equity trading. The cost-benefit balance of intervening in the market in this way would therefore be less proportionate than the one achieved through the Provisions. Many respondents from the industry stated that this alternative would adversely affect competition between firms in the UK, the ability of UK fund managers to compete internationally, the supply of and demand of investment research and equity trading. The FSA concluded that the rebating system would prove more costly and complex for firms to implement, in particular firms could face a conflict of interest over the calculation of the rebate.
24. The FSA's decision to introduce the Provisions was also informed by extensive consultation and thorough cost-benefit analysis on the UK market (links to relevant material are contained within the Appendix). This cost benefit analysis estimated that the one-off costs of the Services Restriction would be in the region of £3.6 million to portfolio managers and brokers, to amend their lists of approved services, communicate the changes to staff and provide training on the new provisions. Continuing costs were expected to be very small, as once firms had made the necessary changes to their systems they would not need to devote any additional resources to monitoring compliance or advising on compliance with the new requirements.
25. These costs are calculated against annual cost savings due to a reduction in expenditure of softing and bundling services of between £2.4 million and £2.8 million. On a discounted cashflow basis this gives a reduction of costs to investors of about £35m to £40m.
26. The estimated costs of the Prior and Periodic Disclosure requirements were one off compliance costs of £6.1 million for portfolio managers and £6.2m for brokers. The on-going estimated costs are £4.3 million per year for portfolio managers and £2 million for brokers. However, these costs are offset against yearly savings due to a reduction of softing and unbundling services of between £50.4 million and £60.1 million.
27. The one-off costs to portfolio managers and brokers in relation to the Provisions will have already been spent by firms when they updated their processes and procedures to comply with the new provisions which became effective on 1 January 2006. These one-off costs cannot now be recovered.
28. The studies also suggested there could be other significant benefits that it was not appropriate to quantify.

*Do the requirements restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC.*

29. The Provisions relate to matters within the scope of Article 19(1) of the Level 1 Directive. They will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated by Article 32(7).

## **APPENDIX**

### *Reference material*

#### FSA produced reports

<b>Name of publication / report</b>	<b>Date published</b>
Consultation Paper (CP176) – Bundled brokerage and soft commission arrangements  <a href="http://www.fsa.gov.uk/pages/Library/Policy/CP/2003/176.shtml">www.fsa.gov.uk/pages/Library/Policy/CP/2003/176.shtml</a>	April 2003
Policy Statement (PS04/13) – Bundled brokerage and soft commission arrangements (feedback on CP176)  <a href="http://www.fsa.gov.uk/Pages/Library/Policy/Policy/2004/04_13.shtml">www.fsa.gov.uk/Pages/Library/Policy/Policy/2004/04_13.shtml</a>	May 2004
Policy Statement (PS04/23) – Bundled brokerage and soft commission arrangements (update in issues arising from PS04/13)  <a href="http://www.fsa.gov.uk/pubs/policy/ps04_23.pdf">www.fsa.gov.uk/pubs/policy/ps04_23.pdf</a>	November 2004
Consultation Paper (CP05/5) – Bundled brokerage and soft commission arrangements: proposed rules  <a href="http://www.fsa.gov.uk/pubs/cp/cp05_05_newsletter.pdf">www.fsa.gov.uk/pubs/cp/cp05_05_newsletter.pdf</a>	March 2005
Policy Statement (PS05/9) – Bundled brokerage and soft commission arrangements (feedback on CP05/5 and final rules)  <a href="http://www.fsa.gov.uk/Pages/Library/Policy/Policy/2005/05_09.shtml">www.fsa.gov.uk/Pages/Library/Policy/Policy/2005/05_09.shtml</a>	July 2005
Consultation Paper (CP 06/19) - Reforming Conduct of Business Regulation - Including proposals for implementing relevant provisions of the Markets in Financial Instruments Directive, and related changes to SYSC, DISP, TC, SUP and other Handbook modules.  <a href="http://www.fsa.gov.uk/Pages/Library/Policy/CP/2006/06_19.shtml">www.fsa.gov.uk/Pages/Library/Policy/CP/2006/06_19.shtml</a>	October 2006
Policy Statement (PS 07/14) – Reforming Conduct of Business Regulation Final feedback on CP 06/19  <a href="http://www.fsa.gov.uk/pubs/policy/ps07_14.pdf">http://www.fsa.gov.uk/pubs/policy/ps07_14.pdf</a>	July 2007

#### Other published reports

<b>Name of publication / report</b>	<b>Date published</b>
Myners review on 'institutional investment' in the UK on behalf of HM Treasury  <a href="http://www.hm-treasury.gov.uk./media/2F9/02/31.pdf">www.hm-treasury.gov.uk./media/2F9/02/31.pdf</a>	March 2001
Oxera report in relation to CP176	April 2003



<p>'An assessment of soft commission and bundled brokerage services in theUK'</p> <p><a href="http://www.fsa.gov.uk/pubs/cp/cp176_oxera_assessment.pdf">www.fsa.gov.uk/pubs/cp/cp176_oxera_assessment.pdf</a></p>	
<p>Oxera report in relation to CP176</p> <p>'Cost-Benefit analysis of the FSA's policy proposition on soft commission and bundling'</p> <p><a href="http://www.fsa.gov.uk/pubs/cp/cp176_oxera_cba.pdf">www.fsa.gov.uk/pubs/cp/cp176_oxera_cba.pdf</a></p>	<p>April 2003</p>
<p>Charles River Associates report in relation the cost and benefits carried out on behalf of the Investment Management Association (IMA)</p> <p><a href="http://www.investmentuk.org/news/research/2004/soft_commissions/crar_eresearchcp176.pdf">www.investmentuk.org/news/research/2004/soft_commissions/crar_eresearchcp176.pdf</a></p>	<p>October 2003</p>
<p>Deloitte report in response to CP176</p> <p>'Assessment of the economic impact of the implementation of the proposals contained within FSA consultation document CO176 with reference to incumbent fund manager's ability to compete in the UK market'</p> <p><a href="http://www.fsa.gov.uk/pubs/Policy/04_13/report.pdf">www.fsa.gov.uk/pubs/Policy/04_13/report.pdf</a></p>	<p>April 2004</p>
<p>Oxera first stage report identifying the baseline for the FSA's post-implementation review</p> <p>'Bundled brokerage and soft commission arrangements: performance management framework - an update'</p> <p><a href="http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2006/bundled_brokerage.shtml">http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2006/bundled_brokerage.shtml</a></p>	<p>October 2006</p>