



Long live unbundling!

What will be the likely impact of CP 176?



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When CP 176, the FSA's Consultation Paper on Bundled Commissions, Soft Commissions and Transparency, was published almost a year ago it prompted plenty of discussion in the fund management and broking communities. Since then - the FSA has announced its preferred way forward, by way of pre-emptive statements made by John Tiner at recent CBI meeting as well as a full and formal announcement, hot off the press. Their policy is to transfer responsibility to investing institutions - 'the buy-side' - to agree and report on procedures to be implemented with a view to ensuring that the FSA's list of essential measures are built in to standardised working procedures. The undercurrent suggests that the FSA continues to see protection of retail investors as paramount, at the same time as wishing to ensure that dealing commissions are whittled down to a minimum. The FSA will accept and ratify an industry solution reflecting this objective if it is submitted in complete by December - otherwise the authority will take up the stick itself and impose a regime of its own design without further ado.

It was broadly agreed that it is cheeky for a fund manager to make his clients pay for the basic tools of his trade without which he could not have drawn them to him in the first place. Most saw sense in saying that if you spend clients' money, it is right that they know how much you are spending

on what; that you are getting good value for money, and that what you buy should work as far as possible in the end-investor's direct best interests.

It followed naturally that one should seek clients' permission in advance for the ways in which their money should be spent, and that the acceptable core of such expenditure should consist only of competitive, high-quality trading execution and of the research services that help form the decision as to what trades should be committed. Most considered it right that 'commission dollars' should be properly and clearly negotiated, explained and allocated. In short, people woke up, compared ideas, saw the light and began to face in one and the same direction.

In response, John Tiner, CEO of the FSA, recently clarified the regulator's position. He recognised - to a point, in principle and on the basis of bespoke research - the dangers of excessive severity driving capital and therefore business offshore: the "regulatory arbitrage effect" that could theoretically see global, integrated fund managers move the domicile of their vehicles offshore. The FSA will 'give the industry space to develop and trial a solution based on improved disclosure', and will 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' oath and code of honour will not be deemed enough.

This last cryptic and curtailed comment of Tiner's begs the question as to what changes those might be. We surmised all along - and are since pleased to note - that tightening and re-definition of traditional soft commission may feature, as may recognition of systems and agents operating with authorisation to act as introducing and funding brokers; norms to ensure that client mandates, articles of incorporation, trust instruments and the like address the need to inform - if not predicated authorisation from - clients as to application of their money.

Perhaps the requirement of brokers that

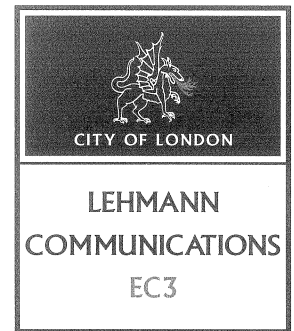
they set up and display clear menus with dishes, recipes, ingredients, origins and prices as a basic component of Terms and Conditions will emerge. This path had been and is still subject to heated discussion amongst the global and integrated brokers, the common sense and propriety of the objectives clashing violently with their excesses, accounting quirks, subsidies and non- or counter-competitive stances and procedures in evidence since Big Bang fell in to place (or failed to ?), over 15 years ago.

The FSA clearly intends that "fund managers' use of clients' commissions should be limited to the purchase of trade execution and of investment research", while emphasising 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"! And nanny will step in again if, as has been decreed, by end-December, the industry's proposed steps to implement enhanced disclosure are deemed insufficient or ineffective. The FSA will seek regular progress reports and will continue to "review the governance of retail funds."

The regulator clearly continues to dislike the perceived "cosiness" between fund managers and the boards of many of the vehicles they manage. (At the other extreme, it has been made increasingly clear that, whilst pension funds and investment trusts are almost overwhelmed with boards of directors, certain other pooled and collective retail funds have none. Cadbury, Higgs, governance, ethics and accountability have set thousands of cats amongst millions of pigeons, and there is blood and feathers everywhere. Look at the split-level trusts; unit trusts, UCITs and OEICs; their similarities, differences, variations in levels of non-executive-type protection of the retail investor..... plenty of blood, plenty of feathers yet to come.) Tiner ended his April address to the CBI Financial Services Council meeting with the sternest of nursery

The Pensions Management Institute News Page 2 of 2 June 2004



admonishments: "The ball is now very much in the industry's court. 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 has no option but to unbundle: goodbye opacity, hello transparency and accountability; declare and disclose for all you are worth - and client permission acquires divine status.

The trick, after commending the slickness, fairness and good sense of it all, endorsed by the latest FSA announcement, now all of a couple of days old, is to predict which stings lie in which tails and whom they will poison.

Scenario 1: Margins in broking and fund management, already under severe pressure from various effects and impacts, will be further eroded - directly and indirectly - by this cleaning-up operation and by the costs entailed to bring about and maintain the squeaky-clean status quo of the future.

Scenario 2: Therefore some failures? - hopefully not.

Scenario 3: Even more consolidation in both segments, leading via piously preached economies of scale and benefits of reach to lower levels of competition, higher levels of monopoly and to US, Japanese and other "super" banks taking control of our home-grown brokers and asset managers.

Scenario 4: Homogenisation, the economies of scale echoed above, needs for consistency and pressurised margins lead, in addition, to further commoditisation of an industry that has been steadily forfeiting many of its levels and qualities of personal service, of performance, of style, of leadership and of evolution for years already. This cannot possibly be good for the UK's leading position in the global industry - and, worse, it may not actually stand the small, investor in good stead at the end of it all.

Scenario 5: Notwithstanding recognition of the likely benign end-effects of CP176, some operators will stamp their feet, sulk and reach for the option of regulatory arbitrage. You don't need many portfolios to emigrate from here to less strict climes to

bring about a capital-drain as well as the brain-drain that will inevitably accompany it.

Scenario 6: Some brokerages will be obliged by commercial factors to compensate for revenues foregone as a result of unbundling. There are precious few ready remedies available to them. One is the insidious move towards widening spreads in prices of stock traded net by market makers. This scenario is compounded by the danger that the recourse could not exist in a few isolated instances; it is more likely to be adopted as a common measure, countering perceived market efficiency and raising considerably the "hidden trading costs" borne by funds.

But there is no need to become obsessed with toxicology. Try reaching for the serum, for the inoculations. With any luck there will be some healing and some health-giving options once the scorpions have been dispatched to the herpetarium.

Amongst them:

- **Benefit 1:** Augean cleansing of the stables of middling research and analysis. The tale, dead dreary by now, is that too many traditional, sell-side analysts (i) exist, (ii) were subsidised by primary business flows, are now in the balance of the books and will weigh on margins if they are left intact in the future; (iii) generate same-ish, turgid stuff which is closer to post-mortems than ideas; (iv) cheat; (v) are made to tell fibs by their overlords; (vi) are neutered by house style, house stance, book positions, corporate-client-focus and the filtration-plant in the office of the head of research; and (vii) lead to distortion of salary scales, too often leading indirectly to exerting a monopoly over the employment tribunal chambers at Woburn Place. When it becomes necessary to rationalise them, reprice them and price their product reasonably, then you, I, Joe, Jane and all investors will regain some confidence and even advantage.

- **Benefit 2:** The natural recourse to in-house, buy-side analysts will resume its growth, jolted by the late (!) bear market and constrained by the market distortions created by traditional, proprietary research. Such buy-side R&A 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.

- **Benefit 3:** Independent research entities, bearing virtuous watchwords as their mottos and excellent work fashioned through competition, price-sensitivity and the drive to succeed as small businesses, will have a more encouraging climate in which to work.

- **Benefit 4:** Hedge funds - for all the disparaging asides born almost exclusively of envy and wannabes out there - will find sensible - enviable? - ways to make the changes work for them, not against. They make money, they set high standards, they proliferate, they employ and they wither and die if they are not competitive and not successful. The nature of their structures, status and style is such that post-CP176 will by and large prove a benign climate for them to flourish.

At Eden Group, we recognised early on the limitations of traditional proprietary research, offering independent research intermediation as a core service platform to investing institutions. We believe that this closely fits the bill that the FSA - and the industry - are designing. Eden was intimately involved in the formation of the Association of Independent Research Providers, and remains equally closely involved in its structure and operations. We applaud the objectives of the FSA and what lies ahead; we are believers in the qualities and values that Tiner has indicated will emerge from CP176.

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