Investment Management Association

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Submitted via email to: wholesalecompetition@fca.org.uk

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To whom it may concern

RE: Wholesale sector competition review – call for inputs

The IMA represents the UK-based investment management industry. Our members include independent asset managers, the investment management arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. Our members manage investments worth more than £5 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals.

We welcome the opportunity to provide input to the FCA's Wholesale Sector Competition Review. We support all initiatives that:

- boost confidence in the UK's wholesale markets;
- maintain London's status as an EU and global financial centre; and
- help shape the UK and international policies that govern markets.

Given the large raft of recent regulatory developments in wholesale markets, at a domestic, EU and international level, we welcome the FCA's remarks that this particular Review will be mindful of the scope of the Fair and Effective Markets Review and ongoing implementation of MiFID II reforms throughout Europe.

We note the focus on bundling in both the investment banking and the asset management sections of this Review. Bundling and cross-selling are well established practices in wholesale markets that often benefit clients through cost savings, expertise, greater choice and better quality products and services.

However, there may be aspects of bundling that are worth investigating. For example, we believe that greater transparency of investment banking services and fees will benefit consumers and may lead to better execution and an enhanced competitive environment for firms to operate in.

Following on from our '*Encouraging Equity Investment*' report published in July 2013, there are a number of areas in a typical UK IPO and secondary capital raising process that can be addressed with the aim of improving the efficiency and competitiveness of the process. Further detail is provided in our responses to Questions 8 and 9.

The IMA has been a strong proponent of increasing competition in the asset management sector and we continue to work with the FCA on its recent thematic reviews in relation to dealing commission and best execution. We also continue to promote high standards of conduct, optimisation of value for money, transparency and accountability for our members' clients.

In this context, we believe that there are sufficient regulatory reforms being carried out within the asset management sector, in relation to competition, not to warrant the establishment of a further market study in this area. Recent and impending regulatory developments, e.g. MiFID II and AIFMD should also be taken into consideration.

The IMA looks forward to continued engagement with the FCA and welcomes further discussion on any of the points we raise in our response.

Yours sincerely,

Pamela Gachara
Policy Adviser, Markets

<u>IMA RESPONSE TO THE FCA WHOLESALE SECTOR COMPTETITION REVIEW</u>

<u>MARKETS AND MARKET INFRASTRUCTURE</u>

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**

The European Commission and the European Securities Markets Authority (ESMA) has stated that data costs in the EU are too high, particularly in comparison to the USA. The IMA agrees with the Commission that data charges are too high and there is not an efficient market operating. There is a clear public good argument for regulatory intervention on this issue.

The IMA supports ESMA's proposal in the latest MiFID II consultation paper that transparency around venues' data pricing should be enhanced. Transparent disclosure by venues of their data pricing will:

- enable our members, and the wider market, to compare the relative metrics on a per venue basis; and
- act as a material break on increasing data costs.

To promote enhanced competition, it is important that each venue isolates the cost for provision of data services. There should not be a cross subsidy within venues between trading and data services.

The IMA supports ESMA's proposition in the draft technical advice provided for MiFID II, that the Commission should review the operation of the definition of reasonable commercial basis three years after its introduction. At that point, it will be appropriate to review the outcomes provided by the market and consider whether a usable consolidated data stream has been created.

The IMA considers that a combination of ESMA's proposed options (as stated in the Consultation Paper for MiFID II) A+B+C should be mandated. That is, additional transparency (Option A), publication of revenue share generated by data (Option B) and implementation of the Long Run Incremental Cost (LRIC+) measure (Option C).

An important outcome of the MiFID II proposals will be to limit the monopolistic behaviours of data providers and trading venues.

There is a significant risk that, with the reduction of transaction costs, trading venues may shift to rely on market data revenue as a primary source of income, without any improvements in service provision.

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.**

No comment.

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.**

No comment.

Q4: We welcome evidence on:

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

In terms of client clearing for OTC (and ETDs), there does appear to be concentration around a small number of clearing brokers. This could become an issue if the clearing broker starts to impose minimum thresholds on trading activity for direct client clearing or refuses some types of clients direct clearing access, in order to minimise operational costs.

We understand that this is already an issue in some EU jurisdictions, where there are no CCPs or local institutions offering direct client clearing. Local banks will become direct clearing members, with their clients becoming indirect clearing members. Indirect client clearing cannot offer the full level of protection available at the top end in the direct client clearing model, due to the 'chain effect'. It is also inherently more risky because more links in the 'chain' may result in higher levels of operational and counterparty risk. In addition, costs are likely to be higher with more intermediaries involved. It is therefore important to promote competition in these markets, so that larger clearers do not move to clear only for large financial institutions (given this is cheaper and easier from an operational perspective).

In relation to barriers to entry, one of the biggest issues faced by clearers (and clients), and which also acts as a high barrier to entry for clearing members in this market, is the wide range of different account types on offer.

In order to compete in the OTC clearing market, at least initially, clearing members have to be able to support as broad a range of accounts (and CCPs) as possible. This will be very expensive. Whilst costs will be passed to clients, as far as possible, there will be up-front costs to cover. Only the largest organisations will be able to cover these costs and offer the full range of options.

We expect the account types and features on offer from CCPs to converge in due course around certain preferred options. However, until they do, it will be hard for new entrants to access the clearing services market.

In relation to the FCA's point that the client clearing model is one of principal and agent, we note that whilst in essence the clearing broker is offering a service to the client, in the European model (for the most part), this is not structured as an agency relationship, but one of back-to-back principal. This creates its own issues, whereby the clearing members' interests are not aligned with those of the client.

One particular issue is that there is little transparency for clients (so far at least), in terms of the costs being incurred by clearing members at the CCP level for different account options and default fund contributions and how this is passed through to the client. Information provided on the risks of various account options is also very generic and not of a sufficiently detailed nature to enable clients to make informed decisions. For example, standard industry disclosures and high level cost information provide minimal transparency for clients. This makes it hard for clients to assess one clearing member's offering against another.

Transparency and the provision of information to clients are key aspects of EMIR, and we urge the FCA to encourage clearing members to provide information which is tailored to the services which the client is requesting.

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 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.**

No comment.

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

No comment.

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?

No comment.

INVESTMENT BANKING

In July 2013, the IMA Markets team (former ABI Investment Affairs) published a report on the facilitation of efficient equity capital raising in the UK Market (the "Equity report") and a number of the points we make in response to the questions related to investment banking were raised in that report.

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

As buy-side participants in wholesale markets, our members are clients of investment banks, as well as counterparties to companies (as issuers and investment banking clients themselves). As such, we have an interest in ensuring that investment banks are competitive and transparent in their service offerings.

We particularly agree that clients are frequently unable to judge the cost of advice on complex transactions. While we appreciate that most large, listed companies have long-standing, multi-faceted relationships with their banks and that they may use a landmark transaction as an opportunity to pay for past advice or a loyal lending/advisory relationship, it is critical that investors are able to understand the structure and fee level of a proposed transaction.

There is no standard for disclosure of fees in offering documents. Sometimes a percentage fee as an underwriting commission is shown and then an additional monetary amount for other expenses, and sometimes a total bundled figure for all fees and expenses. What is typically not shown is a breakdown of who is receiving how much, and for what precise services. This leads to an inability to assess the level of fees and compare these with similar transactions.

We also understand that long-standing advisers/brokers are often appointed as leads on capital raising transactions without going out to tender. Investors recognise the benefit of long-standing and 'trusted' relationships and have no wish to discourage these. However, they are concerned that current arrangements may affect the ability of companies to negotiate fees, as well the ability of competitors to compete appropriately for landmark/significant deals.

The bundling of services may also impact the ability of stand-alone or smaller providers of services, such as corporate broking advice or research, to compete effectively for customers.

As buy-side participants, we support the availability of varied and competitive services to corporate issuers.

Independent research

Investors have been particularly vocal on the value, and relative lack, of independent research coverage on IPO transactions.

Whilst investors value the pre-deal research prepared by investment banking syndicate analysts – 'connected research' - it is important to increase the ability for "non-connected", independent analysts to access information and publish research before pricing in the IPO process.

While investment managers generally find connected research useful for background and as preparation for the arrival of the prospectus, many are sceptical of the independence of its conclusions, despite the regulatory changes that have taken place and the care that investment banks' compliance departments take in its preparation.

Investors like to see more non-connected research, written by independent research analysts, as this would balance connected research. Any concerns relating to the risk of independent research potentially being biased to the negative are balanced by the fact that most investors would not reward, and might even penalise, independent analysts who wrote research that is negative, without appropriate justification. They would, and do, reward research (positive or negative) that is valuable to their investment decisions.

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**

We conducted an extensive review of underwriting capacity and competition as part of the research for the Equity report referred to above. We summarise our findings below.

Underwriting capacity

The financial crisis in 2008-09 provided an important test for the underwriting and sub-underwriting capacity in the London market.

Although, at the time, investment bank risk committees may have been cautious given that substantial amount of underwriting risk they were being asked to take, we are not aware of any issue that was not completed due to a lack of capacity. This is because:

- as is normal practice, banks drew comfort from the soft commitments made by potential underwriters for most or all of the issue before signing the primary underwriting agreement with the issuer,
- there was a substantial widening of discounts, and

- there was an increase in capital raising fees.

In 2008-09, there was sufficient sub-underwriting capacity for the large number of issues. However, there were differing opinions on whether the traditional source of sub-underwriting capacity, the long-only UK institutions, remains sufficient:

- On the sell side, brokers to the small and mid-cap area of the market did not feel there was a capacity problem from the traditional source, whilst brokers to the larger companies disagreed.
- Investors' opinions were also mixed, though a significant number of institutions indicated that there was a reduced appetite for sub-underwriting for a number of reasons, including:
    - reduced equity weightings caused by regulation and Liability Driven Investment (LDI);
    - mandate restrictions, particularly for non-UK clients; and
    - a reluctance or ban on sub-underwriting offerings where the institution is not an owner of the shares ahead of the issue ("naked sub-underwriting").

As traditional capacity has waned, non-traditional sources of sub-underwriting capacity, such as hedge funds and banks, have grown.

There was general agreement that it was important to have the bulk of issues sub-underwritten by existing institutional shareholders. They are seen as more "natural" holders of any shares not taken up or subsequently placed. In such circumstances, should shares be left with the underwriters, they are more likely to be held rather than be sold or hedged following an unsuccessful failed issue, so helping to minimise further pressure on an already weak share price.

Underwriting Fees and Discounts

Some sell-side participants argue that sub-underwriting fees had to rise significantly during the financial crisis because of a lack of appetite and capacity from the traditional UK institutions, despite the increase in discounts at this time. Capacity from less traditional sub-underwriters such as hedge funds was also limited at this time.

The Rights Issue Fees Inquiry (commissioned by the Institutional Investor Council on 5 July 2010 with a final report published on 14 Dec 2010) concluded that the split of risk and reward may not always be appropriately split between primary and sub-underwriters. This view was expressed by many participants on the both the buy- and sell-side.

Primary underwriters bear the risk associated with the issue from when they sign the underwriting agreement, typically shortly before the announcement of the rights issue or open offer, to the moment sub-underwriting commitments are signed by the sub-underwriters. This is typically 24 to 48 hours after announcement.

However, the extent of risk borne also depends on whether the primary underwriters lay off the entire risk to sub-underwriters. Some banks intentionally retain a portion of the risk on their balance sheets to increase their retained fees. Investors have expressed concern over this practice because they see the banks as "non-natural" holders of the shares, in the event that an issue fails and stock is left with the sub-underwriters.

The risk assumed by primary underwriters is often mitigated during a pre-marketing process in the days leading up to announcement to gain support for the issue. Large shareholders are taken inside or "over the wall" and briefed on the issue to enable them to evaluate it and indicate their sub-underwriting commitment.

Sub-underwriters typically carry risk for approximately 2-3 weeks depending on the exact timetable and the requirement for a shareholder meeting. Investors who act as sub-underwriters argue that primary underwriters should reduce their fees to reflect their shorter and more limited risk period.

It is, however, difficult to ascertain precisely the split of fees between the primary and sub-underwriters as the primary underwriting fee is bundled within the overall fee or "gross spread" for the transaction, alongside the advice, preparation and documentation for the issue.

During and since the financial crisis, it has become more common for UK companies to undertake rights issues at "deep discounts" of approximately 30-40% to the TERP.

Both buy-side and sell-side support this development because the level of discount for a rights issue is, in theory at least, economically irrelevant for shareholders who take up their rights or sell their nil-paids (although in the latter case, there is a risk that, in practice, the actual sale price of the nil-paids may not reflect their theoretical economic value). It is, however, difficult to quantify the extent to which this affects shareholders' interests in practice.

Deep discounts reduce substantially the risk of the share price falling below the exercise price of the rights issue, and therefore of the issue being unsuccessful, either because it has resulted in a low level of take up and the need for a large rump placing, or by being left partly or in whole with the sub-underwriters.

However, companies are often resistant to deep discounts because they believe it sends a signal to the market that the company is in distress, despite strong advice from advisers to the contrary.

While there has been a significant increase in the discount on rights issues and also, since 2008-09, a drop in volatility in the market, it is difficult to determine whether there has been a commensurate decrease in the risk-related element of rights issue fees. This, once again, is because of a lack of transparency between the three elements of the fee – advice/preparation/documentation, primary underwriting and sub-underwriting.

Investors argue that companies should continue to adopt the deep discounted structure and should focus their efforts on reducing fee levels. They have said that they are willing to see their sub-underwriting fees reduced for the lower level of risk that a higher discount entails. However, at the same time, they expect to see a fall in the risk-related fees that investment banks retain. They regard the current fee split between primary and sub-underwriters as unfair, given the difference in the underwriting periods.

It has been said that company management are not focused on the fees for raising capital because they lack experience in the process. To help address this, the Office of Fair Trading ("OFT") enquiry encouraged companies to ensure that their boards had relevant experience in this area. Some independent advisers believe that companies require assistance in ensuring that the fees they are quoted by their corporate brokers are competitive.

Other advisers and brokers said that issuers are alert to the concern among investors about rights issue fees, specifically because of previous inquiries by the OFT and the Institutional Investor Council. Companies typically now ask their advisers to provide precedents for any fee quotation, including details on discounts on previous deals, as part of the overall consideration. In addition, in the pre-marketing phase, investors actively engage with companies to find out what process they have gone through to ensure that the fees are kept at a minimum.

Another reason that has been given for the level of fees is that secondary issues are seen as an opportunity to reward long-standing advisers for, possibly, years of advice for which little or nothing has been paid. This tends to make fees structurally uncompetitive because long-standing advisers/brokers are usually appointed to lead on rights issues without going out to tender.

It has been previously proposed by some, including the OFT enquiry, that companies should be encouraged to go to tender for the risk part of a transaction as this may reduce overall fees. The preparation/documentation would be carried out by the adviser/corporate broker(s), with the tendering of the underwriting occurring at the very end of the process, shortly before announcement and sub-underwriting thereafter.

To enable this to happen, corporate brokers/lead advisers would need to be paid a market-value fee for any work they carry out or a retainer for their services over the months or years in between capital market or M&A transactions. This approach could have significant consequences for the UK corporate broking model.

Many parties, in particular the companies themselves, have a concern that tendering the primary underwriting could lead to a leak of sensitive information to the market. Some independent advisers, however, believe that tendering the primary underwriting, for both discount and fee, could be achieved without information leakage. They point to examples in Europe of this model functioning well.

It has also been proposed that a tender process could be used to allocate sub-underwriting and set its fee level. This was briefly tried in the mid-1990s, but with limited success. It was considered by institutions to be too complicated and discouraged many from participating. It resulted in greater participation of "unnatural" holders of shares (e.g. investment and lending banks) in the sub-underwriting. We found no appetite from any participants for this process to be restarted.

There have been a number of recent transactions (e.g. issues by Drax and Resolution), where investors have signed firm sub-underwriting commitments ahead of announcement, thereby avoiding the need for any primary underwriting fee on that portion of the transaction. Although these transactions have relied on a relatively concentrated shareholder base, it demonstrates that strong and early shareholder support can also help reduce overall fees in a capital raising.

Neither fees nor discounts to the market price at the time of agreeing the placing are typically made public in non-pre-emptive placings.

Conclusions & Recommendations

- Deep discount rights issues should be encouraged as a way to lower fees.
- There may however be a level of fees where it will be difficult to attract traditional UK institutional sub-underwriters, even if the discount is high and so risk is low. Too low a fee could lead to substantial proportions of a transaction being sub-underwritten with "unnatural" counterparties, or not sub-underwritten at all. Long-only institutions need to balance their desire to see a transaction fully sub-underwritten by "natural" long-term holders with the minimum size of the fee they are prepared to enter into such sub-underwriting commitments.
- It is currently difficult to reconcile the risk to each underwriter and sub-underwriter with the reward they receive because of a lack of transparency of a bundled fee.
- An unbundled fee, and transparency on other capital raising associated costs, will enable all parties better to reconcile risk with reward, understand the true costs of preparation of the rights issue, and allow greater clarity, where appropriate, in setting the different fees for different roles within the issue. Tendering for primary underwriting could, in principle, lead to a reduction in fees. However, we believe having the transparency of an unbundled fee is likely to anyway introduce a tension that will lead to more competitive primary underwriting fees.
- There is no support for tendering for sub-underwriting. Tendering might in principle bring down fee levels, but at the same time result in a greater proportion of issues being sub-underwritten by unnatural holders. Tendering for both primary and sub-underwriting should be pursued only if the unbundling of fees does not lead to a lowering of the overall fee levels.
- In order to make the process more efficient, it is likely that more standard sub-underwriting documents, negotiated well ahead of time, should be used. These may have to be negotiated on an institution by institution basis, unless a more general document can be agreed amongst all parties. We encourage both buy side and sell side to develop standard sub-underwriting agreements.

- For non-pre-emptive placings, it is difficult for the market to see, particularly on a retrospective basis, whether fees are competitive and transactions are being priced appropriately. Greater transparency is therefore needed for the fees and discounts in such transactions.
- The gross spread for rights issues and open offers should be unbundled, such that the amounts for advice, including document preparation, primary underwriting and sub-underwriting are shown separately. These unbundled fees should be fully disclosed in the offering documents, along with disclosure of other rights issue-related fees including, but not limited to, lawyers, accountants and independent advisers.
- There is no legal requirement for the disclosure of disaggregated fees. As the disclosure requirements are contained in the EU Prospectus Directive, which is a maximum harmonisation directive, it is not feasible to change primary legislation or regulations in the UK to require such disclosure. However, investors would like to see disaggregated disclosure as a matter of best practice.

MiFID II

We welcome the MiFID II proposals[1] which propose a series of organisational arrangements and/or provision of information requirements for firms to be able to take all reasonable steps to prevent conflicts of interest (as required in Article 16(3) of MiFID II) which arise in the underwriting and placing process.

We note the MiFID II requirement for investment banks to have in place systems, controls and procedures to identify and manage the conflicts that arise in relation to possible under-pricing and overpricing of issues and involvement of relevant parties in this process. This will assist in lowering fees. We also welcome the requirement for investment firms to provide clients with information about how the investment firm determines the price of the offering and the timings involved.

MiFID II measures on record-keeping will assist with the transparency that is needed for fees and ensure that there is a complete audit trail between the movements registered in clients' accounts and the instructions received by the investment banks. Ensuring a centralised process to identify all potential underwriting and placing operations of the firm will further mitigate conflicts of interest and keep fees down.

In conclusion, we do not think that a full competition review into equity underwriting is necessary. We do however call for a requirement to unbundle underwriting fees and to provide transparency on other capital raising associated costs, which will enable all parties better to reconcile risk with reward, understand the true costs of preparation of the rights issue, and allow greater clarity, where appropriate, in setting the different fees for different roles within the issue.

[1] http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf

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.

We agree with many of the points raised by the FCA, particularly around the banning of payment for order flow.

We support the MiFID II proposal that, in order to allow clients to evaluate the quality of a firm's execution, any proposed standards should oblige the firm to give an appropriate picture of the venues and the different ways they execute an order.

We believe that information on both directed and non-directed orders is useful and the data should be aggregated to show both types of order together. The directed orders should only be separated out if they represent a significant proportion of all orders, e.g. 10% or more. Similarly, with market vs limit orders, there should be no distinction on the part of the investment firm receiving the order, as it can become over-complicated and unhelpful to separate information on what part of the order was under different instruction.

The splitting of such data would not only be unhelpful for analysis, but would also begin to impede the relationship between investment firm and client, when the execution policies of both already set out to achieve the same goal of getting the best result for the client. Working together to provide best execution is the key to success rather than over-analysis of what parts of certain orders were under direction or limit.

We believe setting out a proposed list of flags to identify trades executed under the reference price waiver and the negotiated trade waiver will be useful in supporting the analysis of best execution, and in defining the trades to be used in the double volume cap calculation.

We also believe that there needs to be better clarity on when firms are executing transactions, and when they are transmitting or placing orders with other entities for execution.

In relation to the FCA's thematic review on best execution (TR 14/13), we agree with the following issues:

- Banks / Brokers cannot rely on general carve-outs such as riskless principal, Request for Quote (RFQ) or specific instructions to avoid their best execution obligations. They must apply the four-fold 'legitimate reliance' test to such situations.
- Asset Managers must ensure that their firm is appropriately classified by their brokers. While they may, by default, be deemed to be an Eligible Counterparty in virtually all situations they will require the brokers to treat them as a Professional Client, so that they can then pass on this best execution to their clients.

Many asset management firms now monitor the execution that they receive from brokers using Trade Cost Analysis (TCA). In relation to concerns raised on the monitoring of best execution, we note that this is easier to do in more liquid markets, especially given recent MiFID II requirements. However, it becomes more challenging to monitor best execution in illiquid or emerging markets as there is less capacity to meet clients' requirements.

Finally, we note that best execution is not only about the price, but also about the brokers' ability to fulfil clients' requirements precisely.

ASSET MANAGEMENT

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**

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.

Dealing Commission

Asset managers continue to negotiate as competitive commission rates as possible for their clients. Clients do challenge managers if they feel that commission rates are higher than their expectations. The IMA disclosure codes provide detailed information for clients in this respect. The client best interest rules also apply to the asset manager, so they are compelled to obtain the best commission rates possible for their clients.

Incentives to negotiate the best commission rate deal for clients would include regulator and senior management attention, the client best interest rule noted above, and the desire to get the best return for a client (based on internal incentive processes, e.g. bonus structures, career progression, risk of clients leaving if their portfolio underperforms etc.).

Consumption of services

In relation to the consumption of services by asset managers, it is important to differentiate services that are 'outsourced' arrangements and other services that require another regulated entity to provide them.

Outsourced arrangements are where an asset manager appoints another entity to undertake some of the tasks that form part of its regulated activities. These services are paid for out of the asset manager's own revenue and the asset manager retains full responsibility for the activity that has been outsourced to a third party (service provider). In such scenarios, the asset manager will carry out oversight of the activities carried out by the service provider, with updates being passed on to that manager's Board and/or senior management team.

Other services are that require another regulated entity to provide them include custody and depositary services, stock lending, etc. These services would normally be charged to the fund / client. In some cases, such third parties are chosen by the asset manager/operator and oversight activities will be carried out; but where a client makes the choice for themselves, the activity cannot be considered an outsourced activity as the relationship/contract is between the client and the provider.

Ultimately, the end investor does not 'look through' as to who is providing various components of the service, and is only concerned with the asset manager's ability to meet their needs. Hence it is in the best interests of the asset manager to ensure that they provide effective and competitive services to clients.

Governance Services

Governance services are only utilised by regulated funds. Given that these services are paid for out of the fund, the costs affect fund performance. Hence, keeping costs down is important for the asset manager.

Further, whilst cost is an important factor, when deciding to outsource an activity, it is not the main driver because asset managers are aware these activities remain their responsibility and therefore will need to be of high quality. Some high-processing/ high-volume activities are outsourced alongside a firm's other activities to create further efficiencies and this may see a bundling of activities with one provider.

There are other factors for investors to consider, such as the value provided, the quality of the service, and the ability of the asset manager to meet their clients' needs as much as possible.

Depositary Services

Depositary services must be undertaken by an appropriately authorised entity. As this service is a regulated commodity, it is the responsibility of the regulator to ensure that the service provider is operating in a competitive manner.

Transfer Agency Services

Transfer agency is a service that can be carried out by the operator, but it is often 'outsourced' and therefore remains the responsibility of the operator themselves with sufficient incentive to ensure the best deal is sought. The industry has seen some automation of high-volume activities and this brings further efficiencies.

Most UK funds are now bought through fund platforms. As a result, transfer agency services have become more focused on value, rather than volume, as the volume has passed to platforms. The asset manager thus has less interaction with the end investor, and greater interaction with the platform provider.

Investors' assessment of negotiation

Services are either:

- provided by entities regulated for the service provided, or by a third party service provider which is overseen by the asset manager / operator – investors should be able to take comfort in this, with costs being disclosed in fund documentation; or
- paid from the operator's revenue and relates to services for which the operator is responsible; or
- services selected by the investor – such as a fund platform, or custodian.

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**

Bundling of services

There are a range of reasons why bundling of ancillary services can benefit asset managers and their clients. These include:

- it enables large firms with the expertise to achieve economies of scale;
- it allows service providers to develop specialised infrastructure to provide these services so that they can be provided more cheaply, and in a more

automated / streamlined fashion, than asset managers could ever hope to emulate; and

- from a risk-management and governance perspective, it is better to separate the fund administration from the fund-management.

Pricing pressure on quality

Ancillary services tend to be high volume and therefore benefit from economies of scale. Given that many of the services are commoditised, cost is the biggest differentiator in choosing which provider to engage. Larger providers are therefore more successful as they can charge less, whilst benefitting from economies of scale.

New entrants

As cost is not the sole criterion for selecting a service provider to carry out an outsourced activity and activities do not necessarily need to be bundled, new entrants will need to consider what they are able to offer.

As described previously, many activities are high-volume, but low-margin, so new entrants may find it difficult to enter the market, if only offering single (non-bundled) activities. In some cases, processes that cut across corporate boundaries tend to be less efficient and therefore often do not provide scale benefits.

Choices and Benefits

We understand that managers consider carefully different services from the same supplier – whether that is called bundled or not – and decide whether to use one, some or all on offer compared to what competitors offer (and such competitors may specialise just in one component of the "bundled" service). So FX rates from custodians may be monitored and compared to other available market prices; execution only brokers may be used alongside full service brokers. In addition, with institutional mandates, many clients arrange stock lending, some FX trading, cash sweeps and transition management separately and do not include them in the mandate given to the asset manager, so questions on the impact of bundling will affect them directly.

Research

In light of the IMA's extensive engagement with the FCA concerning the use of dealing commissions to purchase research, we have not addressed this subject in this answer.

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**

Differences in charges between retail and institutional funds

There are a range of reasons for the differences in charges between retail and institutional funds, as outlined below:

- Economy of scale is the biggest factor. There is a discount for size, due to the benefits of scale. For example, processing one large client is significantly less costly than many smaller clients.
- Regulatory requirements in relation to depositaries and audited annual accounts (following the implementation of AIFMD) do not apply to segregated mandates. So where these are managed for institutional investors, they will have a lower regulatory burden, and lower charges, compared to retail funds.
- Operational requirements such as transfer agency, marketing and distribution will not apply to segregated mandates, and hence they will be able to offer lower charges for these types of accounts. Marketing and distribution costs are typically lower when targeting institutional investors, partly due to less stringent regulatory requirements (e.g. financial promotion rules) and because marketing tends to be more network based for institutions, rather than, for example, through expensive advertising campaigns.
- Transfer agency: Deals from institutional investors tend to be larger value and lower volume, which is more profitable for the management company. Institutional investors also do not use regular savings plans, which are relatively costly to administer. Further, institutional investors and aggregators (such as fund supermarkets) are increasingly using electronic communication systems (e.g. EMX, Calastone) that can utilise straight-through processing onto the transfer agent's dealing system. In addition, transfer agents typically get far fewer customer enquiries from institutional investors, reducing the headcount required in call-centres to service these clients.
- Distribution differences: for retail investors, the majority of fund management business is conducted via intermediaries or platforms. The end consumer pays more because of the platform needs to cover its cost. For example, if the asset manager sets a particular price, the platform adds an additional price that they then charge the retail client, which is not within the control of the asset manager.

We note that the aim of the Retail Distribution Review (RDR) was to strip out the distribution costs of retail funds. Typically, on an old 150bp bundled retail share class, 75bp was going to both advice (approximately 50 bp) and distribution (approximately 25bp). We think it is still too early to say that we have seen all the impacts RDR may have on the total cost of ownership as well as, separately, on fund charges.

Governance of funds – retail vs institutional

Governance activities undertaken by a fund management firm over its own operations are generally consistently applied over retail and institutional funds. This occurs not least because fund managers seek to treat all customers fairly (TCF).

Governance of funds – role of investment consultants

Most institutional investment is conducted under segregated mandates. Pooled solutions may be used within them, for example low cost beta funds. However, the role of investment consultants is more holistic and relates generally to asset allocation advice through to the selection of solutions. We answer your question above as it is framed and so focus our answer on funds.

Institutional investors consider not just the price of the fund but also the governance, reputation and other reputational information on the asset manager in charge of the fund. For a number of institutional investors, investment consultants provide this kind of information and assistance to them, thus ensuring that they make the best choice for their investments. For example, pension fund trustees must take advice, but it does not need to be regulated investment advice. As is well known, generally investment consultants do not provide investment advice under FSMA.

Depositaries are professional, corporate, regulated entities that are tasked by regulation to deliver specific duties which are aimed at protecting the interests of investors. They undertake oversight which is significantly more sophisticated than those of the investment consultants. As well as overseeing investment activity they oversee daily pricing of funds, transfer agency activity and risk management processes. In addition they are also responsible for the safekeeping of the assets in the fund which now includes additional liability.

CORPORATE BANKING

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.**

No Comment