

CITY



Unbundle of joy

Although it may cause some collateral damage, the Financial Services Authority's campaign to bring transparency and accountability to the industry is a welcome one, writes **Jamie Stewart**

When CP176, the Financial Services Authority (FSA) consultation paper on bundled commissions, soft commissions and transparency, was published almost a year ago it prompted great discussion. The FSA has now announced that its policy is to transfer responsibility to investing institutions – “the buy side” – and to agree and report on procedures to ensure that its list of essential measures are built into working procedures.

The FSA continues to see the protection of retail investors as paramount. It also wants to ensure that dealing commissions are whittled down to a minimum. The regulator will accept and ratify a solution from the industry reflecting this objective if it is submitted in full by December – otherwise, it will impose a regime of its own design.

It was broadly agreed in the consultation that it's cheeky for fund managers to make their clients pay for the basic tools of their trade. Most respondents saw sense in the argument that, if you are spending your clients' money, it's only right that they should know how much you are spending. They also accepted that the core of such expenditure should cover only trading execution and research.

John Tiner, chief executive of the FSA, recognised the danger that excessive severity would drive capital and business offshore. He said the authority would “give the industry space to develop and trial a solution based on improved disclosure” and assess progress in December. Meanwhile, he sees “some regulatory change as appropriate to set the right framework”, suggesting that merely shuffling the papers and reaffirming the Cub Scouts' code of honour will not be enough.

Perhaps a requirement on brokers to display clear menus with dishes, recipes, ingredients, origins and prices as a basic component of their terms and conditions will emerge. This approach has been subject to heated discussion among the global and integrated brokers – the sense and propriety of the objectives clashing with their excesses, accounting quirks, subsidies and counter-competitive stances, which have been in evidence since the Big Bang occurred over 15 years ago.

The FSA intends that “fund managers' use of clients' commissions should be limited to the purchase of trade execution and of investment research”. It also stresses the need for disclosure “to separate out the payments for execution from those for research” and for “the emergence of an explicit market price for research”.

So bundling is dead. Long live unbundling. If the financial services industry's proposed steps to implement enhanced disclosure are deemed insufficient at the end of December, then “nanny” will step in again.

The regulator clearly still dislikes the perceived cosiness between fund managers and the boards of many of the vehicles they manage. “The ball is now very much in the industry's court,” Tiner warned when he addressed the Confederation of British Insurers in April. “If it seems to them that we are breathing down their neck on this issue, then that is because we are.”

So what will follow? The industry will have no option but to unbundle: goodbye opacity; hello transparency and accountability. The trick is to predict which stings lie in which tails, and whom they will poison. I believe there are six possible scenarios:

- Margins in broking and fund management could be further eroded by this cleaning-up operation.
 - Some failures could occur.
 - Even more consolidation could take place, reducing competition and creating monopolies. US, Japanese and other “super banks” could take control of the UK's homegrown brokers and asset managers.
 - Homogenisation, economies of scale and pressurised margins could lead to further commoditisation in an industry that has been steadily forfeiting many of its levels of service. This would not be good for the UK's leading position in the global industry. Even worse, it would not stand the small investor in good stead.
 - Regulatory arbitrage could prove problematic in that it might result in the emigration of portfolios to less strict climes.
 - Some brokerages could be obliged to compensate for revenues foregone as a result of unbundling.
- But there is no need to become obsessed with the difficulties. There are many potential benefits too:
- The cleansing of the Augean stables of middling research and analysis could occur.
 - The natural recourse to in-house, buy-side analysts could resume its growth. Such buy-side research teams are geared to their own clients, their own funds and their own fortune and misfortune in a far more palatable, straightforward and profitable mix.
 - Independent research entities could have a more encouraging climate in which to work.
 - Hedge funds could find sensible ways to make the changes work for them, not against them. Their structure, status and style is such that the post-CP176 climate should prove a benign one for them.

At Eden Group we recognised the limitations of traditional proprietary research early on, offering independent research intermediation as a core service to investing institutions. We applaud the FSA's aims and believe in the qualities and values that will emerge from CP176.

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