Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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24/02/14

Dear Adam,

Consultation on the use of dealing commission rules

This is the Financial Services Consumer Panel's response to the proposals in CP13 /17**.

The Consumer Panel welcomes the opportunity to comment on the Financial Conduct Authority's (FCA) proposals to clarify which permissible actions or legitimate expenses can be attributed to dealing commissions. Nevertheless, we are concerned that the problems identified as far back as 2001 will persist without structural reform. Simply tightening up the definition of what is permissible is unlikely to succeed.

The misuse of commission to disguise the full costs of asset management services was highlighted as far back as 2001 by Paul Myners[1]. Subsequently, the FCA's predecessor, the Financial Services Authority, commissioned OXERA[2] to study the way commissions were used to pay for research. In its consultation paper CP176[3] the FSA articulated the deficiencies highlighted in the OXERA report. We responded to that consultation supporting the proposals to unbundle services, arguing that the existence of bundling and soft commissions' creates conflicts of interest between fund managers and their customers and encourages trade other than in the best interests of customers. We also said that these arrangements pose difficulties for effective transparency, disclosure and accountability. More importantly, we agreed with the OXERA report which noted that there was no economic justification for using commission payments to purchase goods and services for which demand is reasonably predictable.

The FSA subsequently softened its position, instead, it introduced a regime which permitted the use of dealing commissions for execution-related and research goods/ services. In the current consultation paper CP13/17, the FCA said that its predecessor favoured a consensual approach led by industry. It is an approach that has not worked. And this approach will continue to fail because the root of the problem lies in a deep principal agent flaw. The FCA needs to combat this structural weakness by eliminating the conflicts of interest and aligning the interests of fund managers with those of investors.

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[1] Myners, P. (2001), "Institutional Investment in the United Kingdom: A Review", March.
[2] Oxera (2003), "An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK", April.
[3] FSA (2003), "Bundled Brokerage and Soft Commission Arrangements", CP176, April.

We appreciate that the FCA may be under considerable pressure from the industry to validate the status quo, bar a few clarifications here and there. The FCA may also feel constrained by government to maintain the competitive position of the UK fund management industry. In its response to Kay's[4] recommendation 8, the Government said that it favoured an industry-led disclosure regime and warned that any regulatory measures would need to be agreed at EU level given the maximum harmonisation requirements of European directives. We are concerned that pressure from industry, coupled with the possibility of a diverging government agenda, may hinder the FCA from taking robust action.

The historical problem described above is further exacerbated by the lack of robust enforcement. There is evidence to suggest that for many years supervisors did not challenge bundled payments which included payment for access. This suggests that tightening up the regulatory definitions will have limited success: there are strong commercial incentives to work around any regulatory rule, and after a short period of extra scrutiny, the enforcement effort may slip.

We are not surprised that investment managers continue to stretch the definition of research. We are however disappointed that the FCA proposes to continue to endorse this approach. This approach underestimates the artfulness of industry players to manoeuvre around any regulatory guidance which continues to permit these expenses to be set against the fund. The Consumer Panel is therefore of the strong opinion that the FCA should actively consider the structural options including:

1. Ban commission charges to the fund altogether, allowing the fund management industry and clients to devise an optimal charging method: the precise solution can be left to the market or

2. Consider the 'rebate' idea of CP176, under which the fund manager would rebate to the fund the cost of services bought from the broker over and above the cost of trade execution. The reasoning behind this was to avoid the danger of under-trading, under-trading would result were the fund manager to post an all-inclusive tariff (as Myners recommended) based on what turned out to be an under-estimate of desirable trading activity; in this case, the fund manager would not be rewarded for trading optimally. The rebate scheme helps to avoid this problem by allowing all trading costs to be deducted from the fund ex post.

We urge the FCA to think more radically and raise (a) and (b) as possible options.

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[4] BIS (2012), "Ensuring Equity Markets Support Long-Term Growth. The Government Response to the Kay Review", November, Department for Business Innovation and Skills, November.