

Agenda

Advancing economics in business

Softing and bundling arrangements: what are the initial findings?

In 2006 the use of softing and bundling arrangements in the UK faced a change in the regulatory regime through both industry-led initiatives and the modification of regulations. Given the complexity of market relationships, it was not clear how the industry would respond or whether the desired market outcomes would result. Therefore, the Financial Services Authority commissioned Oxera to design a methodology for a post-implementation impact assessment, and to undertake a baseline survey for this assessment

What is softing and bundling?

The structure of the fund management and bundled brokerage markets is complex, such that there are multiple fees paid between the different parties for different goods and services. Figure 1 illustrates these relationships before the regime change in 2006. Pension fund trustees may contract an external fund manager to manage a mandate of the fund's assets, although many large funds also employ internal fund managers. By doing so, they entrust the assets within that mandate to the fund manager, paying for management services (and possibly other performance-related fees). These fund managers make trading decisions for the fund, paying for the trade orders they execute with brokerage commissions charged to the

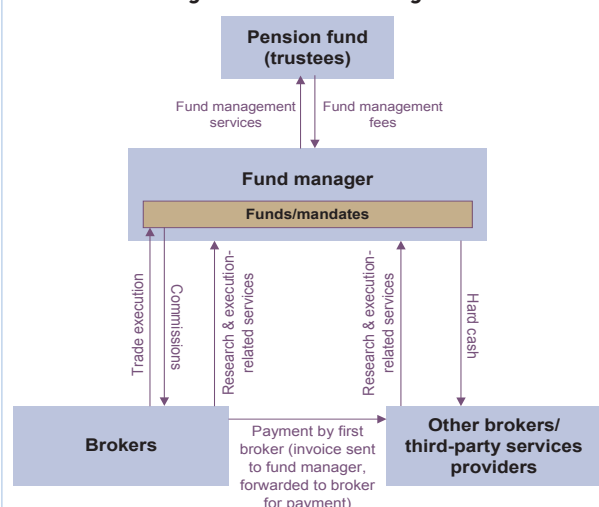
fund. However, fund managers may also receive additional goods and services from their brokers or third parties, which can be purchased with commissions from the fund (on executed trades) or with hard cash. Purchases with commissions can be made using either bundled brokerage arrangements, in which the broker provides the non-execution goods and services, or soft commission arrangements, in which the broker pays for non-execution goods and services provided by third parties (eg, research providers).¹

The background to softing and bundling lies in the fixed brokerage commission rates that existed in the 1960s and 1970s. At that time, brokers competed for trade execution business on the basis of other goods and services provided to the manager for directing trades to that broker. Although the era of minimum commission rates has long since passed, the practices of softing and bundling have continued. This provides two mechanisms through which some of the costs of fund management can be met: with hard cash earned from the management fee, or through commissions in softing and bundling arrangements. Both present problems of potential misalignment between the incentives of the fund manager and the objectives of the fund.

First, if the costs are paid for through commissions, the fund manager may have an incentive to over-consume these inputs, particularly if this enables the fund manager to reduce its other expenditure on such inputs. This will increase the trading costs to the fund, either through higher commission rates or higher trading volumes, but may not provide higher returns on the fund.

Second, if the costs are paid for with hard cash earned through fund management fees, the fund manager has

Figure 1 Former market structure for fund management and brokerage



Source: Oxera.

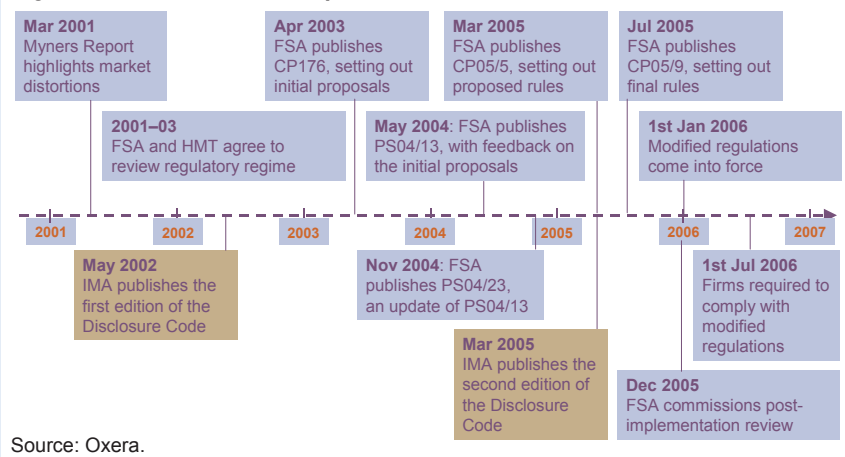
This article is based on the Oxera report 'Soft Commissions and Bundled Brokerage Services: Post-implementation Review', prepared for the Financial Services Authority, October 2006. Available at www.oxera.com.

an incentive to under-consume those inputs where the quantity is variable (eg, research). Given fixed management fees, any additional expenditure on such inputs will decrease the fund manager's profits. Even if increased spending would be expected to improve the returns to the fund, the fund manager still has an incentive to cut these costs, although such an incentive may be reduced through performance-related fees.

The change in the regime for softing and bundling seeks to address both of these potential principal-agent problems. The recent developments in the structure, use and regulation of softing and bundling began in 2001, when the Myners Report highlighted that soft commissions and bundled brokerage arrangements created a market distortion by incentivising fund managers to direct brokerage orders to obtain additional services.² Consequently, the Financial Services Authority (FSA) agreed with HM Treasury (HMT) to review the regulatory regime for soft commissions and bundled brokerage arrangements, culminating in the FSA consultation paper, CP176, which set out the regulator's initial proposals.³ After further consultations and revisions, the final regulations were published in July 2005 and incorporated into the *Conduct of Business Sourcebook*.⁴ The regulations came into effect from January 1st 2006, and required that firms were compliant from July 1st 2006. Alongside the modification to the FSA regulations, industry-led initiatives, such as the Investment Management Association (IMA) Disclosure Code, were issued, with the second version of the Disclosure Code being adopted in spring 2005. These developments are shown on the time line in Figure 2.

To address the potential market distortions from softing and bundling arrangements, the change in the regime in the UK has adopted two approaches to tackling these incentive misalignments. First, the modified regulations restrict the goods and services that can be paid for through commissions to just execution and research. This attempts to strike a balance between the two misalignment problems described above. Restricting the goods and services that can be purchased through such arrangements should reduce the over-consumption of unnecessary goods and services. Allowing research to be purchased through such arrangements should prevent a situation of under-consumption. Second, the modified regulations and industry-led initiatives seek to improve disclosure between fund managers and pension funds. Increased disclosure should make it easier for pension fund trustees to monitor their fund managers,

Figure 2 Time line of developments



Source: Oxera.

which should provide increased transparency of the use of the fund's commission payments.

Similar approaches have subsequently been adopted in both the USA and France. In the former, fund managers were allowed to purchase 'brokerage and research services' through commissions due to a safe harbour established in 1975, when fixed commissions were abolished in the USA, through section 28(e) of the Securities Exchange Act 1934. This safe harbour protects fund managers from liability for breaching their fiduciary duties by failing to achieve best execution if the brokerage commission rate was reasonable for the execution and non-execution goods and services received. However, noting that these rules 'may give incentives for fund managers to disregard their best execution obligations', the Securities and Exchange Commission (SEC) sought to clarify the use of softing and bundling arrangements. In July 2006, in its Interpretative Guidance, the SEC adopted a similar line to the FSA, restricting the safe harbour to just execution and research.⁵ In France, the financial regulator, the Autorité des Marchés Financiers (AMF), has made a similar regulatory change and issued an Instruction requiring the unbundling of commission rates. However, the approach in France has been slightly different, such that the regulation sets out what cannot be purchased through commissions, as opposed to what is permitted, as under UK and US regulation.⁶

The post-implementation impact assessment

Although the changes in the UK were designed to correct for the potential market distortions from softing and bundling with a minimum of regulatory intervention, the effectiveness of these changes was unclear. To determine whether the changes in the regime for soft commissions and bundled brokerage arrangements were adequate, the FSA committed to undertake its first post-

implementation impact assessment of a regulatory change. Oxera was commissioned to develop a methodology for the (ongoing) measurement of the impact and to apply this methodology to construct the baseline for future comparison.

The first stage was to define the performance indicators (see section 2 of the Oxera report for more detail on these indicators). Although conceptually simple, this stage was both complex and critical to successful analysis, involving comprehensive analysis of the market relationships, both before and after the regulatory change. As the impact of the regulatory change is inherently uncertain, a broad range of indicators is required. The Oxera report describes the development of the methodology in detail, but it is worth noting here the combination of different types of indicator needed to capture the impact on the complex market relationships.

When measuring the impact of any regulatory change, the preference is to measure objectively the change in the desired market outcome to determine whether the market has responded to the change. Such performance indicators are both hard (focusing on measures that provide clear and objective data), and direct (focusing on the final market outcomes). However, reliance on hard and direct measures presents three problems:

- there may be other significant factors in determining the final market outcome;
- there may be considerable delay between the regulatory change and the final market outcome;
- clear and objective measures may not always be available.

In the first and second cases, indirect performance indicators can be used to measure the intermediate impacts of the regulatory change; in the third case, soft performance indicators can be used to measure subjective market responses. Successful determination of the impact of regulatory changes is likely to require a combination of both direct/indirect and hard/soft performance indicators. Figure 3 demonstrates how the measures could be combined.

In assessing the impact of the regime change, these factors were combined such that performance indicators were defined throughout the market relationships (as shown in Figure 4), and were often interrelated, with some expected changes dependent on other changes within the value chain.⁷ The

Figure 3 Classification of performance indicators

	Hard indicators	Soft indicators
Direct indicators	Indicators that objectively measure the direct change in the market outcomes— eg, the change in the amount spent on research through commissions	Indicators that subjectively measure the direct change in the market outcomes— eg, monitoring of softing and bundling arrangements by pension fund trustees
Indirect indicators	Indicators that objectively measure an intermediate change leading to the change in the market outcomes— eg, any transition between spending on full service brokerage and execution-only brokerage	Indicators that subjectively measure an intermediate change leading to the change in the market outcomes— eg, the quality and frequency of disclosure from fund managers to pension fund trustees

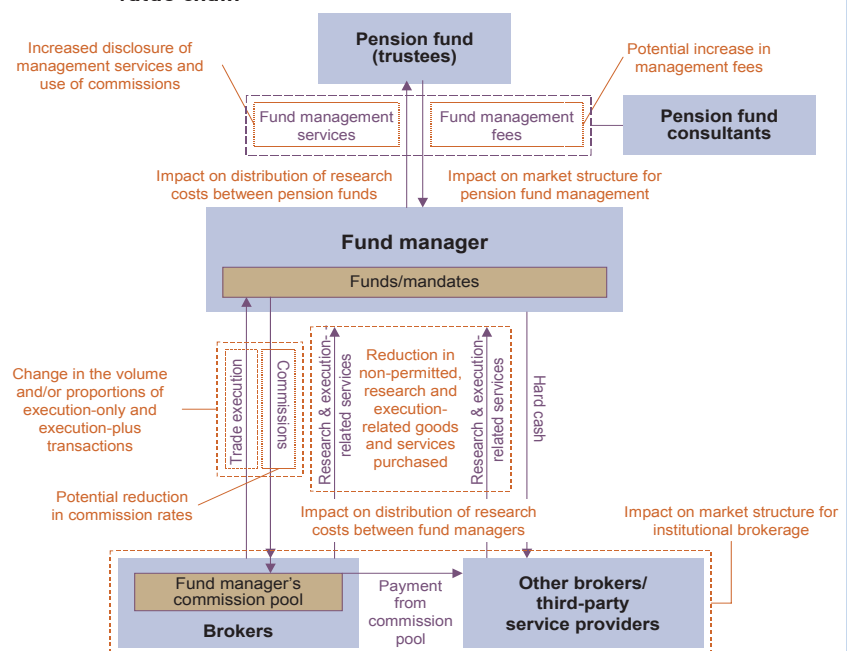
Source: Oxera.

methodology for measuring the change in these indicators was also developed. Although some publicly available data was identified, most of the data was not in the public domain. This required an extensive survey, including both interviews and questionnaires, to collect the data to construct the baseline.

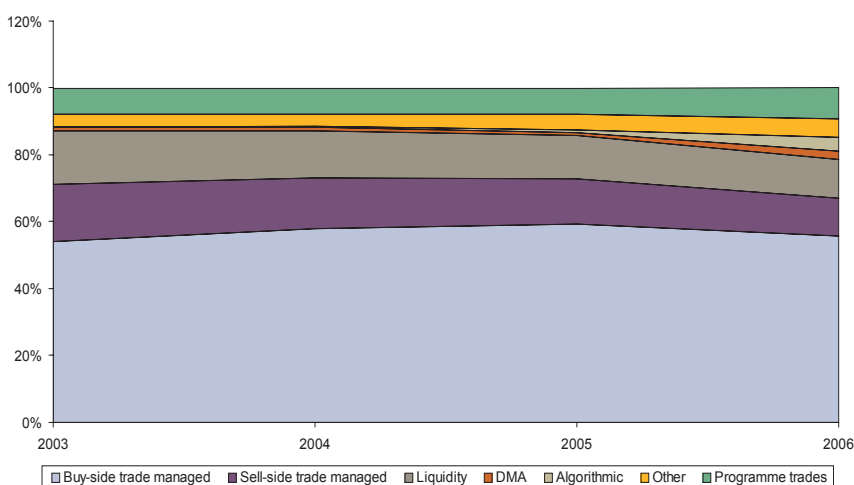
What did the baseline show?

The survey stage was critical to the success of the impact assessment, since it determined the quality of the data available for the analysis. Application of the methodology involved considerable flexibility, since additional follow-up interviews and questionnaires were necessary to gather sufficient data to provide a reasonable basis for the analysis. At this stage, only the baseline has been completed, and the impact

Figure 4 Potential impacts of the change in the regime throughout the value chain



Source: Oxera.

Figure 5 Proportion of trades of different types of brokerage

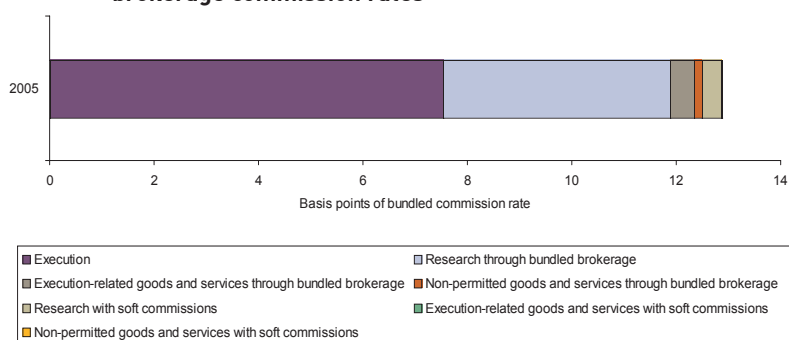
Source: Oxera calculations based on responses to the fund manager questionnaire.

service brokerage to different forms of execution-only brokerage. Both fund managers and brokers were asked to provide data on the proportions of trades distributed between a menu of brokerage services; the results from the fund managers are shown in Figure 5. This shows that, at least from 2005, there has been some decline in the use of both buy-side trade managed and sell-side trade managed brokerage services (ie, those types of brokerage predominantly used in bundled brokerage), and an increase in execution-only trades (particularly algorithmic and direct market access, DMA).

assessment will require comparison of the baseline survey with the results of future surveys. Oxera's report therefore focuses on presenting the extensive results for each performance indicator. This provides a broad baseline of data for future comparison. However, there are already some initial findings from the baseline survey regarding the state of the markets for fund management and institutional brokerage.

The survey highlighted a number of trends in the fund management and brokerage industries. These trends are important for assessing the impact of the change in the regime so that the correct counterfactual can be identified. One such trend was the shift away from full-

Also of interest is the baseline data on the use of commission rates. Fund managers were asked to provide data on the amount spent (by volume and commissions) on different types of brokerage and different types of goods and services. Aggregating this data across all fund managers in the sample, analysis of the baseline survey data allowed the determination of the constituents of the average bundled brokerage commission rate. The results, shown in Figure 6, provide the first aggregate breakdown of bundled brokerage commission rates based on actual data. This gives an indication of the relative value of goods and services purchased through bundled brokerage. Figure 6 shows that the majority of the average commission rate does

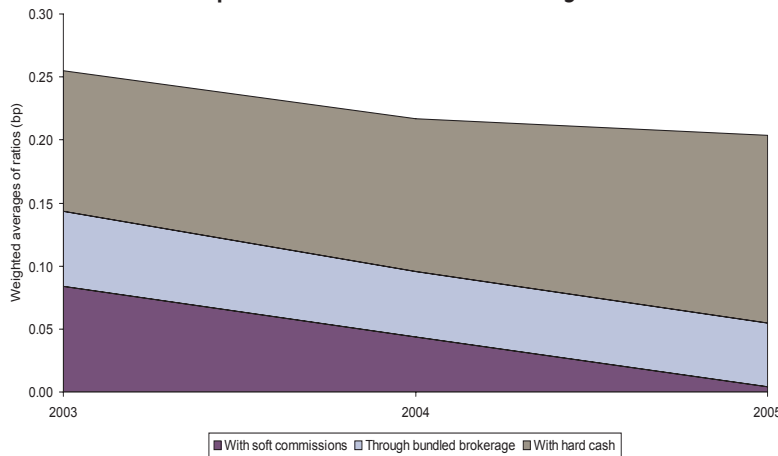
Figure 6 Execution and non-execution constituents of bundled brokerage commission rates

Constituent	Basis points
Execution	7.54
Research through bundled brokerage	4.34
Execution-related goods and services through bundled brokerage	0.46
Non-permitted goods and services through bundled brokerage	0.14
Research with soft commissions	0.38
Execution-related goods and services with soft commissions	0.00
Non-permitted goods and services with soft commissions	0.02

Source: Oxera calculations based on responses to the fund manager questionnaire.

pay for execution, but also that over 40% of the average commission rate pays for non-execution goods and services. Of these, the largest is research, making up 37% of the average commission rate, which is predominantly purchased through bundled brokerage arrangements. The purchase of other goods and services, including now non-permitted goods and services, accounts for a small part of the average commission rate.

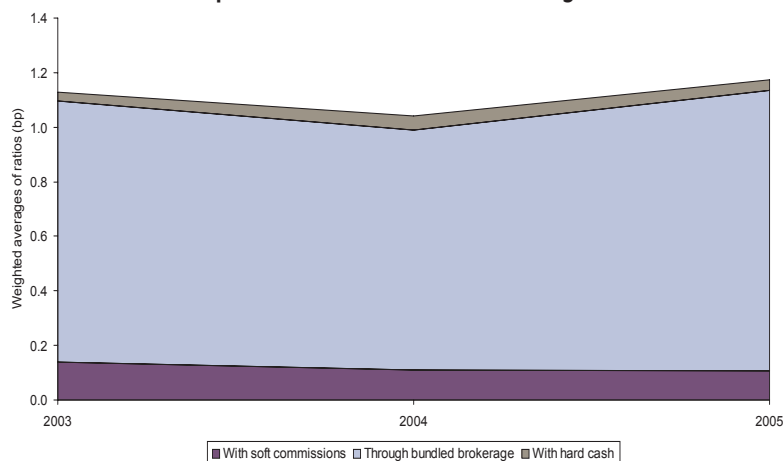
Finally, as regards the impact of the change in the regime, the data from the survey shows that the fund management industry has been moving towards compliance prior to the effective change. This can be seen in Figure 7, which shows that the amount spent on non-permitted goods and services relative to the funds under management (FUM) declined from 2003 to 2005. This was

Figure 7 Weighted average of ratios of non-permitted goods and services purchased to funds under management

Source: Oxera calculations based on responses to the fund manager questionnaire.

predominantly driven by the reduction in spending through soft commissions. In addition, Figure 7 suggests that there was some switch to purchasing these non-permitted goods and services with hard cash, but that the overall amount spent on non-permitted goods and services relative to FUM declined.

The data from the baseline survey also shows that the spending on permitted non-execution goods and services has remained broadly constant relative to FUM.⁹ This is shown in Figure 8, which indicates that the

Figure 8 Weighted average of ratios of non-execution goods and services purchased to funds under management

Source: Oxera calculations based on responses to the fund manager questionnaire.

purchase of such permitted goods did not change in anticipation of the change in the regime. However, in both cases, there was insufficient data to draw robust conclusions on changes in the market for fund management. More data is needed over a longer time period, and firm conclusions on the impact of the regulatory change will require comparison of the results of further surveys with the data from the baseline survey.

Concluding remarks

The final stage in undertaking the baseline survey for the impact assessment was to evaluate the performance indicators and methodology. Two considerations are important: first, whether the quality of the data received was suitable for conducting

an impact assessment; and second, how useful the indicators were in determining the impact of the change. In the case of softing and bundling, this evaluation assessed the usefulness and measurement of each performance indicator, giving both a rating on a five-point scale and an explanation for that rating. This indicated that, with respect to the methodology, the general quality of data provided was either good or very good, and that the performance indicators were either useful or very useful. This suggests that the baseline survey has provided sufficient data to draw together a

comprehensive baseline for future comparison, allowing the ongoing assessment of the impact of the change in the regime for softing and bundling arrangements.

This impact assessment provides an interesting example of the application and use of impact assessments as a tool. It also raises a number of issues associated with such approaches—eg, there may be considerable uncertainty of market outcomes and there may be some delay before the impact of regulatory change is discernable. However, the fact that these problems can be successfully tackled means that impact assessments present a useful tool to regulators and market participants for monitoring market developments.

¹ Execution-related goods and services are those used by fund managers in the execution of their trades, but are not directly related to any specific trades that were executed for the fund manager if they can still be obtained through soft commissions or bundled brokerage arrangements

² Myners, P. (2001), 'Institutional Investment in the United Kingdom: A Review', March, commissioned by the Chancellor of the Exchequer in the 2000 Budget.

³ FSA (2003), 'CP176 Bundled Brokerage and Soft Commission Arrangements', April.

⁴ FSA (2005), 'CP05/9 Bundled Brokerage and Soft Commission Arrangements: Feedback on CP05/5 and Final Rules', July.

⁵ SEC, (2006), Federal Register, July, 71:141.

⁶ AMF (2006), AMF Financial Regulation Newsletter, Q4.

⁷ The inter-relationship between the performance indicators is considered in greater detail in Oxera (2006), op. cit., section 2.

⁸ Non-permitted goods and services are defined as those goods and services that were previously allowed to be obtained through soft commissions or bundled brokerage arrangements, but that do not fall within the new rules and the FSA definitions of 'execution' or 'research'; they are no longer permitted to be obtained through soft commissions or bundled brokerage arrangements.

⁹ Permitted non-execution goods and services are the research and execution-related goods and services that are allowed to be obtained through soft commissions or bundled brokerage arrangements under the new rules and the FSA definitions of 'execution' or 'research'.

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

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