OXFORD ECONOMIC RESEARCH ASSOCIATES

FSA

COST–BENEFIT ANALYSIS OF THE FSA'S POLICY PROPOSITIONS ON SOFT COMMISSIONS AND BUNDLING

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Executive Summary

1. OXERA has been commissioned by the Financial Services Authority (FSA) to undertake a cost–benefit analysis (CBA) of its policy propositions concerning soft commission arrangements and bundled brokerage services. Previously the FSA commissioned OXERA to undertake a study on bundling of brokerage services and soft commission arrangements, and on the markets for brokers and fund managers in which these practices take place. That study should be seen as separate from the present CBA (although part of the data and information obtained for the report are also used for the CBA). The CBA relates to policy propositions formulated by the FSA; they are not OXERA's policy propositions.

2. The FSA's policy propositions consist of two parts (hereafter referred to as Part 1 and Part 2):

   - Part 1: a narrower re-casting of the range of goods and services permitted under both bundling and soft commission arrangements—specifically to prohibit the bundling or softing of market pricing and information services (mainly screen-based services).

   - Part 2: making fund managers directly responsible for paying the cost of any additional services they obtain in connection with trade execution (ie, through softing or bundling). The policy would still allow the additional services to be provided through bundling or softing arrangements and priced into the rate or amount of broker commission charged to the fund. In that case, the fund manager would be required to determine the pro-rate cost to customers (ie, the funds) of the additional services and to repay an equivalent amount to the funds. It would be left to market forces to determine if the costs of services should be recovered through an increase in the management fee, or some other explicit charge.

3. Parts 1 and 2 would apply equally to both softed and bundled services, and to both 'institutional' (eg, pension funds) and 'retail' (eg, unit trusts, life policies) funds under management.

4. The CBA assesses the incremental change in costs and benefits of the FSA policy propositions compared with the current situation—ie, bundled brokerage and soft commissions under the existing regulations. Following the FSA's standard approach to CBAs, policy propositions are assessed on the basis of six categories of market impact:[1]

   - direct or regulator's costs—both one-off and ongoing;

[1] See FSA (2000), 'Practical Cost-Benefit Analysis for Financial Regulators', Central Policy, version 1.1, June.

- compliance costs—both one-off and ongoing;
- quantity of transactions;
- quality of transactions;
- variety of transactions; and
- efficiency of competition.

5. It was agreed that the FSA itself would quantify the direct costs to the regulator, and that OXERA would address the other five market impact categories. A further assumption that OXERA was explicitly asked to make for the purpose of the CBA is that there is a general 'compliance culture' in the industry. That is to say, once any new rules are clearly defined and issued by the FSA, market participants can be expected to adhere to these rules.

6. The CBA is supported by different sources of information, including in-depth industry interviews, interviews with FSA staff and a questionnaire among pension funds, fund managers and brokers.

Underlying market dynamics

7. To assess the implications of the FSA's policy propositions, it is important to understand some of the market dynamics that underlie the relationships between brokers, fund managers and funds.

8. It is well recognised that there is an incentive misalignment between fund managers and their clients. The costs of fund management are typically recovered from institutional funds through two types of charges: the management fee and the pass-through of broker dealing costs. In the fund manager selection process, there is direct competitive pressure on the management fee, but less so on the commission rates. The monitoring of fund managers' performance is an implicit way of monitoring dealing costs, but this monitoring system is far from ideal. Therefore, a cost pass-through could result in total dealing costs being too high from an economic welfare perspective, either because of excessive levels of trading or because of an excessive usage by fund managers of softed and bundled services.

9. Part 1 implies that market and price information services can no longer be softed or bundled, and hence that fund managers can no longer pass on the costs of these services via commission costs. Instead, fund managers would have to recover the costs of market and price information services through the management fee or another separate charge (that is, if they still find it worthwhile to incur those costs in the first place). Part 2 implies that other services, besides trade execution, can still be bundled or softed, but that their costs would have to be reimbursed to the funds. Thus, fund managers would have to pay for these services themselves and seek to recover the costs through the management fee (or another separate charge).

This puts pressure on fund managers to consider more carefully than they do now whether the services acquired provide value for money, and to eliminate any excess consumption.[2]

10. With regard to 'retail' funds, investors are often unable to monitor effectively any type of charges, whether they be management fees, other up-front charges, or passed-on commission costs. This implies that, for retail funds, Part 1 may not have the same degree of impact as in the institutional market in putting pressure on fund managers to consider more carefully than they do at present whether services acquired in addition to trade execution provide value for money. However, OXERA does not expect this to have a major impact on the reductions of excess consumption, for various reasons:

- in the relationship between brokers and fund managers the distinction between retail and institutional is largely irrelevant;
- unit trusts and other retail investment funds still face some 'normative' pressure on charges; and
- insurance funds, which represented the main part of 'retail' funds, are reasonably protected from cost pass-though by external fund managers.

11. Including all of the commission costs in the management fee would require the optimal level of trading to be predicted in advance. This could result in too few transactions and could affect the performance of the fund. However, under the current arrangements, the costs of bundled and softed services are also passed on to funds together with the commission costs. The argument of unpredictability of required consumption—which applies to trade execution services—cannot be readily applied to bundled and softed services.

12. It is important to distinguish the pass-through of costs of additional services together with commission costs—a practice incurred by fund managers—from the bundling of services by brokers. As discussed above, there is little economic justification for the former. Only the pass-through of trading costs themselves is justified because of the unpredictability of demand. However, as identified in the OXERA report, there are certain economic justifications for bundling of additional services by brokers. These justifications include economies of scope in production, reduced transaction costs for customers, efficient pricing methods and the technical difficulty of unbundling.

13. The FSA's policy propositions take this distinction between bundling and cost pass-through, and their different economic justifications, into account. Part 1 and Part 2 have an impact on the passing-on of costs via the commission costs. These

[2] The above is not to say that fund managers currently do not consider value for money. Rather, it means that fund managers will have greater incentives to be careful about costs of services if they have to pay for these services in 'hard' money rather than through soft credits.

policy propositions create economically efficient incentives, in the sense that it is fund managers who ultimately must bear the costs of the softed and bundled services concerned. Rather than readily passing these costs on via commission costs, fund managers would have to recover them through the management fee (or another separate charge). At the same time, Part 2 does preserve the economic justifications of bundling, since it still allows services to be bundled or softed.

Costs and benefits of Part 1

14. The table opposite summarises the costs and benefits of policy proposition Part 1. Virtually all costs have been quantified. (The only cost that has not been quantified—ie, the effect on the competitiveness of small, execution-only brokers—is likely to be low, and even negligible if Part 2 is also implemented.) Many of the benefits of the policy cannot be quantified; all that can be said is that Part 1 creates the correct incentives on market players for these benefits to be realised. Only one type of benefit of Part 1—ie, the reduction in excess consumption in market and price information services—can be roughly quantified.

15. However, the likely order of magnitude of this benefit is already such that the costs of Part 1 are outweighed. The regulator's direct costs are estimated at £2,600 on a one-off basis and at £6,240 per year on an ongoing basis.[3] There is likely to be a one-off compliance cost to the industry in the order of £3.3m. Against this, the estimated saving in total consumption of information services comes to at least around £2.8m per year—ie, only a small, marginal decrease in fund managers' expenditure on market and price information services is required to offset the costs of Part 1. These estimates for the CBA are conservative, in the sense that costs are more likely to be overestimated than underestimated, whereas benefits are more likely to be underestimated than overestimated.

[3] The regulator's direct costs were estimated by the FSA.

Costs and benefits of Part 1 of the policy proposition

Market impact	Type of cost	Magnitude	Type of benefit	Magnitude
Direct costs	Design and implementation	£2,600 (one-off)	n.a.	n.a.
	Ongoing costs	£6,240 per year	n.a.	n.a.
Compliance costs	One-off compliance costs to brokers and fund managers	Around £3.3m	n.a.	n.a.
	Ongoing compliance costs to brokers and fund managers	Close to zero		
Quantity of transactions	n.a.	n.a.	Reduction of excess consumption of market and price information services—leads to reduction in total management costs paid by funds	Around £2.8m per year
			Reduction in excessive trading—leads to better execution quality and reduction in total management costs paid by funds	Not quantifiable; incentives in the right direction
Quality of transactions	n.a.	n.a.	Providers of information services may increase product quality—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
			Increase in quality of trade execution	
Variety of transactions	n.a.	n.a.	Providers of information services may increase product variety—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
Efficiency of competition	Small fund managers disadvantaged	No economic cost	Increased transparency and hence competitive pressure on fund managers (in particular for institutional funds)—reduces total management costs paid by funds	Not quantifiable; incentives in the right direction
	Execution-only brokers disadvantaged	Likely to be low; negligible if implemented in conjunction with Part 2	Increased pressure from buyers on screen providers—leads to reduction in total management costs paid by funds	

Note: n.a. = not applicable.
Source: OXERA. The estimates of direct costs have been provided by the FSA.

Costs and benefits of Part 2

16. The table opposite summarises the costs and benefits of policy proposition Part 2. The most important costs have been quantified. The cost categories that have not been quantified are the impact on smaller fund managers and the reduced scope for efficient price discrimination but both are shown to be relatively insignificant at any rate. Many of the benefits of the policy cannot be quantified; all that can be said is that Part 2 creates the correct incentives on market players for these benefits to be realised. Only one of the types of benefit of Part 2, the reduction in excessive consumption of bundled and softed services, can be roughly quantified.

17. However, the likely order of magnitude of this benefit is already such that the costs of Part 2 are outweighed. The regulator's direct costs are estimated at £5,200 on a one-off basis and at £12,000 to £18,000 per year on an ongoing basis.[4] There is likely to be a one-off compliance cost to the industry in the order of £14.4m, and then ongoing compliance costs in the order of £3.2m per year. Against this, the estimated saving in total expenditure by fund managers on bundled services would be at least around £50m–£72m per year. These estimates for the CBA are conservative, in the sense that costs are more likely to be overestimated than underestimated, whereas benefits are more likely to be underestimated than overestimated.

18. Some of the non-quantified benefits can also be expected to be important, in particular the effects on the research market—with incentives being created for a levelling of the playing field between tied and independent research providers, and a likely increase in research quality and variety.

[4] The regulator's direct costs were estimated by the FSA.

Costs and benefits of Part 2

Market impact	Type of cost	Magnitude	Type of benefit	Magnitude
Direct costs	Design and implementation	£5,200 one-off	n.a.	n.a.
	Ongoing costs	£12,000—£18,000 per year	n.a	n.a.
Compliance costs	One-off compliance costs to brokers	£6m	n.a.	n.a.
	Ongoing compliance costs to brokers	£1.9m per year		
	One-off compliance costs to fund managers	£8.4m		
	Ongoing compliance costs to fund managers	£1.3m per year		
Quantity of transactions	n.a.	n.a.	Reduction of inefficient over-consumption of bundled and softed services—leads to fall in total management costs paid by funds	Around £50m–£72m per year
			Reduction in excessive trading—leads to better execution quality and fall in total management costs paid by funds	Not quantifiable; incentives in the right direction
Quality of transactions	n.a.	n.a.	Increased quality of research services—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
			Increased quality of trade execution	
Variety of transactions	n.a.	n.a.	Greater variety of research—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
Efficiency of competition	Efficient price discrimination more difficult	Incremental cost very low	Increased transparency and hence competitive pressure on fund managers (in particular for institutional funds)—reduces total management costs paid by funds	Not quantifiable; incentives in the right direction
	Small fund managers may be disadvantaged		Levelling of playing field between full-service and other brokers—increases competition in brokerage	
			Levelling of playing field between tied and independent research providers—increases competition in research	

Note: n.a. = not applicable. These costs and benefits assume that Part 1 is also implemented (ie, market and price information services are no longer softed or bundled).
Source: OXERA. The estimates of direct costs provided by the FSA.

Contents

1. Objectives and Methodology of the Cost–Benefit Analysis 1

1.1 Remit 1
1.2 The FSA’s policy propositions 2
1.3 Methodology 2

2. Underlying Market Dynamics of Relevance to the Policy Propositions 5

2.1 Cost pass-through by fund managers to institutional funds 5
2.2 Cost pass-through by fund managers to retail funds 7
2.3 Economic justifications for cost pass-through 10

3. Costs and Benefits of Policy Proposition—Part 1 13

3.1 Direct costs 13
3.2 Compliance costs 13
3.3 Quantity of transactions 18
3.4 Quality of transactions 24
3.5 Variety of transactions 26
3.6 Efficiency of competition 27
3.7 Summary of costs and benefits 29

4. Costs and Benefits of Policy Proposition—Part 2 32

4.1 Direct costs 32
4.2 Compliance costs 32
4.3 Quantity of transactions 37
4.4 Quality of transactions 47
4.5 Variety of transactions 48
4.6 Efficiency of competition 48
4.7 Summary of costs and benefits 52

5. Policy Interactions between Part 1 and Part 2 55

1. Objectives and Methodology of the Cost–Benefit Analysis

1.1 Remit

19. OXERA has been commissioned by the Financial Services Authority (FSA) to undertake a cost–benefit analysis (CBA) of its policy propositions concerning soft commission arrangements and bundled brokerage services. The FSA will issue a Consultation Paper on these policy propositions, and this CBA forms part of that consultation.

20. The FSA's policy propositions follow an extensive regulatory review of soft commission arrangements and bundled brokerage services. This review was initiated in July 2001 in response to the Myners report on institutional investment in the UK.[5] The Myners report identified the problem that, while fund managers are better placed than pension fund trustees to exercise control over dealing costs (in particular, broker commissions), they have few incentives to do so because these costs are passed on to the pension funds. The ultimate objective of the FSA's review is to examine the regulatory risks that may arise from the provision of bundled brokerage and soft commissions, and to construct the most appropriate regulatory regime to mitigate these risks.

21. As part of the review, the FSA commissioned OXERA to undertake a study (hereinafter referred to as the OXERA report) on bundling of brokerage services and soft commission arrangements in the UK, and on the markets for brokers and fund managers in which these practices take place. That report, which will be published together with the FSA's Consultation Paper and the CBA, provides the FSA with:

- a comprehensive understanding of competition in the UK fund management and broker markets, and of the factors that give rise to the practices of providing additional services with trade execution service, and rebating broker commissions to fund managers through soft commission arrangements;
- a detailed analysis of the effects of bundled brokerage services and soft commission arrangements on institutional investors;
- an analysis of the order of magnitude of soft commission arrangements and bundled services in the UK;
- an overview of soft commission practices in the USA, and the manner in which these are regulated in the USA, and also in Germany, France and the European Union;

[5] Myners, P. (2001), 'Institutional Investment in the United Kingdom; A Review', March, commissioned by the Treasury.

- a discussion of policy issues and implications that follow from the economic analysis in the report.

22. The OXERA report on bundling and soft commissions should be seen as separate from the present CBA (although part of the data and information obtained for the report are also used for the CBA). The CBA relates to policy propositions formulated by the FSA; they are not OXERA's policy propositions.

1.2 The FSA's policy propositions

23. The FSA's policy propositions, for which OXERA has been asked to undertake the CBA, consist of two parts (hereafter referred to as Part 1 and Part 2):

- Part 1: a narrower re-casting of the range of goods and services permitted under both bundling and soft commission arrangements—specifically to prohibit the bundling or softing of market pricing and information services (mainly screen-based services).

- Part 2: making fund managers directly responsible for paying the cost of any additional services they obtain in connection with trade execution (ie, through softing or bundling). The policy would still allow the additional services to be provided through bundling or softing arrangements and priced into the rate or amount of broker commission charged to the fund. In that case, the fund manager would be required to determine the pro-rate cost to customers (ie, the funds) of the additional services and to repay an equivalent amount to the funds. It would be left to market forces to determine if the costs of services should be recovered through an increase in the management fee, or some other explicit charge.

Parts 1 and 2 would apply equally to both softed and bundled services, and to both 'institutional' (eg, pension funds) and 'retail' (eg, unit trusts, life policies) funds under management.[6]

1.3 Methodology

24. This CBA assesses the incremental change in costs and benefits of the FSA policy propositions compared with the current situation—ie, the regulation of bundled brokerage services and soft commissions under the existing rules and guidance.

[6] It should be noted that in practice the distinction between institutional and retail is blurred, and different definitions are often used. For the purpose of this CBA, 'institutional' funds means pension funds and other funds ultimately held by institutional clients. 'Retail' means authorised unit trusts and open-ended investment companies (OEICs), as well as life assurance funds, etc. However, in practice both institutional and retail clients may invest in these 'retail' funds. Also, fund managers responsible for both institutional and retail funds may choose to treat them all as institutional assets. In this context, 'retail' does not refer to the 'pure' retail market, ie, private investors using retail fund managers and retail brokers.

Following the FSA's standard approach to CBAs, policy propositions are assessed on the basis of six categories of market impact:[7]

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

25. It was agreed that the FSA itself would quantify the direct costs to the regulator, and that OXERA would address the other five market impact categories. A further assumption that OXERA was explicitly asked to make for the purpose of the CBA is that there is a general 'compliance culture' in the industry. That is to say, once any new rules are clearly defined and issued by the FSA, market participants can be expected to adhere to these rules. Thus, the CBA focuses on the FSA's costs of implementing the new rules and the industry's costs of complying with them. It does not focus on costs that might arise from non-compliance, such as costs of detailed inspections and legal disputes.

26. The CBA is supported by different sources of information, part of which are the same as for the OXERA report on bundled brokerage and soft commissions, including the following.

- In-depth industry interviews—interviews were conducted with a number of fund managers, insurance companies, brokers, third party service providers and industry experts. These interviews focused mainly on the identification of compliance costs and the usage of bundled and softed services. Specific interviews were also held regarding the retail market. This is because the policy propositions apply equally to institutional and retail markets, whereas the main focus of the OXERA report on bundling and softing was on the institutional market.[8]

- Data analysis—for the report on bundling and softing, OXERA analysed data on brokers and fund managers from FSA databases and from other public sources, such as the London Stock Exchange, the National Association of Pension Funds (NAPF), industry journals and web sites. Part of this data was also used for the CBA. In addition, for this CBA OXERA obtained further information on the research market from McKinsey and the Adam Smith Institute.

[7] See FSA (2000), 'Practical Cost-Benefit Analysis for Financial Regulators', Central Policy, version 1.1, June.
[8] This was in accordance with the FSA's terms of reference for the report, and can be explained by the fact that the Myners report had also focused on pension funds rather than on retail funds.

- Industry survey—for the report on bundling and softing, OXERA designed three separate questionnaires for pension funds, fund managers and brokers.[9] The main objectives were to obtain quantitative evidence to underpin the economic analyses of competition, bundling and soft commissions; to estimate the order of magnitude of bundling and soft commissions; and to test the various hypotheses and statements that have been made about these practices. Some of the results of these surveys have also been used for the present CBA.

27. Section 2 of this CBA describes the underlying market dynamics that are of relevance to the FSA's policy propositions. In particular, it explains how Part 1 and Part 2 have the effect of forcing fund managers to recover the costs of certain services that are currently bundled or softed via the management fee (or another separate charge), rather than via the pass-through of commission costs. This gives fund managers incentives to assess carefully value for money when purchasing those services.

28. Sections 3 and 4 present the costs and benefits of Part 1 and Part 2, respectively. Both sections are structured along the lines of the six market impact categories. The assessment of Part 2 assumes that Part 1 is also implemented, ie, market and price information services are no longer available under bundling or softing. Section 5 discusses the interactions between these two policy propositions.

[9] Details on how this survey was undertaken are given in the OXERA report. In short, questionnaires were sent to 30 pension funds (9 responses), 60 fund managers (25 responses) and 37 brokers (10 responses). The respondents to these questionnaire represented 6% of the UK pension fund market (as measured by fund value), 34% of the UK fund management market (as measured by value of funds under management) and 28% of the UK broker market (as measured by broker revenues). The survey results are therefore considered robust. Any deviations from these totals in diagrams and tables in this CBA reflect the fact that not all questions were completed by all respondents.

2. Underlying Market Dynamics of Relevance to the Policy Propositions

29. To assess the implications of the FSA's policy propositions, it is important to understand some of the market dynamics that underlie the relationships between brokers, fund managers and funds. Market dynamics are analysed in detail in the OXERA report. This section focuses on the way fund managers recover the costs of bundled and softed services, and how the policy propositions will affect cost recovery. The section also addresses the fundamental differences between trade execution services, on the one hand, and additional bundled and softed services, on the other. The FSA's policy propositions take account of these differences.

2.1 Cost pass-through by fund managers to institutional funds

30. It is well recognised (for example, in the Myners report) that there is an incentive misalignment between fund managers and their clients. This problem arises because an agent (in this case, the fund manager) has only a partial stake in the profitability of the enterprise of a principal (ie, the fund), whereas the costs to the principal of perfectly monitoring the agent's activities and performance are prohibitive.

31. The costs of fund management are typically recovered from institutional funds through two types of charges:

- the management fee; and
- the pass-through of broker dealing costs.

32. The management fee typically covers all costs incurred by fund managers except dealing costs. It is expressed as a percentage of the value of the fund and agreed in advance for the duration of the contract between fund manager and fund. In contrast, the dealing costs are directly deducted from the value of the fund when incurred. These costs are not specified in advance, but rather depend on commission rates and trading volumes, both of which are left to the discretion of the fund manager. Under the current system, all bundled and softed services are, by definition, paid for through commission rates, and hence are also directly passed through to the funds. Thus, the practices of bundling and softing may exacerbate the incentive misalignment problem between investor and fund manager.

33. In the 'institutional' market, management fees and commission costs are subject to different levels of scrutiny by funds, and this difference has important implications for both Part 1 and Part 2 of the FSA's policy proposition, as further explained below.

34. The management fee is a factor in the decision made by institutional clients to hire specific fund managers (together with past performance, expertise and reputation of fund managers). The commission rates negotiated by fund managers could in theory also play a role in this decision. However, the OXERA pension fund questionnaire shows that funds consistently rank management fees higher than commission rates in the list of factors they take into account when selecting fund managers. Therefore, in the fund manager selection process, there is direct

competitive pressure on the management fee, but less so on the commission rates.[10]

35. The monitoring of fund managers' performance is an implicit way of monitoring commission costs. These costs are deducted from the value of the fund and therefore affect its performance. All other things being equal, the higher the commission costs, the worse the fund performance. Indeed, the OXERA pension fund questionnaire and several other sources indicate that the past performance of the fund is an important reason for selecting a specific fund manager, and for switching fund managers.

36. However, this monitoring system is far from ideal. Commission costs are relatively small compared with the value of the fund, and therefore do not necessarily affect the fund performance in a way that is visible to clients. There is a considerable degree of 'noise' surrounding fund performance which can hide the commission costs—fund performance is subject to random variations and variations related to the performance of the fund manager.

37. The following example demonstrates that an increase in commission costs has only a small impact on fund performance and is therefore difficult to monitor. In a typical fund under active management, with a turnover (trading) rate of 40%, a large increase in commission rates of, say, 40% would result in a reduction in fund performance of only around 2bp.[11] Likewise, a large increase in turnover from 40% to, say, 60% would result in a reduction in fund performance of only 3bp. Random variations in fund performance caused by differential performance in the individual equities held are likely to make such small changes difficult, if not impossible, to identify.[12] Finally, it should be noted that, even if the commission costs were to have a significant effect on performance, contracts between fund and

[10] The larger institutional funds and insurance companies also have the option of appointing in-house fund managers, which puts further competitive pressure on fund managers and management fees.

[11] Assume the value of the fund is £200m, the turnover 40% per year, the commission rate 14bp, the management fee 28bp and the gross return 7.5%. This is a hypothetical example—the OXERA paper contains further sample calculations that result in similar orders of magnitude. The commission rate of 14bp is the average commission rate in 2001 as calculated from the OXERA fund manager questionnaire and the management fee is typical of the level found for 2001 in the OXERA survey of pension funds; the 40% turnover figure is taken from Brealey and Neuberger (2001), 'The Treatment of Investment Management Fees and Commission Payments: An Examination of the Recommendations contained in the Myners Report', Fund Managers Association. The total dealing costs then amount to £112,000 (£200m × 40% × 14bp) and the management costs £560,000, resulting in a net return of 7.164% (ie, the sum of dealing and management costs is equal to 0.336% of the initial value of the fund). This net return drops to 7.14% if the commission rate increases by 40% from 14bp to 20bp. A scenario for a smaller fund gives similar results. Assume that the value of the fund is £50m, the turnover 40%, the commission rate 14bp, the management fee 47bp and the gross return 7.5%. This means total dealing costs amount to £28,000 (£50m × 40% × 14bp) and management cost to £235,000. The net return is then 6.97% (ie, the sum of dealing and management costs is equal to 0.53% of the initial value of the fund). This net return drops to 6.95% if the commission rate increases by 40% from 14bp to 20bp.

[12] This is not to say that the impact of *total* commission costs on overall fund performance is so small that it is not worth placing it under regulatory scrutiny—a view expressed by several market participants—since the total value of commissions received by UK brokers is far from trivial (see below). Rather, the above example illustrates that the effect of commissions on the performance of *individual* funds is difficult to monitor.

fund manager will generally only be terminated if there is substantial evidence of underperformance over a longer period.

38. To summarise, given that the monitoring of commission costs is not optimal, a cost pass-through could result in total commission costs being too high from an economic welfare perspective, either because of excessive levels of trading (a point addressed in sub-section 3.3.2), or because of an excessive usage by fund managers of softed and bundled services.

39. Part 1 implies that market and price information services can no longer be softed or bundled, and hence that fund managers can no longer pass on the costs of these services via commission costs. Instead, fund managers would have to recover the costs of market and price information services through the management fee or another separate charge (that is, if they still find it worthwhile to incur those costs in the first place—see below). Part 2 implies that other services, besides trade execution, can still be bundled or softed, but that their costs would have to be reimbursed to the funds. Thus, fund managers would have to pay for these services themselves and seek to recover the costs through the management fee (or another separate charge).

40. As discussed above, management fees are more visible and subject to greater competitive pressure and scrutiny by funds. The result of both Part 1 and Part 2 is therefore that fund managers will not be able to pass on costs of services purchased besides trade execution to their clients as easily as they can at present through commission costs. This puts pressure on fund managers to consider more carefully than they do now whether the services acquired provide value for money, and to eliminate any excess consumption.[13]

2.2 Cost pass-through by fund managers to retail funds

41. The FSA's policy propositions will apply equally to institutional and retail funds. The Myners report, and the terms of reference for the OXERA report, focused mainly on institutional (pension) funds. This section therefore highlights briefly some of the key features of the retail market as compared with the institutional market. As noted above, it should be kept in mind that in practice the distinction between institutional and retail funds is blurred.

42. First, it is useful to consider the relative sizes of institutional and retail funds. Table 2.1 gives a breakdown of funds under management in the UK for December

[13] The above is not to say that fund managers currently do not consider value for money. Rather, it means that fund managers will have greater incentives to be careful about costs of services if they have to pay for these services in 'hard' money than if they pay for them through soft credits.

1999.[14] It can be seen that institutional fund managers represent over 85% of all funds under management in the UK. Within the category of institutional fund management, pension funds account for roughly 40%, insurance companies 44% and unit trusts and mutual funds around 8%.

Table 2.1: Funds under management in the UK, December 1999 (£ billion)

Holders of funds	Total value of assets (£ billion)	Proportion of total (%)	Proportion of institutional (%)
Pension funds	985	34.5	39.8
Insurance companies	1,094	38.3	44.2
Unit and investment trusts (net)	177	6.2	7.2
Money market mutual funds	28	1.0	1.1
Other	193	6.8	7.8
Institutional management total	*2,477*	*86.7*	*100*
Private client funds total	380	13.3	
All funds	**2,857**	**100**	

Source: International Financial Services (2001), 'Fund Management Brief', September.

43. In the relationship between brokers and fund managers—which is where soft credits and bundled services are generated—there is virtually no difference between institutional and retail funds. Most fund managers manage both types of funds. Trades on behalf of these funds are normally grouped in blocks. When these blocks of trades are sent to brokers, no distinction is made between institutional and retail funds—ie, neither the trading desk within the fund management firm nor the broker are informed at that stage (nor is it relevant to them) whether the underlying funds, on whose behalf the block of trade is sent, are retail or institutional.

44. For this reason, the OXERA report, despite a major focus on institutional funds, also obtained data on bundling and softing on behalf of retail funds. Specifically, when providing information on total commissions and soft credits in the OXERA questionnaires, the responding brokers and fund managers included information on retail as well as institutional funds (given that brokers consider fund managers as institutional clients, whether they manage institutional or retail funds). Hence, when determining the total orders of magnitude of bundling and softing, the OXERA report covers both retail and institutional funds.

45. A further similarity is that insurance companies—which represent the major part of all retail funds—also frequently engage external fund managers to manage their

[14] More recent data have not been obtained. The source, International Financial Services (2001), is frequently quoted by other studies as well. The total values in the table are likely to have changed in the last three years, but the relative proportions may have changed relatively less.

portfolios (sometimes these fund managers may form part of the same holding company, but a functional separation nevertheless exists). In this respect they have the same relationship with fund managers as pension funds do—ie, they will also closely scrutinise the management fee. Thus, in this segment of the retail market, fund managers will also find it difficult to pass on costs of services via the fund management fee (or another separate charge).

46. However, further up the value chain—ie, in the relationship between the retail fund and the ultimate retail investors—there is an important difference with the institutional market. This is the fact that retail investors are often unable to monitor effectively any type of charges, whether they be management fees, other up-front charges, or passed-on commission costs. In contrast with institutional funds, there is relatively little scrutiny on management (and up-front) fees. This is for a number of reasons.

- While there are regulatory requirements on unit trusts, OEICs, etc, to disclose charges, the awareness and understanding of these charges among retail investors is generally very limited.[15] Retail investors may also use independent financial advisers to assist them in selecting retail funds, but such advice is likely to be less effective in generating competitive pressure than, for example, the advice given by independent pension fund consultants to institutional funds.[16]

- Retail fundholders lack the effective bargaining power that pension fund trustees have in the institutional market. By regulatory requirement, unit trusts also have an appointed trustee. However, in practice, these trustees focus mainly on legal procedures and obligations of the funds. They normally do not bargain with the fund manager over management fees and other charges, nor do they remove fund managers for reasons related to performance or terms and conditions offered to the client (unlike pension fund trustees who sometimes remove underperforming fund managers).

- Insurance policy charges seem to be even less subject to scrutiny from investors because they have no appointed trustee, nor do they regularly disclose charges in as much detail.

[15] See, for example, James, K.R. (2000), 'The Price of Retail Investing in the UK', FSA Occasional Paper Series 6, February.

[16] This is because pension funds can generally be considered more sophisticated buyers of management services than retail investors. They are also better placed to judge the advice received from pension fund consultants and to make the most effective use of such advice in putting pressure on fund managers. In contrast, the advice provided to retail investors does not necessarily enhance their level of sophistication. As pointed out by Sandler, retail investors are not well placed to assess the costs and benefits of advice by intermediaries, nor is it always clear to them whether such advice is genuinely independent or influenced by the underlying product providers. Sandler, R. (2002), 'Medium and Long Term Retail Savings in the UK; A Review', July.

47. This difference in the level of scrutiny of management (and other) charges implies that, for retail funds, Part 1 may not have the same degree of impact as in the institutional market in putting pressure on fund managers to consider more carefully than they do at present whether services acquired in addition to trade execution provide value for money.

48. However, OXERA does not expect this to have a major impact on the reductions of excess consumption, which are estimated below in sections 3.3 and 4.3. Specifically, it is not likely that consumption of currently bundled and softed services will remain unchanged or that all the hard expenditure will be recovered on the retail side (ie, an increase in cross-subsidy from retail to institutional is unlikely), for three reasons:

- as explained above, in the relationship between brokers and fund managers the distinction between retail and institutional is largely irrelevant—ie, soft credits or bundled services are not obtained specifically for retail or institutional funds, but rather for the fund manager's business as a whole (and most managers of retail funds are also active in the institutional market);
- unit trusts and other retail investment funds still face some 'normative' pressure on charges. While there are no regulatory rules preventing them from doing so, providers of these retail products may decide on a commercial basis not to increase (or substantially increase) fees since they are aware of the current regulatory climate in which the terms and conditions they offer to customers are under scrutiny;[17]
- in the case of insurance funds, while policy-holders may have little protection against price increases by the insurance companies, those insurance companies can prevent cost pass-through by their external fund managers. Hence, fund managers are unlikely to be able to cross-subsidise previously softed and bundled services by increasing management fees (or other separate charges) to insurance funds.

2.3 Economic justifications for cost pass-through

49. In fund management contracts, principals give a sort of 'carte blanche' to the fund manager with respect to dealing costs—ie, pension funds delegate to the fund manager the negotiation of the commission rate with the broker and the determination of the volume of transactions. The main reason for not including the commission costs in the (fixed) management fee and instead giving the fund manager discretion is that the optimal level of turnover is difficult to predict in

[17] A clear example of this scrutiny is the Sandler report referred to above.

advance. The fund manager is generally in a better position to determine the optimal level of trading than the fund. Delegating this task to the fund manager is therefore likely to represent an efficient division of labour and result in a better resource allocation than in a situation in which trading levels had to be predicted in advance.

50. Including the commission costs in the management fee would require the optimal level of turnover to be predicted in advance.[18] The fund manager would then have fewer incentives to trade, as higher trading costs would erode its profits; it would have no incentive to trade more than estimated, even if this would contribute to a better performance of the fund. This is because the fund manager would have to bear all the costs of the extra trade while only receiving a fraction of the benefits (through the management fee and, where applicable, performance-related fees), which are likely to be lower than the cost of the extra trade. In other words, including a fixed amount of commission costs in the management fee could result in too few transactions and could affect the performance of the fund.[19]

51. However, under the current arrangements, the costs of bundled and softed services are also passed on to funds together with the commission costs. The argument of unpredictability of required consumption—which applies to trade execution services—cannot be readily applied to bundled and softed services. The OXERA report concludes that, of all bundled and softed services, only certain types of advice on trade execution and access to analysts may be difficult to predict in advance, since demand for these services may be closely related to the volume of trades undertaken (as further discussed in section 4.3). Therefore, there is little economic justification for the current practice of passing on costs of bundled and softed services together with the commission costs.

52. It is important to distinguish the pass-through of costs of additional services together with commission costs—a practice undertaken by fund managers—from the bundling of services by brokers. As discussed above, there is little economic justification for the former. Only the pass-through of trading costs themselves is justified because of the unpredictability of demand. However, as identified in the OXERA report, there are certain economic justifications for bundling of additional services by brokers. These justifications include economies of scope in production, reduced transaction costs for customers, efficient pricing methods and the technical difficulty of unbundling. Furthermore, they apply to a different extent to different types of bundled services.

53. The FSA's policy propositions take this distinction between bundling and cost pass-through, and their different economic justifications, into account. Part 1 and

[18] The Myners report proposes an all-inclusive fee which would include both the management fee and commission costs.
[19] This is a point made by Brealey and Neuberger (2001), op. cit. in response to the Myners proposal.

Part 2 have an impact on the passing-on of costs via the commission costs. These policy propositions create economically efficient incentives, in the sense that it is fund managers who ultimately must bear the costs of the softed and bundled services concerned. Rather than readily passing these costs on via commission costs, fund managers would have to recover them through the management fee (or another separate charge). At the same time, Part 2 does preserve the economic justifications of bundling, since it still allows services to be bundled or softed.

3. Costs and Benefits of Policy Proposition—Part 1

3.1 Direct costs

54. Estimates of the direct costs have been provided by the FSA, and are divided between one-off costs and ongoing costs. In both cases the magnitude of the direct costs involved is very small. The one-off cost is calculated on the basis of the requirement for the FSA to:

- communicate to the investment community the purpose of the policy and how to implement it;
- answer queries on how to implement the policy;
- ensure internal staff familiarisation with the policy.

With a monitoring team of around 200 staff and an estimated time spent on the above requirements of around 15 minutes per member of staff, based on the FSA's composite hourly charge of £52 per hour, the FSA estimates its total one-off cost at £2,600.

55. Ongoing costs will arise through the requirement for the FSA to monitor firms' compliance with the new rule. This will involve a small amount of time spent during supervisors' visits to firms ensuring that policies have been updated and that information services (ie, screens) are not on the list of available softed and bundled services.

56. The FSA's estimate of the ongoing direct costs assumes that there are around 1,000 relevant firms (brokers and fund managers), 60% of which have in place soft commission arrangements. The total incremental time required to monitor those firms comes to 120 hours per year. Based on the FSA's current composite hourly charge (see above), the FSA estimates the total annual ongoing costs at £6,240 per year.

3.2 Compliance costs

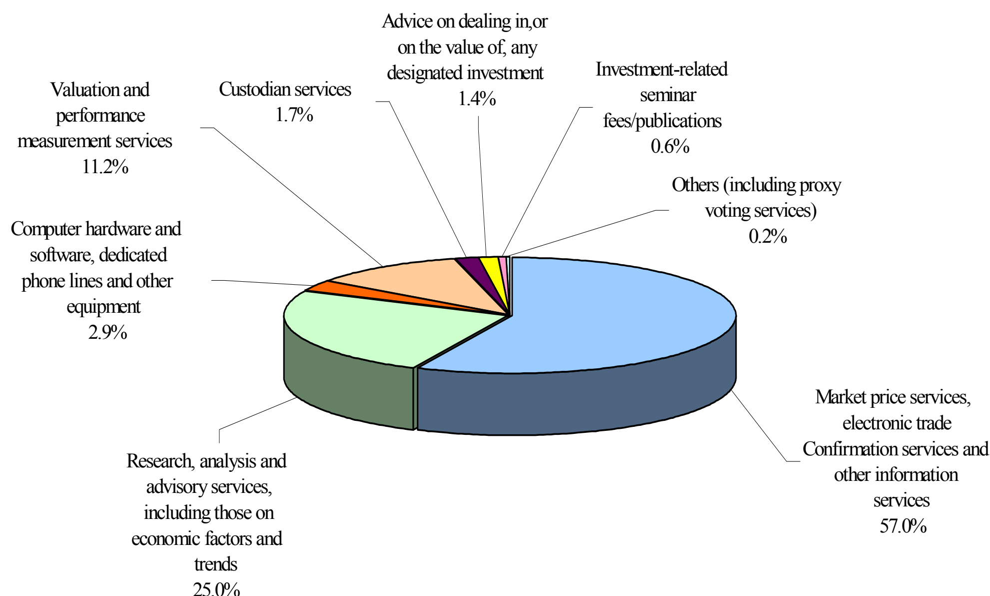
3.2.1 Overall effect of Part 1 on compliance costs

57. Part 1 applies equally to bundled brokerage and soft commission arrangements. However, the results of the OXERA survey show that market and price information services—at which Part 1 is targeted—are mainly obtained under soft commission arrangements, and only to a limited extent through bundling. Thus, for most firms, Part 1 is likely to have a greater impact on their cost of complying

with soft commission regulations than on their cost of complying with the regulations that deal with bundling.[20]

58. Figures 3.1 and 3.2 show the services obtained under soft commission arrangements. The data in Figure 3.1 is taken from the OXERA broker questionnaire. Of the credits, 57% are used to buy market price services, electronic trade confirmation systems and other information services (these are mostly Reuters and Bloomberg screens). This is consistent with the data in Figure 3.2—from the OXERA fund manager questionnaire—which shows that over 50% of soft commission credits are spent on market and price information services.[21]

Figure 3.1: Services provided by brokers under soft commission arrangements

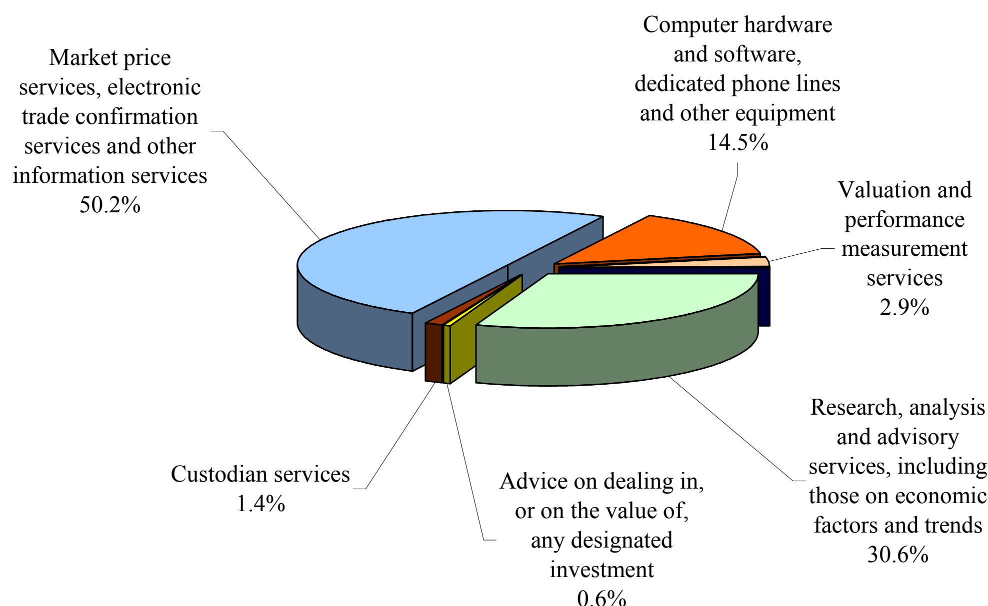


Base: Ten brokers.
Source: OXERA broker questionnaire, 2002.

[20] In the UK, both softing and bundling must be consistent with the general rule that a fund manager is not allowed to solicit or accept an inducement if it is likely to conflict to a material extent with any duty that the fund manager owes to its customers in connection with designated investment business. However, for soft commission arrangements, the FSA rules provide exemptions from the prohibition on inducements under certain conditions. For instance, the arrangement must be subject to written agreements, and only certain categories of services can be provided, such as electronic trade confirmation systems, market price services, research and computer hardware associated with specialised software or research services. Examples of costs that cannot be paid for under soft commission arrangements are employees' salaries, travel accommodation or entertainment costs, and seminar fees not relevant to the conduct of designated investment business.

[21] The proportion of soft credits spent on market and price information services could be higher in reality, since some respondents to the questionnaires may have included (part of) the expenditure on Bloomberg and Reuters screens under the category 'computer hardware and software'.

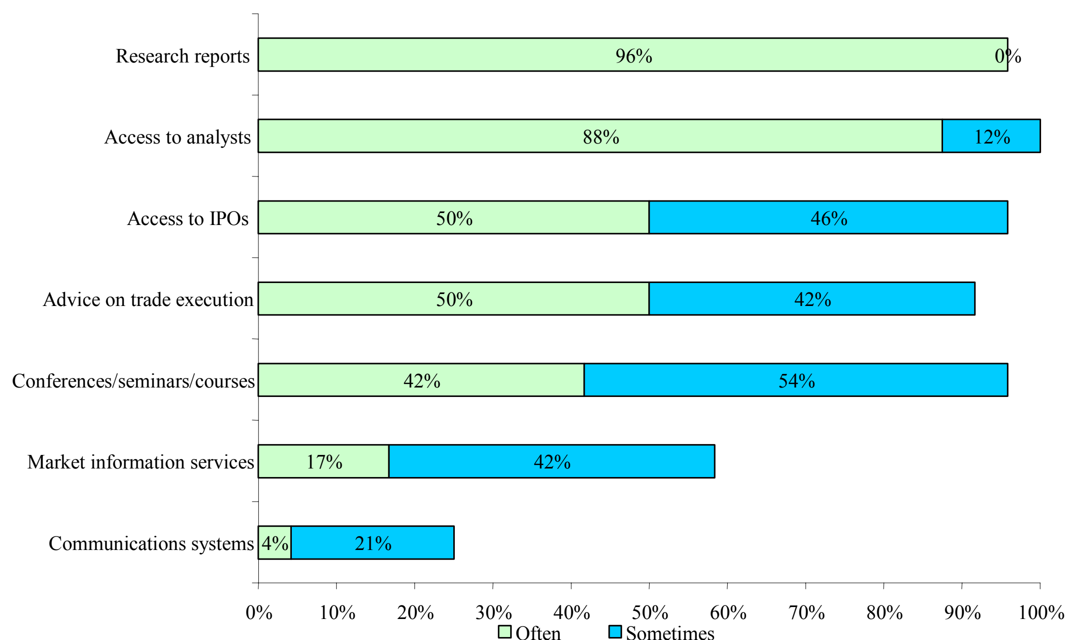
Figure 3.2: Services bought by fund managers under soft commission arrangements



Base: 16 fund managers.
Source: OXERA fund manager questionnaire, 2002

59. In contrast, Figure 3.3—which is based on results from the fund manager questionnaire—shows that only 17% of fund managers 'often' obtain market information services as part of a bundle with trade execution (another 42% 'sometimes' obtain these services in this way). Other services, such as research reports, access to analysts, advice on trade execution, access to IPOs and conferences, seminars and courses, are more commonly bundled. The broker questionnaire results (not illustrated here) also confirm that relatively few brokers offer market and price information services in a bundle, and then only to fund managers who generate large volumes of trade.

Figure 3.3: Bundled services received from brokers by fund managers



Base: 22 fund managers.
Note: Although access to IPOs is regularly provided to fund managers as part of the overall package of bundled brokerage services, the regulations under consideration in this paper would not change or affect this. The issue of access to IPOs is being looked at separately by the FSA.
Source: OXERA fund manager questionnaire, 2002.

60. A distinction can be made between one-off and ongoing compliance costs caused by Part 1. One-off costs for firms will include any incurred as a result of starting to comply with the new regime. The ongoing costs for firms will include those incurred in continuing to comply with the new regime.

3.2.2 One-off costs

61. The systems currently in place to ensure compliance with the rules on bundling and soft commissions are similar for fund managers and brokers. A typical arrangement involves the use of a list of approved services and vendors, monitored by compliance departments or officers. Different firms have systems with different levels of sophistication. However, all these systems share a number of basic features, which are assessed below.

62. For a fund manager, services purchased under soft commission arrangements are usually purchased centrally, according to whether any given service has been included on the list of approved services. This list is typically controlled by a compliance officer. Once a service has been approved, the decision to purchase that service using soft credits is then a matter of routine. Furthermore, irrespective of whether a service is purchased with soft credits, there is normally some sort of expenditure approval process at any rate, involving an authorised person or board member signing off the required expenditure. When a ‘new’ service is proposed for inclusion on the list of approved services, a series of evaluations takes place to establish whether that service can be provided under soft commission arrangement. Such evaluations involve staff from the compliance departments who may also draw upon advice from in-house legal experts.

63. With regard to bundled services, there may not always be an explicit list of products that can be obtained (since, as discussed in the footnote above, the rules on bundling are currently defined in a more general way than those on softing). However, in practice, the procedures in place within fund management firms for bundling will be similar to those for softing—ie, ultimately, the compliance department will verify which services can and cannot be obtained from brokers.

64. As to brokers, unless a service is included on their list of approved services, they will not pay any invoices for that service on behalf of the fund manager using soft credits. However, in an established commercial relationship with a fund manager, it is highly likely that any services to be purchased using soft credits, or offered in a bundle, have already been approved by the broker. In the case that a 'new' service requires approval, the brokerage firm undertakes a parallel set of discussions to those that are undertaken by the fund manager.

65. The one-off costs resulting from the implementation of Part 1 will be dominated by the requirement for fund managers and brokers to familiarise themselves with the new rule, and to review and amend their lists of approved services in their systems. The new rules may also have to be communicated across the firm. This will involve updating internal compliance guidelines/handbooks and informing relevant staff of the change to the rules. Such change in the list of approved services is likely to be straightforward and will not require any major alterations to the way companies currently comply with the rules.

66. In all, on the basis of interview evidence, it is estimated that each fund management and brokerage firm will need to devote at most seven person-days to adjusting internal systems. Six of these are primarily borne in the compliance department. This is likely to be an overestimate of the amount of resources required. Additionally, an estimate of the involvement of internal legal staff is that an in-house legal expert will be required for one day in order to oversee and ensure that the changes to internal systems are compatible with the new rules. Finally, a 10% overhead allowance is made for any management and other staff input that may be required in this process. Table 3.1 shows the total one-off compliance cost of Part 1 for all brokers and fund managers, which is estimated at around £3.3m.

Table 3.1: Total one-off compliance cost (Part 1)

Item	Cost
Annual salary of compliance officer	£40,000[1]
Resource required for compliance (one-off)	6 person-days
Annual salary of in-house lawyer	£60,000[1]
Resource required for compliance (one-off)	1 person-day
Days worked per year	240
One-off compliance cost per firm	around £2,750[2]
Total number of brokers and fund managers	1,200[3]
Total one-off compliance cost to industry (all brokers and fund managers)	around £3.3m

Note: [1] Staff costs taken from FSA Consultation Paper CP153 (October 2002), Annex A. These figures are also consistent with the findings of previous OXERA studies. [2] A 100% mark-up has been applied to the salary costs of the staff involved in the compliance process to cover overhead costs. A further 10% mark-up has been applied to take account of possible management input. £2,750 = 200% times 110% times the sum of 6/240 times £40,000 and 1/240 times £60,000. [3] In the OXERA report, analysis of data from the FSA indicated that there are around 700 fund managers and 500 brokers in the UK. This assumes that all brokers and fund managers partake in soft commission arrangements, while in reality this is not the case.
Source: OXERA calculations.

3.2.3 Recurring costs

67. Once the necessary changes have been made to the internal systems, those systems will continue to operate as at present. The only difference will be that screens are not included in the list of approved items to be acquired or paid for under soft commission arrangements or in a bundle. This difference does not cause any ongoing costs—ie, the systems will simply decline any requests for softing of market and price information services. For all other services, the internal compliance regime will function exactly as it does at present.

68. As such, the ongoing compliance costs caused as a result of Part 1 are likely to be negligible, if not zero.

3.3 Quantity of transactions

69. Restricting the range of services permitted under bundling and soft commission arrangements has two potential effects on transaction quantities, both of which are classified as benefits for the purpose of this CBA:

- as explained in section 2, excess consumption by fund managers of softed and bundled services may fall—in particular, fund managers may reduce demand for market and price information services once they can no longer obtain these services through softing or bundling; and
- fund managers may reduce excessive trading volumes once they can no longer obtain market and price information services in return for sending trades to brokers.

Both effects are explored in more detail below.

3.3.1 Reduced excess consumption of information services

70. If market and price information services could no longer be obtained via soft credits or in a bundle, would fund managers reduce expenditure on these services, and to what extent? This question is addressed below.

71. Fund managers typically determine their expenditure on market and price information services on an annual basis. However, the processes followed for these purchase decisions tend to differ across fund management firms. Some determine their total budget for these and other services completely separately—ie, independently of whether soft credits are available. Only at a subsequent stage is it then determined which part of the required services is paid for through soft credits and which in 'hard' cash. Other firms take the availability of soft credits more explicitly into account when deciding how much to spend on market and price information services.

72. Nevertheless, despite these differences in decision processes, it is conceivable that overall consumption of market and price information services will fall as a result of Part 1. In performing their activities, fund managers (and traders within fund management firms) generally like to have ample access to market and price information, and therefore place a high value on information services such as Reuters and Bloomberg screens. However, beyond a certain minimum amount of information, the marginal benefit of extra pieces of information diminishes. To give an example, a manager of a portfolio of Japanese equity will benefit greatly from having access to screen-based information (eg, from Bloomberg) on Japanese markets and stocks, so the marginal benefit of the first screen is large. However, the marginal benefit of having a second screen on the desk (eg, from Reuters) is already lower, since a large part of the information will be duplicated, even if there were sufficient time to absorb all information on both screens.

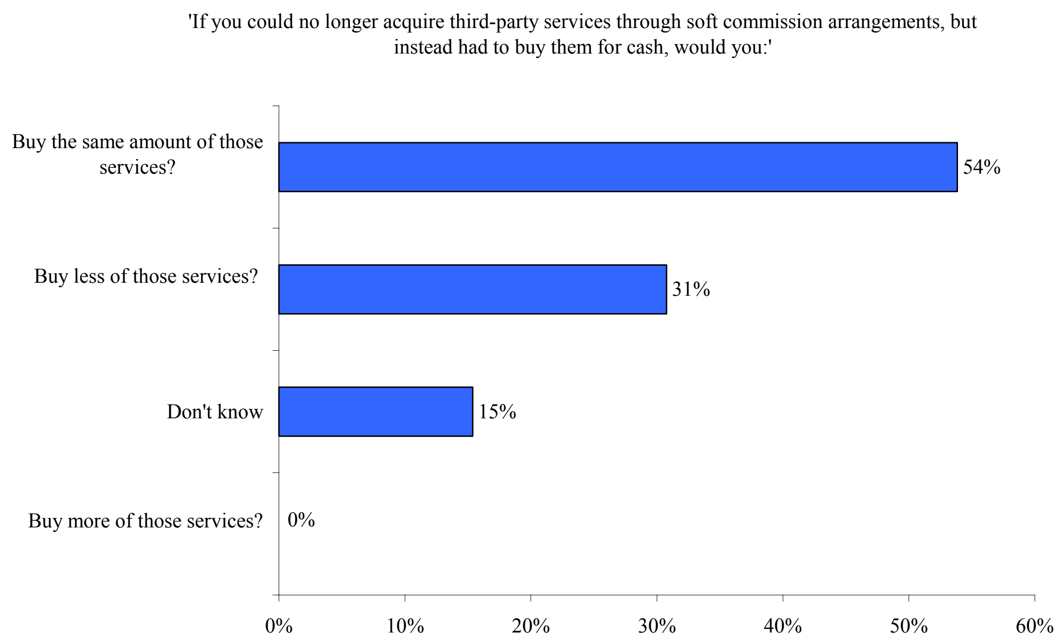
73. The marginal benefits must be compared with the marginal cost of the service. Part 1 has the effect of making the cost of Reuters and Bloomberg screens a 'hard' marginal cost (rather than one that can be readily passed on to clients). Therefore, demand for screens is likely to fall, at least marginally.[22]

74. This conclusion has been confirmed to OXERA in various interviews with market participants, and is backed up by evidence from the OXERA fund manager questionnaire. Fund managers were asked whether they would buy the same amount of softed services (including market and price information services) if they could no longer acquire these services through soft commission arrangements but instead had to buy them for hard money. Figure 3.4 shows the results: 54% of the fund managers would buy the same amount of soft commission services, but 31% would buy less. Furthermore, these 31% fund managers had more funds

[22] Below it is shown that even a marginal reduction in over-consumption will produce sufficiently large benefits to offset the costs of Part 1.

under management than average, indicating that it is the larger fund managers who would be more likely to cut their use of services currently obtainable using soft credits than would smaller fund managers.[23]

Figure 3.4: Evidence of excess consumption of softed services



Base: 13 fund managers.
Source: OXERA fund manager questionnaire, 2002.

75. As shown in Figures 3.1 and 3.2, between 50% and 57% of all soft credits are spent on market and price information services, as available via Reuters and Bloomberg terminals (these two companies are by far the largest providers of such services worldwide). The total amount of soft credits obtained by UK institutional fund managers can be derived from the total commission costs paid by those fund managers to brokers.

76. Data from the London Stock Exchange (2000)[24] indicates that, in 2000, total UK broker commission revenues from UK institutional fund managers amounted to £2.3 billion. This does not take into account the commission costs paid by UK fund managers to brokers outside the UK, which are also substantial and through

[23] The average value of funds under management of the 31% of respondents that indicated that they would buy fewer services was £45.5 billion. The average was £37.4 billion.
[24] London Stock Exchange (2000), 'Survey of London Stock Exchange Transactions 2000'. The survey of 2000 is the latest one available in the public domain.

which bundled services and soft credits are also obtained. No information is available to estimate this amount. Thus, it should be borne in mind that the following calculations substantially underestimate the total current consumption of market and price information services, and therefore also the benefits of Part 1 of the FSA's policy propositions.[25] Figure 3.5 clarifies these relationships between UK and foreign fund managers and brokers, and illustrates why the estimates of costs savings are conservative.

Figure 3.5: Relationship between brokers and fund managers in UK and abroad

	UK Brokers	Foreign Brokers
UK Institutional Fund Managers	*Total turnover: £3 trillion* *Total commissions: £2.3 billion*	*Value of turnover and commissions unknown.* *Cost savings here not taken into account in the analysis.*
Foreign Institutional Fund Managers	*Total turnover: £2.2 trillion* *Total commissions: £2.0 billion* *Not affected by either Part 1 or Part 2 directly, but possibly savings if UK brokerage services to foreign institutional clients change (secondary effect).*	*Not affected by either Part 1 or Part 2*

77. The OXERA report determined that a total of around 7% of all commission payments by UK fund managers to UK brokers are 'paid back' in the form of soft credits. Therefore, the total value of soft credits provided is estimated at around £160m, as illustrated in Table 3.2. Total annual expenditure with soft credits on screen-based services is around £90m. This number does not include costs of market and price information services obtained by fund managers through hard money or bundling (on which no further data is available). As noted above, this number also does not take account of soft credits obtained from non-UK brokers.

[25] This is consistent with OXERA's conservative approach to the CBA—ie, costs are more likely to be overestimated than underestimated, whereas benefits are more likely to be underestimated than overestimated.

Table 3.2: Total annual expenditure by UK fund managers on screen-based services via softing

Item	Detail
Total commission revenue of UK brokers from UK institutional fund managers	around £2.3 billion
Soft commission rebate as proportion of total commissions paid	around 7%[1]
Value of soft credits received through trades with UK brokers (7% of £2.3 billion)	around £160m
Proportion of soft credits spent on screens	57%
Value of expenditure on screens (57% of £160m)	around £90m

Note: [1] This figure is derived from the OXERA survey of fund managers (2001 data).
Source: OXERA calculations, based on LSE data (first row) and survey data.

78. The exact specification of the products provided by Reuters and Bloomberg is complex, and can be tailored to the needs of the individual user. In general terms, however, the products can be divided into the following categories.

- *Information services*—these include data bought from individual markets and exchanges and provided on an agency basis, as well as ‘fundamentals’ and historical corporate accounts and market price data. Examples are the Bloomberg Professional service and the Reuters 3000 Xtra package. Bloomberg and Reuters provide access to information from essentially the same range of markets and sources. Their products differ generally in the way that users access and interact with this information.

- *Analytical software*—this includes programs and packages available to process and analyse data, for example, programs to calculate a company’s weighted average cost of capital.

- *Trading and portfolio software and hardware*—the software enables fund managers to track and model portfolios, and place orders with brokers. Examples are Bloomberg’s ‘Portfolio Order Management System’ and the Reuters ‘Portfolio Management System’. The hardware consists generally of the networks and terminals required to transmit orders to brokers or communicate with them in the course of placing an order.

79. Specific usage of market and price information services is also likely to differ by type of user. For example, portfolio managers or researchers within fund management firms will often use the Bloomberg or Reuters analysis on historic data and ‘fundamentals’ as an input into their own decision-making and analysis processes. In contrast, traders within fund management firms (ie, those in charge of placing orders with brokers) are likely to use these screens mainly to obtain current market price data, and will make less use of the other data.

80. The basic screen-based package consists of a complete range of analytical software and access to historical market price data. In general, all users receive this functionality for a fixed price. They can then choose to access information from various exchanges and data providers, paying extra to access each of these sources. In addition, some users then opt to integrate this package with trading and portfolio software and hardware.

81. It is possible to adjust the scope of the content of the information accessible over the screens provided. As exchanges and data vendors charge for the data they provide, the cost of accessing data from each source increases the end cost of the information system. If Reuters and Bloomberg screens are used efficiently then each user will only tend to have access to the most essential data. For example, it would probably be an inefficient use of screens if, say, a trader in a fund management firm in charge of Japanese equities had paid for access to live data from markets worldwide.

82. It should be noted that anecdotal evidence suggests that, in recent years, many fund managers have already been cutting their use of market and price information services to some extent, in part by purchasing more tailored subscriptions along the lines described above. Part 1 is likely to reinforce this development. However, the way that the analytical and historic data access functionality is provided to (and paid for by) all users suggests that there is scope for expenditure reduction in this area. For example, as discussed above, staff at the trading desks tend to rely only on current market data and a narrower range of analytical functions.

83. Reductions in expenditure on market information services could take several forms—ie, reductions in:

- the total number of screens (ie, terminals for access to information services) by no longer purchasing both a Reuters and a Bloomberg screen for the same user;
- the total number of screens acquired from any one provider;
- the ability to access historical information (not all users require this);
- analytical functionality; or
- the range of information services obtained through any one screen (ie, subscriptions providing access only to data that is actually used).

84. A conservative estimate of the potential further marginal reduction in fund managers' expenditure on screens can be made as follows. Suppose such reductions only came from those 31% of fund managers who indicated a decrease in the use of services if they could no longer be bought with soft credits. It is not unreasonable to expect these firms to be able to reduce their consumption of screen-based services by a small proportion, say, around 10% (through any one of the five forms described above). Relative to the present total level of consumption of screen-based services, this indicates an overall reduction in consumption of at least 3% for fund managers as a whole. Table 3.3 shows the likely total annual cost saving (reduction in expenditure on screen-based services) as a result of Part 1, which is around £2.8m.

Table 3.3: Total annual cost savings (Part 1)

Item	Detail
Total UK fund manager expenditure on screens through softing (soft credits from UK brokers only)	around £90m
Percentage of fund managers indicating that they would reduce their purchase of third party services if they could no longer pay for them with soft commissions	31%
Likely reduction in expenditure on screens for these firms	10%
Overall annual reduction in expenditure on screens (£90m times 31% times 10%)	around £2.8m

Source: OXERA calculations.

85. It should be noted that the above cost saving is derived only from the expenditure on screens via soft commission arrangements. No account has been taken of any reduction in expenditure on screens acquired by fund managers through bundled brokerage services (this cannot be quantified with the information available at present). This is another reason why the overall reduction in expenditure shown in Table 3.3 is likely to be a conservative underestimate of the reduction.

3.3.2 Reduction in excess trading volumes

86. In principle, the more trades fund managers send to brokers, the more bundled and (where an arrangement exists) softed services they can expect to receive in addition to trade execution. Therefore, fund managers may have an incentive to overtrade their clients' accounts simply to generate more commissions. This practice is sometimes referred to as 'churning'.

87. The OXERA report has found no evidence on whether such churning prevails in practice. If anything, it was found that the total order of magnitude of softing (which is used more frequently than bundling to obtain information services) in the UK is relatively low. Fund managers soft on average about 10% of their trades, and a total of around 7% of all commission payments to brokers are 'paid back' in the form of soft credits. In theory, fund managers could obtain more credits by softing more trades (or lowering the agreed multiple), rather than by increasing the total amount of trades. One of the reasons why softing is not more prevalent may be that regulation places a limit on which services can be acquired with soft credits.

88. However, these findings do not preclude the possibility that bundling and soft commission arrangements may contribute to overtrading, and that the order of magnitude of softing may increase in future. Part 1 has the benefit of placing a stricter limit on which services can be acquired with soft credits, and hence will have the effect of reducing incentives to obtain more credits through overtrading. This benefit of the policy cannot be quantified at this stage.

3.4 Quality of transactions

89. The new rules on soft commission arrangements may have effects on the quality of trade execution and the quality of services offered by third party services providers. These two effects are described in this section.

3.4.1 Quality of information services

90. As explained above, under Part 1 fund managers are likely to become more cost-sensitive in their decision to acquire market and price information services. As a result they can be expected to put increased pressure on the providers of market and price information services to deliver better value for money—for example, by improving the quality of their products. Providers such as Reuters and Bloomberg are likely to be sensitive to such pressure since fund managers are an important customer group for them. Therefore, the quality of market and price information services offered in the market may increase.[26]

91. For the purpose of this CBA, such increase in quality can be considered a benefit of Part 1 of the FSA's policy propositions. The increase in the quality of information services may lead to a reduction in the labour input required for fund managers when accessing or processing information, and/or an increase in the effectiveness with which this information is used.

3.4.2 Trade execution quality

92. In addition to their effect on trading volumes (discussed in section 3.3), bundling and softing can also have an impact on quality of trade execution. In theory, fund managers may select brokers offering the most generous bundle of services or soft commission arrangements, rather than the highest execution quality.

93. As discussed in the OXERA report, for bundling this is less likely to be a concern, since those full-service brokers who are most active in bundling are also generally the larger brokers who are able to offer better liquidity and execution quality. Ie, fund managers are unlikely to use brokers who lack the capacity to handle difficult trades in order to obtain bundled services, and hence there should not be a major effect on execution quality overall.[27]

94. The concern with execution quality is more pertinent with respect to soft commission arrangements, as US evidence has demonstrated.[28] This is because fund managers often enter into soft commission arrangements with smaller, execution-only brokers, electronic trading networks or crossing networks. They could have an incentive to send both easy and relatively difficult trades to their soft commission brokers in order to obtain soft credits, despite the fact that other, larger brokers often have greater capabilities to execute difficult trades.

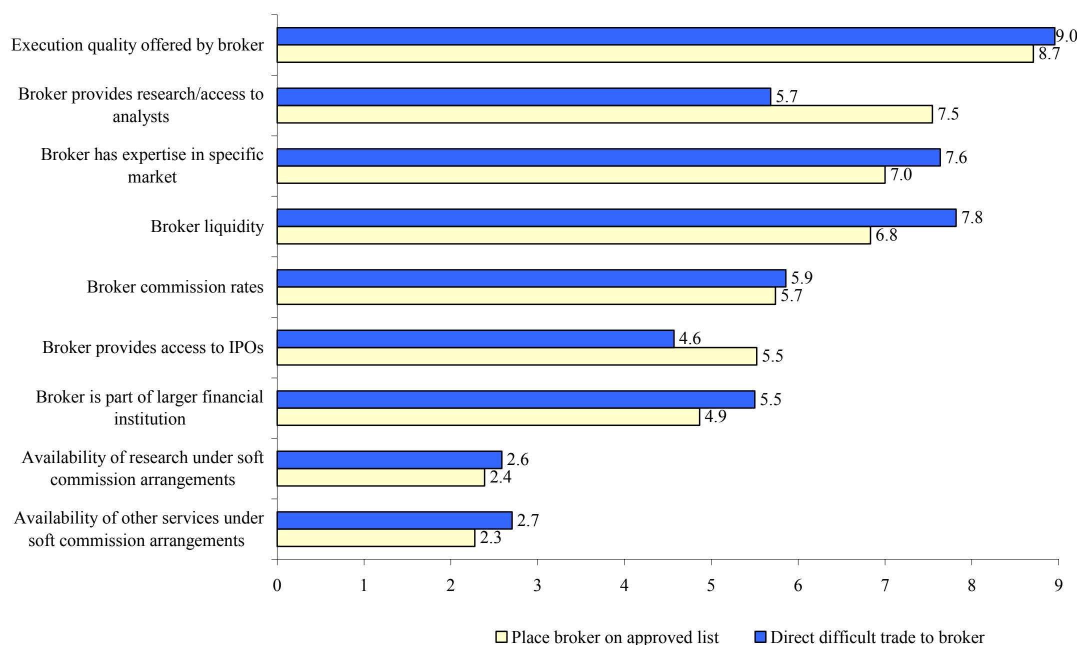
[26] It should be noted that no judgement is made on the current quality of market and price information services, which may be very high. The conclusion above only implies that there will be incentives to increase the quality even further, independently of existing quality.

[27] However, among the large full-service brokers there may also be differences in execution quality (for example, varying quality by type of equity). Hence, there may be some effect on execution quality if fund managers' selection of brokers is influenced by the bundling of services.

[28] See Conrad, J.S., Johnson, K.M. and Wahal, S. (2001), 'Institutional Trading and Soft Dollars', *Journal of Finance*, **51**:1, 397–416. This study shows that the execution costs of soft dollar brokers are generally higher than those of full-service brokers.

95. The OXERA report finds that the adverse effect of softing on quality of trade execution may in practice be limited in the UK. First, there are fewer specialised soft dollar brokers in the UK than in the USA, and fund managers frequently have soft commission arrangements with larger brokers as well. Second, the OXERA questionnaires indicate that quality of execution, expertise and liquidity are the most important factors for fund managers when choosing a broker (see Figure 3.6). When determining which broker to use for difficult trades, these factors receive even more weight, which suggests that difficult trades are generally sent to brokers who have more expertise and liquidity.

Figure 3.6: Ranking of factors determining fund managers' decisions to use a certain broker (10 = most important; 1 = least important)



Note: Market and price information services are included in the category of 'other services under soft commission arrangements'. *Base*: Between 19 and 24 fund managers.
Source: OXERA fund manager questionnaire, 2002.

96. Nevertheless, the above findings do not fully discard the possibility that bundling and soft commissions affect execution quality. Indeed, Figure 3.6 shows that bundled research and access to analysts is an important factor to fund managers when placing brokers on their approved lists, although less so when selecting brokers for difficult trades. Part 1 has the benefit of reducing the likelihood of such effects, by creating the correct incentives for fund managers. Specifically, by restricting the range of services permitted under bundling and soft commission arrangements, Part 1 limits the incentive on fund managers to send trades to the most generous broker rather than to the broker offering the highest execution quality. This benefit cannot be quantified at this stage.

3.5 Variety of transactions

97. The variety of market and price information services offered in the market can be expected to increase for the same reason that the quality of those services may

improve (as discussed in section 3.4)—ie, fund managers are likely to become more cost-sensitive in their decision to acquire market and price information services. For example, they can be expected to demand more tailored (and cheaper) services besides the full-service package as well as subscriptions with access to a more limited amount of information, or to different information for different users within the firm.

98. In the market there is already a certain movement towards such rationalisation of usage by fund managers and pressure on providers of market and price information services to offer a greater variety of service options. A benefit of Part 1 of the FSA's policy propositions is to further reinforce this market development (although, again, one that is difficult to quantify at this stage).

3.6 Efficiency of competition

3.6.1 Effects on competition in the market for fund management

99. Part 1 has the effect of increasing competition in the market for fund managers, leading to greater efficiency and lower total management costs paid by funds. This benefit is explained below. The increased competition may affect smaller or less efficient fund managers, but, as also explained below, this potential cost is outweighed by the benefit of increased competition.

100. Under Part 1, fund managers would have to pay for the costs of market and information services in hard money, and would thus have to seek recovery of those costs (if still incurred) through the management fee (or another separate fee). As explained in Part 1 and discussed in the OXERA report, these fees are subject to closer scrutiny by funds than the commission costs. As a result, under Part 1 a larger part of fund management costs is subject to competitive pressure than currently.

101. On the other hand, as explained in the OXERA report, some market participants have argued that soft commission arrangements are of particular relevance to smaller fund managers who may not have extensive in-house research capabilities and may not be able to benefit from the economies of scale (eg, in overhead costs, including market and price-information services) as larger fund managers. At present these smaller fund managers benefit from bundling and, more importantly, softing because they can buy external services—including market and price information services—and pass on the costs of these services via commission costs, rather than through the management fee. This makes it easier for them to compete with larger fund managers on fees.

102. Under Part 1, the competitive position of smaller fund managers might be affected if market and price information services represented a relatively larger proportion of their overhead costs, and hence their management fee would have to increase by more if those costs are to be recovered. However, the cost of screens is likely to be closely linked to the size of the fund manager—ie, the number of screens purchased will depend to a large extent on the number of portfolio managers and traders in the firm. This implies that larger and smaller fund managers would be equally affected by Part 1. Furthermore, even if smaller fund managers were relatively more affected by Part 1, this is not necessarily sub-optimal from an economics point of view. That is, if soft commission arrangements are needed to

maintain the viability of smaller fund managers, these firms must necessarily be less efficient than their competitors. Thus, Part 1 would only drive inefficient fund managers out of the market—efficient fund managers would not be affected.

103. Furthermore, the OXERA report shows that the market for fund management would probably remain highly competitive even if a number of smaller players were to exit the market. For example, the UK fund management market is currently characterised by a very large number of players (around 700), a low degree of concentration, competitive pressure from fund managers overseas, low regulatory barriers to entry, relatively low switching costs for institutional funds, and management fees that do not appear to be especially high relative to those in other countries.

104. For the above reasons, any effect of Part 1 on smaller fund managers cannot be considered a cost for the purpose of this CBA.

3.6.2 Effects on competition in the market for brokerage services

105. Part 1 has the effect of increasing competition in the market for brokerage, leading to greater efficiency and better value for money of brokerage services provided to fund managers. This benefit is explained below. The increased competition may affect smaller, execution-only brokers, but, as also explained below, this potential cost is outweighed by the benefit of increased competition.

106. As explained in the OXERA report, soft commission arrangements may make it easier for execution-only brokers to compete with full-service brokers. Full-service brokers provide fund managers with a bundle of services consisting of trade execution, access to analysts, research and other services. Softing allows smaller brokers to offer a range of services similar to (or even more extended than) that offered by full-service brokers, without having to produce those services in-house.

107. Restricting the range of services permitted under soft commission arrangements may therefore disadvantage execution-only brokers compared with full-service brokers. However, this potential cost of Part 1 is likely to be limited, for three reasons:

- while softing may give smaller brokers a certain competitive edge, it is not clear that their livelihood depends on it. Only some anecdotal evidence has been obtained on execution-only brokers who claimed that soft commission arrangements offset their competitive disadvantage relative to full-service brokers. Furthermore, even if a few smaller brokers would exit the market, a sufficiently large number of other brokers would remain to maintain a reasonable degree of competitiveness. As found in the OXERA

report, the UK broker market is characterised by a large number of players (around 500) and a low degree of concentration (except in the market for ‘difficult’ equity trades, for which there are fewer providers).

- Part 1 only prohibits market and price information services. This means that execution-only brokers can still compete through softing (and bundling)[29] of other services, such as research.
- As discussed in section 3, Part 2 of the FSA’s policy proposals will have a particularly strong effect on bundled brokerage services. In particular, it is likely to reduce some of the competitive advantage of being able to offer bundled brokerage services. Hence, if Part 1 is implemented in conjunction with Part 2, this cost of Part 1 is likely to be negligible.

3.6.3 Effects on competition in the market for information services

108. The market for screen-based information services is dominated around the world by only two players: Reuters and Bloomberg. Part 1 will not change this high market concentration. However, it will have the effect of incentivising fund managers to scrutinise carefully their purchases of market and price information services, and thus to put pressure on the providers of these services. This increased buyer pressure on Reuters and Bloomberg may bring down prices, as well as increase product quality and variety (as discussed in sections 3.4 and 3.5, respectively). This has the beneficial effect of improving fund management efficiency and reducing the total management costs paid by funds. It is difficult to quantify this benefit.

3.7 Summary of costs and benefits

109. Table 3.4 summarises the costs and benefits of policy proposition Part 1. Virtually all costs have been quantified. (The only cost that has not been quantified—ie, the effect on the competitiveness of small, execution-only brokers—is likely to be low, and even negligible if Part 2 is also implemented.) Many of the benefits of the policy cannot be quantified; all that can be said is that Part 1 creates the correct incentives on market players for these benefits to be realised. Only one type of benefit of Part 1—ie, the reduction in excess consumption in market and price information services—can be roughly quantified.

110. However, the likely order of magnitude of this benefit is already such that the costs of Part 1 are outweighed. The regulator’s direct costs are estimated at £2,600 on a one-off basis and at £6,240 per year on an ongoing basis.[30] There is likely to be a one-off compliance cost to the industry in the order of £3.3m. Against this,

[29] Indeed, execution-only brokers seem increasingly to be offering in a bundle additional in-house services, such as research, thus matching the product offering of full-service brokers.

[30] The regulator’s direct costs were estimated by the FSA.

the estimated saving in total consumption of information services comes to at least around £2.8m per year—ie, only a small, marginal decrease in fund managers' expenditure on Reuters and Bloomberg is required to offset the costs of Part 1. These estimates for the CBA are conservative, in the sense that costs are more likely to be overestimated than underestimated, whereas benefits are more likely to be underestimated than overestimated.

Table 3.4: Costs and benefits of Part 1 of the policy proposition

Market impact	Type of cost	Magnitude	Type of benefit	Magnitude
Direct costs	Design and implementation	£2,600 (one-off)	n.a.	n.a.
	Ongoing costs	£6,240 per year	n.a.	n.a.
Compliance costs	One-off compliance costs to brokers and fund managers	Around £3.3m	n.a.	n.a.
	Ongoing compliance costs to brokers and fund managers	Close to zero		
Quantity of transactions	n.a.	n.a.	Reduction of excess consumption of market and price information services—leads to reduction in total management costs paid by funds	Around £2.8m per year
			Reduction in excessive trading—leads to better execution quality and reduction in total management costs paid by funds	Not quantifiable; incentives in the right direction
Quality of transactions	n.a.	n.a.	Providers of information services may increase product quality—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
			Increase in quality of trade execution	
Variety of transactions	n.a.	n.a.	Providers of information services may increase product variety—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
Efficiency of competition	Small fund managers disadvantaged	No economic cost	Increased transparency and hence increased competitive pressure on fund managers (in particular for institutional funds)—leads to reduction in total management costs paid by funds	Not quantifiable; incentives in the right direction
	Execution-only brokers disadvantaged	Likely to be low; negligible if implemented in conjunction with Part 2	Increased pressure from buyers on screen providers—leads to reduction in total management costs paid by funds	

Note: n.a. = not applicable.
Source: OXERA.

4. Costs and Benefits of Policy Proposition—Part 2

4.1 Direct costs

111. Estimates of the direct costs have been provided by the FSA, and are divided between one-off costs and ongoing costs. In both cases the magnitude of the direct costs involved is very small. The one-off costs for Part 2 are calculated on the same basis as that for Part 1. However, because of the relative complexity of Part 2, the FSA estimate that the time required per member of staff in the monitoring team will be 30 minutes (as opposed to 15 minutes under Part 1). Based on the FSA's composite hourly charge of £52 per hour, the FSA estimates the one-off cost for Part 2 at £5,200 per year.

112. Ongoing direct costs for Part 2 arise through the requirement for the FSA to answer enquiries from affected firms and to ensure during monitoring visits that the systems in place are satisfactory for compliance with Part 2. Owing to the relative complexity of Part 2, the FSA estimate that the ongoing direct costs for Part 2 will be around two to three times higher than those for Part 1. Rounded up, this implies an ongoing direct cost of between £12,000 and £18,000 per year.

4.2 Compliance costs

4.2.1 Overall effect of Part 2 on compliance costs

113. Part 2 of the policy proposition will compel fund managers to refund to their clients the costs of any bundled brokerage services they receive or of any soft credits they generate.

114. For softed services, the identification of costs is relatively straightforward because fund managers already know what they pay for softed services (ie, they receive the invoices).

115. For bundled services, however, fund managers will need to determine how much of the commission paid represents the costs of trade execution, and how much the costs of additional services obtained. This is likely to require the cooperation of brokers, who are able to provide that information. For the purpose of this CBA, it is assumed that fund managers succeed in obtaining the necessary information. A further assumption is made that the arrangement by which the breakdown of bundled brokerage costs is negotiated takes place during the normal course of the negotiations that take place on a regular (ie, at least annual) basis between brokerage and fund management firms. This therefore assumes that there is no significant additional 'negotiation' cost in achieving the desired outcomes.

116. Brokers could break down their costs in one of two ways:

- they could specify in their invoices to fund managers what the total commission rate was in bp (say 15bp), and then also specify a rate that reflects the cost of 'pure' dealing (say 10bp). Fund managers can then use the difference between the two rates to infer the total cost of services obtained in addition to trade execution;

- alternatively, they could specify the total commission rate (say 15bp), and then separately specify in monetary terms the cost of the bundled non-dealing services (say £200,000). This directly gives fund managers the amount to be reimbursed to funds.

117. Another possible market outcome is that fund managers decide to buy only trade execution services from some of their brokers (at say 10bp), rather than the full bundle. This effect on the total consumption of bundled services is discussed further in section 4.3.

118. Compliance costs for fund managers and brokers will have significantly different causes. These are discussed in turn below.

4.2.2 Fund managers

119. The majority of the one-off compliance costs for fund managers will arise from two operational requirements:

- the need to identify the costs of soft credits and the bundled services received. Identifying the costs of soft credits received will be a simple matter—most fund managers do this already. The identification of the costs of bundled services received will also be simple as long as brokers supply an accurate breakdown of the costs of the bundled brokerage services that they have provided.

- the need to apportion the costs of the services (bundled and softed) received between clients. It is likely to be impossible to assign the benefit of such services to each client on a precise basis. More likely is an apportionment between clients in a similar way to the allocation of overheads as charges—for instance, in proportion to the value of funds held or to the value of trades sent on behalf of funds.

120. Both of these measures will require a one-off change to the accounting system of each fund manager. This change is likely to be relatively simple, so a conservative (high) estimate of the cost of the change to this system is as follows below. First, a requirement for one month of a programmer's time (in-house) is assumed in order to adjust the accounting system. Next it is estimated that two days will be spent by an in-house legal expert (or compliance officer) in reviewing the compatibility of the changes to the internal systems with the new rule.

121. Little additional management time will be required. As discussed in section 4.3 below, as a result of Part 2, fund managers will have to make strategic decisions on purchases of currently bundled and softed services. However, these decisions need to be made anyway, and decision processes are already in place (see also section 3.2). Likewise, fund managers will need to alter their existing contractual arrangements with brokers, but they already review these arrangements on a regular basis, often annually or biannually. It can therefore be assumed that any changes to contractual arrangements will take place within the confines of the existing contract review processes, in effect at no extra cost. Nevertheless, to be conservative, a further 10% overhead allowance is included to cover any management and other staff input into the process.

122. On this basis, the total one-off compliance cost to fund managers is around £8.4m (see Table 4.1).

Table 4.1: One-off compliance cost to fund managers (Part 2)

Item	Detail
Annual cost of programmer (in-house)	£50,000[1]
Resource required for programmer (one-off)	1 person-month (ie, 24 person-days)
Annual cost of lawyer (in-house)	£60,000[1]
Resource required for lawyer (one-off)	2 person-days
Days worked per year	240
One-off cost per firm	around £12,000[2]
Total number of fund managers	700[3]
Total one-off compliance cost (all fund managers)	around £8.4m

Note: [1] Staff costs taken from FSA Consultation Paper CP153 (October 2002), Annex A. [2] A 100% mark-up has been applied to the staff costs in order to cover overhead costs. A further 10% mark-up has been applied to cover possible management input. £12,000 = 200% times 110% times the sum of 24/240 times £50,000 and 2/240 times £60,000. [3] In the OXERA report, analysis of data from the FSA indicated that there are around 700 fund managers in the UK.
Source: FSA data and OXERA calculations.

123. In terms of recurring costs, it is unlikely that there will be a great burden on fund managers once systems are set up and running. As such, a conservative estimate of the annual cost of running the upgraded system amounts to five person-days for an administrative member of staff, the cost of which is assumed to be the same as for a compliance officer, although this is likely to be an overestimate. Again, for conservative purposes, a 10% allowance for management and other staff input is also made. Table 4.2 shows the recurring compliance costs faced by fund managers as a result of Part 2. These sum to around £1.3m per year for fund managers as a whole.

Table 4.2: Recurring compliance costs faced by fund managers (Part 2)

Item	Detail
Annual cost of administrator	£40,000[1]
Resource required for compliance (one-off)	5 person-days
Days worked per year	240
Annual compliance cost per firm	around £1,800[2]
Total number of fund managers	700[3]
Total annual compliance cost to fund managers as a whole	around £1.3m

Note: [1] Staff costs taken from FSA Consultation Paper CP153 (October 2002), Annex A. For the purposes of this analysis, it has been assumed (conservatively) that the cost of an administrator is the same as that of a compliance officer. In reality, this is likely to be an overestimate. [2] A 100% mark-up has been applied to the staff costs in order to cover overhead costs. A further 10% mark-up has been applied to cover possible management input. £1,800 = 200% times 110% times 5/240 times £40,000. [3] In the OXERA report, analysis of data from the FSA indicated that there are around 700 fund managers in the UK.
Source: FSA data (staff costs) and OXERA calculations.

4.2.3 Brokers

124. To assess the compliance cost to brokers, the assumption remains that all brokers are induced to provide all of their fund manager clients with an accurate breakdown of the value of the bundled brokerage services provided and the value of soft credits made available to them. The incremental cost of providing fund managers with the value of soft credits provided will be negligible, as this is already done in all soft commission arrangements under the present rules.

125. By far the most important source of one-off costs for brokers will be the need to identify and assign the costs of the bundled services that they provide. Evidence from interviews indicates that many brokers can allocate the costs of research at a high level between brokerage and other investment banking activities. Some of the larger brokers are developing or have already developed systems to assess the profitability to them of their clients on an individual basis. This suggests that some form of cost allocation has already been developed.

126. It is likely that the costs of research and other bundled services across fund managers are allocated in a fairly general way—for instance, in proportion to the level of brokerage fees. This is because it is difficult to assign the costs of research to specific clients, as a large part of broker research is generated for the market as a whole, rather than for specific clients. The only exceptions to this are conferences and the time spent by analysts on the telephone with clients.

127. A conservative estimate of the costs of adjusting the accounting systems of a broker is based again on one person-month of a programmer's time, estimated at a rate equivalent to £100k per year. Again, it is estimated that an in-house legal expert will be required to spend two days ensuring that the changes to internal systems are compatible with the new rules.[31] A 10% overhead allowance for possible management and other staff input required is also made. The total one-off compliance cost faced by brokers as a result of Part 2 is estimated at around £6m, as shown in Table 4.3.

[31] It should be noted that, as explained above, Part 2 imposes obligations on fund managers and not on brokers; brokers are only indirectly affected. Therefore, if anything, the estimate of legal costs to brokers is likely to be an overestimate.

Table 4.3: One-off compliance-related costs faced by brokers (Part 2)

Item	Detail
Annual cost of programmer	£50,000[1]
Resource required for programmer (one-off)	1 person-month (ie, 24 person-days)
Annual cost of lawyer (in-house)	£60,000[1]
Resource required for lawyer (one-off)	2 person-days
Days worked per year	240
One-off cost per firm	around £12,000[2]
Total number brokers	500[3]
Total one-off compliance cost (all brokers)	around £6m

Note: [1] Staff costs taken from FSA Consultation Paper CP153 (October 2002), Annex A. [2] A 100% mark-up has been applied to the staff costs in order to cover overhead costs. A further 10% mark-up has been applied to cover management input. £12,000 = 200% times 110% times the sum of 24/240 times £50,000 and 2/240 times £60,000. [3] In the OXERA report, analysis of data from the FSA indicated that there are around 500 brokers in the UK.
Source: FSA data and OXERA calculations.

128. Recurring compliance-related costs are likely to be dominated by the cost of running the upgraded accounting system and in handling occasional queries about the breakdown of the costs of the package of bundled brokerage services. As a conservative estimate of such costs, it is reasonable to take two weeks of an administrator's time. It is assumed that an administrator receives the same pay as a compliance officer (which is likely to be an overestimate). Again, a 10% overhead allowance for possible management and other staff input is also made. Table 4.4 shows the recurring compliance-related costs faced by brokers, which add up to around £1.9m a year.

Table 4.4: Recurring compliance-related costs faced by brokers (Part 2)

Item	Detail
Annual cost of administrator	£40,000[1]
Resource required for compliance (one-off)	10 person-days
Days worked per year	240
Annual compliance cost per firm	around £3,700[2]
Total number of brokers	500[3]
Total annual compliance cost (all brokers)	around £1.9m

Note: [1] Staff costs taken from FSA Consultation Paper CP153 (October 2002), Annex A. For the purposes of this analysis, it has been assumed (conservatively) that the cost of an administrator is the same as that of a compliance officer. In reality, this is likely to be an overestimate. [2] A 100% mark-up has been applied to the staff costs in order to cover overhead costs. A further 10% mark-up has been applied to cover management input. £3,700 = 200% times 110% times 10/240 times £40,000. [3] In the OXERA report, analysis of data from the FSA indicated that there are around 500 brokers in the UK.
Source: FSA data and OXERA calculations.

129. While brokers may generate these costs in complying with the demands of their fund manager clients, it is not clear to what extent brokerage firms will bear these costs themselves, or whether they will pass them on to their fund manager clients. Given that fund managers are assumed to demand a separate breakdown of the costs of bundled brokerage services, it is likely, but not certain, that much of the

costs of providing this breakdown will be passed on to fund managers. Yet, for the purpose of this CBA, these costs can still be considered compliance costs to the industry (independently of who in the industry bears them).

4.3 Quantity of transactions

4.3.1 Effect of Part 2 on quantity of services and trading

130. The effect of Part 2 is to change the way in which certain services provided to fund managers are paid for. It does not affect the ability of fund managers to contract with their current suppliers of these services, with the exception that, instead of being able to pass the costs of these services directly back to the fund, they have to be paid for by the fund manager from the management fee (or another separate charge), which itself has been negotiated between the fund manager and the fund.

131. As described in section 2 above, the current cost-pass-through arrangements introduce a potential misalignment of incentives between the interests of the fund manager (the agent) and the fund (the principal). This misalignment provides an incentive for the fund manager to over-consume these services, especially as the mechanisms by which the fund can monitor the expenditure of the fund manager are weak and difficult to interpret. Moving the expenditure from the category that can be passed through into the category that cannot reverses this incentive. In the general case, if the agent can avoid the expenditure without having an impact on any of its level of activity, or on any level of activity that is easily visible to the client (principal), the agent can increase its profit by the cost of that expenditure.

132. If, as a result of moving expenditure from the cost-pass-through category to the non-cost-pass-through category, the fund manager does reduce consumption of the relevant good or services, two (extreme) outcomes are possible:

- if, in avoiding this expenditure, there is no impact on the output of the fund manager (agent), the fund (principal) is no worse off, and, in time, market competition between fund managers will tend to eliminate any additional profits that arise for fund managers (for example, by a reduction in management fees). As a result, funds benefit from the change in incentives placed on the fund manager;

- if, however, the reduction in expenditure leads to a decrease in the level of activity of the fund manager which damages the interests of the fund, the change of the incentive on the fund manager (agent) to reduce expenditure is not in the interests of the fund (principal), at least in the short term. If the impact of the (under-) consumption is easy for the fund to monitor, the relationship between fund and fund manager can be expected to correct itself, with the result that funds require fund managers to restore (or continue with) the expenditure, notwithstanding the changed incentives. However, if it is hard for the fund to monitor, the market may find it hard to correct for under-consumption of services, and, as a class, funds will lose out.

133. As described in section 2 above, because the optimal total dealing levels for a fund are difficult to predict, it is likely that, in the face of this uncertainty, funds

are better off giving discretion to their agents, notwithstanding the incentive this produces for fund managers to over-consume trade execution services. This is likely to result in a better outcome for funds than the alternative where the amount of money to be paid by the fund to the fund manager for trade execution is fixed in advance, and the fund manager has an incentive to under-consume trade execution. However, where the total annual costs facing fund managers are reasonably predictable, the reverse is likely to be true—a fixed fee is likely to produce a better outcome since the resulting negative effect of under-consumption is more limited than the effect of over-consumption without a fixed fee.

134. Typically, excluding pure trade execution costs, fund managers already have to cover the majority of their costs from the (agreed in advance) management fee. Excluding trade execution costs, the contribution of bundled and softed services to meeting a fund manager's total costs is likely to lie around 5–10%.[32] To put this another way, excluding trade execution costs, around 90–95% of fund managers' costs already come from the fixed-fee element of their charges. These charges have to pay for rent, rates, salaries, etc, and any other services bought for hard cash. It is unlikely that these services are currently significantly under-consumed.

135. Thus, the net effect of Part 2 is to move expenditure on bundled and softed services from a cost category where there is an incentive to over-consume and where effective monitoring of the expenditure is difficult (ie, cost pass-through included commission costs), to a cost category where there is an incentive to under-consume, but where monitoring is relatively easier (ie, the management fee). Economically, this expenditure is moved from the category which is likely to be better (for funds) for expenditure that is difficult to predict in advance to one that is likely to be better (for funds) for reasonably predictable expenditure. Therefore, any negative effect on under-consumption is likely to be negligible, while the benefit of reduction of over-consumption is large, as discussed below.

136. In relation to the quantities of services consumed, Part 2 has two potential effects: a direct effect on bundled and softed services, and an indirect effect on transaction services:

- first, as explained in section 2, excess consumption by fund managers of softed and bundled services may fall, since marginal expenditure on these services must be taken out of the fund managers' management fees; and

[32] To take a hypothetical, but reasonably typical, example, assume the fund has a turnover 40% per year, the commission rate is 14bp, (of which, as explained below, 10bp is the price of trade execution and 4bp is the price of bundled and softed services) and the management fee is 28bp. These numbers are the same as for the example used in section 2.1. Total annual dealing costs are 5.6bp (40% of 14bp) of the portfolio, of which 1.6bp (4/14ths of 5.6bp) pays for bundled and softed services. Excluding trade execution costs, the total income of the fund manager is 29.6bp (28bp + 1.6bp). The 1.6bp therefore represents 5.4% of total income (1.6 as a percentage of 29.6 = 5.4%). If turnover is higher the relative contribution of bundled and softed services increases; if the management fee is higher, the relative contribution is lower.

- second, to the extent that fund managers are currently induced to trade in order to generate soft dollars or to receive bundled services, there will be a reduction in excessive trading volumes once that incentive is reduced.

137. Both of these effects are likely to be net benefits: the first is a net benefit because the expenditures on these services are reasonably predictable; the second is unambiguously a net benefit. These are explored in more detail below. In the assessment of the reduction in consumption, it is assumed that Part 1 is also implemented, ie, market and price information services are no longer available under bundling or softing (see also section 5).

4.3.2 Reduced excess consumption of bundled and softed services

Reduced excess consumption or increased under-consumption?

138. The first question to address is whether any reduction in consumption of bundled or softed services could represent a cost of Part 2 rather than a benefit. This is the case if the reduction leads to under-consumption rather than a reduction in over-consumption. There is only a risk of under-consumption for those services for which demand cannot be reasonably predicted beforehand, and hence cannot be easily or efficiently incorporated into the management fee structure of rewarding the provision of fund management services.

139. As discussed in section 2, this unpredictability argument applies to trade execution itself, but not necessarily to bundled and softed services. The breakdown of softed and bundled services in Figures 3.1 to 3.3 above indicates that most services delivered to fund managers fall into the following broad categories:

- access to analysts and advice on trade execution (mostly in the form of telephone calls);
- research;
- conferences and seminars;
- market and price information services;
- telecommunications and IT equipment;
- trade confirmation services;
- performance measurement services;
- custodian services; and
- access to IPOs.[33]

[33] As formulated by the FSA, Part 2 would not address access to IPOs. The issue of how access to IPOs is allocated is a broader one, which the FSA addresses in a separate consultation. See FSA (2003), ‘Conflicts of Interest: Investment Research and Issues of Securities’, CP 171, February.

140. As discussed in section 2, certain forms of access to analysts or advice on trade execution may be relatively difficult to predict. Specifically, there are instances where fund managers receive advice on trade execution from the *trader* within the brokerage firm, rather than from the *analyst* (or sales person in the research department) within the brokerage firm. This type of advice is difficult to distinguish from trade execution itself, and its value would at any rate be difficult to determine independently of the transaction process. It is therefore likely to still fall under the definition of trade execution services in Part 2, rather than under research. However, other types of access to analysts, including general advice and telephone calls with sales persons in the research department, are arguably easier to predict in advance from the fund manager's point of view, just like other forms of research—ie, fund managers have a constant need for access to market and industry information, independently of the level of trading.[34] Therefore, the potential cost (to funds) of Part 2 of a resulting under-consumption of access to analysts by fund managers is likely to be insignificant.

141. With regard to the other bundled and softed services, with the possible exception of trade confirmation services (but, even here, not the infrastructure needed to supply them), most of the services currently provided under bundled or softing arrangements do not have an obvious demand variation that is co-variant with the unpredictable element of trading volumes. Even research—demand for which would seem to be driven by subsequent trading—is also necessary to make optimal decisions *not* to trade. Economically, the need for research arises irrespective of the volume of trade actually carried out in any time period.

142. It is therefore unlikely that moving the provision of softed and bundled services from the category of services provided by cost pass-through to the category of cost recovery through the management fee (or another separate charge) will induce significant under-consumption of these services. At a first approximation, it can therefore be assumed that any reduction in demand is a net benefit, and not a net cost, to funds.

How research is valued currently

143. Research, including access to analysts, is likely to constitute the bulk of the value of bundled services—evidence of which is shown in the calculations below. Research also forms a large part of softed services, after market and price information services. The analysis below will therefore mainly focus on research.

[34] If there is a correlation at all between access to analysts and the level of trading, the causality will tend to be the other way around—ie, it is the analysts who call the fund managers with trade recommendations, upon which the fund managers may decide to trade. It is not clear whether fund managers would be willing to pay at all for such calls, although some fund managers find such calls valuable. If fund managers do not value the calls, a reduction in the consumption of bundled services is likely to result, since at present the cost of analysts' time spent on such phone calls is presumably recovered through commission revenue. If fund managers do value the calls, they should be willing to pay for them out of their own income.

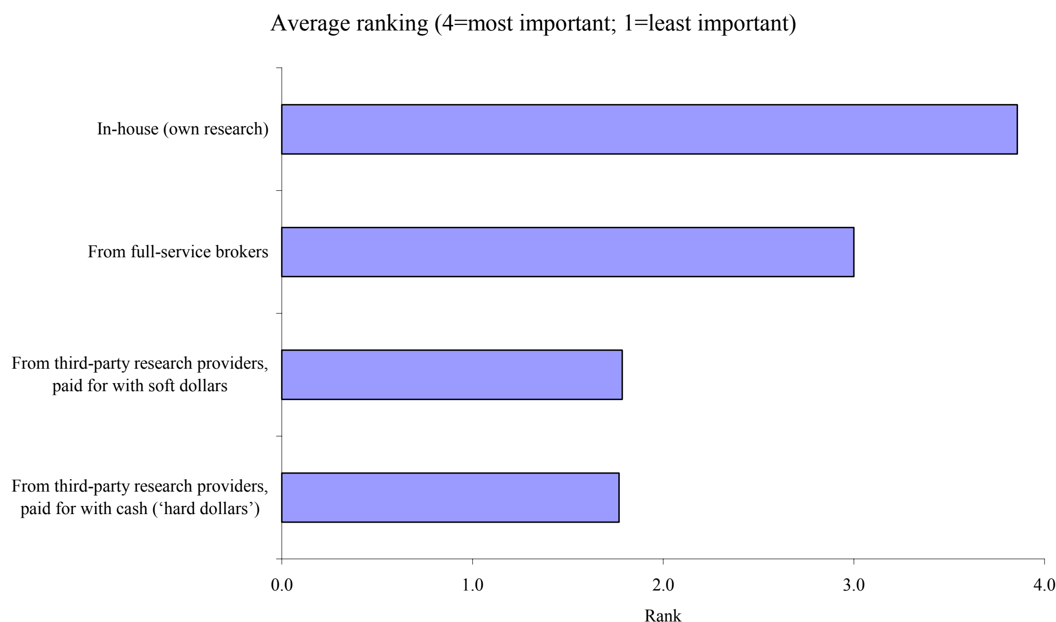
144. Fund managers currently gain access to research from three main sources:

- bundled with trade execution services from full-service brokers ('sell-side' research);
- from their own in-house analysts/researchers;
- from independent providers of research services (paid for either in hard or soft money).

145. The costs of the bundled research are currently passed through to funds with commission costs, as are the costs of third party research paid for with soft money. In-house research and independent research paid for with hard money is not passed through to funds, but is paid out of the management fee.

146. A key question is how fund managers value the research received 'for free' from full-service brokers. The OXERA fund manager questionnaire indicates—as illustrated in Figure 3.6—that the provision of research and access to analysts ranks high among reasons for selecting brokers (this reason came second after trade execution quality). Likewise, among the various categories of research, fund managers rank bundled research second after in-house research (see Figure 4.1).

Figure 4.1: Relative importance placed by fund managers on research from different sources



Base: In-house, 25 fund managers; from full-service brokers, 25 fund managers; from third party research providers (hard dollars), 19 fund managers; from third party research providers (soft dollars), 19 fund managers.
Source: OXERA fund manager questionnaire, 2002.

147. However, these results should be interpreted with care. Figure 3.6 does not give any indication of the actual value attached to this bundled research, only that fund managers value getting the research now that it is 'for free'. The rankings in Figure 4.1 may be biased if they are influenced by current levels of usage (for

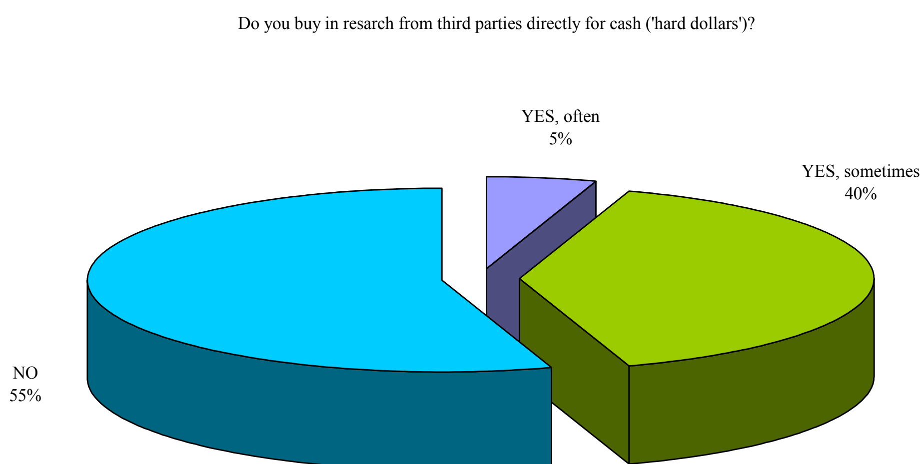
example, bundled research may be valued more than third party research simply because the former is more commonly available than the latter).

148. Considerable anecdotal evidence from interviews with market participants indicates that the only part of research that is actually valued are the telephone calls with analysts (and even this applies to only a small proportion of such telephone calls). Many fund managers indicated that a large part of the published research went straight into the bin. Some of this is as a result of economically inefficient duplication of analysis of the same equities. For example, a fund manager may receive 25–30 different reports each day on large-cap stocks, but will normally review at most five or six of these. Even if different fund managers preferred different research providers, the market could arguably still be served efficiently by, say, 15–20 different reports (if not fewer).

149. From an economic perspective, the same logic of trading off costs and benefits as applied in section 3.3 (concerning market and price information services) also applies to research—ie, fund managers generally like to have as much information available as possible (the more the better). However, beyond a certain minimum amount of information, the marginal benefit of any extra piece of research will decline. This marginal benefit has to be compared with the marginal cost (ie, the price at which the extra research can be obtained). Part 2 has the effect of making the marginal cost of bundled and softed research a 'hard' cost to fund managers.

150. It should be noted that fund managers currently already buy research for 'hard money'. First, as shown in Figure 4.2, 5% of fund managers do this often, and another 40% do so sometimes. These proportions are likely to increase under Part 2 once 'free' research is no longer available.

Figure 4.2: Use of 'hard money' research by fund managers



Base: 20 fund managers.
Source: OXERA fund manager questionnaire, 2002.

151. Second, and more importantly, fund managers already spend large amounts of 'hard' money on in-house research. A study by McKinsey has recently estimated that fund managers spend the equivalent of about 1–1.5bp of the value of the

assets under management on their own in-house research, and that this amount has been increasing (at least until 2000).[35] According to this study, this level of expenditure on in-house research is in the same order of magnitude as the costs of broker and third party research. Thus, despite the availability of 'free' bundled research, fund managers still spend significant amounts of hard money on the research they require to do their job.[36]

Effect on consumption of research

152. The effect of Part 2 on the research market will be to require all research to be paid for in hard money. This will not change the position of research that is already paid for in such a way—in-house research and non-softed third party research. If fund managers are already behaving in an economically rational way in relation to spending hard money then Part 2 should not have a significant impact on the consumption of hard money research. The impact of Part 2 is therefore likely to be concentrated on softed and bundled research.

153. The combination of the anecdotal evidence that much broker research is not valued, combined with the use of cost pass-through money to pay for it, suggest that if fund managers had to pay for research with hard money they would reduce their consumption in order to lower their own costs and to maintain value for (their) money in the supply of research.

154. However, in addition, it is also possible that the current market structure hides significant supply inefficiencies as a result of broker research being available through cost pass-through. If broker research provides less value for hard money than third party research (for example, because of the inherent conflicts of interest in brokers providing disinterested research, or because the use of such research is often supply-driven—ie, the brokers' analysts call up fund managers with ideas for trading, rather than fund managers demanding it themselves) then, in addition to a drop in consumption in total, there may also be substitution between third party research and broker research once both have to be paid for using hard money.

155. A conservative (ie, low) estimate of the potential further marginal reduction in fund managers' expenditure on research and other bundled and softed services can be made as follows.

156. Analysis from the OXERA broker and fund manager questionnaires, which has also been confirmed during several interviews, indicates that a typical rate for 'execution-only' brokerage services is about 10bp. These services are not limited to automatic transmission of trades to the market, but include the costs necessary

[35] Document by McKinsey & Co. provided by the FSA.

[36] It is likely to be the smaller fund managers who are particularly reliant on bundled and softed research since they may be too small to have significant in-house research capabilities.

to 'work' a trade (ie, active trade execution). Such rates are currently offered in the market, including by several full-service brokers, although they probably represent only a small (but apparently growing) proportion of all trades.[37] Nevertheless, the 10bp is a useful benchmark to estimate the cost of bundled services—ie, this cost would be expected to be similar to the difference between 10bp and the commission rate on full-service trades.[38]

157. Data from both the OXERA survey and the LSE indicate that the average overall commission rate for institutional trades was 14bp, of which around 1bp was accounted for in the value of soft credits available. Over the entire market, there is therefore a 3bp difference between the cost of execution-only brokerage services and the cost of 'full-service' brokerage. Table 4.5 shows that, on this basis, the total expenditure by UK fund managers on bundled services from UK brokers only is estimated at around £500m a year. This figure does not take into account expenditure by UK fund managers on bundled services from non-UK brokers, and will therefore result in an underestimate of the total benefit of Part 2.

[37] An article in the November 2002 issue of *Institutional Investor (*'Beat the Clock', pp. 35–42) quotes an estimate from traders that trading systems, such as Instinet and E-Crossnet, have recently doubled their market share to around 10% of volume in the UK. Additionally, an estimated 15–20% of institutional trades in the UK were executed via program trading (which takes place at discounted commission rates) in 2002, up from 10% in 2000.

[38] If anything, the 10bp is likely to be an overestimate of execution costs. Pure 'execution-only' services, as defined in the OXERA report—those that do not require any active working (eg, trades sent to electronic crossing networks)—typically have a charge of around 5bp. Program trades, which do require active working, are often undertaken for only 1–2bp (according to anecdotal evidence).

Table 4.5: Total expenditure by UK fund managers on bundled services from UK brokers

Item	Detail
Total commission revenue of UK brokers from UK institutional fund managers	around £2.3 billion[1]
Average commission rate (full-service)	14bp[2]
Commission identified as payments for soft credits	1bp[3]
Average commission rate (execution-only)	10bp
Average basis points identified as expenditure on bundled brokerage services (ie, in addition to execution)	3bp
Estimate of total expenditure by UK fund managers on bundled services from UK brokers (3/14 times £2.3 billion)	Around £500m
Alternative estimate of cost of bundled research provided by UK brokers to UK fund managers	Around £720m[4]
Reduction in demand for bundled services only, as a result of Part 2	10%
Reduction in annual expenditure on bundled services	around £50m–£72m

Note: [1] In section 3.3 it is explained how this figure is obtained from LSE data and why it is an underestimate [2] In reality, this 14bp average commission rate includes execution-only trades as well (ie, it is an average rate for all institutional trades on a commission basis). However, for the calculation of expenditure on bundled services, this makes no difference. [3] Derived from the OXERA report; this is consistent with the estimate of total soft credits in the UK presented in Table 3.2. [4] This figure is explained in text below.
Source: OXERA calculations, based on LSE data (first row) and survey data.

158. It is difficult to verify this estimate, but, if anything, it is likely to be an underestimate. For example, in a recent article in *Institutional Investor* it was claimed that the largest UK fund managers each spend the equivalent of US$100m (around £60m) on bundled services each year.[39] Only eight or nine large fund managers would already account for the estimated £500m of expenditure on bundled services, which suggests that, in reality, it is likely to be much higher.

159. Another way of cross-checking the estimate is by considering the cost of supply of bundled research (ie, not other bundled services) in the UK. Based on data obtained from McKinsey, Nelson's Investment Managers' Survey 2002 and interviews, OXERA estimates that, in 2001, the top eight investment banks employed at least around 700 equity analysts in London, and incurred a fully loaded, equity research cost of around £1 billion. For the other large and medium-sized investment banks in London, this figure was around 1,000 analysts in total at a fully loaded research cost of at least £600m. Hence, the total cost of equity research in London in 2001 was around £1.6 billion. (This does not take into account the cost of non-equity research, and hence leads to an underestimate of the total research cost in London.)

[39] 'Beat the Clock', *Institutional Investor*, November 2002, pp. 35–42.

160. This research is not only consumed by UK fund managers, but also by foreign fund managers and other areas within the investment banks themselves. Based on anecdotal evidence, it may be that up to 20–25% of research cost is borne by other areas within investment banks. The remainder might be allocated between UK and foreign fund managers based on their share in total trade value (roughly 60% and 40%, respectively).[40] On this basis, the total UK broker research cost allocated to UK fund managers would be around £720m.[41]

161. This estimate is well in excess of the £500m in Table 4.5. In fact, the £500m is an estimate for all bundled services, whereas the £720m is an estimate for bundled research only. This confirms that research constitutes the bulk of bundled services, and justifies the fact that the analysis in this section focuses mainly on consumption of research.

162. Even if total expenditure on bundled services were reduced by only a very small proportion, Part 2 would already provide significant benefits that outweigh the costs by far. Based on the above discussions, it is not unreasonable to assume that a small decrease of, say, 10% is feasible for bundled research services (assuming these services constitute the bulk of bundled services, as explained above). This gives an annual benefit of around £50m–£72m.

163. The adoption of Part 2 could also have an effect on the level of consumption of services purchased via soft commission arrangements. For the estimate of benefits, these effects are not taken into account here. This is because, if Part 1 is also implemented, market and price information services would no longer be softed, and these services constitute the bulk of softed services (see section 3).[42] The remaining soft credits are currently spent mostly on third party research, and, considering the discussion above, the effect of Part 2 on expenditure on third party research is unclear.

4.3.3 Reduction in excess trading volumes

164. As also discussed in section 3.3, in principle, the more trades fund managers send to brokers, the more bundled and softed services (where an arrangement exists) they can expect to receive in addition to trade execution. Therefore, fund managers may have an incentive to overtrade their clients' accounts simply to generate more commissions (churning).

165. The OXERA report has found no evidence on whether such churning prevails in practice. However, to the extent that churning does occur at present, the incentives do so will be substantially reduced by Part 2, since fund managers will have to

[40] This proportion is based on the London Stock Exchange transactions data referred to above.
[41] ie, 60% of 75% of £1.6 billion. Again, this figure does not take into account bundled services obtained by UK fund managers from non-UK brokers, and is therefore an underestimate.
[42] Section 5 discusses the interactions between Parts 1 and 2.

reimburse the costs of any additional services obtained in this way to their clients. Thus, Part 2 will have the benefit of reducing any excess trading caused by bundling and softing. This reduction in excessive trading has the effect of improving execution quality, and also of reducing the total fund management cost paid by funds (since trading costs are passed on to funds).

166. It is not possible with the available information to quantify this benefit. All that can be said is that it will at least be substantially larger than under Part 1 (see section 3.3), since Part 1 covers only market and price information services, whereas Part 2 covers all additional services that are currently bundled or softed.

4.4 Quality of transactions

4.4.1 Quality of research

167. As identified in the OXERA report, soft commission arrangements may facilitate the entry of independent research providers to the market, in competition with bundled research provided by brokers. This results from allowing third parties also to use money that is directly passed through to the fund. Part 2 has the effect of taking both bundled and softed research out of that category of cost pass-through. Thus, although Part 2 would be likely to take away any incentive for brokers to offer softing services, the impact on competition in the research market is likely to be positive. All providers of research services would have to be paid in 'hard' money, so the playing field would become reasonably level.

168. This is likely to be a more effective mechanism for ensuring equality between bundled provision and third party provision than enabling third party providers access to cost-pass-through expenditure through softing arrangements. In addition, fund managers would have increased incentives to ensure that they received good value for money in the research they did purchase, because they could no longer pass the costs straight through to the funds.

169. The overall effect is likely to improve the quality of the research product, and to increase the incentives on research providers to meet the needs of fund managers for analysis and research tailored to meet their needs. This should improve the efficiency of fund management activities generally.

170. The increase in competitive pressure across the research field may, however, have a negative impact on the totality of research providers. Those research providers (be they third parties or integrated brokerage houses) that do not provide value for (hard) money to fund managers may find it more difficult to survive. However, this is not a net cost for the purpose of this CBA.

4.4.2 Quality of trade execution

171. In addition to their effect on trading volumes (see section 4.3), bundling and softing can also affect quality of trade execution. In theory, fund managers may select brokers offering the most generous bundle of services or soft commission arrangements, rather than the highest execution quality.

172. As discussed in section 3.4 (in relation to Part 1), the effect of bundling on execution quality is less likely to be of concern, since those full-service brokers who are most active in bundling are also generally the larger brokers who are able

to offer better liquidity and execution quality. The effects of softing on execution quality may also be relatively limited, since fund managers frequently have soft commission arrangements with larger brokers as well as with smaller brokers, and because quality of execution, expertise and liquidity are the most important factors for fund managers when choosing a broker.

173. Nevertheless, the above findings do not fully discard the possibility that bundling and soft commissions affect execution quality. Part 2 has the benefit of reducing the likelihood of such effects by reducing fund managers' incentives to churn and the incentive to place transactions with a particular broker to obtain either soft dollars or to maintain the supply of bundled service. This benefit cannot be quantified at this stage, although, again, it can be expected to be substantially larger than under Part 1 (see section 3.3), since Part 1 covers only market and price information services, whereas Part 2 covers all additional services that are currently bundled or softed.

4.5 Variety of transactions

174. The availability of soft dollars to purchase third party research has, to a certain extent, already levelled the competitive playing field between broker and third party supply. As a result, the bundling of research with brokerage services has not completely closed the market for third party supply.

175. However, as already described above, the provision of softing services by brokers is unlikely to remove all market distortions between bundled and third party supply. Levelling the competitive playing field by requiring all research to be paid for out of non-cost-pass-through money is likely to make for a more efficient market, especially when combined with the increased incentives on fund managers to obtain value for money from all research providers. As a result, Part 2 should make the research market more open to providers, provided they offer value for money to fund managers.

176. There may also be a change in the focus of research providers as a result of the change in the type of money fund managers have to spend on the research. Sharpening their focus on value for money will make it more difficult for research to be provided in a way that represents value for money of the (integrated) brokerage house. The coverage of smaller stocks and the variety of research products available are likely to increase. This should help to ensure that the market is able to deliver research that is independent of the conflicts that arise inside an integrated brokerage house. On its own, it may not be sufficient, but Part 2 has the effect of making it more difficult for the brokerage houses to control the flow of research analysis to fund managers through their effective control of cost-pass-through money. Again, this improvement in the research product will ultimately allow improved efficiency of fund management activities generally.

4.6 Efficiency of competition

177. Part 2 has various effects on the efficiency of competition, which are discussed in turn throughout section 4.6. Overall, the effect on competition is positive (ie, beneficial for the purpose of this CBA), as the beneficial effects on competition far outweigh the potential negative effects on competition.

- First, in the fund management market, the increased transparency and hence increased competitive pressure on fund managers (in particular for institutional funds) lead to a reduction in total management costs paid by funds—see section 4.6.2. Second, in the brokerage market, there is a levelling of the playing field between full-service and other brokers, which increases competition and benefits consumers (ie, fund managers)—see section 4.6.3. Third, in the research market there is a levelling of the playing field between tied and independent research providers. This increases competition in the research market, and thus allows the users of research, ie, fund managers, to improve their efficiency—see section 4.6.4.

- Second, there are two potential negative effects on the efficiency of competition, but both these effects are shown to be insignificant (and hence are outweighed by the positive competition effects described above. These effects are, first, that Part 2 may make it more difficult to use efficient price discrimination when pricing research—see section 4.6.1—and second, that smaller fund managers may be disadvantaged—see section 4.6.2.

4.6.1 Efficient pricing of research services

178. The first-order effect of Part 2 is just to change the way currently bundled and softed services are paid for by fund managers—from the cost-pass-through category to the category of paid for out of management fee. The total spent by *funds* on having their funds looked after and administered does not have to change. Indeed, if fund managers have not been influenced by the incentive misalignments in the current structure, the effect of Part 2 would be limited to just a change in payment structure, but not a change in the total costs of operating and administering funds.

179. In respect of research, the possibility of brokers maintaining their *prices* for research (and other bundled services) as a proportion of turnover (eg, 3 bp on the value of transactions) means that any existing price discrimination in the provision of research services to fund managers can be maintained. Thus, if there is price discrimination and it is efficient, it would be expected that this would be maintained under Part 2.

180. However, there is little hard evidence that such price discrimination currently exists. Where evidence was available from broker interviews, there was an indication that client profitability (ie, the profitability of serving individual fund managers) was based on costs incurred using relatively simple cost models. Thus the present system does not appear to deliver economically efficient price discrimination, or, if it does, this is largely accidental.

181. Therefore, in the absence of better information about how prices are set by brokers with respect to individual fund managers, the first-order assumption should be that Part 2 will not have an impact on any existing, economically efficient, price discrimination in the supply of broker research.

182. Except in a few instances, third party research is already explicitly priced, even when softed.[43] Thus, whatever price discrimination (if any) that currently exists can be continued under Part 2. In addition, because control of the access to money to be spent on research will be more firmly located with fund managers, and is not reliant on a system that ties the quantum to be spent to trading volumes, more imaginative pricing structures are likely to be viable between research providers and fund managers (for example, subscription-based services, on-demand services, and volume discounts). These varied structures should be better able to deal with the underlying economics of research service provision than one where the dominant price structure is related to trading volumes.

183. As already indicated, the most significant effect of Part 2 is likely to be the move of all payments for research into the non-cost-pass-through category of expenditure by fund managers. This is likely to sharpen their incentives to obtain value for money, which, in turn, will tend to sharpen up the pricing policies of providers to create efficient pricing structures within a competitive market. The overall impact is, therefore, likely to be positive, although, for reasons of complexity and lack of data, it is impossible to estimate the magnitude of this positive effect.

4.6.2 Effects on competition in the market for fund management

184. Part 2 changes the way research (and other bundled or softed services) are paid for. This will apply to all fund managers. However, not all fund managers use softed or bundled services in the same way. In particular, there is evidence that small fund managers rely more heavily on bundled and softed services in order to carry out their activities, especially in relation to access to research where small fund managers are less likely to have extensive in-house research facilities. It is, therefore, possible that there will be a differential impact on different sizes of fund manager, which would alter the competitive dynamics of the market for fund management.

185. In-house research is likely to have some economies of scale—the smaller the fund manager, the more expensive (per unit of funds managed) the provision of in-house research to cover the portfolios managed.[44] If in-house research becomes even more important for the competitive supply of fund management services, this may make it more difficult for small fund managers to compete. However, as the

[43] In the UK, softing requires the supplier to send the fund manager an invoice, which is then subsequently paid by the broker. This invoice has an explicit price attached to it, often in the form of an annual subscription charge.
[44] This is shown, for example, in the McKinsey document referred to above.

existing move to in-house research is at least partially driven by concerns about conflicts of interest with sell-side research, if the market also develops more independent, third party research, small fund managers may be able to overcome the disadvantages they face from the economies of scale of in-house research by sourcing it externally. As described above, Part 2 may stimulate such a development. Thus, the relative impact on small fund managers from this source may be limited, or even neutral.[45]

186. Another way there could be a differential impact is if the current supply of bundled services contains significant price discrimination such that small fund managers pay less (in total commission charges) for any given level of bundled (or softed) service provision. If Part 2 made the continuation of such price discrimination untenable then this could lead to small fund managers being put under more cost pressure than their larger counterparts. However, for the reasons set out above, it should still be possible for suppliers of bundled services to price-discriminate.

187. Finally, if there is a difference between small and large fund managers such that large fund managers currently over-consume bundled and softed services and Part 2 leads to a reduction in over-consumption, small fund managers will come under enhanced competition from large fund managers as these have more ability to become more efficient (ie, to reduce their current over-consumption). Although this may be detrimental to small fund managers, it is likely to be in the interests of funds, as more efficient providers will displace less efficient ones. Only if this led to excessive concentration in the market for fund managers would this be likely to be a net cost to funds; however, as discussed in section 3.6, such excessive concentration is highly unlikely.

4.6.3 Effects on competition in the market for brokerage services

188. As there are economies of scale in the production of research (and some other bundled) services, the current arrangements are likely to give large, full-service, brokers a competitive advantage through the economies of scale of research. As Part 2 breaks some of the links between transactions and research, the effect on competition between brokers is likely to be in the direction of reducing the advantage that full-service brokers have over execution-only brokers, and to reduce the advantage of large, full-service, brokers have over small brokers. As these advantages flow from access to a particular kind of money (ie, money that is passed through by fund managers via commission costs rather than as a result of the fundamental economic characteristics of the activity), their removal should result in enhanced, and economically efficient, competition between the suppliers of brokerage services (full service or otherwise).

[45] In addition, the drift to in-house research appears to be happening already, so small fund managers may already be facing these competitive problems.

4.6.4 Effects on competition in the market for research

189. The impact on competition in the market for research will be similar to that on brokerage. Although the current arrangements allow third party providers access to cost-pass-through money via softing arrangements, this may not be a complete removal of the advantage given to full-service brokers in the research market. However, unlike the market for brokerage, Part 2 also changes the type of money used to pay for research. Therefore, in addition to levelling the competitive playing field between different ways of providing research, there is likely to be a more general hardening of spending decisions on research that is currently paid for using cost-pass-through money.

190. As set out in section 4.3, total spending on research may fall, but spending on in-house research, and the type of third party research currently paid for with hard money, is likely to increase proportionally, if not absolutely. As a result, general competitive conditions are likely to improve, which should be advantageous to the customers of research services.

4.7 Summary of costs and benefits

191. Table 4.6 summarises the costs and benefits of policy proposition Part 2. The most important costs have been quantified. The cost categories that have not been quantified are the impact on smaller fund managers and the reduced scope for efficient price discrimination, but both are shown to be relatively insignificant at any rate.

192. Many of the benefits of the policy cannot be quantified; all that can be said is that Part 2 creates the correct incentives on market players for these benefits to be realised. Only one of the types of benefit of Part 1—the reduction in excessive consumption of bundled and softed services—can be roughly quantified.

193. However, the likely order of magnitude of this benefit is already such that the costs of Part 1 are outweighed. The regulator's direct costs are estimated at £5,200 on a one-off basis and at £12,000 to £18,000 per year on an ongoing basis.[46] There is likely to be a one-off compliance cost to the industry in the order of £14.4m, and then ongoing compliance costs in the order of £3.2m per year. Against this, the estimated saving in total expenditure by fund managers on bundled services would be at least around £50m–£72m per year. These estimates for the CBA are conservative, in the sense that costs are more likely to be overestimated than underestimated, whereas benefits are more likely to be underestimated than overestimated.

194. Some of the non-quantified benefits can also be expected to be important, in particular the effects on the research market—with incentives being created for a

[46] The regulator's direct costs were estimated by the FSA.

levelling of the playing field between tied and independent research providers, and a likely increase in research quality and variety.

Table 4.6: Costs and benefits of Part 2

Market impact	Type of cost	Magnitude	Type of benefit	Magnitude
Direct costs	Design and implementation	£5,200 one-off	n.a.	n.a.
	Ongoing costs	£12,000—£18,000 per year	n.a	n.a.
Compliance costs	One-off compliance costs to brokers	£6m	n.a.	n.a.
	Ongoing compliance costs to brokers	£1.9m per year		
	One-off compliance costs to fund managers	£8.4m		
	Ongoing compliance costs to fund managers	£1.3m per year		
Quantity of transactions	n.a.	n.a.	Reduction of inefficient over-consumption of bundled and softed services—leads to fall in total management costs paid by funds	Around £50m–£72m per year
			Reduction in excessive trading—leads to better execution quality and fall in total management costs paid by funds	Not quantifiable; incentives in the right direction
Quality of transactions	n.a.	n.a.	Increased quality of research services—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
			Increased quality of trade execution	
Variety of transactions	n.a.	n.a.	Greater variety of research—leads to improved efficiency of fund managers	Not quantifiable; incentives in the right direction
Efficiency of competition	Efficient price discrimination more difficult	Incremental cost very low	Increased transparency and hence competitive pressure on fund managers (in particular for institutional funds)—reduces total management costs paid by funds	Not quantifiable; incentives in the right direction
	Small fund managers may be disadvantaged		Levelling of playing field between full-service and other brokers—increases competition in brokerage	
			Levelling of playing field between tied and independent research providers—increases competition in research	

Note: n.a. = not applicable. These costs and benefits assume that Part 1 is also implemented (ie, market and price information services are no longer softed or bundled)—see also section 5.
Source: OXERA.

5. Policy Interactions between Part 1 and Part 2

195. The FSA has also asked OXERA to undertake the CBA for three scenarios: one in which Parts 1 and 2 are both implemented, and two scenarios in which only one of the two parts is implemented.

196. From the analysis in sections 2 to 4, it is clear that Part 1 and Part 2 have very similar effects on the incentive mechanisms in place for fund managers in relation to costs of services—with respect to both purchasing these services and passing the costs of these services on to their fund clients. As a result, both policies have broadly the same categories of costs and benefits, as can be seen by comparing Tables 3.4 and 4.7.

197. There are two main differences between Part 1 and Part 2:

- the net benefits of Part 2 are an order of magnitude higher than those for Part 1. This is because Part 2 covers all bundled and softed services, whereas Part 1 covers only market and price information services;
- for the same reason, and as discussed in section 4, Part 2 has important implications for the market for research—in terms of market size, competition and quality and variety of transactions—while Part 1 has no impact. Part 1 will have some impact on the market for information services (as discussed in section 3), but this impact is probably not as significant as that of Part 2 on the market for research and other bundled and softed services.

198. The CBA of Part 1 as presented in section 3 is one for a scenario in which only Part 1 is implemented.[47] The CBA of Part 2 as presented in section 4 is one for a scenario in which Part 1 and Part 2 are both implemented (ie, the effect on screens is excluded from the analysis in Part 2). Hence, the only remaining scenario to be assessed is the one where only Part 2 is implemented.

199. As follows from the above analysis, if Part 1 is not implemented, market and price information services could still be obtained through softing or bundling. However, Part 2 would have the effect of making the cost of these services a 'hard' cost to fund managers, which is the same effect as Part 1 would have had. Hence, the estimated reduction in excess consumption of screens in section 3 would now occur as a result of Part 2. Thus, in this scenario, the benefits of reduced excess consumption would increase by this amount—ie, by around £2.8m a year—to around £52.8m–£74.7m a year. The costs of Part 2 as estimated in section 4 would not change.

[47] The only exception is the potential cost/disadvantage to smaller brokers arising from Part 1. This cost is negligible if Part 2 is also implemented. However, if Part 1 only is implemented, this cost is also expected to be low (see Table 3.4).