



LONDON INVESTMENT BANKING ASSOCIATION
6 Frederick's Place, London, EC2R 8BT
Tel: 020 7796 3606 Fax: 020 7796 4345
e-mail: liba@liba.org.uk website: www.liba.org.uk

**UK Financial Services Authority:
Policy statement PS04/23**

**A response by the
London Investment Banking Association**

Introduction and summary

1. The London Investment Banking Association (LIBA) has been engaged with the FSA on the topic of soft commission and unbundling since before the publication of CP176. LIBA remains committed to the process outlined in PS04/13 and we will be writing to you jointly with the Investment Management Association (IMA). We have seen and shared with you the report of the National Association of Securities Dealers task force (“the NASD Report”); transatlantic congruence remains an objective which we believe is within our reach.
2. We welcome the fact that FSA has provided thoughtful, constructive leadership in this important area and, in particular, has allowed scope for the industry to provide market-led solutions to the issues identified.
3. In this paper, we set out our response to the ideas discussed in PS04/23; we trust that we will be able to engage you in a serious dialogue as your ideas develop.
4. In the absence of specific questions, we have grouped our responses under the headings set out in the PS.

We read ‘equities’ in paragraph 2.48 as meaning ‘cash equities’. If there is an implication of an extension to other markets, we are concerned that the case for that extension beyond cash equities has not been made.

‘Non-permitted services’, ‘execution’ and ‘research’

5. We think the approach taken is a sensible one; but we think it makes sense to emphasise the distinction between ‘permitted’ and ‘non-permitted’ services rather than to seek to analyse too precisely what is ‘execution’ and what is ‘research’. Firms remain concerned that the case for an extension beyond cash equities has not been made.

‘Non-permitted services’

6. We agree with the approach taken to ‘non-permitted services’ with one exception. Historically, brokers have ‘bundled’ reporting of all kinds into the product. Since valuation services are a form of report, this approach was applied to valuation so there is a market practice of not charging for valuations. The provision of “asset

valuation” services, in the sense of investment research focussed on the valuation of securities, should be a “permitted” service.

7. We would prefer FSA to allow the market practice of not charging for valuations to continue, but recognise that third party valuation services provided directly to the fund manager should be considered as a ‘non-permitted’ service. In other markets (the property market for example) there is a well established practice of charging for valuations where no transaction results. This practice should be permitted in financial markets. While it might be desirable to allow such valuations to be invoiced to the fund manager directly, it may not be feasible for all firms to implement systems requiring payment for such valuations out of non-commission income at reasonable cost.

The scope of ‘execution’

8. We strongly urge FSA to implement a businesslike approach to the sales and trading function. There is support in the LIBA community for a point of view which leads one to think of the sales function as an ‘insight distribution’ business, disseminating the insights captured by the research function. Others, with different business models, might regard the sales function as a business which sells the trading expertise of the firm and brings clients the benefits of access to execution services.
9. This is therefore an area in which the FSA could justifiably take a more nuanced approach, accepting that if firms can demonstrate that the sales function is being remunerated from commission only for execution and research, they are compliant. The distinction between execution and research is less relevant than the distinction between ‘permitted’ and ‘non-permitted’ services. This will require careful drafting and it may be appropriate for the trade associations to publish guidance or good practice notes to supplement the FSA’s material.
10. “Post trade analytics” (i.e. the provision of analysis, reports and information, as well as the provision of software) should be classified as “permitted” on the basis that they are provided to improve execution quality generally or to facilitate the making of investment decisions. However, there are a whole range of pre-and post-trade services and analyses that fit well within the range of investment services that should be “permitted”. Whether such services are classified as “research” or “execution” should be left up to the users and providers; it should, however, be made clear that they are “permitted” services.
11. We turn now to the discussion of custody services. There is an important distinction to be drawn between custodial services that might be provided in connection with a transaction, and custody offered as a distinct stand alone service unconnected to execution. To the extent that a firm acts as a custodian as a direct result of executing a cash equities transaction, we believe this should be viewed as a constituent part of the execution service and thus to be paid for from commission i.e., a permitted service. Such services clearly meet the criteria set out in paragraph 2.13. In addition, it is worth noting that it is difficult if not

impossible to identify the difference between assets receiving any essential though temporary 'safekeeping' function and assets in custody.

12. The policy statement mentions market data in the context of research. We think, however, that market data will also be relevant in the context of trade execution, especially in the context of Direct Market Access (DMA) services. DMA services have been one of the main drivers reducing the execution costs of investment managers. In the context of DMA services, authorised firms acting in a brokerage capacity provide the trading desks of investment managers with the necessary tools to "work" their own orders and to route the orders to the investment firms which then forward them on directly to the relevant exchanges. In some circumstances, the investment firms may take the opportunity to internalise part of the order flow in order to further reduce transaction costs. In this context, the trading desks of investment managers will also need to obtain market data and relevant order management software. The trading desks of investment managers effectively "in-source" through these services aspects of the execution functions which would otherwise be provided for them by the trading desks of brokerage houses, and which would then be compensated through commissions. It will therefore be appropriate to include the services made accessible to investment managers in the context of DMA, including relevant data feeds, in the definition of "execution" services.

The scope of 'research'

13. We support the FSA's approach to research, with two important reservations. First, we do not think that research needs to have an 'original' or 'intellectually rigorous' element in addition to the language from the dictionary definition, "the critical and careful consideration and assessment of new and existing facts" quoted in the joint trade associations' guidance on rule 7.3 (dealing ahead of research) published in February 2004. We attach a copy for ease of reference.
14. We think it is possible to use the existing definitions of 'investment research' and 'research recommendation' for research which can be paid for from commission, so long as it is accepted that the sales force can be paid for from commission, because the services they deliver can reasonably be regarded either as part of the research process or part of the execution process.
15. One qualification to this is that we think the definition needs to be expanded in recognition of the fact that some fund managers prefer to be provided with information from brokers which they use as the basis for developing research ideas in-house rather than being provided with the research ideas themselves. In this instance brokers perform a service which involves the gathering, aggregation, processing and presentation of information for fund managers (rather than the critical analysis of such information). This service - which is clearly part of the research process - should in our view be covered by the FSA's definition of research.
16. We believe it is important to take a flexible approach to the definitions, so as not to restrict innovation in the provision of research and execution services.

Improving transparency and accountability

17. Our expectations are slightly different from yours. Our members will expect to be able to agree a common understanding of the indicative split between the execution and research components of the payments made. Negotiations will be conducted both initially on an indicative basis, and after the event on an ex-post basis. It is, however, important to note that the agreed split does not represent a “rate” for execution or research service; it is, instead, an assessment of the proportion of a bundled commission that can reasonably be attributed to execution or research.

Further consequential issues

Implications for the terms ‘soft’ and ‘bundled’

18. We welcome the simplification brought about by the abolition of “soft” as a regulatory concept. Our members will work with their clients to ensure that payments made under current “soft” arrangements are brought in line with the list of “permitted” services.

Commission-sharing arrangements

19. Where our members choose to establish Commission Sharing Arrangements, rather than make third party payments under the mechanism outlined above, the points outlined in 2.41 appear to be sensible criteria to ensure these relationships are appropriate. We note, however, that there remain complex issues surrounding the taxation treatment, particularly under Value Added Tax. These issues are currently a significant disincentive to the establishment of such relationships, and we would urge FSA to do all it can to ensure that there is finally clarity on this issue.

Scope issues

20. We, too, can see scope issues arising in our business; we hope that these can be resolved by applying the LIBA ‘statement of good practice’ only to those clients of our securities market businesses which are applying the IMA enhanced disclosure formula. Clients wishing to adopt other approaches will need to agree these bilaterally; this may impose costs on the market, as market participants will have to cope with multiple arrangements and different processes.
21. We agree with the approach taken by the FSA in paragraph 2.45 of PS04/23 which involves leaving to the industry the question of whether non-UK clients should be covered by the disclosure regime. Such clients can of course request additional disclosure from fund managers if they consider it desirable; it will be for fund managers and brokers to agree whether and how to handle such requests.

London, 21 December 2004