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Agenda

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A second big bang in brokerage? The new regime in softing and bundling

The UK was the first EU Member State to introduce new rules for soft commission and bundled brokerage arrangements (2006). The impact was predicted by some to be the second 'big bang' for the brokerage sector (the first big bang being the abolition of the fixed commissions in the 1980s). This article analyses new industry data and provides an assessment of the effects of the new regime

When providing trade execution services to investment managers in exchange for commission, brokerage firms tend to offer these together with a number of other services 'for free', such as research, access to analysts, and market information services. These practices, known as softing and bundling, are common across many countries.

Although the financial crisis seems to have pushed them to the background somewhat, softing and bundling have been high on the regulatory agenda in recent years. After a period of consultation (and intense debate) with the industry, the UK Financial Services Authority (FSA) introduced a new regime on January 1st 2006.[1] This article analyses new industry data to assess the effects of the regime on the market.

The analysis is based on a study undertaken by Oxera for the FSA. In 2006 Oxera was commissioned to develop a methodology for the FSA's post-implementation review and to apply it, whereby a set of performance indicators were measured by conducting a survey among investment managers and brokers in 2006 (measuring the indicators pre-implementation) and again in 2008 (measuring the indicators post-implementation).

Myners: incentive misalignment

The use of softing and bundling first came under scrutiny with the publication of the Myners report in 2001, which identified the problem that, while investment managers are better placed than their clients (eg, pension funds) to exercise control over dealing costs (in particular, broker commissions), they have few incentives to do so because these costs are passed directly through to the funds.[2]

It was estimated that, in 2001, UK institutional investment managers paid some £2.3 billion to UK brokers in commission.[3] Rough estimates indicated that between 30% and 40% of this could be attributed to services additional to trade execution—ie, access to analysts, research, conferences and equipment, etc. Soft commission credits amounted to around 7% of total commission costs. The costs of bundled services (ie, other than trade execution) were more difficult to estimate, but were considered to lie in the range of 20% to 30%.

As the Myners report set out, it was believed that such additional services distorted the incentives of investment managers, possibly resulting in over-consumption of these services and investment managers selecting brokers on the basis of the additional services rather than the price and/or quality of trade execution. This prompted the FSA, in conjunction with HM Treasury, to review the regulatory framework underlying the soft commission and bundled brokerage arrangements.

The old regime

Under the old regime, investment managers would buy from a broker through a bundled brokerage arrangement trade execution together with, for example, research and access to analysts. The terms on which these extra services were provided were not always explicitly agreed, but there was usually an understanding that the investment manager would generate a certain amount of business for the brokers in order to receive the extra services.

Soft commission arrangements were more explicit, but essentially similar, to bundling. Under these

This article is based on the Oxera report, 'The Impact of the New Regime for the Use of Dealing Commissions: Post-implementation Review', prepared for the Financial Services Authority, April 2009. Available at www.oxera.com.

arrangements, an investment manager would send trades to a broker and receive, in addition to trade execution, credits (or 'soft dollars' as they are called in the USA), which could be used to purchase services, usually from third-party service providers. The majority of the credits were used to buy market information services (usually Reuters and Bloomberg screens), followed by research, and dedicated hardware and software. Typically, the investment manager would first estimate how much in the way of third-party services, such as research and information, it would need for its business, and subsequently how many trades (and hence credits) were required to buy these services through particular brokers.

Softing and bundling provided a contrast to the way in which other services needed by the investment manager to carry out its functions were paid for. The costs of these other services were borne by investment managers themselves (to be recovered through the management fee), whereas the costs of bundled and softed services were passed on directly to funds as part of the total commission. This could exacerbate the incentive misalignment between the investment manager and its clients (the principal–agent problem). The investment manager had only a partial stake in the returns of the fund, whereas the costs to the fund of perfectly monitoring the activity were likely to have been prohibitive. As a result, investment managers may have had an incentive to consume the additional services rather than keep execution costs down, and to select brokers on the basis of those services rather than on the price/quality of trade execution.

The new regime

The changes in the regime consisted of the following main elements.

- To mitigate the incentive misalignment problem, investment managers' use of commissions is limited to the purchase of execution and research (including execution-related goods). More specifically, market pricing and information services such as dealing screens are no longer allowed to be purchased with commissions.

- To enhance accountability for client funds, investment managers are required to give their clients clearer information about the costs associated with trade execution and research—ie, the split in commissions across the two categories, and the overall expenditure on these services.

- To separate the market for trade execution from that of research services, investment managers are encouraged to seek, and brokers to provide, clear payment mechanisms that enable individual services to be purchased separately.

In response to the second element, brokers and investment managers now explicitly break down (in bundled brokerage arrangements) their commission rates into a component for trade execution and a component for research and execution-related goods and services. In response to the third element, the industry introduced commission-sharing arrangements (CSAs), under which investment managers agree to a split between execution and non-execution goods and services with the executing broker. The non-execution component of the commissions is then placed in a 'commission account', which the investment manager can use to purchase research, either from the executing broker (where the commissions were generated) or a third party (in which case the executing broker would be required to make the payment via the account to the third party) such as another broker or an independent research provider.

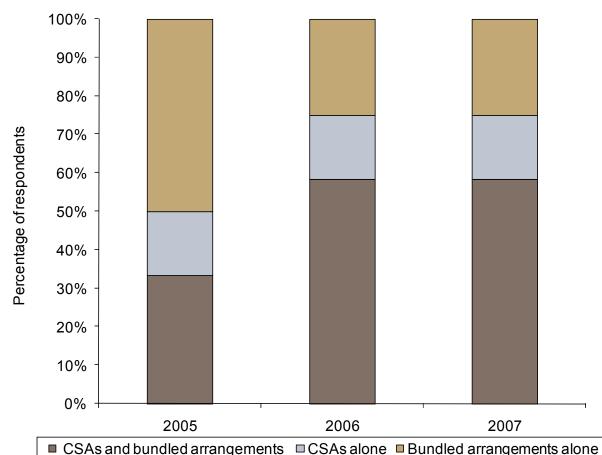
What has been the impact?

Greater separation in the purchase of trade execution and research

One of the key objectives of the new regime was to separate the market for execution from that of research and develop more competition in their supply. To allow investment managers to pay for research through commissions generated at another broker, industry participants were expected to adopt CSAs to an increasing extent. Figure 1 shows the trend over time in the use of CSAs.

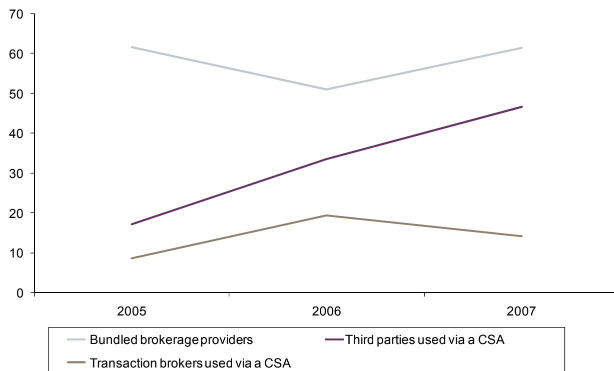
The proportion of investment managers with CSAs increased considerably between 2005 and 2007, from 50% to 70%. This was a result of investment managers with bundled brokerage arrangements also entering

Figure 1 Proportion of respondents using CSAs and/or bundled brokerage arrangements



Source: Oxera (2009), 'The Impact of the New Regime for the Use of Dealing Commissions: Post-implementation Review', prepared for the Financial Services Authority, April.

Figure 2 Average number of non-execution goods and services providers used by investment managers



Note: The averages are estimated for survey respondents with the particular arrangement in place—ie, the average number of CSA providers is calculated only for firms with CSAs in that year.
Source: Oxera (2009), op. cit.

into CSAs, giving them greater access to third-party providers of research.

Increased use of CSAs was expected to lead to an increase in the use of third-party providers, including independent research providers and brokers. Figure 2 shows the trend in the average number of providers used by investment managers for the purchase of research by categorising them as follows.

- **Bundled brokerage**. Brokers that are used for trade execution and from which the investment manager purchases research via bundled arrangements.

- **Third parties**. Either independent research providers or brokers that are used as third-party research providers, from which investment managers purchase non-execution goods and services only.

- **Transaction brokers via CSAs**. Brokers used for trade execution and from which the investment manager purchases research via CSAs—ie, the investment manager has a CSA but still opts to use the executing broker for research.

A striking result is the increase in the average number of third-party providers used via CSAs between 2005 and 2007—the underlying data indicates that within this change the increase in the number of third-party brokers was greater than in the number of third-party independent research providers. This is consistent with the theory behind unbundling: enabling investment managers to use brokers for what they are good at, be it research or trade execution, rather than sending trades to brokers in order to gain access to their research.

Over-consumption?

Restricting the goods and services that can be purchased with commissions, along with the enhanced transparency in pricing, was expected to reduce the commission expenditure on non-execution goods and services. Figure 3 shows the evolution of the trend over time for the ratio of total expenditure on non-execution goods and services to the total funds under management. This ratio was used to normalise for any trends caused by changes in funds under management. The different mechanisms through which non-execution goods and services might be purchased include the following.

- **CSAs**—whereby commissions generated at an executing broker are used to buy research from third parties (brokers and independent research providers) or from the broker where the commissions were generated.

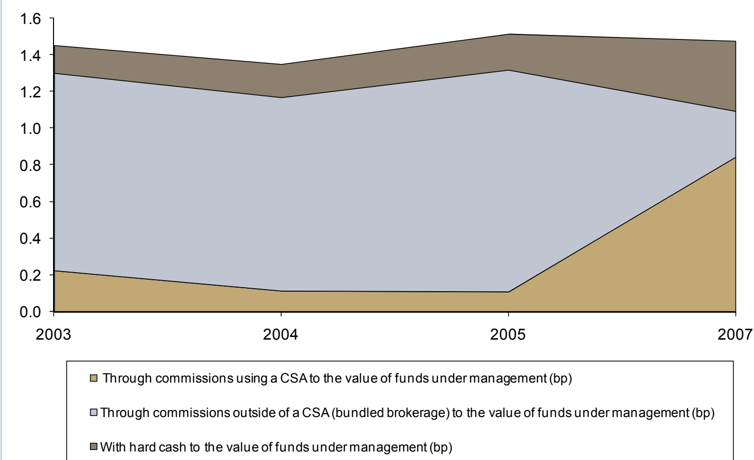
- **Bundled brokerage**—research services provided by the executing broker.

- **Hard cash**—purchasing non-execution goods and services (not necessarily research) with hard cash.

Figure 3 illustrates a number of findings.

- First, total expenditure on non-execution goods and services through commissions (ie, excluding hard cash) declined, on average, after 2005. Despite this, analysis of the underlying data indicates that there is

Figure 3 Ratio of non-execution goods and services to funds under management



Note: Observations for 2006 are omitted due to insufficient data. The figures are based on weighted averages.
Source: Oxera (2009), op. cit.

considerable variation in the responses from investment managers, with the ratio increasing for some and decreasing for others.

- Second, there was a significant increase in the amount spent on research purchased through CSAs and a decrease in expenditure on research purchased through bundled brokerage (outside a CSA).

- Third, it is difficult to draw firm conclusions on whether there was over-consumption under the old regime. If there had been, the reduction in commission spending on non-permitted services would not be expected to be fully offset by an increase in hard cash spending on these services. The ratio of hard cash spending to funds under management increased from 2005, and the increase in such spending on non-permitted services seems to be equivalent to, or larger than, the reduction in commission spending on non-permitted services. However, there was limited data. Furthermore, in discussions at the Investment Management Association it was suggested that some of the increase in hard cash expenditure may be caused by greater demand for new technology and systems and higher data costs after the introduction of MiFID (Markets in Financial Instruments Directive).[4]

The spending on research can also be expressed in terms of proportion of commissions. The data indicates that around 25% of commissions is currently spent on research (10% through bundled brokerage and 15% through CSAs). These are rough estimates—the data indicates that there is significant variation across investment managers, with some of them not using commissions to purchase research at all. This compares with (the also rough) estimates of between 30% and 40% in 2001.

Did disclosure work?

Given that the ability of pension funds to monitor commission costs is weaker than the control of the management fee, increased disclosure and accountability was considered to enable pension fund trustees to monitor investment managers more effectively. The survey among pension fund trustees indicates that they receive disclosures of commission spending from investment managers. However, the content of disclosure was not perceived to be an important input into pension funds' choice of investment managers, and therefore had little impact on their behaviour.

It could be argued that this is consistent with the finding that the level of spending on non-execution goods and services (see Figure 3) has not changed significantly since the introduction of the new regime.

However, there are positive effects of the new regime, such as investment managers separating their choice of trading venue from their choice of research provider through CSAs, and an increase in the use of third-party research providers. Investment managers indicated that these effects are not due to pension fund scrutiny but to changes within the organisation of investment management firms. As a result of the introduction of the new regime, firms have clarified the responsibility of the trading desk (which has the duty of choosing trading venues that offer best execution) and that of the portfolio managers (which are also responsible for the purchase of research). This means that decisions on trading and research are now taken more independently than prior to the implementation of the new regime. This mechanism may have led to the increased use of third-party research providers.

Unintended consequences?

At the time of implementation, some possible adverse effects were identified but the research did not provide clear evidence that any of these had actually materialised. For example, although separating the market for execution and research was expected to lead to improved competition, it was perceived that this might increase the concentration of these markets since investment managers may choose to use a small number of brokers that provide the best service. If this were to result in investment managers all selecting the same set of brokers for the execution of trades, the concentration of the brokerage market could increase. The analysis provides little evidence of this change. The value of trades sent by investment managers to their top five brokers, for both execution and research, has consistently averaged around 50% over recent years. There is also some evidence of an increase in the level of trading going to the smallest brokers.

Remaining questions

Overall, the post-implementation review broadly indicates that the expected changes are taking place. In particular, there are clear signs that investment managers have separated the purchase of research from payments for trade execution, and there is also evidence that smaller brokers and independent research are being used to an increasing extent.

Two questions remain. The first is whether the new regime is permanent or temporary. Some may see the introduction of CSAs as a temporary solution to create more transparency in pricing of research services, with the longer-term aim being the introduction of all-inclusive fund management fees, as originally proposed in the Myners report. Investment managers would then no longer be permitted to pass on commissions to the funds, but would pay for them

themselves and recover the costs through the annual fund management charge.

The second question is what regime will be adopted elsewhere in Europe. The distortion in incentives has also been recognised in other European countries and the possibility of adopting a common supervisory approach across the EU on softing and bundling arrangements has been discussed.[5] Although progress thus far is limited on this front, MiFID has provided the high-level principles for a more detailed regime in EU Member States.

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[1] The new regime is described in Financial Services Authority (2005), 'Bundled Brokerage and Soft Commission Arrangements: Feedback on CP05/5 and Final Rules', Policy Statement PS05/09, July.
[2] Myners, P. (2001), 'Institutional Investment in the United Kingdom: A Review', HM Treasury, March, paras 5.102–5.113.
[3] Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', report prepared for the Financial Services Authority, April. Available at www.oxera.com.
[4] Investment Management Association round-table meeting, December 3rd 2008.
[5] Committee of European Securities Regulators (2007), 'CESR Level 3 Recommendations on Inducements under MiFID: Feedback Statement', CESR/07-316, May.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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