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# Wholesale sector competition review – Call for inputs

July 2014





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We are asking for comments on this *Call for inputs* by 9 October 2014.

You can send them to us using the form on our website at: [www.fca.org.uk](http://www.fca.org.uk).

**Or in writing to:**

Becky Young  
Policy, Risk and Research Division  
Financial Conduct Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

**Telephone:** 020 7066 6894

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We propose to make all responses to this call for inputs available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this document from our website: [www.fca.org.uk](http://www.fca.org.uk).

## Abbreviations used in this paper

<b>AIFMD</b>	Alternative Investment Fund Managers Directive
<b>BIS</b>	Bank for International Settlements
<b>CCP</b>	Central counterparty
<b>CIS</b>	Collective Investment Schemes
<b>CMA</b>	Competition and markets authority
<b>EMIR</b>	European Market Infrastructure Regulation
<b>ESMA</b>	European securities and markets authority
<b>FICC</b>	Fixed income, currency and commodities
<b>FSB</b>	Financial Stability Board
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>HMT</b>	HM Treasury
<b>ICB</b>	Independent Commission on Banking
<b>IPO</b>	Initial public offering
<b>M&amp;A</b>	Mergers and Acquisitions
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>MiFID II</b>	Markets in Financial Instruments Directive II
<b>MiFIR</b>	Markets in Financial Instruments Regulation
<b>MTF</b>	Multilateral trading facility
<b>OFT</b>	Office of Fair Trading
<b>OTC</b>	Over the counter
<b>OTF</b>	Organised trading facility

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<b>PRA</b>	Prudential Regulation Authority
<b>PSR</b>	Payment systems regulator
<b>RDR</b>	Retail distribution review
<b>SME</b>	Small and Medium-sized Enterprises
<b>UCITS</b>	Undertakings for Collective Investment in Transferable Securities

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# 1. Introduction

- 1.1** Wholesale financial markets play a crucial role in our economy and it is important that competition works effectively within them. We have considerable experience of dealing with these markets and their participants but we have not previously approached them from a competition perspective. We are therefore conducting a review of competition in the wholesale sector to identify any areas that might merit further investigation through an in-depth market study. The review is an exploratory exercise that aims to highlight areas from the relevant markets where competition may be weak or not be working properly.
- 1.2** The review will focus primarily on competition in wholesale securities and investment markets, and related activities such as corporate banking. To keep the scope of the review manageable, we have excluded other areas of financial services such as payment systems, credit rating agencies<sup>1</sup> and wholesale insurance. In addition, this review will not focus on the trading practices, including benchmarking activities that are within the scope of Fair and Effective Financial Markets Review, a joint review by the Bank of England (the Bank), HM Treasury (HMT) and the FCA.<sup>2</sup> However, we are open to receiving evidence on other competition issues, and will consider how to address these, whether in the context of this review or separately.
- 1.3** We are opening our engagement with industry by publishing this call for inputs. We are seeking views from stakeholders on areas where they think competition is not working effectively. To aid discussion, we outline some examples of potential competition issues that have been raised by stakeholders previously, or drawn from our internal research and existing supervisory and thematic work. We seek views on the likelihood of these being borne out and problematic, as well as suggestions for other issues that we should explore.

## Who does this call for inputs affect?

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- 1.4** We invite views from across the wholesale sector, in particular:
- Suppliers of products and services to the wholesale markets.
  - Buyers of products and services from the wholesale markets.
  - Any other stakeholders who interact with wholesale market participants, or may indirectly be affected through this review, such as retail investors or any other consumers.
- 1.5** In chapter 2 we set out a simplified diagram of the wholesale sector, indicating the types of activities that are within the scope of the review.

<sup>1</sup> Credit rating agencies are authorised and supervised directly by the European Securities and Markets Authority (ESMA).

<sup>2</sup> Fair and effective financial markets review, terms of reference available at: [www.gov.uk/government/publications/fair-and-effective-markets-review-terms-of-reference/fair-and-effective-financial-markets-review-terms-of-reference](http://www.gov.uk/government/publications/fair-and-effective-markets-review-terms-of-reference/fair-and-effective-financial-markets-review-terms-of-reference)

### Is this of interest to retail consumers?

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- 1.6** By definition, the markets that form the focus of this exercise are not directly accessed by retail consumers. However, if competition in wholesale markets works effectively, we expect retail consumers to benefit. Therefore, as well as participants in the wholesale markets, we are keen to hear from retail investors or their representatives who interact with these participants.

### Context

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- 1.7** The FCA has three statutory objectives:
- An integrity objective: to protect and enhance the integrity of the UK financial system.
  - A consumer protection objective: to secure an appropriate degree of protection for consumers.
  - A competition objective: to promote effective competition in the interests of consumers in the markets for regulated financial services.
- 1.8** These three operational objectives support our strategic objective of ensuring that the relevant markets function well.
- 1.9** The competition objective became effective from the FCA's inception in April 2013. This has led us to review our approach to the markets that we regulate.
- 1.10** Market studies are one of our main tools for examining how competition works in these markets and to assess whether we should intervene in the interests of consumers. We completed our first market study in March this year (general insurance add-ons) and announced our programme of competition work for the year ahead in the 2014/15 business plan. This stated our intention to complete the two competition market studies currently ongoing (cash savings and retirement income), to look at aspects of the credit card market, and to initiate this review.
- 1.11** This review signals the importance of our competition mandate in the wholesale sector. Wholesale markets are characterised by a greater relative sophistication of participants than retail markets. However, issues such as LIBOR have demonstrated that market confidence can quickly be eroded, and that the impact of poor conduct, in and outside our regulatory perimeter, is far-reaching.
- 1.12** Effective competition within the wholesale sector can lead to an increase in institutional efficiency, lower prices, greater innovation and can improve the quality and range of financial services provided. These improvements should contribute to the sustainable development of the financial system, and have positive knock-on effects for retail consumers and real economy businesses.
- 1.13** A wide range of supply-side and demand-side factors can prevent effective competition. Existing regulation and forthcoming regulatory changes can also potentially affect competition in a given market. Examples of supply-side issues could be constraints that make it harder for providers to enter the market, expand or provide certain services. Demand-side factors can, for example, relate to conflicts of interest between the incentives of wholesale agents and their clients (so-called 'principal-agent' problems).



- 1.14** While the focus of the review is on the competitive dynamics of the sector, we will consider all three of our objectives in our analysis, including how these objectives interact in the markets in question.
- 1.15** In some areas there are links between our responsibilities and those of other regulatory authorities, including the Bank of England and Prudential Regulation Authority. Where this is the case, we will also take into account the objectives of, and requirements imposed by, these authorities.

### Summary of this document

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- 1.16** In this review, we are seeking evidence and views on areas in the wholesale sector where competition is not working effectively. In chapter 2 of this document we describe the scope of the review in terms of the areas covered and the type of competition issues on which we are seeking evidence.
- 1.17** We also propose some criteria for determining which, if any, market studies to conduct. These include the possibility and likely impact of any intervention and the extent to which current or forthcoming regulation or market forces may address any issues identified. We will also consider how any potential candidate for a market study would fit with other work being undertaken by the FCA, including current and forthcoming thematic work.
- 1.18** In chapters 3 to 6, to aid discussion, we outline some areas where we consider that there may be competition issues that could merit further examination. It is important to note, at this stage, we have not conducted detailed evidence gathering and analysis from a competition perspective. The areas we have highlighted contain examples of the type of issue that might raise competition concerns, if further investigation finds them to be borne out. We are inviting comments on the extent to which respondents agree that there might be competition issues that merit further examination in these or similar areas, and also on the level of detriment each issue may cause to consumers. We are also inviting respondents to bring to our attention any other behaviours or market features that they believe impede healthy competition in any of these markets.
- Chapter 3 focuses on markets and market infrastructure. It discusses the following:
    - Issues relating to the production and dissemination of data.
    - Arrangements between trading venues and clearing houses in both over-the-counter (OTC) and venue-traded markets.
    - Packaging of trading and clearing services by dealers in the OTC and venue-traded markets.
    - Client clearing, where issues may exist for counterparties that will become subject to forthcoming clearing obligations, in terms of becoming a clearing member of a Central Counterparty (CCP) or clearing indirectly.
    - Concentration in the OTC and venue-traded markets.
    - Colocation, where a market participant pays a premium to locate its server next to the trading venue's matching engine, with resulting reductions in latency.

- Chapter 4 discusses investment banking activities including:
  - Cross-selling of investment banking services.
  - Cost of equity and debt underwriting.
  - Best execution.
- Chapter 5 focuses on asset management and discusses:
  - The incentives of asset managers to pay the correct price for the correct level of service, for example in relation to:
    - Governance services.
    - Transfer agency.
    - Dealing commissions.
    - Ancillary services.

**1.19** Chapter 6 discusses corporate banking and highlights:

- Likelihood of entry.
- Demand for corporate banking.
- Cross-selling.

**Equality and diversity considerations**

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- 1.20** We do not consider that there would be any equality or diversity impacts of this review, but we would welcome your comments.

## 2. Scope of this review

### Introduction

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- 2.1** In this chapter, we set out a high-level summary of the wholesale activities covered by this review. We also explain the process that we have used to identify potential areas where competition issues might exist. We also explain the framework within which we propose to prioritise those, if any, issues that are most suitable for an in-depth market study.

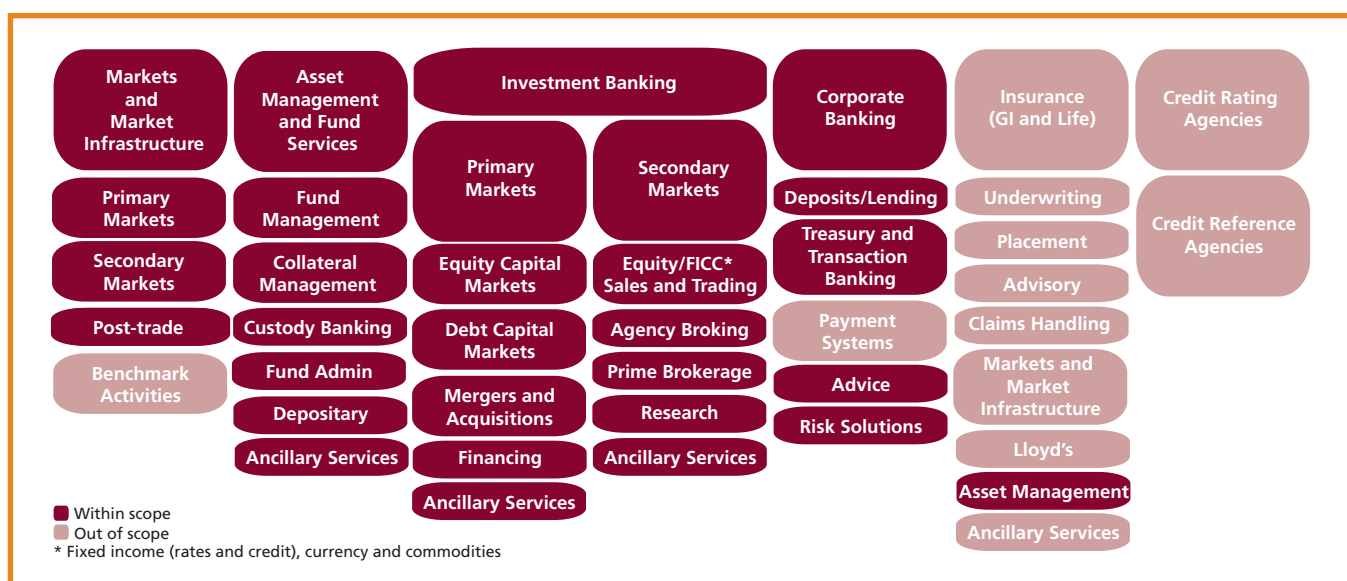
### Wholesale activities covered by this review

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- 2.2** Figure 1 below summarises the areas that are the main focus of this review. In chapters 3 to 6, we outline our understanding of how competition currently works for some of the key activities that take place within these areas and some potential issues which might exist. The diagram is not exhaustive in respect of the activities within scope of this review.
- 2.3** We have chosen to focus the review on the wholesale activities that form part of the investment chain. We have not, at this stage, covered other significant areas of wholesale activity within financial services, such as credit rating agencies and wholesale insurance. We consider that these activities are, to some degree, separable from the sectors in the investment chain and have chosen to limit our coverage to ensure that the review remains manageable. In the case of payment systems, work is underway under the auspices of the Payment Systems Regulator (PSR). In addition, this review will not focus on the trading practices, including benchmarking activities that are within the scope of the Fair and Effective Financial Markets Review. However, we are open to receiving evidence on other competition issues, and will consider how to address these, whether in the context of this review or separately.
- 2.4** In chapter 1 we set out the FCA's strategic and operational objectives. In broad terms, under FSMA, the FCA is responsible for:
- regulating standards of conduct in retail and wholesale markets
  - supervising trading infrastructures that support those markets
  - the prudential supervision of authorised firms that are not PRA-regulated
  - the functions of the UK Listing Authority and other functions under Part 6 of FSMA, and
  - administering a number of specialised regimes covering, for example, payment services and regulated covered bonds

- 2.5** There are various aspects relating to the supervision of markets and market infrastructure where the FCA cooperates closely with the Bank of England (the Bank) and the Prudential Regulation Authority (PRA). A memorandum of understanding has been agreed that sets out the high-level framework that will be used to facilitate such cooperation. Under the Bank of England Act 1998, the Bank has an objective to protect and enhance the stability of the financial system of the United Kingdom. In pursuit of this objective, the Bank is responsible for, amongst other things, the oversight of central counterparty clearing providers, and settlement and payment systems. The PRA is responsible for the authorisation, in conjunction with the FCA, and prudential supervision of individual deposit takers, insurers and certain designated investment firms.
- 2.6** This review covers some activities that are outside the FCA’s existing perimeter (as set out in the FSMA Regulated Activities Order 2001), particularly where they relate to other parts of the investment chain. In addition, when we gain further competition powers in April 2015, we will be able to consider competition issues within financial services, beyond the current set of regulated activities. Currently, any such competition issues are within the remit of the Competition and Markets Authority (CMA), however, from April 2015 both the FCA and the CMA will be able to consider them. We will consider the most appropriate way to address any responses we receive on areas that are not currently within our regulatory perimeter.
- 2.7** Figure 1 illustrates which areas are covered by this review, with the lighter shaded areas outside the scope. It is recognised that wholesale activities can be undertaken within a variety of firms and structures – for example, research will be carried out by different firms in varying contexts.
- 2.8** In some cases, various wholesale activities may be integrated within individual entities, whereas other activities may be undertaken by specialist providers that do not undertake any other activities.
- 2.9** We also appreciate that a number of the activities within the review are international in nature, and this may complicate any assessment of competition from a UK perspective. We welcome comments both on the international nature of the activities and the UK dimension. We will take this into account in our approach to prioritisation when selecting a market study. This is discussed in more detail below.

**Figure 1 - Wholesale overview diagram**



## Identification and prioritisation of issues

### Identifying issues

- 2.10** We are seeking your views on areas in the wholesale sector where competition is not working effectively.
- 2.11** In chapters 3 to 6, in order to aid discussion, we outline some examples of potential competition issues that have been raised by stakeholders previously, or are drawn from our internal research and existing supervisory and thematic work. The list is not intended to be comprehensive and we welcome suggestions, supported by evidence, of other areas in which competition issues might exist and merit further investigation.
- 2.12** As mentioned above, at this stage, we have conducted preliminary analysis to arrive at the issues identified. We have not, however, conducted detailed evidence-gathering and have not reached any conclusions as to whether competition is or is not working effectively. Our thinking on the different areas identified has been developed to varying levels of detail, depending, for example, on the amount of work that the FCA has already carried out on them in other contexts (such as thematic reviews or policy involvement). In this consultation exercise, we are seeking views (backed with evidence wherever possible) on the extent to which potential issues in these areas are borne out in the experience of stakeholders.
- 2.13** We are interested in features of a market or behaviour that could inhibit or distort the healthy functioning of the market. Examples might include:<sup>3</sup>
- Exploitation of market power – where one or more firms have a strong position on a market and are able to exploit their clients or exclude their rivals. This may arise for a number of reasons, including coordinated or cartel-like behaviour, network effects, or barriers to entry (see below).
    - This may result in high prices or poor quality of service.
    - Exclusionary behaviour may include practices that make it difficult for less established players to compete, for example tying or bundling of services, or predatory (below cost) pricing.
  - Barriers to entry or expansion – where it is difficult to enter a market or grow rapidly, and existing players are protected from the threat of someone else coming in offering a cheaper or better service. Regulation can itself be a significant barrier to entry.
  - Barriers to switching – where clients, once signed up with a particular supplier, find it difficult or costly to take their business elsewhere.
  - Issues relating to the flow of information between market participants – this can include problems of data access or technology constraints or a lack of transparency in certain markets. This may mean that clients do not fully understand the price they are paying for a given service, the nature and quality of services they are purchasing or the level of risk which they are exposed to.
  - Principal-agent problems or conflicts of interest – for example, misaligned incentives between agents and their clients.

<sup>3</sup> For a fuller account of the generic features of markets that can give rise to competition concerns, please see the Competition and Markets Authority's (CMA) Market investigations guidelines (<https://www.gov.uk/government/publications/market-investigations-guidelines>). The FCA's approach to analysing whether markets are working well for consumers is in line with that of the CMA.

**2.14** Consumer detriment arising from ineffective competition will tend to take three broad forms:

- Consumers pay too much for the products or services they receive (this might take the form of wider spreads or higher costs) or receive poor service for the price.
- Consumers do not buy the right products or services for their needs. This might arise because the incentives of the agent (for example, a fund manager) are not aligned with the interests of the principal (for example, an investor), and suppliers (for example, brokers) compete to win business from agents. These concerns have been prominent in retail markets, and underlay the Retail Distribution Review (RDR). In wholesale markets there may be similar issues around, for example, the provision of research because it has been paid for out of dealing commissions and bundled with the cost of execution. This is discussed in more detail in chapter 5.
- So-called 'missing markets', where there is a genuine client need that, for some reason, nobody comes forward to supply. This may arise, for example, where a significant problem exists which calls into question the reliability of a given market. This results in the erosion of confidence in the market to such an extent that the market ceases to function effectively any longer.

**2.15** We are seeking evidence and views on the scale of detriment associated with any issues that stakeholders identify. Before we have conducted any detailed competition analysis of the kind we might expect from a market study, estimates of associated detriment will probably be very broad-brush. However, to prioritise between candidates for a potential market study, it is useful to have some idea of the scale of the markets and depth of the problems concerned.

#### **Prioritising issues**

**2.16** In choosing between candidate areas for any market study, we will bear in mind a range of considerations, including:

- The prospects for and likely impact of any intervention in the market – this will be a combination of:
  - the scale of harm, and thus the potential impact of intervening to address the issue in question
  - the scope for the FCA to intervene effectively (taking into account, for example, domestic versus international issues, the impact of harmonising EU legislation and the FCA's regulatory perimeter)
  - the prospects for intervention to have a wider impact, for example deterrent effects or clear read-across to other markets
- How the issue in question fits in with any upcoming regulatory developments/ongoing activity at a domestic, EU or wider international level, for example:
  - Are there other current competition investigations taking place that are considering the issue?
  - Is there due to be any change in regulation that will affect the relevant market/behaviour?
- Whether the market has been subject to recent significant non-regulatory change that has not had sufficient time to bed in, but might have an important impact on the relevant

issues. Or whether, market changes or forces are anticipated in the future that might serve to address any issues identified.

- How a market study would affect the FCA's current portfolio of work, including any resource implications.
- Whether the issue might be better addressed by another form of FCA intervention (such as enforcement or supervisory action), or by another authority (PSR/PRA/Bank of England/CMA/EC/other).
- The likelihood of a successful outcome.

## 3. Markets and market infrastructure

### Introduction

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- 3.1** We are seeking views on areas of markets and market infrastructure services where competition may not be working effectively. In this chapter, we outline some potential areas where competition issues might exist and welcome views and evidence on these and/or other areas.

### Summary of activities

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- 3.2** There are a number of financial markets, ranging from equities and bond markets, to financial derivative and commodity derivative markets. Trades can take place on or off a trading venue (the latter being referred to as over-the-counter, or OTC) and, related to this, there are a number of steps that trades can go through, with various infrastructure and intermediaries providing products and services both pre and post the trade. Broadly, products and services fall into the following categories (though the list is not exhaustive):
- Primary market activities – activities relating to the issuance of securities.
  - Activities relating to trading on the secondary markets in securities, and trading in derivatives, which includes both venue traded and over-the counter (OTC) markets.
  - Post-trade activities – including clearing, settlement, custody and administration.

### Competition issues which may merit further examination

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#### Issues relating to the production and dissemination of data

- 3.3** Market participants use trade data – a by-product of trading – and other forms of market data to make informed decisions, and data costs are, directly or indirectly, one component of the overall cost of trading. Such data may be sold at varying levels of aggregation and latency, and may be packaged or used in the pricing of other products, including benchmarks. The method of production, dissemination and usage can vary from market to market, and the chain can involve various trading venues or participants in the OTC markets, market infrastructures, and other intermediaries, including data services and benchmark providers. Trade data production and provision is an important source of revenue and competition for many of these participants.
- 3.4** Given how it is used, it is important that trade data is accurate, timely and accessible on a fair and non-discriminatory basis. Regulatory developments, in particular through the Markets in Financial Instrument Directive II (MiFID II) and Markets in Financial Instruments Regulation



(MiFIR), should support this by imposing rules that are designed to broaden the scope of pre and post-trade transparency requirements across both equity and non-equity markets and to enhance the effective disclosure and consolidation of trading data, for example:

- A consolidated tape mechanism will be established for post-trade equities data (and potentially for non-equities too). The existing requirement for trading venues to make pre- and post-trade data available on ‘a reasonable commercial basis’ will be broadened to apply to many equity and non-equity instruments not currently covered.
- The requirement will also be tightened by requiring non-discriminatory access to the information and clarifying in a forthcoming delegated act what constitutes a ‘reasonable commercial basis’.
- Trade data will have to be unbundled so that pre- and post-trade data is made available separately, and there will be further requirements specifying ‘the level of disaggregation of the data to be made available to the public’ in forthcoming ESMA technical standards.

**Q1: Taking into account regulatory developments in this area, we welcome evidence on any competition issues in the market for data services – in respect of both venue-traded and OTC products. For example:**

- ***Whether there are instances where those entities producing or disseminating data face limited competition such that they are in a position to charge higher prices and/or create barriers to entry or expansion.***

**Issues relating to market access**

**3.5** Financial market access refers to the ability of market participants, including infrastructure entities<sup>4</sup>, to use, directly or indirectly, market services. A number of regulatory developments are currently underway that will affect the structure of financial markets in Europe and the way in which those markets are accessed. Some of the changes affecting access are directly motivated by a desire to increase competition.

**3.6** For example, the European Market Infrastructure Regulation (EMIR<sup>5</sup>) and MiFIR include provisions to enable open access on a non-discriminatory and transparent basis to trading venues and Central Counterparties (CCPs); EMIR, in respect of OTC derivatives, which EMIR defines as being derivative transactions not carried out on a regulated market<sup>6</sup>; and, MiFIR, in respect of other financial instruments. Forthcoming technical standards under MiFIR will provide more detail regarding open access for financial instruments that are not already subject to access obligations under Articles 7 and 8 of EMIR. This will include the specific conditions under which access may be denied by CCPs and trading venues, and standards to ensure that a non-discriminatory and transparent approach is used for fees relating to such access.

<sup>4</sup> This includes various types of entities that facilitate the clearing, settlement, and recording of monetary and other financial transactions, such as payments, securities, and derivatives contracts.

<sup>5</sup> More formally known as the European Union regulation on Over-the-Counter (OTC) derivatives, central counterparties (CCPs) and trade repositories.

<sup>6</sup> Article 2 of EMIR sets out the following definition: ‘OTC derivative’ or ‘OTC derivative contract’ means a derivative contract the execution of which does not take place on a regulated market as within the meaning of Article 4(1) (14) of Directive 2004/39/EC or on a third- country market considered as equivalent to a regulated market in accordance with Article 19(6) of Directive 2004/39/EC. This definition is wide enough to cover, for example, derivative contracts traded on Multilateral Trading Facilities (MTFs) and Organised Trading Facilities (OTFs) because they are not within the regulated markets definition. However, in this chapter, the term OTC relates to the more commonly used interpretation, that is, trading carried out bilaterally rather than through a centralised trading venue, regardless of the form of this venue.

**3.7** Other regulatory changes may impact market access through the changes to market structure that they bring about, potentially leading to changes in the way competition takes place. For example:

- Requirements introduced under EMIR include:
  - reporting, to a trade repository, any derivative contract entered into
  - an obligation to clear through a CCP those ‘OTC derivatives’ subject to a mandatory clearing obligation, and harmonisation of regulatory requirements across the EU for CCPs, and
  - implementation of stricter risk management processes (including in relation to margin requirements) for all non-cleared ‘OTC derivatives’ trades
- Requirements being introduced under MiFIR and MiFID II will include:
  - An obligation to clear through a CCP derivatives transactions concluded on a regulated market.
  - The introduction of a new category of trading venue, known as an Organised Trading Facility (OTF).
  - A requirement for derivatives, which are specified as sufficiently liquid in forthcoming technical standards under MiFIR and declared subject to a trading obligation, to be traded only on regulated markets, multilateral trading facilities (MTFs), OTFs or third-country trading venues determined as equivalent by the Commission.

**3.8** Below are five areas relating to market access where competition issues might exist now and/or in the future.

### **1) Arrangements between trading venues and clearing houses in both OTC and venue-traded markets**

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**3.9** Given the above regulatory changes, it is expected that there will be an increase in the demand for trading on organised trading venues, and for clearing services in respect of both OTC and venue traded markets, both directly and indirectly. Market operators can find it advantageous to provide a package of integrated transaction services, and there are examples across the international markets of vertical integration between trading venues and CCPs to enable them to offer this chain of services.

**3.10** Such silo structures may provide benefits to consumers, including in terms of efficiency and through network effects.<sup>7</sup> However, there may also be competition implications resulting from any changes to the way in which trading and clearing services are accessed, where vertical integration exists. These competition issues could arise at various stages in the vertical chain.

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<sup>7</sup> When the value of a product or service rises as others use it – for example, liquidity will increase as more trades are executed on a particular venue, which tends to attract more liquidity

- 3.11** For example, a vertically integrated entity may restrict access to certain services that it provides, or not provide them in a proportionate manner; for example if participants on a particular trading venue are unable to connect to a CCP that exists as part of a silo arrangement on a reasonable basis. This may make it more difficult for stand-alone trading venues to compete.
- 3.12** Similarly, if an organised trading venue mandates for certain products to be cleared through particular CCP(s), this could restrict the ability for stand-alone clearing houses to compete due to the restricted size of their available market. Some trading venues allow multiple CCPs to offer clearing services within their marketplace, but this is not a common feature across the markets. It is recognised that risk considerations may also be a relevant factor here – for example, the possibility of connecting to a single or multiple CCPs each carry their own risks (e.g., concentration versus fragmentation).
- 3.13** Another example might be silo structures bundling services provided across the transaction chain and rebalancing the proportion of the charge relating to each activity. For example, clearing or trading fees may be reduced with offsetting increases elsewhere. This may provide some benefits, but may also create barriers to entry or expansion for standalone trading venues and CCPs, which could be further reinforced via network effects.
- 3.14** Intellectual property rights could also impact the ability for trading venues to directly compete with each other in some markets. More specifically, unlike shares and bonds that are issued by the company raising capital and admitted to trading by a venue (and which can be traded across multiple venues), derivative contracts are often designed by the venues themselves. Thus, while economically equivalent contracts can be created by other venues, they are generally not legally the same nor fungible or transferable across markets. This may make it difficult for venues to offer a competing service, particularly given network effects, although there may also be advantages to market participants concentrating liquidity in a particular contract on one venue.
- 3.15** We would welcome evidence related to those areas not currently being considered or addressed by regulatory changes. In addition, if there are aspects of the way in which the markets are structured or function that we should take into account alongside any competition considerations, please include these in your response (e.g., if intervening to address an identified competition issue might have broader implications for risk, financial stability, or market functioning).

**Q2: We welcome evidence on whether there are any competition issues in the market for trading and clearing services, both for OTC and venue traded products.**

**For example:**

- ***Whether there are instances in which standalone trading venues and CCPs are limited in their ability to compete with silo structures.***
- ***Whether there are instances of barriers to entry that prevent competition from new entrants.***

## 2) Packaging of trading and clearing services by dealers in the OTC and venue-traded markets.

**3.16** In a similar way to the arrangements described above, dealers may seek to package together services across the transaction chain, in particular, execution and clearing businesses. Accordingly, fee arrangements may be amended to reflect packaged services by, for example, offering discounts and/or rebalancing the proportion that comprises trading versus clearing fees. In a similar way to the case described above, this may provide benefits for consumers, but there may also be implications for competition that arise from changes to the way in which trading and clearing services are accessed.

**Q3: We welcome evidence on whether there are any competition issues in the supply of trading and clearing services by dealers. For example:**

- *whether there are instances in which standalone dealers providing trading or clearing services are disadvantaged in competing with dealers that integrate such services*
- *whether there are instances of barriers to entry that prevent competition from new entrants*

## 3) Client clearing

**3.17** In Europe, the first clearing obligations under EMIR are expected to be implemented in late 2014 and will apply to financial counterparties and some non-financial counterparties. Demand for clearing services is expected to increase as the implementation date approaches. Those counterparties that are subject to clearing obligations and are unable<sup>8</sup>, or choose not to clear directly with a CCP by becoming a clearing member of a CCP, will need to make alternative clearing arrangements. More specifically, they will need to ensure that either clearing members can clear transactions on their behalf (i.e., they become a client of a clearing member, so that they can clear through a process known as 'client clearing') or they become a client of a clearing member client (known as 'indirect client clearing').

**3.18** In its recent progress report<sup>9</sup> the Financial Stability Board (FSB) explained that some authorities (particularly from jurisdictions with smaller OTC markets) were concerned that client access to centrally cleared markets may be limited. For example, the FSB noted that, while the number of intermediaries offering client clearing services appears to be increasing as the implementation date approaches, it remains the case that most of this activity is carried out globally by fewer than ten large banking groups and trading firms.

**3.19** We acknowledge the importance of clearing intermediaries being able to manage risks effectively, and regulatory and CCP demands in this regard. Thus, there are likely to be some barriers to entry that are justifiable, and where increasing competition could have detrimental effects for, for example, risk management. Such barriers may include, for example, the balance sheet size and trading capabilities needed to participate in the default management process. However, there may be other barriers and features of the market that merit further

<sup>8</sup> For some counterparties, becoming a clearing member will not be a possibility due to, for example, risk management requirements and the capital and operational capabilities needed to undertake default management. Such counterparties will therefore need to clear via the alternative routes outlined above.

<sup>9</sup> [www.financialstabilityboard.org/publications/r\\_140408.pdf](http://www.financialstabilityboard.org/publications/r_140408.pdf)

consideration. For example, if principal-agent type issues arise from the indirect relationship between CCPs and clients of clearing members, if the incentives of clearing members (as the agent) are not directly aligned with those of the client (the principal) and CCPs compete for clearing member business.

- 3.20** Where competition issues are identified, we would be grateful for any evidence on relevant factors such as the risk considerations noted above so that we can consider these alongside those relating to competition.

**Q4: We welcome evidence on:**

- *whether there are competition issues such as those noted above in the market for client clearing*

#### **4) Concentration in the OTC and venue-traded markets.**

- 3.21** According to the Bank for International Settlements (BIS)<sup>10</sup>, the notional amount outstanding in the OTC derivatives markets totalled \$693 trillion as at the end of June 2013. Estimates suggest as much as 80% to 90% of all trades by notional volume have one of 14 dealers as the counterparty, and that around a third of market volume is traded solely between these dealers. High levels of dealer concentration may be found in other financial markets – for example, FCA estimates suggest that concentration may be high in some segments of UK bond markets.
- 3.22** The OTC markets, although often well organised, rely on networks of trading relationships and are typically less formal than centralised venue-traded markets, although changes under EMIR, MiFIR and MiFID will increase formality.<sup>11</sup> Dealers act as market makers by quoting prices at which they will buy or sell to other dealers and to their clients, and quoted prices can differ depending on the counterparty that the dealers are dealing with; for example, the price quoted to a particular client can differ from that quoted to other clients or to dealers. This can be for reasons such as the nature and complexity of the product, the size of the counterparty's trade, and counterparty credit risk, but may also relate to how competitive the market is.
- 3.23** Prices in the OTC markets may be conveyed and negotiated through various means, including via the telephone, email, instant messaging, and electronic bulletin boards. Negotiations are typically bilateral since only the two market participants are generally (subject to some exceptions) able to observe directly the quotes or execution. This is in contrast with the level of public data that is typically available when products are traded on trading venues. It also means that to get a view of the market, clients may need to call multiple dealers to obtain quotes. The lack of transparency may impact how much competition takes place between incumbents, with potential implications for the quantities traded and pricing efficiency. An increase in transparency could lead to greater competition in the market, lowering the costs of market access and improving efficiency. However, it could also reduce competition if, for example, market participants are discouraged from providing liquidity due to excessively onerous transparency requirements.

<sup>10</sup> [www.bis.org/publ/otc\\_hy1311.htm](http://www.bis.org/publ/otc_hy1311.htm)

<sup>11</sup> For example, EMIR implements requirements in terms of transparency, risk management and margin for non-regulated market transacted derivatives, and MiFIR mandates for some derivatives to be traded on regulated markets, MTFs, OTFs or equivalent third-country trading venues.

**Q5: We welcome evidence on whether there are any competition issues relating to concentration in the OTC and/or venue-traded markets. For example:**

- *whether there are ways in which the markets are structured or function (taking into account the expected impact of regulatory developments) that discourages competition from potential new entrants, or competition between incumbents*
- *whether there are any competition issues that arise from the lower levels of transparency in the OTC markets relative to the venue traded markets*

## 5) Colocation

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**3.24** Colocation, where a market participant pays a premium to locate the server running its algorithms next to the trading venue's matching engine, allows a market participant to receive market information and to submit, amend or cancel orders with less latency<sup>12</sup> than participants that are not co-located. This provides a market access advantage for colocated participants over those that are not colocated. Such market developments could be viewed as a natural consequence of innovation and evolution of the markets. Competition issues may not arise when such services are made available in a fair and non-discriminatory manner. However, competition concerns could arise, for example, if the availability or cost of the colocation creates a barrier to entry for new market participants.

**3.25** With this in mind, a recently published MIFID discussion paper<sup>13</sup> regarding microstructural issues considers the tools that could be used to ensure that access to colocation services is fair and non-discriminatory. These include considering whether (a) there is a level playing field for all users seeking to access the trading venue via co-location services, (b) the pricing models used by providers of such services are applied in a transparent, fair and non-discriminatory manner to all users, and (c) the level of technical support services provided is fair to users. These concerns do not attempt to curb colocation activity, rather, they aim at ensuring that access to services is fair and service levels are consistent among the participants.

**Q6: We welcome responses on whether there are any competition issues associated with co-location.**

### Previous competition investigations

**Q7: We note that certain types of market and market infrastructure have been subject to previous competition scrutiny via the mergers regime. Are there grounds for revisiting any of the competition issues previously considered?**

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<sup>12</sup> Latency is a synonym for delay. Less latency therefore means being able to do something within a shorter period of time.

<sup>13</sup> <http://www.esma.europa.eu/consultation/Discussion-Paper-MiFID-II/MiFIR>

## 4. Investment banking

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### Introduction

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- 4.1** We are seeking views on areas of investment banking where competition may not be working effectively. In this chapter, we outline some areas where competition issues might exist and welcome views and evidence on these and/or other areas.

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### Summary of activities

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- 4.2** Investment banks offer a wide range of financial services, including:
- Assisting with capital raising, financing and securities lending.
  - Sales and trading (principal and agency).
  - Structuring of risk and investment solutions, including securitisations.
  - Research.
  - Advice (e.g. on mergers and acquisitions (M&A)).
  - Securities services including custody, clearing, settlement and operational services.
- 4.3** This list is not exhaustive and investment banks' business models vary, for example, in the product areas and services that they choose to integrate, and the client segments in which they operate. Some investment banks will also provide services (such as corporate finance, clearing and institutional asset management) through other parts of their business. Therefore some of the issues referred to in other chapters of this document will correspond to activities carried out by some investment banks.

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### Competition issues which may merit further examination

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#### Cross-selling investment banking services

- 4.4** Investment banks, like retail/commercial or universal banks, will try to increase revenues by maximising their share of total client spending (often referred to as maximising the 'share of the client wallet'). To do so, the bank will attempt to cross-sell and bundle services together.

- 4.5** Two groups of clients that may buy bundled investment banking services are asset managers and corporate clients. For example, banks provide investment research to their asset management clients, making recommendations on where to invest or divest; and may also provide execution services by facilitating the purchase or sale of securities either by using their own flow or crossing networks or by routing orders to other dealers. To their corporate clients banks may provide advice related to raising capital or M&A transactions together with services like underwriting or financing of transactions. Sometimes that may be conditional upon or tied to using the investment bank’s balance sheet to provide products to that client.
- 4.6** Where these services and other are bundled together, there is potential for investment banks to compete on the service their clients value most, for example deal completion, and not on others like the quality of the advice, or quality of execution when dealing with securities.
- 4.7** Cross-selling and bundling are compatible with intense competition if clients are able to anticipate the overall cost of the range of investment services provided over the long term and are able to disaggregate each element to determine the overall cost. But some clients may be unable to anticipate correctly the cost of advice on infrequent, complex transactions such as underwriting (see next section), M&As or on transactions that combine a suite of products as part of an overall solution. It could also be that banks are not providing to clients the costs of services for every bundled product offered. Switching providers may be difficult if the current adviser has a better understanding of the client’s business and a strong relationship with the management. Shareholders of issuers of securities may not exercise sufficient control over their company management to properly measure the quality of advice; and asset managers/wealth managers may not control certain research or execution costs effectively for their funds’ investors (this is discussed further in chapter 5).
- 4.8** In addition, the focus on bundled services may mean that stand-alone or small providers of services such as corporate broking advice or research are unable to compete effectively for customers who require a whole suite of services. This may act as a barrier preventing stand-alone or small providers of advice (and other services) from entering the market.
- 4.9** Larger corporations may have the expertise to undertake some of the advisory work in-house, carefully monitor what’s being offered to them or be in a position to negotiate fees and services. In this case, it may be less problematic for them if competition is not focused on the quality of advice. However, if stand-alone or small advisory providers are unable to compete effectively by using the quality of advice provided, it may cause detriment to smaller clients who rely on advice, particularly if they find it difficult to evaluate the cost and quality of the advice or services provided.

**Q8: We welcome comments on whether bundling of investment banking services distorts competition.**

**Cost of equity and debt underwriting**

- 4.10** In 2011, the OFT completed a market study on equity underwriting, focusing on secondary offerings.<sup>14</sup> The market study followed concerns from corporate issuers about underwriting fees and discounts on rights issues. The OFT found that in many cases issuers did not negotiate effectively with underwriters for a number of reasons: weak pressure from shareholders; lack of experience with raising equity; focus on speed, confidentiality and successful ‘take up’ (rather than on price).

<sup>14</sup> OFT (2011), Equity underwriting and associated services. Available at: [http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared\\_offt/market-studies/OFT1303.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared_offt/market-studies/OFT1303.pdf)  
Other reports on equity underwriting have been published by the Director General of Fair Trading (1997), the Monopolies and Mergers Commission (1999) and the Department of Trade and Industry (2005).



- 4.11** The OFT also observed that issuers usually appointed banks with which they have an existing relationship as equity underwriters. As a result, competition focused on establishing the relationship (e.g. through favourable terms on loans), rather than on underwriting services. Over 55% of relationships lasted longer than five years and 25% longer than 10 years. The OFT study did not find evidence of underwriters' conflicts of interest that harmed issuers, and did not refer the market to the Competition Commission for further investigation, but suggested a number of options for companies and shareholders to achieve better outcomes – including seeking more advice and more transparency on fees.
- 4.12** Aside from pricing and fees for issuers, there are also a number of other aspects on which investment banks may compete in the underwriting space and/or where competition issues may exist; for example, in relation to who gets access to corporate issues or allocations in the issue process, transaction fees for issuers and access to stabilisation support in relation to the issuance. In addition, some academic research suggests that underwriters tend to favour in their IPO allocations investors with which they have an existing relationship from previous IPOs and from broking business.<sup>15</sup> This has been interpreted as evidence of conflicts of interests, but also as a way to manage the risk of unsuccessful IPOs. Another potential conflict of interest, which is discussed in the National Audit Office report on the privatisation of Royal Mail, is when underwriters are also investors through their asset management arm.<sup>16</sup>
- 4.13** MiFID II will introduce a number of requirements on firms engaging in underwriting and placing specifically to increase transparency and address conflicts of interest that can arise in the provision of these services. Specific practices that MiFID II has identified as abusive include allocating securities to investment clients in return for a commitment from those clients that they will direct future commission payments to the firm (a practice known as 'laddering'), and allocating securities to clients as a reward or inducement for past or future corporate finance business ('spinning').
- 4.14** We have referred here mainly to findings related to the issuance of equity as this has been the focus of previous competition work undertaken by the OFT. However similar mechanisms might be at play in the issuance of debt securities and we welcome evidence in particular on whether these or other issues exist in the supply of debt.

**Q9: Taking account of the work already carried out in this area and the MiFID II developments, we welcome evidence on:**

- **whether there are reasons to revisit competition in equity underwriting (including IPOs), or**
- **the need for similar analysis of the market for debt issuance**

<sup>15</sup> See for example:

Cornelli, F., & Goldreich, D. (2001). Bookbuilding and strategic allocation. *The Journal of Finance*, 56(6), 2337-2369.  
 Gondat-Larralde, C. & James, K. R. (2008). IPO pricing and share allocation: The importance of being ignorant. *The Journal of Finance*, 63(1), 449-478.  
 Jenkinson, T., & Jones, H. (2009). IPO pricing and allocation: a survey of the views of institutional investors. *Review of Financial Studies*, 22(4), 1477-1504.  
 Jenkinson, T., and H. Jones. (2004). Bids and Allocations in European IPO Bookbuilding. *Journal of Finance* 59(5):2309-38.  
 Goldstein, M. A., Irvine, P., & Puckett, A. (2011). Purchasing IPOs with commissions. *Journal of Financial and Quantitative Analysis*, 46(05), 1193-1225.

<sup>16</sup> National Audit Office (2014), *The Privatisation of Royal Mail*, para 3.8-3.10.

### Best execution

- 4.15** ‘Best execution’ refers to the obligation for investment firms trading on behalf of retail and professional clients (ranging from individual clients to large buy-side firms) to take all reasonable steps to obtain the best possible result for the clients. Investment firms are required to take into account price, costs and other factors such as speed and likelihood of execution. Best execution rules were substantially amended in 2007 as a result of the implementation of MiFID, which broadened the scope of the obligation and the range of factors involved in assessing the best possible result.<sup>17</sup>
- 4.16** Because it covers many dimensions, best execution can be difficult to monitor for clients, in particular when there are many alternative execution venues available to brokers, and price transparency or liquidity is low. On some markets investment firms that execute client orders may receive commission both from the client originating an order and also from the counterparty with which the trade is then executed (the market maker). In 2012, guidance issued by the Financial Services Authority (FSA) on the practice of ‘payment for order flow’ noted that these arrangements create a conflict of interest for the broker and are unlikely to be compatible with the inducements rule (which governs when third-party payments are acceptable and risk compromising compliance with best execution rules).<sup>18</sup> The practice of ‘payment for order flow’ can increase clients’ trading costs where:
- the broker has an incentive to send the order to the market maker that offers the highest payment, instead of the one that offers best execution, and
  - the market maker needs to recover the cost of making a payment to the broker and increases bid-ask spreads.
- 4.17** Competition between brokers may limit the impact of ‘payment for order flow’ and other inducements on clients. Effective competition on the dimensions of the service that are observable to their clients may force brokers to return to clients rents extracted on unobservable trade execution.<sup>19</sup> For example, brokers may lower commissions. But the ability of clients and their agents to scrutinise broker performance remains crucial to the operation of a competitive market for order execution.
- 4.18** Other potential competition issues arise if investment firms internalise the execution of their client order or route them to affiliates. While this practice can be consistent with best execution, it can also result in cost savings or other benefits for investment firms which are not passed back to clients. Where a very large percentage of investment firm order flow is executed in this way it could inhibit competition from other execution venues that cannot access the flow.
- 4.19** These issues have also been considered by the FCA in its ongoing thematic work in relation to best execution and inducements, which will be published shortly.
- 4.20** MiFID II contains a very wide range of measures that may improve competition in the market for client order execution. These include broadening the scope of pre- and post-trade transparency obligations to other classes of financial instruments; requiring execution venues to publish data on execution quality; and, requiring investment firms to publish where they are directing their

<sup>17</sup> See COBS 11.2.

<sup>18</sup> FSA (2012), *Guidance on the practice of ‘Payment for Order Flow’*.

<sup>19</sup> Battalio & Holden (2001) show in a model with competitive brokers and competitive dealers that there is no detriment for clients as permissible inducements are channeled back to them via lower commissions. This result does not hold if either the brokerage or the dealer market is not competitive. Parlour & Rajan (2001) provide a specific market setup where even under the same assumption on competition the total cost paid by retail investors (commission and spread) is higher.

order flow and summarise the execution quality that they are achieving for clients. Additional measures complement this increase in transparency with improvements to client disclosures. Collectively these measures may enable clients to monitor broker performance and improve competition between brokers.

**Q10: We welcome evidence of how competition is working in the market for client order execution – in particular evidence on:**

- *how clients monitor delivery of best execution*
- *how brokers compete for clients*

*Responses should take into account the impact of MiFID II and other regulatory changes.*

*Responses to this review may touch on issues addressed in the context of the FCA's best execution thematic work which will be published shortly. Where we receive responses relating to best execution we will work closely with the thematic review team to ensure that these are considered together and that we are not duplicating work.*

## 5. Asset management

### Introduction

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- 5.1 We are seeking views on whether competition is working effectively in the wholesale sector of asset management.
- 5.2 We have recently undertaken a number of pieces of work in the asset management sector, such as thematic reviews<sup>20</sup>; however, the focus of this review is on the effectiveness of competition within the sector.
- 5.3 In this chapter we outline some examples of where competition issues might exist within the asset management sector and welcome views and evidence on these and other areas.

### Summary of activities

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- 5.4 Asset managers are professional services entities that act as agents specialising in managing assets on behalf of investors. They perform two main functions: operating collective investment schemes<sup>21</sup> (CIS), or other types of fund for a number of investors, and managing accounts for individual investors (e.g. institutional investors), within the constraints agreed with their clients. Clients' assets may be managed actively or passively. An asset manager's role and objectives will be influenced by the investors, which can include institutions, such as pension funds and insurance companies, and retail investors.<sup>22</sup>
- 5.5 Pension funds, which are the biggest investor group of the industry in terms of assets managed, are typically advised by investment consultants on various aspects of their investment arrangements, including how their assets are allocated between asset classes and on selection of asset managers within asset classes. There is no obligation to appoint an asset manager, and some very large pension funds manage their own assets and only use the services of asset managers in some specialist areas.

<sup>20</sup> Recent thematic reviews include TR13/10 *Outsourcing in the asset management Industry*, TR14/7 *Clarity of fund charges* and TR14/01 *Transition management*. In addition to the thematic reviews, the FCA has made significant changes to the retail investment advice market through the retail distribution review (RDR).

<sup>21</sup> An authorised collective investment scheme must be established in the UK and must be an Undertakings for Collective Investment in Transferable Securities (UCITS) scheme, a non-UCITS retail scheme, or a Qualified Investor Scheme. Non-UCITS retail schemes and Qualified Investor Schemes will also be alternative investment funds under the Alternative Investment Fund Managers Directive (AIFMD). Managers of schemes that are also alternative investment funds are subject to additional requirements as a consequence of the AIFMD.

<sup>22</sup> The direct relationship between asset managers and retail investors is not a subject of this review, which is focused on the wholesale sector. The scope of our review includes all wholesale activity relating to the asset management sector – i.e., asset managers and those businesses that purchase or provide services from/to them. To the extent that this affects (or is affected by) the relationship between asset managers and retail investors, these considerations will be taken into account.

- 5.6** In carrying out their function, asset managers typically use a range of suppliers, intermediaries and outsourced service providers. These may be broadly grouped into:
- Suppliers of services that are used in the investment decision-making process. Examples of these include research, trading and market information services. Suppliers of these services include investment banks, brokers, index and data providers and independent research providers.
  - Suppliers of operational (e.g., custody) and fund administration services. This may include, for example, pricing, valuation, reconciliation services, transfer agency, and corporate actions. Suppliers of these services include custody banks and their subsidiaries, or other independent service providers.
- 5.7** There are three key parties involved in a UK-regulated CIS: the scheme operator, the asset manager and the depositary (trustee). The scheme operator is ultimately responsible for the scheme and for appointing service providers to the scheme. The asset manager makes investment decisions on behalf of the scheme. The depositary monitors the activities of the scheme operator and asset manager in a number of areas.

### Competition issues which may merit further examination

- Incentives of asset managers to pay the correct price for the correct level of service**
- 5.8** There are a number of areas where there is potential for the interests of the asset manager (acting as ‘agent’ in the relationship) to differ from those of the investors (‘principal’<sup>23</sup>). This can have implications for the effectiveness of competition between suppliers of services to asset managers, if competition is aimed at winning custom from asset managers, rather than directly targeting the interests of investors.
- 5.9** A misalignment of incentives between the principal and the agent will generally not be a problem where the principal has the ability to monitor the agent and take action when the agent does not act in the principal’s best interest. However, it may not always be possible for the principal to monitor the agent, for a range of reasons. This, in turn, can reduce the likelihood of the principal taking actions, for example by switching, that drive competition between agents.
- 5.10** Asset managers are often in a position, either implicitly or explicitly, to pay for services using investor funds.<sup>24</sup> This could lead to problems where the asset manager does not pay the correct price for the correct level of service, or is not incentivised to search for value for money. For example, the asset manager may pay too much for a product or service, relative to the value it provides to the investor. Alternatively, a product or service that would be of value to the investor may not be sufficiently valued by the asset manager.
- 5.11** Examples of where this might occur are suggested below, based on our existing thematic and supervisory work. We would also be interested to understand other areas where similar issues might arise.

<sup>23</sup> Although the asset manager in a funds context is appointed by the fund, the ultimate owners of the fund are the end-investors and therefore we consider that this relationship can be described as one of principal-agent.

<sup>24</sup> An example of an explicit costs is administrative charges borne by the CIS; an example of an implicit cost is the cost of trading.

**5.12** We understand from our thematic work that fees for trustee and depositary services are generally static, but the scope of the services provided and the level of liability taken on is potentially increasing (for example, as a result of AIFMD). This may indicate pricing pressure from asset managers, or that asset managers do not value these governance services as highly as the investors. If pricing pressure leads to a reduction in the quality of these services, there could be a risk to the safeguarding of investors' assets.

***Transfer agency***

**5.13** Another potential example of where there may be a misalignment of incentives relates to transfer agency where the fund market has a number of processes that are not fully automated (with processes requiring a number of steps, human intervention and sign-off rather than straight-through processing).

**5.14** The costs of existing processes are likely to be higher than a fully automated process and there may be increased risks, in terms of data protection, for example if a large number of holdings needs to be transferred at one time. Our understanding is that this is not typically an area where an asset manager could gain competitive advantage – asset managers do not appear to win market share through increased efficiency arising from increased automation. Where this is the case, the asset manager may not be incentivised to increase automation despite potential benefits to investors in terms of lower administration charges and reduced risks.

***Ancillary services***

**5.15** As discussed above, asset managers, in performing their core function, typically use a number of suppliers and outsource a number of activities, including ancillary services such as operational and fund administration services.

***Dealing commissions***

**5.16** Where dealing commissions are used to pay for both research and execution, asset managers might not pay a clear price for research services or consume an appropriate amount. As the dealing commission is paid out of the fund (in a funds context), the incentives of the asset manager to analyse properly the value of the research may be reduced.

**5.17** When research is provided as part of a bundled package alongside execution, it may put independent research providers that do not operate dealing desks at a disadvantage. This can be exacerbated in situations where a bank is in a position to offer other services such as access to IPOs and company management.

**5.18** Banks often allocate scarce research services on the basis of the revenue a client generates globally across multiple business lines and asset classes. This can disadvantage asset managers that are smaller or operate in only a single market, and do not have access to a captive distribution network. It may incentivise asset managers to trade more with certain brokers to access particular services, which may create a conflict of interest with their customers' best interests.

**5.19** The FCA has been undertaking thematic supervisory work and an open discussion with stakeholders in this area and we will publish these findings shortly. This update will also discuss potential reforms under MiFID II in more detail.

***Governance services***

**5.20** A different example of a potential misalignment of interests between the principal and agent relates to the incentives of asset managers to purchase services at the appropriate level of quality.

- 5.21** Some ancillary services are low margin (such as the governance services discussed above) and are generally provided bundled with higher margin services. This may be because it would not be economic to provide certain services in isolation; or that there are some efficiencies gained from providing the services together.
- 5.22** However, if bundling a large number of services is necessary to provide lower margin services, it may be difficult for smaller/niche competitors to enter the market and to compete effectively for higher margin services.
- 5.23** It may also be more difficult for asset managers to negotiate the price of ancillary services when purchasing bundled services, particularly if competition is not working effectively. In addition, as discussed above, an asset manager may not have an incentive to negotiate the best deal for the investor where incentives are not aligned. Examples of ancillary services where this could happen include stock lending, foreign exchange, transitions management and custody services.
- 5.24** If investors are not able to monitor these arrangements effectively, and governance services do not provide sufficient scrutiny, then this could harm the investor, where the asset manager does not pay the correct price for the correct level of service.
- 5.25** The ability of investors to monitor these arrangements is likely to be lower for CIS, compared to individual accounts for institutional investors. Our understanding is that, where institutional investors have their own fund operator (for example an independent investment consultant), these operators hold the asset manager to a higher standard of governance, and is better able to monitor transactions.
- 5.26** Conversely, we understand that in the retail space there is a lack of choice in fund operators. In many collective investment schemes, the asset manager and the fund operator are part of the same entity. Any problem arising from this potential conflict of interest might be exacerbated if governance services are not sufficiently targeted at the needs of the investor (see above).

**Q11: We welcome evidence on whether:**

- ***sufficient incentives exist for asset managers to negotiate the best deal for investors in relation to areas such as:***
  - ***governance services***
  - ***transfer agency***
  - ***dealing commission and research (including evidence on how competition is working among providers of research)***
  - ***other ancillary services, such as stock lending, transitions, custody or foreign exchange services***
- ***Investors are able to assess effectively the quality of the asset managers' negotiations or are able to gain sufficient assurance that appropriate governance arrangements are in place.***

- *There are other activities where the incentives of the asset manager and the client may not be aligned and where competition is not aimed at satisfying the needs of the investor.*

*Responses to this review may touch on issues addressed in the context of the FCA's thematic work on dealing commissions which will be published shortly. Where we receive responses relating to dealing commissions we will work closely with the thematic review team to ensure that these are considered together and that we are not duplicating work.*

**Q12:** We welcome evidence on whether the bundling of ancillary services provided by intermediaries to asset managers is in the interests of funds and investors. In particular:

- *whether the pricing pressure on some services has made it un-economic to provide certain services on a stand-alone basis, making it necessary to bundle*
- *whether pricing pressure affects the quality of the service being provided*
- *whether the bundling business model deters new entrants from competing in the market for ancillary services*
- *whether any benefits of bundling are passed on to the fund*

**Q13:** We welcome evidence on reasons for the differences in charges between retail and institutional funds. In particular we would like to understand:

- *the extent that this is due to economies of scale*
- *the extent to which volume discounts are available*
- *the effectiveness of governance for retail funds relative to institutional funds*
- *the role of investment consultants in relation to fund charges and governance and the effectiveness of competition between investment consultants*



## 6. Corporate banking

### Introduction

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- 6.1** We are seeking views on areas of corporate banking where competition may not be working effectively.
- 6.2** In this chapter, we have set out, at a high level, our understanding of how competition may work for the services corporate banks offer.
- 6.3** The FCA does not regulate certain aspects of corporate banking, including the activity of corporate lending, and the regulation of payment systems falls within the remit of the Payment Systems Regulator (PSR).<sup>25</sup> However, we consider it important to understand the nature of the sector, as it can provide links to other areas of the wholesale sector.

### Summary of activities

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- 6.4** Corporate banks provide a range of important services to clients that can include:
- Deposit taking and lending – including long-term finance that may be an alternative to equity or debt raising.
  - Treasury and transaction services – including cash management and payment services.
  - Risk solutions – the provision of bespoke structuring and hedging services.
  - Advisory services.
- 6.5** There may be a degree of cross-over between the service provided by a corporate bank and those provided by other divisions within a bank, such as investment banking.

### Our understanding of competition in corporate banking

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- 6.6** The corporate banking sector is dominated by large institutions that have sufficient capital and resources to undertake financing activities.

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<sup>25</sup> We have not considered potential competition issues in relation to payment systems in this section as this falls under the remit of the PSR. In March 2014 we published a call for inputs that sought views on the UK payments industry, in particular on issues of competition, access, governance, ownership and innovation. The PSR will use the findings of the call for inputs to develop specific regulatory options for formal consultation later this year.

- 6.7** The Bank of England's 2014 *Trends in Lending* showed that, as at June 2013, the major UK lenders (Santander, Barclays, HSBC, Lloyds, Nationwide and RBS) accounted for 70% of the stock of lending to businesses.<sup>26</sup>

**Likelihood of entry**

- 6.8** Significant capital is required to set up a corporate banking business. In addition to the prudential and regulatory requirements in place, capital is required to operate the business (including potentially costly IT systems) and lend out to clients. The combination of these capital requirements may make it difficult for new entrants to enter the market.

- 6.9** Price is not necessarily the most important factor for corporates selecting a corporate bank. Factors such as reputation, existing relationships and knowledge have been found to be at least as significant as price<sup>27</sup>, which may make it difficult for new entrants to compete.

- 6.10** The Independent Commission on Banking (ICB) interim report noted that new entrants have entered in some wholesale markets (for example, foreign lenders joining lending syndicates to UK businesses prior to the financial crisis) and that in these cases prices appeared to be responsive to the changes in supply.<sup>28</sup>

**Demand for corporate banking**

- 6.11** The ICB interim report also noted that there is a lack of price transparency for wholesale products, with high prices for some products and services. The commission felt that this could indicate a lack of effective competition, but it noted that corporate clients were generally content with the service provided.<sup>29</sup>

- 6.12** Some of the issues that the OFT has identified, in its emerging analysis, in relation to the SME market<sup>30</sup> may apply equally to corporate banking in relation to smaller corporates. For example, there may be costs of switching, either in the form of search costs or because new lenders may charge higher fees as they do not have the level of company information which the incumbent has.

**Cross-selling**

- 6.13** Corporate banking provides universal banks with an additional source of information (for example, on primary market activities such as corporate finance) and therefore the ability to cross-sell products and services to their clients. In addition, as discussed in chapter 4, certain services such as equity underwriting are often undertaken by banks with which the client has an existing relationship. Establishing a relationship through the provision of corporate banking services, for example lending or transaction services may enable universal banks to cross-sell services such as underwriting or M&A.

<sup>26</sup> *Trends in Lending*, Bank of England, January 2014. Available at: [www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjanuary14.pdf](http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjanuary14.pdf)

<sup>27</sup> Page 43, Interim report, Independent Commission on Banking, April 2011. Available at: [http://webarchive.nationalarchives.gov.uk/20121204124254/http://www.hm-treasury.gov.uk/d/icb\\_interim\\_report\\_full\\_document.pdf](http://webarchive.nationalarchives.gov.uk/20121204124254/http://www.hm-treasury.gov.uk/d/icb_interim_report_full_document.pdf)

<sup>28</sup> Page 43, Interim report, Independent Commission on Banking, April 2011.

<sup>29</sup> Page 43, Interim report, Independent Commission on Banking, April 2011.

<sup>30</sup> The emerging analysis was provided in an update paper, available at: [www.offt.gov.uk/shared\\_offt/markets-work/sme-update.pdf](http://www.offt.gov.uk/shared_offt/markets-work/sme-update.pdf). The FCA has been working closely with the Office of Fair Trading (OFT) on the SME banking market study. As of 1 April 2014 the Competition and Markets Authority (CMA) will take over responsibility for concluding the market study from the OFT. The FCA will continue to work closely with the CMA.

**6.14** As explained in chapter 4, there can be benefits to clients of cross-selling services; however clients may be unable to anticipate correctly the cost of advice on infrequent, complex transactions that combine a suite of products as part of an overall solution. Switching providers may be difficult if the current adviser has a better understanding of the client's business and a strong relationship with the management. Shareholders of issuers may not exercise sufficient control over their company management to properly measure the cost of advice.

**Q14: We welcome evidence on whether:**

- *There are competitive or regulatory factors that affect the likelihood of new competitors undertaking corporate banking services, or affect the ability of existing competitors to expand.*
- *Issues that the OFT has discussed in relation to SME banking apply equally to larger corporate clients.*
- *Cross-selling has an impact on firms' ability to compete, either in relation to corporate banking services or in relation to other services such as investment banking services.*

## 7. Next steps

- 7.1** We would like your thoughts on areas where competition is not working effectively within the wholesale sector.
- 7.2** Please send us your responses to the questions set out in the document, along with evidence to support your views by 9 October 2014. In addition, please let us know any other areas where you feel that competition is not working effectively in the wholesale sector by responding to Question 15, below.

**Q15: We welcome evidence on any other areas where competition is not working effectively in the wholesale sector. In particular:**

- **exploitation of market power, including exclusionary behaviour.**
- **barriers to entry**
- **barriers to switching**
- **problems in the flow of information, and/or**
- **principal/agent problems and conflicts of interest**

**How?**

- 7.3** Use the online response form on our website or write to us at the address on page 2.

**What will we do?**

- 7.4** We will consider your feedback and publish our findings, including, if appropriate, our proposed topic for a market study in a Feedback Statement later in the year.
- 7.5** We would then expect any market study to be launched in early 2015.

# Annex 1

## List of questions

### Markets and market infrastructure

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- Q1:** Taking into account regulatory developments in this area, we welcome evidence on any competition issues in the market for data services – in respect of both venue-traded and OTC products. For example:
- *Whether there are instances where those entities producing or disseminating data face limited competition such that they are in a position to charge higher prices and/or create barriers to entry or expansion.*
- Q2:** We welcome evidence on whether there are any competition issues in the market for trading and clearing services, both for OTC and venue traded products. For example:
- *Whether there are instances in which standalone trading venues and CCPs are limited in their ability to compete with silo structures.*
  - *Whether there are instances of barriers to entry that prevent competition from new entrants.*
- Q3:** We welcome evidence on whether there are any competition issues in the supply of trading and clearing services by dealers. For example:
- *whether there are instances in which standalone dealers providing trading or clearing services are disadvantaged in competing with dealers that integrate such services*
  - *whether there are instances of barriers to entry that prevent competition from new entrants*

**Q4:** We welcome evidence on:

- *whether there are competition issues such as those noted above in the market for client clearing*

**Q5:** We welcome evidence on whether there are any competition issues relating to concentration in the OTC and/or venue-traded markets. For example:

- *whether there are ways in which the markets are structured or function (taking into account the expected impact of regulatory developments) that discourages competition from potential new entrants, or competition between incumbents*
- *whether there are any competition issues that arise from the lower levels of transparency in the OTC markets relative to the venue traded markets*

**Q6:** We welcome responses on whether there are any competition issues associated with co-location.

**Q7:** We note that certain types of market and market infrastructure have been subject to previous competition scrutiny via the mergers regime. Are there grounds for revisiting any of the competition issues previously considered?

### Investment banking

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**Q8:** We welcome comments on whether bundling of investment banking services distorts competition.

**Q9:** Taking account of the work already carried out in this area and the MiFID II developments, we welcome evidence on:

- *whether there are reasons to revisit competition in equity underwriting (including IPOs), or*
- *the need for similar analysis of the market for debt issuance*

**Q10:** We welcome evidence of how competition is working in the market for client order execution – in particular evidence on:

- *how clients monitor delivery of best execution*
- *how brokers compete for clients*

*Responses should take into account the impact of MiFID II and other regulatory changes.*

*Responses to this review may touch on issues addressed in the context of the FCA's best execution thematic work which will be published shortly. Where we receive responses relating to best execution we will work closely with the thematic review team to ensure that these are considered together and that we are not duplicating work.*

## **Asset management**

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**Q11:** We welcome evidence on whether:

- *sufficient incentives exist for asset managers to negotiate the best deal for investors in relation to areas such as:*
  - *governance services*
  - *transfer agency*
  - *dealing commission and research (including evidence on how competition is working among providers of research)*
  - *other ancillary services, such as stock lending, transitions, custody or foreign exchange services*
- *Investors are able to assess effectively the quality of the asset managers' negotiations or are able to gain sufficient assurance that appropriate governance arrangements are in place.*
- *There are other activities where the incentives of the asset manager and the client may not be aligned and where competition is not aimed at satisfying the needs of the investor.*

*Responses to this review may touch on issues addressed in the context of the FCA's thematic work on dealing commissions which will be published shortly. Where we receive responses relating to dealing commissions we will work closely with the thematic review team to ensure that these are considered together and that we are not duplicating work.*

**Q12:** We welcome evidence on whether the bundling of ancillary services provided by intermediaries to asset managers is in the interests of funds and investors. In particular:

- *whether the pricing pressure on some services has made it un-economic to provide certain services on a stand-alone basis, making it necessary to bundle*
- *whether pricing pressure affects the quality of the service being provided*
- *whether the bundling business model deters new entrants from competing in the market for ancillary services*
- *whether any benefits of bundling are passed on to the fund*

**Q13:** We welcome evidence on reasons for the differences in charges between retail and institutional funds. In particular we would like to understand:

- *the extent that this is due to economies of scale*
- *the extent to which volume discounts are available*
- *the effectiveness of governance for retail funds relative to institutional funds*
- *the role of investment consultants in relation to fund charges and governance and the effectiveness of competition between investment consultants*

### Corporate banking

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**Q14:** We welcome evidence on whether:

- *There are competitive or regulatory factors that affect the likelihood of new competitors undertaking corporate banking services, or affect the ability of existing competitors to expand.*
- *Issues that the OFT has discussed in relation to SME banking apply equally to larger corporate clients.*
- *Cross-selling has an impact on firms' ability to compete, either in relation to corporate banking services or in relation to other services such as investment banking services.*



### Next steps

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**Q15:** We welcome evidence on any other areas where competition is not working effectively in the wholesale sector. In particular:

- exploitation of market power, including exclusionary behaviour.
- barriers to entry
- barriers to switching
- problems in the flow of information, and/or
- principal/agent problems and conflicts of interest

Financial Conduct Authority



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© Financial Conduct Authority 2014  
25 The North Colonnade Canary Wharf  
London E14 5HS  
Telephone: +44 (0)20 7066 1000  
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